29 March 1999

Dr Alan Preston
Secretary
Review of Business Taxation
Department of Treasury
Parkes Place
CANBERRA ACT 2600

Dear Dr Preston

**A Platform For Consultation – First Submission**

I am writing to provide Lend Lease's comments on the second discussion paper released by the Review of Business Taxation ("RBT") titled: ***A Platform for Consultation***.

Lend Lease is an Australian based international property and financial services group with $71bn in funds under management and administration.

In Australia, the MLC financial services group has $29bn in life insurance and funds under management and is responsible for the interests of 1.1 million policyholders, superannuation members and unitholders. Lend Lease is also the manager of the listed property vehicles, GPT and Darling Park Trust, with over 76,000 unitholders.

Lend Lease welcomes the opportunity to participate in the review process and fully supports the aims of the Review. I understand the consultative process and the availability of the Review staff to meet and discuss issues through the Focus Groups has been (and continues to be) an outstanding success.

I understand that you have encouraged comments to be made before 16 April 1999 particularly where the issues are considered to be of importance. In response to that invitation I propose to provide our comments over the period to 16 April with a final submission lodged at that time.

The two issues that most concern Lend Lease remain those referred to in my letter to you of 17 December 1998. They are:

- The taxation of superannuation, particularly where it is provided through pooled vehicles such as Pooled Superannuation Trusts (PSTs) and Life Companies; and
- The taxation of Collective Investment Vehicles ("CIVs").

The Treasurer's announcement of 22 February 1999 was a significant step forward in alleviating our concerns on the taxation of CIVs. In order to further clarify the position we ask that the Review clarify the reference to the "in-principle" exclusion in the Treasurer's announcement.

The attached four Appendices contain Lend Lease's detailed comments on each of these matters. A summary of Lend Lease's position is outlined below.

**Taxation of Superannuation**

If the proposals to subject Life Companies superannuation and PSTs to entity taxation proceed in their current form over 5 million investors whose superannuation savings are with Life Companies or PSTs will be significantly disadvantaged.

The only competitive alternative will be for Life Companies and PSTs to establish their own public offer superannuation funds and offer to transfer millions of investors and $200bn in underlying investment assets to these new funds. That will trigger income tax, capital gains tax, stamp duty, GST and administration costs materially disadvantaging those investors for no benefit to any party.

The current tax treatment of superannuation investors in Life Companies and PSTs leads to no loss of revenue. The proposed reforms seriously disrupt the superannuation savings of millions of Australians and impose upon them additional costs for no benefit, either to the investors or the Government.

The benchmark for the design of the existing system of taxing superannuation provided by Life Companies and PSTs has always been the treatment of stand-alone superannuation. Implementation of the RBT proposals will have the effect of unilaterally altering that benchmark so that superannuation provided by life companies and PSTs will be aligned with the taxation of companies. This will mean that investors in pooled superannuation, provided by Life Companies and PSTs, will be materially disadvantaged when compared to the taxation treatment of members in "stand alone" superannuation funds.

The material tax disadvantages are as follows:

- Superannuation investors in unit linked life contracts (which form the bulk of life office superannuation) will not be able to obtain a refund or credit for the 21% overpaid tax until the superannuation policy matures or is surrendered, which could be for as long as 30 to 40 years. This is a major cash flow disincentive to investing in Life Company superannuation products.
- Superannuation investors in capital guaranteed and investment account contracts (which are unique to the life insurance industry) will pay tax, at 36%, on unrealised gains. No other superannuation investors, or indeed any other taxpayer, will be taxed on unrealised gains;

- Certain exempt foreign income and tax preferred income received by Life Companies and PSTs will be subject to tax when distributed to superannuation investors. Identical investments made by a "stand alone" superannuation fund will not be subject to this new tax. This anomaly will exist regardless of the development of an efficient refund mechanism.

In addition to the material tax detriment suffered by investors the proposals will:

- Reduce the range of investment choice to trustees of superannuation funds (and in many cases their members), by denying access to investment options provided by Life Companies and PSTs.
- Reduce competitiveness by making Life Company superannuation and PSTs commercially unattractive. This will advantage DIY and Industry Funds.
- Create capital market disruption as Life Companies and PSTs transition their assets to public offer superannuation funds so as to restore tax neutrality.
- Compel thousands of superannuation funds, whose sole investment is in either a PST or Life Company super policy, to have to lodge tax returns so as to obtain refunds of overpaid tax. This will impose a significant additional compliance burden on both the funds and the ATO.

