16 April 1999

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

Dear Sir

REVIEW OF BUSINESS TAXATION
A PLATFORM FOR CONSULTATION
SUBMISSION ON DISCUSSION PAPER NO.2

The Taxation Institute of Australia (the Institute) welcomes the opportunity to make a submission and to provide commentary to the Review of Business Taxation on Discussion Paper No. 2, *A Platform For Consultation*.

The Institute applauds the release of *A Platform for Consultation* as a vehicle to facilitate widespread community debate and discussion on tax reform. The Institute has been a long time supporter of the need for major tax reform. It has been a significant contributor to the current tax reform debate, and played an active role in the consultation and submission processes established by the Review of Business Taxation. Our submission on Discussion Paper No. 2 follows our submission in December 1998 in response to the Discussion Paper, *A Strong Foundation*.

At the broadest level, the Institute believes successful tax reform is one which brings about changes premised on simplicity and equity, the lowering of compliance costs and the minimisation of tax avoidance opportunities, resulting in ease of administration for taxpayers and the Australian Taxation Office alike.

To that end, the Institute embraces those aspects of *A Platform For Consultation* which promote the development of a framework for consistent and equitable taxation treatment.

Whilst the Institute acknowledges the difficult task before the Review of Business Taxation in trying to canvass the broadest range of possible options in arriving at a better and fairer taxation regime, it is resolutely opposed to the following key conceptual propositions in *A Platform For Consultation*:

- It is not recognised that the concept of investment neutrality impacts differently on big and small business; this concept is more relevant for bigger businesses operating in sophisticated capital markets rather than for smaller businesses;

- There should be no move towards taxing economic gains as opposed to realised gains;
- The drive towards tax comprehensiveness is at the expense of simplicity; and
- The balance sheet or cash receipts method of calculating taxable income totally ignores accounting principles and would result in over 50 years of court precedents on the capital/income dichotomy being rendered ineffective.

Representatives from the Institute are available to meet with representatives from the Review of Business Taxation to discuss our submission and any matters arising therein. The contact person is:

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Yours sincerely

Gordon Cooper
President

Review of Business Taxation

The

Taxation Institute of Australia

responds to

Discussion Paper No. 2
A Platform for Consultation

April 16 1999

Level 7

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Sydney NSW 2000

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Cross – references in this submission to relevant paragraphs in Discussion Paper 2 are made in italicised print. Where a proposal in the EXECUTIVE SUMMARY supports one of two or more options contained in the paragraphs cited, reference is made to the preferred option in italicised print after the proposal.

This submission responds to Discussion Paper 2 on a chapter by chapter basis except in those instances where certain chapters have warranted an integrated response.

PREFACE

This submission in response to Discussion Paper 2 is the product of the National and State Technical Committees of the Taxation Institute of Australia. It contains comment on policy and principle and, in many instances, comment on technical detail.

It constitutes a basis for further ongoing consultation with relevant government agencies to ensure optimum policy and technical outcomes in the reform of business taxation.

The strategies adopted to introduce the reforms addressed by the Review are of paramount concern to the Institute. Many of the issues and options raised involve radical conceptual changes to the current law . Any new framework to accommodate such changes ought to be preceded by exhaustive and inclusive consultation with all professional bodies concerned.

Whatever the final report to government, the Institute is concerned about the timetable for implementing such wide ranging and fundamental reforms. The common perception within the Institute at the present time is that any new framework ought to be introduced in phases and in a manner which not only embraces extensive consultation but which maximises certainty in relation to procedures and outcomes. Amendment by reference to Budget days and the dates of Treasury press releases which occur months and even years before the relevant legislation is sighted are not appropriate to any tax system let alone a New Tax System. It is an understatement to say that the attendant confusion and uncertainty does little for the standing and administration of the system. The potential for these problems to occur is magnified by the scope and depth of the options raised in the Review Discussion Paper 2. A new framework based on economic substance rather legal form and the coalescence of tax and accounting principles will sweep aside well established and well known precedent. This fact is not per se an obstacle to change but makes it imperative that any new legislative framework is unambiguous and comprehensive. Further extensive consultation and fine tuning before enactment should substantially reduce the number unforeseen eventualities and the need for corrective legislation.

It is apparent from this submission that Discussion Paper 2 has ignited a lively debate within the Institute which will continue throughout the reform process. The Institute's submission is an initial response forged within the time constraints of the Review's reporting process. The issues raised by the Review demand thorough and ongoing analysis and the Institute looks forward to the opportunity of actively participating in that process.

Executive Summary

EXECUTIVE SUMMARY

Taxation of physical assets and goodwill

Chapter 1: Towards a new policy framework for wasting assets

Paragraphs 1.1 – 1.6
The Institute supports a consistent taxation treatment of all wasting assets under which all expenditure on wasting assets used for income - producing purposes is deductible.

Paragraphs 1.12 – 1.17
The taxpayer that incurred the expenditure should be entitled to the deductions.***Option1.***

Paragraphs 1,21 – 1.24
Deductions should be based on the actual cost to the taxpayer.

Paragraphs 1.31 – 1.37
Deductions should commence from the time the asset is installed and ready for use. ***Option 1.***

Paragraphs 1.39 – 1.52
The cost of a wasting asset should be deducted over the effective life of the asset on a self – assessment basis. ***Option 1***.

Paragraphs 1.53 – 1.66
Buildings and structures should be incorporated into the general depreciation regime. Land and buildings should be valued separately at the time of sale. ***Option 2***.

Paragraphs 1.67 – 1.69
The current special rules should continue to apply to the resources sector.

Paragraphs 1.70 – 1.78
An annual dollar limit for immediate write - off should be placed on the aggregate of purchases of items each costing less than the *de minimis* threshold. The *de minimis* threshold should be $600. ***Option 2***.

Paragraphs 1.79 – 1.85
The diminishing value method of depreciation should apply.

Items with low written down values should be written – off in the year that the value falls below 4% of the taxpayer's original cost base or $100 whichever is the greater.

Paragraphs 1.86 – 1.92
In the interests of equity and consistency a new system for depreciation should not include the current option for balancing charge offsets available to taxpayers in the case of plant and equipment. The disposal of depreciated assets should be treated consistently with the disposal of other assets for capital gains purposes.

Paragraphs 1.93 – 1.95
Where an asset is converted from a business use to a non – business use such conversion should be treated as a disposal at market value. Conversely where an asset is converted from a non – business use to a business use such conversion should be treated as an acquisition at market value.

Paragraphs 1.96 – 1.104
The Institute supports the proposed treatment of ' blackhole ' expenditure put forward in the discussion paper.

Chapter 2: The case for accelerated depreciation

Paragraphs 2.1 – 2.35
The Institute supports a consistent and equitable framework for the taxation treatment of wasting assets. Tax equity may be enhanced by a trade – off of accelerated depreciation for a reduction in the rate of company tax. However, if a convincing case based on economic and other benefits can be demonstrated for retaining accelerated depreciation for particular industries or particular cases, the Institute would support this.

Chapter 3: Trading stock and similar assets

Paragraphs 3.1 – 3.14
The Institute supports applying the accounting approach to the valuation of trading stock requiring trading stock to be valued at the lower of cost or net realisable value. ***Option 1.***

Paragraphs 3.15 – 3.28
The Institute does not support any change to the current taxation treatment of consumable stores, spare parts, standing crops, mineral resources or partly completed service contracts.

Chapter 4: Determining the appropriate treatment of goodwill

Paragraphs 4.1 – 4.21
The Institute supports retaining the current taxation treatment of goodwill. ***Option 2.***

Taxation of financial assets and liabilities

Chapter 5 – Towards a new policy framework for financial assets and liabilities
Chapter 6 – General application of the policy framework for financial assets and liabilities
Chapter 7 – Debt/equity hybrids and synthetic arrangements

Paragraphs 5.1 – 5.35
The Institute supports the introduction of a specific regime for the taxation of financial arrangements.

Regrettably some of the proposals suggested in Discussion Paper 2 add complexity without providing any increased certainty about tax outcomes.

Paragraphs 6.116 – 6.120
The Institute strongly opposes the quarantining of losses in relation to financial arrangements

Paragraph 5.32
The Institute supports the adoption of a realisation method for those financial arrangements where gains or losses cannot be predicted.

Paragraphs 6.2 – 6.48
The timing adjustment should be restricted to cases where the circumstances, as set out in ***paragraph 6.2,*** warrant its application.

Paragraphs 6.46 – 6.48
The Institute generally supports the recognition of foreign exchange gains and losses on a realisation basis.

Paragraphs 6.56 – 6.73
The Institute submits that specific hedge rules are required to enhance risk management decisions.

Paragraphs 7.1 – 7.43
The Institute supports the introduction of a comprehensive regime for the taxation of debt equity hybrids.

Paragraphs 7.12 – 7.25
Specifically the Institute supports a 'blanket approach' to the classification of the whole as either debt or equity.

Paragraphs 5.33 – 5.35
Arrangements entered into before the introduction of any new measures should be grandfathered and taxed under the existing law. Taxpayers should be given the option of bringing all arrangements under the new framework.

Taxation of leases and rights

Chapter 8 – Towards a new policy framework for leases and rights
Chapter 9 – Leases and similar arrangements over wasting assets
Chapter 10 – Other leases and rights

Paragraphs 9.1 – 9.24
The Institute supports taxing all leases of depreciable assets using a sale and loan treatment in which the depreciation allowances are allocated to the lessee (***Option 1)***.

However, this treatment should not apply to:

- Operating leases;
- Short term leases (say, 2 years or less)
- Leases of assets of less than a minimum threshold (say $50,000); or
- Some categories of assets such as office equipment and data processing equipment.

The Institute supports the allowance of tax preference transfer through leasing assuming that tax preferences such as accelerated depreciation are limited to instances where a convincing case for the preference has been demonstrated.

Paragraphs 9.83-9.90
The Institute does not support the imposition of balancing adjustment rules on the assignment of existing leases. Leases entered into before any new leasing rules are introduced should continue to be taxed under existing rules. Any balancing adjustment rules should be limited to tax preference transfer situations entered into after any new leasing rules are introduced.

The Institute supports extending sale and loan treatment to non – lease arrangements which amount to the provision of debt finance.

Paragraphs 10.1 – 10.40
The Institute does not support the application of either the “implicit benefits” approach or the “deemed benefits “ approach to the taxation of leases over non – wasting assets and other rights including rights arising from service and other contracts. This would involve considerable complexity and high compliance costs for taxpayers which are not justified by the drive for a theoretically pure and comprehensive income tax model.

Paragraphs 10.41 – 10.48
The Institute does not support the principle that the grant of a right in relation to an asset be treated as the realisation of a part of, or all of, the underlying asset. The complexity involved with implementing such a principle would be very high, and would not justify any perceived changes. The current treatment of taxing grants of rights over assets at the time the consideration for the grant is received or accrues should continue.

Taxation of capital gains

Chapter 11: Towards a more competitive regime for taxing capital gains

Paragraphs 11.26 ; 11.43 – 11.45
The proposal to provide some reduction in CGT for individuals is a welcome development, if it will relieve individuals of some, at least, of the complicated compliance tasks currently imposed upon them by the CGT.

Paragraphs 11.27 – 11.33
The Institute feels that the proposal for a 30% capped rate suffers from the same problems as the $1000 exemption. It does nothing to relieve the compliance burden of the CGT. It exacerbates the problem that currently exists of the interaction mechanism between the income tax and the CGT.
Paragraphs 11.46 – 11.67
The Institute supports scrip – for – scrip rollover relief.

Paragraphs 11.68 – 11.74
The Institute gives qualified support to targeted concessions for certain types of investment.

Paragraphs 11.75 – 11.79
The Institute supports the rationalising of the small business rollover regimes.

Chapter 12: Indexation, averaging and quarantining of losses

Paragraphs 12.1 – 12.10
The Institute strongly opposes the removal of indexation.

Paragraphs 12.11 – 12.21
The Institute does not support the proposed modification of the rules for CGT averaging.

Paragraphs 12.22 – 12.30
It is the view of the Institute that the Discussion Paper 2 has not clearly demonstrated the need to reform the rules relating to the quarantining of capital losses.

Chapter 13: Involuntary receipts

Paragraphs 13.16 – 13.18
The Institute does not support a framework which makes no distinction for tax purposes between voluntary and involuntary events.

Paragraph 13.19
The Institute supports the principle of a differential tax treatment for involuntary receipts. ***Option 2***.

Paragraphs 13.26 – 13.29
The Institute does not support the concept of compulsory rollover relief for CGT losses.

Paragraph 13.30
The Institute does not believe that there is a need for special anti – avoidance rules in this regard.

Chapter 14: Disposal of partnership assets and interests

Paragraphs 14.25 – 14.35
The Institute gives qualified support to the proposal to apply an entity approach to partnerships for both depreciation and capital gains.

Taxation of entities

Chapters 15: A fairer and more consistent treatment of entity distributions

The entity tax regime as it should apply to trusts is commented on separately.

Paragraphs 15.27; Option 1 15.28 – 15.31;15.38
A deferred company tax regime should **not** be implemented.

Paragraphs 15.64 – 15.71
All resident shareholders should receive a credit and where relevant a full refund for franking credits.

Paragraph 15.64
As with the current system shareholders should be taxable on the grossed-up amount of the dividend.

Paragraphs 15.13 – 15.14 Option 3: 15.36 – 15.37; 15.40
The inter-company dividend rebate should be eliminated in full. Companies should be taxable like other shareholders on the grossed-up amount of the dividend with a credit and where relevant refund of any franking credits. Unfranked dividends should be fully taxable to all resident shareholders who are not exempt including companies.

A resident dividend withholding tax system at the corporate rate of tax could be implemented as a compliance and collection method. If a resident dividend withholding tax system is implemented the required franking amounts and franking streaming rules should be repealed. The degree to which a dividend is franked should become purely elective. From a shareholder'' perspective either an unfranked dividend with a withholding credit or a franked dividend with a franking credit will be the same. Both will need to be grossed-up and both will have an associated credit.

Chapter 16: An alternative treatment for collective investment vehicles

Paragraphs 16.2 – 16.7
A flow through taxation regime for particular joint investment vehicles should be adopted.

Paragraphs 16.14 – 16.15
All passive income should remain flow through income.

Paragraph 16.15
Collective investment vehicles must distribute all of their income each year

Chapter 17: How a redesigned imputation system would apply to entities

Paragraph 17.3
If the Institute's submission that a deferred company tax regime should not be adopted**,** is not accepted, the Institute would strongly recommend that the existing imputation system should form the basis for the new deferred company tax calculation. Since in principle deferred company tax is merely a tax imposed for over franking, the Institute recommends that the existing rules, with minor amendments, for topping up the franking account if dividends are over franked be employed. No franking penalty tax should be imposed.

Paragraphs 17.36 – 17.48
The Institute recommends that the franking year and the income year be aligned, that deferred company tax be calculated and payable as part of the income tax return

calculation for that year and that the deferred company tax should not become part of the PAYG system.

Paragraph 17.34
The Institute strongly recommends that all deferred company tax related to temporary tax preferences be creditable against future company tax.

Chapter 18: Defining 'distribution' in an entity regime

Paragraphs 18.1 – 18.62

The Institute recommends that no change should be made to the current definition of dividend.

Paragraphs 18.64 – 18.75

The Institute does not support the extension of Fringe benefits tax to shareholders of closely held companies.

The Institute submits that Division 7A in relation to loans from private companies should be amended to become a "commercial loan" test. The loan should need to be documented in writing, have a commercial interest rate (with safe harbour rates provided), and be repayable after given safe harbour periods.

Chapter 19: Distinguishing profit and capital distributions

Paragraphs 19.1 – 19.73
"Profits first" rules create unnecessary and artificial complexity and should not be adopted.

A company or trust should generally be free to choose the source of funds for distribution.

Extensive and recent consultation in relation to "profits first" led to the view that it should not be adopted for companies, and its adoption for trusts will be even more complex.

In practice the vast bulk of trust income is distributed on a current year basis so there is no need to force its distribution.

Profits First will involve "notional accounts" and "reconstructed balance sheets" (and recent examples of this kind of methodology give no cause for optimism that the regime will be simple or fair).

The proposed definitions of Contributed Capital would require considerable refinement. As presently drafted the definitions alone would operate unfairly, and would not deal meaningfully with a range of trusts.

If there is to be a profits first rule it is desirable that it be tied to a concept of accounting profits which meshes with actual accounts (rather than to an artificial formula).

Prior Taxed Income should be permanently excepted from any "profits first" rule.

For many trusts there will be no obvious method of attributing capital thus discriminating against them.

Chapter 20: Preventing double taxation of buy-backs, redemptions and liquidations

Paragraphs 20.1 – 20.58
Identifying double tax problems for resolution has not commanded the attention it deserves.

Chapter 20 identifies one of the fundamental double tax issues but places insufficient emphasis on its resolution (wrongly perceiving that it is merely a timing issue).

Extension of Entity Taxation to Trusts will widen the double tax Issues (rather than narrow them).

Liquidations are inherently on Capital Account and should not be subject to profits first or modified slice.

Any solution to the double tax issue on liquidation (if it remains) should address the income overlap provisions in the CGT regime.

Liquidators should be free to choose the accounts from which distributions are (notionally) made.

The only practical option for on market buybacks is the third option (avoiding DCT or RDWT)

Off market buybacks should have a choice.

There are many other double tax issues arising out of entity taxation which need to be addressed.

Chapter 21: Consistent treatment of entity income

Paragraphs 21.1 – 21.44
Our submissions in relation to Chapter 21 may be summarised as follows:

Measures for Entity Taxation in the form discussed in the Report should not be adopted.

The legitimate objectives of ANTS could be achieved by assessing trust income to the trustee at corporate rates (and permitting franking) without treating trusts as entities.

Tax preferred income should be allowed to flow through trusts. However if a contrary policy decision is nonetheless taken, such amounts could be appropriately defined and assessed to beneficiaries on distribution.

Trusts are not entities and the new regime (as proposed by the Report) will deliver more complexity, will produce no more meaningful consistency, and will increase compliance costs.

The proposal to tax trusts as companies contravenes the very principles of Integration of Ownership Interest and Investment Neutrality (on which the Report relies).

Any argument that this is the price of limited liability cannot withstand scrutiny.

Any general entity loss framework must cure the shortcomings of the tests for continuity of business and ownership.

Various regimes discriminating against discretionary trusts must be dismantled, and any new regime must assiduously avoid them.

Regimes for the fictional deeming of dividends should not be adopted.

