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Dear Sir

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

I refer to the *Exposure Draft – New Business Tax System (Entity Taxation) Bill 2000* released by the Federal Treasurer on 11 October 2000 and the accompanying Press Release inviting public comments by 3 November 2000.

Telstra welcomes the opportunity to provide comments in relation to the Exposure Draft.

1. Entity Tax Regime

Telstra appreciates the need for the extremely wide definition given to “non-fixed trusts”. However, given the extremely wide ambit of the definition we believe it is of crucial importance to ensure that the definition of “excluded trusts” is used appropriately to exclude all non-fixed trusts inappropriately caught within the new entity tax regime.

In paragraph 2.8 of the Explanatory Memorandum to the Exposure Draft it is stated that rules relating to what trusts will be excluded trusts for the purposes of the entity tax provisions are to follow. It is also stated that such trusts will essentially be trusts which are created in circumstances where there was no choice to use a structure other than a non-fixed structure.

We believe that this, “no choice”, criteria for excluding trusts is too narrow and will result in trust structures which were never intended to be caught within the new regime nevertheless being included. We believe that it would be far more appropriate to apply the exclusion criteria where the non-fixed structure was considered, for commercial purposes, to be the most appropriate structure to be utilised in the circumstances (for example, because of its obvious compliance, security or regulatory advantages) and where the structure does not result in any tax leakage from the Revenue.

The criteria prescribed in paragraph 2.8 can lead to a taxation bias based solely on the entity used in the transaction, which is contrary to the objectives underlying the business tax reform.

Consequently, Telstra believes that the following categories of trusts should be specifically listed as excluded trusts:

- Employee Share Scheme ("ESS") Trusts which fall within the ambit of Division 13A of the *Income Tax Assessment Act 1936* ("the *Tax Act*"); and

- Customer Loyalty Trusts established specifically to provide loyalty rewards to customers.

(a) Employee Share Scheme Trusts

Corporate employers traditionally establish ESS trusts as a means of encouraging a sense of employee commitment, loyalty, participation and reward. The Government actively encourages participation by employees in such schemes through the provision of taxation concessions to participants pursuant to Division 13A of the *Tax Act* (and formerly through section 26AAC of the *Tax Act).*

While it is not strictly necessary to operate an ESS through a trust, many large corporates, such as Telstra, nevertheless utilise a trust mechanism to operate such schemes. The main reasons for operating an ESS through a trust structure are essentially as follows:

- A trust structure provides an efficient and certain means of ensuring that trading restriction periods imposed on employees with ESS shares (as required by Division 13A of the *Tax Act*) are strictly adhered to and can be easily enforced; and

- The holding of the ESS share in a trust structure provides a means of security where an employer makes a loan to an employee to purchase the ESS shares.

The alternative to holding ESS shares through a trust structure is to utilise a "holding lock" structure over the ESS shares. It is generally considered, depending on the size of the corporate employer, that such a mechanism is a far less certain means of controlling trading restrictions and providing security.

The utilisation of the trust mechanism does not provide any taxation benefits or advantages to either the employer or the participant employees. Any taxation benefits or advantages arising from the operation of an ESS are deliberately created and encouraged by Division 13A of the *Tax Act* and are not created by the type of entity that holds the shares on behalf of the participating employees.

It is submitted that Division 13A provides a comprehensive taxation mechanism for taxing benefits provided to employees through ESS and that this mechanism is complemented by the, "flow-through treatment" provided by Division 6 of the *Tax Act*.

Accordingly, I believe that ESS should continue to receive "flow-through treatment" under Division 6 of the *Tax Act* and therefore should be included in the definition of "excluded trusts". Such a taxing regime reflects the true nature of the trust, being a conduit for holding legal title in the shares while there are restrictions imposed on an employee trading in the ESS shares.

