

31 March 1999

The Secretary
Review of Business Taxation
Department of the Treasury
Parkes Place
CANBERRA ACT 2600

Dear Sir

Submission - Taxation Of Exempt Entities

This submission is made in respect of the possible income tax implications arising in respect of distributions made to particular tax exempt entities. This submission considers the potentially detrimental effects to those tax exempt entities if the entity tax system and associated full franking system is implemented without consideration to the matters raised below.

Current Treatment of Distributions to Tax Exempt Entities

The current treatment of distributions to tax exempt entities may be summarised as follows:

1. ***Trust Distributions:-***

In general, trust distributions currently are not taxed at the trust/entity level and on receipt by the tax exempt entity are not subject to any taxation. Income received in this form is currently subject to a full and pure exemption from income tax.

2. ***Unfranked Dividends:-***

Unfranked dividends, representing the distribution of income not subjected to tax at the company level, are also not subject to any further taxation when received by the tax exempt entity.

These distributions are also therefore granted a full and pure exemption from income tax.

3. ***Franked Dividends:-***

Franked dividends represent the distribution of income which has been subjected to tax at the company level. The dividends are not subject to further tax on receipt by the tax exempt entity. No refund of tax is available in respect of the unutilised franking credits transferred with the dividend. Accordingly, income received by way of franked dividend distributions is in effect currently subject to taxation at the corporate rate.

Likely Impact of Tax Reform on Distributions to Tax Exempt Entities

If the Review of Business Taxation results in tax reform which includes an entity tax system, such that trusts are taxed similarly to companies, and a full franking system, the likely tax effect of distributions to tax exempt entities can be summarised as follows:

1. Distributions from trusts will represent distributions either of income taxed at the trust level or subject to a form of distribution tax. The income received by the tax exempt entity would not be included in the taxable income of the entity. However, if the tax exempt entity is not a registered charity, as currently outlined in *A New Tax System* and the RBT report, it is likely no refund of excess imputation credits would be available to the tax exempt entity.
2. Distributions by way of company dividends would be taxed on the same basis as 1) above given the options put forward do not contemplate the receipt of unfranked dividends.

Given the above, under the options considered for tax reform, all distributions received by tax exempt entities from other entities would represent income taxed at the corporate rate. The exemption granted to these tax exempt entities (being other than registered charities) would not be a pure or effective exemption from income tax on income derived.

Submission For Further Extension of Entitlement to Imputation Credit Refunds

It is our submission that further consideration be given to the criteria for tax exempt entities to be granted eligibility for the refund of excess imputation credits received by way of distributions from other entities under the proposed entity taxation system. It is our submission that entitlement to refunds should be extended beyond registered charities, though not necessarily extended to all tax exempt entities. Primarily, it is submitted that refund eligibility should be extended to tax exempt entities which are established for the benefit of the community and promoting community interests. Such entities would include sporting clubs, societies or associations established for the encouragement of music, art, science or literature or other associations established for community service purposes. In support of our submission, we note the following:

1. Providing refunds of excess imputation credits to an entity, which it is considered in the public interest should qualify for tax exemption, would improve the fairness of the system (as outlined in paragraph 15.17 of RBT).
2. Extending the entitlement to refund to community focused tax exempt entities will facilitate financial support for such entities without constraints being placed on how funds received are expended. This can be contrasted for instance to sponsorship arrangements which may facilitate tax deductible contributions by an entity though require the tax exempt entity to expend the funds in a form which gives due recognition to the benefactor. This may not ultimately result in the most optimal use of the contributed funds from the tax exempt entity's perspective.
3. Granting eligibility to refund of excess imputation credits will allow flexibility for investment of surplus funds by such entities and does not create a natural bias to debt

security investments. The income from debt security investments would receive the benefit of a pure exemption of income tax under an entity/full franking credit system.

Further Considerations

This submission is made in recognition of previous references by the Federal Government in respect of anticipated “wastage” of franking credits in the hands of some recipients. It is submitted that a designed wastage of franking credits in the hands of a community based tax exempt entity is not in the interests of the general community and should not be a design feature of a new business taxation system designed to be for the benefit of all Australians.

It is also submitted that whilst tax exempt entities are unlikely to consistently be significant investors, the increasing complexity of the business and investment environment is likely to increasingly necessitate investment of surplus funds in transactions and structures which previously may have been the domain of commercial business. If the taxation system prohibits community based tax exempt entities from investing in the most efficient and expedient manner, it is submitted this would be imposing unnecessary impediments to such entities and ultimately would be to the detriment of the community who benefit from the activities of such entities.

Anti-Avoidance Issues

It is submitted this proposal to extend refund of excess imputation credits to such tax exempt entities would not provide any incentive for such activities as dividend streaming, franking credit trading or dividend stripping. If such entities are in effect able to obtain the benefit of the franking credits passed to them, there will be no inclination to direct those credits to other parties by way of streaming or trading. Accordingly, it is submitted extending the entitlement to refund would not necessitate any further anti-avoidance provisions over and above those discussed in RBT.

We trust this submission will be viewed favourably and incorporated into the final recommendations of the Review.

Should you wish to discuss any of the matters raised, please do not hesitate to contact the writer on 9248 5555.

Yours faithfully
Ernst & Young

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