3 November 2000

The Hon. Mr Peter Costello MP
Treasurer
Parliament House
CANBERRA ACT 2600

Dear Mr Costello

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

1. The Taxation Institute of Australia (TIA) welcomes the release of the "Exposure Draft: New Business Tax System (Entity Taxation) Bill 2000" (the Exposure Draft). The TIA appreciates the opportunity to respond to the policy aspects of the Exposure Draft. However it is unfortunate that crucial parts of the new regime were not included in the Exposure Draft.

2. The TIA was established in 1943 and has a membership of 11,000 tax practitioners throughout Australia. Our members range from small rural and suburban accountants to senior members of the bar specialising in tax. Taken together with their clients our members views reflect the opinions of many tens of thousands of small, medium and large businesses throughout Australia. This submission has been compiled from comments made by senior tax practitioner members of the TIA and from comments made at a series of seminars organised by the TIA. Therefore, this submission highlights the key concerns of many tax practitioners about the Exposure Draft. This letter focuses on the policy issues of the Exposure Draft. In another letter to you we have focused on the technical deficiencies of the Exposure Draft.

Summary of the TIA's s view

3. The TIA believes that the Government should abandon the non-fixed trusts provisions and the member-to-entity non-commercial loan provisions of the *Exposure Draft: New Business Tax System (Entity Taxation) Bill 2000* as they:

   - are incomplete;
   - add substantial complexity to the tax law;
   - impose massive compliance burdens;
   - are inequitable;
   - impose double tax; and
   - are unworkable due to the inability of the drafters to determine key definitions.

4. Due to retrospective nature of the legislation in situations where a family trust election cannot be made, the Government has created a wealth tax by stealth.

5. In addition to these problems, the relief for restructuring is inadequate. The Government needs to introduce a package of measures, which provide relief from GST, income tax and capital gains tax and ensure that there is relief from state/territory stamp duties.

6. Further, the TIA believes the major objects of the Government can be achieved through a withholding tax regime.

7. If the Government chooses to continue down this path, the TIA requests that the measures be delayed until 1 July 2002 and a joint working party be established to iron out the difficulties.

8. The benchmarking rules for franking credits for trust distributions should be amended to permit corporate tax entities to vary the franking rate between franking periods. Other franking issues also need to be addressed.

9. These issues are addressed in detail below.

The reasons for abandonment of the measures

Incompleteness - Missing Law

10. In making these comments we regret that the Exposure Draft contains a number of key omissions which makes impossible a global evaluation. The omissions include fundamental definitions crucial for determining who is caught under the measures. There is no clear definition of:

    - a fixed trust;
    - an excluded trust; and
    - an Australian resident.

11. As well the following areas were not available for review:

    - transitional provisions;
    - the provisions intended to deal with capital distributions to members without a fixed membership interest;
    - CGT consequential provisions;
    - Division 6 consequential changes (including incorporating the definition of “net income of a trust” in section 95);
    - international tax issues; and
    - the machinery provisions (lodgement, collections, etc).

These omissions are particularly disappointing given the extensive confidential consultations which were held prior to the release of the Exposure Draft

12. Also, there are many terms used in the Exposure Draft Explanatory Material, such as “family group” and “23 December 1999”, which do not appear in the draft legislation.

13. As the Exposure Draft does not explore the international tax issues, simple questions (such as “What is the status of foreign trusts and the returns from those trusts? Will they generally be treated as deemed companies (non-fixed trusts) and will this depend on the existence or absence of a DTA?”) cannot be answered.

14. All these definitions and areas of law must be opened up to scrutiny and considered before the Bill is introduced into the Parliament. This is particularly so in respect of the interaction between the proposed entity tax measures and the international tax system, as foreign trusts, designed to meet the requirements of a foreign tax law, will not be able simultaneously to meet the proposed Australian definition of a “fixed trust”. This is likely to lead to inappropriate tax treatment.

15. Other key areas are the interaction between the measures and the PAYG system. These rules again have not been considered and the entity tax regime should not be implemented until they are fully considered. Where possible taxpayers should be required only to apply one set of rules to their different compliance obligations.