Generally the shortcomings (and inequities) of the Corporate Regime should be understood and addressed (rather than uncritically accepted and extended to trusts).

The Proposal to extend liability for payment of tax are unreasonable and should not be adopted.

The Report fails to appreciate that private trusts are not simply investment vehicles.

Measures to tax trusts as “entities” are ultimately directed against small and medium business and private structures, and will operate against them in a way which is harsh and inappropriate if the full weight of an “entity regime” is brought to bear against them.

The substantive effect of the existing set of proposals (considered as a whole) will be to create a discriminatory regime for the taxation of wealth in trusts.

Chapter 22: Bringing trusts into the new entity regime

Paragraphs 22.1 – 22.100

The trust concept is so pervasive that there are real dangers in including all trusts subject only to specific exclusions.

The exclusions should automatically exempt trusts which do not have the characteristics said to justify the new regime.

Trusts not used principally to invest or conduct business should be excluded.

Where “liability limitation” is not a material factor the trust should be excluded.

Absolutely Entitled Trusts should be excluded.

Stakeholders should be excluded.

Constructive trusts should be excluded.

Family Trusts should be excluded.

Deceased Estates must be excluded regardless of the period of administration.

Any resettlement principle must be far narrower than that discussed in the report.

Changes to accommodate the new law must be given stamp duty (and CGT) exemption without equivocation.

Rollovers should clearly apply to distributions from testamentary trusts.

Parallel income and capital regimes for excluded trusts should be elective.

Discretionary objects should not be brought into the CGT net.

If discretionary objects are nonetheless brought into the net they must be given a deemed cost base (on a general basis).

Chapter 23: Bringing all co-operatives into the new entity regime

Paragraphs 23.1 – 23.33
The present status of a co-operative company as a public company should not be disturbed by any new framework.

Chapter 24: Anti – avoidance provisions

The submissions in relation to Chapter 24 also relate to the letter to the Treasurer by the Chairman of the Review of Business Taxation, John Ralph AO, which recommends that measures be put in place to stop potential abuse of weaknesses in the current system.

Paragraphs 24.1 – 24.3
The Institute agrees with the views expressed in the above paragraphs.

Paragraph 24.9
The assumption implicit in this paragraph that Part IV A of the *Income Tax Assessment Act 1936* is deficient is questioned in the light of recent relevant court decisions.

Paragraph 24.22
The Institute agrees with the view that the role of a general anti – avoidance provision should never be that of a primary taxing provision.

Paragraph 24.23
In a self assessment environment it is doubtful that a robust general anti – avoidance provision will provide certainty.

Paragraphs 24.24 – 24.51
The discussion of specific issues and avoidance measures before the new framework for business taxation is determined, is premature.

Taxation of entity groups

Chapter 25 – A case for consolidation
Chapter 26 – A framework for consolidation
Chapter 27 – Determining the cost base for the disposal of equity

Paragraphs 25.1 – 27.45
The Institute supports the introduction of a regime for consolidated group taxation in Australia with the following features:

- Consolidated group taxation would be voluntary and eligible groups would be 100% wholly-owned Australian resident companies, co-operatives and trusts, including groups comprising a mixture of such entities where the wholly-owned requirement was satisfied.

- Consolidated groups would be treated as a single entity and dealings between group members would be ignored for the purposes of the group's tax assessment. A consolidated group would lodge a single tax return and pay consolidated income tax instalments. There would be joint and several liability to pay tax. The group would keep consolidated accounts for certain tax purposes including a single franking account and single accounts for carry-forward revenue and capital losses, foreign losses, foreign tax credits and tax exempt income, and a common tax accounting period for all member entities.

- Entities entering a consolidated group would be able to bring franking account balances into the group and also carry-forward losses on a basis consistent with the principles underlying existing tax law.

- There would be appropriate entry and exit provisions determining equity cost bases for entities joining and leaving a consolidated group.

- In recognition of the pooling of franking credits and losses during consolidation, entities exiting a continuing group would be unable to take with them carry-forward losses or franking account balances. The losses and franking account balances would stay with the continuing group.

The general principles outlined above are consistent with the Government's proposal in the 1998 document "Tax Reform – Not a new tax but a new tax system" (ANTS) released in August 1998 and the discussion of that proposal in *A Platform for Consultation* ("Platform") released by the Review of Business Taxation in February 1999.

The Institute's support for such a proposal would, however, be dependent upon certain additional principles being recognised in the consolidation regime and accompanying legislation. These additional principles differ in certain respects from the proposal outlined in *ANTS* and, in particular, from some of the principles which are apparently preferred options in *Platform*. These additional principles are:

- The "all-in" principle is inappropriate and "selective grouping" should be allowed, with appropriate safeguards. A rule that all eligible entities are required to form part of a consolidated group, if an election is made to consolidate, would cause significant commercial impediments not related to Australian tax in many cases . It would also encourage avoidance strategies which would be difficult to combat in practice, particularly where eligibility is based on 100% common ownership. New Zealand has a 100% common ownership rule for consolidation, but does not apply the "all-in" requirement and allows "selective grouping" so that consolidation can occur with some eligible members remaining outside the group. Some of the difficulties discussed in *Platform* become less significant if selective grouping is allowed.

- The existing inter-company dividend rebate rules should be replaced. These rules were developed in an era before dividend imputation and should be replaced either by a dividend deduction for the recipient company as in the US, or an exemption system with certain additional rules, details of which are discussed later. In particular, the existing dividend rebate rules would cause problems for consolidated groups, which would be unable to prevent the wastage of dividend rebates when the group was in a loss situation. The dividend rebate rules should be changed for all companies, as well as consolidated groups.

- Unfranked dividends should still be payable without any tax consequences between 100% commonly owned companies, which have not elected to consolidate.

- Foreign owned groups of entities that satisfy the 100% common ownership test should be able to consolidate without a requirement for a resident holding company. Suitable alternative requirements, being the economic equivalent of a resident holding company, to protect the revenue could be enacted.

- Even with "selective grouping" and the replacement of the inter-company dividend rebate provisions by a suitable alternative, some eligible companies will be unable to group for reasons that are unrelated to Australian tax. They should be allowed to group revenue and capital losses with other 100% commonly owned companies under the existing rules. To this extent, existing group concessions should continue.

- The consolidation model adopted should not be unnecessarily complex and should not have additional design features (not referred to in *Platform*) which cause compliance problems or make consolidation commercially unattractive.

- Depending on the consolidation model adopted, the same business test may become unworkable when determining whether losses can be carried forward. The existing carry-forward loss rules operate arbitrarily, denying a deduction for losses where loss trafficking has not occurred, and allowing the deduction of losses in some cases where the dominant purpose of a change in ownership of the loss entity was to traffic in losses. The existing rules for carry-forward losses should be replaced for all entities (as well as consolidated groups) by a new set of rules which allow losses to be carried forward by entities except where there has been a change in the ownership of the entity and it can be established on the basis of objective criteria that the dominant purpose of the new owners when acquiring their interests in the entity was to access the losses.

- The consolidation model should have rules that allow the grouping of different types of entities (companies, trusts and co-operatives) where appropriate and that facilitate consolidation for small business entities.

- After a consolidation regime commences, it may no longer be appropriate to apply the family group concessions to groups consisting of trusts and/or companies, but there will still be a necessary role for a family trust concession for stand-along family trusts, and the family trust rules should not be repealed completely, which may be an implication of comments at ***paragraph 26.37*** of *Platform*.

Consolidation rules have the ability to affect major investment decisions, and poorly designed rules would adversely affect the efficient operation of corporate groups in Australia and damage Australia's economic well-being. A time frame of less than 8 weeks for the preparation, review and lodgement of a submission on this extremely complex subject has been too short. In addition, the ability of professional bodies to analyse and comment on the issues is limited – as their resources are limited. There are too few private sector appointments to the Review of Business Taxation for private sector concerns on this subject to be adequately represented. Consolidated group taxation requires the appointment of a subgroup within the Review of Business Taxation which has an adequate representation of experts hired by the government from the private sector.

This subgroup should continue to operate after the Review of Business Taxation has reported on 30 June 1999, as it is likely that many issues regarding consolidation will still need to be resolved. Resolution of these issues means that a consolidation regime could not be introduced before 1 July 2001 or perhaps, more realistically, 1 July 2002, as early balancing companies would require enacted legislation to be in place not later than two months before the commencement of their financial year.

Chapter 28: Towards single recognition of losses and gains

Paragraph 28.22

The Institute strongly disagree with the proposal at ***paragraph 28.22*** that the same business test should be removed. Indeed, we believe that the retention of the same business test (and in fact its updating and broadening) is essential as not only does the same business test not result in the duplication of losses, but as is demonstrated in our submission, its existence prevents the duplication of gains.

Paragraph 28.17
The removal of group concessions will leave company groups with little choice but to elect to consolidate for tax purposes.

Paragraphs 28.20 – 28.21
There is a lack of clarity of thought in these two paragraphs relating to the avoidance of the duplication of realised losses. The example given in ***table 28.1*** is not an accurate reflection of the existing treatment of the continuity of ownership requirement in the current tax law.

Paragraphs 28.23 – 28.36
Where there is a change in the majority underlying ownership of an entity and an unrealised net loss exists in respect of the underlying assets of the entity, the Institute supports the approach whereby the unrealised capital losses are deemed to have been realised immediately before the change in ownership occurs. ***Option 1.***

Paragraphs 28.40 – 28.46
The Institute supports the proposal to adjust equity cost bases using the entity-based model in order to avoid duplication of realised losses and gains. ***Option 1***. It is noted that this option could only be adopted if the proposal for consolidated taxation of company groups were implemented on an entity based model basis.

Chapter 29: Towards a systemic solution to CGT value shifting

Paragraphs 29.1 – 29.55
Any wholesale broadening of the current rules is likely to create a greater need for exceptions and thus added complexity. The Institute are of the view that adjustments in relation to value shifting arrangements should generally only be appropriate where the purpose or motive for an arrangement is one of tax avoidance.

Taxation of international income

Chapter 30: Investment in Australia by non – residents

Paragraphs 30.13 – 30.34

The Institute agrees with the statement in ***paragraph 30.16*** that the “NRITC” system would be preferable to Option 1 as described in ***paragraphs 30.14 and 30.15. Option 2***.

Paragraphs 30.14 – 30.16
The Institute agrees with the statement in ***paragraph 30.16*** that the “NRITC” system would be preferable to ***Option 1*** as described in ***paragraphs 30.14 – 30.15. Option 2.***

Paragraphs 30.38 – 30.44
The Institute supports the “Flow through tax treatment” of collective investment vehicles being made available to all investors whether resident or non – resident. ***Option 2.***

Paragraphs 30.63 – 30.72
The Institute questions whether the added complexity of a non – resident withholding tax is worth it.

Paragraphs 30.73 – 30.78
The proposals for enforcement of tax on indirect transfers of Australian assets by non – residents raise enormous practical problems

Chapter 31 – Conduit investment through Australia

Paragraphs 31.14 – 31.18
The Institute strongly supports a flow through treatment for all collective investment vehicles. ***Option 1.***

Paragraphs 31.19 – 31.34
The Institute strongly supports the extension of the current conduit provisions using a foreign income account –***paragraphs 31.22 – 31.25.***

Paragraphs 31.35 – 31.40
The Institute supports allowing franking credits to "flow" through non – resident companies but does not believe that this should be a high priority issue.

Chapter 32 - Foreign source income residents

Paragraph 32.34
The Institute generally supports the proposition that under an entity taxation regime distributions of foreign income derived through trusts should be treated as dividends provided there is an appropriate exclusion from entity taxation for collective investment vehicles operating as trusts. **Option 1.**

Deemed distribution rules for loans made by foreign trusts to Australian beneficiaries should include an exclusion for loans based on normal commercial terms.

Paragraphs 32.35 – 32.43
The Institute supports the proposals that under an entity taxation regime resident trusts deriving foreign source income should be allowed foreign tax credits for underlying tax in the same way that resident companies are allowed a foreign tax credit for foreign dividend withholding tax for portfolio foreign dividends.

The Institute supports the proposal to allow imputation credits for non – portfolio foreign dividend withholding tax for both Australian resident trusts and companies.

Paragraphs 32.44 – 32.52
The Institute does not support the option to remove the active business exemption for foreign investment funds – **paragraph 32.45.**

Paragraph 32.48

The Institute does not support an exemption for all non – portfolio foreign investments which satisfy an active income test similar to that currently applicable to controlled foreign companies.

Paragraphs 32.49 – 32.52
The Institute favours an exemption for all interests in foreign investment funds resident for tax purposes in broad exemption countries or which are subject to tax in a broad exemption country.

Paragraphs 32.53 – 32.65
The Institute favours the option of only applying the transferor trust rules to interests in discretionary trusts if an Australian resident transferor can be identified. The Institute also favours the application of an interest charge regime to distributions from foreign based discretionary trusts in the absence of an identified resident transferor.

The Institute does not favour the removal of exemptions from the transferor trust rules for transfers made prior to the operation of the rules, transfers made before a taxpayer becomes a resident and transfers made under the terms of a will.

Paragraphs 32.70 – 32.71
The proposal to introduce specific rules for "hidden trusts" requires further consideration.

Chapter 33 – Allocating world wide taxable income between countries

Paragraphs 33.10 – 33.17
The Institute supports specific source of income rules for specific types of income based on the OECD model convention source rules. ***Option 2.***

Paragraphs 33.23 – 33.39
The Institute does not support the option of introducing a "domestic thin capitalisation " rule to deny a deduction for interest incurred on borrowings used by Australian owned multinationals to finance Australian operations which is in excess of a prescribed limit.

Paragraphs 33.23 – 33.31
The lack of an Australian deduction for financing costs incurred by Australian multinationals in respect of non – portfolio investments in foreign companies located in listed countries is a major concern.

Paragraphs 33.32 – 33.39
The options dealing with the existing thin capitalisation rules should be considered further. If a more restricted debt / equity ratio is considered necessary, the Institute would favour a combination of the world wide group gearing option and the fixed gearing option.

Paragraphs 33.40 – 33.48.
The Institute supports in principle the option of providing a self - assessment system for transfer pricing.

Paragraphs 33.49 – 33 64

The Institute supports in principle the option of treating Australian branches of non – residents as separate entities in calculating the Australian taxable income of such branches.

Paragraph 33.63
The Institute does not support the option of denying a deduction for expenses paid by an Australian entity to a related entity resident in a low tax jurisdiction where insufficient information is provided to support the expense claimed.

Taxation of life insurance

Chapter 34 – Building a more consistent regime for life insurers
Chapter 35 – Life insurance policyholders
Chapter 36 – Pooled superannuation trusts
Chapter 37 -Implications for superannuation funds and approved deposit funds

Paragraphs 36.1 – 36.13
The Institute is of the view that the taxation of pooled superannuation trusts remain unchanged as the benchmark for PST taxation should be determined by reference to the treatment of similar investments undertaken directly by a superannuation fund.

The Institute submits that whatever mechanism is ultimately applied for the taxation of life insurance companies in terms of the profits available to shareholders, a mechanism needs to be found to ensure that the taxation of superannuation fund policyholders is not detrimentally effected.

Paragraphs 37.1 – 37.11
It is the Institute's view that many smaller superannuation funds enjoy the benefit of reduced compliance costs by being able to make such transfers where they are invested wholly in life insurance policies and PST units. To withdraw this capacity to transfer tax liability (which we note is the subject of separate deliberations by the Review) is likely to result in an increased administration cost for both individual superannuation funds and the Tax Office.

Paragraphs 35.1 – 35.89
From the point of view of the policyholders who have entered into contracts with life insurance companies other than in relation to a superannuation fund, the proposal to apply a corporate rate of tax to the investment earnings of those policyholders is substantially little different to the present regime. The utilisation of a refundable credit regime seems to the Institute to be an appropriate mechanism to ensure that the proper tax rate is levied on a policy holder in respect of their investment.

It is the Institute's submission that existing life policies should retain the current treatment under the Tax Act.

We note the option contained in the Discussion Paper 2 that would provide policyholders with an ability to elect. We suspect that such an election may have some administration costs which the Institute is concerned may ultimately be borne by the policyholders themselves. Accordingly, the Institute recommends that the Review work with the life insurance industry to ensure that if such an option is proceeded with, such costs be minimised.

The Institute agrees that it is appropriate that the profits of a life insurance company that are attributable to the shareholders should be taxed at the corporate rate.

The Institute submits that some form of phasing in or grandfathering needs to be considered and the details of any such grandfathering or phase-in needs to be determined in conjunction with the life insurance industry.

Taxation of fringe benefits

Chapter 38 – Towards a better regime for taxing fringe benefits

Paragraphs 38.1 – 38.6

The Institute is in favour of the reformation of the FBT regime and agrees with the general conclusion of the Ralph Report that a serious case exists for reforming the taxation of fringe benefits.

The Institute's preferred option for reform is to undertake a complete overhaul of the FBT legislation which would be consistent with the Government's tax reform agenda and tax laws simplification project.

Paragraph 38.7

The Institute supports the recommendation of subjecting employees to tax, at marginal rates, in respect of the provision of fringe benefits. This will restore equity and fairness to the taxation of low to middle income earners, enhance the transparency of taxation in decision making, reduce the burden on employers and improve Australia's international competitiveness.

Paragraphs 38.15 – 38.16

The Institute recognises that compliance costs associated with FBT are far too high. Therefore, the Institute supports the recommendation of adopting a system of specific inclusion of fringe benefits. A system of specific inclusion would eliminate the need for numerous exemptions, resulting in greater certainty and a reduction in business compliance costs

To ensure that the list of benefits is closely monitored, the list of benefits could either be governed by Regulations or Determinations by the Treasurer.

Paragraphs 38.17 – 38.21

It is suggested that entertainment and on premise car parking be removed from FBT coverage as these benefits are difficult to determine, value and attribute to individuals. It is also suggested that the tax treatment of entertainment revert to the pre-1995 position, whereby entertainment expenditure was non-tax deductible. This option is preferred by the Institute as the compliance costs outweigh the revenue collected via the FBT system. In order to reduce compliance costs, both meal and non-meal entertainment should be excluded from FBT.

The Institute further submits that the income tax and FBT legislation be amended so as to clearly define the meaning of entertainment. Alternatively, a specific inclusion approach for classification of entertainment expenditure should be adopted.

In order to maintain administrative simplicity, the car parking exclusion should also extend to fleet vehicles used principally for work related purposes that are parked "off site". Alternatively, all car parking fringe benefits could be excluded from FBT, except "off site" parking which has been salary packaged.

