Comments on an Exposure Draft of the New Business Tax System (Entity Taxation) Bill 2000

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<u>Comments on an Exposure Draft of the New Business Tax System (Entity Taxation) Bill 2000</u>

This paper's purpose is to comment on and set out some problems in the design and drafting of the exposure draft of the New Business Tax System (Entity Taxation) Bill 2000. Because of limited time available for those comments they are less comprehensive and less considered than ideally they would be. The paper provides a number of examples of the draft's bill's impact. The examples are either directly from real life or composites from real life, de-identified to protect privacy. Suggestions for remedy of the problems are deliberately brief. As will be observed, particularly in points 4, 5, 10, 11, 17, 18, 19 and 43 the exposure draft's philosophical basis is unsound. This means it needs fundamental rethinking. Doubtless it will not get that and thus problems raised by the exposure draft are individually discussed for individual attention in exposure draft sequence.

1. Treatment of non-fixed trusts not comparable to treatment of companies

1.1 Section 153 - 20 states that the object of the non-fixed trust rules is to provide a tax treatment for non-fixed trusts and distributions by non-fixed trusts that is comparable with the tax treatment for companies and dividends paid by companies. Though the differences are a minor focus of these notes, this is not the effect of the part, as is observable from elements of the following discussion.

2. Risk that estates of deceased members will not be tax free recipients of prior taxed amounts

2.1 Subsection 154 - 50 (3) provides that a distribution of a prior taxed amount is included in your assessable income if you are not a tax free recipient of it. In brief you are a tax free recipient of an amount in respect of which you were the beneficiary and which was assessed under either sections 97 or 98 or on which the trustee was assessed under sections 99 or 99A (less tax) where you were a member of the trust for the income year in which the section 99 or section 99A assessment was made.

2.2 It seems that the estate of someone who would have been a tax free recipient had they still been alive, being a different entity will not have been a member of the trust in the relevant year of income of the trust and will therefore not be a non tax free recipient. It seems reasonable that the estate should be a tax free recipient.

3. Risk that some prior taxed amounts earned on or before 30 June 2000 cannot be distributed without being again taxed

3.1 Item 3 of the table in subsection 154 - 55 (1) provides that you are a tax free recipient if you are a member of a trust assessed under Sections 99 or 99A if you were a member of the trust during the income year for which the assessment was made. It is expected that the definition of member of the trust will not come into effect until 1 July 2001. It follows, unless the transitional provisions resolve the problem, that there is a real risk that income earned on or before 30 June 2000 and assessed to a trustee under Section 99 or 99A will be incapable of being a prior taxed amount.

4. "Fixed Entitlement" has an undefined meaning so far as it refers to fixed trusts

4.1 Some suggest the definition of "fixed trust" through use of the definition of "fixed entitlements" imports such problems connected with the meaning of "vested and indefeasible" in Division 272, that very few trusts will be fixed trusts. With all respect due to those opinions, it appears that the definition of fixed trust does not use the defined meaning of "fixed entitlements". "Fixed entitlements" defined meaning applies only to non-fixed trusts. That being so, the problem seen by other commentators does not arise. The real problem is that the meaning of "fixed entitlements" for the purposes of the definition of "fixed trust" must be found in the natural meaning of those words. Identification of a fixed trust is therefore extremely problematic, but for a reason different from that generally imagined.

4.2 In more detail, the conclusion that "fixed entitlements" as relevant to the definition of "fixed trust" must take its natural meaning, not the defined meaning is derived as follows:

1. Per subsection 995-1(1):

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

2. "an entity has a **fixed entitlement** to a share of the income or capital of a trust covered by the *non-fixed trust rules if the entity has a fixed entitlement to that share within the meaning of Division 272 in Schedule 2F to the Income Tax Assessment Act 1936" (subsection 995-1(1)).

   "Fixed entitlement" it will be observed from this definition is defined only in relation to a trust covered by the non-fixed trust rules.

3. Section 153 - 25 is headed "Trusts covered by the non-fixed trust rules." In brief, section 153-25 says the non-fixed trust rules **apply to** a trust if it is or has been a non-fixed trust (if not an excluded trust). Headings do not mean anything so it might not be clear what trusts are covered by the non-fixed trust rules. Section 153 – 25 says nothing about "covering" but "covering" is apparently used as an expression of and to mean "apply to".

4. Section 153 - 5 says a trust **covered by** the non-fixed trust rules is liable to pay tax on its taxable income. A non-fixed trust is defined as one that is not a fixed trust.

5. The clear outcome of all this is that the definition of fixed trust stands alone without reference to the definition of fixed entitlements, leaving one still to ponder what may be on

the distinguishing characteristics of a fixed trust.

What is the function of the new definition for the purposes of the 1997 Act generally of "fixed entitlements"? It seems, none at all.

5. Present Entitlement Results in a Distribution

5.1 Section 156-20 provides as follows:

"(1) A *non-fixed trust makes a **distribution** to you if you are a member of the trust and the trust:
(a) distributes money to you; or
(b) distributes other property to you; or
(c) credits an amount to you as a member of the trust.

(2) For the purposes of this section, the)non-fixed trust is not to be taken to credit an amount to you as a *member of the trust merely because you become presently entitled to income or capital of the trust."

5.2 Becoming presently entitled does not amount to the trust distributing money or other property to you (though it does create a right in you, being the right to your entitlement). Paragraph 156-20(1)(c) (credits as distributions) is affected by subsection (2) which states that for the purposes of the section the non-fixed trust is not to be taken to credit an amount to you as a member **merely** because you become presently entitled to income or capital (emphasis added). I shouldn't have thought that a non-fixed trust would be taken to have credited an amount to you merely because you became presently entitled unless as a technique to avoid tax you carefully refrained from having an amount credited to you.

5.3 Present entitlement can arise in two broad ways:

1. A decision to benefit you implemented by provision to you of the benefit, for example by payment.
2. A decision to benefit you not immediately implemented.

Present entitlement not accompanied by an instantaneous actual payment of money or transfer of property will ordinarily arise from a decision of the trustee, usually minuted by the trustee, especially a corporate trustee. In the alternative, that present entitlement might arise directly out of the trust deed, for example, where a unit trust deed provides that the unit holders shall be presently entitled in specific shares or amounts to the income at the end of the year. Any crediting of the member will usually take place at a much later date when the books of account of the trust are recorded. Use of the word Amerely@ in subsection (2) limits its exclusion to the state of becoming presently entitled only and any other steps, such as actually crediting a member, clearly do not form part of the exclusion from the meaning of benefit.

5.4 A consequence of this would appear to be that when the books of a trust that does not

accumulate (many trusts haven't power to accumulate and, the settler being deceased, cannot obtain the power), the crediting of the members (or of a trust on their behalf) will amount to a distribution to them when the book entry is made although the actual present entitlement won't. A trust up to date with its records might credit in the year of decision. Most non-fixed trusts would probably credit somewhere between two and twelve months after the end of the year of income.

5.5 I note that it is normal and indeed usually necessary that the trustee=s decision to benefit a member be recorded in the trust=s books of account by crediting either the member or a trust for the member. Thus, although present entitlement itself won=t give rise to a distribution, a subsequent step arising automatically out of the decision to grant present entitlement will give rise to a distribution.

5.6 The time of the distribution will turn on a combination of the trustee=s decisions when to record the books of account and the workload of the accountant recording those books. There may be some advantages to this if the credit is made in the next income year. At least by the second year of the system the trustee may have some franking credits so that the beneficiary doesn=t also pay full tax on what has been previously taxable to the trustee.

5.7 However that may be, there are consequences here for trustees in determining the most appropriate time for a distribution, perhaps affected by franking rules, while still acting properly in the role of trustee and recording the books on a reasonably timely basis. Because of the peculiarities of the benchmark system, accountants may need to look to their PI policies.

6. Double Taxation of Credits and Payments

6.1 Paragraph 156-20(1)(c) raises yet another problem. Since a payment of money by way of income benefit to a beneficiary will be a distribution under paragraph (a), and that payment is not the identical thing as a book entry credit, there seems to be a real risk that paragraph (c) will treat the amount as income again. Perhaps the principle for avoidance of double taxation overcomes this, though arguably, since they are different events even though related, it does not. Indeed the amount credited and the amount paid or distributed in kind might differ. The trust though solvent when determining to grant the benefit mightn't be sufficiently solvent to pay it when the moment for payment arrives (arguably a trust income entitlement is not a debt that can be written off to generate an offsetting tax deduction) or an in kind distribution of a monetary benefit might have a value more or less than the amount credited (whatever the other tax consequences of this, paragraph 156-20(1)(b) and section 156-75 may have some application).

