Chapter 21

CONSISTENT TREATMENT OF ENTITY INCOME

A case for reform 471

Existing taxation treatment of entities is inconsistent 471

A strategy for reform 471

Apply consistent rules for entities 471

Key policy issues 471

How would the taxable income of entities be calculated? 471

How should unincorporated associations be treated? 471

How should the taxation treatment of losses be aligned? 472

Should entity concessions be applied uniformly? 473

On what basis should entities be classified for taxation purposes? 474

What rules should apply when an entity moves between different taxation regimes? 476

How should a tax liability be met if the entity has insufficient assets? 476

Which trust beneficiary should bear the economic burden of tax paid by the trustee? 477

A case for reform

Existing taxation treatment of entities is inconsistent

21.1 Under the current tax system, the taxation treatment of companies, trusts, limited partnerships and co-operatives is inconsistent. Inconsistent treatment leads to complexity and increased compliance costs.

A strategy for reform

Apply consistent rules for entities

21.2 *A Strong Foundation* suggested that 'facilitating simplification' should be one of the national taxation objectives and that 'investment neutrality' be a key design principle. Consistent taxation treatment would support such objectives and principles.

21.3 The move to a consistent approach raises a number of policy issues for consideration.

Key policy issues

How would the taxable income of entities be calculated?

21.4 The calculation of taxable income for entities covered by the new entity tax system, including trusts and co-operatives, as a general rule would be determined in a manner consistent with that for companies.

How should unincorporated associations be treated?

21.5 Many unincorporated associations are currently treated as companies for taxation purposes. This treatment would continue under the proposed entity tax regime. Such unincorporated associations may be entitled, depending on the nature of their activities, to an exemption for some, or all, of their income. Additionally, the provision of money, property or services would only be a distribution if made to a person in their capacity as a member of the entity, or an associate of such a member.

How should the taxation treatment of losses be aligned?

Current framework

21.6 Currently trusts and companies have to satisfy different tests relating to factors such as ownership or control to be able to deduct current and prior year losses and bad debts.

A consistent framework for the future

21.7 *A New Tax System* proposed that the taxation treatment of losses held in trusts and companies should be aligned as much as possible. Given the differences in the nature of non-fixed trusts and other entities it does not appear possible to achieve full alignment. However, greater consistency is achievable. A general entity loss framework (consistent with the proposals in *A New Tax System*) could provide the following outcomes.

- Entities would be able to recoup the benefit of prior and current year losses or bad debts if there is majority continuity of beneficial ownership.
  - For non-fixed trusts there would need to be majority continuity of beneficial ownership, for fixed interests in hybrid trusts, no change in control, and less than a 50 per cent change in the pattern of distributions for non-fixed interests.
- Closely held entities would have to test continually for continuity of beneficial ownership. Widely held entities would test for changes in ownership only if there had been abnormal trading in the shares or units. This testing would either be at the end of every year or during the year depending on the circumstances.
- Failing these control and ownership tests, entities would still be able to utilise losses if they met the same business test currently applying to companies.
  - Chapter 28 discusses the option of removing the same business test for all entities as part of a suite of measures aimed at addressing the duplication of single economic losses.

21.8 With the new entity tax system proposed to apply from 1 July 2000, any changes made to the trust loss provisions would apply prospectively from the 2000-01 income year.

Consolidated groups

21.9 *A New Tax System* proposed that discretionary and fixed trusts could be part of the group consolidation regime under consideration. The ability to

use losses within a family group of entities would be formalised within a family group consolidation regime.

21.10 The discussion concerning family group consolidation is in Chapter 26.

The 'closely held' and 'widely held' distinction

21.11 Application of the current company loss measures varies depending upon whether the company is classified as being either private or public. Similarly, the trust loss measures are currently based upon the type of trust, such as whether the trust is a fixed trust (other than a widely held unit trust), an unlisted or listed widely held trust, an unlisted very widely held trust, a wholesale widely held trust, a non-fixed trust, a family trust or an excepted trust (other than a family trust).

21.12 Consistency of treatment across entities would require common loss measures to apply to all closely or widely held entities subject to the new entity tax system.