Lend Lease strongly urges the Review of Business Taxation to endorse the existing superannuation tax regime and to reject, as unworkable, proposals which would:

- Materially disadvantage investors in pooled superannuation vehicles such as Life Companies and PSTs; and
- Create competitive distortions between superannuation products, where currently no distortion exists.

In Lend Lease's view:

- PSTs should continue to provide 15% tax paid returns to superannuation fund investors; and
- Life Company superannuation should be taxed on a basis corresponding to that applying to Retirement Savings Accounts. Investor returns would be taxed at 15%, while shareholder returns, including fee income, would be taxed at the corporate tax rate.

Our detailed comments are included in Appendix 1.

## Collective Investment Vehicles

Lend Lease welcomes the Treasurer's announcement of 22 February 1999 that "flow through" taxation status will continue to apply to cash management trusts and "in principle" to certain other CIVs. We understand this decision to be consistent with the proposal contained in Chapter 16 of the Review's second discussion paper.

In Lend Lease's view the Review (or the Government) should clarify the position of all CIVs at the earliest opportunity. For example, the present "in principle" exclusion of some CIVs (as opposed to the absolute exclusion of CMTs) from the entity tax regime has created uncertainties.

CIVs are typically trusts in which individual investors, either directly or indirectly (via other pooled vehicles), pool their investment capital so as to obtain access to a range of investment opportunities which would otherwise be denied them as individual investors. In addition they are able to diversify risk and access the services of professional investment managers.

In Lend Lease's view eligibility for "flow through" tax treatment as a CIV should be determined having regard to factors including:

- Profile of the underlying investors.

  A substantial majority of these investors should be individuals, or vehicles that invest the savings of individuals such as Superannuation Funds, ADFs, PSTs, Life Companies, Master Trusts or Excluded Trusts.

- Diversity of ownership.

  Any requirement that a CIV be "widely held" should be determined having regard to both direct ***and indirect*** ownership without the introduction of complex tracing rules. This would permit ownership by relatively few legal entities albeit that those entities invest on behalf of many underlying investors.

  It should also take account of whether the CIV is newly established, or being wound down, when there may be an unavoidable initial or final period of concentrated holdings.

- Sufficient Distribution

  At present CIVs are effectively required to distribute all of their taxable income to the underlying investors, otherwise the trustee is required to pay tax at punitive rates. In circumstances where errors arise in calculating the required distribution, the failure to properly distribute can give rise to disproportionate consequences for the investors. For this reason Lend Lease would advocate that CIVs be required to ***distribute substantially all but not necessarily 100%*** of their taxable income to underlying investors.

  By way of comparison, Real Estate Investment Trusts in the United States are effectively entitled to "flow through" taxation status provided, among other things, they distribute **95%** of their taxable income. For US mutual funds the distribution percentage is effectively **98%**.

Our detailed comments are included in Appendix 2.

**Excluded Trusts**

Our recommendation is that the proposed list of Excluded Trusts should be expanded to include discretionary master trusts and "WRAP" accounts.

These recent product innovations have seen the emergence of combined custodial/nominee and investment administration services in the form of member discretionary master trusts and "WRAP" accounts.

These products, while using the form of a trust, have been established simply to provide efficient ways to administer and report on portfolios for investors. The underlying investors pay tax on an annual basis. There is no tax deferral associated with these arrangements.

We have attached as Appendix 3 our detailed comments on these arrangements.

**Tax Preferences flowing through CIVs**

A Platform for Consultation raises for discussion the treatment of tax preferences flowing through CIVs. The discussion paper proposes that tax preferences could be either taxed or untaxed.

In Lend Lease's view the flow through of tax preferences to investors in CIVs is the position which most correctly reflects the taxation treatment of a direct investor. Since the benchmark for the taxation of CIVs is that of the underlying investors it is appropriate for the characteristics of those tax preferences to flow through the CIV. Enabling tax preferences to flow through to the underlying investors will be consistent with the way interest income, dividends, foreign income and capital gains will also retain their character.

Lend Lease does not agree that the flow through of tax preferences would give rise to a need for investment criteria to apply to CIVs. The discussion paper suggests that CIVs holding assets such as shopping centres and office buildings should be subject to investment criteria so as to preclude them from having a controlling interest in an "active" business. The rationale being that CIVs could have a competitive advantage over entities subject to the "entity" tax regime.