Paragraph 38.22

The Institute, prima facie, is in favour of aligning the FBT and personal income tax years. Despite the reduction in complexity and business compliance costs, some employers may prefer to retain the current FBT year. Therefore, a comprehensive survey of employers should be conducted before a conclusive decision is reached.

Alternatively, the operating cost method could be modified to allow employers to adopt standard operating costs and/or a minimum prescribed business use.

Paragraphs 38.23 – 38.34

It is suggested that the current statutory formula scales could be changed to a flat rate of 25% or a scale increasing from 25% to 35% as distance travelled increases. The Institute is not in favour of this suggestion on the contrary basis that the proportion of work-related use of a car increases the more it is used. Further, employers operating a fleet of "work horse" cars are likely to be severely disadvantaged.

The Institute is not in favour of replacing the current statutory formula scales with a flat scale of either 25% as this option is inflexible, inequitable and contrary to the spirit of taxation of fringe benefits.

It is suggested that a schedule of pre-determined operating costs in conjunction with a prescribed level of business use, either at 50% or 20%, could be adopted. The Institute submits that a statutory formula based on standard operating costs and a prescribed level of business use is inequitable and practically unworkable.

It must be accepted that the use of any statutory formula, including the recommended options, will unfairly advantage or disadvantage a minority of the population.

The Discussion Paper 2 does not discuss the feasibility of extending the FBT regime to company shareholders and trust beneficiaries. The proposal to tax the provider of non-cash benefits provided to shareholders and trust beneficiaries will require new systems and procedures to identify benefits provided to shareholders and trust beneficiaries. The cost of developing these systems would be significant.

The Government's objectives could be achieved by extending the operation of existing provisions within the Income Tax Assessment Act 1936 (ITAA36) which already tax shareholders and trust beneficiaries on the receipt of certain benefits. This, however, is likely to result in legislation which is complex and would require some methodology for attributing value. On balance, it may be preferable if these proposals were not proceeded with.

Comments

Taxation of physical assets and goodwill

GENERAL AND SPECIFIC COMMENTS

Taxation of physical assets and goodwill

Chapter 1: Towards a new policy framework for wasting assets

GENERAL COMMENTS

1.1 A consistent and coherent framework for the taxation of wasting assets used to produce income will only be achieved by the universal use of comprehensive basic concepts .

1.2 Such a framework will capture all relevant wasting capital expenditure including *blackhole expenditures* which currently do not qualify for write – off but which produce benefits that endure for a fixed period only.

1.3 It should be a hallmark of the standard system that wasting capital expenditures undertaken for the purpose of earning assessable income unambiguously qualify for write – off

1.4 It is essential that variations from the standard be transparent.

1.5 The entitlement to the capital write – off or deduction should accrue to the taxpayer that incurred the relevant capital expenditure **(*This is Option 1 at paragraphs 1.15-1.17*)**. The concept of 'incurred' is well established. A standard primary test based on this concept is preferable to one based on the more amorphous concept of control.

1.6 A taxpayer's entitlement to tax deductions should in principle be based on the actual cost of the asset to the taxpayer **(*This is the Option put forward at paragraphs 1.23-1.24*)**. The compliance benefits (including those relating to less abuse through value – shifting) do not justify the distortions arising where the deductions are based on the original cost of creating the asset.

1.7 The Institute does not support the reduction of the depreciation cost base to take the estimated end life scrap value of an asset into account **(*paragraphs 1.25-1.26*)**. Any gain in equity or efficiency (which is doubtful) will not be justified by increased complexity and compliance costs. The Institute does not believe there are any wasting assets where it would be appropriate to take estimated end life scrap value into account.

1.8 The implementation of the principle that a taxpayer should not be entitled to a write – off until there has been a decline in value of the relevant asset through use in the production of income raises difficulties similar to those in relation to the denial of depreciation for receipts on disposal. The Institute strongly disagrees with any suggestion that deductions should not commence until the asset in question is producing income. The underlying assumption that decline in value results almost exclusively from use in producing income is questionable .It is far more appropriate that deductions should commence when the asset is installed and ready for use than is when the asset has been applied in producing income producing purpose (***paragraphs 1.31-1.36*****).**

1.9 The types of expenditure referred to in ***paragraph 1.35*** of the Discussion Paper incurred during the period of construction or establishment of an asset should remain immediately deductible, e.g., interest on funds borrowed for the construction of assets. This type of expenditure is quite different from the construction costs themselves, because it produces no enduring benefit, i.e., once interest is paid it represents an economic loss for which there is no corresponding wasting asset or advantage. To deny immediate deduction for costs such as interest would mean that the cost base of the same asset which has the same value would differ according to whether or not a taxpayer had borrowed to finance the construction, which would be an absurd result **(*****paragraphs 1.35)***.

1.10 The Institute prefers ***Option 1 at paragraph 1.37*** of the Discussion Paper over ***Option 2 at paragraph 1.38.***

1.11 The Institute endorses the proposition that requiring assets to be written – off over their effective life is likely to result in annual depreciation deductions being more closely aligned with annual declines in the value of the asset than any other practical approach.

1.12 The Institute supports the retention of the existing system which enables taxpayers to self – assess or to select an appropriate effective life from the Commissioner's schedule **(*****Option 1 at paragraph 1.48*****).** This is consistent with the current self-assessment regime for taxpayers generally. Option 2, discussed at paragraphs 1.49-1.51 of the Discussion Paper, would be moving backwards to a paternalistic regime with greater administration and compliance costs to taxpayers. Requiring taxpayers to follow the Commissioner's schedule unless a variation is obtained from the Commissioner would be costly and involve considerable resources of the ATO, for no overall benefit. The Institute completely rejects the statement in paragraph 1.51 that Option 2 would provide taxpayers with certainty and predicability. On the contrary, it will result in greater uncertainty and unpredictability than the current regime.

1.13 The Institute welcomes the fact that the Commissioner has advised the Review that the ATO will progressively update and expand the effective life schedule to ensure that the schedule is as representative as possible.

1.14 Buildings and structures should be brought into the depreciation regime applying to all physical assets. Taxpayers would receive taxation depreciation on the full purchase price over effective life and full balancing adjustments would apply **(*****Option 2 at paras 1.56-1.59*****).**

1.15 The Institute rejects as patently wrong the statement in ***paragraph 1.59*** of the Discussion Paper that Option 2 would not be compatible with allowing indexation in respect of capital gains. When buildings and structures on the one hand and the underlying land on the other are considered separately, it is only the underlying land that appreciates in value and gives rise to capital gains. Building and structures as separate assets rarely increase in value and in this way are the same as plant and equipment. Therefore, over the life of any buildings or structures the total deductions **would not** exceed their original cost **(*paragraph 1.59*).**

1.16 The Discussion Paper states that under a standardised model for the treatment of capital allowances no special rules would apply to the resources sector **(*paragraph 1.69*)** . However, the Discussion Paper makes no proposals for change and the Review notes that the resources sector is favourably taxed in all of the jurisdictions surveyed. The Institute believes that the current special rules applying to the resources sector should remain in place. Those rules reflect the special features of the resources sector – the inherent speculative risk in exploration and prospecting expenditure and in mining operations, the way this risk is spread by sale and farm-in activity, the real practical difficulty in estimating project life in advance, the variability of project life due to economic, geological and other uncontrollable variables, etc – rather than representing any form of concessional or favourable treatment. This is why all jurisdictions apply special rules to the resources sector. Australia would be taxing the resources sector more harshly and unfairly than other jurisdictions, and be making our resources sector internationally uncompetitive, if these special rules are remove **(*paragraphs 1.67-169*).**

1.17 The Institute supports an immediate write – off for low cost items thereby obviating the need for taxpayers to make annual calculations of depreciation entitlements in respect of such items. The Institute also recognises that such a concession should be limited and supports the option that would place an annual dollar limit of say $10000 for immediate write – off on the aggregate of purchases of items each costing less than the *de minimis* threshold **(*Option 2 paragraphs 1.77-1.78*).** Further proposals that are less discriminatory and simpler to administer are explored below under specific comments.

1.18 The Institute supports the option removing the election for a balancing charge offset which currently exists in relation to plant and equipment. Such a change will make any new system more equitable and consistent.

1.19 The Institute does not support the removal of capital gains tax indexation for depreciating or any other assets **(*paragraph 1.89*).**

1.20 If the new framework for wasting assets were to treat conversions from business to non – business use and vice versa as disposals and acquisitions at market value neutrality and equity would be enhanced. Special provisions would be required in the case of mobile assets being moved offshore **(*paragraphs 1.93-1.95*).**

1.21 The Institute's approach to so – called ' blackhole ' expenditure is that the integrity of the tax system is compromised when expenditure to produce assessable income is either not taken into account at all or incorrectly accounted for in the determination of any liability to tax. It follows that any new framework for the taxation treatment of wasting assets should be sufficiently comprehensive to capture all expenditure in the acquisition of wasting assets or benefits. Expenditure which produces no enduring benefit or short term benefits should be deductible when incurred.

SPECIFIC COMMENTS

1.22 One method for achieving a universal taxation treatment of all wasting income – assets is by developing a definition of asset for these purposes which is sufficiently elastic to embrace all economic benefits including those which fall outside legal concepts of property.

1.23 Whilst this approach may go some way to facilitating the introduction of standard provisions for capital allowances which are currently not treated uniformly, definitions which extend beyond commonly recognisable concepts lack precision and impair the certainty of the system.

1.24 The alternative method is a comprehensive schedule of write - off events. The advantage of this approach is that it can accommodate both the efficiencies to be derived from a comprehensive, but meaningful, definition of asset or benefit and capital expenditures to acquire things which cannot be confidently accommodated by such definitions. This will increase certainty, enhance the ability to define the parameters of a wasting asset and ensure that the framework for capital allowances is more equitable.

1.25 A standard rule allowing a capital write – off to the taxpayer who has incurred the expenditure for an income producing activity regardless of the taxpayer's economic interest in any wasting asset or benefit associated with such expenditure ensures that the deduction accrues to the taxpayer bearing the loss. In practice there may be a close correlation between past capital expenditure and the acquisition of future economic benefits that will decline in value. Where this is not the case and the taxpayer entitled to the relevant capital allowances is not the owner of the asset, the owner will bear any tax liability arising from value added.

1.26 Where a taxpayer has acquired an asset by way of a gift rather than expenditure and the asset is wasted in the course of producing income or conducting a business activity to that end, the taxpayer has borne a cost which ought to give rise to relevant capital allowances. The fact that the taxpayer did not undertake or incur any expenditure in acquiring the asset is irrelevant. Any new framework for the taxation of wasting assets should ensure that the current position in this regard is not compromised.

1.27 A taxpayer's capital allowances in respect of an asset should be based on the cost of the asset to the taxpayer. Where a relevant asset has been gifted to the taxpayer it is appropriate that its tax value equal its market value at the time the taxpayer commences using it for an income producing purpose.

1.28 The assumption that the scrap value of a depreciable item is zero ought to be maintained. The alignment of the taxation treatment with accounting standards which deny depreciation for estimated disposal receipts would increase compliance and administration costs to an extent not justified by the gains in equity and efficiency.

1.29 The taxation of the value of revenue exemptions and direct subsidies in kind as assessable income in the year of exemption or receipt may create cash flow difficulties for some subsidised taxpayers. It may on that account be more desirable that subsidies be taxed over the write – off period for the asset rather than immediately.

1.30 Capital allowance deductions should commence when the asset in question is installed and ready for use unless the system provides that losses incurred on the disposal of business assets before their use in the production of assessable income are allowable revenue deductions in the year they are incurred. This is especially so in the case of investments such as vineyards where the taxpayer is at risk for some considerable time before the investment is capable of producing income.

1.31 It is noted that Australian Accounting Standard AASB 1021 'Depreciation' provides that depreciation may not be allocated until the asset is first put into use **or held ready for use**.

1.32 A part year deduction should be allowed in the first year reflecting the proportion of the year for which the asset was in use.

1.33 Australian Accounting Standard AASB 1021 specifies that where an asset is a complex structure made up of interdependent sub – structures requiring installation in successive stages, depreciation may not be allocated until installation has been completed to a stage where service or saleable product can be obtained. Whilst this standard is compatible with a rule that deductions should commence from the time the asset is installed and ready for use, it takes no account of asset wastage that may occur during the construction and establishment of an asset. A new framework for wasting assets should secure a deduction for capital expenditure incurred before service or saleable product can be obtained. In the case of components replaced during long term construction the cost of replacement should be included in the cost base.

1.34 Where part of an asset has been completed to a stage where service or saleable product can be obtained depreciation should be allowed in respect of a proportion of construction cost allocated to that part.

1.35 Ongoing costs incurred during the period of construction or establishment of an asset such as those associated with the tending of horticultural plants and interest on borrowings should continue to be allowed as immediate deductions. Such deductions should be allowed notwithstanding that the capital assets to which they relate are not yet installed and ready for use.

1.36 The period of write – off should, at the option of the taxpayer, be self – assessed or selected from the Commissioner's updated effective life schedule. A system of self – assessment affords taxpayers the flexibility of taking account of the special circumstances surrounding their business use of the asset without the compliance costs associated with an application to vary the Commissioner's schedule. It is overstated to say that it would be unrealistic to expect that the average effective lives applied under this system would be as long as those resulting from a system requiring taxpayers to follow the schedule unless a variation has been granted. Most taxpayers will select the appropriate effective life from the Commissioner's schedule especially if the schedule is comprehensive and current. It is unlikely that many taxpayers will deviate from the schedule except for demonstrable and sustainable reasons. The risk of avoidance in this instance does not justify the loss of flexibility associated with the abolition of self - assessment for effective life.

1.37 The Institute does not support a system of allowing taxpayers to reassess the effective life and the value of assets from time to time for the reasons outlined in the discussion paper **(*paragraph 1.52*).** This may mean that where taxpayers improve existing buildings and structures, such improvements will continue to be written – off separately.

1.38 The Institute supports a new framework for wasting assets which brings buildings and structures into the general depreciation regime. The discussion paper raises the question as to whether this approach is compatible with allowing indexation in respect of capital gains. The concern is that the vendor will not be taxed in respect of that part of the consideration which is sheltered by indexation but this untaxed amount will nevertheless be included in the depreciation cost base of the purchaser.

1.39 The policy that only real capital gains be brought to tax underpins the indexation provisions. Consequently the vendor incurs no tax liability in respect of the indexation component of any capital gain. This fact should have no bearing on the ability of the purchaser to depreciate from a cost base which includes that component. The purchaser will incur a balancing charge on disposal to the extent that there has been over depreciation and will derive the benefit of indexation on the full purchase price in the calculation of any capital gain. This is the current position in relation to plant and equipment and there is no reason of principle why this should not be the case in respect of all wasting assets including buildings and structures which will be valued and treated separately from the land for depreciation purposes following accounting principles **(*paragraph 1.59*).**

1.40 Buildings and structures should be treated consistently with other wasting assets. Their effective life assessed by the taxpayer or included in the Commissioner's schedule should approximate as closely as possible the actual decline in value taking into account factors such as quality and type of construction, usage patterns and location. This option will eliminate the need to distinguish plant from buildings and structures, standardise balancing charge arrangements and permit the purchasers of second hand property a depreciation cost base equal to the purchase price.

1.41 The new framework including buildings and structures within the general depreciation regime should apply to buildings and structures acquired after the new measures take effect **(*Option 2*).** Paragraph 1.66 states that this option would require vendors of existing buildings to be subject to full balancing adjustments, up to the value of depreciation deductions allowed to them in respect of the building, upon disposal. No reason or argument is given for this statement. The Institute rejects this completely. The most appropriate transitional arrangement is for the new measures to apply to taxpayers acquiring buildings and structures after the new measures take effect and not to the vendors of such assets who acquired the building or structure before the measures take effect.

1.42 The Institute recognises the taxpayer’s compliance need for an immediate write – off for low cost items. It also recognises the need that such a concession be capped lest the integrity of the law be compromised by providing unfair advantages to particular taxpayers, In this regard the Institute favours the option of an annual dollar limit but questions whether the discriminatory nature of the concession could not be eliminated by simply extending the concession to all taxpayers regardless of whether the write – off relates to low cost items or not. This may only be fiscally achievable by reducing the overall monetary limit from what it might otherwise have been had the concession been limited to taxpayers purchasing low cost wasting assets. Such a concession would reduce the compliance costs of all taxpayers including those who use the concession for low cost items and it would be more easily administered. Wasting low cost items in excess of the immediate annual dollar limit should be placed in a low cost asset pool and their aggregate cost depreciable over 3 years.

1.43 The Institute supports the introduction of a full write – off for items with low written down values where the diminishing value method of depreciation has been applied. The greater of $100 or 4% of the original cost would be an appropriate threshold for this full write-off **(*paragraph 1.79*)**

1.44 The diminishing value method of depreciation should be the general or standard method of depreciation for wasting assets coupled with an immediate write – off for low value assets. The Institute accepts that this method may better approximate changing value because it provides a more rapid rate of decline in the early years. The Institute also accepts that this method will produce compliance benefits where assets are modified or improved. Any new framework however should take account of the fact that the diminishing value method may not be appropriate in all instances and in particular in relation to intangibles. In such cases it may be appropriate that the taxpayer be given the option of a write – off using the prime cost method **(*paragraphs 1.80-1.85*)**.

1.45 In the interests of equity and consistency a new system for depreciation should not include the current option for balancing charge offset available to taxpayers in the case of plant and equipment. This is especially so if the removal of the offset produces revenue gains which are used to fund alternative measures which produce benefits to all taxpayers.

1.46 Alternatively the balancing charge offset option ought to be included in any new system such that it is available to all taxpayers. The obvious drawback of this latter proposal is that it is not revenue neutral.

1.47 The reduction in record keeping requirements associated with the removal of indexation in the calculation of any capital gain on the disposal of a depreciated item does not justify the denial of indexation to those taxpayers who are able to dispose of an item for a consideration in excess of cost. It is by no means clear that the removal of indexation will produce any significant revenue gains and in any event such gains would not justify the denial of indexation in the case of depreciated items while the concession remains for other assets.

1.48 If business and non – business use conversions are to trigger adjustment calculations based on market value then the integrity of the system will require special provisions catering for situations where mobile assets are moved off – shore.

1.49 As stated above expenditure to produce economic benefits which endure for a fixed time ought to qualify for write - off under a system based on a sufficiently comprehensive definition of asset or under a schedule of write – off events.