Complexity

16. There are a number of reasons why the proposals in relation to trusts will not lead to any overall "simplicity". Indeed, they will add yet further complexity to our already complex tax laws. These proposals are the antithesis of “simplification” of our tax laws and it is difficult to understand how a Government that espouses simplification of our tax laws as a major policy issue could be the proponents of these ill conceived and poorly drafted changes to the taxation of non-fixed trusts. The Exposure Draft exhibits all the hallmarks of hastily assembled and poorly thought through changes, lacking any logical policy basis. Examples of added complexity include the following:

    (a) the fictional treatment of a trust as a company will necessitate or lead to a considerable number of further fictions. These types of deemings plagued the CGT regime and were one of the reasons for the new approach adopted during the TLIP rewrite;

    (b) the adoption of a number of new and complex measures to be applied to trusts (including non-commercial loans and profits first). This is illustrated by the difficulty in finalising a fixed trust definition; and

    (c) the five old trust regimes are retained in order to deal with many classes of trusts.

17. If these measures are adopted, rather than restoring equity in the taxation of all entities, the proposed rules will have the effect of negating many of the small business CGT concessions granted in September 1999. They will impose a significant and unreasonable burden on small business, which has had to utilise the non-fixed trust to take advantage of these concession.

Compliance Costs

18. By introducing a further (sixth) method for taxing trusts, the legislation again imposes massive compliance burdens on small to medium business. For example, it is likely that every trust deed will have to be reviewed by 30 June 2001 to determine whether it is a "fixed trust" or requires amendment to cope with the new entity tax regime. This cost alone could be as high as $453 million (453,629 trusts @ a conservative $1,000 per review). Such costs are totally unacceptable to the Australian business community.

19. Another example of imposition of compliance costs relates to "prior taxed amounts". Any credit balances to beneficiaries may have arisen over a large number of years, some part of which may well represent "prior taxed amounts. However, such credit balances also may include the difference between tax and trust income, non-taxable pre-20 September 1985 gains, the indexed component of gains and cash contributed by the "member" to the trust. A full "reconstruction" of such credit balance will be required. This may be difficult and expensive.

20. An exercise to reconstruct every discretionary trust beneficiary entitlement account will be considerable. This will place an enormous strain on the resources of accounting and legal firms to revisit/reconstruct those balances as well as substantial costs on their clients. Again that reconstruction would be necessary prior to 1 July 2001, as to properly assess the impact of the profits first rule by that date the accountants will need to consider the exact amount that represents "prior taxed amounts". Although, the limitations imposed by section 170(2) of the Income Tax Assessment Act 1936 may limit reconstructions to four years, still this work will involve considerable resources on behalf of taxpayers and their advisors.

21. These two examples demonstrate, yet again, that the bureaucracy has an extremely poor understanding of the compliance burdens imposed on taxpayers and advisers by tax law changes and fails to properly advise the Government on these issues. As a result, much of the recent "tax reform" legislation has added substantially to the compliance burden in a context where the Government's rhetoric is all about reducing compliance and simplifying the law.

Distribution statements

22. The requirements of the proposed Section 160-95 will be a compliance cost nightmare for the typical discretionary trust. Every time a payment is made to or for a member a statement will be required. A typical small business discretionary trust will make literally hundreds of payments a year on behalf of beneficiaries as it is common practice to pay private expenditure through the trust and treat this as an income distribution. The proposed distribution statement requirements will impose a compliance burden of incalculable proportions. It is another example of a lack of understanding of typical commercial practices by those responsible for drafting these proposed laws which is particularly disappointing as this issue (along with many others addressed in this submission) was raised more than once during the confidential consultations. Moreover, it is impossible to see the policy rationale for such a requirement. An annual statement – if one is required at all – would suffice to record the relevant details. In the context of quarterly BAS requirements, a quarterly statement could perhaps be justified.

Once a trust always a trust

23. Compliance costs are generated by inflexible rules such as those in the proposed Section 153-25.

24. The proposed Section 153-25(1) deems the non-fixed trust rules to apply to a trust for an income year if at any time during the income year the trust is a non-fixed trust. The problem is that if a trust becomes a non-fixed trust during a year it is taken to be a non-fixed trust for the whole year. This retrospective application may cause problems where a trust changes status during a year. Prior to the change it may have made full distributions on the basis that it is a flow through entity. Once it becomes a non-fixed trust it has a number of irrevocable and retrospective obligations, including:

- a tax liability on the income distributed;
- a possible franking credit requirement; and
- the need to notify the recipient of the distributions made.

