REVIEW OF BUSINESS TAXATION

SUBMISSION BY PITCHER PARTNERS

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Pitcher Partners is a large Melbourne based public accounting firm with approximately 2,000 clients conducting businesses. We welcome the opportunity to make this submission on issues canvassed in *A Platform for Consultation* ("the Document").

In particular, in developing this submission, we have had regard for the statistics released by the Australian Taxation Office regarding the likely goods and services tax registrations. In summary, approximately 1,470,000 registrations are expected with 17,500 of these registrations being in respect of businesses with a turnover of more than $20M. Broadly, therefore, only approximately 1% of total businesses have a turnover of $20M with approximately 99% of total businesses obviously having a turnover of less than that amount. For the purposes of this submission, these latter businesses (i.e. the 99%) are referred to as SMEs. Our thrust in reviewing the Document therefore has been to consider the likely impact, revenue cost and compliance cost of its measures to SMEs. Whilst the focus has been to SMEs, many of the comments are equally valid when considered in the context of the 17,500 other business taxpayers.

Executive Summary

As would be noted from a thorough reading of this submission, we have taken the time to analyse the document in its entirety and in so doing have raised over 100 points for consideration.

The Executive Summary which follows seeks to highlight what is to Pitcher Partners the more important points. Nonetheless, a review of the Executive Summary should not be relied upon in isolation from a review of the entire Submission.

1 Assuming that the States continue to levy stamp duty on commercial property transactions, they should be required to permit a stamp duty exemption in respect of any transaction undertaken within a consolidated group. (Refer the discussion at 1.1)

2 Consideration should be given to an election basis whereby closely held entities could elect to be transparent with their equity participants being taxed as partners. (Refer the discussions at 1.2)

3 There should be a formal and independent mechanism for draft legislation consultation and for a timely technical review and correction of taxation legislation generally and, in particular, the legislation arising from this Review. (Refer the discussion at 1.3 and 6.7)

4 Due to the significant impact in terms of liquidity, volatility, valuation and compliance issues, we strongly urge against the taxation of unrealised gains. (Refer the discussion at 1.4)

5 In identifying who should be entitled to deductions for wasting assets, it is unclear whether the parties seeking the deduction must have both incurred the expenditure and have the requisite economic interest in the asset. (Refer the discussion at 2.1)

6 The adoption of the accounting concept of 'control' in identifying who should be entitled to deductions in respect of physical assets and goodwill is too subjective and complex. (Refer the discussion at 2.2)

7 The adoption of a zero rate of depreciation on buildings and structures will discourage economic growth through building construction. (Refer the discussion at 2.8)

8 The removal of the balancing charge offset would remove strong incentives to up-grade plant and improve efficiency, particularly within capital intensive industries. (Refer the discussion at 2.12)

9 Capital intensive industries such as manufacturing are particularly affected by the abolition of accelerated depreciation which if inadequately compensated for by the reduction in the entity tax rate should receive some compensation through relief such as the former investment allowance. (Refer the discussion at 2.14)

10 In relation to the valuation of trading stock, the accounting approach is the most preferred of the identified options given it will reduce the amount of timing differences and not tax unrealised gains whilst assisting the Revenue with a reduction in valuation flexibility. (Refer the discussion at 2.15)

11 Chapter 8 dealing with a new policy framework for leases and rights is supported, if not founded upon, Cameos 8.1, 8.2 and 8.3. It is submitted that the proper commercial income on which decisions to alter treatment in respect of leasing transactions is reflected in Cameo 8.3. If this method is consistently applied, the perceived problems and disadvantages noted in Cameos 8.1 and 8.2 can be seen to be exaggerated as they presently stand. (Refer the discussion at 4.2)

12 It would appear impractical and unworkable to extend the "sale and loan" approach in relation to leases and similar arrangements to "service contracts". (Refer the discussion at 4.5 and 4.7)

13 In determining a threshold for the application of the "sale and loan" approach, we consider that the figure of $25,000 is too low particularly if accelerated depreciation is removed. We would suggest that a figure in the order of $500,000 is a more relevant threshold. (Refer the discussion at 4.7)

14 In relation to leases and rights, there is discussion as to when the granting of rights should be treated as the realisation of an underlying asset. This discussion is founded upon a suggestion that one can avoid tax by issuing rights rather than selling the asset. In our view, this is an incorrect conclusion. (Refer the discussion at 4.12)

15 The permitting of scrip-for-scrip roll-over relief should not be limited to public companies as such a limitation would make it more difficult for SMEs to grow by way of mergers. (Refer the discussion at 5.1)

16 In relation to capital gains tax, an option considered is the application of an entity treatment to partnerships. There is a particular transitional issue here in that every partnership with a partnership interest which is pre-CGT (however small) will have to be valued at the transitional date. This would be an extremely expensive exercise. (Refer the discussion at 5.5)

17 We do not favour limiting the capping or stepping of the CGT rate to individuals due to the bias which that step demonstrates along with the fact that as the step is to be financed in part by the withdrawal of indexation, assets held in entities could lose the benefit of indexation with no lowering of CGT rates. (Refer the discussion at 5.6)

18 Proposals to merge and simplify the general goodwill exemption, small business roll-over exemption and small business retirement exemption arise because the existing provisions are reportedly complex to prevent tax avoidance. It is submitted that following the High Court decision in *Murry*, it is no longer possible to categorise non-goodwill gains as goodwill. As a consequence, it is recommended that the threshold for the current goodwill exemption should be raised to $5M and that this would produce a revenue neutral outcome. (Refer the discussion at 5.10)

19 If collective investment vehicles tax tax-preferred income which arises due to a timing difference, double tax could arise. (Refer the discussion at 6.1, 6.18 and 6.19)

20 There is a suggestion that there is a case for subjecting closely held entities to special tax arrangements where they do not distribute all, or some substantial portion, of their income annually. The various reforms set out in Chapter 18 dealing with distributions have the effect, whichever is introduced, that earnings retained in a closely held entity will be retained for the purposes of working capital. If they are otherwise sought to be accessed, they will be subject to taxation. (Refer the discussion at 6.2)

21 There are compelling arguments for allowing companies with pre-imputation taxed reserves to allow those reserves to be released tax free at least as a transitional measure. (Refer the discussion at 6.5)

22 The integrity of the Australian taxation system must be questioned whilst a difference remains between the top marginal individual rate (with GST to apply to the after tax income) and the corporate rate. (Refer the discussion at 6.6)

23 We do not endorse a robust general anti-avoidance rule founded upon that in the GST legislation as that rule has introduced unintended consequences and uncertainty. (Refer the discussion at 6.8)

24 In order to aid compliance, the requirement that a loan (in order not to be a deemed distribution) be supported by a written agreement entered into prior to the loan being made should be replaced by a requirement that that written agreement be entered into on or by the date of lodgement of the income tax return for the year in which the loan was made. (Refer the discussion at 6.10)

25 The use of personal assets held by entities where the acquisition of those assets is funded by way of loans or gifts should not be subject to the Distribution or fringe benefits tax regimes provided the entity is not claiming tax deductions for expenses associated with the asset. (Refer the discussion at 6.11)

26 Overall, in our view, the deferred company tax regime is not the preferred alternative. If it is to be considered further then it is imperative that it be accompanied by the Non-Resident Investor Tax Credit concept. (Refer the discussion at 6.13 - 6.17)

27 In relation to the definition of 'distribution', we would prefer an option that limits the potential temptation to argue whether a benefit is received in one's capacity as a member or an associate of a member or as an employee or as an associate of an employee. (Refer the discussion at 6.20 and 6.21)

28 In relation to distributions involving the provision of benefits, we support the need for an appropriate reasonable de minimis threshold. (Refer the discussion at 6.23 and 6.24)

29 In relation to the proposals regarding trust resettlements, the Document suggests that the introduction of a spouse as a beneficiary or the making of a capital advancement to a beneficiary would both bring about resettlements with the dramatic taxation consequences associated therewith. If "statutory resettlement rules" are introduced which have this effect, they will be draconian in their impact. (Refer the discussion at 6.28)

30 Should entities choose to consolidate there will be the potential for the consolidated group to breach the requirements that would otherwise enable them as individual entities to satisfy a number of concessions currently

available. It is submitted that entities which choose to consolidate should not be any worse off by so doing. (Refer the discussion at 7.5)

31 It would appear that if it is intended that entities which are wholly owned by family members are to be incorporated in the consolidated family group then it would be necessary for those family members to elect to consolidate their personal tax affairs in the group. Clarification is required as to whether this is an option or is mandatory. (Refer the discussion at 7.6)

32 There seems to be an implication in Chapter 26 that within a consolidated group, gains can only be on capital account or revenue account and it is not possible for a consolidated group to hold certain assets on capital account and certain assets on revenue account. This is inconsistent with present case law. (Refer the discussion at 7.7)

33 There is little discussion in Chapter 6 in relation to trusts with losses entering a consolidated group. Clarification is required of what is intended in this regard. (Refer the discussion at 7.9)

34 We acknowledge the need to calculate the cost base of equity in a group entity being sold by a consolidated group. However, in the options identified in Chapter 27, we note the prospect for double taxation, for possible inadvertent value shifts, for significant transitional and ongoing compliance costs and for compliance generally. (Refer the discussion in 7.10 - 7.18)

35 The proposed Australian consolidation regime requires prima facie 100% ownership. Many other jurisdictions, including to our knowledge the United States, France and New Zealand, do not require 100% ownership recognising that a substantial but nonetheless lower threshold provides commercial flexibility. (Refer the discussion in 7.20)

36 The discussion in relation to the taxation of international income contemplates amendments to the transferor trust provisions, broadly, prospectively removing the grandfathering offered by the "control" test. If this were to happen, individuals would become assessable notwithstanding the fact that the individuals have no control of the trust and consequently no access to the trust assets or income out of which to pay the Australian tax liability. (Refer the discussion in 8.2)

37 There are number of instances in the discussion of international income relevant to trusts and whether or not there should be relief from double taxation. As a generalisation, genuine attempts are being made to offer compliance relief for companies without the same effort being made in relation to trusts. This is founded upon, generally, perceptions regarding the concessional tax treatment for trusts in foreign jurisdictions. Remembering that there are approximately as many trusts in Australia as there are companies, it would seem consistent with the neutrality design principle in *A Strong Foundation* that efforts be made to offer relief from double taxation for trusts in bona fide circumstances. (Refer the discussion in 8.3, 8.4 and 8.6)

38 The document recognises the inequity which arises where an Australian resident invests in a foreign entity which in turn invests in Australian resident companies. The inequity is that the franking credits arising in the Australian resident companies are not able to be passed through for the benefit of the Australian resident investors. There appears to be no real commitment in the Document to rectify this inequity. On the other hand, there is significant commitment to easing the Australian tax burden for non-resident investors in Australian entities where those Australian entities have foreign income. Particularly in order to assist Australian businesses seeking to build strategic commercial international relationships we recommend that a realistic effort be made to assist those Australian businesses by formally developing some form of franking credit flow through reforms. (Refer the discussion in 8.5)

39 On balance, we support the recommendation to transfer the taxation liability in respect of fringe benefits from the employer to the employee. However, we recognise that this has a number of compliance issues, collection issues, industrial relations issues and cost issues (approximately doubling the cost of on-costs attributable to fringe benefits). (Refer the discussion in 9.1 - 9.5)

40 We support the view that the position in relation to "entertainment" should return to the pre-1995 status whereby it was not subject to FBT and non-deductible. (Refer the discussion in 9.6)

41 We submit that the proposal for the alignment of the FBT and income tax years would create significant compliance problems for employers. (Refer the discussion in 9.8)

42 In relation to the proposals regarding FBT and motor vehicles, we recommend -

1 That any changes not be made without a comprehensive review of its impact including that on the domestic motor vehicle industry; and

2 That transitional arrangements would be necessary to ensure that any revisions in the taxing of cars should only impact on new agreements and not have a retrospective impact on existing agreements.

(Refer the discussion in 9.9 and 9.10)

With this foundation, our specific submissions are set out as follows -

1 **Macro**

1.1 The announcement in the original Government statement on 13 August 1998 to repeal stamp duty on commercial property transactions was a very attractive reform for business.

Quite apart from encouraging business generally, it had the implicit benefit of simplification in relation to internal business re-organisations.

Whilst it is acknowledged that most States have some form of stamp duty relief where property transactions are undertaken as part of a group re-organisation, the actual terms of the relief are limited in ambit.

One of the design features of the business tax reform package was a desire to simplify business re-organisations. The potential consolidation regime is a driver in this regard and the abolition of stamp duty on many business imposts will complement that regime.

The effect of any agreement with the States to allow the States to continue to levy stamp duty on commercial property transactions is to limit the potential ability of groups to simplify re-organisations.

Assuming that the States continue to levy stamp duty on commercial property transactions at very least for an extended transitional period it would seem that it is not too late to require the States to permit a stamp duty exemption in respect of any transaction undertaken within a consolidated group.

