ARTHUR ANDERSEN

Trustee Corporations Association of Australia

Submission to the

Review of Business Taxation

16 April 1999

SUBMISSION TO THE RALPH REVIEW OF BUSINESS TAXATION

CONTENTS

Overview

Our submission focuses on issues relevant to the proposed taxation of trusts as corporations. In particular we highlight:

- that resident trusts are tax transparent legal arrangements, meaning that the income of trusts is already taxed in the hands of the ultimate owners;
- some problems in using the concept of "profits" as the basis for the taxation of trusts;
- some practical legal problems that a shift in the tax arrangements will have on trustees;
- some defects in the proposed entity taxation rules as announced, as they would apply to trusts and to trustee companies;
- the need for a cost effective compliance system for those newly affected by entity taxation, should it be introduced; and
- the adverse revenue impact that an entity tax system could have upon certain classes of trusts and trust beneficiaries.

The Association wants to ensure that the Review Committee is mindful of the unintended consequences that would flow from implementation of the proposals as they stand.

We are aware that the Review Committee has considered some of these issues in "A Platform for Consultation, Discussion Paper 2, Volume II ", but remain greatly concerned that the position of trusts and extent of the identified problems have not been adequately canvassed in this document. The Association strongly supports many of the concessions noted in A Platform for Consultation as they apply to trusts. However, we believe that there are additional important issues that will affect trusts upon the introduction of the proposed regime that have not been considered.

Ultimately the Association is concerned that, unless the proposed taxation treatment of trusts is [essentially] retained in its current form, many beneficiaries will be unfairly taxed and trustees will be forced to either wind-up trusts or even move the domicile of trust property abroad into the hands of foreign trusts, located in places such as the Cook Islands or Nauru. If this occurred, through the introduction of an increasingly hostile Australian tax environment for trusts:

- Australia will lose access to substantial pools of private investment capital;
- federal and state governments will potentially receive less revenue as transactions are executed off-shore;
- essential human resource skills will migrate to meet the demand for services in off-shore jurisdictions, resulting in reduced personal income tax revenues; and
- less advantaged Australians will suffer as they bear more of the costs necessary to maintain the financial infrastructure they require.

Are all trusts used for tax avoidance purposes?

Taxing all trusts as companies will have a negative impact on many Australian families, including widows, children and the socially disadvantaged, and will cause many negative, inappropriate and presumably unintended consequences in terms of the distribution of wealth and disposable income within Australian society.

We quote from the Media Release of the Association's National Director, Ms Kerrie Kelly issued on 9 September last year:

> "Efforts to increase the tax take from trusts as an end in itself will hurt those people who have a legitimate use of trusts and have the right to expect a level of protection in our legislation."
>
> "Many trusts are created for legitimate purposes to look after the interests of Australians who must rely on others and who will otherwise not have adequate financial protection."

The following are, the Association submits, excellent examples of the legitimate uses of trusts:

- Protecting the interests of minors, particularly orphans, under a will.
- Protecting the long term interests of disabled people to ensure that assets are secured for their future use.
- Protecting the proceeds of court cases arising from workers compensation and criminal injury matters.
- Protecting the interests of minors arising from compensation as a result of personal injury claims.
- Charitable trusts established for the benefit of recognised charitable purposes.

Current arrangements governing taxation of trust income

Currently, the general rule is that the net income of a trust is taxed either in the hands of the ultimate beneficiary or in the hands of the trustee in the financial year it is derived by the trust. This means that the income is taxed in the same year that it is derived by:

- the beneficiary according to their present entitlement;
- the trustee on behalf of a beneficiary who suffers a legal disability according to the beneficiary's present entitlement; or
- the trustee where there remains net income to which no beneficiary has a present entitlement.

As such, trusts are largely tax transparent and the tax treatment of trust income is characterised by the tax profile of the beneficiary. This means that trusts;

- are essentially extensions of their ultimate beneficial owners; and
- the income of a trust bears only a single layer of taxation in the hands of the ultimate owner or their proxy.

In the vast majority of cases, trusts are merely *conduits* through which beneficiaries' income and capital can be invested and maintained for the benefit of future generations or for the prudent management of assets during the beneficiary's life. These arrangements are not intended to avoid tax. Instead, the vast majority of trusts maintain passive capital investment (predominantly Australian based) for specific, socially justifiable ends.

Trusts carrying on trading activity

We do recognise, however, that in a limited number of cases trusts are used as vehicles through which trading activity is conducted. Such trusts can, therefore, be used as a means to preferentially distribute income and reduce the overall tax burden on family groups. This may be viewed as undesirable, but still falls short of true tax avoidance.

If the Review Committee sees a need to distinguish between different types of trusts - to carve out desirable from undesirable trust uses - then consideration of what constitutes a business entity deriving "business income" must be made. In this way, trusts being used as investment vehicles (as opposed to trading vehicles) can be separated from an entity tax system.

In this regard, the Association submits that the definition of "business income' is too widely drawn in the *A New Tax System* ("ANTS") proposals. An unintended consequence of this is that virtually all trusts relationships would be caught up in an entity tax system. As pointed out later, this will cause unnecessary complications and disadvantage those who can least afford it.

Maintenance of Tax Transparency

The Ralph Review (in "A Strong Foundation") outlined three main policy design criteria as essential elements to achieve the policy objectives set out in ANTS proposals for entity taxation. These were that:

- entities should be considered as extensions of their ultimate owners (the "integration of ownership interests" principle - see page 75 of ANTS and 15.19 of A Platform for Consultation);
- there should only be a single layer of domestic taxation - see page 76 of ANTS. It is acknowledged in A Platform for Consultation that any alternative (whether it be 'Deferred Company Tax', 'Resident Dividend Withholding Tax', or 'the taxation of unfranked inter-entity distributions', would give rise to a double tax problem – see 15.42; and
- there should be no distortion to the investment decision due to the business entity used (the "investment neutrality" principle - see page 76 of ANTS and 15.3 of A Platform for Consultation).

In essence, this means that the structure or entity used should be tax transparent.

As tax transparent vehicles, non-trading trusts satisfy the Ralph Review's policy design principles for determining tax liability, namely:

- there is an integration of ownership interests, where trusts are dealt with as extensions of their ultimate owners;
- the income of a trust bears only a single layer of taxation in the hands of a beneficiary or that of the trustee; and
- trusts provide a simple conduit through which the various interests of beneficiaries are pooled - the underlying investment decisions remain unaffected by the trust structure itself.

Risks of overlooking the important role of trusts and their tax transparency

We are concerned that any reform of the taxation of trusts, to treat all trusts as companies, could lead to the migration of a substantial proportion of private investment capital from Australia. Trustees, as part of their general trust duties, would need to consider whether it continued to be appropriate to remain domiciled in Australia or to move to an off-shore location.