The existing tax law already contains rules that would operate to tax a CIV like a company in circumstances where it is carrying on a business. Lend Lease considers that the continuation of those rules should provide a better alternative than restrictive, complex rules which try to distinguish between passive and active businesses.

Furthermore the imposition of investment criteria could force CIVs to divest existing interests in relatively illiquid assets to the detriment of investors.

**Employee Share Scheme CIVs**

The taxation of employee share schemes where those schemes are provided by way of trust does not appear to have been explicitly considered in A Platform for Consultation.

Lend Lease submits that employee share scheme trusts:

- Are not vehicles associated with tax avoidance;
- That all share scheme income flows through to the employee beneficiaries of the trust on an annual basis;
- That employee share schemes are already subject to their own well established code of taxation under the existing law. That code is designed to encourage employee share ownership;
- That to tax employee share schemes provided by way of trust would create competitive non-neutralities with employee share schemes that do not utilise a trust structure.

For these reasons Lend Lease encourages the Review to provide a clear statement that employee share scheme trusts will not be subject to the entity basis of taxation.

Our detailed comments are included in Appendix 4.

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I trust that the above comments are of assistance to the Review in formulating its recommendations to Government.

I would appreciate if senior officers of Lend Lease were able to meet and discuss this submission with you at your earliest convenience.

Yours faithfully

David Higgins
**Group Chief Executive**

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**APPENDIX 1**

# TAXATION OF SUPERANNUATION

## Background

Superannuation is provided through vehicles which:

1. have been established for the sole purpose of providing superannuation benefits;
2. are subject to the Superannuation Investment Supervisory ("SIS") legislation, or the Life Insurance Act, and
3. are subject to the superannuation tax regime under which investment income is taxed at 15%.

A robust superannuation regime, well supported by the Government, the public and employers, is crucial for longer term national savings, the well being of our growing retired population, and the avoidance of a drain on Government resources.

The preservation of the 15% tax regime for all superannuation investment vehicles is essential to maintain widespread community support for superannuation.

## Types of Superannuation Investment Vehicle

The primary vehicle is the "stand alone" superannuation fund. This includes employer superannuation funds, industry funds, public offer superannuation funds and DIY (Do-it-Yourself) superannuation funds.

These funds may invest in markets directly.

Alternatively they may invest in Pooled Superannuation Trusts (PST's) or Life Company superannuation policies, which vehicles have been approved by the authorities to provide only superannuation benefits. Essentially such vehicles are intermediaries between the "stand alone" fund and the investment markets.

Other superannuation investment vehicles are those available for direct investment by individuals - Retirement Savings Account ("RSAs") and Deferred Annuities and Approved Deposit Funds ("ADFs").

Total superannuation assets at 30 June 1998 were $364b. Of this, $123b was invested in Life Company superannuation policies and $78b in PSTs.

## Why are Superannuation Collective Investment Vehicles Important?

Essentially, they provide pooling of investments for millions of individuals. By dealing in larger amounts, a greater spread of underlying investments is obtained which reduces the investment risks. Unit costs of investment administration are also lower.

The individual "pools" within the PST or Life Company can also facilitate the making available of choice of investment for members.

**Life Company superannuation policies can also provide strong capital guarantee options which, by virtue of the prudential reserves required by APRA, are stronger than the capital guarantees implied in Industry Funds that are not subject to that degree of regulation.**

PSTs and Life Company superannuation policies provide superannuation tax paid vehicles for fund managers, thereby reducing the trustees' work in tax administration. They also provide diversification of investment for larger superannuation funds – in particular for those wishing to invest more widely – such as into venture capital or infrastructure development.

### Submission

If implemented without modification, the RBT proposals will have the effect of:-

- ***Disadvantaging the superannuation of all members of funds invested in Life Company superannuation policies and Pooled Superannuation Trusts.***

  Members of funds invested in Life Company superannuation policies and PSTs will incur 36% tax on their investment income and be required to wait, possibly until retirement, for the 21% refund to reduce the tax to the superannuation norm of 15%.

  Apart from the unfair loss of cash flow, the funds will incur the additional administrative costs involved in claiming the tax refunds. These costs will ultimately be borne by the members.

  There are approximately 5 million such potentially disadvantaged members – more than half the country's total superannuation membership.

