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

Dear Sir/Madam

Enclosed is my submission for consideration on some aspects raised in the second discussion paper - A Platform for Consultation.

I am happy to discuss such aspects in person at a later date if considered necessary by the Review panel. I also give permission for the publication of those parts of my submission which the Review panel considers applicable.

Yours faithfully

John Hammond
16 April 1999.

EXECUTIVE SUMMARY

Taxation and accounting have not always seen eye to eye on several matters eg trading stock valuation, treatment of work in progress, and the timing of when standing crops become trading stock. These matters are discussed in depth in my submission.

Consistency in approach would ensure practitioners in the accounting profession can provide one set of accounting records from which a taxation return can be completed. This consistency would negate the detailed reconciliation of taxable income to accounting income.

Tax planning has favoured the use of trusts in order to reduce the tax burden of a trading entity. However the original purpose for the creation of a trust has become clouded or overlooked in modern usage of the trust vehicle. Most schemes involve the use of at least one trust if not multiple trusts to achieve the desired effect of escaping any tax being paid. The simplistic notion of taxing a trust as a company will remove the many anti-avoidance measures which have been inserted into the Income Tax Assessment Act. If this notion becomes a reality, then the many different treatments of bad debts, losses, profit retentions, capital gains, excessive payments to associated persons, and franking accounts will require some watering down in order to remove any bias. Arguments have been put forth to retain the different tax treatments of completely diverse structures - one a legal entity whilst the other is not.

Unincorporated associations and body corporates are necessary nebulous structures however their tax treatment has not always been clear or consistent. For consistency purposes, the Federal Government should require all states to have uniform legislation in relation to body corporates.

Most unincorporated associations are exempt from tax however both structures require a minimum income level after which tax may be levied. By setting a minimum income level, the costly administration of these structures could be put to far better use. Compliance costs would be reduced, as assessments would not be raised on small amounts of non-mutual income.

The principle of mutuality should be adopted into the Income Tax Assessment Act.

Chapter 3 - Trading Stock and Similar Assets

TRADING STOCK

The dichotomy between tax law and accounting concepts for inventories has always been a problem and an area open to manipulation. The Discussion Paper 2 - A Platform for Consultation recognises this however it fails to address areas omitted from the tax interpretation.

Whilst the definition of trading stock for income tax purposes includes anything produced, manufactured or acquired, the difference in the closing and opening valuation crystallises any profit or loss. The valuation has been the problem in that the option exists to alter any method of valuation in order to generate a desirable taxation advantage. The tax law valuation compared with the accepted accounting standard valuation methods has caused an annual review of adds or deducts in the reconciliation of accounting profit to taxable income.

Option 1 no more allows a deduction for unrealised losses than the current valuation methods whether the term used is “net realisable value,” “market selling value” or “replacement price.” Each of these terms generates recognition of unrealised gains or losses. The true measure of recognition of profit or loss is by way of cost only. This is the value of the asset held in the balance sheet unless a provision for obsolescence has reduced its value. However I do not advocate the abolition of choice however certain requirements must be placed on the use of these different valuation methods.

If stock is valued at cost for accounting and tax law purposes, there is no mischief.

If stock on hand is valued other than cost ie at net realisable value, market selling value or replacement price, then the company must use this method of valuation for all subsequent valuation of this particular stock item or range. Having decided to use this “true worth” valuation, then the company must annually obtain 2 independent valuers to attest to the estimated value which is at a valuation lower than its cost.

In addition, the tax laws and accounting standards differ in their treatment of work in progress. For income tax purposes, work in progress is predominantly applied to long term construction contracts which span two or more accounting periods. There are two methods of recognising profit or loss on these projects namely the billings basis or an emerging profits basis. However work in progress applies equally to any number of businesses which produce or manufacture items for sale. If the accounting concept of matching revenue to expenses is to be adopted, then any work in progress should be brought to account by valuing the costs of the inputs at balance date regardless of whether the client has been billed. In effect the purchases are reduced to account for the work in progress items which would be held in the balance sheet. [A prospective purchaser of any business would purchase this work in progress as distinct from any raw material stock. The vendor would likewise factor into the sale price, the amount of imputed profit attributable to any work in progress performed to date of sale.] The tax laws should reflect everyday business activities of commercial reality.