Chapter 2 – The case for accelerated depreciation

GENERAL COMMENTS

2.1 The decision whether to move from accelerated depreciation to effective life depreciation and to use the revenue gains to cut the company tax rate will remain a matter for judgment by government. As is pointed out in the Discussion Paper, the issue is whether the resultant redistribution of benefits across industries will increase or reduce overall economic growth, employment and welfare. In the absence of relevant modelling it is not possible at this stage to identify the economic merits and demerits of such a change. The Institute is concerned however that the general principles underpinning any new framework for the taxation treatment of wasting assets reflect a consistent and equitable approach. It should therefore proceed from the base position that taxpayers are treated equally. Deviations from this position based on identified economic imperatives should be transparent.

SPECIFIC COMMENTS

2.2 If some form of accelerated depreciation is to be retained for the possible reasons outlined in the Discussion Paper and if the introduction of an effective life regime with a loading would result in the more uniform treatment of wasting assets with differing effective lives, the Institute would support such changes on the grounds of equity and consistency.

Chapter 3 - trading stock and similar assets

GENERAL COMMENTS

3.1 The Institute supports reform that would require all trading stock to be valued on a consistent basis.

3.2 In the event that a single method for valuing all trading stock is not achievable, where a taxpayer has selected a particular method that option should be irrevocable except where the taxpayer has made a case for change on non – tax considerations. There is no reason for excluding such an exception in a system that provides alternative methods for valuing trading stock.

SPECIFIC COMMENTS

3.3 The Institute supports the accounting approach that requires inventories to be valued at the lower of cost or net realisable value **(*Option 1*)**.

Whilst it is recognised that this method would allow deductions for unrealised losses but deferral of unrealised gains, the deferral advantage is more than outweighed by the cash – flow and administrative implications of bringing unrealised trading stock gains to tax.

3.4 Consumables and spares to meet operational requirements are not held for the purpose of sale or exchange in the ordinary course of a business. The fact that such assets are treated as inventories to be valued at the lower of net realisable value and cost for accounting purposes does not justify their treatment as trading stock for taxation purposes. The deductibility of expenditure on the acquisition of consumables and spares at the time when it is incurred accords with the general principle in relation to outgoings and losses incurred in carrying on a business **(*paragraphs 3.16-3.18*).**

3.5 Crops do not constitute trading stock until severed from the land. Such are the vagaries of primary production that it is inappropriate that they be treated like trading stock for tax purposes before they are severed from the land. It may be appropriate for accounting purposes that such assets be valued at net market value bringing increases or decreases in value to account as they accrue, but it does not follow that the accounting treatment will also produce a proper reflex of income for taxation purposes. As in the case of consumables and spares, the Institute does not support treating standing crops like trading stock. By the same token it does not support the option of deferring deductions until the value of the crop has been realised. In this instance there is no reason for varying the operation of the general principle in relation to allowable deductions. Indeed consistency would require that all standing crops be treated similarly in this regard **(*paragraphs 3.19-3.22*).**

3.6 Minerals do not become trading stock until severed from the land. For the same reasons outlined above in relation to spares and standing crops, the Institute does not support the option of taxing mineral resources as trading stock nor does it support the option of treating expenditure on the extraction of minerals as capital depreciable over the life of the relevant core body. Such measures would detract from principle and consequently consistency **(*paragraphs 3.23-3.25*)**.

3.7 The Institute does not support the recognition of revenue before billing or before a contractual liability to make a periodic payment has arisen, in relation to partly completed contracts for the provision of professional services. As in the case of other assets with 'trading stock characteristics', this option involves a significant and unjustified departure from the well established principle relating to when income accrues to a taxpayer. Further, its will create cash flow problems for taxpayers **(*paragraphs 3.26-3.28*)**.

3.8 At the practical level the taxation treatment of standing crops, mineral resources and work in progress as trading stock will involve complex valuation issues.

3.9 The proposed treatment of assets with "trading stock characteristics" discussed at ***paragraph 3.15-3.28*** of the Discussion Paper represents a drive for a theoretically pure and comprehensive income tax model at the expense of simplicity and compliance costs. The proposed treatment would involve a massive increase in the complexity of the taxation treatment of consumable stores, spare parts, crops, mineral resources and partly completed service contracts. The cost of valuing these items alone would amount to many millions of dollars across Australia, plus massive compliance and administrative costs for taxpayers. This cost and the massive amount of time lost and disruption caused would not be justified by the drive for theoretical purity, especially given that this is simply a timing issue. The current taxation treatment of consumable stores, spare parts, crops, mineral resources and partly completed service contracts should remain unchanged.

Chapter 4 – determining the appropriate treatment of goodwill

GENERAL COMMENTS

4.1 As a general rule plant and equipment are amortised because there is a reasonable expectation that they will be consumed in the production of income over a period. The same cannot be said of goodwill. There is generally an expectation on the part of taxpayers that their business endeavours and business expenditure will not only produce income but will simultaneously grow their business. The extent to which that expectation has been realised can only be determined when the business is sold. Any attempt to value accretions to goodwill prior to a sale must of necessity be based on highly speculative considerations. It is therefore appropriate that goodwill be treated as a non – wasting asset for income taxation purposes. Different considerations underpin the accounting treatment of goodwill which have no justifiable bearing on the taxation treatment of goodwill.

SPECIFIC COMMENTS

4.2 It follows from the general comments above that the Institute does not support the option that acquired goodwill be depreciated.

Taxation of financial assets and liabilities

Taxation of financial assets and liabilities

Chapter 5 – Towards a new policy framework for financial assets and liabilities

Chapter 6 – General application of the policy framework for financial assets and liabilities

Chapter 7 – Debt/equity hybrids and synthetic arrangements

GENERAL COMMENTS

5.1 The Institute supports the introduction of a specific regime for the taxation of financial arrangements. It is clear that the current law fails to provide the requisite certainty necessary for the efficient operation of the self - assessment system. For example, the decision in Coles Myer Finance v F.C.T (1993) 176 CLR 640 and in F.C.T. v ERA (1996) 185 CLR 66, both deal with discount expense but reach completely different conclusions as to when discount expense was deductible.

5.2 The uncertainty of tax outcomes under the current law has created distortions in financial markets. It is submitted that greater certainty as to tax outcomes would enhance Australia's role as a regional financial centre.

5.3 The Institute recognise that many financial arrangements are inherently complex. However, this does not justify the introduction of complex taxation treatment. It is particularly important that any regime not be complex as the ambit of the financial arrangements under consideration is extremely wide and would extend to relatively straight forward items such as bills of exchange, consequently affecting a large number of fairly unsophisticated taxpayers. These rules should not be written on the assumption that, "only banks would have to comply …". This kind of assertion has often been made in the past but has rarely been true.

5.4 Regrettably some of the proposals suggested in A Platform For Consultation add complexity without providing any increased certainty about tax outcomes. Generally speaking this complexity stems from revenue protection measures as is highlighted below.

SPECIFIC COMMENTS

Quarantining of Losses

5.5 The Institute strongly opposes the quarantining of losses in relation to financial arrangements. The Institute queries whether this is a necessary companion to a "realisation" method of recognising unpredictable gains and losses. In our view the existing general anti avoidance provisions, combined with appropriate "realisation" rules, should be sufficient to deal with any exploitation of a "realisation" method.

5.6 The Institute note that this proposal is inconsistent with the proposal to remove the quarantining of capital losses, ***see* paragraph *12.22*.**

5.7 Also the Institute note that if loss quarantining applied only to losses calculated on a "realisation" method, that this would create a distortion in the operation of financial markets and risk management. "Mark to market" and "timing adjustment" would be favoured, relative to "realisation", as such losses would not be so confined.

5.8 This is obviously a revenue protection measure that would result in increased complexity. In our opinion it is not justified and these concerns would be better addressed in defining the "realisation" approach.

Realisation

5.9 The Institute supports the adoption of a realisation method for those financial arrangements where gains or losses cannot be predicted with certainty.

5.10 As noted in <u>A Platform For Consultation</u> the term "realisation" needs to be clarified. In this respect there are three alternatives available, firstly defining realisation by reference to economic ownership or risk, secondly by reference to legal form, thirdly a cocktail of the two.

It is readily apparent that a legal form approach would be simpler to legislate and would provide greater certainty about tax outcomes.

It appears that the rationale for an economic approach is revenue protection, namely the perception that a legal form approach can be manipulated. Interestingly an economic approach would necessarily involve concepts similar to the "45 day rule" pertaining to franking credits, a situation that is recognised in <u>A Platform For Consultation</u> as undesirable and given as a reason for a move to full franking.

In the Institute's opinion the concerns expressed in <u>A Platform For Consultation</u> about the scope for "adverse selection" under a "realisation" method could be dealt with by defining "realisation" primarily on legal form subject to a threshold level of change in economic ownership or risk. Complete reliance on an economic approach would be administratively complex and contribute to uncertainty.

Nevertheless there are some grey areas such as "rollovers" where further consultation is necessary. Perhaps a "purposive" test could be introduced as a part of the economic approach to except "rollovers" from constituting a "realisation".

Timing Adjustment

5.11 The timing adjustment should be restricted to cases where the circumstances, as set out at ***paragraph 6.2***, warrant its application. However taxpayers should be able to elect that the timing adjustment apply in the same manner as is proposed for mark to market. This flexibility may reduce the compliance burden for taxpayers that may be accounting on an accruals basis for financial reporting, particularly if they are able to use the same commercial accounting method for taxation purposes.

Foreign Exchange

5.12 .The Institute generally supports the recognition of foreign exchange gains and losses on a realisation basis.

5.13 A significant number of taxpayers account for some foreign exchanges gains and losses on a retranslation basis for financial reporting. In this respect retranslation is not the same as "mark to market" and produces a different monetary result. In an effort to reduce compliance and improve financial and risk management, retranslation should be available for taxation purposes where it is used for commercial accounting purposes.

5.14 The Institute does do not support a "timing adjustment" for the taxation of anticipated gains or losses calculated by reference to 'forward rates'. This measure if introduced would tax unrealised gains that may never be realised due to the volatility of currency markets. It effectively extends the timing adjustment to unpredictable gains. The volatility of exchange rates means that there is a high degree of uncertainty attaching to the gain estimated by reference to forward rates. Consequently the proposal is not supported. This would also impose on taxpayers the effects of a 'mark to market' approach, seemingly in conflict with the stated proposal for 'mark to market' to be available only on election by taxpayers.

5.15 Again it is apparent that the proposed taxation of foreign exchange gains utilising forward rates is a revenue protection measure that would add unnecessary complexity.

Hedging Rules

5.16 The general discussion concerning hedging rules implies that there is little community support for comprehensive tax hedge rules. This is particularly puzzling as the 1996 Issues Paper on the taxation of financial arrangements indicated that hedge rules were being seriously considered following significant taxpayer lobbying in response to the 1993 Consultative Document which had rejected hedge rules.

5.17 It is submitted that specific hedge rules are required to enhance risk management decisions.

Whilst it is no doubt true that many ".submissions on the 1996 Issues Paper considered that the proposed hedge tax rules were onerous, imposing considerable compliance requirements that went beyond what was undertaken for non-tax purposes..", these complexities stem from extreme revenue protection measures. Concerns about 'after-the-event' determination of the tax treatment are not new as is evidenced by existing provisions in tax law such as s. 82Z(2) Income Tax Assessment Act, 1936. Interestingly, s. 82Z(2) potentially applies to a "hedging contract" as defined in s. 82V. History reveals that workable revenue protection measures can be introduced in relation to hedging contracts.

5.18 In this respect the Institute submit that the "realisation" and "mark to market" methods do not obviate the need for specific hedge rules. Importantly both these methods are to have restricted application, in the case of "realisation" it is limited to unpredictable gains whilst "mark to market" is only available where it is also used for commercial accounting purposes. Consequently mismatches will occur where the hedge contract and the underlying contract are tax accounted for on a different basis. This will distort risk management decisions.

Debt Equity Hybrids

5.19 The Institute supports the introduction of a comprehensive regime for the taxation of debt equity hybrids.

5.20 Specifically the Institute supports a ‘blanket approach’ to the classification of the whole as either debt or equity. In The Institutes view the alternative bifurcation approach of splitting the hybrid into separate debt and equity components will be relatively more complex to legislate and to apply in practice.

5.21 The Institute submits that only objective factors should be taken into consideration and questions of degree should be avoided in the classification of hybrids as either debt or equity. In this respect the Institute submits that the range of factors should be limited so as to better illuminate the dividing line between debt and equity.

5.22 The Institute welcome the proposal to extend full debt or equity treatment to hybrids, unlike the current treatment of debt dividends under s. 46D <u>Income Tax Assessment Act</u> 1936 which are not taxed as either dividends or interest (see also the current taxation of convertible notes). This should simplify the application of the tax law to such hybrids.

Transitional Arrangements

5.23 Generally speaking all new provisions should be given prospective operation only. Accordingly arrangements entered into before the introduction of any new measures should be grandfathered and taxed under the existing law. However the uniform application of any new rules to all financial assets and liabilities would mitigate the compliance burden associated with maintaining two separate tax accounting regimes based on whether the arrangements were entered into before or after the introduction of any new rules.

In these circumstances the Institute supports a flexible approach that would allow taxpayers the option of bringing existing arrangements under the new framework.

Taxation of leases and rights

Taxation of leases and rights

Chapter 8 – Towards a new policy framework for leases and rights

Chapter 9 – Leases and similar arrangements over wasting assets

Chapter 10 – Other leases and rights

GENERAL COMMENTS

6.1 In relation to capital allowances generally the Institute supports the view that an entitlement to a capital write – off or a deduction should accrue to the taxpayer that incurred the relevant capital expenditure (see the general comments in the submission on chapter 1 above).

6.2 If leases of depreciable assets are to be taxed using the sale and loan treatment, lessees will be deemed to have incurred the cost of acquisition of the leased asset for the duration of the lease.

6.3 The alternative taxation of leases with transfer of tax preferences as formulated in ***paragraphs 9.21 – 9.24*** involves the keeping of correlated depreciation schedules by lessor and lessee. This option may have the merit of simultaneously permitting the transfer of tax preferences and eliminating the potential to obtain unwarranted tax benefits through payments structuring. On the other hand, it is conceptually more complex.

6.4 The Institute recognises that by applying the sale and loan methodology to leases of wasting assets, a bias may arise in favour of service contracts. The Institute is of the view however that this consideration is outweighed by the revenue gains and the gains in simplicity and consistency associated with the sale and loan approach. The Institute agrees that this problem may be reduced to some extent by extending the sale and loan treatment to non – lease arrangements which amount to the provision of debt finance.

6.5 The Institute favours applying sale and loan treatment to financial leases only, with exclusions based on materiality in relation to the duration of a lease, the value of the leased asset and categories of equipment.

6.6 The Institute does not support the application of either the “implicit benefits” approach or the “deemed benefits “ approach to the taxation of leases over non – wasting assets and other rights including rights arising from service and other contracts. A principal concern in relation to this option is the complexity and cost of its implementation. Rights over non – wasting assets which are themselves wasting assets used for income producing purposes should be depreciable under a new framework for the consistent treatment of all wasting assets. This would address the present issue of capital losses arising on the expiry or other disposal of such assets.

6.7 The question of whether some grants of rights be treated as the realisation of assets goes to the basic principles governing the derivation of assessable gains. Both the partial realisation and the threshold realisation approach involve complex record keeping in relation to transactions which would not ordinarily involve the disposal of the asset to which they relate. The current approach of treating the consideration derived on such sales as a gain separate from any gain that may be realised on a disposal of the underlying asset is preferable. This is not to say that the legislation should not contain special provisions governing extreme cases such as the grant of a 100 year lease of land.

SPECIFIC COMMENTS

6.8 The Discussion Paper at ***paragraphs 8.6 – 8.9*** lists examples of complexity and inconsistency in the current taxation of leases and rights. It specifically refers to the fact that a lease premium is a taxable capital gain on receipt whereas a lump sum payment for services is spread over the period of the service contract. There is little analytical merit in comparing lease premiums with payments for services – their only common feature is the fact that they have been paid in relation to a contract.

6.9 The different tax treatments for lease premiums, lease surrender payments and lease incentive payments are also mentioned. These differences are based on the traditional income / capital dichotomy which in turn is based on considerations other than the fact that the payments are all transactions in relation to a lease. Any new framework for the consistent taxation treatment of lump sum payments in relation to a lease could simply stipulate that such payments are derived proportionately over the term of the lease for taxation purposes or conversely as assessable gains on receipt.

6.10 The tax biases against certain leases and rights mentioned in ***paragraphs 8.10 – 8.12*** are eliminated where up – front lease premiums paid for leases of land are spread over the term of the lease and wasting business rights over assets are depreciable under a new framework for the expensing of all wasting capital assets used in the production of assessable income.

6.11 In relation to the tax benefits from the use of leases and other rights (structured payments ***– paragraphs 8.15 – 8.20,*** transfer of tax preferences ***– paragraphs 8.21*** – ***8.25***,lease assignments – ***paragraphs 8.26 – 8.28,*** tax exempt leasing – ***paragraphs 8.****29 – 8.33*) the Institute is of the view that these issues are best addressed by the application of the sale and loan methodology to leases of business assets and service contracts which amount to the provision of debt finance.

6.12 The practical difficulties of moving tax value closer to commercial value particularly in relation to structured payments and the sale of rights over assets far outweigh the conceptual merits of such an approach.

Taxation of capital gains

Taxation of capital gains

Chapter 11 – Towards a more competitive regime for taxing capital gains

GENERAL AND SPECIFIC COMMENTS

$1,000 CGT Relief for Individuals

7.1 The proposal to provide some reduction in CGT for individuals is a welcome development, if it will relieve individuals of some, at least, of the complicated compliance tasks currently imposed upon them by the CGT. If, on the other hand, the proposal is designed to be an incentive to encourage individuals to invest in CGT assets, we doubt that it is a particularly worthwhile proposal — the $1,000 exemption will be consumed in compliance costs.

The main problem with the proposal lies in the way that the proposed exemption is structured at present. Exempting an amount based on the taxpayer's gain means that the taxpayer benefits only in the amount of the tax saving, not in being removed from the CGT system and its compliance obligations. In other words, in order to know whether the taxpayer qualifies for the exemption, the taxpayer will still have to keep all the records and perform all the computations that are currently required. It is only when those tasks have been performed that a taxpayer will know whether or not they qualify. There will have been no compliance benefit for taxpayers.