- ***Through the application of the Deferred Company Tax (or RDWT) proposals, causing the disadvantaged members to incur tax on unrealised gains, lose the benefit of indexation of gains, and incur tax on tax preferred income like foreign investment income and depreciation allowances – all of which will remain for members of Stand Alone Superannuation Funds (including Industry Funds) investing directly in the investment markets.***

  It is imperative that tax legislation does not differentiate on the treatment of tax preferred income of superannuation business. Under the current proposals stand alone superannuation funds (either industry funds, public offer funds or Do-it-Yourself funds) will receive the benefit of tax preferred income. PSTs and superannuation conducted through a Life Company will not receive the benefit of tax preferred income if the tax is to be imposed on the amount credited to the member of the PST or the superannuation policyholder in a Life Company. The proposals therefore discriminate between different entities conducting the same business.

  There is increasing competition for superannuation funds and as such relatively minor points of differentiation are seized upon and exploited by competitors, advisors and investors. Unless tax preferred income is protected in both PSTs and Life Company superannuation business, superannuation investments will transition from PSTs and Life Companies to stand alone public offer funds.

All superannuation business should be taxed on a comparable basis regardless of the entity in which it is conducted. Tax preferred income should be treated on the same basis in all forms of entity conducting superannuation business. The imposition of a 36% rate, DCT/RDWT and taxing tax preferred income creates discrimination and complexity.

- ***Providing a bias in favour of Industry Funds and RSAs***

  Industry Funds tend to make most of their investments directly into the markets while many employer funds and public offer funds utilise Life Company policies and PSTs. These pooled vehicles enable the fund to offer a wide range of choice to members as regards their investment mix. If such vehicles are disadvantaged through tax changes, the funds will revert to investing directly, with reduced investment choice for members. One choice that would be lost is the opportunity to invest in Life Company policies with long term capital guarantees, which are unique in the market.

- ***Providing a bias in favour of "Do It Yourself" (DIY) superannuation investment against the use of a pooled approach. A member of a superannuation fund should be able to make suitable judgement as to whether it is desirable to utilise the risk reducing benefits of diversification of investments, on a level playing field basis as far as tax is concerned.***

  **T**his is an important issue for many investors who can only obtain diversification through a pooled approach. For some asset sectors, such as property, international shares and venture capital, even very large superannuation funds use superannuation investment vehicles to ensure prudent diversification of investments and to access specialist investment expertise.

  Additionally, since DIY schemes usually only have a few members, unit administration and transaction costs tend to be much higher than under pooled arrangements, which impacts member benefits.

**What are the Problems associated with Taxing Life Company Superannuation Business?**

By their nature, for policyholder security purposes, Life Company statutory funds include both shareholders' and policyholders' assets.

However, the separate taxation of shareholders and policyholders income for superannuation business can be achieved in a robust manner by simply extending the principles already in force for taxing of RSAs.

With relatively minor modifications, the options set out in the Ralph Committee paper can achieve an equivalent taxation position without disrupting the retirement arrangements and expectations of millions of individuals.

Essentially, all the taxable income in a life company's superannuation statutory fund, including fees on policies, would be subject to tax at the company rate, 36%, other than the income which has been credited to members, or set aside for them. For superannuation business, members' income would be taxed at 15%.

Apportionment of income and expense issues need not arise under the new regime: Policyholders are taxed on what is credited to them: Shareholders are taxed on the remaining taxable income, including fees on policies.

There is no purpose or benefit to the Government from the proposed changes. They will simply cause enormous disruption to an efficient and competitive market and widespread resentment.

Treasury numbers indicate that there is no anticipated revenue gain, or timing benefit, from the implementation of the proposals. To the extent that the actual outworking would cause revenue gain or timing benefit, it is probable that many funds will change their investment structures to avert this impact.

## Recommendations

The Review is asked to submit to the Government that:

(i) It supports the principle of taxation of superannuation investment vehicles on the current 15% tax paid basis,

(ii) It notes that "A New Tax System" (ANTS) paper did not suggest that the taxation of such vehicles at 15% on investment earnings should fundamentally be changed,

(iii) The proposals in the ANTS paper (to levy 36% on the investment earnings on some vehicles with 21% to be refunded on application) will cause material disadvantage to the members of funds investing in such vehicles and major disruption in the industry.

# TAXATION OF COLLECTIVE INVESTMENT VEHICLES ("CIVs")

It is submitted that the definition of CIVs excluded from the proposed Business Entity Tax Regime be widened to accommodate all trusts satisfying the requirements set out below.

**Background**

- The managed funds industry does not consist of a single layer of trusts interposed between investors and direct investments. It is submitted that the flow-through concept should apply to all layers of trusts involved in the industry.