6.2 Here, it is the act not the income that gives rise to the tax. The income is simply the thing by reference to which the tax is calculated. It can be argued that neither present entitlement nor crediting is income since at that point nothing has come in (to adopt and mostly adapt a variety of judicial reasoning from times of yore), and that the income comes in only on payment. The Tax Acts are replete with acts or events that create taxing points with the tax not on income, but calculated by reference to income (often, at the risk of multiple subjects of taxation, not real,

but imaginary or notional income). If it is the act of crediting that is taxed (as it appears to be) then a separate act at a different time, perhaps in a different income year, namely distribution of money or property, may be a different taxing point, especially if the value of the money or property differs from the amount of the credit. If the principle of avoiding double taxation does not apply, and there is a risk, a large one where the value of what is distributed differs from the amount credited, an almost certain outcome with an in specie distribution, accountants will need to take care not to credit to members benefits that have been paid, but rather debit payments to an income benefits account so that there is no crediting to a member potentially to trigger double taxation.

7. Do sections 156-20 and 156-75 etc seems to cover the same ground? A multiple taxing risk

7.1 Sections 156-20 and 156-75, puzzlingly, seem to cover much of the same ground. This raises the question whether one is intended to be an expansive or explanatory complement of the other.

7.2 Section 154-5 states:

"A *distribution that a *non-fixed trust makes to you from profits is included in your assessable income."

7.3 Section 154-10 provides that a distribution from a non-fixed trust from *contributed capital is to be dealt with under Division 104 CGT provisions.

7.4 In other words, once something is a distribution it is either assessable or to be dealt with under CGT provisions.

7.5 Section 156-20 states:

"(1) A non-fixed trust makes a distribution to you if you are a member of the trust and the trust:

(a) distributes money to you; or

(b) distributes other property to you; or

(c) credits an amount to you as a member of the trust."

7.6 Section 156–20 alone (ie without subsections 156-65 to 156-94) is enough to bring the amount or value of a distribution to account in your assessable income provided you are a member of the trust, though it doesn't tax distributions to associates of members or former members and associates.

7.7 Sections 156-70 to 156–94 comprise Subdivision 156-C-Special inclusions.

Section 156-65 in stating what the Subdivision is about states: "This subdivision provides that

a non-fixed trust will be taken to have made a distribution to you in certain circumstances even though the basic test in section 156-20 has not been met."

7.8 Clearly the intended structure is that certain amounts will be caught as distributions by section

156-20, with other amounts not caught by that section to be caught as distributions by Subdivision 156-C.

7.9 However, Subdivision 156–C isn't drafted to make amounts referred to in it distributions for the purposes of section 156-20. For example section 156-75 simply states that a non-fixed trust is taken to make a distribution in a variety of circumstances dealt with in that subsection. To the extent there is overlap therefore each subsection will separately subject amounts to the application of section 154-5, the section that includes distributions in your assessable income. Nor is the Subdivision drafted simply to cover ground not covered by section 156-20, but it covers both new ground and much of the ground covered by section 156-20. The result is that amounts can be taxable under both provisions.

7.10 An example of the covering of the same ground can be seen with a distribution of property.

Under section 156-20 a non-fixed trust makes, under paragraph (c), a distribution to a member if the trust distributes property other than money (money is dealt with in paragraph (a)) to the member.

Under section 156-75 a non-fixed trust makes a distribution of property to a member if the trust transfers property to the member. The word transfers covers ground that the word distributes in its natural meaning does not, but a distribution requires a transfer. To that extent therefore the two sections cover the same ground.

This was merely an example. There is much more ground covered equally by each section, albeit that section 156-75 covers much ground not covered by section 156-20.

7.11 It might be hoped that either the general principle for prevention of double taxation of the same amount of income or section 156-115 will prevent double taxation. However, it is far from clear that this will result.

7.12 The distributions happen at different times. The section 156-75 distribution happens at the end of the trust's year of income. The section 156-20 distribution happens when it actually happens.

7.13 Furthermore, the distributions are to be valued differently. As a preliminary note, section 156-105 can be viewed as not being a valuation provision, but as simply causing something not to be a distribution, but the section uses the words "to the extent" and thus if a thing partially fits the criteria for exclusion the effect is a valuation. For example, section 156-105 provides for exclusion from the distribution value such of the amount as discharges an obligation of the trust to pay money to you. This calculation has regard to the amount that would be payable if you were dealing at arm's length. Section 156-25, the valuation provision for section 156-20 (and probably to some extent relevant also to valuations for the purposes of section 156-75) allows

a deduction for consideration provided to the trust for the distribution, but that deduction, where the consideration is money, isn't limited to what would apply at arm's length. Furthermore, although discharge of an obligation of the trust to pay money to you (section 156-105 for the purposes of section 156-75) will often be the same thing as consideration provided to the trust for the distribution (section 156-25), it is not necessarily the same thing. For example the trust might be entitled at its discretion either to pay money or provide goods as consideration for the distribution.

7.14 Many other valuation differences can, with careful consideration of them, be teased out of the valuation provisions.

7.15 If the values are different there is not identity between the amounts. There is therefore little or no scope for the principle for avoidance of double taxation of the same amount to have operation.

7.16 Further, section 156-115 does not avoid double taxation in this circumstance.

Subsection 156-115(1) provides as follows:

"(1) A *non-fixed trust is not taken under section 156-75 or 156-80 to make a distribution because of:
(a) a *distribution benefit the trust provides to you; or
(b) a *loan the trust makes to you;
to the extent that the distribution benefit or loan would be included in your assessable income apart from Subdivision 156-C."

A distribution benefit is an artificial construction under subsection 156-75(2) with, as already observed, its own timing and valuation rules. Given the difference in timing and valuation method for a distribution benefit (156-75) from the timing and valuation for a section 156-20 distribution, they are likely not to be the same distribution, especially if the value under the two provisions is in fact different as in some circumstances it will be. If they are not the same distribution subsection 156-115(1) does not operate on the section 156-75 benefit and double taxation will occur.

7.17 Subsection 156-115(1) does not apply to section 156-92. There may be even readier scope for double taxation under this section.

7.18 Section 156-25 is not expressed as limited to operation within its own Subdivision and may therefore perhaps have general operation, not limited to 156-20. If so, there may be conflict between sections 156-25 and 156-105 which provides that a non-fixed trust is not taken under section 156-75 to make a distribution to the extent a distribution benefit discharges within the arm's length amount a trust obligation to pay you money, but (per subsection (2)) doesn't apply to a payment covered by section 156-93 (trust repaying non-commercial loan). Presumably where there is such conflict, the provisions of section 156-105 which are specific to valuation of section 156-75 benefits will override section 156-25. If section 156-25 (which excludes from consideration cancellation of membership interests) is general in its application, then

membership interest cancellation will be excluded for the purposes of Subdivision 156-C. However, if it is general why is it necessary to provide in Subdivision 156-C a set of valuation rules that are to some extent at odds with those in section 156-25? The intended interaction of Subdivisions 156-A and 156-C is unclear.

7.19 Why is it necessary to place outside the basic rule the intent to tax a distribution to an associate?

7.20 The question regarding double (or multiple) taxation of what is broadly the same amount is examined in this paper in relation to section 156 – 75, though at least 6 other sections of the subdivision create in different ways the risk of effective multiple taxation.

7.21 Subsection 156-75(1) is headed "*When non-fixed trust is taken to make a distribution*". However, it goes further than the heading indicates. If its purpose was merely to declare the time of the distribution it need do no more than state that a distribution is deemed to be made at the end of the trust's income year. It also does at least the following additional things:

(i) Whereas section 156-20 deals with distributions made only to members of the non-fixed trust, subsection 156-75(1) provides that a non-fixed trust is taken to make a distribution to you not only if you are a member of the trust, but if you are an associate of the trust or a reasonable person would conclude that the benefit was provided because you had at some time been a member or an associate of a member.

(ii) It provides that a distribution is made to you if the trust provides a distribution benefit (a separately defined term) during the income year.

7.22 Section 156 - 105 provides that a non-fixed trust is not taken under section 156 - 75 to make a distribution benefit to the extent it discharges an obligation of the trust to pay money to you and isn't more than would have been required to discharge the obligation had you and the trust been dealing at arm's length (excluding repayment by the trust of a non-commercial loan. Does this (but only for you?) overcome the multi-taxing problem provided benefits aren't credited or paid in kind?

7.23 Section 156 - 75 makes much more than payments of money distribution benefits. The section deals also with credits and transfers of property. Because under subsection 156 - 75 (4) "consideration given by you for the transfer" is deducted, probably a transfer of property to you will not ordinarily be a problem if you gave the consideration. But it will at best be less clear if someone else, for example, your spouse or a joint venturer, provided the consideration to the trust. You might still argue that you gave consideration to the spouse or joint venturer (if you did) and that this ought be deducted. It is not entirely clear that it should be deducted and, where your spouse gave the consideration to the trust, if you didn't give your spouse consideration in return for your spouse giving the consideration to the trust, then you are taxable on something that is not a net benefit in the real world, just an exchange of value at the level of the trust and a normal domestic transaction as between you and your spouse.