A better system would be one based on the initial cost of the asset — it has the advantage that the taxpayer knows from the outset that it is, or is not, within the CGT system in respect of its asset. The Institute proposes that a more valuable system for individuals would be one where a taxpayer would not be liable to CGT on the disposal of an asset that was acquired for less than $5,000. We currently adopt such a system for personal use assets and it could easily be expanded to include all low-cost assets. There would obviously need to be rules to deal with groups of assets (such as portfolios of shares) the cost of each of which might fall under the threshold. In addition, if it were necessary, it would be possible to exclude from such a system assets the cost of which could be identified — again, listed securities might be excluded from the automatic carve-out based on cost because it is relatively easy to locate the cost at which a parcel of listed shares was trading on a particular day. But such a cost-based threshold would eliminate many of the compliance and record-keeping problems that taxpayers currently face.

If, however, a gain-based computation is still preferred, the amount of gain should be increased to $3,000, and be based on a 3 year cycle, rather than $1,000 per 1 year rule. The problem with a 1 year rule is that it could exacerbate lock-in. On the other hand, if a taxpayer were permitted to realise up to $3,000 in gains measured over the last 3 years, it is more likely that individuals who are shareholders will be less reluctant to sell their small shareholdings and that parcels of shares will be of marketable size.

Capped 30% CGT rate

7.2 The Institute feels that this proposal suffers from the same problems as the $1000 exemption. It does nothing to relieve the compliance burden of the CGT. It exacerbates the problem that currently exists of the interaction mechanism between the income tax and the CGT — that, rather than allocating assets exclusively into one or the other of the two systems, most assets are in both and are taxed at the higher rate, thus doubling the computations that have to be performed. And the 30% CGT rate will be a poor outcome if it is delivered at the loss of averaging, or the expense of reducing the overall corporate tax rate to 30%.

Scrip for Scrip Rollovers

7.3 The Institute supports this proposal and recommends that it should be extended to investments in private as well as listed companies. One important area where this regime should apply is where a small entrepreneur is able to convert their holding in their small venture company into a holding a development company — that is, where an owner wants to retain an interest in the product he or she developed through a private company but is willing to sell to another company with access to the funds necessary to allow the product to be developed and marketed. If private companies are excluded from the system, this kind of rollover will be too limited.

The Institute would have concerns with the proposal, however, if the proposal is to be limited to circumstances where "a takeover" of the target company occurs [***see paragraph 11.46***]. If this means requiring that the raider must acquire 100% of a target company, the proposal will be too limited.

If this proposal is to be introduced it should commence from 1 July 1999. If it is announced but does not commence from that date, there will be a great temptation for shareholders to sit on their shareholdings until the new regime commences.

Venture Capital

7.4 The Institute understands the arguments for a special regime for investments in high risk ventures. The disincentive to risk taking of the CGT, the potential spillovers from R&D and other high-risk activities, and the high cost of capital for small high-tech firms are all important matters that the tax system can help alleviate.

Consequently, the Institute gives qualified support to this proposal. The Institute suggests that a better strategy to deal with these matters would be to adopt more flexible rules for allowing access to capital losses, or making entities more transparent for losses. If the choice is between a 30% corporate tax rate and the introduction of a special venture capital regime, the Institute would prefer to see a 30% corporate tax rate.

Small Business Rollovers

7.5 The Institute supports the rationalising of these regimes, although we do recognise that the two small business regimes are directed at different policies — one concerning the potential for the CGT to constrain the growth of small business, and the other concerning retirement income policy.

Chapter 12 – Indexation, averaging and quarantining of losses

Indexation

8.1 The Institute strongly opposes the removal of indexation. The Institute has always maintained the position that more parts of the tax system should be indexed for inflation and, rather than eliminating some areas, indexation systems should be expanded. It should, for example, be applied at least to the computation of capital losses. An unadjusted system should be regarded as over-taxation; an inflation-adjusted system is not a concession.

In fact, the Institute would prefer to see indexation retained, rather than some of the other proposals — a 30% capped rate, or a $1,000 gain exemption — that are being proposed in ***Chapter 11*.** Indexation is, in our view, a fairer system than either of the other two suggestions.

There are two main reasons for opposing the removal of indexation. First, while current inflation rates may be low, experience suggests that this state of affairs will not last. Certainly, no-one could confidently predict that inflation has been forever defeated. Secondly, inflation is a matter that is largely under the control of governments through its control of monetary and fiscal policy.

The Institute also notes with regret the suggestion that the removal of indexation would occur before the introduction of GST so that the impact of the GST on inflation would never be reflected in the computation of capital gains. This method makes the point very eloquently — inflation is a matter that governments control in so far as any does, and governments should be discouraged from making money out of inflation.

Averaging

8.2 The Institute does not support the Review's proposed modifications of the averaging provisions.

The Review purports to identify a pattern of behaviour which is alleged to be a distortion caused by the averaging provisions. The Institute does not agree that these Tables unambiguously display avoidance or other unsatisfactory conduct. In so far as the individuals who are enjoying the benefit of indexation are genuinely low income earners, the system is working entirely appropriately. A very common group would be retirees who derive non-income cash distributions from unit trusts which are in fact reported as capital gains by virtue of the operation of the CGT. In so far as they are benefiting from averaging, the system is working appropriately. Indeed, if these individuals were to continue receiving trust distributions of non-income amounts under the entity tax system with deferred company tax option, the surplus would in future be returned to them in cash. Of course, if there is a lack of integrity to the system so that it is high income earners who are enjoying access to averaging benefits, the Institute would share the Review's concern. But we feel no adequate proof of the concern has yet been demonstrated.

8.3 In addition, the Institute observes that the averaging provisions, as currently structured:

(i) result in manipulation of the averaging provisions by:

- discretionary trusts distributing capital gains to beneficiaries with little or no other income; and

- individuals who have realised an assessable capital gain in a year of income incurring additional allowable deductions in that year to reduce their taxable income.

(ii) can result in a taxpayer being subject to extremely high effective tax rates in relation to income earned. For example, a taxpayer who has realised a capital gain of $20,000 in a year of income and who has already derived other taxable income of $16,700, derives a further $1,000. The additional tax (including Medicare levy) payable as a result of earning the extra $1,000, will be $915 (an effective tax rate of 91.5%).

However, the Institute does not support the Review's option in relation to averaging, as:
the proposed modifications are as complex as the existing provisions; and
any proposal for averaging based on income in the year of realisation of the gain lends itself to manipulation.

The Government's proposal to subject trusts to taxation as if they are companies should remove the capacity of discretionary trusts to manipulate the averaging provisions.

8.4 The Institute suggests a modification of the averaging provisions so that capital gains are taxed by reference to the tax rates applying to the taxpayer over a 5 year period. Under this proposal, the rate of tax on a capital gain would be determined as the average rate of tax payable if 1/5 of the gain had been added to the taxable income of the taxpayer in each of the 5 years immediately preceding the year in which the gain was realised. A taxpayer would only be able to take advantage of the tax free threshold if the taxpayer was below that threshold in a prior year of income.

8.5 For taxpayers who were aged less than 18 in any of the 5 previous years, consideration should be given to the tax being determined by reference to the rates payable as if the person was 18 in each of those years.

8.6 For taxpayers who had been non-residents in any of the 5 previous years, the tax would be determined by reference to the non-resident rates of tax in those years (that is, there would be no tax-free threshold).

8.7 This proposal would effectively eliminate the incentive to manipulate a taxpayer's taxable income in the year in which a capital gain is realised, as the rate of tax in relation to the capital gain will be fixed by reference to past events.

Quarantining of Capital Losses

8.8 In the Institute's view, the Review has not clearly demonstrated the need to reform the rules relating to quarantining of capital losses. Therefore, the Institute does not have a strong view on the need to reform the rules relating to quarantining of capital losses.

8.9 If there is to be reform of the capital loss quarantining rules, the Institute supports the Review's proposed ***Option 2*** permitting carry-back of capital losses, possibly with a limitation of the period of carry-back. The carry-back of capital losses is consistent with an approach where tax is imposed on the profits of a taxpayer over the taxpayer's life. Strictly speaking, the losses should not be "carried back". The losses should only be allowed as a deduction in the year in which they were incurred (to eliminate problems with amendment of assessments).

8.10 Capital losses should only be an allowable deduction to the extent to which capital gains had been realised in an earlier year of income. If there was to be a limit to the period for which the losses could be "carried back", that time limit should be the period within which amended assessments may issue.

8.11 In relation to the other options posed by the Review, the Institute's view is:

(i) the introduction of a deemed interest rate on carry forward capital losses is effectively the introduction of indexation of capital losses. For this reason the Institute does not support ***Option 1.***

(ii) the Institute does not support an approach that provides for different taxation treatment of capital losses depending on the nature of the asset involved. Such an approach adds further complexity to the tax system and increases the incentive for taxpayers to classify particular assets in particular ways. For these reasons the Institute does not support ***Option 3*** **or** ***Option 4***.

Chapter 13 - Involuntary receipts

GENERAL AND SPECIFIC COMMENTS

9.1 The Institute believes that involuntary receipts should be treated differently under the CGT legislation. The main distinction to be drawn from an involuntary receipt is, commonly, the receipt would be used as a means of replacement of an asset rather than the realisation from disposal of an asset. Accordingly, the treatment of involuntary receipts proposed under ***Option 1*** is unacceptable.

9.2 Although ***Option 1*** removes the problems associated with defining involuntary events and involuntary receipts, the Institute is of the view that creates issues that outweigh the benefits. Under ***Option 1***, the greatest difficulty would be created in a tax liability being created by the mere replacement of an asset. This can be illustrated by simple example, if an asset purchased for $1,000 with a current market value of $1,500 was destroyed, the receipt of a replacement asset (or fair market payment to replace the asset) would, prima facie, create a CGT liability of $180 (i.e. $500 @ 36% ignoring indexation). Therefore on a cash flow analysis, the taxpayer would only have $1,320 to replace a $1,500 asset. Thus, the purchase replacement assets would need to be funded from post-tax proceeds. This outcome fails to recognise the unique nature of involuntary events and involuntary receipts.

9.3 As the Institute, in principle, supports ***Option 2***, the remaining comments will be devoted to discussing ***Option 2*.**

9.4 An essential element of ***Option* 2** is to determine where to draw the appropriate boundary for determining whether a transaction is involuntary. This element recognises that there may be stages in an involuntary acquisition where the asset owner has scope to negotiate a settlement which may appear on the face of it to be a voluntary disposal. On this issue guidance can be drawn from existing law. Existing tax law recognises that a negotiated agreement to dispose of a CGT asset, where that negotiation has been backed with a threat of compulsory acquisition, can give rise to rollover relief (refer s. 124-70(1)(c) of the Income Tax Assessment Act 1997).

Therefore, in order to determine the involuntary nature of a transaction, the Institute suggests that regard be given to the full circumstances surrounding the transaction. In this process, any recognition of any impending threat of compulsory or involuntary disposal should be identified and dealt with under the special involuntary disposal rules.

9.5 The recognition that a threatened involuntary transaction could be negotiated would assist in ensuring an equitable outcome as taxpayers would be able have some control. The recognition of pure involuntary transactions could potentially distort economic activity as taxpayers may postpone action until the involuntary event has occurred, thus driving a business decision on tax considerations.

9.6 The Institute supports the preservation of pre CGT status where replacement assets are replacing pre CGT assets. This concept is consistent with the general principle of ***Option 2***.

9.7 It is recognised that a difficulty arises where the replacement asset has a greater market value than the replaced asset. However, attention is drawn to the existing "120% test", or the "substantially the same asset test" in s. 124-85(3) of the Income Tax Assessment Act 1997. Consideration should be given to determining the acceptability of applying such tests in this situation.

9.8 The notion of apportioning the replacement asset's cost base into pre and post CGT elements would create an administrative burden on the taxpayer, which would act as an offset to the potential compliance savings offered in the tax reform proposals.

9.9 The concept of compulsory rollover relief for CGT losses cannot be supported. It should be left to the choice of the taxpayer as to whether or not the loss is to be realised or added to the replacement asset cost base. Assuming that rollover relief for CGT gains on replacement assets is by the choice of the taxpayer, the Institute submits that both gains and losses should be treated consistently and therefore subject to the choice of the taxpayer.

9.10 The Institute believes that any avoidance opportunities (e.g. over compensation for involuntary disposals) can be adequately dealt with under the general anti avoidance rule.

Chapter 14 - Disposal of Partnership Assets and Interests

GENERAL AND SPECIFIC COMMENTS

10.1 The Institute encourages the intent to reduce the complexity associated with the differing treatment of the disposal of certain partnership assets and partnership interests. It has been recognised by the profession for some time that the fractional interest approach has led to an extremely complex system that is difficult to deal with. We are pleased that this is now also recognised at ***paragraph 14.10.*** The Institute strongly supports adopting only one system for the recognition of capital gains derived by partnerships, rather than continuing the current duplication of calculations.

10.2 To extend a fractional interest approach to depreciable assets as suggested in ***Option 1*** would only exacerbate an already complex system. Performing special computations for, say, depreciation, at the partner level rather than the partnership level will only make the accounting for partners more complex, and render precise compliance less likely, which is exactly the problem that the reform is designed to address according to ***paragraph 14.10.***

10.3 ***Option 2*** appears to be the only acceptable option of the two proposed. There are, however, some issues that would need to be considered if this Option is pursued. The main issues are discussed below. They all stem from the difficulties that underlie the glib phrase "applying an entity approach to partnerships" **[*paragraph 14.25*]** and are not really addressed in any of the Scenarios to the Chapter. Indeed, there are worrying indications in the text that the implications of the phrase have seized the imagination of the authors who write without a full comprehension of the difficulties of what it might imply. For example, none of the Scenarios presented distinguish the admission of a partner by making a contribution to the capital of the partnership (in which case only a fraction of the incoming partner's contribution would be included in the incoming partner's cost base) from the admission of a partner by purchasing portions of interests from the current partners (in which case the full payment would be the cost base).

10.4 It is unclear in ***Option 2*** how partners will deal with pre- and post-CGT interests, despite ***paragraph A9*** in Appendix A. The Institute would support the preservation of pre-CGT partnership interests and a system where pre- and post-CGT interests can be ascertained. Presuming that pre CGT partnership interest will be retained on establishment of an entity regime, it will need to be established whether the admission of new partners affect the pre-CGT status of CGT partnership assets — ie, whether Division 149 [former s. 160ZZS of the Income Tax Assessment Act 1936] would apply to partnerships as well.

10.5 Similar questions would then arise about the impact of this deeming on other regimes that trigger tax consequences on a change of "ownership" of an entity — for example, would the ability to carry forward realised net capital losses be jeopardised [Division 165CA, or the ability to recognise unrealised capital losses [Division 165CB] and the impact on current year capital gains [Division 175CB] would need to be addressed. Further, would the deeming of an entity to be a partnership be carried through to other regimes that trigger tax consequences on a change of "ownership" of an entity such as the ability to carry forward prior year losses [Division 165], or recognise bad debts [Division 166C]?

10.6 There would be similar problems from having to perform the computations required by former s. 160ZZT i.e. would a CGT event K6 under the Income Tax Assessment Act 1997 apply where the partnership no longer holds sufficient pre-CGT assets as partnership assets?

10.7 It is also unclear whether tax free distributions from partnerships would have the same effect as currently exists with unit trusts.

10.8 Based on the foregoing issues, the Institute would be reluctant to give unqualified support to Option *2* until the issues are adequately resolved. In particular, the Institute strongly believes that (the successors to) s. 160ZZS and 160ZZT should not be applied to partnerships if the entity model is adopted.

Taxation of entities

Chapter 15 – A fairer and more consistent treatment of entity distributions

GENERAL COMMENTS

11.1 This chapter asserts that the current imputation system for taxing company distributions has three deficiencies:

(i). It asserts that the imputation system is complex.
(ii). It asserts that low income shareholders are disadvantaged.
(iii). It asserts that the inter-corporate dividend rebate rules can lead to unintended tax benefits accruing to company shareholders.

The chapter then canvasses three possible remedies:

(i). A deferred company tax regime.
(ii). A resident withholding tax.
(iii). Amendment to the way inter company dividends are taxed.

The chapter also outlines the potential for a form of double taxation to apply when certain types of tax preferences are distributed from a company.

Finally the chapter outlines some alternative methods by which refunds of franking credits might be made available to shareholders.

SPECIFIC COMMENTS

The Deficiencies

Option 1: paragraphs 15.81 – 15.88
Option 2: paragraphs 15.89 – 15.92

11.2 It should be recognised that the source of complexity in the existing imputation system springs not from the basic system itself but rather from the different values placed on the receipt of franked dividends by different taxpayers. Corporate taxpayers effectively pay no tax on franked dividends. Individual taxpayers pay their marginal tax rate on the grossed up amount of the dividend with an allowance for a non-refundable credit for the corporate tax. Non-residents receive franked dividends tax free. Because different shareholders place different values on franked dividends there exists an incentive to stream dividends to those who value the franking credit most. The anti avoidance provisions brought in to control this streaming causes most of the complexity. If all shareholders received the full value of the underlying franking credit much of the complexity associated with the current imputation system would be eliminated.

11.3 In order for shareholders to receive equal value a full refund rule needs to be implemented. On a limited basis this is part of the proposed deferred company tax regime. It is proposed that individuals, super funds and certain registered charities would be entitled to the refund. It is not proposed that other exempt shareholders, companies and non-residents be entitled to a refund. ***Paragraphs 15.64 – 15.80***

11.4 The treatment of non-residents is addressed in a separate chapter and is not commented on further here. It is the Institutes submission that all resident shareholders should be entitled to a refund of franking credits.

11.5 If a full crediting and refund system were implemented the differing values placed on franking credits would be eliminated. No incentive to stream dividends would exist. Most of the complexity of the existing system would be eliminated.

11.6 Low marginal taxpayers would no longer be disadvantaged by the existing system if full refunds became available.

11.7 The Institute would recommend that all unfranked dividends should be fully taxable to all non-exempt resident shareholders, of course no credit or refunds would be available. This would also be the case for corporate shareholders.

Paragraphs 15.13 – 15.14; Option 3: 15.36 – 15.37; 15.40

11.8 For inter corporate dividends the Institute makes the following recommendation. The dividend rebate should be eliminated in full. All dividends received by a company should be fully taxable. For franked dividends it would be the grossed up amount of the dividend which would be taxable with a credit and where relevant full refund of any associated franking credit. The unintended consequences of tax benefits accruing to company shareholders through the misuse of the inter company dividend rebate system would be reduced with the recommended approach to the treatment of both franked and unfranked inter corporate dividends. Unfranked dividends will be fully taxable. The existing dividend stripping provisions contained in Part IVA of the 1936 Act should be capable of controlling any other misuse. The amendments to the inter corporate dividend regime can be supported provided they are accompanied by a full credit and where necessary full refund of franking credits as discussed above.