Quite apart from enabling a simplification of business re-organisations, such a concession is also logical. The reality is that if there is a re-organisation in a consolidated group then for all practical purposes there is no change of beneficial ownership. Where such a change does not arise, the imposition of stamp duty is inequitable.

1.2 The Document regularly distinguishes between widely held entities and closely held entities.

Pitcher Partners' experience is that closely held entities tend to be of two generic categories -

(i) Entities associated with discreet individuals and/or that individual's family;

(ii) Entities that involve a limited number of independent individuals which usually operate pursuant to some form of equityholders agreement effectively as partnerships.

The Document generally seeks to distinguish between individuals and partnerships on the one hand and companies and trusts on the other.

Whilst the Document and the initial announcement in the form of *A New Tax System* are effectively founded upon this basis, the association of trusts with companies is primarily due to the perceived benefit of a trust being able to avail itself (through a corporate trustee) of a limited liability. Absent this benefit of limited liability, the characteristics of trusts are consistent with those of individuals and partnerships of individuals.

Overall, it would seem that the Document in a sense consolidates trusts and companies but does not seek to contrast the substantive differences between widely held entities and closely held entities.

There is a clear basis of distinction between closely held entities and widely held entities with the latter operating largely separate from their equityholders.

It is submitted that closely held entities are in a sense alter-egos of individuals. Accordingly, consideration could be given to recognition of this substance and thereby distinguishing the basis of taxation of widely held entities and closely held entities.

By way of illustration, the United States has the concept of an S Corporation which is a company which can elect to be "transparent" with its shareholders being taxed analogous to partners. This status is only available for closely held corporations.

France has a similar concept in the form of its *Societe Civille* ("*SC*"). A French *SC* can choose to be taxed as a company or as a partnership.

Returning to our emphasis in looking towards the impact of tax reform on the multitude of small entities in Australia, it is therefore submitted that consideration be given to an election basis whereby closely held entities could elect to be transparent with their equity participants being taxed as partners.

1.3 We have a concern regarding the timing of the implementation of the results from this Review.

Broadly, it would seem that the Review has to be complete and legislation implemented in a manner which will enable the companies with a substituted accounting period ending on 30 June 2000 (typically this means that the substituted accounting period ends on 31 December

1999) to have newly legislated provisions available in order to have certainty.

Prima facie, this requires the passage of legislation by 31 December 1999.

Whilst it is acknowledged that there is to be consultation on the reform principles, equally there must be a period for consultation on the consequential legislative provisions.

There have been many examples in recent years where poor drafting and/or lack of consultation have meant that the associated legislative provisions are either/or inoperable, inequitable, anomalous and unduly complicated.

These examples include proposed Division 243 dealing with non-recourse financing, Division 7A dealing with payments and loans by private companies, Schedule 2F dealing with trust losses and the recently introduced dividend streaming, anti-franking credit trading and capital benefit provisions.

On the one hand, we acknowledge the need for a speedy implementation of the measures to be introduced as a consequence of the review. However, the consequence is that it is virtually certain that there will be the need for technical corrections.

Accordingly, in our view, it is necessary that there be a formal and independent mechanism -

(i) Draft legislation consultation; and

(ii) For a timely technical review and correction of taxation legislation generally and, in particular, the legislation arising from this review.

1.4 Page 29 of the Document identifies practical constraints standing in the way of a universal application of a comprehensive income, tax base. These might be summarised as liquidity, volatility, valuation difficulties, downsides to the Revenue and international competitiveness constraints. We would add compliance costs.

A critical factor on which we would like to focus at this early point is in respect of those measures which might have the possibility of taxation applying in relation to unrealised gains. For SMEs this could be particularly significant in terms of liquidity, volatility, valuation and compliance issues and we would strongly urge that taxation of unrealised amounts be very much the exception rather than the norm coming out of the consultation process. Without limiting the generality of this statement, we note particularly the prospect for this occurring in relation to the taxation of financial assets and liabilities.

1.5 The term "*tax-preferred income*" is defined in paragraph 36, page 13, as "income not included in taxable income for specified taxpayers".

This general concept is then elaborated upon in the same paragraph by identifying that such income can arise from domestic tax incentives, exemptions including in relation to foreign sourced income and the offsetting of deductions for previously incurred losses against current income so that dividends paid out of that income are unfranked.

Importantly, on page 14, it is recognised that the reference to offsetting deductions for losses "...is somewhat misleading..." when encompassing those amounts in the concept of *tax-preferred income*. The concluding sentence of paragraph 13 provides that whilst it is misleading "...as the tax effects are the same, usage of this umbrella term is retained".

We strongly query whether the tax effects are the same.

As a generalisation a loss incurred by most forms of taxpayers is an economic loss in that there is a cash outflow which has not been recovered. Losses are typically reflected in reductions in equity or offsetting debts, these debts having funded the losses.

Accordingly, where there is income subsequently generated that offsets deductions for previously incurred losses, that income does not ordinarily become available to the individuals where the losses have been funded by loans. In that event, the income is used to discharge the loans. Nor does the income ordinarily become available to individuals where the losses have been funded by way of a reduction in equity. The income derived and offset by deductions for previously incurred losses replaces that equity.

Accordingly, it is submitted that it is inappropriate to regard income which is offset by deductions for previously incurred losses as being tax preferred income as the income is not able to be disbursed in that form. This point within this submission is of particular relevance when seeking to apply the general principle in relation to *tax-preferred income* to trusts.

Paragraph 50 and latter paragraphs refer to "distributions of tax-preferred income". It is submitted that where previously incurred losses as offsetting deductions are applied against subsequent income derived, that that income is not able as a rule to be distributed to "equity participants".

At paragraph 50 on pp 16-17, the following statement is made -

> "Under current arrangements, for example, discretionary trusts are able to distribute such tax-preferred income without further tax consequences for their owners, whereas such distributions by companies and fixed trusts usually entail taxation...".

It is submitted that where a discretionary trust has made a loss and subsequently recovers that loss, there is no net amount which can be distributed. Nor is there in the case of companies and fixed trusts.

Overall, it is submitted that it is erroneous as a statement of principle to treat the offsetting of prior loss deductions against subsequent income as bringing into existence tax-preferred income.

1.6 Figure 5 on page 40 outlines under two options alternatives for the treatment of expenditure.

It would seem that Option 1, broadly speaking, is the status quo, i.e. the maintenance of the existing dichotomy between assessable income and deductions.

In working through the table within Figure 5, there is a question in relation to Option 1 - "Are there any associated benefits (*including assessable income*) beyond the year in which expense is incurred?" (Italics added) The flow chart proceeds that if the answer is "yes" then the expenditure is of a capital nature and prima facie no deduction is allowed.

A concern is expressed here where the associated benefits are limited to the derivation of assessable income beyond the year in which the expense is incurred. Putting to one side for a moment the operation of the 13 month rule set out in Section 82KZM of the Income Tax Assessment Act 1936 ("the 1936 Act"), expenditure where the benefit is a recurring income stream (e.g. interest on monies borrowed to generate that income stream) is not always of a capital nature.

Accordingly, Figure 5 in this respect may represent an over-simplification.

It is also implicit in Figure 5 that the purchase of trading stock is presently capital expenditure. This is also not the case.

1.7 Paragraph 156 at page 41 contemplates a "practical definition of *assessable income*".

The first bullet point includes "current receipts and earnings derived in the year (other than private benefits)".

Prima facie, the expression "current receipts" would incorporate the proceeds on disposal of assets other than those held for private purposes.

However, the consequential definition of "*losses and outgoings*" at paragraph 158 does not provide any relief for the cost of any assets disposed of.

1.8 There is discussion at page 44 on the "generalised treatment of interest".

To this point in Volume 1 "interest" is not defined.

Is it intended that the generalised treatment be extended to finance expenses generally, e.g. discounts on commercial bills and promissory notes?

If the principles of reform are, among other things, influenced by substance over form, then such discount expenses are "effectively interest" and should be treated consistently with interest.

1.9 Paragraph 208 on page 55 states that "companies are able to achieve tax benefits that are unintended by these provisions - as well as from the rebate which free inter-corporate dividends from tax and from the separate tax assessment of each company in the group". Discussion then ensues on examples being the creation of artificial losses through loss cascading or transactions at non-arm's length values and separately the creation of unintended taxation benefits by manipulating transactions between companies in the group.

In each of the above cases, there are significant anti-avoidance provisions in the first two examples specific provisions as well as the general anti-avoidance provision within Part IVA of the 1936 Act. The last example would in the event of a dominant tax purpose be covered by Part IVA.

It is submitted that the comments made in Paragraph 208 are correct at best at the margin and to the extent to which the views expressed in the Discussion Paper are founded upon Paragraph 208 those views are misguided.

It is recommended that the Membership of the Review should meet with industry and tax professionals to consider the points made in Paragraph 208 in detail in order to ensure that the comments are well founded.

It is noted as set out in Paragraph 210 on page 55 that "anti-avoidance provisions should not have to be relied upon to address such structural flaws in the law". This is accepted.

1.10 The Document comprises 844 pages of comprehensive analysis traversing virtually all material areas of income tax.

We have had less than two months to seek to analyse the Document in order to develop and lodge this submission. Regrettably, the level of detail involved and the limited time available ensures with virtual certainty that there will many issues which have not been identified by us but which will become apparent as we seek to apply the principles of the Document to specific client circumstances.

Accordingly, in developing and lodging this submission, we must qualify our comments accordingly.

2 Taxation of physical assets and goodwill

2.1 In identifying who should be entitled to deductions for wasting assets, it is unclear whether the proposal in paragraph 1.15 requires the satisfaction of **both** of the following tests:

(a) Must have incurred the relevant expenditure; and
(b) Must have the requisite economic interest in the asset.

This lack of clarity is accentuated by the lack of any definition or discussion on the meaning of the expression ‘requisite economic interest’. It appears from the discussion in paragraph 1.16 that, in the absence of legal ownership, a taxpayer will only have the requisite economic interest in the asset if the asset has been acquired via a hire purchase, lease or some equivalent form of financing.

The foregoing references would only continue to create difficulties and commercial uncertainties. For example, where a tenant has incurred expenditure on a fit out on leased premises via their own cash sources, it would appear they would continue to be ineligible for deductions because they have not ‘acquired’ the asset under hire purchase, lease or equivalent form of financing. Furthermore the landlord would not be entitled to deductions because they did not incur the relevant expenditure.

2.2 The adoption of the accounting concept of ‘control’ in identifying who should be entitled to deductions in paragraphs 1.18 to 1.20 is too subjective and complex. It would require legal resolutions as to who has the right to access to an asset and continual assessments of future economic benefits, thus increasing compliance costs.

2.3 A more consistent approach should be adopted by reflecting the receipt of subsidies or bounties in a lower cost base for the asset rather than being assessed in year of receipt. Such treatment more accurately reflects the actual decline in value of the asset. After all, this is the key fundamental of Chapter 1.

2.4 If the 'installed and ready for use' concept is adopted for determining when deductions should commence, clarity would be required for certain assets such as films, mining, water conservation and grapevines. The differing nature of such assets justifies continuation with the current law. The comments in paragraph 1.33 appear to be confusing the concepts of 'installed ready for use' and 'use for the production of assessable income'. It is strongly arguable that grapevines, to continue with the paragraph's example are installed ready for use when planted. If the 'installed ready for use' concept is to be adopted, grapevines and similar investments should be subject to depreciation from installation time rather than a time with any nexus to income derivation.

2.5 The standard write-off proposal should be adopted as an alternative for taxpayers seeking to reduce compliance costs whilst not disadvantaging seasonal taxpayers or encouraging taxpayers to defer capital expenditure until the later stages of a financial year.

2.6 There is no discussion in paragraphs 1.49 to 1.52 on what would be appropriate circumstances for taxpayers to seek a variation from the Commissioner's schedule of effective life determinations. The ability to vary must be flexible in this ever-changing and highly technological world where the Commissioner would find it difficult to produce a sufficiently comprehensive schedule.

2.7 Consistency and simplicity would not be achieved if capital gains indexation was not available on buildings and structures so included in the depreciation regime. The perceived mischief in paragraph 1.59 should only be of concern with disposals of buildings and structures to related parties not dealing with each other at arm's length.

2.8 The adoption of a zero rate of depreciation on buildings and structures will only discourage economic growth through building construction. These are inherently risky ventures and from a commercial and macro-economic perspective need to be encouraged.

2.9 The de minimis thresholds for immediate write offs should also include a reference to items with an effective life of three years or less. The mischief this seeks to address would not appear to warrant the adverse effects on the general tax paying population such a threshold would cause.

2.10 Record keeping and other compliance costs for SMEs would not be reduced with the adoption of an annual dollar limit for immediate write off items. SMEs would still need to record such items on their depreciation schedules in determining whether the annual limit has been breached.