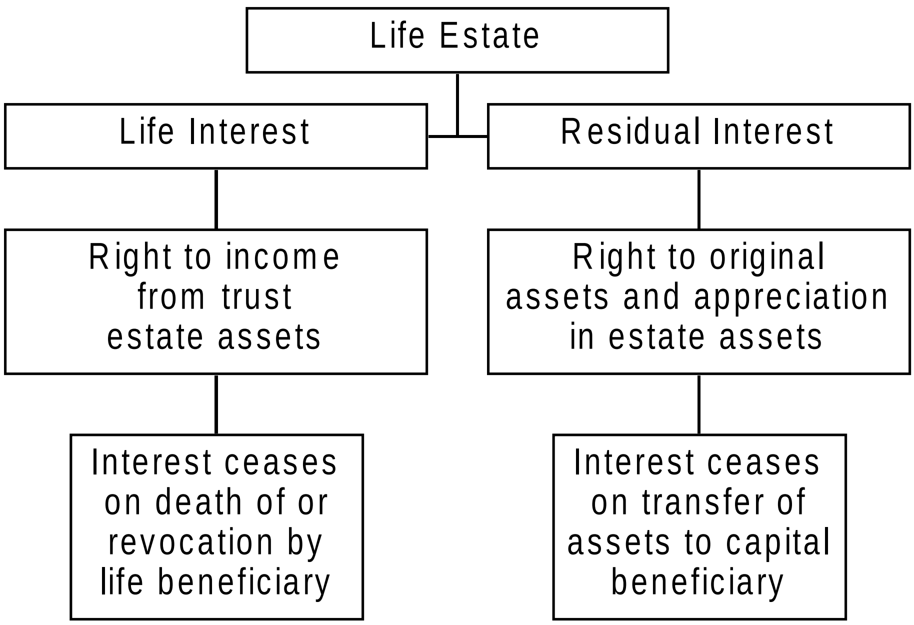
Apart from the double layer of taxation, local and overseas investors, faced with additional 'deferred entity tax' will base decisions upon the after-tax return on their investments. If a superior return can be achieved through moving a trust off-shore, then the risk of this happening would become a reality, particularly for larger trusts. An unfortunate side effect of this is that smaller trusts would not have the resources to do the same and would remain disadvantaged.

Problems with using the concept of taxing trust "profits"

The importance of the distinction between income and capital

In a significant number of trusts, there is a distinction between income and capital. This distinction is well highlighted with life interests created consequent to the death of a taxpayer. In such a case, the life beneficiary is generally given rights to the benefit and enjoyment of the underlying trust assets, which is the net income of the trust. In contrast, it is the residual or capital beneficiaries who have the right to full use of the asset once the life beneficiary's interest terminates. This means that a trustee must separate the interest of the life beneficiary to the income from the trust while preserving or enhancing the right of the capital beneficiaries to the future assets. This separation of interests at law is highlighted in the diagram below.

<u>Diagram 1</u>



Currently, the income, as defined, of such a trust is typically distributed and taxed in the hands of the life tenant, who is "presently entitled" to the income of the trust and any capital gains realised are subject to tax in the hands of the trustee.

A Platform for Consultation does not add any further guidance as to a distinction between income and capital of the trust and how this is to be practically treated at the entity level.

Under the proposed entity tax model, testamentary trusts, such as the life interest created in the other example, would be subject to taxation as an entity. Practically speaking, this means that there would be a merging of the income and capital rights of beneficiaries for tax purposes as the entity's taxable income (assuming that is determined under current principles) is taxed at the single entity level. This would require trustees to maintain individual capital and income accounts for tax purposes to maintain equity between beneficiaries. If not, the introduction of an entity tax could distort the income and capital rights of beneficiaries - through inappropriate allocation of tax liabilities and benefits - and potentially cause the trustee to be in breach of their fiduciary obligations.

As discussed later in this submission, legislative backing may be necessary to ensure that a trustee is relieved of financial liability where they act to comply with an entity tax system.

Practical legal issues in taxing trusts as an entity

Trusts are not limited liability entities, and to regard them as such inappropriately includes all trust relationships in the proposed taxation of trusts as corporations. Apart from the different roles and responsibilities taken on by a trustee compared to a director of a limited liability entity, there are legal impediments to taxing trusts as a corporation.

Trust deeds and the common law have defined concepts of income and capital. The manner in which these concepts are modified will vary from trust to trust depending upon the purpose for which the trust was established. For example, some trust deeds define income by reference to the current tax concepts of assessable income while other deeds remain silent as is common with testamentary trusts.

Should an entity tax regime be introduced, there is likely to be a need for trustees to amend their trust instruments. This is acknowledged in A Platform for Consultation at page 488. However, this document does not address the need for possible amendments to be made to trust deeds to remove the traditional distinction between income and capital or to redefine income by reference to accounting principles. This could have a number of unintended consequences, including:

- trustees having to amend the trust instrument to the detriment of a member's entitlement as an income or capital beneficiary. This would be done to preserve the tax position of the trust. Potentially, trustees acting to adversely affect a member's interest will require member consent or will need to seek a court order or will be forced to act in breach of their role as a trustee;
- consequent to amending the trust instrument, a reorganisation of beneficial rights could result in a resettlement of the trust. This will trigger unnecessary capital gains tax liabilities unless federal rollover relief is enacted. Additionally stamp duty relief will be required at a State level.
- the alienation of property rights of certain beneficiaries due to a change in federal law. If this occurred, beneficiaries may have a claim for compensation against the Commonwealth on Constitutional grounds. As a result, careful attention to the drafting of the entity tax rules is essential to avoid such an outcome.

Other Unaddressed Taxation Issues

The Association is concerned that there are still various taxation issues which have still not adequately been addressed in ANTS or A Platform for Consultation. In particular, these issues relate to the following:

- the definition which may be adopted for 'excluded trusts' for entity taxation purposes;
- particularly given the first point, the potential inequitable application of Fringe Benefits Tax (FBT) or the Division 7A rules to trusts which are not excluded from entity taxation;
- the ability for some trusts, which will fall under the entity taxation regime, to fund a liability to either 'deferred entity taxation' or 'resident dividend withholding tax';
- the timing of refunds of tax paid at the entity level to the beneficiaries of trusts, where those beneficiaries have concessional taxation treatment;
- an appropriate transitional regime.

'Excluded trusts'

We note that in A Platform for Consultation there has been some consideration as to what types of trusts would be treated as 'excluded trusts' (ie. trusts which would be excluded from the application of entity taxation). Potential excluded trusts are noted in Appendix A of chapter 22 of that document.

The Association strongly supports the fact that it has been recognised that there are a range of trusts for which it would be inequitable to apply entity taxation to. However, the types of trusts which are included in this list are not broad enough.

For example, not all trusts established under a will would be excluded from entity tax (if the list in Appendix A to chapter 22 were adopted). Deceased estates which have not had the administration completed within 2 years will fall within the entity taxation regime. There is no comment on how and when these rules will commence to apply to such trusts (eg. transitional application of the rules after the 2 year period has passed).

The exclusions do not currently cover certain child maintenance trusts or testamentary trusts. A life interest created in an asset after the death of a taxpayer is a trust. Therefore, entity taxation would apply to these trusts.

Also, there would be certain trusts established for bona fide compensation purposes which would not fall within the exclusion.

A Platform for Consultation does not include any analysis as to how the trusts included in Appendix A of chapter 22 were selected and why other trusts (which are similar to those in the list) have not been added to the exclusion list.