The argument for bringing work in progress to account can further be explained by a simple example:

A manufacturer purchases half-completed items which it inputs further pieces of materials to complete the task ready for sale. On 29 June, the company only adds some materials which render the items not yet complete for sale. In this case the company purchases say aluminium window frames and either manufactures or purchases glass panes. The windows take 4 panes however the company only fixes 2 per frame into 1000 units as at 30 June. What are the tax consequences? The claim for purchases includes all window frames however the closing valuation would not include these semi-completed items as they are not closing stock for tax purposes (only accounting purposes). They cannot be stock unless they are in a saleable state. But this uncertainty of correct treatment is of great contest between the accounting profession and the Australian Tax Office auditor. The reform should remove the doubt and apply consistent treatment to include all items considered work in progress.

Advocates against this proposal suggest strongly that the company would suffer extreme cash flow problems. This is absolute nonsense. For a company, the final liability for tax becomes due when the company lodges its return. This event happens between December and May after the income tax year. The company would have received the moneys from the work in progress items well in advance of the tax liability time (6 months after balance date. For an individual, the requirement to lodge a tax return depends upon the lodgment program of the tax agent, with the tax liability becoming due generally in March after the year of income. Once again this date is some 9 months after the valuation had been included in the return and ample time to generate sales. The cash flow argument is no different to the business expense of holding large stock levels. Thus this application discourages large buildup of stock levels resulting in higher stock holding costs (warehouse, finance, spoilage, etc) and ultimately improve the competitiveness of each business.

The final consideration regarding trading stock is regarding land. In the past, a developer has been able to hold land for different purposes namely trading stock or investment purposes. The latter category is generally retained in the balance sheet as an asset. The land may be developed by the company to be used for its own purposes eg to be rented out, or alternatively used for the benefit of the directors and/or shareholders. Whilst the ultimate sale may attract capital gains tax, this tax effect is markedly less than normal income tax on the sale due to the benefits of indexation under capital gains tax. Under the reform package, all land regardless of ultimate use should be included in their portfolio and consequent stock valuation for tax purposes.

STANDING CROPS

Regarding standing crops, the value of the crops cannot be treated as trading stock until generally they are severed from the land. In the interim the standing crop is held as an asset in the balance sheet - therefore capitalised until harvest. Accordingly no deduction for the crop should be allowed until the crop is harvested. In this way the accounting principle of matching cost and revenue is consistent. This treatment would be consistent regardless of whether the crop is grown or purchased.

Another aspect regarding standing crops is the timing of harvest and the consequential valuation of standing stock. In some products, the produce cease to remain trading stock when they have been delivered to a merchant or agent for a marketing board, irrespective of the payment arrangements. Surely consistent application of principles should apply to all crops or produce which are pooled.

Chapter 21 - Consistent Treatment of Entity Income
Chapter 22 - Bringing Trusts into the new Entity Regime

Whilst the Discussion Paper 2 makes note of various issues eg private v public, widely held v closely held, it has not given a clear option choice as in similar chapters. The chapter did not raise the issue of legal entity.

I believe the crux of the matter is to look at the underlining reason for the creation of the entity. A company is created as a vehicle for the purposes of trade with an advantage of limited liability over a sole trader.

A trust on the other hand was originally developed eons ago as an instrument of trust. A trust was no more than a promise. A promise was developed into the instrument to be performed or carried out at a future date or upon the happening of an event eg land or other property given to a person on attaining the age of 21 years of age. Obviously this notion has been lost in the “trustee can do anything” belief as evident in the discussions in other quarters on trust resettlements. I believe and would argue that the creation of a new or additional promise must be a new trust in every situation.

Over time, these trust instruments have grown to include many powers which the trustee could perform. These powers predominantly were to carry on a business to make profits for the benefit of specific beneficiaries. These beneficiaries were usually “minor” beneficiaries prior to the introduction of Division 6AA of the Income Tax Assessment Act. After the introduction of this legislation, the attractive tax advantages over a company have been lost.

Following on from the above, a “commercial” distinction can apply to trusts. The types of trusts identified in Appendix A of Chapter 22 encompass the intent of the instruments of trust of bygone years (before tax planning). These “pure” trusts in addition to the deceased estates (and other specific trusts as described later) are the trusts which should be afforded exclusion from any proposals under the reform exercise. All other trading trusts (fixed, non-fixed, discretionary, express, implied, inter vivos, constructive, intentional, unit, hybrid or otherwise) could be considered for tax purposes as a company however there are many specific anti-avoidance or penalty provisions which have been introduced into the legislation since 1964.

Trusts are not permitted to retain moneys in the trust. If the trustee does not distribute all income of the trust, then such non-distributable income is taxed under section 99A of the Income Tax Assessment Act (1936) at penalty rate of 47% plus the medicare levy. In contract, companies can retain all profits and possibly not declare a dividend since the provisions dealing with sufficient distribution and retention allowance last applied to the year ended 30 June 1987. Under these repealed provisions a penalty rate of 50% tax was imposed on undistributed amounts after allowance for specific retention of up to 80% of the after tax profit of the company. From 1 July 1987, the dividend imputation system was introduced effectively removing the “double” taxation on dividends paid to shareholders, in addition to removing the impost of having to declare a dividend each year.