7.24 Credits remain a problem. If a trustee agrees in an offer available only to members to buy from members goods or services at market value and credit the members against later purchases to

be made by the members of goods or services the trustee supplies to the members, the trustee's act of crediting you will be a distribution. The subsection (4) deduction for consideration given by you is only available in relation to transfer of property to you, apparently only property referred to in paragraph (2)(c) with no scope provided for reduction of distributions in the form of payments or credits for consideration provided for those distributions.

8. Payments by Direction Potentially Lead to Taxation of the Wrong Person and Multiple Taxation

8.1 Subsection 156 - 75 (2) states that Aan entity **provides a distribution benefit** to you if the entity makes a payment (other than a loan) or credits an amount that is wholly or to some extent, made to you, on your behalf or for your benefit or transfers property to you.@

This provision may result in taxation of the wrong person and/or taxation of multiple persons in relation to the one amount.

8.2 It is common for payments and property transfers to occur by direction. Payment made by direction will both be made to one person and on behalf of or for the benefit for another. Both ways of looking at the transaction satisfy the provision. Accordingly, subject to whether a principle or provision for prevention of double taxation can apply, it appears that both the payee and the person on whose behalf the payment was made will be taxable.

8.3 Much the same can be said about the crediting of an amount.

8.4 Where the direction occurs by reason of a debt owed between the parties other than the trust involved in the direction there is consideration for the transaction. This consideration is ignored by the subsection in the case of a payment and the crediting of an amount.

8.5 The transfer of property involves additional considerations. Subsection 156-75(4) states that the value of the property transferred is the amount that would have been paid for the transfer by parties dealing at arms length less any consideration given by you for the transfer. It can be argued that the transferor of property (the trust) might do so to the value of a debt owed to the transferee (you) by the person entitled to the benefit. Where that is so there is indirect consideration for the transfer. However, it is unclear whether the section contemplates consideration given other than to the trustee. Thus there is still risk in these circumstances of taxation of both parties or of the wrong party, you.

8.6 In the case where by direction the benefit to which one party is entitled is provided by a transfer of property to another as an act of charity or love and affection by the giver of the direction then clearly there is no consideration and both parties are or either party is at greater risk of being taxed.

8.7 A distribution benefit will affect multiple persons only where each is a member or an associate of a member of the trust. However, even without the extension to the problem caused by a wide meanings of associate, a wide range of persons within many classes of persons who can be members of many trusts, the fact that transactions between associates and family members involving trusts are common and that the delays and costs inherent in passing amounts through individual bank accounts means that this will be a common problem.

8.8 Because paragraphs (a), (b) and (c) of subsection 156-75(2) are expressed in the alternative, each may perhaps result in multiple benefits to the same persons. That is, if the trustee credits a member of the trust and then makes payment to the member of the trust a distribution benefit will have been obtained under paragraph (b) and another under paragraph (a). There is even a possibility that paragraph (c), a transfer of property, can provide another or alternative imposition of tax since the money is property, something which the wording of this subsection does not deal with, although, for example, subsection 156 - 20 (1) in dealing with property in paragraph (b) uses wording apt to distinguish between property as money and property other than money.

8.9 Subsections 156 - 20 (1) and 156 - 75 (1) each cover the same territory. For example if a payment is made to you a distribution will have been made to you pursuant to paragraph 156 - 20 (1) (a) and not only has the trust made a distribution to you under that subsection at the time at which the distribution was made, but under subsection 156 -75 (1) the trust is taken to make a distribution to you at a specific point in time, namely at the end of an income year of the trust, if it provides a distribution benefit which in turn is defined as the making of a payment (other than a loan) to you. No specific time point is defined under section 156 - 20 and accordingly it seems appropriate that the time is the actual time of distribution. The two times, though within the one income year of the trust, might be in different income years ofhte person taxed. Again there appears to be a risk taxing the same person twice, once on an actual amount and again once on an actual amount deemed to be a distribution.

8.10 Although I do not take the time to discuss it here, there also exists the problem in tandem with multiple taxation of the one person, taxation of other persons on the same distribution as discussed above.

8.11 It might be argued that section 156-75 is a subsidiary to section 156-20. However, the valuation rules are different. Section 156-20 is contained in subdivision 156 - B and its valuation rules are set out at section 156-25. Section 156-75 is contained in subdivision 156-C and its different valuation rules are contained in subsections 156-75(3) and (4). This suggests section 156-75 is not subsidiary to section 156-20.

8.12 Despite these comments, I suspect that the drafter may have intended (at least at some stage) to make Section 156-75 subsidiary to section 156-20. I simply think that the drafter failed to do so or had a change of mind.

8.13 The valuation rules in section 156-75 differ from section 156-20 in particular in relation to the manner in which consideration provided to the trust is dealt with. There is no provision in section 156-75 for deduction of consideration except in the case of the transfer of property. Thus any consideration provided for an amount paid or credited will not be deducted from the amount of the distribution except to the extent section 156-25 applies for the purposes of section 156-75 (discussed briefly earlier).

8.14 The transfer of property itself is problematic. Subsection (4) provides the value of the property transferred is the amount that would have been paid if the transfer by parties dealing at arms length within a consideration given by you for the transfer. Does subsection (4) refer only to property other than money which by implication (though not words) paragraph (c) of subsection deals with or does it refer also to money (which is property)? Why is there no offset for consideration for the crediting of an amount?

8.15 There are also inconsistencies about cancellation and reduction of membership interests.

9. Possibility of tax free distributions and entrapment or retention of franking credits

9.1 How in each section are the discharge of present entitlements by payment to be dealt with? A present entitlement to income without concurrent payment usually creates a separate trust. Payment of such a present entitlement (which now constitutes a separate trust) has consideration, being the discharge of that trust (a separate entity). Section 156 - 25 excludes from offsetting consideration cancellation or reduction of your membership interest. Arguably the cancellation of a trust over earned income is not a membership interest in the trust from which the entitlement was generated and if so the entitlement can be offset making the distribution tax free.

9.2 Given that the distribution is from the new trust, the new trust arguably has no franking credits or if it has them can't build up its benchmark to full franking for at least 2.5 years if ever, though the trust that generated the present entitlement does have franking credits and may have built up a 100% franking benchmark. The consequence may be that present entitlements when paid, unless paid precisely concurrently with present entitlement (failing which a trust will be created) must always be unfranked despite extensive machinery to permit franking. Payment can be adequately concurrent with present entitlement only if payment is, improbably, made precisely contemporaneously with the decision to confer present entitlement.

9.3 Subsection 157-90(1) states that you contribute capital to a non-fixed trust if you make a payment or transfer an asset to the trust as consideration for issue or grant of a membership interest in the trust. The trustee of the source trust contributes capital to the trust in respect of income. Payment of this trust capital, ignoring capital gains tax, should be tax free.

10. All loans on which interest is payable will become new loans subject either to the commercial or non-commercial loan provisions

10.1 Subsection 156-80(4) provides that if the terms of a loan made before 1 July 2001 are varied after that date by extending the term or increasing the amount, this Division (157-D) applies to the loan as if it were made on the new terms when the variation occurred. Consider a loan made on commercial terms that unpaid interest is added to the amount of the loan, though if paid

within seven days default does not occur. True arm=s length loans can occur between parties who under the draft bill will be associates. Periods of grace may well be taken advantage of by the borrower (just as they may with loans from professional lenders). Borrowers can be forgetful occasionally. Borrowers can be in financial difficulty. Often such a loan will increase in amount though in a commercial sense there has been no variation of the terms. Subsection (4) implies that an increase in amount, for example by late payment of interest, is a variation of terms.

10.2 There can be an increase in amount by reason of interest without late payment of interest. If interest is due on a particular day, even at a particular time, unless the utmost precision in payment timing is achieved the amount of a loan will increase.

10.3 At 9 am on the interest payment date the interest is typically due. If interest was paid the day before so as not to be late the amount of interest will have reduced the loan balance which will increase again when the interest is debited (though the increase may be minute, even if interest was debited daily, early payment of interest will reduce the balance and the debiting of interest when due will increase it).

10.4 If interest is paid at some time on the day it is due, the loan balance will still have increased on that day by the amount of interest pending its payment.

10.5 The conclusion is that any loan on which interest is payable will as soon as interest is due be treated as made on or after 1 July 2001. This is unconscionable. The draft bill should be amended to remove this effect.

11. The commercial and non-commercial loan provisions are impractical and will undo existing reasonable family funding and investment strategies

11.1 Section 156-86 makes provision for minimum annual repayments. Whether such repayments are practical depends on the purpose of the loan and, if the purpose is to generate income, the income generation performance of the activity selected for income generation.