In addition, the Association would recommend that a flexible mechanism be built in to the new regime to allow for additions and changes to be made as necessary to the list of excluded trusts. This mechanism for change could be by way of regulation or gazette notice, rather than by legislative change.

Unintended FBT or Division 7A application

The proposed rules could give rise to inequitable liabilities being imposed on certain trusts. For example, a liability could arise for FBT, or alternatively ‘deferred entity tax’ or ‘resident dividend withholding tax’ for certain trusts in absurd situations and where the trusts can not even fund this liability. This is based upon the options canvassed in chapter 18 of A Platform for Consultation as to what will be taken to constitute a “distribution” from a trust (and given the proposed amendments to the FBT legislation already announced as part of ANTS).

By way of illustration, it is possible that a life interest in an asset under a trust may be subject to FBT under the proposed regime. Alternatively (under other options considered), such an interest could be subject to ‘deferred entity tax’ or ‘resident dividend withholding tax’. If a trust is established upon the death of a taxpayer where a life interest is granted in relation to an asset (which is not producing any income), it is possible that either a ‘deferred entity tax’ or ‘resident dividend withholding tax’ or FBT liability could arise in respect of the use of that asset by the beneficiary. For example, if a life interest is created in a principal home and its contents, FBT, ‘deferred entity tax’ or ‘resident dividend withholding tax’ could become payable.

Under the proposed rules, there could be a value associated with the use of this asset by the beneficiary imputed. This notional value could be determined perhaps with regard to rental which is otherwise given up in respect of the property. The notional value could then be treated as a distribution to the beneficiary. This distribution would be subject to ‘deferred entity tax’ or ‘resident dividend withholding tax’, or alternatively, under option 3 in chapter 18 of A Platform for Consultation, there may be FBT payable in respect of that notional/imputed value.

The question arises as to whether there has actually been a “distribution” (see 18.32 on page 408 of A Platform for Consultation). However, the analysis does not adequately consider the nonsensical results of examples such as the above. Also, if there has been a distribution, numerous issues arise as to how this distribution would be valued (on a notional basis).

An extension of the issue raised above is if there is an amount which is treated as a distribution (or there is a FBT liability), how will the liability for ‘deferred entity taxation’ or ‘resident dividend withholding tax’ (or FBT) be funded? In many cases (such as the example given), the trust has no cash available to fund this obligation. Even though there is a “deemed distribution”, the trust’s only asset is the property (which is not income producing) and no cash. (This issue is further dealt with below).

There is a need to address some form of exclusion in respect of non-business and non-income producing assets in these circumstances. For example, there would appear to be an exclusion from the proposed reforms to FBT in respect of principal residence held in an entity (see 18.64 on page 414 of A Platform for Consultation). This exclusion is only for FBT purposes. There is no corresponding exclusion if the amount was not subject to FBT but would have otherwise given rise to a ‘deferred entity tax’ or ‘resident dividend withholding tax’ liability (under Division 7A for example).

Recommendation: The Association suggests that the regime should include a clear otherwise deductible rule so that non-business and other non-income producing assets would not attract FBT and ‘deferred entity tax’ or ‘resident dividend withholding tax’.

Funding entity tax liability and timing of refunds

It was noted in ANTS that charitable organisations would be required to register under newly proposed rules in order for them to be entitled to claim refunds in respect of ‘deferred entity tax’ payable by an entity at source prior to making a distribution to that charity. The procedure appears to have also been adopted in A Platform for Consultation where it is mentioned on page 362.

Therefore, this registration procedure would appear to be whether the 'deferred entity tax' or 'resident dividend withholding tax' options were adopted.

It would obviously be inequitable for charitable organisations to not be entitled to refunds in respect of either 'deferred entity tax' or 'resident dividend withholding tax'. One of the obvious issues which will have a major impact for charitable organisations will be the cashflow timing of obtaining refunds. This issue has been raised in A Platform for Consultation on page 362 in respect of charities, and possible options for obtaining timely refunds has been dealt with on pages 362 and 364. However, the Association believes that these options are not practical as option 1 requires what could be a lengthy delay prior to obtaining a refund, and option 2 requires the calculation of estimates of refunds which would be overtly complex and, in most cases, highly inaccurate.

Perhaps an alternative option in respect of refunds could be some form of tax file number quotation mechanism by beneficiaries to trusts. In this way, the beneficiary who has some tax preferred treatment (e.g. charitable organisations or superannuation funds) who would be entitled to a refund, could quote their tax file number at the time of the distribution to the trust. At that time the trust would be able to identify that 'deferred entity tax' or 'resident dividend withholding tax' would not be required to be paid (or would be required to be paid at a reduced rate) in respect of the distribution to that beneficiary. The advantage of this option would be that there would be no requirement later for refunds and therefore delays would not be required prior to obtaining cash entitlements, and that there would be no requirement to estimate possible refunds based on prior year figures. In addition, the quotation mechanism may be able to be modeled on existing legislation and systems which are in place. The integrity of the requirements of the Ralph Review of Business Taxation which have been established in A Strong Foundation and extended in A Platform for Consultation would be preserved.

As mentioned above, there is a broader issue also in respect of the total application of the entity rules to currently non-excluded trusts. Situations will arise where the trust itself has no cash to fund any liability to entity tax arising (either as 'deferred entity tax', 'resident dividend withholding tax', or FBT).

Another example which highlights this issue would be a situation where a trust is established by a church or other charitable organisation to hold, for example, a residential property which is rented out to low income or otherwise disadvantaged persons. In this case, the church or charitable organization would be the beneficiary of this trust. As part of the constitution of the trust, all income of the trust is used to reinvest either in the existing building for maintenance purposes, or an extension to the building, or for constructing other buildings for similar purposes. It is unclear whether the trust has made a "deemed distribution" to its beneficiary under the proposed rules. If so, there would be a liability for 'deferred entity tax' or 'resident dividend withholding tax'. However, the issue of how this liability would be funded is also important as all funds of the trust are reinvested and there is no excess cash available to fund this liability.

Appropriate transitional regime

Association recommends that consideration be given to the necessary transitional rules which would also need to be available to cover existing trusts (assuming these trusts were not to be included in the list of excluded trusts). We recommend that the transitional regime should include:

- A perpetual exclusion / grandfathering of certain existing trusts, and
- Sunset provisions for other situations where it is believed that the immediate application of the entity rules to certain trusts would be inappropriate.

A perpetual exclusion should be available to existing deceased estates, child maintenance trusts, testamentary trusts, life interests created under a will, and bona fide compensation trusts. It would be inappropriate to apply the new entity tax regime to existing trusts of this kind. These trusts would have been established before the entity tax proposals had been announced.

The Association also believes that it would be inappropriate to immediately apply the entity tax regime to trusts established under a will. Perhaps a 2 year phase-in period could be adopted for such arrangements, after which time, the full entity tax regime would apply to these trusts. This phase-in period would allow taxpayers sufficient time to reconsider the structure of their existing estate arrangements. Wills and estate issues are generally matters which are reviewed by taxpayers on an irregular basis. Practically, a more generous temporary exclusion for trusts established under a will, tapering down to full application after a certain period of time would be more appropriate.