  At present such trusts are effectively required to distribute all of their taxable income to the underlying investors, otherwise the trustee is required to pay tax at punitive rates.

- Individual investors will normally invest into Retail Trusts, so called because they will predominantly issue their units directly to the end investor. Retail Trusts may reinvest some or all of the funds received by acquiring units in intermediary trusts (including Wholesale Trusts) which are perceived to have investment expertise in a particular asset sector or a particular part of an asset sector.

- The minimum subscription required to invest in a Wholesale Trust is quite substantial - commonly $500,000. There are a number of reasons why this minimum subscription policy is adopted, including the fact that the trust can obtain certain efficiencies and minimise administrative costs as a result of the policy. This is reflected in the fact that the various fees associated with a Wholesale Trust are usually lower than those for a Retail Trust.

- The individual investor would not normally have access to investment in a Wholesale Trust because of the minimum subscription amount required. The benefits of investing in Wholesale Trusts can be accessed, however, where the funds of individual investors are pooled in a Retail Trust which then invests in a Wholesale Trust.

- At present the existing provisions in Division 6C of Part III of the Income Tax Assessment Act 1936 (1936 Act) limit the scope of a public unit trust to invest without being treated as a company. Division 6C effectively restricts the activities of a trust to the derivation of passive investment income (which includes the derivation of rental income from office buildings and shopping centres).

**Submission**

- The concept of "flow through" CIVs must include participants at all layers at the managed funds industry. The mere fact that the ownership of a trust is concentrated should be irrelevant if regard is had to the underlying beneficial ownership. The concept of "flow through" must be sufficiently defined to include trusts where the unitholders/beneficiaries of the trusts are entities such as (other) widely held trusts, complying superannuation funds, ADFs, PSTs, Life Companies and Excluded Trusts.

  This concept has previously been accepted in relation to other income tax provisions. Particular reference is made to Section 160APHR(1)(k) of Taxation Laws Amendment Bill No. (4) 1998 concerning the "45 day rule" and the availability of franking credits. In broad terms, this section states that a unit trust will be considered to be widely held if at least 75% of the units in the trust are themselves held by widely held entities.

**Recommendation**

If a trust conforms to the following requirements it should be treated as a Collective Investment Vehicle exempted from the proposed Business Entity Tax Regime:

***Profile of the underlying investors:***

A substantial majority of the underlying investors are individuals, or vehicles that invest the savings of individuals such as complying superannuation funds, ADFs, PSTs, Life Companies and Excluded Trusts.

***Diversity of Ownership***

This should be determined having regard to both direct and indirect ownership and should also take account of whether the CIV is newly established or being wound down. In other words, any requirement that a CIV be "widely held" should be determined having regard to both direct and indirect ownership interests. This would permit ownership by relatively few legal entities albeit that those entities invest on behalf of many underlying investors.

"Widely held" should therefore include any trusts where at least 75% of the trust property or units are held by another widely held trust (including a trust which is deemed to be widely held by a previous operation of this extended definition), a Complying Superannuation Fund, a Complying ADF, PST, Life Company and/or an Excluded Trust.

***Sufficient Distribution***

At present CIVs are effectively required to distribute all of their taxable income to the underlying investors, otherwise the trustee is required to pay tax at punitive rates. In circumstances where errors arise in calculating the required distribution, the failure to properly distribute can give rise to disproportionate consequences for the investors. For this reason Lend Lease would advocate that CIVs be required to distribute substantially all but not necessarily 100% of their taxable income to underlying investors.

By way of comparison, Real Estate Investment Trusts in the United States are effectively entitled to "flow through" taxation status provided, among other things, they distribute 95% of their taxable income. For US mutual funds the distribution percentage is effectively 98%.

Lend Lease recommends that provided a CIV distributed 95% of its taxable income it should retain flow through status.

### *Eligible Investment Business*

We submit that the statement on page 374 (paragraph 16.24) of ***A Platform For Consultation*** is entirely incorrect when it suggests that an active business consists of the ownership of office buildings and shopping centres. The management and administration of these buildings (the active business) is invariably conducted in a separate, often unrelated, legal entity to the entity that owns the assets. Where an owner merely holds the assets to derive rental income and the administration of the building or shopping centre is conducted separately that this amounts to a passive investment on the part of the owner of the asset.

We recommend the provisions of Division 6C of Part III of the 1936 Act which define in section 102M eligible investment business be incorporated into the required profile of an eligible CIV.