25. Assume a trust becomes a non-fixed trust on 29 June. There will be no distribution statement in respect of any interim distributions resulting in penalties and the trustee may not have retained funds to meet the retrospective tax liability on income distributed.

26. The proposed Section 153-25(2) states that a if a trust is one for which the non-fixed trust rules apply for one income year of the trust, then they apply to the trust for all subsequent income years of the trust:

(a) even if the trust ceases to be a non-fixed trust; and
(b) even if the trust becomes an excluded trust.

27. A crucial point to appreciate is that once a trust is a non-fixed trust no amount of restructuring can stop it from being a non-fixed trust. This seems particularly harsh where the trust becomes an excluded trust. An excluded trust is yet to be defined.

28. Treasury's concerns that this will stop trusts moving in and out of the measures during a year of income are unfounded and the policy basis illogical. To do so would require changes to Deeds, which in turn may amount to a trust resettlement with income tax, CGT, GST and dire stamp duty consequences. Where a trust does become non-fixed, then provided they remedy the problem it should be treated as a fixed trust.

Inequity

29. The non-fixed trust measures treat create further inequities between business entities. This is illustrated in the following tables.

Active Assets

Detail	**Discretionary trust ($)**	**Fixed/unit trust ($)**	**Direct owner ($)**	**Company owner ($)**
Capital gain	100	100	100	100
Less corporate tax payable by discretionary trust and company.	-15	-	-	-15
Paid to beneficiary/direct owner	85	100	100	85
Less tax payable by beneficiary/direct owner	-24.25	-30.31	-12.12	-36.37
Plus imputation credit for tax already paid at trust level	15	-	-	15
After-tax amount in beneficiary/direct owner's hands	**75.75**	**69.69**	**87.88**	**63.63**

Investment Assets

Detail	Discretionary trust ($)	Fixed/unit trust ($)	Direct owner ($)	Company owner ($)
Capital gain	100	100	100	100
Less corporate tax payable by trust (Discretionary trust and company pays corporate tax on half gain under discount for "active" assets of small business)	-15	-	-	-15
Paid to beneficiary/direct owner	85	100	100	85
Less tax payable by beneficiary/direct owner (Footnote explains differences in taxes)	-24.25	-30.31	-12.12	-48.5
Plus imputation credit for tax already paid at trust level	15	-	-	30
After-tax amount in beneficiary/direct owner's hands	**75.75**	**69.69**	**87.88**	**66.5**

Assumptions

- Beneficiaries/shareholders pay tax 48.5%.
- Distributions after new trust laws and 30% corporate rate come into effect on July 1 next year.
- Assets acquired after December 23 last year (assets acquired by a discretionary trust before that date retain existing tax treatment under draft legislation).
- For an active asset, if the company were to distribute its "tax free" amount of $50 - after applying the active asset reduction, CGT event G1 (the company equivalent to E4) would apply to capture that amount, but if the shares had been held for a year or more, the shareholder would be eligible for the general discount on that gain. This is assuming a zero coast base for the shares.
- Investment assets: the general capital gains tax (CGT) concession introduced in September last year for assets held at least 12 months is claimed for directly held assets and assets in a fixed/unit trust. However, existing CGT provisions will claw back some of the tax saved by fixed trusts. Discretionary trusts will be excluded from the general CGT concession (same applies to companies).
- "Active" assets of a small business: discretionary trusts (along with direct owners and fixed/unit trusts) will keep a special CGT concession for "active" assets of an eligible small business – even if assets were acquired after December 23. An "active" asset, for example business premises, is used in the operation of a small enterprise. Under this concession, half the capital gain is initially taxable. For the tables, it is assumed that the fixed/unit trust and direct owner take advantage of both the "active" asset concession and the general CGT concession. And it is assumed that the discretionary trust takes advantage of the "active" asset concession. But existing CGT provisions will claw back some of the tax saved by fixed trusts.
- For the company it is assumed that the company is in liquidation.

[Note: These tables were prepared by Geoff Petersson and are modifications of those prepared by Geoff Petersson and Michael Lawrence published in BRW on 27 October 2000.]

30. Thus, the measures perpetuate and create further preferences in the tax law for form over substance, rather than creating a level playing field.

Double taxation

31. During the year ending 30 June 2002 many non-fixed trusts will want to make interim payments that are distributions for the purposes of proposed Section 156-20. It may be that the only source of franking credits will be franked dividends received. Distributions of other amounts are likely to have to be made on an unfranked basis.