Impact on trustee companies of entity taxation

There are various issues which have not been adequately addressed in respect; of the option of implementing a 'deferred entity tax' in respect of trustee companies.

In many cases, the trustees of trusts are widely held and publicly listed companies. Therefore, the imposition of a 'deferred entity tax' affects the reported earnings of these entities. This will be particularly if there is significant "tax preferred" income of the trustee company.

In addition, the issue of double taxation (as noted in Chapter 15 starting from page 355 of A Platform for Consultation) would be the cause of major concern for trustee companies. For example, in the case where the accounting income of a trustee company were not taxable but were distributed in the first year to its shareholders, a 'deferred entity tax' liability of 36% of that distribution would need to be met. However, if in the second year where those timing differences reverse and the company had taxable income but no accounting profit (and no distribution was made), the company itself would be required to pay company tax at 36%. In this case there would be double taxation (albeit it that it may only be temporarily until sometime in the future when the situation reverses).

We would also hope to see private and public charitable trusts, which are currently regarded as exempt from taxation in accordance with Division 50 of the Income Tax Assessment Act 1997, included within the definition of excluded trusts.

Need for a cost effective compliance system

Introduction of an entity tax system will require careful thought to ensure that the compliance obligations are not excessive for either the trustee or the beneficiaries of the trust.

A system similar to that which companies are required to maintain for current imputation purposes will place an excessive administrative burden which is economically unjustifiable. In some cases, beneficiaries may request the closure of trusts established voluntarily to preserve assets or, where the trust exists by legal compulsion, an accelerated realisation of assets may be needed to fund additional compliance obligations.

In particular, the Association's Public Trust Office members emphasise that:

- their client base includes many relatively low value trusts often managed as community service obligations;
- trusts are used for a very wide range of purposes, often in connection with deceased estate administration and protected persons, none of which involve artificial or contrived tax avoidance as a key objective; and
- the inclusion of all trusts in such a system will:
    a) involve proportionally high costs for many low income earners and minors, who will now have to lodge taxation returns in order to receive franking credits in situations where they otherwise don't meet the relevant income thresholds;
    b) compromise the trustee's ability to maintain the purchasing power of long term estates, including for severely disadvantaged persons.

Revenue Impact of Taxing Certain Trusts under an Entity Tax System

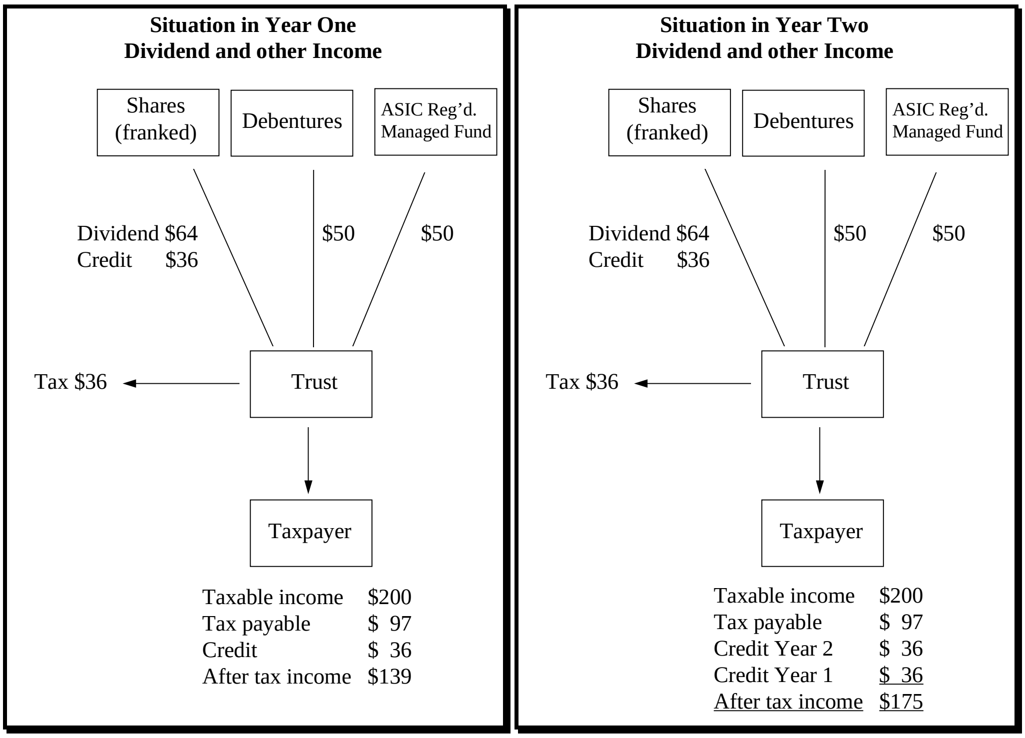
The introduction of an entity tax upon private trusts - as opposed to publicly offered trusts which the Treasurer covered in his Press Release No 009 - will have an adverse financial impact upon the wealth of a significant number of Australian taxpayers. In particular, Australians with assets invested through trusts such as:

- minors trusts including settlements under will or arising from a compensation claim
- compensation trusts for adults suffering a permanent legal disability consequent to a personal or criminal injury; and
- non-profit trusts established for charitable purposes,

will be adversely affected without regard to the special purposes that these trusts have in protecting or supporting Australian taxpayers. The extent of the adverse impact for each type of trust is dealt with separately below.

How an entity tax will affect beneficiaries of trusts

The reason why entity taxation has an adverse impact compared to the current (tax transparent) taxation treatment of trusts now is the accelerated collection of tax revenue that such a system imposes. Thereafter, return of the entity tax paid in a prior income year is delayed for between 12 and 21 months depending upon when the tax return for the taxpayer is lodged, processed and a tax refund made where surplus entity credits are available.



The diagrams above demonstrate the timing over two years of entity taxation assuming that:

- shares comprise 50% of the investment portfolio; and
- the taxpayer is on the top marginal tax rate of 48.5 percent.

In effect, an entity tax will operate in a similar way to provisional tax, a system which is to be abandoned as part of the move to *A New Tax System*.

Understanding the constraints upon the investment powers of trustees

Trustees of longer term trusts, particularly those identified in this submission, must carefully consider a number of investment issues, not just the after-tax return achieved by the end beneficiaries. These constraints are typically contained in:

- the trust deed itself, such as a prohibition on buying shares;
- specific state-based legislation [which impacts some non-profit trusts and constrains their investment powers]; and
- "prudent person" legislation which requires trustees to develop investment strategies consistent with the purpose and duration of the trust.

  These changes occurred over the last few years, but mean that trustees of any trust must review their investment powers, align their investment activities with the requirements of the new legislation and the deed and, in many cases, plan to progressively alter the way they will invest into the future. Failure to do so, while not an offence, will expose trustees to potential litigation (and liability) where beneficiaries demonstrate that a trustee has not acted prudently (as required by the legislation) in investing trust assets.

  These changes also affect the process used by trustees to select specific investments. Trustees will have to demonstrate a disciplined approach in their investment selection and in matching these with the purpose and position of beneficiaries (both current and future) of the trust. This has increased the commitment expected of trustees in fulfilling their investment responsibilities and taxation is but one consideration in this process.