### *Full Flow Through of Tax Preferred Income*

Unless the full flow through of tax preferred income is protected, property held in a CIV will be differentiated from property held by an individual. In effect tax preferred income will only be available to those investors who are sufficiently well off that they can invest in property assets without the need for pooling their investment through a CIV.

We recommend that a CIV be able to distribute tax preferred income without the imposition of tax at the CIV level.

# EXCLUDED TRUSTS

It is submitted that Member Discretionary Master Funds (commonly known as Master Trusts) and WRAP Accounts satisfying the requirements set out below should be classified as "excluded trusts" as set out in chapter 22 for the purposes of the proposed Business Entity Tax Regime.

**Background**

- Products have been developed which combine custodial/nominee services with investment administration services. Such products are commonly referred to as Member Discretionary Master Trusts and WRAP Accounts.
- The trustee of a Member Discretionary Master Trust has no discretion in relation to the trust, rather the term "discretionary" refers to the fact that the individual investors, not the manager of the Master Trust, chooses the underlying investments.
- A member in a Member Discretionary Master Trust has an absolute beneficial interest in his or her investments in the trust. Essentially it is an investment administration service using a trust as the legal vehicle. The services include consolidated tax and financial reporting of the investment portfolio, execution of buy and sell orders, and access to investment research and information.
- The individual trusts within the Master Trust are also provided with access to Wholesale Trusts.
- WRAP Accounts provide a similar service. They generally involve a custodial/nominee service combined with the other services outlined above. Again, an investor in a WRAP Account has an absolute beneficial interest in the underlying investments.
- Both products are technically innovative and provide efficient ways to administer and report on an investment portfolio. The products merely seek to reduce the administrative burdens of the investor and there are no tax deferral opportunities associated with the products.
- Tax is paid in accordance with the requirements of the underlying investments – whether they are direct investments, life company policies, or other trusts falling into the "flow through" collective investment vehicle definition set out in Appendix 2.

**Submission**

- As stated above, the investor enters into these products merely to simplify the administration, settlement and reporting of the underlying investment portfolio. In all circumstances the investor retains absolute beneficial interest in the income and capital of the trust and therefore has real economic ownership of the trust property.

- The investors should therefore, for tax purposes, be treated as owning the property directly. Therefore the trust relationship should be ignored and all acts of the trustee should be treated as those of the beneficiary.

**Recommendation**

If a trust conforms to the following requirements, it should be treated as an "excluded trust" for the purpose of the proposed Business Entity Tax Regime:

*(i)* ***the beneficiaries are absolutely entitled to the income and capital of the trust on a continuous basis,***

*(ii)* ***all distributions flow directly to members' accounts,***

*(iii)* ***the members will be subject to tax on the distributions, including realised gains, in the year of receipt by the trust,***

*(iv)* ***the trustee or manager has no discretion over the distribution of a any monies flowing into the trust.***

The paper suggests alternative methods of taxing excluded trusts. We submit that the Member Discretionary Master Funds and WRAP Accounts be ignored as trusts, and all acts of the trustee should be treated as those of the beneficiary who is made directly subject to the tax.

# EMPLOYEE SHARE SCHEME CIVs

## Summary

The strategy for reform described in Chapter 22 of ***A Platform for Consultation*** is to align the taxation of trusts as closely as possible with that of companies. It is accordingly proposed that the new entity tax system would apply to all resident trusts unless they are specifically excluded.

Taxing genuine employee share trusts as companies will negate a number of key benefits offered by employee share schemes. Furthermore, much complex legislation would be required to overcome anomalies which will arise if employee share trusts were to be taxed as companies.

To tax genuine employee share trusts as companies will accordingly be contrary to two stated aims of the tax reform process: to improve the concessions for employee share schemes (page 13 of ***Tax Reform - Not a new tax, a new tax system***) and simplicity.

The taxation of employee share benefits is detailed comprehensively in Division 13A of Part III of the Income Tax Assessment Act 1936 ("the 1936 Act"). Those provisions permit no tax leakage.

Genuine employee share trusts should be excluded from the new entity tax system. To be excluded those trusts could be defined by reference to existing legislation, for example, paragraph (ha) and (hb) of the definition of "*fringe benefit*" in s.136 of the Fringe Benefits Tax Assessment Act 1986 ("the FBT Act"). The concept of excluding employee shares from legislation affecting other trusts was most recently endorsed in Taxation Laws Amendment Bill (No.4) 1998, whereby franked dividends distributed by genuine employee share trusts were excluded from the so-called "*45 day rule*".