21.13 The distinction between closely held and widely held entities, the merits of adopting such a distinction and a common basis for the distinction are discussed later in this chapter.

Transitional arrangements

21.14 One transitional issue requiring consideration concerns the treatment of prior year trust losses carried forward to 1 July 2000, the start of the proposed new entity tax system.

21.15 The simplest option would be to apply the loss arrangements described above for the new entity tax system to *all* prior year losses existing from the start date of the new regime, regardless of when they were incurred.

Should entity concessions be applied uniformly?

21.16 As a general principle, entities subject to the proposed new entity tax system should have consistent access to tax concessions.

21.17 This general principle does not preclude the restriction of particular concessions to particular entity types for non-tax reasons.

21.18 In the case of concessions such as Pooled Development Funds and Film Licensed Investment Corporations, the relevant entities could be dealt with outside of the new entity tax system (though some consequential changes may need to be considered to ensure compatibility with the new system).

21.19 The existing research and development (R&D) concession is an example of a tax concession currently available only to companies. The proposal in *A New Tax System* to retain primary production averaging in relation to trust income would be an example of concessional treatment provided just for trusts.

On what basis should entities be classified for taxation purposes?

21.20 Companies are currently classified for tax purposes as either private or public companies (the distinction differs from that in the Corporations Law). Private companies are generally subject to more stringent tests, and the distinction is relevant in a number of circumstances. These more stringent tests derive from the closely held nature of most private companies which provides greater scope to manipulate the taxation position of members in such a way as to reduce the overall tax liability of the entity and its members.

21.21 An example of more stringent rules applying to closely held entities is found in the treatment of certain loans and payments by private companies to associated persons. If, under those rules, the loan is a disguised distribution of profit, the loans may be treated as a dividend. Excessive salary and wage payments are also disallowed as deductions for a private company and treated as a dividend.

21.22 Consideration could be given to removing the distinction between public and private companies and applying one set of rules to all entities subject to the proposed new entity tax system. While this is appealing conceptually, it would mean either applying more stringent rules to public companies (and other comparable entities) or weakening the integrity of the tax system as it applies to private companies.

21.23 If removing the private/public company distinction were not considered feasible, it would be necessary to consider means of applying a distinction of that sort in a consistent manner to all entities. Three options are discussed below.

Option 1: Use the 'public' and 'private' distinction

21.24 The current classification of private and public companies could be maintained and extended to fixed and non-fixed trusts. The benefit of this approach is that the current classifications are understood in relation to companies. The potential disadvantages are that fixed and non-fixed trusts may not 'fit' easily into such categories, especially as under trust law 'public trust' and 'private trust' already have established meanings in many jurisdictions.

21.25 In addition, the current classification of limited partnerships as public companies would need to be reconsidered. This public company status has been used by closely held groups to avoid the operation of provisions aimed at such practices as disguising distributions as loans and avoiding tax on unfranked dividends. One option would be to treat all limited partnerships in the same way as private companies. The effects of consolidating entity groups and the introduction of full franking arrangements (or taxing unfranked inter-entity distributions) would be relevant to this issue.

Option 2: Use the 'closely held' and 'widely held' distinction

21.26 Under this option two new categories would be established: 'closely held entities' and 'widely held entities'. All companies and trusts (other than excluded trusts, discussed in Chapter 22) and co-operatives as well as all limited partnerships, would be closely or widely held in accordance with a common test.

21.27 'Closely held entity' and 'widely held entity' could be defined on the basis of the rationale behind the current distinction between private and public companies.

21.28 The class of closely held entity could be defined as entities where 20 or fewer individuals hold, directly or indirectly, 75 per cent or more of the interests in the profits or contributed capital of the entity. This is the definition referred to in Chapter 16 in relation to collective investment vehicles. All non-fixed trusts would be treated as closely held, as the discretionary objects of such a trust do not have an interest in either the profits or contributed capital of the trust. This treatment is consistent with the current treatment under the trust loss measures.

21.29 A widely held entity would be any entity that is not a closely held entity.

21.30 Additionally, if this option were adopted consideration would need to be given to extending widely held status to certain types of entities which would otherwise be treated as closely held. For example, should wholly owned subsidiaries of a widely held entity (outside consolidated groups) also be treated as widely held? Should non-profit entities be treated as widely held or closely held?

