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 – The Technical Deficiencies

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 technical deficiencies of the Exposure Draft. In another letter to you we have focused on the policy issues of the Exposure Draft.

The Exposure draft by provision

Section 156-20 - Definition of distribution

3. The proposed Section 156-20 defines a distribution. What is not clear is what constitutes a crediting to a beneficiary's account that will be treated as a distribution.

4. It should be noted that where a beneficiary becomes presently entitled to a distribution it will not be taken to have been credited. Consequently it will not be a distribution until something more is done. An accounting entry in the member's account may be sufficient, although case law relating to company dividends suggests that this may be insufficient: see *Brookton Co-operative Society Ltd v FCT* (1981) 11 ATR 880; 81 ATC 4346.

5. In order for a crediting to be a distribution do assets have to be appropriated to match the amount of present entitlement? If so, it is probable that a new bare trust comes into existence, which, presumably, will be within the definition of an excluded trust. Alternatively, does the beneficiary have to acknowledge their entitlement to an amount and confirm that the amount can be held by the trust? If so will this be a loan as defined and potentially a non-commercial loan. This issue needs urgent review.

Section 156-75(2)

6. What constitutes a "distribution", as defined in proposed section 156-20, is extended by the proposed section 156-75(2).

   An entity provides a distribution benefit to you if the entity:

   (a) makes a payment (other than a loan) that is wholly, or to some extent, made to you, on your behalf or for your benefit; or
   (b) credits an amount that is wholly, or to some extent, credited to you, on your behalf or for your benefit; or
   (c) transfers property to you.

7. This extension covers the familiar territory of payments made on behalf of or for the benefit of the "recipient". One concern is whether the extended definition could encompass a superannuation contribution paid by a non-fixed trust. A superannuation contribution does not appear to be covered by the exclusion in the proposed Section 156-115. Some comfort may be drawn from the Full High Court decision of *Constable v Federal Commissioner of Taxation* (1952) 86 CLR 402.

8. Treating superannuation contributions as distributions is unlikely to be the policy intent. Any doubt could be removed by the type of specific exclusion in paragraph (j) of the definition of fringe benefit in Section 136 of the FBT Act. This needs clarification.

Section 156-75(3)

9. Unfortunately, except where property is involved (ie s 156-75(4)) applies), the extension to the amount of a distribution does not appear to take into account any consideration which the beneficiary may have given to the non-fixed trust, unlike s 156-25(1). This paragraph needs review.

Section 156-80(4) - Deemed distributions

10. Generally an existing loan at 30 June 2001 will be grandfathered. However, the proposed Section 156-80(4) provides that:

    If the terms of a loan made before 1 July 2001 are varied on or after that day by extending the term of the loan or increasing its amount, this Division applies to the loan as if it were made on the new terms when the variation occurred.

11. This means that if an existing loan is "freshened-up" the whole amount of the loan, not just any increase, will be a deemed distribution. This provision should be removed or modified to capture only any additional advance or any significant change to loan terms.

Section 156-86(3)

12. This subsection gives the Commissioner the power to reduce the minium yearly payment period without the full scrutiny of Parliament, via regulation. The relevant term of a loan should only be varied by legislation. If this remains, the regulation should apply only where the Commissioner is seeking to grant a concession.

Section 156-115

13. The adoption of the proposed Section 156-75 in the proposed Section 156-115 again raises the issue of treating a superannuation contribution paid by a non-fixed trust as a distribution (as discussed above). Again, changes are needed to ensure that such payments are expressly excluded.

Section 157-85(1)

14. In determining the available profits a deduction may be taken for accounting provisions. These are defined in the proposed Section 157-85(1). Where available profits have to be determined during an income year they are likely to be overstated as a result of this definition. This is because usually such provisions are taken up annually at the end of a year in determining the profit or loss for the year. To overcome this problem non-fixed trusts are going to have to take up pro-rata provisions. This definition needs revision.

15. The last item in the proposed definition refers to "other provisions prescribed under regulations". Interestingly there are several other instances in the Exposure Draft where there is reference to change by way of regulation. The use of regulation rather than amendment to the provision does mean that an anomaly can more easily be remedied. In this context it can only be used to increase the provisions, which reduce available profits and so will only ever be beneficial to taxpayers. However over-reliance on regulations should be avoided (see comments in respect of Section 156-86(3)).