2.11 The identified inequities of the prime cost method could be overcome by taxpayers not being required to assume second-hand plant is new. The current self assessment regime should permit taxpayers to self assess effective lives which may include obtaining information from the vendor.

2.12 The removal of the balancing charge offset would remove strong incentives to up-grade plant and improve efficiency, particularly with capital intensive industries. The tax deferral savings offered by balancing charge offsets are an important saving in financing new capital expenditure. As mentioned earlier, incentives for these types of investment are important and should be retained where possible.

2.13 Aborted asset acquisition and disposal costs (eg. advertising), should be considered in the category of blackhole expenditure. At worst, such costs should be included in the CGT cost base of the relevant eventual asset. These are real costs of doing business and some relief should be available.

2.14 Capital intensive industries such as manufacturing particularly affected by the abolition of accelerated depreciation should receive some compensation through relief such as the former investment allowance. Special government incentives for the most affected industries could also be implemented.

2.15 The possibility of requiring all trading stock on hand to be valued at net realisable value is strongly opposed because it will tax unrealised gains Applying the accounting approach is the most preferred of the identified options given it will reduce the amount of timing differences, not tax unrealised gains whilst assisting the revenue with a reduction in valuation flexibility.

2.16 Consumable stores and spare parts should not be treated as trading stock because of the inherent nature of such assets, the immaterial values usually involved, and the likely compliance problems in valuing such items.

2.17 The treatment of standing crops as trading stock fails to recognise the differing features of standing crops. There is a substantial risk getting to harvest, unknowns as to what is available to harvest and there would be consequential valuation difficulties. Investment in the rural sector would also diminish.

2.18 The inclusion of partly completed contracts for the provision of services into trading stock should be subject to a de minimis exemption for SME taxpayers subjected to potentially disastrous cash flow problems.

2.19 Clarification is required on whether the capital gains tax concessions applicable to the disposal of goodwill would be retained if acquired goodwill could be depreciated.

2.20 In developing a framework for the depreciation of acquired goodwill, consideration needs to be given to the fact that many expenses incurred in acquiring and maintaining goodwill may be capital in nature and therefore non-deductible (eg. restrictive covenants, franchise/license fees, advertising signage). Difficulties will arise when considering whether these items should form part of depreciable goodwill.

3 Taxation of financial assets and liabilities

Chapters 5, 6 and 7 set out proposals in relation to what is broadly referred to as financial assets and liabilities.

The broad suggestion within Chapter 5 and detailed in more precise terms in Chapter 6 is for a "timing adjustment benchmark" method to be applied to such assets and liabilities which would include a balancing charge at the end of the life of the financial asset or liability.

It is also proposed that there be an elective mark to market approach permitted in some circumstances and in other circumstances a realisation approach will be appropriate.

Given the complexity of this area, it is important that taxpayers have clear guidance in relation to the rules to be applied in their appropriate circumstances. This is particularly important in the context of taxpayers who may be classified as small or medium enterprises and who may not have sophisticated systems in place to perform complicated accruals calculations.

Amongst the issues which need to be clarified are the following -

- The definition of financial asset and liability.

- The appropriate method for calculating the timing adjustment benchmark. In addition, taxpayers need clear guidelines as to when they will be required to apply this methodology.

- Determination of a precise methodology for calculating any balancing charge.

- Setting out the circumstances in which it is appropriate to use an elective market to market basis or a realisation approach.

Other general issues which require more detailed examination or consultation with industry and the professions are the following -

- The issue in relation to treatment of hedges.
- Clarification of issues in relation to economic and legal disposals of assets and liabilities.
- Establishing a position in relation to extinguishment of liabilities.
- The position in relation to quarantining of losses.

The above issues are recognised and discussed in the paper but no particular direction is given. These are clearly significant issues which require consultation.

4 Taxation of leases and rights

4.1 Chapters 8, 9 and 10 are titled "Taxation of Leases and Rights". At paragraph 8.2 it is noted that "restrictive covenants" are a type of rights contract to be covered by the discussion. We have not been able to find any specific further discussion of restrictive covenants in chapters 8, 9 or 10. Further elaboration on this issue would be helpful.

4.2. At paragraphs 8.5, 8.10, 8.13, 8.21 and at numerous other points in chapter 8 it appears to be implied that there is a preference for aligning the taxation treatment of leases and other rights with changes in commercial or economic value. Yet Cameos 8.1, 8.2 and 8.3 all show differing commercial incomes from what appears to be identical (or very similar) commercial transactions. It appears that in essence only the taxation outcomes are different in these examples. It is submitted that the proper commercial income on which decisions to alter treatment in respect of leasing transactions is best reflected in Cameo 8.3. If the method of determination of commercial and taxable income used in Cameo 8.3 is applied consistently to Cameo's 8.1 and 8.2, the perceived problems and disadvantages noted in 8.1 and 8.2 can be seen to be exaggerated as these graphs presently stand. Further, if depreciation or amortisation of a wasting leased asset was instead reflected commercially on a reducing balance rather than straight-line basis, the divergence reflected between commercial and taxable outcome would not be as significant.

We believe it is critical that there is a consistent understanding of commercial outcomes as a basis for proposing change in this area.

4.3 From a compliance, fairness and practicality perspective we agree with comments made at paragraphs 8.29 to 8.37 in relation to the proposed removal of 51AD and modification of Division 16D.

4.4 We also agree with the proposal (from an ease of compliance and fairness perspective) to only apply any new rules to arrangements entered into on or after the proposed commencement date. Refer to paragraph 8.54 and 8.55.

4.5 Chapter 9 outlines two approaches for dealing with leases and similar arrangements. Option 1 considers a "sale and loan" approach. This option has essentially been recently introduced into the 1936 Income Tax Assessment Act in the form of Division 42A which deal with leases of luxury cars and in proposed Division 240 which deals with hire purchase and similar arrangements. In principle we favour this approach over Option 2, "tax preferred leasing" approach. However, we submit that it would be impractical and unworkable to extend this concept (sale and loan) to service contracts as is suggested at paragraphs 9.18 to 9.20.

4.6 Paragraphs 9.25 and 9.26 refer to the potential imposition of a balancing charge. It is unclear whether this only applies to Option 2 and whether the balancing charge is to be applied to either or both the lessor and lessee.

Paragraph 9.26 states that a balancing charge at the end of the lease would ensure neutrality for the lessee between owning the asset and leasing the asset. It is difficult to see how neutrality is achieved. A former owner of an asset receives consideration on disposal of the asset out of which any tax that arises on the balancing charge may be paid. A lessee receives no such consideration on expiry of a lease.

4.7 At 4.5 above we suggested a preference for the "sale and loan" approach. Should that approach be adopted we would favour what is described as the Canadian leasing regime at paragraphs 9.69 to 9.73. That is, we would generally favourably consider the "sale and loan" treatment being applied consistently to all types of leases and hire purchase transactions for the purposes of consistency. All types of leases would encompass operating leases, finance leases and operating leases (with options to purchase). As stated above, we do not favour the extension of the sale and loan treatment to service contracts on the grounds of perceived complexity and potential increased compliance cost.

We acknowledge the comments at paragraph 9.69 regarding "significant exclusions applying on the basis of materiality" which is critical in our view.

We do not however consider that the figure of $25,000 (asset value) noted at paragraph 9.70 is a relevant materiality threshold to most business taxpayers. In that regard we would suggest that a figure in the order $500,000 is a more relevant threshold, over which it is compulsory for the lessee/user and lessor/financier to use the "sale and loan" methodology. We suggest that for leased assets below a $500,000 threshold that either the current taxation treatment or the "sale and loan" treatment could be elected by the lessee/user and the lessor/financier by mutual consent.

Should accelerated depreciation no longer be available post implementation of tax reform, there would appear to be grounds for any minimum threshold to exceed a figure of $500,000.

4.8 Should the "sale and loan" option be adopted with significant de minimus exemptions, issues regarding tax exempts, and overseas asset use would be addressed, without significant potential revenue leakage and with due regard to SME compliance costs.

4.9 To assist SME compliance where the "sale and loan" approach is required or elected it may be relevant to have lessors/financiers prepare and provide to the lessee/user a schedule outlining the interest and principal components of each periodic lease/hire purchase etc. payment.

4.10 We acknowledge the disparity of taxation treatment where rights to non wasting assets are disposed of. As indicated at paragraph 10.5 the grantor of such rights is often taxed on the upfront payment whereas the grantee is usually only able to claim a capital loss on expiry of the right. We also acknowledge the proposal for taxation on an accruals basis and note the potential relevant exclusions at paragraph 10.16.

In regard to the first bullet point at paragraph 10.16 it is suggested that the fact that there is a low present value of rights payments should not, on its own, automatically exclude the grantor or grantee from an accruals regime. Instead, it is submitted that if an accruals regime is desirable, that grantors and grantees be given, by mutual agreement, the option to be part of the accruals regime, even if the present value of rights is below the proposed minimum threshold.

4.11 It is acknowledged at 10.15 that one approach is to assume that benefits are distributed equally over the period of the right. This approach would appear to accommodate income being returned on a straight line basis to the grantor over the life of the right and deductions be available to the grantee.

It is submitted that such an approach achieves the objectives of simplicity (not readily apparent under either the "implicit benefits" or "deemed benefits" approach) and addresses the concern raised at 10.5. A simple straight line time based apportionment approach also would meet the key policy issues recognised at paragraph 10.11.

4.12 Paragraph 10.34 raises the issue of whether and when the granting of rights should be treated as the realisation of an underlying asset. It is stated at 10.37, "without an appropriate recognition of in substance realisations taxpayers would be able to avoid tax by issuing rights over an asset rather than selling the asset outright. It is submitted that it is difficult to think of situations where tax would be avoided. If rights are issued any consideration received by the grantor would usually be assessable as ordinary income (eg. as a royalty) or fall to be assessed with the capital gains tax provision (eg. lease premiums, or under deemed disposal provisions, formerly contained in section 160M(6) and (7) of the 1936 Income Tax Assessment Act and now included in the 1997 Income Tax Assessment Act at section 104-35 and section 104-155 respectively).

At worst, tax may be deferred if the grantor is only assessed on, say, receipt of royalties instead of being assessed on an immediate capital gain. However, deferral of the immediate capital gain that presently otherwise arises would generally be consistent with the objective of taxing rights payments in accordance with income flows as discussed at paragraphs 10.1 to 10.33.

In short, there would appear to be no basis for treating sales of rights as realisations of assets as consideration received from such sales would appear to be assessable under current tax legislation.

5 Taxation of capital gains

5.1 Chapter 11 of the RBT Document proposes scrip for scrip roll-over but confines the relief to publicly listed companies. From a broad policy perspective, it is submitted that there should not be any discrimination against private companies in favour of public companies. The same issues in terms of a significant barrier to takeovers applies equally at the private company level and the disadvantages to shareholders outlined in Chapter 11 also apply to private company shareholders.

At paragraph 11.63 the RBT Team have stated that roll-over relief could be limited to public companies as this would avoid problems if the provisions were extended to unlisted companies where the value of shares is less easily determined. This is not a valid reason for not extending the scrip for scrip roll-over relief to private companies as the CGT market value rules and value shifting rules require those private company shares to be valued in certain circumstances. There is no reason then why the value of these shares for roll-over purposes cannot also be ascertained without any greater difficulty.

When so much of the Document is devoted to obtaining consistent treatment across entities, it is disappointing to see a concession that then discriminates between the treatment of equity interests in those entities. Not only does it discriminate across entities, it would also give rise to inconsistent treatment across different types of companies.

It is therefore recommended that as a minimum scrip for scrip roll-over should be extended to private company shares. Arguably the concession should be extended across all equity interests in all entities. However, it is conceded that this would be more difficult to achieve.

Overall, it is very important to ensure that in seeking to overcome tax avoidance and minimisation problems that one does not stifle economic growth.

Further, the Document proposes a "robust" general anti-avoidance provision. If this is the case then the anti-avoidance concern that might otherwise limit scrip-for-scrip transactions may be illusory.

5.2 Example 14.6 on page 334 seeks to identify an opportunity where a vendor of a part interest in an asset can crystallise an unrealised loss for capital gains tax purposes but pass that on to the transferee with a base for depreciation purposes which includes the amount of the unrealised loss. Prima facie, the consequence is a double deduction, i.e. a capital loss to the transferor and a depreciation deduction or balancing charge to the transferee.

Specifically the following is an extract from that example -

> "For CGT purposes, A would be taken to have disposed of an asset comprising a 50% interest in the partnership asset. The cost base of the asset would be $40 (calculated as 50% of the $120 cost of the asset less 50% of the $40 depreciation deductions allowed). A would therefore incur a capital loss of $20 (that is, $40 cost base less $20 received for the sale of the interest to C). However, B and C would have cost bases of $40 each for the asset and so C could deduct $20 more than he or she paid for the asset."