It is considered that it would be inappropriate to tax ESS under the proposed new non-fixed trust regime. To include ESS trusts within the new entity tax regime would simply create added and unnecessary compliance costs (for example through the need to maintain a franking account) in operating an ESS through a trust without creating any benefit to "the Revenue".

A main component of many ESS is an interest free loan to employees to purchase the relevant shares, with a repayment mechanism through dividends derived on the ESS shares. It is considered that the application of the non-commercial loan rules and profits first rule, which will apply to non-fixed trusts, will undermine the viability of this key component of such schemes.

Consequently, to include ESS trusts as non-fixed trusts could destroy the viability of employers offering such plans to their employees in the future or at least could create a tax bias towards operating ESS through a non-trust mechanism such as through the use of holding locks. Such a bias undermines the Ralph Committee's recommendation that the choice of an operating or investment vehicle is determined by commercial considerations rather than taxation considerations.

Finally, various issues in relation to employee share ownership in Australian enterprises have recently been considered by the House of Representatives' Standing Committee on Employment, Education and Workplace Relations in its report titled "*Shared Endeavours*". In particular the Committee addressed the proposed recommendations for Business Taxation Reform ("BTR") and its impacts on ESS and acknowledged at paragraph 4.20 of the Report that:

> "The Committee considers that trusts, as a well established and accepted vehicle for employee share ownership plans:
>
> - minimise the costs associated with the operation of the plan;
> - are easier to administer to ensure compliance with taxation and corporations law; and
> - are a well-established and familiar legal structure resting on a long established and clear body of law."

The Committee concluded by making the following recommendation (Recommendation 26):

> "The Committee recommends that the Government clarify the taxation treatment of trust arrangements that are used to operate bona fide employee share plans established under Division 13A, and legislate specifically to exempt such trusts from proposed entity taxation provisions."

I support the Standing Committee's recommendation.

(b) Customer Loyalty Trusts

Over recent years consumer loyalty reward programs have become extremely successful marketing tools operated by a supplier of goods and services (including credit card providers), or a group of suppliers to encourage customers to be loyal to the supplier(s).

While it is not strictly necessary to operate a customer loyalty reward program through a trust, many large companies, such as Telstra, nevertheless utilise a trust structure to operate such programs. The commercial advantages for operating loyalty programs through a trust structure are essentially as follows:

- The trust structure provides greater security for participating points providers with regard to their contributions to the program; and

- The trust structure provides greater security for participating cardholders with regard to their accumulated reward points.

The Australian Taxation Office in Taxation Ruling *TR 1999/6* has stated that certain flight rewards received under frequent flyer and similar consumer loyalty programs will not form part of a participating customers assessable income. This approach is consistent with the decision of Foster J of the Federal Court in *Payne v FC of T* (1996) 66 FCR 299 (*Payne's* case).

Based on the decision in *Payne's* case and *TR 1999/6*, the vast majority of rewards received by participants in customer loyalty reward programs currently do not form part of those participating consumers' assessable income.

If customer loyalty program trusts fall within the ambit of the proposed entity tax regime, as it applies to non fixed trusts, reward entitlements received by participants in the schemes (which are currently not taxable) would potentially become taxable because of the application of the associated "profits first rule" to the distribution of the reward.

If the loyalty trust did not have any profits at the time of the distribution, the reward could potentially trigger a capital gain if the reward is considered to be a distribution of contributed capital in excess of the recipients cost base for their membership interest.

It is acknowledged, at paragraph 5.15 of the Explanatory Memorandum, that the rules covering distributions of contributed capital where a member has a zero cost base will be introduced in a later Bill. However, it appears from the comments in paragraph 5.15 that the exception to the rule relating to contributed capital to members may only apply in respect of family discretionary trusts and may not be broad enough to include customer loyalty trusts.