## Background

The platforms of each of the major political parties in Australia support the encouragement of employee share schemes through maintaining the existing concessional tax treatment of the benefits provided under such schemes.

Page 13 of the Government's Tax Reform Package, "***Tax Reform - Not a new tax, a new tax system***", states that the policies outlined in the document are intended to build on a range of measures implemented by the Government intended to:

- reduce the tax burden,
- strengthen compliance,
- increase the system's fairness, and
- encourage investment and entrepreneurial activity.

The Government has a long history of recognising that employee share schemes should be encouraged. Indeed, one of the measures identified on page 13 in the Tax Reform Package is the improvement of concessions for employee share schemes.

A great number of employee share schemes like the Lend Lease Employee Share Acquisition Plan ("ESAP") are administered by leading Australian companies through trust structures.

As an example, for Lend Lease Corporation Limited, this means that the ESAP Trust holds Lend Lease shares on behalf of more than 3,300 beneficiaries (employees). This is a common practice where the employee will not become entitled to the shares until certain conditions are satisfied eg. where a minimum employment period must occur.

**Current Taxation Arrangements**

The Lend Lease Employee Share Acquisition Plan was created as a trust structure in 1988. Then, as now, one of the underlying philosophies in creating the Plan was to ensure that all Australian Lend Lease group employees participated in the Plan.

A new tax regime for benefits provided under employee share schemes was introduced in 1995. The regime contained in Division 13A of Part III of the 1936 Act was introduced to counter the Government's perception that employee share schemes had become, in the Treasurer's words, "*no more than executive remuneration packages designed to convert salary into shares in order to take advantage of open-ended tax deferral opportunities available under [s.26AAC]*". Employee share scheme benefits were taxed under s.26AAC prior to 1995.

The basic tax principle applicable to employee share scheme benefits under Division 13A is that the discount - the difference between the market value of the share or right and what an employee pays to acquire it - is taxable to the employee in the year of acquisition. However, in relation to a "*qualifying*" share or right, concessions have been deliberately made available by the Government under which the employee can either:

- defer (for a maximum period of 10 years) the inclusion in the employee's assessable income of the discount given in relation to qualifying shares or rights to which disposal restrictions apply; or
- elect to have the discount included in his or her assessable income in the year of acquisition and, where certain exemption conditions are satisfied, qualify for an exemption for the first $1,000 of the discount.

Accompanying the introduction of Division 13A were other specific rules addressing the capital gains tax ("CGT") implications, both of the trustees' disposal of shares and rights and the acquisition and disposal by the employees of those shares and rights. The interaction of Division 13A and the FBT regime and the timing of deductibility to employers of contributions to genuine employee share trusts are also settled by explicit legislation.

The deferral and exemption concessions are only available to an employee if specific conditions are satisfied. The six conditions relevant to determine whether a share or right is a "*qualifying*" share or right are set out in s.139CD of the 1936 Act. Anti-avoidance measures are contained in s.139DF.

In light of the above legislation it can be seen, and it is important to appreciate, that in employee share trusts there is no tax "*mischief*" to correct. The availability of benefits afforded to genuine employee share schemes is detailed comprehensively in Division 13A. In broad terms, if the shares or rights do not meet the qualifying rules set out in that Division, then any benefit accruing to the employee is immediately taxable (ie. no deferral).

### Effects of Proposed Changes

It is proposed that the new entity tax regime will apply to all resident trusts unless they are specifically excluded. There is a list of trusts which may be excluded from the entity regime set out in Appendix A of Chapter 22 of ***A Platform for Consultation***. It is noted that complying superannuation funds and complying approved deposit funds are proposed to be excluded. It is submitted that "*complying*" employee share trusts should also to be excluded. If genuine employee share trusts are not excluded from the new entity tax system, the following issues will need to be addressed:

- **The loss of endorsed concessions**

  The "*up to 10 year*" deferral and $1,000 exemption concessions contained in Division 13A would be lost if distributions from genuine employee share trusts were deemed to be a dividend. Paragraph 22.69 of ***A Platform for Consultation*** provides that an in-kind distribution from a trust to a beneficiary should be treated in the same way as an in-kind distribution by a company to a shareholder (ie. a dividend). This would be subject to the "*profits first*" rule to determine the assessable amount. Accordingly, there would have to be legislation written that carved out of each deemed dividend the amount not subject to tax either pursuant to the deferral or exemption concession. There would also have to be a convoluted tracking mechanism introduced in the case of the deferral concession so that the deemed dividend would become assessable after 10 years at its then value.