It is submitted that for CGT purposes C would not have a cost base of $40 (notwithstanding the fact that it does for depreciation purposes), but would have a cost base of the actual amount paid, i.e. $20.

The effect of roll-over relief for the purposes of Section 58 (in conjunction with Section 59AA) of the 1936 Act and subdivision 41A of the 1997 Act is only for depreciation purposes and not for CGT purposes.

5.3 In dealing with partnerships and in particular depreciable assets in which partners have an interest, the review proposes two reform options, i.e. a fractional interest approach on the one hand and an entity treatment to partnerships on the other.

So far as the former is concerned, the following comment is made at paragraph 14.23 and 14.24 -

> "In theory, the fractional interest approach should impose little additional record-keeping obligations on taxpayers, as they already have to keep such records for CGT purposes. Indeed, it could reduce compliance costs as a single set of records could be used for both depreciation and CGT.
>
> In practice, the reverse is likely to be the case because many partners experience considerable difficulty in complying with the fractional interest approach for CGT purposes. To require them to do the same for depreciation purposes would exacerbate matters for them."

Income Tax Ruling IT2540 in fact provides that the fractional interest approach is not formally to be applied to depreciable assets held by large professional partnerships, but rather certain capital gains tax issues on disposal can be accounted for within the partnership return.

5.4 In relation to the application of an entity treatment to partnerships, the following comment is made at para 14.34 -

> "A disadvantage relative to Option 1 is that it allows a situation to arise where the aggregate cost base of the partner's interests in the partnership differ from the aggregate cost base of the assets owned by the partnership. This opens up opportunities for tax minimisation practices. The problem of dual cost bases can also arise for companies and other entities. This issue is discussed in more detail in Chapter 28."

It should also be noted that whilst such an approach might open "...up opportunities for tax minimisation practices", it also opens up opportunities for double taxation, for example where an asset of the partnership has an unrealised gain and the partner disposes of the partner's interest in the partnership, a taxable capital gain will arise to the partner. If the partnership were to then dispose of the asset, a taxable capital gain would then arise to the partnership, which would flow through to the new partner.

This can be specifically illustrated by looking to the examples set out in Appendix A at page 339. The base fact scenario at A.2 would cause the balance sheet at the first year end to appear as follows -

	Consolidated	**A**	**B**
Capital	200	100	100
Undrawn profits	180	90	90
Capital & Undrawn Profits	380	190	190

Represented by -

Cash	300	150	150
Asset at written down value	80	40	40
Net assets	380	190	190
Adjustment to reflect market value -			
Asset (market value)	120	60	60
Adjusted net assets	420	210	210

The market value adjustment is to reflect the fact scenario in A.3, which recognises that the asset has a value of $120.

If the first transaction were for A to dispose of its interest in the partnership, the market value of that interest is $210. As Paragraph A.2 establishes that A has a cost base of $190 on disposal of that interest A would have a taxable capital gain of $20.

For completeness of the example, it is assumed that A sells that interest to C.

If the partnership were to then dispose of the asset, it would realise a profit of $40, which would flow as to $20 to B and as to $20 to C. Accordingly C would be taxed on what is economically the same profit as that upon which A has been taxed.

Indeed, this fact outcome is highlighted in Scenario 3 under which Partner B sells his interest in the partnership to C and realises a capital gain of $110.

If the partnership were to then dispose of the relevant asset for $300, a balancing adjustment would arise within the partnership which would flow through to Partner A and Partner C.

5.5 Paragraphs A.8 and A.9 on page 340 deal with transitional arrangements associated with moving the taxation of partnership interests to an entity basis.

The effect of A.9 is that every partnership with a partnership interest, which is pre-CGT (however small), will have to be valued at the transitional date. This would be an extremely expensive exercise to the economy overall.

Has this been considered?

5.6 The discussion in Chapter 11 regarding CGT provisions for individuals and in particular the introduction of a capped rate or a stepped rate with similar effect if introduced will lead to an investment bias in favour of individuals (typically low income earning spouses) because as paragraph 11.30 on page 290 notes "[C]onfining the option to individuals would limit its revenue cost". It is noted that there would seem to be the intention to extend the individual CGT reform to investments held by individuals through collective investment vehicles. In particular over time, as noted above, this will lead to a bias in favour of individuals particularly where the contemplated investment is a passive investment, e.g. a share or unitholding.

Reasons of limited liability will ordinarily mean that business assets will be held in one form of entity or another.

Broadly, the objective of providing CGT relief is to -

(i) Encourage saving and investment;

(ii) Produce net economic benefits;

(iii) Encourage long-term investment;

(iv) Encourage high risk investments; and

(v) Help attract mobile international capital.

A capped or a stepped rate favouring individuals only is at best likely to satisfy the first three of those objectives only.

Paragraph 12.5 on page 306 provides that "[I]f CGT was reformed to encourage investment by lowering CGT tax rates, there is a strong reason to support the elimination of indexation".

This comment is accepted broadly where indexation is not available to the party that has the benefit of the lower CGT tax rate. However, it would seem that assets held in entities could lose the benefit of indexation with no lowering of CGT tax rates. This would further exacerbate the bias towards individuals.

5.7 The CGT concessions for small business, i.e. the CGT roll-over relief, the CGT retirement exemption and the CGT goodwill exemption are discussed at pp.300 - 301.

In paragraph 11.79, the Document identifies as a possible reform substituting the goodwill exemption with "a generalised exemption of, say, 20% of all capital gains arising on disposal of active assets of the small business, defined as those with net assets of less than $5M". Confirmation is sought that a generalised CGT exemption for small business, if introduced, would be included in the transitional arrangements for trust distributions.

5.8 The Document suggests the removal of indexation from the CGT regime. At paragraph 12.5, it is noted that the argument in favour of this would be stronger if CGT rates of tax were reduced. This may be true if the only changes were the removal of indexation and a reduction in rates.

However, any change to the averaging rules must also be factored into likely impacts. Both of the recommendations offered in relation to averaging have the potential to significantly increase the CGT liability of a person without offering any reduction in complexity.

5.9 It is a concern that the use of the current averaging provisions is perceived as inappropriate or some form of 'abuse'.

The averaging provisions were introduced to overcome the very real problem of a capital gain 'pushing' a person into a higher tax bracket than would ordinarily apply. It is submitted that where a taxpayer plans the realisation of assets to best avail themselves of the averaging provisions it is neither an abuse nor inappropriate. It is similar to the way a person may plan their retirement to be early in a new financial year rather than at the end of financial year to take advantage of lower marginal tax rates.

The averaging provisions reflect the fact that in most cases a gain may have accrued over a number of years but is taxed only in one year, at the time of realisation. Whilst it is accepted that there is no basis for saying that a 5 year average is relevant to the period any taxpayer has held a particular asset, the same can be said in relation to a 2 year average.

The total removal of averaging would simplify CGT to some minor extent. However, if averaging is to be removed it needs to be replaced by a sufficient tax-free threshold which would provide most taxpayers with approximately the same effect as averaging.

5.10

The taxation treatment of capital gains and losses is a complex issue for all taxpayers as the majority are likely to be affected at some time. As a category of "taxpayer" SMEs are the ones that are most affected by the complex CGT provisions. SME taxpayers generally do not have the benefit of in-house specialist tax or accounting advice, yet are the ones that frequently encounter CGT issues on the acquisition and disposal of business assets.

Specific provisions, such as the general goodwill exemption, small business roll-over on replacement of business assets and the small business retirement exemption, that relate to small business are complex and in most cases the requirements are difficult to satisfy.

In Chapter 11 of "Building on a strong foundation" it has been recognised that the above provisions are complicated and that there would appear to be scope to merge and simplify them. The Review Team states that the small business roll-over provisions are necessarily complex to prevent tax avoidance through taxpayers rolling gains into goodwill and then using the goodwill exemption.

However, given the High Court decision in the *Murry* case, it is submitted that the reason for the complexity, as stated above, is no longer valid. The *Murry* decision has considerably narrowed the definition of what constitutes goodwill to such an extent that it is no longer possible to categorise non-goodwill gains as goodwill.

In stating that there is scope to merge and simplify the current rules, the Review Team does not however follow through its observations and state how this could be done.

As noted above, the qualifying conditions that apply to the current concessions are unduly complex and restrictive. It has been our experience that most small business taxpayers that should have been entitled to concessionary treatment have in fact failed to satisfy some aspect of the qualifying requirements.

It is therefore recommended that the tests that apply to the three concessionary provisions outlined above should be simplified and streamlined so that the tests are the same for all three sets of provisions. Given the restrictive definition of goodwill as set out by the High Court in *Murry* it is recommended that the threshold for the current goodwill exemption should be raised from the current $2.2M to the $5M that applies in respect of the provisions dealing with the replacement of business assets and retirement exemption.

It is also recommended that the qualifying tests in relation to all three sets of provisions should be simplified, made less restrictive and should also be uniform.

Broadly, the design of the system would be as follows -

(i) A $5M threshold test would apply to the goodwill exemption, the replacement of business assets provisions and the retirement exemption.

(ii) The qualifying tests for all three provisions would be simplified, made less restrictive and apply uniformly across the three provisions.

(iii) Qualifying taxpayers would therefore be entitled to claim either -

(a) 50% goodwill exemption on the disposal of goodwill (as defined by the High Court in *Murry*); or

(b) Roll-over relief on the replacement of business assets; or

(c) The retirement exemption.

The revenue implications of the above recommendation could be expected to be revenue neutral. The revenue costs of simplifying the qualifying tests and increasing the threshold for the 50% goodwill exemption will be negated by the much narrower definition of what constitutes goodwill.

6 Taxation of entities

6.1 In Chapter 16 dealing with "An Alternative Treatment for Collective Investment Vehicles", Option 2 contemplates taxing tax-preferred income.

It would seem that the tax is levied on the entity not on the investor[1].

An example of when this situation could arise is where the accounting profit of the entity is greater than its taxable income because the tax depreciation rates are higher than the accounting rates. Prima facie therefore, tax will apply to the distribution of the surplus. The discussion in Chapter 16 generally and in respect of Option 2 in particular does not address the circumstance where there is a subsequent reversal of that timing difference and, as a consequence, the taxable income is greater than the accounting income.

If some form of reversal adjustment is not allowed, this could theoretically bring about a double tax.

6.2 Paragraph 59 on page 18 of the Document asks the question as to whether there is a case for subjecting closely held entities to special taxation arrangements where they do not distribute all, or a substantial portion, of their income annually.

This would imply the introduction of some form of taxation sanction similar to the "sufficient distribution" regime, which operated prior to the introduction of imputation.

[1] "Tax preferred income distributed by a CIV would be taxed in a way equivalent to distributions by entities." (Para 16.30)

It would seem that this presents a potential penalty to SMEs, which seek to minimise the distribution of cash reserves in order to fund the working capital requirements of their businesses.

Such a proposal should be considered against the proposed definition of "distribution", the possible expansion of the FBT regime and the existence of Division 7A of the 1936 Act, which it is understood, is to be retained subject to the removal of existing anomalies and inequities.

Accordingly, if cash reserves are retained within closely held entities then prima facie they will be retained for the purpose of working capital and where they are otherwise sought to be accessed by the equity holders then prima facie they will be taxed as distributions either explicitly or by way of operation of Division 7A or that they would be subject to any expansion of the FBT regime.

Any attempt to impose some form of special taxation arrangements will mitigate against the benefit of any reduction in the entity tax rate.

6.3 At paragraph 19.46 on page 436, there is a statement that "[N]et income of an existing trust which a beneficiary is or has been presently entitled, and which has not been paid to the beneficiary prior to commencement, would be automatically included in a trust's contributed capital. That would follow from the fact that contributed capital would include the cash and property representing that prior taxed income".

It would seem however that if a beneficiary is or has been presently entitled then two possibilities arise -

(i) The existing trust has a liability due to the beneficiary, which needs to be deducted from other balances when calculating contributed capital. As a consequence, the amount not previously paid to the beneficiary would effectively be excluded from contributed capital; or

(ii) The net income to which the beneficiary is or has become presently entitled is held by the trustee of the existing trust in a separate trust for the benefit of that beneficiary. As a consequence the existing trust would no longer hold the relevant cash and/or property representing that prior taxed income. As a consequence, it cannot form part of the existing trust's contributed capital.

6.4 Chapter 21 deals with Consistent Treatment of Entity Income and Chapter 22 is titled Bringing Trusts into the New Entity Regime. It is noted that partnerships are to be provided differential treatment on the basis that tax implications flow through to partners. It is difficult to understand why partnerships are not included in the “Entity Taxation” regime at least on an election basis and the proposed approach allows the opportunity for distortion of tax outcome, especially whilst a difference exists between the top marginal individual rate and the company (entity) tax rate.

6.5 Many of our client groups involve multiple companies which have earned and paid tax on profits over the decades leading up to the introduction of imputation in 1987.