Option 2: 15.32 – 15.35; 15.39

11.9 A resident withholding tax (RWT) regime could be implemented provided it was administratively simple like the non-resident regime. The amount of the withholding should be the corporate tax rate. If such a regime were adopted franking should become totally elective. That is no required franking amounts should need to be calculated. Rather a company should merely elect either to declare the dividend as being franked or alternatively unfranked. If the latter occurs then RWT would need to be withheld and remitted. For a given size of each dividend receipt a shareholder will be indifferent to a franked or unfranked dividend. Both would be taxable on a grossed up basis with a credit and where relevant a refund for either the franking credit or the RWT. If a company overfranks its dividends the existing franking deficit rules should apply. The resident withholding tax proposal for unfranked dividends does not of itself address any of the identified deficiencies. Rather it has the effect of bringing forward the collection of the receipt of some tax payments. For this reason it should be seen as a tax collection proposal only. Provided it is implemented as outlined above such a measure could be supported.

The Proposals in a Platform for Consultation

Option 1: 15.28 – 15.31; 15.38; 15.64 – 15.71

11.10 The deferred company tax regime is not necessary to address the deficiencies identified. The introduction of such a regime in fact will lead to more complexity not less. Any reduction in complexity associated with the deferred tax proposal is solely caused by that part of the regime which deals with full refunds of franking credits. This part and this part alone of the proposal can be supported and as outlined above should be expanded to all resident shareholders.

Potential Double Taxation Comments

Paragraphs 15.42 – 15.53; Option 1: 15.54 – 15.55;Option 2: 15.56 – 15.61;Option 3: 15.62;Option 4: 15.63

11.11 In order to sensibly comment on the double tax issue a more complete definition of tax preferences is needed. In a sense it is misleading to label all differences between taxable income and accounting income as tax preferences. Clearly some differences come about by an overt policy decision to afford a tax preferred status on a particular amount. For example some income may be treated as exempt or a deduction may be unilaterally given even though no liability or outlay exists. However the rule is seldom as simple as this. For example some income is exempt only if it has already suffered an overseas tax of an amount equivalent to Australia. It is hard to see how such income could be said to be tax preferred. Other differences between taxable income and accounting income say more about the accounting rules rather than the tax rules containing a concession or preference. For example, the capitalisation of interest during the construction phase of a project will give rise to a difference between accounting income and taxable income. It is hard to see that the allowance of the deduction for tax in those circumstances is in fact the giving of a tax preference for the deductibility of interest. It is the Institutes submission that tax preferences need to be carefully defined. The definition should positively identify those concessions which are tax preferences. In addition tax preferences should be classified as permanent or temporary. The treatment of each form of preference should be different. If contrary to the Institutes recommendation a deferred tax regime is implemented credits against future company tax should be provided for any deferred company tax paid as a result of temporary tax preferences. If no deferred tax regime is implemented and regardless of whether a RWT is adopted credits against future company tax should also be provided in relation to any unfranked dividends paid to the extent of any temporary tax preference.

Chapter 16 – An alternative treatment for collective investment vehicles

GENERAL COMMENTS

12.1 The chapter outlines a proposal for a "flow through taxation" approach for so called collective investment vehicles ('CIV').
The two issues on which clarification is sought are:

- how to define a CIV; and
- how to treat the distribution of tax preferred income.

SPECIFIC COMMENTS

12.2 The Institute agrees that there is a need for the adoption of a flow through taxation regime for particular joint investment vehicles. The main criteria advanced in Discussion Paper 2 for the definition of a CIV are:

- widely held;
- non-active business;
- full distribution of income;
- the manner in which the income of the CIV is attributed to particular members; and
- the income distribution rule for CIVs. ***Paragraphs 16.13 – 16.17***.

Widely held

paragraphs 16.16 – 16.17.

12.3 The definition of widely held needs to be carefully defined. At present the term is defined in a number of different ways in the existing law. Some points to note are:

(i). The definition should not be restricted to publicly listed vehicles.

(ii). The Institute agrees that the definition of public unit trust in the Public Trading Trust rules could form the basis of the definition of CIV.

(iii). As with those Public Trading Trust rules the definitions should extend to vehicles which have superannuation funds and other exempt entities as their members.

(iv). Further the definition should allow for flow through status to apply to subsidiary entities owned and controlled by a parent CIV provided that subsidiary entity also satisfies the other CIV criteria.

Non-Active Business

paragraph 16.14

12.4 The existing public trading trust rules provide a template for the definition of non-active businesses. The Institute recommends a continuance of that definition such that only "eligible investment businesses" are allowed to be carried on by the CIV.

However the institute would recommend that either a threshold test for active business should be introduced or alternatively a parallel taxing regime for active income should be adopted.

At present even minor active business activities can cause the entire income of the trust to be subject to tax at the entity level. Instead the Institute believes that only the active income should suffer the tax at the entity level. All passive income should remain flow through income.

As an alternative and minimum approach the Institute recommends some form of active income test (perhaps similar to the CFC rules) could be used to regulate the activities of the CIV's. With this alternative only if the CIV failed the test threshold would its entire income be taxed at the entity level.

The Institute also recommends that the restrictions covering the control of trading businesses should be eliminated. If a CIV owns shares or interests in a separate entity and controls that entity via that shareholder control the CIV should not be said to lose its passive investment status. Any income earned by the controlled entity will be subject to corporate tax at the controlled entity level. No leakage of revenue will result by the maintenance of CIV status for the shareholder entity.

Income Distribution Rule

paragraph 16.15

12.5 It is accepted that CIV's should be required to distribute all of their income each year. The Institute recommends that income for this purpose should be taxable income. If any other notion is used to regulate full distribution further definitional complexities will be introduced.

Tax Preferred Income

paragraph 16.18; Option 1: 16.19 – 16.27; Option 2: 16.28 – 16.31

12.6 The Institute strongly believes that all tax preferences should fully flow through to members. On philosophical grounds this is consistent with the design principle expressed by the Review. The potential cost to the Revenue can be controlled by an appropriate definition of CIV as discussed above.

Chapter 17 – How a redesigned imputation system would apply to entities

GENERAL COMMENT

13.1 This chapter considers some of the mechanics associated with the three options outlined in Chapter 15.

SPECIFIC COMMENTS

Deferred Company Tax

paragraphs 17.3 – 17.51

13.2 The Institute has submitted that a deferred company tax regime should not be adopted. The matters canvassed in this chapter reinforce the notion that such a regime would increase the complexity of the rules relating to entity distributions.

However if the Institutes submission is not accepted then we would strongly recommend that the existing imputation system should form the basis for the new deferred company tax calculation.

From a shareholders perspective every dividend received would be fully franked. The only issue which would need to be determined is how the company keeps its franking account whole for the deferred company tax. The existing system already provides for a mechanism to top up the franking account if dividends are over franked. Since in principle deferred company tax is merely a tax imposed for over franking we would recommend that the existing rules with minor amendment should be employed. Of course no franking penalty tax should be imposed.

The Institute would recommend that the franking year and the income year should be aligned. The Institute would recommend that the deferred company tax if any is calculated and payable as part of the income tax return calculation for that year. The Institute would recommend that the deferred tax should not become part of the PAYG system. The Institute would recommend that the tax both paid and if any remains outstanding payable in respect of the particular year of income as well as prior years of income all contribute to the franking accounts balance for deferred tax purposes. Since the Institute recommendation is for the calculation to occur with the lodgement of the company tax return all tax for the relevant income year should have been paid. Instalments of tax relating to the subsequent income year should not be included in the calculation.

This approach would mean all of the alignment difficulties of income years, franking years and payment years are eliminated.

The Institute strongly recommends that all deferred company tax related to temporary tax preferences should be creditable against future company tax. This process is both fair and consistent with the design principles espoused by the Review. It eliminates the so called double tax effect identified in Chapter 15. It also would introduce a measure of discipline in the definition of tax preferences such that all differences between accounting income and taxable income would need to be classified as either permanent or temporary. This process is familiar for accounting purposes.

Resident Withholding Tax (RWT

paragraph 17.52

13.3 The Institute submittes in respect of Chapter 15 that a RWT would be an acceptable regime. In conjunction with the introduction of the regime an entity should be able to merely elect whether or not the dividend paid is franked or unfranked. No required franking amount should need to be calculated. Rather if a dividend is declared to be unfranked, the franking credits of the company should be preserved but the dividend should be subject to the RWT. This would eliminate the need for complex required franking amount calculations. If it is the case that via this election process dividends have been overfranked during a year the normal franking deficit tax and related penalties could remain.

The withholding tax could be collected in a way similar to non-resident withholding tax.

Inter Entity Distribution

paragraphs 17.64 – 17.85

13.4 The Institute have no comments regarding the notion of the removal of the inter entity dividend rebate. The Institute recommends that the gross up and credit approach to the treatment of inter-entity dividends should be adopted with some modifications to the position outlined.

Firstly for fully franked dividends (either under a deferred tax regime or under the existing regime) the grossed up amount of the dividend should be included as income. However a full credit against tax payable should be received and a credit to the franking account of the receiving entity should result. If the receiving entity has less taxable income than the credit a full refund of tax should become available. However a reduced franking credit equal only to the primary tax payable on the taxable income of the receiving entity should be available. This refund matter differs from the options outlined in the Review. However on an investment neutrality basis it should follow. Why should an individual receive a refund of excess franking credits but a company receiving the same dividend not be entitled to the refund?

For unfranked dividends whether RWT applies or not the dividend should be taxable to the receiving entity. If a RWT applies a credit and where relevant a refund of the RWT should also be available. A franking credit should then apply for the receiving entity which can then pass on the net dividend as a fully franked dividend to its shareholders.

Examples of the recommendation with comparisons to the existing system are set out in the attachment, on page 9.

Transitional Arrangements

paragraphs 17.86 – 17.89

13.5 The transitional arrangements and their complexity differ for each of the options under consideration. For the RWT option little in the way of special rules will be necessary. Rather any unfranked dividend after July 1, 2000 would be subject to the RWT rules.

If the recommendations outlined above are adopted for the inter entity distributions again no controversy will exist for receiving entities. Fully franked dividends (either through franking or because of a deferred company tax regime) will be taxable with full credits and refunds. Unfranked dividends (either because no deferred tax regime is adopted or because the paying entity has not yet fallen into the regime due to the transitional rules) would be taxable.

The transitional rules for the application of the deferred tax regime for the paying entity should be such that it must apply for the first accounting period that begins after July 1, 2000. However for any accounting period commencing before July 1, 2000 and in substitution for the income year ended June 30, 2001 the entity should be allowed to elect either the proposed ***Option 1*** or ***Option* 2** if they want the deferred tax regime to apply to them in that earlier period.

6.*Taxed Income – Parent Entity Not Taxable*

		Recommended	Existing
Subsidiary Company			
Accounting Income		100	100
Tax Difference		-	-
		------	------
Taxable Income		100	100
Tax Payable	(1)	36	36
		------	------
Available for Distribution		64	64
Parent Entity			
Dividend Received		64	64
Gross Up		36	N/A
		------	------
Taxable Dividend		100	64
Losses recouped		(100)	(64)
		------	------
Net Taxable Income		NIL	NIL
		------	------
Tax Thereon		NIL	NIL
Rebate		N/A	NIL
Refund	(2)	(36)	N/A
		------	------
Net Tax Payable/(Refund)		(36)	NIL
		------	------
Available for Distribution		100	64
Individual Shareholder			
Franked Dividend Received		-	64
Gross up		-	36
Unfranked Dividend		100	N/A
		-----	------
Taxable Dividend		100	100
		-----	------
Tax thereon		47	47
Less: credit		-	36
		-----	------
Net Tax payable	(3)	47	11
		-----	------
After Tax Dividend Received		53	53
		-----	------
Total Tax Payable			
Subsidiary	(1)	36	36
Parent	(2)	(36)	-
Individual Shareholder	(3)	47	11
		-----	------
		47	47

	-----	------
Other Tax Benefits Used		
Tax Differences – subsidiary	-	-
Tax losses – Parent	100	64
	------	------
Total	100	64
	------	------
Tax Benefit at 36%	36	23

7. *Taxed Income – Parent Entity Taxable*

	Recommended	Existing
Subsidiary Company		
Accounting Income	100	100
Tax Differences	-	-
	------	------
Taxable Income	100	100
Tax Payable	(1) 36	36
	------	------
Available for Distribution	64	64
Parent Entity		
Dividend Received	64	64
Gross Up	36	N/A
	------	------
Taxable Dividend	100	64
	------	------
Tax Thereon	36	23
Rebate	N/A	(23)
Credit/Refund	(36)	N/A
	------	------
Net Tax Payable	(2) NIL	NIL
	------	------
Available for Distribution	64	64
Individual Shareholder		
Dividend Received	64	64
Gross up	36	36
	-----	------
Taxable Dividend	100	100
	-----	------
Tax Thereon @ 47%	47	47
Credit/Refund	(36)	(36)
	-----	------
Tax Payable	(3) 11	11
	-----	------
After Tax Dividend Received	53	53
	-----	------

Total Tax Paid			
Subsidiary	(1)	36	36
Parent	(2)	NIL	NIL
Individual Shareholder	(3)	11	11
		-----	------
Total		47	47
		-----	------

7. *Untaxed Income – Parent Entity Taxable*

	Recommended	**Public Existing**	**Private Existing Note A**
Subsidiary Company			
Accounting Income	100	100	100
Tax Differences	(100)	(100)	(100)
	------	------	-----
Taxable Income	NIL	NIL	NIL
Tax Payable	NIL	NIL	NIL
	------	------	-----
Available for Distribution	100	100	100
Parent Entity			
Taxable Dividend Received	100	100	100
Tax Thereon	36	36	36
Rebate	N/A	(36)	-
	------	-------	------
Net Tax	36	NIL	36
Available for Distribution	64	100	64
	------	------	------
Individual Shareholder			
Unfranked Dividend	N/A	100	N/A
Dividend Received	64	N/A	64
Gross up	36	N/A	36
	-----	------	------
Taxable Dividend	100	100	100
	-----	------	------
Tax Thereon @ 47%	47	47	47
Credit		(36)	-
36			
	-----	------	------
Net Tax	11	47	11
	-----	------	------
After Tax Dividend Received	53	53	53
	-----	------	------
Total Tax Paid			
Subsidiary	-	-	-

Parent	36	-	36
Individual Shareholder	11	47	11
	-----	------	-----
Total	47	47	47
	-----	------	-----
Other Tax Benefits Used			
Tax Differences – subsidiary	100	100	100
Tax losses – parent	-	-	-
	-----	-----	-----
Total	100	100	100
	-----	-----	-----
Tax Benefits at 36%	36	36	36

Note A: This is for dividends received by a private company from a non-groupable subsidiary. To the extent that dividends from a groupable subsidiary are received the numbers are the same as for the public company example.

8.*Untaxed Income – Parent Entity Not Taxable*

	Recommended	**Public Existing**	**Private Existing Note A**
Subsidiary Company			
Accounting Income	100	100	100
Tax Differences	(100)	(100)	(100)
	------	------	-----
Taxable Income	NIL	NIL	NIL
Tax Payable	NIL	NIL	NIL
	------	------	-----
Available for Distribution	100	100	100
Parent Entity			
Taxable Dividend Received	100	100	100
Losses brought forward	(100)	(100)	(100)
	------	-------	------
Tax Income	NIL	NIL	NIL
	------	-------	------
Tax Thereon	NIL	NIL	NIL
Rebate	N/A	-	-
	------	------	------
	NIL	NIL	NIL
	------	------	------
Available for Distribution	100	100	100
	------	------	------
Individual Shareholder			
Unfranked Dividend	100	100	100
Tax Thereon	47	47	47

	-----	------	------
After Tax Dividend Received	53	53	53
	-----	------	------
Total Tax Paid			
Subsidiary	-	-	-
Parent	-	-	-
Individual	47	47	47
	-----	------	-----
Total	47	47	47
	-----	------	-----
Other Tax Benefits Used			
Tax Differences – subsidiary	100	100	100
Tax losses – parent	100	100	100
	-----	-----	-----
Total	200	200	200
	-----	-----	-----
Tax Benefits at 36%	36	36	36

Note A: This is for dividends received by a private company from a non-groupable subsidiary. To the extent that dividends from a groupable subsidiary are received the numbers are the same as for the public company example.

Chapter 18 – Defining ‘distribution’ in an entity regime

GENERAL COMMENTS

14.1 The chapter asserts that there is no adequate, generally applicable definition of “distribution”. Shareholders are taxed on the basis of dividends paid while trust beneficiaries are taxed on a present entitlement basis regardless of payment.

14.2 The chapter asserts that the relationship between closely held entities and their members can provide conditions conducive to disguising distributions of profits as other types of benefits and payments. It asserts that the current law does not address these issues comprehensively.

14.3 The chapter finally asserts that the issue of additional ownership interests in an entity can substitute for entity distributions. Rules which address this at the moment are said to be complex and also not comprehensive.

14.4 The Chapter then outlines various reform options to deal with.
(i) Reform options based on the definition of distribution.
(ii) Reform options for created ownership rights.

SPECIFIC COMMENTS

The Institute’s comments on each of the Reform options set out in the Chapter can be summarised as follows:

Definition of Distributions

paragraphs 18.1 – 18.62

14.5 Three options are canvassed to deal with this issue.

Option 1 – apply a broad definition of distribution covering all benefits provided by an entity to its members.

This option should be rejected completely. The notion that somehow all “benefits” provided to “owners” by an entity should be treated as a “dividend” is unsustainable and would lead to very complex deeming rules and definitions. The experience with FBT demonstrates the complexity of such an approach. Rules would be needed to define the types of benefits either included in the regime or alternatively excluded from the regime. Rules would be needed to assign a net value to the relevant benefits. Timing questions would need to be addressed and this would need to be co-ordinated with either the Deferred Company Tax Payments or Resident and Non-Resident Withholding tax obligations. Member or owner would need to be defined precisely especially for trusts. Associate rules of both the entity and member/owner level would be needed. Associate or similar rules would be required. Some form of threshold test would be needed probably otherwise “benefits” provided to shareholders in the normal course of company secretarial matters would be included (e.g. provision of annual reports, refreshments at annual general meetings, information disclosures to the Stock Exchange).