32. There will be the potential for double taxation. The non-fixed trust will make unfranked distributions, which will be assessable to the recipient at their marginal tax rate. Then the non-fixed trust will pay tax at 30% on the income for the year. Whilst this will give rise to a franking credit in the year ending 30 June 2003 unless the non-fixed trust has substantial tax preferences these will be surplus franking credits so that effectively there will have been double taxation.

33. This problem could be resolved by permitting a 2 year franking period in the transitional year. Such a measure could also apply when a new non-fixed trust is created as the double taxation problem exists in the first year of any trust.

34. For non-fixed trusts the potential for double taxation is exacerbated by imputation changes in the Exposure Draft. Unless appropriate transitional provisions are introduced there will be the potential for a significant windfall revenue gain for the Government.

35. It is the benchmark provisions in proposed Subdivision 160-C which will create the problem for non-fixed trusts and the windfall revenue gain for the Government.

EXAMPLE

Franking and the Government's windfall revenue gain

Facts

1. The Flo Ting Trust is a non-fixed trust.

2. Usually it has made the maximum possible interim distributions to one of the beneficiaries Beau Ting.

3. Beau Ting has a marginal tax rate of 48.5% (including Medicare Levy).

4. The income of the Flo Ting Trust is as follows:

Year ending	$
30 June 2002	10,000
30 June 2003	10,000
30 June 2004	10,000

5. No franking credits or tax preferences are associated with the income.

Likely outcome

	Franking Account		Tax Paid
	$	$	$
Year ending 30 June 2002			
Flo Ting Trust:			
$10,000 x 30% =			3,000
Beau Ting			
$7,000 x 48.5% =			3,395
			6,395
Year ending 30 June 2003			
Flo Ting Trust:	3,000		
$10,000 x 30% =			3,000
Beau Ting:			
$(7,000 + 900) x 48.5% =		3,832	
Franking credit:			
$1,500 x 20% =	(300)	(300)	
$1,500 x 40% =	(600)	(600)	2,932
	2,100		12,327
Year ending 30 June 2004			
Flo Ting Trust:	3,000		
$10,000 x 30% =			3,000
Beau Ting Trust:			
$(7,000 + 2,100) x 48.5% =		4,414	
Franking credit			
$1,500 x 60% =	(900)	(900)	
$1,500 x 80% =	(1,200)	(1,200)	2,314
	3,000		17,641

Notes:

1. On income of $30,000 tax of $17,641 has been paid which is an effective rate of approximately 59% and the Flo Ting Trust has surplus franking credits of $3,000.

2. In order the Beau to be entitled to franking credits the Flo Ting Trust may need to make a family trust election. If it can not or does not then the effective rate of tax on distributed income will be approximately 64%

3. The problem may be avoided if the Flo Ting Trust makes a commercial loan to Beau Ting during the year ending 30 June 2002.

36. The Government will not get a windfall gain if non-fixed trusts made commercial loans of their income to members during the year ending 30 June 2002 and then distribute on 1 July 2002. This is because the member and the non-fixed trust will have no tax liability in the year ending 30 June 2002. Moreover the member will have only one day's interest to pay so that non-deductibility will not be a significant issue.

37. Further problems arise where a family trust election can not be made This occurs where beneficiaries are not real persons (eg a church or university), a beneficiary dies, or the trust is service trust for an accounting firm (big or small), a law firm, or medical practice. The problem is that, although all these trusts will pay company tax, apparently the beneficiaries will be ineligible to receive the franking credits.

38. Under the proposed Section 161-210 franking credits are available only if you satisfy certain criteria. The recipient has to satisfy the provisions in sub-section 161-210(2)(b), ie the recipient has to be a qualified person. That is yet to be defined, but under the existing legislation, it means someone who is a member of a family group pursuant to a family trust election.

39. The effect is not just on the flow-through of franking credits but also on credits from the tax payable by the non-fixed trust. This requirement should be removed to avoid double taxation. Treasury's concerns about dividend streaming are no longer legitimate given the other proposed measures in the "simplified" imputation tax regime.

40. To stop further double taxation the definition of "prior taxed amounts" should be amended to include undrawn beneficiary current accounts with amounts of previously taxed distributions, realised capital gains, the difference between accounting and net income, the indexation component of any capital gain and CGT concessional amounts (eg goodwill).