16. In the calculation of "available profits" there is an opportunity to double dip. Having determined the net market value of an asset, which reflects depreciation, that value can be further reduced by depreciation provision in the accounting records of a non-fixed trust.

17. In determining "available profits" unrealised gains on pre-20 September 1985 assets have to be included, even though the realised gain from such assets can be distributed outside the profits first rule. This is unfair. It means artificial profits, which on realisation would not be assessed would have been treated as distributed and be assessed before a capital distribution can be made. This is a further case for revising the "available profits" rule.

Section 157-85(2)

18. It is not necessary for a non-fixed trust to value all its assets every time it makes a distribution under the proposed Section 157-85(2). However, this concession is confined by s 157-85(3). The reservation in proposed Section 157-85(3) is curious and indeed may negate the compliance cost benefit apparently being sought to be achieved by Section 157-85(2).

19. If the accounting records of a non-fixed trust show that it has sufficient profits then the distribution is taken to be out of available profits. That means the distribution will be assessable to the recipient (unless they are an exempt body) and it might be thought that the objective of the "profits first" rule had been achieved. Therefore, it is irrelevant if the accounting records "significantly undervalue the net market value of its assets" due to the trust carrying assets at historical cost rather than market value. The rider, therefore, seems unnecessary as the "profits first" rule applies anyway. There is nothing to be gained by increasing the pool of available profits. The rider requires review.

Section 157-85(3)

20. In the Explanatory Materials at paragraph 4.17 it is stated that non-fixed trusts may rely on their accounting records to determine whether a distribution is wholly from available profits. However, the accounting records will almost always not disclose any internally generated goodwill. Furthermore, very rarely will accounting records for a "family/discretionary trust" show the

current market value of land and buildings, or for a share portfolio (except for trading stock). This requirement imposes further compliance costs and needs revision.

21. Subsection 157-85(3) states that if the Commissioner considers the “accounting records significantly undervalue the net market value of it's (ie. the trust's) assets,” then the Commissioner may substitute the value the Commissioner considers is appropriate. Ascertaining the “market value” of assets when they have not been realised on the open market is another extremely vague and imprecise matter. For example, intellectual property such as trade marks, patents, copyright and designs, whilst they may have a value, which is determined when those assets are sold, in an unrealised form the “market value” can span a very large range. It is easy to see the non-fixed trust rules giving rise to a plethora of tax cases based on valuations. This needs further clarification. Safe harbour rules on the determination of market value need to be developed and included in the legislation.

22. Further, another issue exists in how the proposed Section 157-85(3) is to operate in a self-assessment regime. Does the trustee of a non-fixed trust which has assets in its accounting records at historical costs way below market values have to substitute an appropriate net market value for its assets? If it must, then what is achieved other than putting it to the expense of determining the appropriate values? If nothing is to be gained, the need for this requirement needs to be reconsidered.

Section 157-85(4) - Item 2.3

23. The definition of available profits is set out in the proposed Section 157-85. Item 2.3 of the table in the proposed Section 157-85(4) excludes an obligation that is not present legal obligation.

24. This means that no account may be taken of the contingent tax liability associated with any unrealised gain. As a consequence the available profits will be overstated. This is quite unacceptable and if accounts were to be prepared on such a basis they might be regarded as fraudulent. Moreover a member may be taxed on an amount they never can receive because it will go as a tax payment when there is an asset disposal. This statutory over statement of assessable profits is tantamount to fraud and is an unacceptable provision.

25. It would have been fairer if the proposed definition had required available profits to be determined as if there was a disposal at market value of all the assets of the non-fixed trust, so that account is taken of the contingent tax liability. Such a formulation is used in the proposed Sections 115-6 and 115-7 in Taxation Laws Amendment Bill (No 7) 2000. However in the context of the general CGT discount it is not necessary to consider the tax liability, which would be generated. Again further review is required.