Option 3: Draw on the Corporations Law

21.31 The Corporations Law currently distinguishes between closely and widely held companies for corporate governance purposes. The distinction is at two levels.

21.32 First, the law distinguishes between proprietary and public companies. A proprietary company may not have more than 50 shareholders, not including employees. Accordingly, companies with more than 50 shareholders must be public companies.

21.33 The second distinction turns on whether the entity is a disclosing entity. Disclosing entities have additional financial reporting obligations considered necessary because the ownership and management groups would ordinarily be different. In general terms, they include bodies that:

- have securities quoted on a stock exchange; or
- have issued securities under a registered prospectus, takeover or scheme of arrangement and have maintained at least 100 members since one or other of these events occurred.

21.34 Drawing on these Corporations Law distinctions would involve a widely held body being either a public company or a disclosing entity. All other bodies would be closely held.

What rules should apply when an entity moves between different taxation regimes?

21.35 A particular entity may move from being subject to the entity tax regime to being taxed in some other way. Alternatively, an entity may become subject to the entity tax regime at a point after it comes into existence.

21.36 Consideration needs to be given to what rules should apply in these situations.

How should a tax liability be met if the entity has insufficient assets?

21.37 The tax liability of an entity would generally be met by the entity, or someone on behalf of the entity (for example, a trustee), out of the assets of the entity. However, where the entity has insufficient assets to pay the tax, there is an issue of how the liability is to be met. Under the current tax system, there have been considerable administrative problems involved in collecting tax from entities when the liability has not been met and there are no longer any assets in the entity to pay the tax. Any solution should take into account both the current legal framework and the limited liability currently enjoyed by most company shareholders.

21.38 The *Taxation (Unpaid Company Tax) Assessment Act 1982*, in limited circumstances, imposed a liability to pay unpaid company tax upon the former shareholders of that company. The Act also had a limited form of tracing to

individual shareholders and beneficiaries of companies or trusts that had been shareholders in a company that had an unpaid tax liability. The individual shareholders' and beneficiaries' liability was based on the benefit that they had received. These provisions did not apply where trustees were liable for the original unpaid tax.

21.39 Currently, the *Crimes (Taxation Offences) Act 1980* imposes criminal sanctions on individuals who enter into arrangements with a purpose of ensuring that a company, or trustee, will be, or is likely to be, unable to pay income tax that is, or is reasonably likely to become, payable. The courts also have a discretion to order a person convicted under this provision to pay an amount up to the unpaid tax liability. This amount is then offset against the unpaid amount of tax. This provision allows recovery of the unpaid tax only from persons who have actually been convicted of the offence, and then only at the discretion of the court. There is no tracing based on the receipt of a benefit as a result of the arrangement.

21.40 Consideration needs to be given to what rules should apply for the collection of unpaid company tax. A starting point for determining a sound basis for the collection of unpaid company tax is the proposition that those individuals who were knowing parties to an arrangement which resulted in the entity being unable to pay its tax liability should themselves be liable to pay the tax. A related question would be whether the test should extend to parties related to such knowing parties.

21.41 In applying such a test, it would not always be clear who was a party to the arrangement. For example, prior to paying its company tax liability, a discretionary trust could distribute all of its assets to a single object of the trust. The object has certainly benefited from the arrangement, but it may have done no more than be a passive recipient of the distribution.

Which trust beneficiary should bear the economic burden of tax paid by the trustee?

21.42 In the case of a trust estate the trustee will have the primary liability for company tax. A question arises as to which beneficiaries should bear the economic cost of that tax liability.

- For example, should the tax be paid from the income of the trust, in which case the income beneficiaries bear the cost of the tax?

21.43 An additional issue arises where the trustee has a liability for deferred company tax.

- Should the economic cost of that tax be met from the entitlements of the beneficiary who received the distribution which gave rise to the liability, or should the cost be borne by the beneficiaries generally?

21.44 One option for dealing with these issues is to allow trustees and relevant beneficiaries to determine which assets are to bear the economic burden of the tax liability in accordance with trust law.