The practical application of these investment requirements, particularly the advent of "prudent person", is that trustees are generally limited to investing the assets of a trust in a diversified portfolio. This limits the exposure that a trustee can have in Australian shares, for example, to around 50 percent of a trust's total assets. In some cases, trustees will decide, based upon a number of competing issues, that a lower exposure is more appropriate.

Independent research commissioned by one of the Association's members indicates that an appropriate "prudent person" portfolio will be comprised as follows:

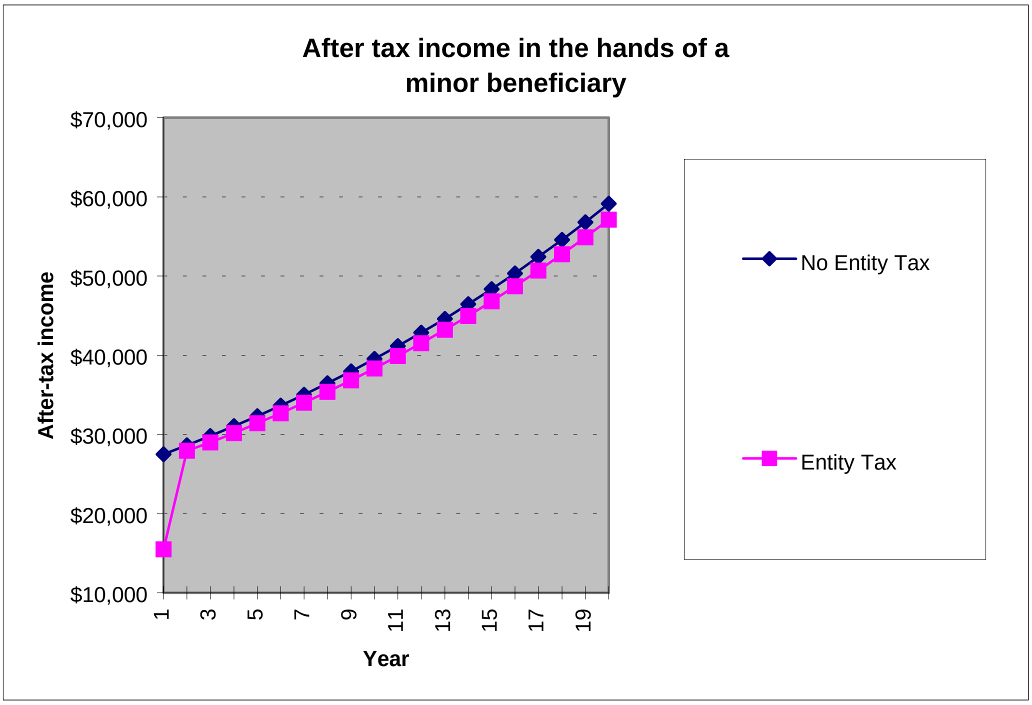
Asset Class	**Suggested exposure (%)**
Australian cash	5 - 10
Australian fixed interest	10 - 20
International fixed interest	0 - 10
International shares	5 -10
Australian shares	40 - 50
Australian property	10 - 15

As such [and as highlighted later in this submission] prudent trustees will be hesitant to increase their exposure to Australian shares and so obtain the benefit of franked dividends and any refund that may be available to the beneficiaries of unused franking credits. As such, for the purposes of any modeling presented in this submission, we have used a prudent investment portfolio where the maximum exposure to Australian shares is 50 percent, unless otherwise stated.

Impact of an entity tax upon Minors trusts

Minor beneficiaries will be impacted by the entity tax system proposals and should expect significant reductions in their distributable income over the life of their interest in the trust. This is due to the accelerated collection of entity tax without recompense until the following year.

The extent of the possible detriment is demonstrated in the chart below where a minor beneficiary becomes subject to taxation at the entity level and at a personal level.



Assumptions to minors example
1. The initial settlement sum is $1.0 million which is invested in a portfolio made of shares (50 percent), with the balance invested in cash, fixed interest and other unfranked income. This profile is consistent with a "prudent person" or balanced type of investment portfolio.
2. Dividends, where paid from a company, are franked to 80 percent.
3. Rates of return are 4.81% for income and 4.5% for capital, providing a total return of 9.31% before tax.
4. Ten percent of the portfolio assumed to be turned over each year resulting in realised capital gains. This level of turnover is conservative, but is consistent with a longer term investment strategy.
5. Distributions from the trust occur at the beginning of each financial quarter. Entity tax is deducted and electronically remitted to the Taxation Office at the same time under the PAYG arrangements.
6. Refunds of surplus franking credits and entity tax credits are assumed to occur at the end of October in the following financial year. October coincides with the requirement that natural persons lodge their tax return for the prior financial year at that time. Refunds of surplus franking credits are fully re-invested [rather than distributed]. This results in the full repayment of assumed capital drawdowns.
7. Personal tax rates and tax thresholds used are those that exist as at present.

As shown, the minor will always have less after -tax income under an entity tax regime, even assuming around half of the portfolio is invested in shares which are 80 percent franked. This is a best case position.

Unfortunately, the ANTS proposals fail to identify minors as a group requiring separate consideration. For example, trusts established consequent to the death of a parent or carer will become subject to the general entity tax rules, whereas at present, concessional rules apply. Also trusts arrangements used to protect the financial interests of minors suffering a physical or mental disability (from birth) will become subject to entity taxation to their own and the community's detriment.

A Platform for Consultation does included suggested 'excluded trusts' (ie. trusts which would be excluded from the application of entity taxation) – see Appendix A of chapter 22 of that document. While this is an improvement on the ANTS proposals, the Association believes that the types of trusts which are included in this list are not broad enough. The exclusions do not currently cover certain child maintenance trusts or testamentary trusts. Therefore, entity taxation would apply to these trusts.

This result highlights the need to ensure that minor beneficiaries of trusts established to protect their interests while a minor are:

- treated on a tax transparent basis; and
- given proper consideration based upon their needs. This should be on the same basis as exists presently for protective trusts under Div6AA of PtIII of the Income Tax Assessment Act 1936.

Impact upon compensation trusts for adults suffering a legal disability

Who uses compensation trusts?

Compensation trusts are used by employers, insurance companies and trustees of superannuation funds to place money on trust for people who are unable to look after their own financial affairs. This will be because of some form of mental or physical injury or incapacity which means they cannot look after their own financial affairs in a consistent manner.

For example, an employee who is seriously injured in a work accident will be entitled to superannuation benefits and possibly compensation for the injury suffered. However, due to the seriousness of the injury and / or the need to ensure they (and their family) are as well provided for as possible, the only option is to establish a trust to hold the assets for the benefit of that person. In this way, the trustee, employer or insurance company ensures as far as is possible that the money will be managed prudently now and into the future.