Section 157-90

26. The proposed Section 157-90 sets out a general rule for what constitutes a contribution of capital. Where an asset is contributed it is "the market value of the asset" which is the amount contributed. Even though the proposed Section 157-90(3) refers to "the market value exceeds the amount of the liabilities transferred with it" it would appear that would be restricted to an asset, which is transferred together with a secured loan. There does not appear to be any mechanism to reduce the amount contributed by any consideration given by the non-fixed trust. Further review is required.

Section 157-115(1)(c) - Contribution to capital

27. In order to try to satisfy the proposed Section 157-115(1)(c) the original non-commercial loan might be repaid and a new commercial loan drawn down. Unfortunately the original non-commercial loan may not be treated as repaid. This is because the proposed Section 960-190(2) provides that:

Disregard a payment made in respect of the loan if:

(a) a reasonable person would conclude (having regard to all the circumstances) that, when the payment was made, the borrower intended to obtain a loan from the lender of an amount similar to or larger than the payment; and
(b) the payment is not covered by subsection (3) or (4).

28. The proposed Section 960-190(2) may create a problem in another situation. A non-fixed trust may use a commercial loan from a member to acquire a particular asset. It may make the required payments of interest and principal. Then it may use a second commercial loan from the member to acquire another asset. If the intention to enter into the second loan is known when a payment is made on the first loan it may be that the proposed Section 960-190(2)(a) will have been satisfied.

Section 157-120(1)(d)

29. The second circumstance where a loan can give rise to a contribution of capital is in the proposed Section 157-120. The proposed Section 157-120(1)(d) states that interest does not have to be paid for the year in which a loan is made. It is not clear how this provision would interact with the proposed Section 157-115(1)(c). Clarification is required.

30. The proposed Section 157-120(1)(d)(ii) has the effect that annual repayments of principal are not required. The reference to "before the end of the term of the loan" may mean that technically the provision will be breached if the loan is repaid at the end of the term of the loan. This provision needs amendment to correct this anomaly.

Section 157-125

31. The proposed Section 157-125 gives the Commissioner discretion not to apply the proposed Section 157-120. Broadly the discretion is to be exercised where circumstances beyond the control of the non-fixed trust now make it impossible for it to make a payment. This discretion is too narrow and should be reviewed.

Section 157-150(2) - Item 3

32. It may be noted that Item 3, the Subdivision 152-B small business 15 year exemption is excluded from the proposed Section 157-55(1)(b). However Section 152-125(2) provides that any payment must be ". . . within 2 years after the CGT event to an individual". This is inconsistent and needs review.

Section 157-165(2)

33. The proposed Section 157-165(2) provides that:

> The cost base of a CGT asset acquired before 20 September 1985 should not be added under item 1.1 in the table in subsection (1) if the non-fixed trust cannot:
>
> (a) establish that the asset was acquired before 20 September 1985; and
> (b) establish the cost base of the asset.

34. This rather begs the question of how a CGT asset could be a pre-20 September 1985 asset if the non-fixed trust cannot establish that it "was acquired before 20 September 1985". Cost base is determined by Subdivision 110-A. In practice for pre-20 September 1985 assets it may be impossible to determine that cost base as Section 121-30 has not required records to be kept where "any capital gain or capital loss you make (or might make) from it is to be (or would be) disregarded". Again, a review is required.

Section 159-10(1)(e)

35. The proposed paragraph does not take account of the fact that if there are two representatives, they may disagree and exercise different elections. This paragraph needs review.

Section 159-15 – Net income of representative

36. The proposed section does not exclude capital gains. Capital gains of a trust are not usually income. Therefore the section needs to be amended to exclude capital gains of the trust.

Section 160-38A – Benchmark rules

37. The discretion contained in Sections 160-38A(5) and 160-85(1) (ie it can only be exercised in "extraordinary circumstances") is too restrictive. The benchmarking rules should be amended to permit corporate tax entities to vary the franking rate between franking periods by more than 20 percentage points.

Section 160-95 - Distribution statements

38. The proposed Section 160-95 requires that:

    (1) An entity that makes a frankable distribution must give the recipient a distribution statement if the entity is a franking entity at the time the distribution is made.
    (2) The statement must be given before the end of the period of 3 months after the distribution is made.
    (3) The statement may be given before the distribution is made.

39. 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. It would cut compliance costs if distribution statements could be prepared annually, or no more than quarterly to coincide with the BAS periods.