The introduction of imputation was a recognition that double taxation of company profits was, as a matter of policy, inappropriate.

Notwithstanding this recognition, the introduction of imputation was prospective and as a consequence has not assisted in a compliance sense the tidying up of these various company structures with pre-imputation taxed reserves.

It is submitted that the introduction of a reform permitting the release from these companies of pre-imputation taxed reserves would not in reality bring about a loss to the revenue.

Those reserves have ordinarily been "released" to shareholders and/or their associates by way of pre-Division 7A of the 1936 Act loans which loans, if properly structured, are not deemed dividends pursuant to Section 108 of the 1936 Act.

Accordingly, in a practical sense, those pre-imputation taxed reserves are now outside the tax net and with care can remain so indefinitely. Accordingly, to permit a reform that would enable them to be now released tax free would not involve any practical cost to the revenue whilst at the same time permitting significant compliance savings.

6.6 As noted above, the integrity of the Australian taxation system must be questioned whilst a difference remains between the top marginal individual rate and the corporate tax rate. Personal services income is taxed at up to 48.5% whereas business income may only suffer tax at 36%.

6.7 Chapter 24 deals with anti-avoidance provisions. In particular, paragraph 24.19 sets out an evaluation process when determining the need for specific anti-avoidance provisions.

We strongly recommend that there should be a timely programme for independent review of any draft anti-avoidance provisions and a formal and independent post-implementation review of any specific anti-avoidance provisions in order to ensure that they have achieved relative certainty and that their ambit is limited to resolving the problem identified thus ensuring that they do not "... have a broader application than originally intended, thereby increasing taxpayer uncertainty".[2]

At an earlier point in this submission, we have discussed the need for formal pre-legislative review and post-legislative technical correction processes and highlighted recently introduced anti-avoidance provisions that fundamentally produce uncertainty and inequity.

6.8 Further, in terms of anti-avoidance, we note the proposal to introduce "a robust general anti-avoidance rule". Within this context, we note the general anti-avoidance rule introduced into the Goods & Services Tax legislation.

In our view, that provision goes beyond being robust and in fact has introduced unintended consequences and uncertainty.

Accordingly, we do not endorse a robust general anti-avoidance rule founded upon that in the GST legislation.

6.9 Among other things in Chapter 18 there is consideration as to the character of an amount of profit where a beneficiary is entitled to part of a trust's profits and that amount is retained by the trust.[3]

The suggestion is made that there are only two alternatives here. The first of these is that the profits are distributed and re-invested as trust capital. The second is that the amounts "are simply retained trust profits".[4]

As noted in 6.3 arguably neither of these suggestions is correct and that the alternatives are -

(i) That the trustee holds the amount to which the beneficiary is presently entitled on a new and separate trust for the benefit of that person; or

(ii) The amount has been "paid" to the person and lent back.

It is submitted that as a matter of trust law our two alternatives are the correct treatment.

6.10 Table 18.1 on page 413 of Chapter 18 identifies in relation to loans which are not to be treated as distributions that those loans should be pursuant to a written agreement "...entered into prior to the loan being made...".[5]

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[2] Paragraph 24.13 on page 517
[3] Refer paragraph 18.18 at page 406
[4] Paragraph 18.18 on page 406
[5] Paragraph 18.48 on page 411

At the time that the professional bodies were liaising with the Australian Taxation Office in relation to the introduction of Division 7A of the 1936 Act, the need for a written agreement was discussed at length. The then advice of the Australian Taxation Office was that the written agreement was evidentiary only. On this basis, the professional bodies recommended that it was therefore not necessary for the written agreement to be entered into prior to the loan being made but rather that it should be a requirement that the written agreement be entered into prior to the lodgement of the income tax return for the year in which the loan was made.

The definition of "loan" is likely to be, and justifiably should be, very broad. It is therefore quite possible that members of closely held entities may not appreciate that a transaction they are entering into is in fact a loan as defined and may not as a consequence execute a written agreement prior to entering into the transaction. In this event, a distribution could inadvertently be created with the attendant taxation sanctions when in reality a loan was intended.

With the current number of trusts and companies in existence, there are potentially in the order of 1,000,000 entities virtually all of which are closely held which are impacted by this requirement to have a pre-loan written agreement.

It is submitted that compliance would be eased and the legislative form honoured in reality (which is very often not the case in relation to Division 7A of the 1936 Act) if the requirement were that the written agreement be in place by the time of the lodgement of the taxation return for the year in respect of which the loan is made.

The reality of this suggestion is clear in paragraph 18.60 which, among other things, notes the following -

"• Many small business owners typically draw from their businesses in an *ad hoc* basis throughout the income year.

• At the time the accounts are drawn up (usually after the end of the year) they decide how much of the aggregate drawings over the year they wish to be treated as wages, dividends, or loans."

Whilst the above bullet points are the reality, we note that we do not condone deciding after the end of the year how much of the aggregate drawings are to be treated as wages, dividends, or loans.

Our concern as enunciated above is not the decisions taken after the year end but, rather, that "many small business owners typically draw from their businesses on an *ad hoc* basis throughout the income year". Allowing the loan agreements to be brought into existence subsequently is not a recognition of the re-allocation of amounts between wages dividends or loans but rather of the ad hoc nature of these drawings.

6.11 An important element in the proposed broad definition of "distribution" in relation to closely held entities under either options 1 or 2 set out in Chapter 18 is that there is a value transfer from the entity to the equityholder or an associate. This is recognised in the need for a proviso "...to not treat as a distribution the use of a principal residence held in an entity,".[6]

Very often the holding by an entity of a principal residence is part of an estate planning or asset protection measure entered into by the "controller" of the entity.

In fact, many assets which might otherwise be regarded as personal in nature are held in entities with the same estate planning or asset protection reasons. Holiday homes, art works, other collectibles and motor vehicles are inclusive examples of the further assets held by entities for these reasons.

Hereafter, all assets held by entities for these reasons are described as "personal assets".

However, under each of the three options set out in Chapter 18, there is now the prospect that the use of such assets held in an entity will in one way or another be taxable.

Further, it is noted that option 3 which contemplates treating benefits provided to members or their associates as Fringe Benefits does not seem to have the principal residence exemption.

The funding of the entities for the purposes of the acquisition of these personal assets is very often by way of gift or loan from the individual and in some cases, though less so, by the acquisition by the entity of the relevant personal asset out of profits of the entity.

Where the funding of the acquisition of the personal asset by the entity is out of profits of the entity, we have no fundamental conceptual concern with any of the three options applying in this regard. Indeed, one could question why in this circumstance there should be a principal residence exemption.

However, there does not seem to be any conceptual support for applying any of the three options where the funding of the acquisition

[6] Paragraph 18.16 on page 406

of the personal asset by the entity is as a consequence of a gift or loan from the "controller".

Indeed, where the funding is by way of gift or loan even if it could be said that there is a distribution through the use of the personal asset, prima facie there are no "profits" subject to the fact that the definition of 'distributable profits' is likely to pick up any appreciation in value of the personal asset. Within this context, it is noted that paragraph 19.13 identifies circumstances where in calculating distributable profits one would look beyond the "book values" of the relevant assets.

Accordingly, it is recommended that the definition of 'distribution' and/or of fringe benefit exclude the use of personal assets funded by way of loans or gifts from the "controller" provided the entity is not claiming tax deductions for expenses associated with the personal asset.

6.12 Chapter 18 also considers reform options for "created ownership rights", e.g. bonus share issues, share splits, issues of shares or of options, dividend re-investment plans and the like.

The following is an extract from paragraphs 18.80 and 18.81 on page 418 -

> "18.80 Some transactions have combined elements of selective transfers of value from the entity to the member (distributions) and value shifting between members, particularly the following -
>
> - 'Dividend re-investment plans' - which offer shareholders a choice between taking dividend in cash or having the amount of the dividend applied towards acquiring new shares; and
>
> - 'Bonus share plan' - under which shareholders can choose to forego entitlement to a dividend in advance and are allotted shares instead.
>
> 18.81 In both cases, some shareholders receive cash from the company while other shareholders receive new shares. *The cash component is a transfer of value from the company to the shareholders, while shareholders receiving new shares obtain benefits by value shifts from other shareholders*. A consistent treatment of shareholders would treat the new shares, as well as the cash payments, as distributions." (Italics added)

It is submitted that these two forms of plans do not in fact effect a transfer of value from other shareholders.

A 'dividend re-investment plan' is in effect the payment of a dividend by the company (depressing retained earnings) and the re-injection by the shareholder of that same amount as an equity contribution to the company. In this event, unless the dividend re-investment plan permits the re-investment at a discount to market value, there is no value shift from other shareholders.

Many public company dividend re-investment plans are currently criticised because any discount benefit provided to the shareholders is nominal.

Broadly, the same analysis applies in relation to 'bonus share plans'.

Notwithstanding the above misconception, it would seem that the highlighted paragraphs were scene-setters for circumstances where there was other than a pro-rata transaction for members or alternatively where there was in fact a discount effecting a value shift.

6.13 Under the deferred company tax (‘DCT’) regime, the effective rate of tax payable by a non resident taxpayer investing in Australia will be substantially increased to a minimum of 36%, compared to the current situation of a maximum of generally 15%. Due to this impact it is imperative that should this reform proceed that it is accompanied by the reforms proposed in Chapter 30 (more particularly the adoption of a Non resident investor tax credit concept discussed at paragraph 30.16).

6.14 As noted by the Report, DCT would impact on the reportable profits of entities. Consequently, this may encourage entities to retain profits rather than pay them out. The potential economic consequences of this action need considered in addressing this option. For example, it may influence the financing and investment decisions of such entities.

6.15 It is stated in paragraph 15.38 at page 353, that no tax treaty renegotiations are formally required following implementation of a DCT. In particular, it is stated that foreign jurisdictions **should** allow foreign tax credits for DCT to non-portfolio foreign investors. This assumption requires a more detailed analysis giving the varying types of foreign jurisdictions together with assurances that the FTCs **will** be allowed.

6.16 Consideration should be given to imposing DCT only on permanent tax preferences, not on temporary tax preferences. This would be the simplest method of overcoming the double taxation on the reversal of temporary tax preferences.

6.17 The options for overcoming potential double taxation under the 3 proposals (as identified on page 359-360 of the report) would involve considerable compliance costs for taxpayers. Of these options, we consider that Option 2 is the preferred option and should be implemented to overcome the double taxation issues.

Option 1, is inappropriate as it relies on the entity going into liquidation. Further, it ignores the potential for changes in 'members' over the life of the entity. Option 3, is considered to present compliance problems and Option 4, is considered inappropriate as it merely considers one source of temporary tax preferences.

6.18 Chapter 16 discusses the concept of Collective Investment Vehicles ('CIVs') and the concept of flow through taxation.

The Document contains little discussion on any specific tests to be applied in determining whether or not an entity is a CIV. Threshold tests with reference to the income and assets of the entity would need to be established and monitored. Problems will be encountered in the frequency in application of these tests. For example, if the tests are considered on an annual basis it may give rise to the situation of an entity moving in and out of the CIV regime from year to year.

6.19 Paragraph 16.15 discusses the implications of CIVs not distributing all income. In particular, it proposes that an undistributed profits tax be imposed at the corporate rate. It implies that such non-distributions are the result of a tax driven initiatives.

The proposal fails to recognise that accumulations of income are not necessarily tax driven. The proposal is not entirely clear on whether or not such an entity would continue to qualify as a CIV in such circumstances.

6.20 Chapter 18 discusses the need for a broad definition of 'distribution' to overcome the existing difficulties associated with the definition of 'dividend' and to cater for a common entity based taxation system. In particular, the Document details (at paragraph 6.11) the elements of a distribution.

The elements suggest that a distribution will only occur where a 'benefit' or 'transfer in value' has been provided to a member (or associate) in that person's capacity as a member (associate). This suggests that benefits provided in some other capacity (eg employee would not fall within the definition of a distribution). However, we note that the table 18.3 states that under Option 1 all items are taxed under income tax proposals, none under FBT.

This seems to be an inconsistency and requires some clarification.

6.21 Where it is proposed that some benefits will be taxed as a distribution and some under FBT, depending on the person's capacity (eg Option 3, page 413), there is the potential for considerable uncertainty, particularly for small businesses where often the members are also employees (often not in receipt of a salary).

It is acknowledged that this difficulty already exists (eg Division 7A applies to payments to a member unless provided in their capacity as an employee). Unless concessional valuation rules, similar to those in FBT, are applied, there will be a tendency for taxpayers to argue that such items are not provided in the capacity as a member. This may become a point of contention between ATO and taxpayer, adding further to the level of complexity and cost.

An example of where such uncertainty may arise is where a car is provided by a trust to a spouse of a person who is both an employee and member of the trust. That spouse may also be a member of the entity but has no involvement in the trust's business. Typically, in the current circumstances the car would be caught under the FBT provisions. The situation would be less certain under the proposed reforms and the effective cost to the person and the entity would potentially be quite different.