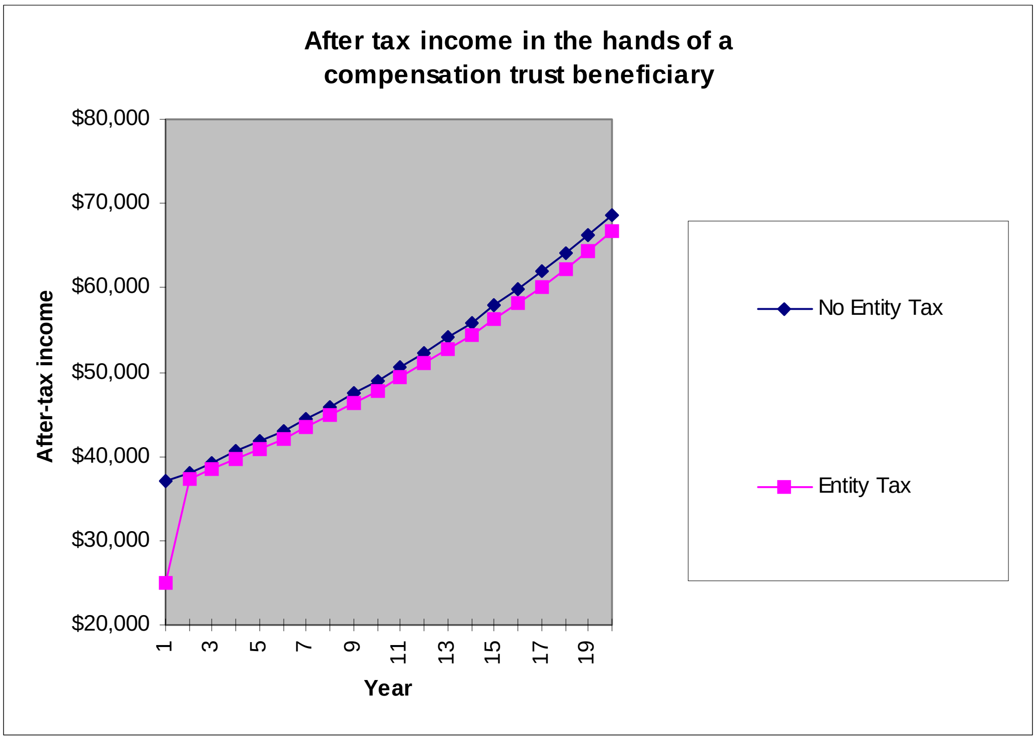
The critical point is that these people are unable to look after themselves and will rely upon others to do that for them.

How are legally disabled beneficiaries affected by entity taxation?

Legally disabled beneficiaries should expect the same reductions in their distributable income over the life of their interest in the trust as would apply to any other beneficiary of a trust. Once again, this is due to the accelerated collection of entity tax earlier in time without recompense until the following year.

One feature that distinguishes this type of trust is that beneficiaries typically receive large lump sums (by way of compensation payments) as the settlement sum. This lump sum is then intended to generate future earnings (as a substitute for lost future earnings capacity) and to fund additional lumpy costs. Importantly, existing court awards will have made no allowance for a change to federal tax arrangements and any tax detriment suffered will be at a cost to the on-going care of that person.

The extent of the possible detriment is demonstrated in the chart below where a beneficiary becomes



subject to taxation at the entity level and at a personal level.

Assumptions to adult suffering a legal disability example

1. The initial settlement sum is $1.0 million which is invested in a portfolio made of shares (50 percent), with the balance invested in cash, fixed interest and other unfranked income. This profile is consistent with a "prudent person" or balanced type of investment portfolio.
2. Dividends, where paid from a company, are franked to 80 percent.
3. Rates of return are 4.81% for income and 4.5% for capital, providing a total return of 9.31% before tax.
4. Ten percent of the portfolio assumed to be turned over each year resulting in realised capital gains. This level of turnover is conservative, but is consistent with a longer term investment strategy.
5. Distributions from the trust occur at the beginning of each financial quarter. Entity tax is deducted and electronically remitted to the Taxation Office at the same time under the PAYG arrangements.
6. Refunds of surplus franking credits and entity tax credits are assumed to occur at the end of October in the following financial year. October coincides with the requirement that natural persons lodge their tax return for the prior financial year at that time. Refunds of surplus franking credits are fully re-invested [rather than distributed]. This results in the full repayment of assumed capital drawdowns.
7. Personal tax rates and tax thresholds used are those that exist as at present.

As shown, the beneficiary will always have less after -tax income under an entity tax regime. This is a best case position.

Once again, the ANTS proposals fail to identify this special needs group as requiring separate consideration. For example, under the proposals as presented trusts established consequent to a court award of damages for personal injury will become subject to the general entity tax rules. Under the current rules, such arrangements are tax transparent, the trustee merely providing a protective role for the beneficiary.

As noted above, A Platform for Consultation does include a list of possible excluded trusts. However, these exclusions do not include all types of compensation trusts. There will be many bona fide compensation trusts which would exist which will fall under the entity taxation regime as currently proposed.

This result highlights the need to ensure that beneficiaries of compensation trusts established to protect their interests while disabled are treated on a tax transparent basis. Otherwise they will be financially disadvantaged with their consequent reliance upon government services (and revenue) to meet future needs at an earlier stage.

Impact upon non-profit charitable purposes

How large is the non-profit sector?

Recent research by the Australian Bureau of Statistics estimates that the non-profit sector in Australia has an annual operating expenditure of $26.5 billion, of which organisations with “public-serving” ends make up $16.3 billion annually. This includes health, education, community and human services and charitable purposes.

These organisations serve a vitally important role in our general community and allow targeted distribution of scarce financial resources. Vitally, such organisations assist:

- in research into medical and scientific matters not able to be financed by universities or hospitals which assist in the treatment or cure of disease, environmental problems etc;
- in the relief of poverty and distress suffered by an increasing number of people in our Australian society
- in the provision of support services such as community health, counseling, respite care, drug rehabilitation, youth drop-in centres etc.

Increasingly, governments rely upon or team up with such organisations to provide or deliver the services rather than duplicate the same infrastructure. Also, there is a recognition that, in many cases, non-government support is able to penetrate deeper and more effectively into the community than can be achieved through their own agencies.

How are charitable purposes potentially affected by entity taxation?

Charitable purposes are affected by the entity tax system proposals at three levels:

a) Potential reductions in distributable income due to the flow on impact of entity taxation where a charity invests through other trusts.

b) Inappropriate narrowing of the categories of organisations which will qualify (as a charity) for exclusion from the entity tax system.

c) Passing through the benefit of full imputation to grant recipients requires clarification.

Potential reductions in distributable income due to entity taxation and trustees investing through interposed trusts

The imposition of an entity tax may ultimately reduce the capacity for charities to fund on-going grants programmes, particularly where the charity is invested predominantly in investments producing unfranked income or are invested through pooling arrangements via interposed trusts. This is due to the accelerated collection of entity tax [at the interposed trust level] without recompense to the charity until the following year. In so doing, the government could force non-profit organisations to:

- favour investing directly in specific assets as opposed to indirectly through interposed trusts which are subject to entity taxation. In this way, the impact of entity taxation is minimised.