11.2 If, for example, the purpose is to aid a child of a controller of the trust to bridge the gap between bank funding and total funding needed to start or buy a business, a common purpose of loans within family units, the loan will be very unlikely to be able to be secured by a first mortgage over real estate. The business must deal with the bank=s repayment needs, usually rapid where the person doesn=t have substantial security and a demonstrable track record of significant success within the business, and meet the seven year repayment terms imposed via section 156-86. Repayment over a 7 year period requires an approximately 24% pre tax return on funds in the first year. Statistical evidence suggests that this is a rarely achieved rate of return. It=s particularly difficult in the first year of a new business. This requirement simply doesn=t gel with what is possible in the real world. To get the flavour, imagine you are buying on credit an expensive house and, while maintaining your family reasonably well and encountering all the stresses and risks of a new business (you no longer have a steady job), you must to pay it off within seven years. The penalty for failure to do so is that your parents who lent you the money

have to pay tax on whatever you haven't repaid at the moment you stumble (however slightly) and you too have to pay tax on the same balance (but of course this isn't double taxation and it is extremely fair because it protects the revenue).

11.3 The 24% return calculation is made this way: At 8% pa interest a loan of $100 requires annual payment of $19.21 for payments made at the end of each year. $11.21 of that is principal. At a 30% tax rate it's necessary to earn $16.01 before tax to pay that (ie 16%). Add the the 8% interest and the total return needed to meet the first year's payments is 24%.

11.4 It's actually a lot worse than this. The new business owner, if successful, and even if earning 24%, will almost certainly fall in to the bank manager's (and now the Tax Office trap). An expanding business often doesn't generate cash. It often consumes cash. Bank managers ignore this and usually demand vigorous debt reduction, as will the Tax Office. I came close to divorce in the early years of my business as my wife continually complained we had more money before I had a business. She was right. We now had children (and only one income after years with two incomes) and the new business needed a professional library, furniture, rental bonds, work in progress as staff were employed and work built up, computers, strategic investments and more. I had essentially no money when I started the business and I'm desperately glad there was no doting parent with money who would have arranged that I be lent some from a family trust. Despite hopes of success I could never have repaid according to the rigid time scale of the draft bill.

12. Wrong person taxed in relation to repayment of a loan treated as capital of a trust

12.1 Section 156-93, in making repayment by a non-fixed trust of a non-commercial loan to it potentially taxable, repeats the problem of taxing the wrong person that arose in earlier sections. A payment by direction to you (whether or not you have a relevant connection with the trust) in respect of a loan made to a non-fixed trust by someone else (who in turn owed you money and makes the direction to discharge the debt to you) will attract the operation of the section. You, rather than the person whose loan is repaid, will be treated as receiving a distribution. The person whose loan is repaid will (unless some other provision taxes that person, something I've not searched for) receive the loan repayment free of tax.

12.2 It is counter-intuitive that you should be so taxed even if you are not a member or associate of a member, nor a former member or associate of a member. Accordingly, the reasoning is briefly set out.

Section 154-5 provides:

"A *distribution that a *non-fixed trust makes to you from profits is included in your assessable income." This section, it will be observed, does not require does not require any connection with the trust.

Section 156-93 as relevant provides:

"A *non-fixed trust is taken to make a **distribution** to you if:
(a) the trust makes a payment to you, or an associate of yours, in respect of a *loan to the trust; and
(b) the loan gave rise to a *contribution of capital to the trust…"

Again there is no requirement that you should be a member of the trust.

12.3 The consequence is that you can be taxed on a trust loan repayment even if you do not have what would be thought to be a relevant connection with the trust.

13. Debt forgiveness exclusions from distribution for hardship are probably inaccessible to all but those who were very well to do at the time of taking out the loan and have fallen since into exceptional penury

13.1 Subsection 156-100(3) provides an out for those who have benefited from debt forgiveness if the Commissioner is satisfied there would have been undue hardship had you been required to repay the debt, you had the capacity to repay when you obtained the loan and inability to repay arose from circumstances beyond your control. It's worth noting that the hardship board is often prepared to see people need to sell their home to pay tax debts though many of those cases don't get as far as a reported hearing (and there is at least one reported case where a woman was permitted to keep her home). This suggests the standard of undue hardship may be very high. It is to be expected that taxation designed (in part) to tax someone who is unable to pay debts (ie a law arguably designed or expected to enhance hardship, will have the bar set very high on this test. Though expected, it is unreasonable and should, at the least, be greatly ameliorated.

13.2 Query whether there is a similar let out section for late paid debts?

14. The rationale of section 156-10 etc seems to turn on the assumption that certain benefits to non-fixed trusts and companies will be to benefit others. This will often be an invalid assumption

14.1 It seems that section 156-10's exclusion of loans to non-fixed trusts and to companies from distributions as defined by sections 156-75 and 156-80 and the similar exclusion by section 156-100 in relation to a debt forgiven is directed at ensuring that where such a step ultimately benefits another entity that the first entity is looked through so that the later entity is taxed. Often enough there will be no later entity. The loan is simply to the first entity which uses it for its own purposes.

15. Private Lenders and Marginal Borrowers Disadvantaged by Section 156-70

15.1 Section 156-75 provides that if, for example, a non-fixed trust of which you are a member guarantees a bank loan made to you and the liability is other than contingent the non-fixed trust is treated as having made a distribution to you. The reality of bank (and other lender) default

clauses is that unless the borrower argues hard when the loan is taken out it is highly likely that the borrower will within twelve months, if not immediately, be in default.

15.2 An example of the reason, quoted from a major bank's standard mortgage terms is: "you are, or a *debtor/guarantor* is in default under any arrangement under which either of you has or could in the future have monetary obligations to any other person". If you, the debtor have an arrangement under which you are to deliver goods or services to another party or pay another party and you are or in the recent past have been a day late in fulfilling such obligation it is the bank's and the writer's view that the act of default has occurred. Bank guarantees are usually so drawn that default activates the guarantee so that what was previously a contingent liability ceases to be contingent.

15.3 It might be argued that the debtor should negotiate with the bank for amendment of the terms. The reality is that the major Australian banks will absolutely not vary their terms one iota for their average customer. A strong customer that the bank woos and slashes rates for can often (but not always) negotiate change, but with great difficulty and at the price of extended delay, something commercially untenable if a settlement deadline is approaching.

15.4 Another example: It is current banking practice to require business debtors to supply management accounts within 45 days of quarter end. I am a director of a company with such an obligation. I don't act for that company. It's an important client for the accountant concerned who is a responsible and able man with whom I have a good rapport. Yet I've been unable to reach him by telephone in the last three weeks to discover whether he can meet the deadline. He's too busy dealing with the New Business Tax System. Failure to supply accounts on time is a default. The bank manager tells me that he expects very few customers to have this quarter's management accounts ready within 45 days. GST and activity statements have more than swamped accountants. He's told me orally that he's likely to approve an application for a time extension. However, banks frequently don't give such approvals in writing (though they make lots of oral promises to do so). Many bank managers like to have a few events of default up their sleeve in case they are ever needed. As a consequence of the introduction of the New Business Tax System the majority of guarantees given by non-fixed trusts will no longer be contingent.

15.5 Section 156-75 will make it harder for people who are marginal borrowers to obtain loans. The section creates adverse tax consequences where a borrower obtains funding from a private company or non-fixed trust with a guarantee from a non-fixed trust. In marginal lending cases the arm's length lender is far more likely to be a private company or non-fixed trust than a mainstream public company lender such as a bank. Lenders normally want the guarantee of any family trust connected with a borrower to ensure if income exists in such a trust that the lender, including a bank, has access to that income. Strong borrowers can withstand the bank's request for such a guarantee, but many cannot.

15.6 A recent example is a client whose family trust owned a significant stake in a profitable company. The client seized an opportunity to cause the company to buy back the holdings of other shareholders on favourable terms using bank funding. The borrower was the company conducting the buy-back, but the lender required the guarantee of the family trust.

15.7 Another example of but a week ago is this: A client with others desired to buy the freehold of a rundown hotel under lease in respect of which no serious trading figures were available from the lessee whose lease was to expire in about twelve months. On the strength of an oral bank funding approval the client signed an unconditional contract to purchase. The formal approval did not issue. A stockbroker's finance company then orally approved funding, but 7 days from the expiry of the notice to complete period and thus within days of expected settlement the finance company board decided not to lend on hotels except for owner operators. The funding could not proceed. The buyers who were proposing to buy through a hybrid trust then obtained expensive emergency funding through a private company that specialised in providing such funding and may well have been the trustee of the family discretionary trust of the family behind the lender. The lender wanted all the guarantees it could get. Fortunately, given the nature of the draft bill, none of the investors were using family trusts as their investment vehicle. However, had they been, the draft bill if in force would have been a major problem. They were in a position of no choice. Loss of their deposit (which would have immediately followed failure to complete) would have financially crippled them.

15.8 The problem the draft bill creates for private lenders is particularly acute in some regional centres. Throughout Australia there are a number of privately owned finance companies that have a strong position in local financing, especially in high risk or specialised areas eschewed by banks. Such lenders again take all the security they can get, including, if they exist, family trusts' provision of guarantees. Furthermore, how is the borrower to know whether the lender is a private company for income tax purposes or whether a company or other lender is acting in its or his or her own right or on behalf of a non-fixed trust. It's highly relevant in an era of self assessment, but it's hard to imagine a borrower, particularly a marginal one, succeeding when putting such requisitions to a lender.