41. There appears to the potential for double or multiple tax where there is a Div 7A style loan to a member. The member is taxed on the distribution. Subsequently the member may repay the loan which was treated as an assessable distribution. If the trust distributes the underlying profits to a different member or even worse makes a

non-commercial loan to that other member from the same underlying profits, the amount will be assessable again. This is manifestly unfair. Scope for multiple tax must be eliminated.

Unworkable due to the inability determine key definitions

Definition of non-fixed trust

42. The proposed amendments to Section 995-1 define a "non-fixed trust" in terms of fixed entitlement within the meaning of Division 272 in Schedule 2F to the Income Tax Assessment Act 1936, ie where there is a "*vested and indefeasible interest*". Section 272-5(2) sets out cases where as interest will not be regarded as defeasible. Section 272-5(2) is intended to deal with the possibility that a literal interpretation of "*vested and indefeasible interest*" could mean that the ability to issue or redeem units would preclude a unit trust from qualifying as a fixed trust. 44. Many (quite possibly most) unit trusts may not satisfy the requirements of Section 272-5(2) and that could mean that s 272-5(1) is not satisfied with the consequence that the unit trust will be a non-fixed trust. Situations where a unit trust will not satisfy Section 272-5(2) would include:

- new units being issued at a discount to market value or net asset value as the case may be. This is not uncommon where there is a distribution reinvestment plan or the placement of units, perhaps to fund an asset acquisition;
- rights issue to existing unit holders;
- where there are different classes of unit. These may be income and capital units or there could be participation units where the manager of a unit trust participates in income in excess of a benchmark rate;
- if the unit trust deed contains the common clause that the manager can determine what is income or capital; and
- where a power to amend is subject to a veto by beneficiaries.

Thus, the use of "*vested and indefeasible interest*" concept in the context of unit trusts is clearly inappropriate.

43. Thus, the proposed definition, taken from an anti-avoidance provision, is totally inappropriate for these measures. Ironically, the decision to abandon the unified entity taxation proposals because of the issues raised by the property and unit trust organisations is, in most instances, unlikely to exclude them from the non-fixed trust measures because almost always they will fail one or more of the above tests.

44. Even if it is possible, in circumstances listed above, that the Commissioner would exercise the discretion granted to him in Section 272-5(3), this will create reverse work flows and is therefore unsatisfactory, particularly as this issue will have to be resolved for all "fixed" trusts by 30 June 2001.

Excluded Trust

45. The category of excluded trusts indicated by Treasury is too narrow. The definition of excluded trust should include:

- testamentary trusts (ie person with life interests and discretionary beneficiaries). As many older deeds (particularly many farmer's wills) date back to the 1920's and 1930's they are unable to alter the deeds to comply with a 2001 law. Beneficiaries (many widows) of such wills have already been singled out by the "45 –day rule" measures and again appear to be in the Government's sights. Treasury has not provided any data to show risk associated in this area. Such trusts should be excluded from the non-fixed trust measures;

- all employee share trusts. Employee share trust deeds often permit discretionary distributions in the event of the termination of employment or non-distribution where a member commits a forfeiture event or fails to meet a performance requirement. As there is no mischief with the activities of employee share trusts which comply with Division 13A, such trusts should be excluded from the non-fixed trust measures. As a consequence any transfers of shares or options to employee beneficiaries would be treated as if it is a transfer from a bare trust and caught under Division 6; and

- trusts created without a Court order, to manage the affairs of persons with health or addiction problems.

Wealth Tax by stealth

46. The Explanatory Materials state that there will be provisions to ensure that capital distributions by a non-fixed trust to members with a non-fixed interest trust will not be assessable. However, this is subject to two provisos:

- The recipient must be a member of the family group. This may not mean a family trust election is required but the recipients will be limited as if there had been a family trust election. This will cause problems where beneficiaries are not real persons (eg. a church or university), a beneficiary dies or the trust operates for a disparate group of beneficiaries (eg. a service trust); and
- All capital must have been contributed by the family group. Except for deceased estates, rarely will this be satisfied as usually the initial settlor is a professional adviser or family friend.

