Office of Asset Sales and IT Outsourcing

Burns Centre
28 National Circuit
FORREST ACT 2603

Our Ref: 98/1613

16 April 1999

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

Dear Dr Preston

Submission on Entity Taxation and Instalment Sales

The Office of Asset Sales and IT Outsourcing (OASITO) welcomes the opportunity to make the attached submission to the Review of Business Taxation in relation to Entity Taxation as discussed in "A Platform for Consultation: Building on A Strong Foundation". OASITO is responsible for the sale of Commonwealth owned businesses. We have experience with both sales of assets and sales of shares.

Where there has been concern about the market's capacity to absorb a large share sale in one transaction, the sale has been effected by way of instalment sale, such as occurred with the sale of the third tranche of shares in the Commonwealth Bank of Australia, and the initial sale of shares in Telstra. It is expected that this structure would be used in the Government's proposed sale of a further 16.6% of the Commonwealth's equity in Telstra. Preparatory work is underway for this sale, in parallel with the Government seeking legislative authority to execute the transaction.

Instalment sales by the Commonwealth necessarily involve the creation of a security trust for each investor. The structure was developed in consultation with the Australian Taxation Office. It is the only instalment sale structure that is viable within the Australian legal, taxation and regulatory framework.

If entity taxation is applied to security trusts, we are concerned that the administrative issues and potential taxation liabilities arising would jeopardise the effective and efficient operation of the structure, and may even prevent the future use of instalment sales by the Commonwealth.

Our submission therefore advocates that the instalment sale structure used by the Commonwealth should not be subject to entity taxation.

For the record I note that this submission deals with an issue that involves the separate business interests of the Chair of your review committee in his capacity as the Deputy Chairman of Telstra Corporation.   I do not consider that this situation involves any conflict of interest for Mr Ralph.

We would be pleased to meet with you or your representatives to discuss our submission, or provide any further information that may assist.
Yours sincerely

M. J. Hutchinson
Chief Executive

Office of Asset Sales and IT Outsourcing

Submission to the
Review of Business Taxation

A Platform for Consultation:
Building on A Strong Foundation

Entity Taxation and Instalment Sales

The Office of Asset Sales and IT Outsourcing ("OASITO") is an agency of the Federal Government. It is responsible for, amongst other things, implementing the sale of Australian Government owned businesses. OASITO advises the Government on the preparation of businesses for possible sale and its shareholder role during the sale process.

OASITO and its predecessor (the Office of Asset Sales) were responsible for the sale of the third tranche of Commonwealth shares in the Commonwealth Australia Bank and the sale of the first tranche of Commonwealth shares in Telstra Corporation Limited. Each of these occurred by way of instalment sale.

OASITO expects that instalment sales will be necessary for the efficient execution of future planned sales of Telstra equity.

Instalment sales

Under instalment sale arrangements, consideration for the sale of shares by the Commonwealth is paid to the Commonwealth in instalments (ordinarily two). Instalment sales are favoured where the volume of shares to be sold is large and there is doubt that the sale can be absorbed by the market in one tranche at an acceptable price.

Following payment of the initial instalment and in order to secure payment of subsequent instalments, legal ownership in each share is held by a trustee ("the Trustee") pursuant to a trust deed. The shares are held by the Trustee for the Commonwealth as security for payment of the final instalment, and otherwise for the Investor.

A separate trust is constituted in respect of each share.

The Investor's beneficial interest is evidenced by an "instalment receipt" ("IR"), which is listed on the Australian Stock Exchange ("ASX") and possibly on stock exchanges in other jurisdictions (the Telstra IRs were listed on the ASX, on the New Zealand Stock Exchange (the "NZSX"), on SEAQ International ("SEAQ") in London, and on the New York Stock Exchange (the "NYSE") in the form of Interim American Depositary Shares).

Any dividends paid whilst the shares are held by the Trustee are paid directly to the Investor, pursuant to the direction of the Trustee. Equally, the Trustee is the Investor's proxy for voting in relation to the share.

The Investor is not absolutely entitled to the share until payment of the final instalment.
Upon payment of the final instalment, legal ownership in the underlying share is transferred by the Trustee to the Investor.

If the Investor does not pay the final instalment, the Trustee is able to sell some or all of an Investor's underlying shares - with the proceeds to be applied to satisfy amounts owing to the Commonwealth.

Current taxation treatment of instalment sales

Under current law, instalment sales have simple taxation implications because the role of the Trustee is effectively ignored. These implications are outlined below.