If trusts were treated as companies, then certain anti-avoidance measures aimed at trusts would become inoperative. The one provision which instantly springs to mind is the newly enacted section 109UB dealing with unpaid present entitlement and any notional loans deemed as dividends regardless of the amount outstanding at the end of the year and/or any reductions by way of loan repayments. This section was inserted with an obvious bias against loans before trust distributions. Under the new regime would these anti-avoidance measure still apply?

In addition, if trusts were taxed in similar fashion to the treatment for a company, then undoubtedly the following divisions of the Income Tax Assessment Act would be repealed:

(a) Division 6 dealing with the taxing of trust distributions in accordance with sections 97, 98, 99 and 99A (in addition to less used sections like 100A),
(b) Division 6AA,
(c) Division 6B, and
(d) Division 6C.

Most of these divisions were enacted as anti-avoidance measures. If these divisions are repealed, then there may be revenue leakage.

There are a number of other issues which are afforded different treatment for tax purposes namely trading losses. As mentioned above, a trust came into being as a result of an obligation attracting to property. It was never intended to encompass a trading entity. Accordingly, the legislators in their wisdom do not permit the distribution of a trading loss from a trust. Companies have relatively simple rules in relation to the extent of carry forward losses as deductions against future income compared to the new trust loss provisions. Is it envisaged that these new measures be watered down to the extent of the company tests or are companies going to be subjected to more stringent tests? The answer will not be simple.

The point I wish to make is that over time, tax planning has interfered with the intent of trust law. Although the use of trusts is acceptable by many as a tax planning vehicle, many are equally prepared to fight against the contrived schemes involving trusts to escape taxation. I don't believe the answer lies in simply taxing of trusts as companies as this will open new problems eg franking accounts, payments to associated persons, losses and bad debts. The reform should look at the case law and the many rulings dealing with trusts and attempt to restore the intent of trust law into the tax legislation. A distinction should be made between a "bare trust" and a "trading trust" with the former afforded concessional treatments eg relaxed provisions under section 109UB of ITAA (1936).

UNINCORPORATED ASSOCIATIONS.

It has been put forth that many unincorporated associations are currently treated as companies for taxation purposes (para 21.5). Further it is suggested that this treatment would continue under the proposed entity tax regime.

The first statement is in fact incorrect. Many are not treated as companies. They are an unincorporated entity. The entity may or may not be subject to tax. The exemption lies in specific provisions which exempts the income of such organisations eg sporting associations.

The administrative problems encountered by the Taxation Office lies in the confirmation as to the exemption and the application of the principle of mutuality. Although this rule does not appear anywhere in the volumes of taxation legislation, it should! The principle correctly does not tax members contributions however these contributions do earn income in the form of interest. In addition the association may in fact "trade" with its members. For about 7 years now the Commissioner of Taxation has ruled on the application of the "Waratahs Formula" regarding member and non-member receipts within the club. Although this formula was developed by an incorporated trading entity, it can have application to unincorporated associations. In order to simplify many of the compliance aspects of such unincorporated associations, there should be placed an income floor level ie for example an unincorporated association may earn say $10,000 per annum of non-mutual income before being liable for taxation. This would remove the present situation whereby non-mutual income of small amounts attract taxation which is administratively costly to impose and collect. This would also remove the confirmation of exempt status of these clubs and associations in the present self assessment climate.

BODY CORPORATES

Body corporates are another entity which lacks consistency in treatment. Depending on the state in which the body corporate is registered, the different state laws treat some body corporate receipts differently eg income from property jointly. This joint income implies a quasi partnership flavour but for taxation purposes, however the income may be assessed at company rate based on the taxation definition of a company under section 6 of ITAA. In contrast, other states have different provisions governing these body corporates and assess the income to a trust as the income is generated for property held in trust by the body corporate.

Reform is required from a national level to promote consistency in application to body corporates. As suggested for unincorporated associations, an income floor level of income could be established to relieve small body corporates for income tax where only small amounts of interest income are earned. For consistency purposes, a suggested floor of $10,000 is put forth. Thus administratively for the Taxation Office and taxpayers, the processing of small assessments would disappear.

These floor levels should not be indexed each year. In stead, the figure may be reviewed say every 5 years to reflect the level of growth in the funds and inflation (and interest) rates. Although a review is suggested, it is not mandatory that the level be adjusted either upwards or downwards.