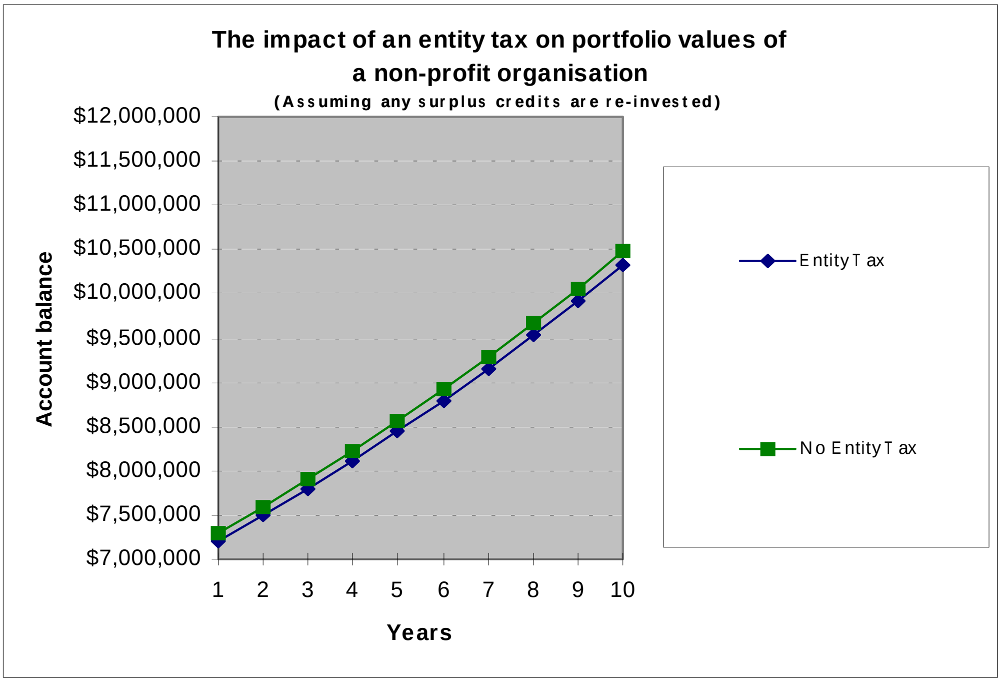
  The disadvantage to this approach is that trustees will need to attain / obtain specialist investment skills and be more actively involved in the investment decision process. Experience of member companies of the Association strongly suggests that, except with larger charitable foundations where the financial capacity exists to support an investment team, executive members of charities without a professional trustee or investment background are less likely to make this transition successfully or with sufficient speed;

- alter their portfolios to include higher levels of direct Australian share ownership so as to gain the advantage of the franking credits and the potential to obtain refunds of these credits. While this approach is consistent with the prudent person investment requirements imposed under [most] state Trustee Acts. However, over exposure to Australian shares may be counter productive to the longer term viability of the trust and to achieving its stated charitable purpose(s);

- draw upon capital to maintain existing funding programmes and maintain existing outlays where additional share investments are seen as inappropriate.

The extent of the potential detriment is demonstrated in the chart below where a non-profit organisation's investments become subject to entity taxation. As a result, in order to fund the shortfall caused by the prepayment of entity tax [in the interposed trust] trustees could be forced to realise assets from year to year.

It is important to appreciate the assumptions used in this example to understand the relationship between the level of additional franked income received by a charity and the impact this has upon the rate at which investments need to be sold. Critically, it is assumed that 50 percent of the portfolio is invested in Australian shares which are 80 percent franked. An increase in the level of franking assumed on Australian shares or an increase in the overall exposure to Australian shares will reduce the need to realise investments



Assumptions for charitable trust example

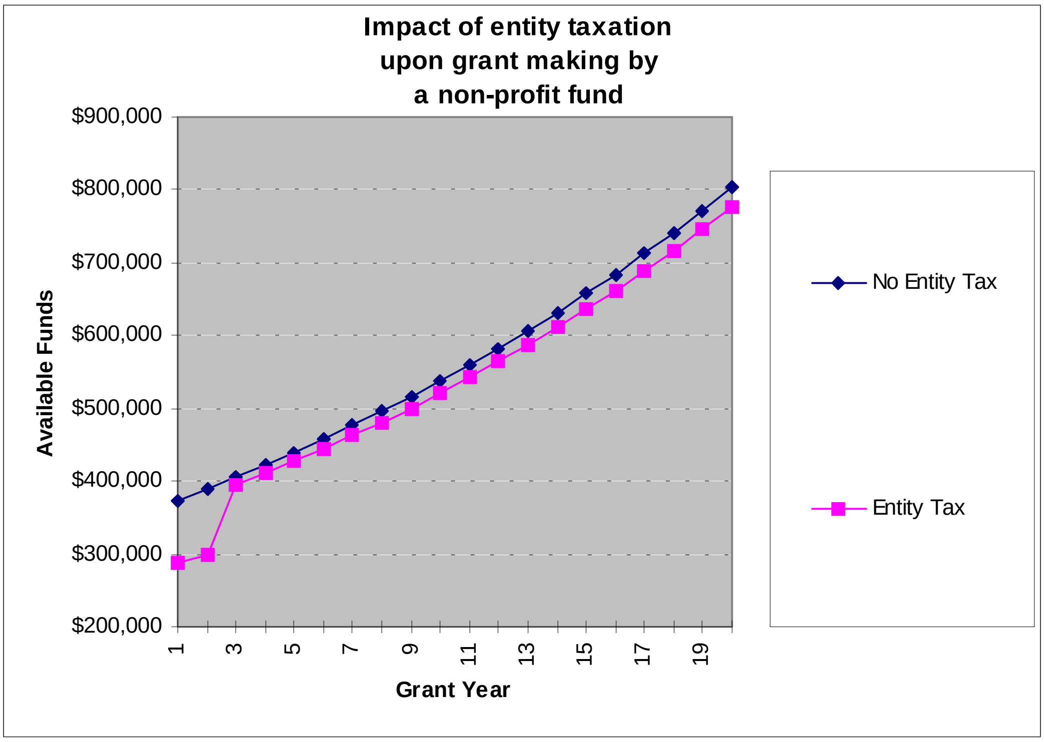
1. The initial settlement sum is $7.0 million and is invested in a portfolio made of shares (50 percent), with the balance invested in cash, fixed interest and other unfranked income. This profile is consistent with a "prudent person" or balanced type of investment portfolio.
2. The fund currently distributes all income to other non-profit organisations recognised as tax exempt by the Commissioner of Taxation.
3. Rates of return are 4.81% for income and 4.5% for capital, providing a total return of 9.31% before tax. Dividends, where paid from a company, are franked to 80 percent.
4. Ten percent of the portfolio assumed to be turned over each year resulting in realised capital gains. This level of turnover is conservative, but is consistent with a longer term investment strategy..
5. Distributions from the trust occur at the beginning of each financial quarter. Entity tax is deducted and electronically remitted to the Taxation Office at the same time under the PAYG arrangements.

6.	Refunds of surplus franking credits and entity tax credits to the charity are assumed to occur at the end of October in the following financial year. Refunds of surplus franking credits are fully re-invested [rather than distributed]. This results in the full repayment of assumed capital drawdowns.
7.	A corporate tax rate of 36 percent has been assumed.