Payment of dividends

Providing all dividends paid in respect of the shares are distributed to shareholders who are not under a legal disability, the Trustee is not assessed on these dividends but they "flow-through" to Investors as trust distributions. Accordingly, the Commissioner of Taxation (the "Commissioner") has in the past not required the Trustee to provide an income tax return in respect of each trust.

Capital Gains Tax

The participation of the Trustee is effectively ignored for the purposes of calculating the Australian tax on capital gains. This is due to the operation of provisions in Part 3-1 of the *Income Tax Assessment Act 1997* which provide that:

- transfers of the share to and from the Trustee in order to provide or redeem the security are not treated as disposals or acquisitions of the share (sections 104-10(7) and 109-15); and

- acts done by the Trustee for the purpose of enforcing or giving effect to the security (such as selling the share) are treated as if done by the Investor (section 106-60).

Effect of Entity Taxation

OASITO notes that if entity taxation applies to instalment sales, the simple taxation implications outlined above may no longer apply, thus jeopardising the efficient operation of instalment sales. This is because each Instalment Receipt Trust (the "IR Trust") would become a taxable entity in relation to the arrangements[1].

Payment of dividends

The taxation of IR Trusts as companies would have the following consequences for payment of dividends in respect of the underlying shares:

- conceptually, the treatment of franked dividends should not significantly differ from the current treatment. Presumably, franked dividends received by IR Trusts would not be subject to tax as the inter-corporate dividend rebate would apply. Distributions by the Trustee would be dividends rather than trust distributions, but the franking treatment would effectively "flow-through". Although the Trustee would have no tax liability, the Trustee would be required to provide a return in respect of each entity (ie each trust). (In the case of Telstra 1, this implies that there would have been in excess of 4 billion

[1] In the case of the sale of one-third of Telstra Corporation Limited, there would have been approximately 4.3 billion separate IR Trusts.

returns, none of substance . If the IR Trusts could be consolidated for each instalment receipt holder, the Trustee would still have been required to submit returns in respect of more than 1.8 million entities.)

- the treatment of unfranked dividends paid in respect of the underlying shares under option 1 ("deferred company tax") or option 2 ("resident dividend withholding tax") in chapter 15 of "A Platform for Consultation", would have the effect of converting the unfranked dividends into franked dividends. The result for the IR Trust would therefore be as set out above for franked dividends. Once again, although the Trustee would have no tax liability, the Trustee would be required to provide a return in respect of each entity (ie each trust). Further, if option 3 ("tax unfranked inter-entity distributions") were chosen, the Trustee would be taxed on the unfranked dividend (as the section 46 rebate would not be available), and would pay a franked dividend to shareholders. Therefore, under option 3 the Trustee would be required to pay tax in respect of unfranked dividends and lodge a return in respect of each trust (and therefore in respect of each share).

Capital Gains

(a) Transfer of the share to the Investor upon payment of the final instalment.

It is important that the transfer of the share to the Investor upon payment of the final instalment have no capital gains tax implications for the Trustee. If the IR Trust is to be subject to entity taxation, the trust capital must be defined so as to ensure that it comprises the share transferred.

(b) Sale of the share on default of payment of the second instalment.

Under entity taxation, any gain on the sale of the share will be subject to tax in the hands of the Trustee at the corporate tax rate. This will require the lodgment of a return and payment of tax by the Trustee in respect of individual IR Trusts.

Application of Entity Taxation to Instalment Sales

"A Platform for Consultation" does not address the treatment of security arrangements, although it foreshadows that stakeholder type arrangements should be treated as an entity (chapter 22). The administrative burdens with this are noted (paragraph 22.14).

OASITO notes that entity taxation, if applied to the security trusts which form part of instalment sale arrangements, would unduly complicate the arrangements and may, in certain circumstances, cause a tax liability to arise in the hands of the Trustee.

Entity taxation would therefore jeopardise the effective and efficient operation of future instalment sales. This might require their abandonment. The consequences could include the extension of the time over which it is practicable to divest the remaining equity in Telstra (from about four years at present to 6-8 years); an increased cost of sales of about $500 million because of the need to increase then number of separate sale processes (say from four to six); and an increased exposure to market risk in the residual equity value pending its sale.

Recommendation

We suggest that consideration be given to excluding security from entity taxation. Such treatment would be consistent with existing law and the “flow-through” concept of taxation in “A Strong Foundation”.

Office of Asset Sales and IT Outsourcing
16 April 1999