- **The impact of capital gains tax on trustees**

  Under the present regime, a distribution of shares by the trustees of a genuine employee share scheme to beneficiaries does not give rise to a CGT liability (see s.160ZYJD of the 1936 Act). Paragraph 22.69 of ***A Platform for Consultation*** provides that where an asset is transferred to a beneficiary, the trustees would be treated as having realised an asset. For post-CGT assets, the trustees would be required to include the net capital gain in assessable income. In the entity tax regime, the net capital gain would be subject to tax at the general rate of tax applicable to entities. This clear double tax - the trustees being assessed to CGT on any above-inflation increase in value of the shares whilst in the trust and the employee being assessed on the value of the shares acquired - would need to be addressed in the legislation.

  To the extent that the trustees were forced to sell shares to meet the entity tax liability upon a distribution of shares, gains on the shares sold would themselves be subject to CGT, therefore convoluting the position.

- **The deductibility of contributions to employee share trusts**

  Contributions by an employer to a genuine employee share trust are deductible to the employer subject to constraints imposed in Div.13A (see s.139DB of the 1936 Act). Not only would employers contributing to the schemes be forced to seek ATO confirmation that the contributions remained deductible, but s.139DB would probably have to be rewritten to ensure Government policy as to deductibility was maintained.

- **The non-assessability of contributions to employee share trusts**

  It is common ground that contributions by an employer to a genuine employee share trust are contributions to corpus and are not immediately taxable to the trust. If genuine employee share trusts were to be taxed as companies specific legislation to this effect would have to be introduced.

- **The FBT Assessment Act would require amendment**

  Excluded from the definition of "*fringe benefit*" in s.136 of the FBT Act is a benefit constituted by the acquisition by a trust of money or other property where the sole activities of the trust are obtaining shares, or rights to acquire shares, in a company (the "*employer*"), or a holding company of the employer, and providing those shares or rights to employees of the employer. This provision may have to be rewritten, or other legislation needed to clarify its meaning, if the trust were deemed to be a company for taxation purposes.

### What do the proposed changes mean for Trustees?

Trustees will need to explain to current and potential members that their future benefits may be reduced on an after-tax basis as a result of the tax impacts arising from these proposed changes.

Many trustees and therefore employers may be in the unenviable situation that they are forced to address treatment of any increase in tax costs – either by absorbing it themselves because they are locked in to a gross entitlement strategy or, if possible, by passing it onto employee members. To alter member entitlements so that all members bear an equal proportion of the additional tax costs may well involve costly amendments to employee share trust deeds.

Trustees of affected schemes may need to amend trust deeds to ensure that the scheme returns the desired outcomes without the imposition of additional tax.

Consequently, companies offering employee share trusts will need to know precisely the tax impact post 1 July 2000 of these proposed measures. This is crucial both for companies with existing employee share schemes such as Lend Lease, and for those companies currently contemplating the establishment of such schemes for their employees.

### Possible Solutions

If the Government is desirous of maintaining existing tax concessions for genuine employee share trusts, two solutions are available.

The first is to introduce a raft of amendments across the board - affecting income tax, capital gains tax, fringe benefits tax - to ensure that the existing arrangements for the taxation of employee share plan benefits continue.

But enacting further legislation will simply add increased complexity to the employee share scheme provisions. This would be clearly contrary to one of the stated objectives of the Tax Reform Package: simplicity. Consequently, this is not our recommendation.

In drafting the Tax Reform Package, the Government has accepted that certain categories of trusts should not be subject to the new regime, such as trusts arising out of a legal requirement. It is our opinion that employee share trusts should also be excluded from the proposal to tax trusts as companies. Such trusts are established for fiduciary and administrative requirements only, are not vehicles of tax abuse and are well legislated under the present regime of Division 13A.

## Recommendation

We therefore recommend that the list of trusts excluded from the proposed regime of taxing trusts as companies be extended to include employee share trusts. Such an exclusion would be consistent with the Government's policy to encourage employee participation in such schemes and maintain the concept and social benefits of employee share ownership.

Our suggested expanded definition for an excluded trust would be

"A trust, the sole activities of which are obtaining shares, or rights to acquire shares, in a company (the employer), or a holding company (within the meaning of the Corporations Law) of the employer, and providing those shares or rights to employees of the employer."