15.9 Section 156-75 is unreasonable. A distribution should occur, if at all, only to the extent that there is a payment by the non-fixed trust not recovered by the non-fixed trust. It may be argued that the draft of section 156-75 mirrors Division 7A and is therefore fair. That does not make it fair and it is not fair. Division 7A should also be amended to provide that a distribution occurs, if at all, only if there is an actual payment pursuant to the guarantee and then only to the extent that the payment is not recovered. Since banks will, if that is the easiest course, go straight to the guarantor, rather than exercising their security, any deemed distribution should be undone to the extent the trust ultimately recovers its funds.

16. Hardship provision re guarantees is unreasonable

16.6 Subsection 156 – 175 (3) provides that a non-fixed trust is not taken to make a distribution because of the operation of subsection (1) in relation to a guarantee if the Commissioner is satisfied as to tests;

(a) you would suffer undue hardship if the trust were taken to make a distribution because of the liability;

(b) when you entered the loan, you had the capacity to pay the loan.

16.2 It will be unusual for a debtor to have the capacity to pay the loan (whater that may mean) at the moment the loan is taken out.

16.3 Consider a person who borrows money to purchase a business, obtaining the smallest practicable loan. If paying a loan means repaying the loan then it is very unlikely that if the loan is other than minor that the borrower will have the capacity to do so. This is for two reasons:

16.4 Firstly, the borrower has all the funds tied up in the business. It is because a borrower hasn't capacity to repay a loan that prudent borrowers long term loans and, if they are wise, renegotiate those loans well before their due date.

16.5 Secondly, stamp duty and other inwards charges mean that even if the business was sold, insufficient funds would be available to permit repayment of the loan. Consider the purchase of a business for $2 million. Stamp duty will be $95,000, inwards legals perhaps $15,000, bank establishment fee perhaps $5,000 to $20,000 and other inwards professional charges of perhaps $10,000 to $20,000. Here there are sunk charges of between $125,000 to $150,000 incapable of being recouped from sale of the business.

16.6 For these two reasons the borrower will not have been in a position to repay the loan when the borrower entered into the loan.

16.7 However, in the alternative the term "capacity to pay the loan" might mean merely to service it (but if this is so why were such words not used). Even here some borrowers would be unable immediately to service it if there was a requirement to do so as some borrowers rely on business cash flow to provide the funds with which the debt can be serviced. At the moment of taking out the loan the business cash flow might not have commenced. This provision should be amended to reflect the realities of business.

17. It is unnecessary to provide for repayment of non-business loans and unreasonable to provide for repayment of loans applied to income generation

17.1 The draft bill generally provides that loans involving non-fixed trusts must be repaid on pain of unpleasant tax consequences.

17.2 I note that the commercial investment loans my family has from its bank lender are for a 20 year term with no repayments during that term and both I and the bank expect when the 20 year term, which is presently half-expired, finally does expire, that the bank will renew the loan and again no principal repayments will be required. This is because this bank, perhaps unusually, recognises that to maintain an existing loan at its full value is much cheaper than to demand repayments and continually seek new customers for the money repaid.

17.3 Companies and corporate trustees of which I am a director have 3 to 5 year arrangements with major banks and others, but the companies have so far been able to persuade the lenders, despite their policies to the contrary, that it is in their interests to permit us continue our loans without

capital repayments. Some of these loans are now a decade old. No capital reductions have ever been made.

17.4 There are reasons for our method:

1) Significant time and cost are consumed to negotiate, settle and document loans.

2) Investment reality is that if the investment is intended to generate income for investors, repayment of a loan prevents that since the bulk or the entirety of the income will be applied to principal repayments.

17.5 The draft bills' requirement of repayment where interest is paid is unreasonable and unnecessary. Where interest is paid and the loan is not used for a business purpose, on an overall discounted cash flow basis, the interest being assessable to the related or associate party receiving it and not deductible to the borrower, it is disadvantageous to have a loan in place. It is far more tax effective to take a franked distribution (ordinarily franking credits will be available) and repay the loan. Only people in tight financial circumstances will keep a loan in place. The repayment provisions have no effect on those not in a tight financial situation and punish those who are in a tight one.

17.6 The other effect of the repayment provisions, as already noted, is to make funding of family trusts to generate income for a family, in future impractical.

17.7 In plain language:

1) Personal, non-business loans are highly likely to come from an associated entity. Payment of non-deductible interest that would not otherwise arise is a significant tax disadvantage to the group with such a loan to one of its number. For this reason the

revenue gets more tax by leaving the loans in place. Please do the arithmetic if you doubt this.

2) Requiring repayment of business loans, which is contrary to much commercial practice, prevents generation of family income.

18. Franking credits should be offset against distributions in respect of unrepaid loans (if, contrary to good sense and good policy, unrepaid loans are treated as distributions)

18.1 Subsection 156-210(2) provides that though a later unfranked distribution may offset a previous distribution under Subdivision 156-C, a later franked distribution may not, but will still be treated as a distribution. This follows the logic of penalising those who fail to meet the obligations of commercial loan agreements etc. However, the logic of penalising those who are in trouble or don't have the nouse to engage an accountant to advise them to take a franked distribution in the first place and help them through the paperwork traps eludes me. I suggest it would be appropriate instead to remove those penal provisions and if that is not done merely to include the franking credit in the income and allow that credit as an offset against the

consequent tax.

19. The profits first rule does not tax distributions on the basis of their economic substance

19.1 Section 157-10 in effect says the profits first rule represents the economic substance of distribution transactions. It is shown below that the profits first rule is arbitrary and does not represent economic substance. It is as arbitrary to say that the economic substance of a distribution is that a trust with profits first distributes those profits as it is to say that the first thing a trust distributes is always capital. I find it offensive to see untruths or woolly thinking in legislation. The statement in subsection 157-10(1) that the object is to tax distributions on the basis of their economic substance is plainly at least one of these. Division 157's true object, and certainly effect, is to tax profits first regardless of economic substance and, where the source of the distribution is neither in profits or capital, to treat it as if from profits.

19.2 It is particularly odd to see such a statement of object then allied with terms that, while having economic meanings, are used in their trust law or accounting sense.

19.3 Though it will often be difficult to discern the economic substance of a distribution, that does not make it impossible. A distribution's economic substance will be found in what generates the capacity and intent to make it, not necessarily the trust or tax law source attributed to it. The capacity to make it will arise from availability of assets with which to make it and the trustee's intent or the deed's fiat that those assets ought be in the hands of the beneficiaries. Most commonly, that will be the result of periodic decisions to distribute revenue account gains. However, this is far from invariable. Where a trust has had funds tied up in particular assets either for an investment or strategic reason or to protect family assets, whether from the ravages of internal parties (strife, financial imprudence, etc) or external parties (the litigious society), once that purpose is satisfied the trustee may wish to distribute those assets. Accordingly, when, for example, Johnny's imprudent marriage has either concluded or proven itself, the trustee may be prepared to transfer to Johnny certain assets bought from trust capital and worth, say, $150,000, notionally earmarked for the beneficiary. Those assets may be worth on distribution exactly what they were worth when purchased. Initially, assume the trust has no franking credits and no other assets. The transaction's economic substance, like the legal and accounting treatment, is that capital of the trust has been distributed.

19.4 Now assume the trust has a second asset notionally earmarked for Johnny's children. That asset cost $100,000 and at the time of the distribution of the first asset to Johnny is worth $250,000. The economic substance of the transaction with Johnny hasn't changed. The distribution is still both for trust law and economic purposes from capital. Yet the profits first rule would have it that the distribution to Johnny was entirely from unfranked profits.

19.5 The example is a simple one. The real world for non-fixed trusts is often more complex, yet amid that greater complexity the real economic substance of distributions is often as readily discerned.

19.6 Why cannot the lawmaker at least deal honestly and state plainly that in order to accelerate the take of the revenue (Morton or more modernly, *Zeta Force*, rides again), where a trust has available profits the law is intended to tax people on capital distributions whether or not they are the appropriate people to tax. Pretty clearly, the law maker does not say this, because to exact a tax, regardless of whether the person taxed obtains the economic benefit of gains, is obviously unfair. To state plainly this unfair proposition as the object or result of legislation is politically unacceptable. It is therefore dressed up in fancy language to hide the reality of what is being done with a vague (here false) aura of anti-tax avoidance to sneak in an unreasonable law. The proposition lacks intellectual rigour and produces unfair results. It should not proceed.

19.7 It is interesting that this reintroduces in a different form, limited at this stage only to non-fixed trusts, an earlier proposal to tax unrealised gains. That proposal was withdrawn. Distributions of income are taxable in any event. Thus the only new effect of this proposal is to tax repayments of loans and other distributions of capital. This proposal which has much the same effect as the former now withdrawn proposal should also be withdrawn.