By implication, if a trust does not come within the exception, a capital distribution to a beneficiary with a non-fixed interest will be assessable. This amounts to a wealth tax by stealth

Relief for restructuring

47. Schedules 3 and 4 of the Exposure Draft provide some very limited relief for restructuring. Proposed Section 125-5 explains the limited nature of the relief. It is unacceptable that there is no roll-over relief to enable a non-fixed trust to restructure to take account of the new entity tax regime. Such relief was granted in Sections 960-100 and 960-110 of the Transitional Act 1997 with respect to the Managed Investment Schemes (MIS) changes.

48. If an objective of the entity tax regime is to discourage the use of discretionary trusts, it might have been desirable to offer an incentive for them to be terminated. Such an incentive was offered for a limited period to controlled foreign trusts and is a recommendation in *A Tax System Redesigned* with respect to proposed international tax changes applicable to certain foreign trusts.

49. *A Tax System Redesigned* states that roll-over relief on the transfer of assets from non-fixed trusts to beneficiaries would be inappropriate as there is no the continuity of beneficial ownership. CGT rollover relief is available on the transfer of assets pursuant to a marriage breakdown where clearly there is a change in beneficial ownership. Moreover, the CGT relief extends to the transfer of assets from a trust to a spouse. If similar CGT and income tax relief were offered now for a limited period a number of discretionary trusts might be wound up.

50. Even if a trust is not to be terminated it may be desirable to amend the trust deed to take into account the entity tax regime in the Exposure Draft. A concern, as it was in the MIS context, is that the amendments may give rise to a resettlement with potential income tax, GST, CGT and stamp duty consequences.

51. The Government needs to introduce a package of measures, which provide relief from income tax, GST and CGT and ensure that there is relief from state/territory stamp duties. In particular it will need to:

    - extend the restructure relief provided by the proposed Subdivision 125-A to cover converting and convertible notes of the transferor entity and options issued by the transferor entity;

    - amend Division 6B of the Tax Act 1936 (corporate unit trusts) to ensure that it does not apply to unit trusts which come into existence as a result of a restructure carried out in accordance with the restructure relief provided by the proposed Subdivision 125-A.

52. Where there is a rollover of a pre 24.12.99 acquired asset, the replacement asset should retain the earlier acquisition date. This would enable a realised gain to be distributed to the member consistent with your announcement and would complement the intended operation of the Division 115 general CGT discount.

Alternative methodology

53. In our view it is *essential* that alternative measures be identified, which are simpler and fairer than those in the Exposure Draft. The tax regime for trusts suggested by the Exposure Draft is vastly more complex than the existing system and will include many unfair and unacceptable elements. In order to provide a starting point for discussion the TIA would like to put forward two such measures for consideration.

54. A much simpler means could have been used to "crackdown on discretionary trusts". The existing regime in Division 6 of Part III of the 1936 Act could have been left in place. To it could have been added a withholding tax regime perhaps similar in operation to the TFN and ABN withholding tax regimes. If necessary there could have been a minimum withholding tax rate, possibly 30% to align with the corporate tax rate.

55. A variation on this approach, which will also meet most of the legitimate objectives of *A New Tax System* (ANTS) in relation to trusts, is the adoption of the relatively simple Corporate Rates Approach. This measure operates as follows:

(a) The *income* of trusts (other than those excluded from the regime) could be assessed at *corporate rates* under Section 99A or a new equivalent of that provision.

(b) The assessment of the Trustee would generate franking credits for the Trustee, and a franking account which would be used to pay franked dividends from the Trust (carrying the potential for refunds proposed elsewhere in the Report).

(c) The franking rules should accommodate the franked payout of *current year income* so that current year income can continue to be distributed to beneficiaries (as present entitlements) on a franked basis.

(d) The recently enacted denial of use of franking credits by discretionary trusts should be removed.

(e) If (contrary to submissions made elsewhere) there is to be a concept of "tax preferred income" which is to be taxed on distribution, that concept should be appropriately defined and amounts within such definition assessed under Division 6 on their actual distribution.

(f) The benefits of foreign tax credits should continue to flow through to beneficiaries.

What this would achieve

56. The Corporate Rates Approach would achieve the Government's objective of taxing trust income at *corporate rates* within each trust (and thus secure any reasonable collection objectives in respect of trust income) and could assess "tax preferred" income (if that is considered essential). It also will remove the need for Ultimate Beneficiary Statements as tax is collected at source.