I believe that it was never the intention of The Treasury, the Australian Taxation Office or the Ralph Committee to tax participants in customer loyalty programs, established solely for marketing purposes. It is considered that it would be inappropriate to tax customer loyalty trusts under the proposed new non-fixed trust regime. To include customer loyalty trusts within the new entity tax regime would create added and unnecessary compliance costs and an unintended tax liability for persons receiving rewards from loyalty trusts.

Accordingly, I believe that customer loyalty trusts should continue to receive "flow-through treatment" under Division 6 of the *Tax Act* and therefore should be included in the definition of "excluded trusts". I believe that the taxing regime under Division 6 of the *Tax Act* reflects the true nature of the loyalty trust, being a conduit for holding loyalty reward points accumulated by participating consumers.

I believe that to include customer loyalty trusts within the proposed entity tax provisions applicable to non-fixed trusts would clearly undermine their ongoing viability. I believe that it is inappropriate for a taxation policy to effectively destroy a very effective marketing tool, especially where the use of a trust mechanism does not create any revenue leakage and is chosen as the preferred vehicle for commercial and security reasons.

2. Proposed Amendments to the Dividend Imputation System

Telstra welcomes the proposed amendments to the dividend imputation system as set out in the Exposure Draft.

One of our main concerns lies in the area of the benchmark rate for franking of dividends. In particular, we are concerned as to how the benchmark rate rule 1 will apply, in practice, to a consolidated group consisting of numerous closely held subsidiary companies.

I believe that the new franking rules can only operate effectively if the entire corporate group is excluded from the benchmark rules where the holding company is a widely held company and only has one class of membership interest. That is, I do not believe the new franking rules can operate effectively if the holding company is excluded from the benchmarking rules and some or all of its subsidiaries are bound by the benchmarking rules. Such an approach would also be inconsistent with one of the underlying objectives of BTR, namely to treat corporate groups as single economic entities.

In paragraph 7.63 to the Explanatory Memorandum, it is explained that closely held trusts with only one class of shares are excluded from the benchmarking rules on the basis that there are limited opportunities for dividend streaming in such circumstances. As there are the same limitations for wholly owned consolidated subsidiaries to stream dividends we believe that the same logic should be applied and that they should be equally excluded from the benchmarking rules.

I appreciate that the expression "widely held" is yet to be defined and that the proposed definition could clarify this issue. I also appreciate the inter-dependency of all of the various components of BTR legislation and therefore this issue could be addressed or clarified in the drafting of the proposed consolidation legislation or other Business Taxation Reform legislation.

Another area of concern to Telstra relates to the definition of "one class of membership interest" as that expression is used in the benchmarking rules. The definition of "class" as it relates to a membership interest in a company is determined solely on the basis of rights attaching to the interest. It is unclear from the Exposure Draft or its Explanatory Memorandum whether the definition is wide enough to include hybrid debt instruments which are deemed to be equity pursuant to the proposed BTR rules relating to defining debt and membership interests.

I believe that the reference to classes of membership interest should relate solely to classes of shares issued to shareholders and should not encompass hybrid instruments which may be deemed to be equity under the proposed BTR debt/membership legislation. Again I appreciate the inter-dependency of all pieces of BTR legislation and that this issue could be clarified in the pending debt/membership interests legislation.

Finally, it is stated in paragraph 7.8 of the Explanatory Memorandum that the new proposed “gross up and credit” approach merely provides a structural change to the former Part IIIAA of the *Tax Act*. The Explanatory Memorandum fails to note that under the new approach, imputation credits attaching to franked dividends received by a company will be offset against current year losses. The result being that a corporate shareholder could be required to offset current year losses to the extent of the available imputation credit. Such losses would have otherwise been available for offset against other income under the current structure. If this “wasting” of losses was an intended policy change I believe that it should be set out as such in the Explanatory Memorandum.

If you have any questions or wish to discuss the above, please do not hesitate to contact either David Mouritz on (03) 9634 8605 or myself on (02) 9298 4851.

Yours faithfully

John Burke
Group General Manager Taxation