Whilst the above example would not create a problem under Option 3 (as all use benefits would be caught under FBT), if Option 1 requires consideration of a person's capacity the uncertainty would exist.

It is submitted that where distributions are to include the use or provision of goods/services, the valuation of the 'benefit' should be linked to the FBT valuation rules to limit the potential temptation to argue one position over another.

6.22 6.22 Further to, and notwithstanding the point at 6.11, the Document does not discuss how the use of assets will be valued for the purposes of determining the distribution. Whilst this may be easy to determine in some cases, we have a concern for the potential for such treatment to create significant compliance and substantiation problems for some taxpayers.

For example, assume that a discretionary trust holds a holiday home which is used exclusively by the family and for which no expenses are claimed. On the assumption that the amount of the distribution would equate to a fair rental value of the home, how would the family substantiate the extent of the use of the house? Would the value be the rental value for the period the house was used or for the full year?

Further, to determine who received the 'distribution' how would it be established which family members used the house at any given time? If the house were made available to friends of the family would the amount of the distribution be assessable to a member of the family or to the friends who actually used the property? If the house were to be shared by two people within a family, would the amount of the distribution be apportioned equally?

6.23 At paragraph 18.23, it is stated that where a member receives a discount through the use of a shareholder discount card the amount of the discount would be a distribution.

This is another instance where care must be taken because of the potential for a significant increase in compliance costs. Further, in such circumstances the ‘transfer of value’ or ‘benefit’ to the member may be merely an illusion.

In many instances, the provision of a shareholder discount card is in reality a marketing and customer loyalty ploy by the retailer. Whilst it is accepted that consumers receive discounts it is not uncommon for a consumer to be able to buy the same item from another store at a lower or the same discounted price.

For example, a shareholder may use their card to purchase a $100 item from the company at a 5% discount, thereby paying $95. However, it is quite possible that they could have gone to a competitor and similarly obtained a price of $95, or maybe $94. It may be that they prefer to go to the retailer with the shareholder discount because of other reasons (eg better return of goods policy etc).

In the above example it would seem inappropriate to say that the distribution is $5. However, if the retailer has to take any value other than its own retail price as representing fair market value would create a significant compliance and administration burden.

It is submitted that if such a broad definition is to be adopted, this situation provides further support for the need for an appropriate de minimis rule which adopts a reasonable threshold.

6.24 In paragraph 18.25, the Document states that a de minimis threshold is ‘difficult to support from an equity point of view’. However, it then notes that such a threshold could be incorporated into a definition of distribution.

Whilst the Report’s comment is accepted in part, due to a potential for abuse, it is submitted that from a compliance perspective it is essential that some such threshold is introduced. The sheer breadth of the type of definition contemplated by the Document will give rise to significant administrative issues as well as potential anomalies. The use of an appropriately set de minimis rule will go some way to removing these problems.

6.25 Paragraph 18.26 states that costs associated with the provision of a benefit which constitutes a distribution will not be deductible to the distributing entity. This is in line with the view that costs associated with the payment of a dividend are non-deductible.

This comment requires further elaboration as to the extent of the non-deductibility. For example, if a shareholder uses a discount card to purchase an item at a discount from a retailer, what expenses will be non-deductible to the retailer? Is it intended that only the costs associated with the administration of the card scheme are non-deductible or will some part of the cost of the item which was sold to the shareholder be non-deductible?

When considering the interaction between FBT and the income tax on distributions, particularly on distributions involving the use or provision of goods/services, such treatment further widens the gap between FBT and income tax.

For example, if an entity provided a laptop computer to a member under the FBT rules, the cost of the laptop would be deductible to the entity and no FBT would be payable. However, it would appear that under the proposed reforms, if the laptop were provided to a member the cost would be non-deductible to the entity and it would be a taxable distribution.

6.26 Whilst Option 3 allows for use benefits to be taxed under the FBT legislation, thus allowing for any concessional valuation rules to apply, it is considered that the number of rules necessary to apply the option are unduly complex.

6.27 Paragraphs 21.37 to 21.41 deal with the question "How should a tax liability be met if the entity has insufficient assets?". It is stated that "[a] starting point for determining a sound basis for the collection of unpaid company tax is the proposition that those individuals who were knowing parties to an arrangement which resulted in the entity being unable to pay its tax liability should themselves be liable to pay the tax".

Any notion that the Commissioner of Taxation should be allowed to pierce the corporate veil in circumstances where the relevant parties have acted bona fide in all respects is strongly opposed. If the provisions of the Crimes (Taxation Offences) Act are considered inadequate, their amendment may be appropriate. However, the contention that a knowing party to a commercial transaction conducted in good faith should be made personally liable for an entity's tax liability is unwarranted.

6.28 Chapter 22 deals, among other things, with the taxation treatment of trust resettlements. It identifies the "...opportunity to establish clearly when a resettlement occurs and the consequences of that resettlement for taxation purposes".[7]

Broadly, two options for dealing with resettlements are offered. The first of these is to establish "statutory resettlement rules". The second is to ignore the actual resettlement and apply value shifting rules.

The foundation for the "statutory resettlement rules" is that a "...Resettlement occurs when there has been a substantial alteration to the interest of existing or potential beneficiaries or discretionary objects".[8]

In establishing "statutory resettlement rules", it is imperative to recognise the implications of a resettlement in order to ensure that a statutory resettlement arises only where appropriate.

As the discussion in paragraph 22.48 acknowledges "...A resettlement may have a number of tax consequences for the trustee in relation to things such as capital gains tax..., revenue and capital losses, foreign tax credits, depreciation balancing adjustments and trading stock. It may also have implications for beneficiaries". Accordingly, as that paragraph notes, the implications of a resettlement can be dramatic.

Paragraph 22.51 sets out a number of circumstances which could be taken into account in establishing statutory resettlement rules. Broadly, it would seem that those circumstances are consistent with the equity law understanding as to what constitutes a resettlement, though it is acknowledged that "neither trust law nor taxation law is clear as to what constitutes a resettlement".[9]

However, paragraph 22.52 then identifies situations which could potentially be statutory resettlements. These include -

- Changes or additions to the beneficiaries or class of beneficiaries in trusts (for example, to include spouses, new employees or related companies or trusts); and

- Exercise by the trustee of a power of advancement or appointment.

In relation to changes or additions to the beneficiaries or classes of beneficiaries, most modern discretionary trust deeds would contemplate the inclusion of spouses and related companies or trusts. It is not usual that a conventional discretionary trust deed contemplates the inclusion of new employees.

[7] Page 491, paragraph 22.50
[8] Paragraph 22.51 on page 491
[9] Paragraph 22.46 on page 490

It is submitted that in particular the inclusion of spouses and the related companies or trusts pursuant to a discretion presently available to the trustee does not fit within the circumstances identified in paragraph 22.51 as giving rise to resettlements.

Further within the context of the consolidation regime, it will very often be important that related companies or trusts be able to be introduced into the consolidated group and this would ordinarily require their introduction as beneficiaries.

In relation to the exercise by the trustee of a power of advancement or appointment, it would seem to us that rather than bringing about a statutory resettlement in fact, the advancement or appointment is entirely consistent with and contemplated by the existing trust deed and in actuality gives effect to that trust deed. Indeed, it is submitted that the exercise of a power of advancement or appointment in isolation does not come within the circumstances set out in paragraph 22.51.

Our own anecdotal experience would be that the number of non-fixed trusts would be significantly greater than the number of fixed trusts assuming that the definition within the current trust loss measures is adopted in the course of tax reform generally as contemplated in paragraph 22.34.

Accordingly, in terms of the alternative of ignoring resettlements and applying value shifting rules, as noted in paragraph 22.56, such rules are likely to be impractical in relation to discretionary trusts particularly. We also add that they would be impractical in relation to hybrid trusts.

6.29 Under the transitional arrangements for trusts, there are to be exceptions from the profits first rule where the relevant amounts are distributed in the year realised. These exceptions apply to assets held in trusts prior to the commencement of the new entity tax system and are for -

- The realised gains on pre-CGT assets; and
- Realised inflationary and goodwill exemption gains on post-CGT assets.

It is to be noted that prior taxed income is not to come within the above exception. However, it is proposed that "...such prior taxed income could be allowed a five year exception from the operation of the profits first rule".[10]

[10] Paragraph 19.59 on page 438

Confirmation is sought that such prior taxed income does not bring about a cost base reduction where a beneficiary has a cost base in the relevant trust nor should it bring about an assessable capital gain.

6.30 Paragraphs 22.72 - 22.79 discuss disposal of beneficial interests in trusts to third parties and distributions of contributed capital.

In the course of those discussions, it is noted that the objects of a discretionary trust do not have a cost base as they do not have a vested and indefeasible interest in the capital of the trust.

Prima facie, this would mean that they are not disposing of an asset for the purposes of the CGT provisions and therefore the amount that they receive should not be subject to tax. However, this position is never clearly stated within this area of the discussion in the Document.

Accordingly, confirmation is sought as to the position of a discretionary object in a trust where that discretionary object receives a distribution of contributed capital.

7 Taxation of entity groups

7.1 In relation to "consolidated taxation of entity groups", it is noted that the Government may not be proceeding with a proposal initially announced in *A New Tax System* to eliminate stamp duty on commercial property transactions.

If consolidation is to achieve its full economic and anti-avoidance benefit, it would be aided if the stamp duty provisions of the various States exempted from stamp duty all transactions within consolidated entity groups. This would facilitate the advantage set out in Paragraph 25.11 on page 536 of achieving "tax-free movements of assets...".

It is submitted that many corporate groups and "...groups of trusts and companies 'owned' by members of the one family..." could be considerably simplified as a consequence of the consolidation regime. However, the optimal simplification will not be possible in the absence of complete stamp duty exemptions for transactions within the relevant group.

7.2 Paragraph 26.24 provides "a requirement that there be an ultimate head entity of the group..." without elaboration.

This a flow on from the requirement in relation to groups generally to the effect that there must be "a resident holding entity at the head of the group in order to give practical meaning to the concept of a single Australian taxpayer".[11]

[11] Refer para 26.3 on page 545

In practice, many family groups do not have a "head entity" because they are comprised largely of discretionary trusts.

It is submitted that in the context of family groups "and ultimate head entity of the group" is in effect the person by reference to whom the group is established. This is reflected in paragraph 26.25 which states as follows -

> "The entities which could be included in a family group which chooses to consolidate could be determined by reference to a particular individual and the family members of that individual."

Indeed, conceptually, it is entirely consistent with the concept of "a single Australian taxpayer"[12] that this be so because in effect that person is the "alter ego" of the group.

To allow consolidation where family groups do not have a “head entity”, it is submitted that such groups be given the opportunity to nominate a “head entity”

7.3 Paragraph 26.25 establishes that "each family member would be able to elect whether or not to consolidate their taxation affairs in the group". This is an important statement because paragraph 26.27 proceeds to state that "the consolidated group would then include all companies and fixed trusts wholly owned by the family members who elect to consolidate (and the entities that those entities wholly own)".

Accordingly, if a company has two shareholders and only one of those elects to consolidate their taxation affairs in the group, it would appear that the company is not part of the consolidated family group.

7.4 It would appear implicit from the prior reference that the single Australian taxpayer therefore will include the entities within the group and the individuals within the group.

7.5 Paragraph 26.63 on page 556 is to the effect that the existing rules in relation to a substantial change in the majority underlying ownership of an entity with pre-CGT assets "...would apply to a consolidated group so that any pre-CGT assets held in the group would lose their exempt status if there were a substantial change in the majority underlying ownership of the group".

How is this principle to apply where the group is a family group pursuant to the "...special optional consolidation regime for family

[12] Refer para 26.3 on page 545

groups,..."[13] whereby the family group which chooses to consolidate would be "...determined by reference to a particular individual and the family members of that individual"[14]

In this regard it is also noted that should entities consolidate there will be the potential for the consolidated group (as opposed to single entities) to breach the requirements to satisfy a number of concessions that may currently be available when the provisions are applied to a single entity.

Specific examples of concessions potentially lost include:

- The potential to more easily breach CGT thresholds such as the goodwill exemption limit,

- The potential to substantially change majority underlying ownership where pre-CGT assets exist on consolidation, and

- The potential to breach the 75% threshold in relation to the disposals of pre-CGT interests in entities which have post-CGT assets.

In this regard it is submitted that entities which choose to consolidate (and indeed are encouraged to do so by the proposed removal of current grouping provisions – see paragraphs 26.68 to 26.71) should not be any worse off by choosing to consolidate.

7.6 The consolidation regime for family groups may go so far as to consolidate the taxation affairs of an individual. In particular, paragraphs 26.25 - 26.27 on page 549 read as follows -

"26.25 The entities which could be included in a family group which chooses to consolidate could be determined by reference to a particular individual and the family members of that individual. The individual and family members could make an irrevocable election for the group to consolidate. *Each family member would be able to elect whether or not to consolidate his or her taxation affairs in the group*.