What this course would avoid

57. The Corporate Rates Approach would avoid:

(a) forcing trustees to accumulate income generally or pending generation of franking credits (thus further undercutting any residual argument for profits first);

(b) treating each trust as an *entity* (which it is not);

(c) deeming various distributions of *capital* to be income (when they are not);

(d) taxing *notional amounts* as deemed assessable distributions (when they are not);

(e) the application of a number of inappropriate (and unfair) regimes to trusts (including the zero cost basing of discretionary trusts); and

(f) the addition of many new layers of complexity to the taxation law.

It would also reduce (but not eliminate) the need to amend Deeds and the dangers of not identifying constructive and other trusts arising as incidents of various transactions so as to avoid their treatment as "spectral" companies;

58. We do not suggest that the Corporate Rates Approach is the only alternative measure which could be adopted to achieve fairness and simplicity. It would (for example) be perfectly feasible to adopt a system under which closely held companies are permitted to deal with income and assets as "look through" entities, and approaches of that kind are more than worthy of further examination. However the Corporate Rates Approach is relatively close to the course suggested by ANTS, and may for that reason be easier to adopt.

Simplified Imputation Provisions

59. The benchmarking rules, by requiring entities to frank their dividends within 20 percent points of the previous franking period benchmark (generally franking periods will be six months), does not recognise that there are legitimate reasons (rather than streaming behaviour) why the potential level of franking may change by more than 20 percentage points between franking periods. As the above example illustrated, this

is a particular problem on the application of the entity tax regime where a non-fixed trust making interim distributions will take 2 ½ years to reach full franking.

60. As the discretion (contained in the proposed Sections 160-38A(5) and 160-85(1)) can only be exercised in "extraordinary circumstances" it is too restrictive. The benchmarking rules should be amended to permit corporate tax entities to vary the franking rate between franking periods. At the very least there should be a transitional concession.

61. The feature in the proposed rules by which a company that overfranks (even accidentally) will suffer the penalty of franking deficit tax, which will not be offset against the company's final tax liability, lacks any rigorous basis in policy. Such a rule is a hangover from the deferred company tax regime, which has been abandoned. Under the present regime there is no loss to the revenue as the company must pay its Franking Deficits Tax (FDT) within 28 days of the franking year end. The subsequent offset of FDT against the final payment of tax by the company is entirely appropriate and consistent with the integrated company tax regime. It should be removed.

62. The exposure draft does-not set out the rules for the flow through of franking credits via trusts. To ensure that these rules work in practice, you are urged that such rules be the subject of a consultation process before being introduced into the Parliament.

Delay the application of the measures

63. This operative date is of major concern. From 1 July 2000 tax advisors and their clients (ordinary Australians) have had to deal with the Goods and Services Tax (GST), the new tax collection system (the Pay As You Go (PAYG) System), the draconian ill conceived Ultimate Beneficiary measures, the new penalty regime, the alienation of personal services income measures, the modifications to the prepayment rules and the non-commercial losses regime. These changes have put enormous pressure on advisors, particularly accountants assisting their clients, in coming to terms with GST and PAYG. Currently the resources of advisors are stretched to the limit in preparation of client's Business Activity Statements.

64. Whilst some of these problems will diminish over the next 12 months as taxpayers become familiar with GST, PAYG and the BAS, the problem is that these measures will impact not in 12 months time but in the next six months. This is due to the fact that the "once a non-fixed trust always a non-fixed trust" approach imposes the workload prior to implementation, ie before 30 June 2001.

65. It is unreasonable (and unrealistic) to expect taxpayers and their advisiors to become familiar with the proposed taxation of non-fixed trusts under a completely different regime from 1 July 2001.

66. The operative date should be deferred until 1 July 2002 and a joint working party of Government officials and tax practitioners with a good understanding of the practical commercial issues should be established to iron out the difficulties or devise a better approach. To allow the proposed legislation to go forward with its current poor policy basis and hastily drafted and error-ridden form, is likely to result in many unintended consequences, (including an effective wealth tax and death duty) particularly on small rural and regional businesses. Coupled with the present considerable disquiet developing in the business community over the unreasonable imposts of "tax reform" changes, the TIA believes that the Government risks a substantial backlash from the business community over these proposed changes.

Conclusion

67. The TIA would be pleased to amplify any aspects of our submission if you need further information, and seeks an opportunity to discuss the issues raised in this submission with you.

Yours sincerely,

Ray Conwell
NATIONAL PRESIDENT