On complexity grounds above the proposal should be rejected.

Particular unintended consequences would also need to be identified and allowed for. For example it is not an uncommon practice for a Family Trust to be used not for commercial purposes but rather as an asset protection vehicle. The family home might be owned via a family trust. The funds for the house having been vested in the trust by the principal of the family. Under this proposal it is possible that the fact that the family lives in the home could cause these to be a deemed dividend. As the trust earns no taxable income the dividend would be unfranked and so fully taxable in the hands of each beneficiary who lives in the house. This result cannot be the intended outcome of the proposed rules.

Option 2 - Apply a broad definition of distribution but exclude certain benefits provided by widely held entities.

This alternative should be rejected as well. It provides no different result than for ***Option 1*** for most entities. It should therefore be rejected on the same grounds.

So far as the special rules for CIVs are concerned it would appear that the proposed rules are broadly the same as those which currently apply for all entities.

Option 3 - Adopt ***Option 1*** or ***Option 2*** but tax certain benefits under FBT.

This option should also be rejected. It provides no better result than the current system. The rules would be complex. Different rules would apply for employee members and non-employee members. The overlay of the FBT rules for some benefits (e.g. use of assets) would further complicate the rules.

The Institute is of the view that the existing definition of dividends does not need amendment. Further the treatment of trusts and their taxation can be dealt with without a wholesale change to a more comprehensive definition of distribution. For the latter point see our comments in relation to Chapters 19 to 22.

14.6 The Institute believes that suggested changes to the rules of Division 7A discussed at ***paragraphs the 18.44 to 18.56*** can be broadly accepted. Certainly the existing provision of Division 7A must be amended. At present the rules can lead to at least double taxation effects. Under the existing rules a loan can be deemed to be an unfranked dividend to the extent that it fails certain tests. The effect of this deeming is to cause the affected taxpayer to be subject to tax on the full amount of the loan. Of course no actual distribution will have occurred. If the taxpayer ever in fact repays the loan and an actual dividend is declared the same shareholder will be taxable again. If instead the loan is forgiven rather than repaid the debt forgiveness rules can apply to cause the taxpayer to lose other tax benefits (e.g. losses and cost base). The Institute recommends that the rule for loans should be a "commercial loan" test. The loan should be on commercial terms. In order to achieve this the loan should be:

1. Documented in writing.
2. Have a commercially set term (with safe harbour rules provided).
3. Have a commercially set interest rate (with safe harbour rules provided).

It should not be a requirement that the loan is secured. However the level of security should effect either or both of the safe harbour for the term of the loan and the interest rate. The existing safe harbour of 7 years for unsecured loans and 25 years for secured loans should be retained. It should not be a requirement that regular repayments must occur. However interest should be calculated on a compound interest basis so that unpaid interest is capitalised into the value of the loan. At the end of the term the loan should be able to be rolled over provided that the terms of the new loan satisfy the definitions for commercial loans. A safe harbour interest rate should be set. However, it could be an option that taxpayers could use other rates if they can show the rate is arm's length given the overall terms and credit risks involved. To the extent that a loan does not meet the requirements then a deemed unfranked dividend equal to the amount of the safe harbour interest rate should result. The whole amount of the loan should not be treated as a dividend. If the commercial loan test is failed, the entire loan should not be deemed to be a dividend. Rather the company should be deemed to have claimed interest at the safe harbour rate and to have distributed a franked dividend of the after tax amount of this dividend to the shareholder to whom the loan has been made.

Reform for Created Right

paragraphs 18.77 – 18.93

14.7 The need for the reform of the treatment of created ownership rights is not accepted. There seems little policy reason for changing the existing regime. The proposed rule changes will further complicate the law in this area. The existing value shifting and capital streaming rules will cover any significant areas of potential abuse identified.

Chapter 19 – Distinguishing profit and capital distributions

GENERAL COMMENTS

Choice Should be Allowed

15.1 A company or a trust should generally be free to make a choice between the sources which will be used to fund distributions (and particularly whether the company or trust wishes to return capital or pay out profits). Restrictions of this ability are not based on any principle which can withstand scrutiny. They increase complexity and compliance costs and (insofar as may be relevant) create an artificial bias towards debt rather than equity funding.

15.2 The extent to which a profits first rule should be adopted in relation to *companies* has been the subject of extensive (and recent) consultation in the context of the package which flowed from Corporate Law Simplification. In that context a discussion paper issued (the Discussion Paper) and considerable amount of work was done attempting to develop a sophisticated "profits first" regime. However following consultation with the various professional bodies (including the Institute) the proposals for a profits first regime were abandoned in favour of much simpler measures (including use of a "tainting account" to quarantine retained earnings).

15.3 Adoption of a profits first rule applicable to *trusts* as well as companies will be even more complex than the issues which arose in respect of companies. <u>The need for such a rule is *inexplicable* given that the bulk of current trust income is already distributed on an annual basis, so there is no need to force its distribution.</u> The full distribution of such income should be encouraged because it eliminates any argument in favour of "profits first" and "double tax" issues for retained earnings. The approach taken in relation to "profits first" cannot be reconciled with the approach taken to double tax issues discussed in Chapter 22.

2. Rationale for Profits First Rule is Flawed

15.4 The underlying rationale for application of a profits first rule appears to be a view that profit distributions can be "*disguised as capital distributions*". The basis for that view is not set out in the Report. However one can only assume that its conclusions are based on the same *logic* as was contained in the Discussion Paper. An examination of the underlying logic contained in the Discussion Paper made it difficult to escape the conclusion that it sought to label distributions perceived as not yielding the maximum tax as involving "disguise", "substitution" or "streaming". The "*label*" could then be attacked because it sounds like a vice.

15.5 The Discussion Paper gave examples which proceeded on the simplistic view that if "profits" generate the cash available for distribution then the distribution must be characterised as a "distribution of profits disguised as a return of capital". This is not the case as can be readily demonstrated by comparing the provision of funds by way of loan rather than capital. In the case of a loan there can be no suggestion that the repayment of the loan (from the same underlying source of cash) involves a disguised distribution of profits. The discussion at ***paragraphs 19. 24- 19.27*** suggesting that anti avoidance measures might be considered to deal with use of loans rather than capital simply compounds the error.

15.6 ***Chapter 19*** also argues that "the tax consequences of an entity distribution should not depend (as has always been the case) upon whether the actual source of the distribution is in fact profits or contributed capital. The Report claims that this feature of the existing law "gives rise to complexity and uncertainty" (see ***paragraphs 19.1 – 19.4***) thereby *implying* that the proposed rules will be *less complex*. <u>This rationale for the adoption of a profits first rule cannot withstand scrutiny because the profits first rule will inevitably create many more layers of complexity than presently exist</u>.

15.7 The Treasurers statement of November 1997 acknowledged that in developing its taxation response to the Corporation Law changes (abandoning profits first) the government had benefited from consultations with relevant parties. The relevant legislation was enacted via the Taxation Laws Amendment (Company Law Review) Act 1998. That is not to say that the Institute entirely supported the measures ultimately adopted. In particular the Institute recorded material concerns in relation to the form of the anti avoidance measures (including the streaming rules) and the precise operation of the tainting rules. It would seem that the Report also has concerns about those measures. However the Institute nonetheless believes that the *basic approach* otherwise adopted (apart from the streaming and other anti avoidance provisions) was *generally* appropriate. The difficulties with the anti avoidance provisions should be separately addressed.

15.8 Given this very recent history it is surprising that the Institute should so quickly be faced with a fresh set of proposals for a profits first rule which makes no reference to the earlier proposals or the reasons why those proposals were abandoned. It would be disturbing to think that they were then abandoned simply on the basis that they would be brought forward as soon as any fresh opportunity to advance them presented itself.

15.9 The only hint of an explanation is provided at ***paragraph 19.4*** which suggests that the proposal to tax Trusts like companies makes the issue "more pressing". There is of course a great deal of irony in the proposition that trusts must be subjected to profits first rules to ensure that they distribute their earnings. In practice the vast bulk of current earnings of a trust are distributed to beneficiaries in the year of derivation. In the case of private trusts it is unlikely that there will be any need to force the distribution of income. The profits first rule is therefore being advanced to cure a perceived problem which does not presently exist but which might be *created* by the proposals to tax trusts as companies. <u>The proposals for reform involve a contradictory process. That process deems profits not to have been passed through to the beneficiary, and then feels obliged to create a further set of complex rules to force their distribution.</u> The Institute discussion in relation t*o Chapter 21* proposes a simpler practical measure which taxes trust income to the trustee at corporate rates (but avoids entity taxation in the sense used in the Report).

If that simpler measure were adopted we assume that it would follow that no profits first rules would be needed.

SPECIFIC COMMENTS

1. Use of Notional Accounts

15.10 Once you begin a process of *requiring* distributions to occur in a *particular order*, it becomes necessary to provide a mechanism to deal with the consequences which arise when payments are not made in the order dictated by policy. The kinds of solution to this problem which have been adopted in the past involve the creation of a set of *notional accounts.* The Report effectively recognises this in part by canvassing the possibility that there should be notional "contributed capital" accounts even in the case of companies.

15.11 It is enlightening to consider past attempts to deal with this kind of issue. For example Secs. 46G-M approached this kind of problem by requiring the establishment of a set of "notional disqualifying accounts" to deal with the quarantining issues for corporate dividends. In the cases of secs. 46G-M, the operation of the system of notional accounts gives rise to a considerable number of *problems*. The system of notional accounts which it established has the potential to operate in a most unfair fashion. <u>The complexities of Sec 46G-M do not produce any degree of confidence that a "profits first" rule can or will be introduced in a satisfactory fashion</u> (even if it were otherwise desirable contrary to the Institute submission).

15.12 One of the many difficulties with 46G-M is that there would seem to be prospects for *"double counting"* so that you are punished when you actually pay from a disqualifying account as well as when you notionally pay because of an ordering mistake. One wonders whether the new "profits first" rules will carry similar prospects. A misordered payment of capital will be deemed a dividend and will leave more actual profits available for later distribution. Will those actual profits also be taxed as a dividend when they are distributed? The Institute will not presently seek to elaborate on other issues under these provisions. For the moment the Institute simply wish to make the point that documenting ordering rules in a simple clear and fair fashion is very difficult and a solution to this has evaded the draftsman in the past. If adopted a profits first rule should do no more than accelerate the time at which profits are taxed.

15.13 The Report describes the proposed rules as "a more *objective* basis for determining the source of funds for a distribution" ***(paragraphs 19-5)***. A description of that kind is both inaccurate and misleading. The objective source of the funds will always be the account from which they are actually paid. A complex set of fictional rules using notional accounts and moving away from the objective facts of payment will provide a tax framework which will be complex and (if previous examples of such a regime are any guide) will provide real potential for unfairness. <u>Representing such a course as "reducing complexity" demonstrates a clear failure to appreciate the complexity involved in notional ordering rules</u>.

Meaning of "Profit"

15.14 ***Paragraph 19.4*** suggests that *distributable profits* could be defined as *"the market value of the entities net assets less contributed capital at the time of distribution"*. It is important to appreciate that the number which is so calculated will be an *artificial difference* between two defined amounts. It will rarely represent the amount of any profit which can actually be identified in a balance sheet at any time. There will simply be a calculated amount which is *labelled* as a "profit". Having labelled the amount in this way it becomes much easier to suggest that it should be taxed. In substance the measures will therefore tax distributions of *amounts* regardless of whether they are really "profit" or income or capital. This becomes all the more apparent once you consider the way in which contributed capital is to be defined.

15.15 The definition of "distributable profit" means that (in concept) the nature of any particular distribution will only be known once you *reconstruct all balance sheets* to market before any distribution. In many cases this kind of approach will probably be *impractical*. The Report downplays this by suggesting that "distributable profits would not commonly be exhausted by an entity's distribution" and suggests that it would follow (that in *practice* as opposed to "theory") most entities could rely on *book values*. That may be the case for public entities and *some* private companies and trusts. However in many cases it will not be the case for private trusts.

15.16 In the case of private Trusts the whole of the income of the trust is commonly distributed on an annual basis. Accordingly there will often be little in the way of undistributed profits to act as a *practical buffer* of the kind assumed in the Report.

15.17 As the Report points out, in the case of companies, the *corporate accounts* have proven a logical (and practical) starting point. However that may well not be the case for trusts if the relevant definitions must all use an artificial calculation using a notional definition of contributed capital. In the case of trusts there may well be little practical option but to create a notional "contributed capital" account because (amongst other things) trusts often have no "contributed capital" account in the corporate sense (which captures funds contributed by shareholders for shares). Again this should bring into doubt the viability of the proposed regime.

15.18 If a profits first rule is to be introduced (contrary to our submission) it is desirable that it use a concept of accounting "profit" which ties into the actual accounts of the company or trust.

Contributed Capital – New Trusts

15.19 ***Paragraph 19-35*** begins the process of drafting a definition of "contributed capital" for "*new* trusts". In relation to this definition we make the following preliminary comments:

(a) The definition does not appear to include amounts contributed as capital for the *allotment of units* or other forms of creation of interest (and it should clearly do so).

(b) The definition talks about property or amounts "*settled*" on the Trust. The Institute assumes that this would be defined to include all other obvious gifts to the trust including (for example) declarations of trust, releases of debt etc.

(c) The definition appears not to include assets transferred to a trust at an *under value* (but for consideration) and the final definition will need to include such amounts.

(d) If the new regime insists on valuing every benefit flowing *out* of a trust (and deeming that benefit to be a distribution) there is a question whether consistency requires an equivalent definition which values all benefits flowing *into* a trust as capital contributions.

(e) The definition will not deal meaningfully with a range of trusts which are not "settled" including various constructive trusts and other forms of "trust" discussed in our commentary on Ch 22.

(f) The treatment of amounts distributed from one trust to another is unclear. There will be cases where such distributions should be treated as contributed capital.

Contributed Capital – Existing Trusts

15.20 ***Paragraph 19-43*** begins the process of drafting a definition of "contributed capital" for *existing trusts*. In relation to this definition the Institute makes the following preliminary comments:

(a) The Institute assumes that the amounts included under **19-43** are in addition to all post commencement amounts of the kind outlined in **19-35** including any *further* settled amounts and presumably contributions to capital etc (**cf paragraph (vi)** of the draft which refers only to *later settlements*). Assuming that is so, the comments the Institute has made in relation to *new trusts* are equally applicable. If it is not the case the definitions will be defective.

(b) Generally the formula "*reconstructs a capital account in reverse*" by using a *further* notional balance sheet which *differs* from the notional balance sheet used to calculate the deemed dividends and which does not seek to include all assets at all relevant times. Conceptually this is likely to produce problems. The proper approach is to calculate each of grandfathered amounts separately (and not by reverse engineering) using market valuations consistent with those used for the notional balance sheet which is otherwise used for deemed dividends.

(c) The mechanism for recognition of capital arising from the realisation of gains on pre CGT (and certain other) assets operates on the basis that any such gain can only be recognised at the point of *realisation* of those assets. This is suggested on the basis that it is "simpler" than recognising a commencing amount which is subsequently adjusted. ***(paragraphs 19-42)*** However the amounts of contributed capital as so determined are to be deducted from the "*market value*" of all net assets to determine the distributable profits which might be deemed to be notionally distributed under further provisions ***(see paragraphs 19-12)***. If it is conceptually necessary to value *all* the assets to determine the net assets then there is no "simplification" is gained by not recognising the capital inherent in the grandfathered assets.

(d) <u>This methodology simply creates an inappropriate potential for dividends or deemed dividends to arise in respect of amounts which should never be taxed in the first place</u>. The *artificially low* amount of contributed capital will (for example) create problems under the deemed dividend regime, and where the slice principle is applied to units in a unit trust.

(e) The Institute notes that the formula deducts *all liabilities* of the trust at the commencement date. Whilst most relevant classes of asset are *ultimately* referred to as assets from which the liabilities are deducted <u>there should be a catch all provision which requires the recognition of *all other assets* at the commencement date</u>.

(f) <u>It seems likely that the formula in ***paragraphs 19-43*** will (initially) produce a *negative amount* for many trusts which have material pre CGT assets, because those assets are initially excluded from the calculation whilst all liabilities are included from the outset.</u> The Institute will need to clarify what implication (if any) flow from such a negative figure or whether the initial capital is simply taken to be *zero*. The Institute sees difficulties with either approach. For example if a negative number is carried forward it might preclude the distribution of realised amounts of gains (under (vii) or (viii)) which are simply "absorbed" by the negative amount. <u>The Institutes view is that pre CGT assets should not be excluded.</u>

(g) The drafting needs modification to ensure that grandfathered amounts distributed through a chain of trusts have grandfathered status preserved.

Prior Taxed Income

15.21 ***Paragraph 19-48*** deals with *"prior taxed income"* (which we assume includes amounts taxed to the trustee as well as amounts included in the assessable income of a beneficiary). The Institutes view is that this should simply be *quarantined* permanently as a separate amount which can *always* be distributed free of any application of the new regime regardless of the state of the capital account, and *regardless* of the "profits first" rule. <u>The Institute has difficulty seeing why it should lose that kind of status after 5 years as suggested in ***paragraph 19-48***. That</u>

is particularly the case if the rules for calculating the level of capital effectively *prevent distribution* of such amounts because they are absorbed by other negative amounts in the calculation. Although ***paragraph 19-46*** assumes that such amounts are automatically included by the general calculation (without separate identification) it will be necessary to separately identify such amounts on the proposal in ***paragraphs 19-58*** because they will lose their exemption from the profits first rule after 5 years.

15.22 The suggestion that prior taxed income should become subject to a profits first rule (after the sunset period) is especially anomalous given that it includes amounts to which a beneficiary is presently *entitled*. If the beneficiary exercises its right to demand the income then profits first rules will be triggered. Similar observations may be made in relation to realised "tax preferred income" which may (depending on the definitions in the trust deed) also comprise amounts to which a beneficiary is presently entitled.

Extinguishment of Interests

15.23 The Report takes the view that where ownership interests are extinguished the "profits first" rule will generally not apply. However, at ***paragraph 19-64*** it suggests that proportionate extinguishments of all ownership interests are economically equivalent to a dividend (applying substance over form). The Institute does not agree with this conclusion and note that it serves to illustrate the way in which the supposed application of "*economic equivalence*" to reconstruct the facts can be used to reach almost any conclusion one might wish for.