26.26 The family members who could be included in the election could be based on the existing trust loss measures...

26.27 The consolidated group would then include all companies and fixed trusts wholly owned by the family members *who elected to consolidate (and the entities that those entities wholly own)*." (Italics added)

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[13] Paragraph 26.23 on page 549
[14] Paragraph 26.25 on page 549

Clarification is required as to whether there is an option or indeed it is intended to be mandatory for individuals to form part of the consolidated group.

It would appear that if it is intended that entities which are wholly owned by family members are to be incorporated in the consolidated family group then it would be necessary for those family members to elect to consolidate their taxation affairs in the group.

7.7 Paragraph 26.45 on page 553 explains how it is possible within groups of entities to have some assets held on capital account and some held on revenue account.

Importantly, that paragraph makes the following comment -

> "...Gains may be treated as capital gains if each company is considered separately, but would be 'recurrent' revenue gains if the companies were considered as part of a wider group."

With the above background, paragraph 26.46 then provides -

> "A generalised unified treatment for investment assets is discussed in the Overview. That approach would remove the current problems with characterisation. However, if this generalised treatment were not adopted, issues may arise for consolidated groups because the character of a transaction should be determined according to the character of the transaction in the hands of the group rather than the individual entity."

There seems to be an implication from paragraph 26.46 that within a consolidated group gains can only be capital gains or alternatively can only be 'recurrent' revenue gains and that it is not possible for a consolidated group to hold certain assets on capital account and certain assets on revenue account.

Case law clearly establishes that the same individual or entity can in fact hold certain assets on capital account and certain assets on revenue account.

It would therefore be in substance an over-simplification to mandate that all assets of a consolidated group can only be held on one or other of the two bases (i.e. capital or revenue).

7.8 At paragraph 26.96 on page 563 there is discussion in relation to Option 3 of the alternatives for enabling entities to bring carry forward losses into a consolidated group.

That paragraph opens with the following comment -

> "Reviving previously 'trapped' losses (for example, carry forward losses which currently cannot be claimed due to the cessation of income earning activities in the loss company) explains the high revenue cost likely from Option 2."

It is difficult to envisage how this situation occurs other than in one instance. That is, where the group of companies held a majority interest in the loss company at the time at which the loss was incurred and acquired the residual shareholding after the loss was incurred. As a consequence, the loss company cannot transfer its loss into the group because the loss was incurred prior to it becoming a group company. However, the loss is still prima facie protected because the Continuity of Ownership Test has been satisfied.

Where this is so, it would seem that that group would ordinarily have structured its activities so that income was derived by the loss company directly. The existing law would permit that result subject to the potential operation of anti-avoidance provisions and in particular Division 175 of the 1997 Act.

As a consequence therefore, query whether there is a "...high revenue cost likely from Option 2".

7.9 Chapter 26 sets out a number of options for enabling entities to bring carry-forward losses into a consolidated group. However, these options seem to focus upon companies.

Paragraph 26.72 on page 558 states that "...A company or trust entering into a consolidated group would be able to bring such carry-forward losses into a consolidated group consistent with the principles underlying the existing law".

There is no further discussion in Chapter 26 re trusts with losses entering a consolidated group. Clarification is required of what is intended in this regard.

7.10 Chapter 27 identifies the need to calculate the cost base of equity (shares or units in a unit trust) in a group entity being sold by a consolidated group. It acknowledges that the cost base is needed to determine any capital gain or loss on the sale of that equity. Very importantly, it identifies the need to, among other things, avoid double taxation.

Two options are identified as to how this might be achieved. The first is defined as the *entity-base model*. This model retains the identity of subsidiary entities and increases the pre-consolidation cost base of that entity by the net movement of the asset cost bases within the entity (with liabilities being treated as negative assets) between the time of entry into the consolidated group and the time of exit from the consolidated group.

Example 27.2 on page 574 illustrates this option.

This example is founded upon a holding company ("H") subscribing for the shares in a wholly owned subsidiary ("S") on the creation of S. H subscribed $100 into S. S immediately acquired an asset for $100. At the time that H and S elect to consolidate H's cost base in S is therefore $100.

S subsequently sells that asset for $160. The example assumes that tax is paid by an entity other than S. S then reinvests the consideration of $160 into another asset which at the time of the sale of S by H has a market value of $200.

The reconstructed Equity Cost Base of S thus becomes $160.

Accordingly, at the time of the sale by H of that equity for $200, H realises a taxable capital gain of $40. Under the present taxation system (ignoring indexation) that would be a taxable capital gain of $100.

The example identifies that there is therefore no duplication of the gain on disposal of the original asset.

However, it would seem that duplication nonetheless arises if the purchaser of S were to immediately procure the sale of that asset for its market value. In that event, S would have a taxable capital gain of $40. This is economically exactly the same gain upon which H has been taxed when it disposed of S.

Indeed, Example 27.2 acknowledges this anomaly where in the last sentence of the example it states the following -

> "The capital gain on sale of equity represents a realisation by the group of the unrealised gain (net of tax) in respect of A(2)."

The reference to "A(2)" is a reference to the second asset acquired by S.

It can be observed that in the actual example the capital gain on the sale of equity is in fact not the unrealised gain (*net of tax*) in respect of A(2). (Italics added). Assuming a 30% entity tax rate (the unrealised gain) (net of tax) in respect of A(2) is $28 (i.e. historical cost gain of $40 minus $12 tax on that gain at a 30% rate).

It may be argued that the example in fact is founded upon a net of tax outcome if the actual value of A(2) was greater than $200 and the difference between its market value and $200 is the tax payable by S on the subsequent sale of the asset. Nonetheless, double tax remains because H itself pays capital gains tax on $40.

It would seem that this double taxation anomaly could be avoided if one of two remedies are considered -

1. The vendor H is not taxed on what is in essence the unrealised gain in respect of the underlying asset, A(2); or

2. There is an automatic step up in S's cost base to the market value of the underlying asset, A(2).

7.11 The second option for reconstructing an equity cost base at the time of the sale of a group entity by a consolidated group is called the "*Asset-Based Model*".

The asset-based model is founded upon the group's cost base for its equity in the entity being allocated to the assets the entity brings into the consolidated group.

Paragraph 27.14 provides that this allocation is achieved by apportioning the sum of the cost bases of the underlying assets of the entity with the amount paid for the equity in the entity. This apportionment is first to assets other than goodwill with any remaining amount being applied to goodwill.

It would seem as a matter of concept that this means of apportionment may not accord with the economic substance where at the time that the entity was acquired, it had substantial goodwill but subsequently that entity acquired other tangible assets. Prima facie, the effect of the approach identified in Paragraph 27.14 is in fact a value shift away from goodwill and into the tangible assets.

7.12 Further, in considering the asset-based model from a compliance point of view, Paragraph 27.14 identifies that "the information required by the group is the market values of all assets on entry and the cost bases of assets on exit...".

As a consequence, an immediate compliance cost to groups is identified when comparing the entity-based model with the asset-based model. The entity-based model focuses upon historical costs and the identification of other information that should be readily available from the relevant financial records of the various entities. On the other hand, the asset-based model requires a valuation of "all assets on entry".

Accordingly, the asset-based model would impose a significant out of pocket compliance cost due to the need to value all assets on entry.

Further, given that such valuations are to give effect to a new taxation regime, would the cost of the valuation be deductible for taxation purposes?

7.13 At page 582 there is a reference to the asset-based model requiring an apportionment of the purchase price of an entity between the "identified assets, the value of any franking credits or carry forward losses and goodwill".

In practice, with companies, the value of carry forward losses is ordinarily reflected in a Future Income Tax Benefit ("FITB"). In all probability, if trusts are taxed as companies then trusts will move to some form of tax effect accounting.

A critical question therefore is whether for taxation purposes the generally accepted accounting approach would be followed so far as carry forward losses are concerned, i.e. if they are recognised for accounting purposes in an FITB.

Further, in our experience, it is rare that directly or indirectly a value is attributed to franking credits when acquiring or disposing of an entity. To do so formally is likely to be difficult and imprecise.

7.14 It is noted at paragraph 27.17 that liabilities are to be treated as negative assets under both the entity-based and asset-based models. In this regard clarification is required as to whether all liabilities are to be recognised as negative assets and in particular whether the following liabilities are to be recognised as negative assets:

- Provision for income tax
- Provision for deferred income tax
- Provisions for employee leave entitlements
- Beneficiaries entitlements to trust income

7.15 Finally it is noted that certain assets or liabilities that are recognised for accounting purposes are either included in assessable income or allowed as deductions for taxation purposes. In this regard clarification is sought as to whether such assets and liabilities are to be taken into account.

Two examples are:

1 Prepayments - are recognised as assets for accounting purposes but are generally “expensed” for taxation purposes.

2 Income earned in advance - income may be derived for taxation purposes on receipt but treated as a liability for accounting purposes until it is recognised as earned under generally accepted accounting principals.

7.16 The asset-based model as noted previously proposes an apportionment of the group's cost base for its equity across the various assets of the entity being acquired.

Paragraph 27.15 poses the possibility that the allocation to depreciables "...potentially becoming the cost base for depreciation, as well as for capital gains tax, of depreciable assets...". This is later referred to as resetting "...the depreciable values of those assets". (Para 27.28 on page 581)

Paragraph 27.28 on page 581 also proposes that "...the price paid for equity...should...reflect any balancing adjustments on depreciable assets".

How is this to be achieved in practice? Is it intended for example that the asset cost bases on exit is reduced by the amount of any depreciation claims since the depreciable values were last reset.

If depreciable assets are to be reset on entering into consolidation it will be relevant to determine whether assessable/deductible balancing charges arise on entering into consolidation.

This is not discussed in any detail in the Document.

7.17 Page 582 considers the transitional issues relevant to the adoption of the asset-based model.

It presents two suggestions. These are -

1 Immediate cost base alignment on a reasonable basis. This would appear to require the allocation to the underlying assets of the entity of the existing cost base for the equity of the entity; or

2 A use of the entity base model. This is transitional only with entities and other assets acquired after consolidation being subject to the asset based approach.

Paragraph 27.33 notes that the immediate cost base alignment option under the first sub-reference above involves a degree of arbitrariness.

In particular, it may be that part of the cost base of the equity was relevant to the acquisition of underlying wasting assets (tangible or intangible). How is this to be accommodated, if at all?

7.18 Under the transitional arrangements regarding the adoption of the entity base model or the asset base model arises consideration of pre-capital gains tax status in relation to equity and/or underlying assets which are pre-CGT when consolidation commences.

Essentially the Document at paragraphs 27.43 through to 27.45 proposes subject to provisions equivalent to Section 160ZZS and Section 160ZZT of the 1936 Act that pre-CGT status will be maintained.

However, the discussion in these paragraphs is very limited and not supported by any specific examples.

7.19 Chapter 29 deals with the proposal regarding value shifting at the direct (asset) level and at the indirect (interest in entity) level. It is acknowledged that the value-shifting proposal will to some extent depend on whether the proposed consolidation regime proceeds and that this area is to be subject to further consultation. We would welcome the opportunity to be involved in further consultation and at this stage only wish to make the following broad statements:

- The complexity of current measures is significant,
- The proposal to extend these measure to “controlled” entities is of concern given the present complexities of measures that deal with direct asset holdings and 100% or commonly owned company groups, and,
- In light of the first two points it will be critical that significant exceptions, safe harbour and de minimis rules are included.

7.20 The proposed Australian consolidation regime requires prima facie 100% ownership. Many other jurisdictions, including to our knowledge the United States, France and New Zealand, do not require 100% ownership recognising that a substantial but nonetheless lower threshold provides commercial flexibility.

Requiring 100% ownership limits, for example, the ability to offer employee equity arrangements, restricts the ability to consolidate where there is a dissident minority and makes it more difficult to enter into commercial arrangements by way of strategic equity placements. These are but three examples.

We recommend that consideration be given to allowing a substantial but lower than 100% threshold in this regard.

8 Taxation of international income

8.1 Chapter 30 at page 649 contemplates the taxation in Australia where there is an indirect transfer of Australian assets held by non-residents.

An example given is where a foreign company owns an Australian asset and the shareholders in that foreign company rather than selling the asset and crystallising an Australian taxable gain sell their equity in that foreign company.

The Document proposes in that event the deeming of a realisation of the relevant asset by the foreign company that holds that asset.

It is also noted that this reform could potentially operate where a minority shareholder in that foreign company was to sell its equity.

It is further proposed in paragraph 30.78 on page 650 that the tax liability of the vendor shareholder could be enforced against the asset of the entity holding the taxable Australian asset.