19.8 I don't pose a potted solution. I don't believe there is one. If it is necessary to change the basis of taxation and tax according to economic substance then let us have a law that does that. Such a law probably will need to be flexible rather than work by rigid rule. Probably it should work rather more along the lines of section 45B and provide scope for the Commissioner and taxpayers to agree on what the effect is where particular transactions are in mind.

20. Taxing as profit distributions items that can't be identified as capital or profit results in taxing amounts that are not profit and might never be profit

20.1 Related to the previous point is the draft bill's proposal to tax profits that are from neither capital nor profits as if distributions of anticipated profits. Example: A trustee without profits, with only nominal capital, but with some borrowing power borrows and lends non-commercially to a beneficiary. It's easy to identify family or commercial circumstances where this might happen. For example, someone who might need some financial help yet might be sloppy on a debt owed to an individual might take a corporate debt more seriously. A personal loan might in such a case be channeled through a non-fixed trust merely as an accommodation party. Such a loan will be taxable to the recipient. Is this fair? I suggest that it is not and distributions that are not from profits should not be taxed.

21. Limitation of franking credits to situations of surplus net assets creates significant cost for many trusts in determining whether they have surplus net assets and will cause hardship for many people dependent on trust income

21.1 Footnote 1 to section 157-20 indicates that a distribution is frankable only to the extent it is from available profits under paragraph (a). Available profits are defined via section 157-85 to turn on the net market value of assets.

21.2 Not only (simplifying slightly) does the rule mean non-fixed trusts, especially those without a clear net surplus, must carry out an asset revaluation (expensive) if they have available imputation credits and wish to make franked distributions, but there is great scope for economic damage to beneficiaries.

21.3 Example: Bob and Mary have retired and live on the earnings of their family trust. The trust invested the whole of savings over the years in Austrim Nylex shares at $2.10 per share which in the long run is expected to pay fully or substantially franked dividends. However, the market value falls to $1.60. This is something like what has really happened. Until either the share price recovers to $2.10 (which it might never do) or until about 3 years dividends have been accumulated within the trust (assuming the share price doesn't fall further), despite availability of franking credits, the trust cannot pay franked distributions to Bob and Mary. The benchmark

rules make the recovery period either eternity or an extra 2.5 years on top of this. Bob and Mary suffer a significant available income cut because, instead of their income being tax paid, it no longer is. Either they put up with a slashed income, perhaps permanently, or they try to rejoin the work force for about five years (probably difficult, perhaps not possible and certainly no fun at all when they thought they had retired).

21.4 This valuation rule doesn't apply to companies, nor should it. This rule should be scrapped.

21.5 There is an odd solution to this problem: overvalue the trust assets in the trust books (tell some non-punishable lies). The Commissioner can require the asset value to be lifted if it is too low, but there is no requirement to lower the value if it is too high. Here is a law that encourages dishonesty by providing a heavy economic sanction for failure to be dishonest. That is not a good law.

22. The rules for valuing net market value should permit further deductions

22.1 Item 2.3 of the table in subsection 157-85(4) states that an obligation that is not a present legal obligation is to be disregarded in calculating the net market of a non-fixed trust's assets under subsection (1). The consequence is that an imminent judgement with a high risk of being an adverse one that will strip much value from the net assets may not be taken to account. If a non-fixed trust was an insurer its provision for claims would be sufficiently real to be deductible to determine the taxable income, but (unless such provisions are later prescribed under regulations) could not be deducted to determine the value of the net assets. These are unreasonable oddities of tax law. The draft should, if net market value is to be a relevant concept (in the writer's view questionable), permit deduction for expected economic outcomes that can be properly brought to account under accounting standards.

23. The rules on contribution of capital will destroy savings retirement plans based around family trusts

23.1 Section 157-115 provides that you contribute capital to a non-fixed trust if you make a non-

commercial loan to it that isn't repaid within 12 months of the end of the income year in which it was made. See previous comments and the following example about the commercial validity of a conception that loans can always (or even usually) be repaid within time scales of 12 months/7 years/etc.

23.2 Another example: Peter and Petrina, both in their mid 50s, both careful professionals, both therefore the target of the litigious society, in order to protect and provide for their family, manage a family trust funded by long term advances they make to the trust from funds they have borrowed on security of the family home (bought in their own names long ago when one was public servant immune from financial and litigious risk). Their children don't have the same capacities as their parents. One is schizophrenic and like most so afflicted unable either to hold a job or properly self-care (a problem as the government policy for life within the community for the mentally ill is not seriously backed by the government's purse), another a

business woman who sets up exciting and promising ventures which sometimes succeed and sometimes lose the money made by the previous venture, and another is a paraplegic as a result of a surfing accident when a child. None of their children have a talent for managing money. It is therefore convenient to keep asset management within the parent's hands through the trust. That has another virtue for the parents who have driven the generation of the assets and income: if they need income in retirement they have not stripped themselves of the capacity to obtain it by putting the assets in the hands of their children. All the children need financial assistance from time to time. The parents are approaching retirement within about a decade. They have put family and quality of work before the financial result of that work. Other than the family home (for investment and asset protection reasons mortgaged to the hilt), they have little economic substance. Such substance as exists is the assets built up in the family trust. The family trust investment process has been worked on over several decades, earnings and vaue have gradually grown and the trust is now sufficiently cash flow positive that it will aid greatly in the parent's approaching retirement and may still help the children. The parent's loans to the family trust are subject to interest (so they in turn can pay the bank) but being long term and not secured to them by first mortgage over real estate are not commercial loans in terms of the draft bill. The parents have no plan to repay the bank and no means to do so. If the family trust was at this stage to repay the parents, the assets which generate the income would need to be sold, thus defeating the trust's purpose. When, in ten years or so, they retire and the assets have grown further in value and income generation capacity they may need to repay the bank a substantial part of the bank loan, as they will then no longer have the income from work that makes them such comfortable customers for the bank.

23.3 Their problem is that under the profits first rule, repayment by the trust of their loan to it (treated for tax purposes as capital) so they can repay the bank will be a profit distribution though the economic objective is repayment of the bank. Indeed the true economic substance of a loan repayment is discernible when one considers that if the trust repaid an interest bearing loan it had from the bank there would be no question of taxing the repayment. That the interest bearing loan is from an associated party doesn't change the economic substance from a loan repayment. The tax burden of repayment where the loan repayment is subject to tax will slash, perhaps entirely consume, the available assets. If the available income over the decade to retirement is applied to family needs, as much or all of it may have to be, there will be few or no imputation

credits to offset the tax charge. As some of the assets are pre 23 December 1999, some gains in asset value may be taxed to the beneficiaries and with an appropriate deed (which they might not have) it might be possible for the trust to pay them the gains on the assets sold rather than to that extent repay their loans to the trust. I put that aside to see the impact of the draft bill for a family that operates in the manner of this family in the long term. Allowing for the impact of entity tax and the fact that franking credits from that tax will not arise until after the repayment of the loan, to repay $250,000 of loans may require, ignoring transaction costs which will make the picture worse, realisation of up to about $650,000 of assets, very possibly more than is available as assets. (See Footnote 1 at end of paper).

23.4 Perhaps a solution might be for the trust to borrow directly from the bank on security of a third party mortgage over the family home. That has problems. The bank, if its documents are like some I know of, will through its standard documentation which is difficult (sometimes impossible) to have varied require covenants restricting the trustee from dealing with trust assets through distributions of income or capital without the bank's specific written approval. The bank will require regular, possibly quarterly or monthly, accounts from the trust and will want brief explanations from time to time of what the trust is doing. All these make a low maintenance home loan into a high maintenance commercial loan and intrude significantly into the family's privacy and freedom of action and indeed the trustee's power to comply with the terms of the trust deed.

23.5 The above problems stem in essence from the profits first rule. As already noted, the profits first rule doesn't tax on the basis of economic substance. Here repayment of some or all of a loan has the economic substance of repayment of a loan or if loans must be called capital then return of capital. It does not have the economic substance of a distribution of profits.

23.6 Again the profits first rule wreaks economic havoc, if not disaster, on people who are acting responsibly and effectively in planning and implementing arrangements that benefit their family (and keep them outside the welfare system).

24. Interest on non-commercial loans poses an interesting question

24.1 Is interest on an interest bearing non-commercial loan tax deductible? Unless any payment to a member is a distribution (and interest should not be a distribution) interest won't be a distribution. Even if that is wrong, consideration was provided through use of the money and it still isn't a distribution. Further, the interest won't have been paid because the recipient is a member or associate but because the payee made a loan. In short the payment of interest on a non-commercial loan to a non-fixed trust seems unlikely to be a distribution. It is quaint that interest on capital is deductible. While it is undesirable that loans be capital, at least interest on loans whether or not capital should be tax deductible.