Section 161- 210(2)(d)

40. Non-fixed trusts that are service trusts for accounting firms (big and small), law firms, medical practices etc are adversely affected by the non-fixed trust measures. Because of the wide spread of potential beneficiaries, they cannot be family trusts. Yet they will pay tax and pass out the income to family trusts or individual beneficiaries associated with the partners.

41. The problem appears to be that, although the trusts will pay company tax, the beneficiaries will be ineligible to receive the franking credits. Under the proposed Section 161-210 franking credits are only available 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.

42. 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.

43. The rules dealing with the circumstances in which beneficiaries of a trust can benefit from imputation credits should be amended so as to facilitate the operation of the imputation regime where the non-fixed trust does not make, or is not able to make a family trust election

Section 960-135 - Proportionate rearrangement

44. The proposed Section 960-135 defines a proportionate rearrangement. The justification for excluding a proportionate reduction of all membership interests from the slice rule is that it is no different to any other distribution. The exclusion may be harsh where part or all of a business has been sold and the surplus capital, albeit with a proportion of profits, is being returned to members. A proportionate rearrangement would include a reduction in capital from say one dollar to fifty cents. In addition a proportionate rearrangement would include a pro rata buy back of say 50% of each membership interest. Amendment is required to overcome this inequitable outcome.

Section 960-180

45. There is a potential trap in the proposed Section 960-180(1)(a) (as there is for Division 7A purposes in Section 109N(1)(a) of the 1936 Act) in that there must be a written agreement before the loan is made. This condition may be satisfied if a non-fixed trust enters into a loan facility agreement with any member who may be likely to advance money to the trust.

46. As drafted the proposed Section 960-180(1)(b) may create problems. This is because the interest rate payable must not be less than "the benchmark interest rate . . . for the income year in which the loan is paid". This means that the interest rate must be fixed and cannot fluctuate as the benchmark interest rate changes. In contrast Section 109N(1)(b) of the 1936 Act provides that:

> the rate of interest payable on the loan for years of income after the year in which the loan is made equals or exceeds the benchmark interest rate for the year.

47. It is hard to find a reason for the difference between the two regimes. If the difference is reflected in the final legislation it is likely to cause confusion. Again this clause requires review. From a compliance cost aspect, the best solution would be to fix the benchmark interest rate.

48. As far as the maximum term of the loan is concerned with one exception the provisions are congruent with Section 109N(3) of the 1936 Act. The exception in proposed Section 960-180(2) is that:

> However, the maximum term for a loan is the period worked out under the regulations, if they provide for working out the maximum term for that kind of loan.

49. The ability to specify the term of a loan in regulations may cause some disquiet. The making of the appropriate regulation might change the term of a secured loan from 25 years to a shorter period. This would be done without the rigorous Parliamentary scrutiny that an amendment to proposed Section 960-180(2)(a) would receive.

50. Such discretions should be in the statutory provisions and the use of regulations should be removed. If it was to be retained it should only be available where there is a decision in favour of a taxpayer.

Section 960-195(5)

51. Section 960-195(5) appears to create an amount being "forgiven" by simply refinancing to pay out an existing creditor. This appears to be unintended and it is suggest that this subsection needs to be revisited.

Section 995-1 – definition "class"

52. The definition on one reading appears to say trusts can have "only" one membership class. Unfortunately, this is not what was intended. This definition needs redrafting.

Minor amendments

Section 153-25(2)(a)

53. Insert the word "to" between the words "ceases" and "be".

Section 156-75(1), example

54. In the last line insert the word "the" between the words "between" and "trust".

Section 157-10(1)

55. The words "economic substance" are vague and undefined. As such its placement in an objects clause will only create confusion as it means many different things to different people. Therefore the object of the division in turn is confused. The term should be removed.

Section 157-215

56. The words “membership interests” should be singular.

57. There is also a split infinitive in the first sentence. It should be “normally can” rather than “can normally”.

Explanatory Materials, example 3.3 at page 37.

58. This is not an appropriate situation for a “distribution” to arise (ie the taxable “distribution” to Kia of $100,000). It should be redrafted.

Conclusion

59. The Institute would be delighted 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