Another consequence of introducing entity taxation is that grants will reduce in year one from $373,830 to $288,910, a shortfall of $84,920 and in year two from $389,201 to $299,007, a shortfall of $90,194. This is shown in the chart over the page. The chart also highlights the on-going impact upon funding programmes assuming:

- assets are being realised on an on-going basis;
- different levels of franked income are received from investments made by the organisation's management; and
- differing levels of reinvestment of refunded franking credits.

As shown in this chart non-profit organisations such as private charitable funds will progressively contribute less to the social well being of Australian society. Ultimately, this must mean that governments will be expected to provide higher levels of assistance funded from tax revenues.



It was noted in both ANTS and A Platform for Consultation that charitable organisations would be required to register under newly proposed rules in order for them to be entitled to claim refunds in respect of 'deferred entity tax' payable by an entity at source prior to making a distribution to that charity. This registration procedure would appear to be whether the 'deferred entity tax' or 'resident dividend withholding tax' options were adopted.

One of the issues which will have a major impact for charitable organisations will be the cashflow timing of obtaining refunds. This issue has been raised in A Platform for Consultation on page 362 in respect of charities, and possible options for obtaining timely refunds has been dealt with on pages

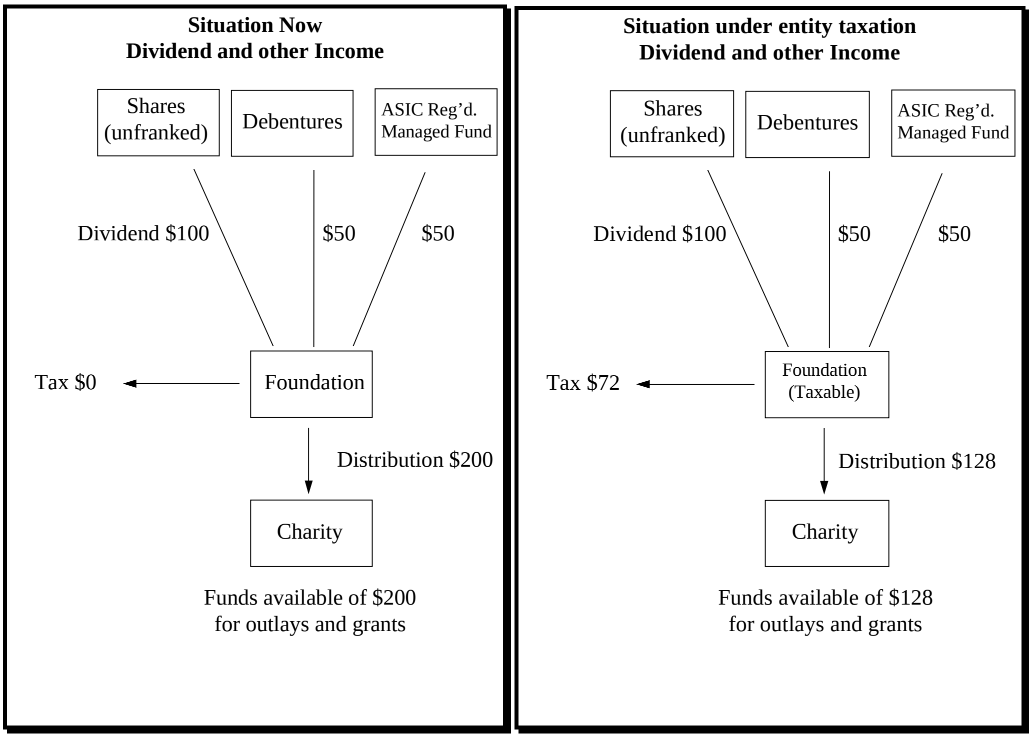
362 and 364. However, the Association believes that these options are not practical as option 1 requires **what could be *a lengthy delay prior to obtaining a refund, and option 2 requires the calculation of estimates of refunds which would be overtly complex and, in most cases, highly inaccurate.***

Impact of narrowing tax exemptions to "registered organisations" only

The recommendation that current tax exemptions be limited to a range of "registered organisations" may cause many private charitable trusts to be unnecessarily taxed for the first time. This will add additional complexity that does not exist at present.

Taxation of this "public serving" sector, through an entity tax, could reduce the possible outlays by this sector by up to 36% or $5.9 billion in the first year. This assumes that the estimate of current outlays (mentioned on page 17 in ANTS) is a reasonable estimate of the income earned by the non-profit sector. This first year shortfall will increase demand for government funding to the detriment of Federal revenues.

Practically, how such a deficit is calculated is highlighted in the following two charts comparing the position now against what it could be through entity taxation and the removal of tax exemptions.



It is acknowledged that the reduction in distributable income could be lessened or improved in subsequent years where franked dividend income is received. This is on the basis that franking credits have no value for a charity under existing tax arrangements, but will have value under a full dividend imputation tax system. However, this gain may not be sustainable in the longer term and may reverse, to the detriment of the non-profit sector and government revenues, depending upon the investments selected by trustees or managers in this sector.

Passing on the benefits of imputation through grants if foundations become taxable

Grants are not currently regarded as taxed distributions. If this treatment were to be carried across to an entity tax system, the value of franking credits will effectively be cancelled once distributed to an end user. The end result is that on-going funding programmes will be significantly affected.

Where entity tax is paid by a charity (through withdrawal of a tax exemption) consideration must be given to allow the end recipient to claim the value of those franking credits attached to “gifts” or grants. Otherwise, entity taxation will result in a continual degrading of the capacity of non-profit organisations to service essential social and welfare programmes.

How the position of beneficiaries could be worsened

This submission has used reasonable assumptions when modeling the potential detriment that a beneficiary could suffer under an entity tax system. However the Association believes it is instructive to highlight instances where the outcomes modeled could be made worse through minor changes to the assumptions. These changes include:

- reducing the exposure of a trust to Australian shares below 50 percent. In such a case, the beneficiary will be worse off as, proportionally, more entity tax would be payable without the benefit of a refund of unused credits in the next financial year. This will affect the amount of income available to the beneficiary and the rate at which capital is used to fund any shortfall.
- we have assumed in our modeling that the impact of inflation upon the income needs of minors and beneficiaries of compensation trusts is neutral. If the needs of these beneficiaries were increased to account for the real value of their after-tax income, trustees will have to accelerate their use of capital to meet those needs. As such, this combined with the additional imposition of an entity tax, will further accelerate the realisation of assets to meet the needs of the beneficiary.
- increasing the rate of return from that assumed (9.31 per cent) to a higher rate. This is because a higher rate would increase the cost to beneficiaries of paying tax at the entity level, rather than at the beneficiary level (i.e. the cost of paying tax earlier), without the benefit of a refund of the unused credits until the next financial year.
- increasing the rate at which assets are turned over within the portfolio from the 10 percent assumed in this submission will increase the amount of entity tax payable. The direct impact of this is that there will be less to re-invest after the tax liability has been provided for by the trustee.
- allowing for compliance costs such as for the preparation of annual tax returns which currently are not required. This will be necessary to obtain a refund of any unused franking credits. Once again, this is a cost which non-profit organisations are currently not required to meet. As such, each additional dollar of compliance cost will reduce the amount of income available for distribution or the rate at which trustees will need to realise investments to fund the cost.