25. Possible undefined term

25.1 Is "interest's share of contributed capital", used throughout (eg in section 157 – 225) defined?

26. Subdivision 157-F taxes persons other than those who receive the benefit. The existing law has the same defect. In neither case should that defect be permitted

26.1 Section 157-240 states that an object of Subdivision 157-F is to limit the ability of a non-fixed trust to distribute profits to one member and contributed capital to another. With respect, it is unreasonable to restrict that choice. As in the examples discussed above, trustees may have, even where tax plays a part as it will in every financial decision, proper reasons apart from tax for decisions as to the character of distributions. Placing artificial rules over the trustee's decision will often apply the tax burden to a party that didn't, can't or won't obtain the benefit being taxed. The true recipient of capital may be taxed on income while a recipient of income may be taxed as if the amount was to some extent capital.

26.2 The proportionate approach can have that effect now and the draft perpetuates and expands this effect under the current law. An example: A member of a trust receives the monthly income distribution of $2,000 for July, then immediately disposes of his or her interest at arm's length to a third party for full value of $100,000 (all of which represents a taxable gain) whereupon the trust for ten months falls on hard times, making no distributions, but in June makes an unexpected capital gain when Deep River Oil, formerly a 1 cent stock strikes a major find. The shares are sold. The gain, which being on capital account does not form part of the net income of the trust for trust law purposes, is distributed to the then members of the trust, the July buyer receiving a distribution of $300,000. The July vendor, a maximum rate taxpayer, has received $102,000 but is taxable on far more and indeed has more tax to pay than the amount received. This, though more extreme, is the essence of what happened in Zeta Force. It seems very unfair. It should not be permitted in the present law and should not be perpetuated in a new form by the draft bill.

26.3 The reform needed to the tax law is not to limit for tax purposes what and to whom trustees may distribute, but to ensure the correct person is taxed.

27. Rebatable distributions

27.1 Paragraph 158-10(1)(b) refers to a distribution that is not rebatable. What in general terms is a distribution that is rebatable and what is the effect of that? I note that bonus issue provisions make reference to a rebatable distribution without answering the question.

28. Special rules should be introduced to permit prepayment of tax to generate imputation credits and at the same time provide reasonable protection to the revenue. Failure to do so will injure those dependant on trust income and will discriminate against new ventures

28.1 Provisions are needed to permit tax to be prepaid by the end of the year of income so that non-fixed trusts may frank distributions made in that year. It may be argued that the prepaid tax may be refunded and taxpayers will thereby double dip through a refund to the entity and a refund to the individual. This isn't the true ultimate outcome. The ultimate outcome is that the entity will pay franking deficit tax. If it is the short term effect that causes the concern the answer is to provide that voluntary advance payments of tax by entities are non-refundable to the extent that a franked dividend has been founded upon such payment. The Commissioner should have power to defer refund until he is satisfied on this score. Another solution would be to provide that such advance payments are absolutely non-refundable (which will make entities think twice about paying them), but that probably goes further than is needed.

28.2 Failure to permit advance payment of tax will impose for a year to about two years (a long time when you are living through it) severe financial difficulty on those dependant on non-fixed trust income to meet their needs. Either those people must wait a year, perhaps nearly two years until franking credits are available (and at least another 2.5 years while the benchmark is built up) before they can receive income or alternatively about two years they must receive 70% of what previously they have received and then bear tax on that as an unfranked distribution. Then for another 2.5 years or so they are forced to work slowly back to their original position. Someone formerly on a 30% tax rate will for up to about two years be on a 51% tax rate and on an excessive rate for some years after that.

28.3 This is not merely a transitional problem. It now is and in future will be a problem of new entities. Either the entity holds earnings until franking credits are available or it makes unfranked distributions. If they can afford it and believe their members can afford it, entities will hold funds until franked distributions can be made. This may not be an economically efficient use of resources. The alternative of making unfranked distributions may aid the revenue, but it will correspondingly injure those dependant on investment income and narrow their investment choice to entities with sufficient track record to have a surplus of franking credits. This is a disincentive to new ventures.

28.4 The draft bill provides for advance payment of tax not to give rise to franking credits and to ensure debits arise where payments of tax are refunded within 6 weeks of year end. Why this is so, unless the intent is to create the financial difficulty and investment disincentives referred to, is hard to understand. Why this is unreasonable is stated briefly above.

28.5 In tandem with the provision to deny franking credits is a provision that payment of franking deficit tax will not credit the tax account of the entity paying it. This is said to be because individuals will receive refunds of excess franking credits. In other words there is a deliberate intent to claw back the refunds.

28.6 This is not how the system was originally announced. Originally it was announced that subject to review it was likely that the franking credit trading restrictions would be lifted, ie the intent appeared to be a system where claw backs where unnecessary. With respect, design of a tax system the government cannot afford to pay for is poor design. If refunds are available people will naturally seek to obtain them. If the revenue cannot afford to pay them, better not to offer them. Simple tax rules are desirable. Honest legislation and administration are desirable. These things are not possible in a system hedged about by claw backs. Those who seek to use the system are in such a system described as tax avoiders, those who take tax events as they come are enbrambled in complexity, and administrators and legislators strike at the innocent and "guilty" alike, masking their actions in words of doubtful meaning.

28.7 With respect, the design is fundamentally flawed and needs rethinking.

29. Australian corporate tax entity

29.1 It would be good for section 960-116 which defines Australian corporate tax entity, used widely in the exposure draft, to appear in the dictionary.

30. Buy-backs are made unnecessarily difficult and uncertain in tax effects

30.1 Subsection 160-31(3) provides that if the purchase price in a buy back exceeds the share's market value at the time of the buy-back as it would be if there was no buy-back, the frankable distribution is reduced by the excess. Buy-backs are often pitched at a price that makes them attractive, a little above the market price at the time. This suggests the board believes the market price for taking a slice of shareholding out of circulation is above the formerly prevailing price. The reason is the same one that takeovers are usually pitched above the formerly prevailing market price. Sometimes buy-backs are preannounced and preapproved by shareholders at an average price that is unknown until the buy-back commences. Even if there is no buy-back effect, that average will usually be more or less than the price at any given point in the period that generated the average. Apart from these issues, it is hard for a market watcher to know what the market price would be in the absence of a buy-back.

30.2 Doubtless the provision's aim is to spare the revenue. This is done at the price of enormous doubt as to outcomes. The provision makes it almost impossible to know how much of the buy-back price will be franked or alternatively if market price is seen as the price at some suitably distant past time, missstates the proper franking credit. Perhaps a Commonwealth Bank is big enough to warrant a special known deal done (sometimes) quickly. Every company in Australia isn't. Again, why not provide something simple that the government can afford. If it is a problem in buy-backs to afford franking credits without debate, amend the Corporations Law to ban buy-backs. Don't give buy-backs with one hand and with the other create great difficulty in using them by installing a partial profits without franking credits rule imbued with great computational uncertainty and therefore cost.

30.3 Subsection 160-32(4) provides that a distribution is unfrankable to the extent it is taken to be a distribution under Subdivision 156-C (except section 156-94). What is so heinous about a distribution that arises from a loan that a franking credit should be denied. It is open to an organised borrower who has some influence with the trustee to arrange to receive a franked distribution with which to repay the loan. Why penalise those who strike difficulty in making payments and don't have that influence or having it don't have that forethought? If loans should give rise to distributions (a matter on which this paper expresses reservations), then trustees should have the opportunity of providing franking credits if a distribution is their real intent. If a distribution isn't the real intent, then provided the borrower isn't in too much trouble, presumably the loan will eventually be repaid.

31. The benchmark rules discriminate unfairly against mobilisation of private equity capital

31.1 The benchmark rules create major problems for private equity structures. For example: If an enterprise has franking credits available and fully franks a 100% distribution of profits in one period, but in the next period (though it expects Australian profits to resume) has no Australian, only pre-taxed foreign profits available, its shareholders will also pay Australian tax if it distributes these profits. Only if the company holds the foreign profits and refrains from paying dividends until it can pay dividends from Australian profits or otherwise in tandem with franked distributions will it avoid the problem. Thereafter it will not be able to resume fully franked dividends but must for a considerable period pay partially franked dividends or refrain from dividend payment. In effect entities that are not widely held will be able to distribute untaxed gains only at a heavy cost to themselves, and their shareholders in unavailability of fully franked distribution for a very long time. That causes a significant cost to shareholders and therefore a significant cost to the company in terms of capacity to raise capital.

31.2 The benchmark rules don't apply to widely held corporate entities (para 160-50(2)(b)), but do apply to other corporate entities. We act for many structures in which unrelated parties have invested private equity. They are private, not widely held. Why is private equity investment discriminated against? I suggest that absent good reasons to act against private as distinct from public capital combination is poor policy and the distinction should not be maintained. Either remove it (preferably) or apply it to all corporate entities.

32. Benchmark rule 2's meaning is unclear

32.1 Benchmark rule 2 is ambiguous. The natural meaning has the effect that entities without franking credits when the system starts will never be able to make franked distributions.

32.2 Benchmark rule 2 is per subsection 160-38A(4):

"The benchmark franking percentage for a franking period cannot be more than 20 percentage points higher or lower than than the benchmark for the immediately preceding franking period."