It is observed that in practice the identified mischief will often not succeed because the purchasing shareholder will recognise the underlying latent tax liability in the entity holding the asset and will seek to negotiate a reduction in the consideration payable for the shares accordingly which is unacceptable to the vendor.

Further, any anti-avoidance rule of this type would need to be supported by some form of alleviation of the potential for double taxation that could arise on the assessment of the vendor shareholder initially and the subsequent disposal of the underlying asset at a later point consistent with the proposals under the heading "Taxation of Entity Groups" generally and Chapter 28 which deals with moving "towards" single recognition of losses and gains particularly.

8.2 We note with some concern that Appendix E to Chapter 32 contemplates removing the exemption for pre 12 April 1989 transfers to foreign trusts. At E2 it is stated that,

> “These transfers are exempt unless it can be conclusively demonstrated that the transferor or an associate is in a position to control the trust”

This statement is clearly incorrect and misleading in two respects.

Firstly, the concept of “control” for the purposes of the transferor trust rules is set out at s.102AAG of the 1936 Income Tax Assessment Act. Control for the purposes of the transferor trust rules includes situations where it might reasonably be expected that a trustee of the discretionary trust would act in accordance with the wishes of an entity or a group including an entity and its associates.

Secondly the onus of proof in income tax matter rests with the taxpayer and it is not for the Commissioner to have “conclusively demonstrated” anything.

If this proposal were to proceed, a person or entity who became a transferor of a foreign trust prior to the introduction of these measures on 12 April 1989 may be liable to be assessed on some or all of the income derived by that trust notwithstanding that he or she may have no real control over the trust or access to the trusts assets or income out of which to pay attributed Australian tax.

8.3 Pages 669 - 671 consider how relief from double taxation available for companies could be extended to trusts.

Paragraph 32.27 - 32.28 deal with dividends paid by foreign companies to resident trusts and broadly speaking extend to resident trusts under the entity taxation regime the concession currently available to resident companies in Section 23AJ of the 1936 Act.

Consideration is then given to whether that form of exemption should be extended to distributions derived by resident trusts from foreign trusts. In particular paragraph 32.29 provides as follows -

> "It may not be appropriate...to allow the dividend exemption for distributions from foreign trusts. ...Trusts,..., are taxed as flow-through entities in many countries and may not be subject to a comparable level of tax. Foreign trusts could therefore be used to stream low-taxed third country income...".

There are at least some countries, e.g. New Zealand, which tax trusts analogous to companies.

Accordingly, it would seem possible as a minimum to identify in relation to foreign trusts those countries which have comparable taxation regimes and allowing distributions from foreign trusts in those jurisdictions to be permitted the dividend exemption. If this alternative is not permitted, where there are distributions from those jurisdictions "...little or no Australian tax would be payable after a credit is provided for foreign underlying and withholding tax paid on the distribution".[15]

Within the context of this suggestion, it is noted that paragraph 32.26 proposes allowing, among other things, resident trusts an 'underlying tax' credit for distributions derived from a non-portfolio interest in a foreign trust.

8.4 Consideration is given on pages 676 - 678 as to how the anti-tax-deferral rules for foreign trusts could be improved.

There is a proposal in paragraph 32.55 in relation to widely held fixed trusts that interests in these trusts could become to subject to the FIF

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[15] Refer paragraph 32.27 on page 670

measures but also qualify for the active business exemption within the FIF measures.

However, there is a proposal in relation to the FIF measures that the active business exemption might be removed and one option being that it be replaced with a jurisdictional exemption. The precise terms of the jurisdictional exemption are set out as follows in paragraph 32.50 -

> "A jurisdictional exemption could apply, for instance, to interests in company FIFs that are taxed on a world-wide basis in a listed comparable tax country (this list could be limited to countries with effective anti-tax-deferral regimes)."

Essentially, 32.50 would require the identification of comparable tax countries with effective anti-tax-deferral regimes.

However, in relation to widely held fixed trusts, it is proposed that the jurisdictional exemption might not be extended to such trusts because "...trusts are often taxed as flow-through entities in other countries and there is significant risk that third country income derived by a trust in a listed country will not be taxed in that country".[16]

As noted previously, as it is going to be necessary for other circumstances to identify comparable tax countries with anti-tax-deferral regimes, it would equally be appropriate to identify such jurisdictions that do not tax trusts on a flow-through basis so that equityholders in such trusts receive relief where, in reality, there is no significant tax-deferral.

This outcome "...would be consistent with the neutrality design principle in *A Strong Foundation*".[17]

8.5 Consideration is given as to whether franking credits should be available to Australian residents investing in non-resident entities which entities in turn invest in Australian resident companies.[18] It is noted that in such circumstances, if the non-resident entity pays a dividend to its Australian shareholders, the dividend will not carry an Australian franking credit and the dividend will be fully taxable to the Australian shareholders.

An option is briefly discussed regarding the possibility of allowing franking credit flow through where Australian companies paying dividends to non-resident parents issue dividend franking certificates to Australian residents that are shareholders in the parent. Paragraph 31.36 suggests that allowing some form of flow through produces

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[16] Refer paragraph 32.55 on page 676
[17] Refer paragraph 32.31 on page 671
[18] Refer page 660

relatively minor efficiency and equity benefits against the cost of increased complexity. Our reading of this part of the Document suggests to us no real commitment to the concept notwithstanding the inequity identified.
Not allowing some form of franking credit flow through is an economic disincentive for Australian resident investors investing in non-resident companies and also for Australian businesses seeking to build strategic commercial international relationships.

It is submitted that the increased complexity contemplated is in many senses no more complex than that being proposed in relation to the maintenance of Foreign Income Accounts ("FIAs") as outlined in pp.657-660.

It would seem that there is a positive effort being made to assist non-residents through the use of FIAs with no realistic effort to assist residents by formally developing some form of franking credit flow through.

Paragraph 31.38 contemplates restricting relief for franking credit flow through *if it is to be provided* to circumstances where the parent was a listed company resident in a broad-exemption list country. No such restriction exists in relation to Foreign Dividend Account arrangements presently. Again, thus favouring non-residents as against residents.

8.6 In paragraph 32.60, it is stated that it is not proposed to extend the FIF active business exemption to trusts other than widely held fixed trusts "...because trusts have a history of being used for tax avoidance purposes owing partly to lower regulatory requirements and their flexibility of operation". Whilst the first of these reasons, i.e. lower regulatory requirements, might have substance, it is submitted that the second does not.

If the trust is genuinely a fixed trust then it is analogous to a company as the equityholders have vested and indefeasible interests in the trust. Accordingly, it is submitted that they do not have "flexibility of operation" and that therefore the "lower regulatory requirements" is not sufficient reason to deny other than widely held fixed trusts the active business exemption.

9 Taxation of fringe benefits

9.1 The discussion paper recommends, at paragraph 38.7 on page 774, that to improve equity, the liability for fringe benefits should be transferred from the employer to the employee.

On balance, we support this recommendation and urge the committee to continue to promote it notwithstanding the Government's current view that the liability cannot be transferred to the employee due to revenue implications and the fact that it will result in a much greater number of taxpayers having to deal with fringe benefits. Given the recent introduction of the FBT reporting requirements, we submit that this will not have a significant impact in terms of compliance.

Given that many benefits provided to employees are not provided as part of the employee's remuneration and in many cases, are incidental to employment, we submit that a *de minimus* rule be applied (eg. the $1,000 minimum under the FBT reporting requirements). This rule could be limited by an appropriate remuneration test if it was a concern that it would be abused.

Without this threshold, and with all benefits taxable in the hands of recipient employees, distortions in prudent and normal business practices may result as employees take steps to avoid receiving fringe benefits which are incidental to their employment. We submit that this is supported by the original intention of FBT which was designed to tax benefits which were provided in lieu of salary and wages.

9.2 If the liability for fringe benefits were to be transferred to the recipient employee certain issues need to be addressed such as the appropriate point of collection and industrial relations.

If it is considered appropriate to collect tax at under the Pay-As-You-Go system, a system must be developed for an interim valuation of benefits given that the taxable value of some benefits such as cars cannot be accurately determined until the conclusion of the FBT year. This issue is highlighted when you consider the treatment of shared benefits such as pool cars. How is the system to cope with interim valuations in such circumstances given all possible contingencies?

9.3 Industrial relations and awards will come under close attention if the liability were to be transferred to the employee level. The system must ensure that employees are adequately compensated by their employers for the increase in their liability especially for those benefits not provided as part of the employees remuneration. Legislative safeguards may need to be built into the system upon introduction.

9.4 A further issue in transferring the tax obligations of fringe benefits to the recipient employee level is the impact on on-costs such as WorkCover, pay-roll tax and superannuation guarantee. Cashing-out benefits will result in a net increase in employer liability given the current system of taxing fringe benefits under WorkCover and pay-roll tax (based on the non-grossed up value) and the fact that fringe benefits are currently not subject to superannuation guarantee. Adjustments would need to be made to ensure that these remain cost neutral to employers if such a change were to occur.

9.5 The committee has recommended, at paragraph 38.15 on page 776, a system of specific inclusion rather than the present approach whereby all benefits are taxable unless specifically excluded. We are not in favour of this proposal and submit that whilst it may appear to simplify the taxing of fringe benefits, it will introduce greater scope for avoidance and place substantial emphasis on legislation to ensure that all relevant benefits are included without leaving significant gaps.

9.6 The issues of entertainment and car parking are addressed by the committee and it is recommended at paragraphs 38.17 to 38.21 on page 777 that both be removed from the FBT taxing regime. This is consistent with the FBT reporting requirements which exempt both, particularly due to the difficulties in valuing.

Entertainment is governed by a complex set of rules and is a substantial burden on employers in terms of administration and compliance. We support the view that it should return to the pre-1995 status whereby it was not subject to FBT and non-deductible. The revenue costs are far outweighed by the benefits which employers would enjoy in not having to deal with this issue.

If entertainment were not to be fully exempt, we submit that it should only be taxable in those instances where it is provided as part of an employee's remuneration. A specific remuneration test would need to be designed.

9.7 The committee has focused on on-premises car parking and recommended its removal. This appears to have been done under a misunderstanding as indicated on page 38.8 on page 775 and paragraph A.2 on page 783 that the FBT reporting requirements exempt only on-premises car parking. All car parking is exempt under the new reporting requirements and we recommend that the removal of car parking be extended to include all car parking. It is inequitable to distinguish on-premises parking from off-premises especially for CBD businesses which have limited scope to provide on-premises parking.

If on-premises car parking were not to be fully exempt, we submit that, as with entertainment, it should only be taxable in those instances where it is provided as part of an employee's remuneration. A specific remuneration test would need to be designed. Therefore no distinction should be made between on-premises and off-premises parking where provided as part of remuneration.

9.8 We submit that the proposal for alignment of FBT and income tax years as stated at paragraph 38.22 on page 778 would create significant problems for employers. Whilst it is recognised that the alignment of FBT and income tax years would significantly simplify administration for employers, it would seem that the new FBT reporting requirements effectively render the proposal impractical. Delays would result in the issuance of group certificates. The present three month gap between FBT and income tax years provides employers an opportunity to deal with FBT issues, especially with the new FBT reporting requirements, before being confronted with end of year issues such as the preparation of group certificates allows.

9.9 The committee highlights on page 778 perceived inequities and distortions in demand resulting from the concessional treatment of cars for FBT and believes that these should be addressed by changes in the methods of valuation.

We submit that the concessional treatment of cars was an intended outcome of FBT and should not be altered without a comprehensive review of its impact, which includes its affect on the domestic motor vehicle industry.

Furthermore, transitional arrangements would need to be made to ensure that where employees are provided with cars under the present concessional regime they are not unfairly disadvantaged and retrospectively taxed under pre-existing agreements. If the concessions did not exist in their present form, it is unlikely that similar decisions would have been made. Consequently, any revisions in the taxing of cars should only impact on new agreements.

9.10 The committee proposes either a schedule of costs or revision of the statutory formula to address the perceived inequities. We submit that the schedule of costs is not appropriate as it is based on the flawed presumption that business use is either 20% or 50% of total usage. This presumption is as baseless as the perceived deficiencies of the present statutory formula method. In addition, the schedule of costs does not factor in costs variances between the States which can in some cases be substantial.

The committee alternatively recommends either a flat statutory formula percentage of 25% or an upward-stepping percentage starting at 25% and ranging up to 35%. We submit that these percentages are not appropriate and are unduly harsh for those cars which have high usage. The presumption under the existing formula that high usage implies high business usage is in our view sound and should be preserved in any revisions.

We submit that if the statutory formula were to be revised that an additional step be added between the 20% and 11% levels (eg. 15% for travel between 20,000 kms and 24,999 kms) which would remove much of the incentive for employees to go on long drives close to the end of the FBT year. In addition, the existing operating costs method should be preserved for those taxpayers who wish to avail themselves of it as it is equitable and closely aligns to income tax methodology.

Pitcher Partners
15 April 1999