20 percentage points higher than 0% is still 0%.

32.3 Alternatively, if the benchmark franking percentage starts at 0% then one might argue that it can increase to 20% of the maximum in the next period and to 40% of the maximum in the following period. Five periods (ie two and a half years) from zero to maximum.

32.4 Another alternative may, perhaps, exist. Benchmark franking percentage is defined in a manner that on quick inspection appears to be circular. It isn't the same term as franking percentage. Perhaps, assuming the term can't be said to have no meaning at all, it means the benchmark can move to 20% credit then to the corporate tax rate of 30% at the next step.

33. Cross reference to be corrected

33.1 Imputation benefit is defined to have the meaning given in subsection 160-87(3). The reference should, it seems, be to subsection (4).

34. Streaming rules have far wider operation than is probably intended or desirable

34.1 The simple payment of distributions to all members on a common basis is the streaming of a distribution. The distribution is one stream, all alike.

34.2 Section 160-87 empowers the Commissioner to make determinations if a corporate tax entity streams distribution(s) so one member gets more imputation benefit than another. I wonder, but have not had time to consider whether it is possible for some entities to get full benefit and others to get less benefit (perhaps an exempt entity outside the range of those referred to) though all members are treated alike by the corporate entity so that the Commissioner may determine to deny imputation credits.

35. Is the meaning of liability to pay income tax and PAYG unclear?

35.1 The meaning of liability to pay income tax or PAYG in section 160-120 may be ambiguous. I seem to recall that courts have held that a company that has earned profits is liable to pay income tax even though the year is incomplete. To hold otherwise would give scope for fraudulent tax evasion. Yet the section may mean that there must be a presently due liability to pay. However, that will mean that tax paid other than on or after the due date can't be counted for imputation purposes. That isn't conducive to efficient collection of the revenue. This should be clarified and, as stated above, the capacity to prepay tax and thereby create an imputation credit should be provided.

36. Section 125-5 relief should be more widely available

36.1 Section 125-5 provides welcome relief for restructure. It should always be available, not merely as a transitional measure during a period when the law is not in force and therefore can't be relied upon. However, the stamp duty cost of restructure makes it, especially with the uncertainty inherent in restructure when the law is unknown, not likely that the relief will be much availed of.

36.2 The conditions for relief set out in section 125-30 are not all necessary. For example, if ownership is identical, what does it matter if the new entity has carried on commercial activities or has others of the forbidden attributes? It would be wonderful to remove structures instead of replicating them in a new form. The only condition for relief should be substantial identity of ultimate ownership.

37. Bank loan repayments may be assessable to the bank

37.1 The beneficiary classes of typical discretionary trusts are sometimes so widely drawn that a loan transaction between the trust and a major bank may be between the trust and a member because either another member of the trust holds shares in the bank or the trust itself does. This in tandem with some of the proposed entity taxation rules may greatly complicate commercial life. Banks won't enjoy being taxed on loan repayments. Borrowers will enjoy the experience even less.

38. Offsets other than property should be allowed for

38.1 Subsection 960-190(4) allows for offsets of property. There are many offsets that are commercially possible but which are not allowed for. The scope should be widened.

39. What happens if a notionally but not actually forgiven loan is repaid?

39.1 I've not had time to reread and find what happens if a notionally but not actually forgiven loan referred to in section 960-195 is repaid. Is this dealt with?

40. Are there problems with contributed capital accounts and sub-accounts

40.1 Time has not permitted a study of classes of membership and of contributed capital accounts. It seems that this will be simple for a discretionary trust where there is no contributed capital of note but, especially in the case of hybrid trusts, it is readily imaginable that complex and anomalous results may occur, but this is not a reasoned comment, rather an impression.

41. Ultimate beneficiaries

41.1 The definition of "ultimate beneficiary non-disclosure tax" is worrying. It might have been hoped that the poorly drafted UB legislation could have been disposed of on design of a rational entity taxation regime. I still have the hope and commend the thought to you.

42. Widely held

42.1 The definition of "widely-held" is also worrying. Although it is used in section 160-50, the use severely discriminates against private equity investments and may presage further discrimination against private equity investments. Such discrimination should not be promoted by tax legislation.

43. Family trust elections should not be required for a non-fixed trust to pass through imputation credits, but if required the included members of the family should widened

43.1 There seems to be significant risk that it is intended that non-fixed trusts will only be permitted to pass on imputation credits if the trust makes a family trust election. If so it will be, I understand, because of the fear that without such restrictions, trading in franking credits will become possible. I reiterate earlier comment about the desirability of designing an affordable system that need not be hedged around with safeguards that make it difficult for the multitude, penalises many not intended to be harmed, etc.

43.2 Should those comments fall on deaf ears there is still much that should be done about family trust elections.

43.3 The Bible enjoins a man to care for his brother's wife should the brother die (even to taking her in marriage, illegal in a monogamous society). If the surviving brother is the link person in the family trust election, then a trust distribution to his sister-in-law, very likely in need of help if she has children to raise, attracts the penal tax.

43.4 Former spouses who part amicably but wish to continue to share the value they have created together in a family trust cannot do so except at the price of the penal tax rate.

43.5 If grandad or great grandma is the link person then the family trust mightn't have long to go before all or many distributions are subject to a penal tax rate.

43.6 Some controllers of trusts have a wide range of people they regard as family although legally they are not family. It might be someone who cared for them when they were young, or a child they cared for or raised, or a present or former boyfriend or girlfriend in difficult circumstances, or simply a friend or a person who has taken their sympathy. Any family trust distribution to such a person is visited with heavy tax consequences.

43.7 The limitations that apply heavy taxes to distributions to such persons don't guard against trafficking in losses, franking credits or anything else. They just inhibit people in looking after their own.

43.8 The revenue doesn't need to worry about back to back arrangements (you scratch my back) with absolute strangers (or even those who are close). Those problems have other solutions in the tax law.

43.9 The family trust election provisions are inhibitive of normal things done for non-tax reasons.

The provisions commercially compelling such elections should be removed.

43.10 If that is not done, then the classes of permissible beneficiaries should be greatly widened and capacity to distribute up to the lesser of say 20% of net income and some generous fixed amount, perhaps $100,000, outside those widened but fixed beneficiary classes should be permitted.

43.11 That won't solve the problem for a trust of considerable years standing with a diverse range of beneficiaries (and such trusts exist) but it will help other trusts.

44. A recurring theme of taxing those least able to afford it

44.1 It seems that the draft bill most adversely affects those whose flexibility or financial resources are lowest. This can be seen in provisions that affect those who have difficulty repaying loans, retirees dependant on trust income or loan repayments who are made unable to obtain them without crippling new tax costs, private capital handicapped by the benchmark rules in competing with public capital mobilisation (as if lack of liquidity wasn't already a significant handicap) and far more. As much attention should be given to the people affected by the bill (a very large proportion of the business community) as to the "government's" convenience.

45. Conclusion

45.1 I hope the proposal receives fundamental reform bearing strongly in mind the effects on the business, investment, and financial community, some of which are outlined above. Failing that then I hope the above comments concerning discrete provisions of the exposure draft will help development of the law.

3 November 2000

Stephen Page

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1 Assume the assets have been held for twenty years with 10% compound capital growth. Compound interest calculations show the cost of such assets is 14.86% of closing market value. Entity tax is therefore applied to 85.14% of the asset value. Franking credits won't arise from this in time to permit distribution with franking credits attached. Personal tax will therefore apply without offsetting imputation credits. Given the size of the repayment personal tax will be at the maximum rate of 48.5%. The calculation is below. Because of the impact of personal tax on the loan repayment, short of the family selling its house, it is necessary to augment the loan repayment with a distribution so that tax can be paid and therefore necessary for the family trust to sell even more assets.

Receipt of the loan repayment is subject to PAYG.

Loan repayment by the trust $250,000 plus $235,437 distribution	$	485,437
Less: Tax at 48.5% on $485,437		235,437
Available to repay bank		250,000
Net proceeds of asset sales		651,961
Less: entity tax at 30% of 85.14% of $651,961		166,524
Available for payment by the trust to the parents		485,437
Loan repayment		250,000
Tax burden		401,961
Total asset sales		651,961

Personal pressures and tragedies, family break ups, financial pressures, unco-operative banks and other causes can push families into positions where they need to undo loans to trusts quickly. Such people will face the problems of the heavy tax burden set out above.

For those who can hang on and keep the trust and bank loans in place it would be possible to keep the funds parked in cash in the trust and when franking credits are available (which if the benchmark system proceeds might be some years away) obtain franking credits, considerably ameliorating the above position. However, repayment of what in economic substance is a loan will even then require paying tax representing the gap between the corporate rate on the gains realised and the personal rate on the full amount of the loan. The actual economic substance of the transaction is evident when you consider that if it was the bank being repaid directly there would be no question of taxing the repayment because the trust has available profits. The tax is imposed because the loan is from a related party, not because the economic substance of the payment is the distribution of profits.