15.24 The earlier Discussion Paper acknowledged that it was not possible to classify all proportionate reductions as defacto dividends. Distributions of proceeds of *sale of part of a company's business* were (for example) acknowledged not to be a defacto dividend. That is to say the logic in the Discussion Paper would acknowledge a class of proceeds of sale of capital assets the distribution of which is not a disguised dividend. However no categories of that kind appear to be acknowledged in the Report.

15.25 The Report proceeds on the basis that certain grandfathered amounts (being prior realised tax preferred income prior and unrealised gains on assets) will not be excepted from the profits first rule. There does not seem to be any logical reason why these amounts should be subject to the profits first rules.

Slice Principle

15.26 The Report proposes a "*slice principle*" to be applied generally in the case of "*extinguishments*" of interest. In some respects this proposal may have the potential to be even more restrictive of the ability to "choose" than the proposals in the Discussion Paper. Firstly it attributes to each share or unit a portion of "contributed capital" and a portion of the "taxed profit" and thus impacts directly on the extent to which franked dividends can be used to fund the buyout. Secondly a "modified slice" is the best option offered for liquidations. Thirdly the

Discussion Paper acknowledged classes of capital proceeds to which the rules would not apply.

15.27 An even more fundamental problem is that there are many cases (particularly in relation to *trusts*) where there is *no obvious methodology* for attributing capital and taxed profit. The complexity involved in attempting to work this through (which is clear enough from Appendix C) demonstrates that a profits first rule will add too much complexity and should be abandoned. The Report on simplification as one of its core objectives (and repeatedly asserts that this is why the changes are occurring (eg see ***paragraph 19-4*** referring to a "simpler better structured solution"). <u>It is difficult to understand why the complexities encountered in the analysis of the Report itself do not give cause for reflection on the appropriateness of the proposal</u>.

Liquidators Choice

15.28 It has long been accepted that a company liquidator can maintain his accounts so that particular distributions can be made from particular profits or funds (under the principle in *Archer Bros Pty Ltd (in vol liq) v FCofT (1953) 90 CLR 140*). The present proposal seems to propose application of profits first or a modified slice principle so that the current ability of liquidators to nominate the source of distribution will be constrained. A negation of the principle (in favour of a profits first rule or a modified slice rule) would involve a fundamental change in both principle and practice a further expansion of the revenue base. The Discussion Paper proceeded on the basis that the position for liquidations would be unaltered. <u>It is difficult to understand how the underlying logic could have altered so that liquidations are no longer conceded to be an occasion on which distributions are not characterised as disguised dividends.</u> This issue is discussed further in relation to Chapter 20.

Attribution of Capital – Non Fixed Interests

15.29 Appendix C begins to work through the issues involved in attributing contributed capital, taxed profits and untaxed profits to ownership interests. In the case of "non fixed interests" in Trusts the Appendix takes the view that no share of capital can be attributed (save upon ultimate vesting) and that it may well be that the same conclusion should be reached in relation to "taxed profits" ***(se C14 and C21)***. The suggestion therefore seems to be that the profits first rule applies in all cases to non fixed interests save at the point of vesting of the trust ***(paragraph C14).***

Classes of Beneficiaries

15.30 Some trusts distinguish between "*income beneficiaries*" and "*capital beneficiaries*" (a possibility which is expressly recognised at ***paragraphs 22-5*** which deals with the tax position of "excluded trusts"). Such trusts may or may not allow the trustee to distribute amounts in an "*order*" which complies with the profits first rules. Again this illustrates the peculiar difficulties which arise in relation to trusts which are unlikely to arise in the context of companies. Under the proposals it would seem that whatever adverse consequences flow from breach of the profits first rule will apply automatically to such trusts.

Discrimination Against Trusts

15.31 This analysis reveals a number of ways in which the proposed "profits first" rules will operate in a potentially discriminatory fashion against trusts because of the ways in which trusts differ fundamentally from companies. There is little to commend in an analysis which decides to treat trusts as companies on the basis that they are essentially the *same* (when they are not) but then focuses on the real differences to discriminate against trusts.

Anti Avoidance

15.32 The Report suggests that one of the reasons to embrace a profits first rule is that it will allow the removal of anti avoidance measures directed to streaming etc. Whilst the Institute agrees that the anti avoidance rules need to be rationalised (and confined to a sensible scope of operation) that provides no reason to make the ordinary provisions of the Act unworkable. In effect the suggestion is that measures such as "profits first" should be used as a "surrogate" anti avoidance measure.

15.33 The view taken by the Report in relation to interest free loans *to* and *from* a trust can only be described as highly inconsistent. Where the trust lends out money at low interest there is said to be a deemed distribution. Where money is lent to a trust at low interest there is no suggestion that a notional amount is added to capital. Concern is nonetheless expressed ***(at paragraphs 24-27)*** that anti avoidance measures could be considered to prevent the use of debt funding as that might be "substituted" for contributed capital. This suggestion is made notwithstanding that the effect of making an actual contribution of capital to a discretionary trust will now mean that its subsequent distribution converts the amount to income.

CONCLUSIONS

15.34 The Institute major conclusions in respect of Chapter 19 can therefore be summarised as follows:

(g) Very recent consideration of the "profits first" concept for companies led to the view that it was too complex to implement.

(h) In practice the vast bulk of current earnings of a trust are distributed on a current basis and there is little to be gained from a profits first rule if the new regime facilitates the continuation of that practice.

(i) Adoption of such a principle for trusts will be even more complex because (amongst other things) you need to construct meaningful definitions of "contributed capital" and "distributable profits".

(j) The proposed definitions of "contributed capital" for trusts will often produce an artificially low amount, and will not deal satisfactorily with a range of trusts.

(k) The proposed definition of "profit" will calculate an "artificial difference" between two defined amounts, which is simply labelled a profit and will often be an artificially high amount.

(l) The terms of particular trusts may or may not permit the trustee to distribute amounts in an order which is consistent with profits first.

(m) Application of profits first to trusts will create peculiar difficulties for them (and thus discriminate against them).

(n) It is difficult to understand why (on any view) profits first should apply to (for example) the distribution of capital proceeds of the sale of a business or the proceeds of a liquidation (both of which were previously conceded to be situations in which it should not be applicable).

Chapter 20 – Preventing double taxation of buy-backs, redemptions and liquidations

GENERAL COMMENTS

Identifying the Double Tax Issues

16.1 Chapter 20 is to be commended for the fact that it commences a process of identifying ways in which an entity tax regime imposes double taxation. <u>It correctly recognises that a proposal to expand entity tax is an occasion on which double tax issues effecting entities should be considered</u>. It seeks to make a positive contribution by attempting to reduce the scope of double tax in certain situations which it identifies. However the problems which the Chapter ultimately attempts to resolve are limited to *buybacks redemptions and liquidations* (and the treatment of liquidations is impeded by profits first analysis). There are a considerable number of other relevant "double tax" issues which need to be considered although the Report does acknowledge a further problem in relation to the "*sale*" of shares (rather than buyback redemption or liquidation). It seeks to prove that the "sale" problem is simply one of *timing*. Unfortunately the double tax will in many cases be *permanent*.

SPECIFIC COMMENTS

Double Tax on Sale of Shares

16.2 The opening paragraphs of Chapter 20 go so far as to acknowledge *one* of the most fundamental (but simple) double tax issues within the tax regime. This arises where shares are *sold* in a company with *retained earnings* on which tax has been paid. Because the price paid for the shares reflects the value of the retained earnings a further layer of tax is paid (under the CGT regime) although the profits which have already been taxed to the company. This is an issue which the Institute has raised in the past and which arises out of the interaction of the CGT regime with entity taxation. <u>It is a clear and widely recognised double tax problem of considerable magnitude</u>. The magnitude of the problem is conceded in the 1985 Draft White Paper on Reform of the Australian Tax System which concedes (***at paragraph 7-27***) that "a substantial proportion of aggregate capital gains in industrial economies takes the form of increased share values as a result of retained company profits". The Institute adds that the totality of the double tax problem is even greater than this suggests because the other major determinant of share prices is "*accruing*" and "*future earnings*" (although that is a problem flowing from the interaction of CGT with ordinary income tax rather than the entity regime).

16.3 However, the Report ultimately dismisses this issue as one not worthy of resolution because it perceives the issue to be merely one of "*timing*". The Report suggests this on the basis that the purchaser *may* ultimately realise a capital loss (if the profits are distributed to him in a franked form) and *may* ultimately be able to offset that loss against a capital gain. This ignores the real prospect that the retained earnings may never be distributed, any loss may not be crystallised for a very long time and the purchaser may never be so fortunate as to derive a capital gain which can be offset. The example at 20-1 sets out to "prove" that the overall outcome in such cases is "fair" because the issue is simply one of timing. The example appears not to appreciate the basis upon which shares are *valued*. The example assumes that a purchaser of a share with retained earnings (after tax) of $64 would be prepared to outlay $100 on account of those retained earnings and that (after distribution of the $64) the shares would fall in value by $100. However the Institute accept the point that over time (and in *some cases* only) the double taxing effect *may* be washed out of the system. However the analysis needs to acknowledge that such an outcome will often *not* occur, so that the double tax is *permanent*.

16.4 Even if the issue becomes one of timing (in a *particular case*) the timing difference will often be very considerable. A quarantined capital loss is no fair substitute for the current payment of double tax. The relaxed approach to timing issues of this kind (which create disadvantages to taxpayers) can be contrasted with the apparent concern of the new regime to advance the timing of tax collections as much as possible by increments as small as months (via measures such as the PAYG arrangements). Nor can it be reconciled with the adoption of complex measures such as "profits first", the ultimate purpose of which *should* only be to accelerate the time at which profits are treated as distributed, and which demonstrate a frenetic pursuit of that acceleration.

16.5 It is therefore difficult to accept any view which suggests that the outcome is inherently fair (or that the problem does not merit solution). One of the classic resolutions to this problem is to divide the capital gain into an element arising from retained earnings and an element associated with other factors (including goodwill) (Australian Tax Research Foundation Study No 25 suggests that the cost base of shareholders should be incremented annually so as to take into account retentions). One might at least understand a view that a resolution of the problem would be complex and would not be implemented out of a desire not to further complicate the existing system. However, *if* that is the proper conclusion the importance and *magnitude* of the double tax should nonetheless be forthrightly acknowledged. The decision should then be taken into account when considering whether additional and very *complex* measures should be adopted in the pursuit of revenue. It should (at the least) serve to moderate that pursuit to a degree commensurate with the acknowledged scale of double tax already flowing to the ATO.

Double Tax on Sale of Units

16.6 The "double tax" effect for "*retained earnings*" arises to some extent out of the fact that the company is an entity and that the shareholder has no entitlement to annual income until distributions are made in the form of dividends. The extension of the entity tax regime to trusts has the *potential* to further expand the practical operation of this classic double tax issue into the sphere of trusts. One of the classic resolutions of the double tax issue for retained earnings is to encourage their full distribution. However the new regime for trusts will work against that resolution.

16.7 This extension may arise in at least two ways. The first problem arises if the new regime proceeds on the basis that all of the undistributed amounts remain part of the entity until actually distributed (so as to generate a dividend as suggested by 22-41). If that course is adopted then sale of units in a unit trust will be all the more likely to occur "cum accrued entitlements" (rather than ex accrued entitlements) and the purchaser will derive the franked distribution in due course. The second problem will arise if (in consequence of the changes) Trust Deeds are amended (for reasons including the better protection of trustees) so that they do not create automatic present entitlements. Once again the sale of units will in a practical sense be more likely to occur cum "accumulated income".

Liquidators Choice

16.8 It has long been accepted that a company liquidator can maintain his accounts so that particular distributions can be made from particular profits or funds (under the principle in *Archer Bros Pty Ltd (in vol liq) v FCofT (1953) 90 CLR 140*). The present proposal seems to propose application of profits first or a modified slice principle so that the current ability of liquidators to nominate the source of distribution will be constrained. A negation of the principle (in favour of a profits first rule or a modified slice rule) would involve a fundamental change in both principle and practice a further expansion of the revenue base. The Discussion Paper proceeded on the basis that the position for liquidations would be unaltered. It is difficult to understand how the underlying logic could have altered so that liquidations are no longer conceded to be an occasion on which distributions are not characterised as disguised dividends.

16.9 The Report suggests that the reason why the slice principle must be applied is that "a liquidator could for tax purposes easily *stream* the contributed capital to members with a relative preference for share capital" ***(paragraphs 20-47)***. <u>However the real issues in most cases will have little to do with streaming of capital in any sense which involves any consideration of avoidance</u>.

Liquidation is on Capital Account

16.10 Distributions by a liquidator to shareholders are inherently distributions of capital (although there are specific statutory exceptions). Once the process of liquidation has begun it should be perfectly legitimate to distribute "capital" (or other tax free amounts however defined first) so as to ensure that the only amounts taxed as profits comprise any surplus which is ultimately available for distribution. To suggest ***(as does option 1 at para 20-51)*** that interim distributions should be subjected to a profits first rule would be to turn the whole issue "on its ear". The rationalisation of the profits first rule is a view (with which we disagree) that the distributions which are really "on revenue account" are being disguised so that they appear to be "on capital account". <u>To extend such a principle to liquidation (which is inherently a transaction on capital account) stretches the logic far beyond breaking point.</u>

16.11 Option 2 suggests a “modified slice” rule under which liquidators would apparently be allowed some choice. This suggests that liquidation would have the discretion to source particular distributions from “contributed capital” or “profit” so long as that when the distributions over the course of the liquidation are looked at as one they meet the requirements of the slice approach. It follows that we would support option 2 (at page 467) rather than option 1 if those are the only options which are available.

Double Tax Issues

16.12 The Institute agrees that any scope for double taxation of the final distributions of liquidators (or for that matter any interim distributions) should be removed. The Institute notes that this issue arose because the “income overlap” provision originally in sec 160ZA(4) (now rewritten in Sec 118-20) was not drafted in a fashion which clearly extends to this kind of situation. In the context of 160ZA(4) the problem arises because it may be argued that the amount assessed under sec 47 as a deemed dividend does not arise “because of the disposal” (see Gates: Tax Aspects of Corporate Structuring at ***paragraphs 8-52***). Presumably similar questions may theoretically arise under sec 118-20 (eg does the 47 amount arise “because of the event”). <u>The Institute had understood these problems had been resolved in practice having regard to the views expressed in TD95/13. However (insofar as a problem remains) part of the solution should be to focus on sec 118-20 and make it absolutely plain that all amounts which are otherwise assessed are excluded from the calculation of gains</u> (analogously with the provisions excluding from cost base calculations any amounts which are otherwise deductible see sec 110-25(7)).

Options in Report

16.13 The analysis of buybacks and redemptions discusses two kinds of option which it refers to as a “dividend treatment” (Option 1) and a “capital gains tax treatment” (Option 2 of which there are 2 versions which the Institute will refer to as 2A and 2B). Option 2B appears to be relatively similar to the current analysis of an “on market” buyback save that the company will be able to claim a capital loss for an amount equal to the “taxed profit component” of the distribution. Option 2A differs in that the untaxed profit component of the dividend would attract deferred company tax (DCT) or resident dividend withholding tax (RDWT).

On Market Buybacks

16.14 In the Institutes view option 2B is the only one of the 3 options which appears likely to be practical in the context of an *on market buyback* (where the market price needs to be paid to an unidentified buyer) generally supportive of the reduction in choice involved in profits first.

Off Market Buybacks - Shares

16.15 The Dividend Treatment in Option 1 appears to be similar to the current treatment of "off market buybacks" but with two key modifications. Firstly the company would be allowed a capital loss (which is of course beneficial). Secondly the slice approach would be applied to determine the source of funds for the buyback (which involves a reduced degree of flexibility in choice of funds than is currently available). The Institute welcomes the attempt to do something to assist the double tax problem but (for reasons discussed elsewhere) are not supportive of profits first. However if this proceeds, the Institute thinks that an off market buyback should be able to elect between option 1 and option 2A.

Off Market Buybacks - Trusts

16.16 The Paper appears to discuss the "buyback" "redemption" and "liquidation" models in the context of companies only. The reason for this appears to be in the discussion at ***paragraphs 20-21***.

16.17 In relation to *discretionary trusts* the paper correctly observes that there "*does not appear to be any circumstances in which they could be said to receive a* distribution *related to an extinguishment of their ownership interest*". This is a further recognition that trusts are "different" which is difficult to reconcile with the Reports basic premise that trusts are the same as companies.

16.18 ***Paragraphs 20-21*** further observes the "partial vesting of a trust, or the cancellation or redemption of units in a *unit trust* does involve extinguishment. However it is unclear to us whether the inference to be drawn is that parallel options for relief of double tax are to be offered in the case of unit trusts.

16.19 The way in which "*capital contributions*" are measured would appear to create significant problems for existing trusts with grandfathered assets (if the slice principle is applied as well as in cases where it is not). The proposed formula will not recognise the "capital" which is inherent in the unrealised proceeds of pre CGT assets. The level of capital may therefore by unrealistically low.

Other Double Tax Issues

16.20 Chapter 20 correctly recognises that a proposal to materially expand the "entity tax" regime is an appropriate occasion to consider the double tax issues arising from the use of entities. Unfortunately it does not begin to address or acknowledge the range of issues which arise. It is therefore appropriate to mention a *few* of those issues so that they can at least be weighed in the balance.

(a) As noted above, the most basic problem arises where shares in a company (with retained earnings are sold) and the Institute shall not repeat that analysis. As noted above this problem arises because there is no CGT or other relief for tax paid (or payable) on the retained earnings.

(b) A more acute version of this problem arises if you have a series of entities where A holds most of the shares in B which holds most of the shares in C. If C has a realised (or for that matter unrealised) profit the shares in B and C will increase in value. If A sells its shares in B and B later sells its shares in C there will be a "cascading" (and multiple counting) of the gain at the various levels.

(c) The sale of shares in a Company also produces double tax because the value of the shares is affected by the accruing and future earnings of the Company (which will themselves be taxed).

(d) Where Division 7A operates to deem a fictional dividend it results in a loss of franking credits (via Sec 160AQNC) and this leads to double tax. In some limited circumstances there is relief for this when the ultimate dividend is paid (Sec 109ZC). However in many instances there is no such relief. For example where a company is presently entitled to the income of a trust and the trust thereafter makes loans to associated individuals the total tax may exceed 100% in each dollar of income. The individual may pay approx. 50c as a deemed dividend (sec 1094B), the company pays corporate tax at 36c and the ultimate unfranked distribution from the company suffers a further 32c. This kind of outcome is clearly unfair, and can arise only too readily under Division 7A. If there is to be some kind of deemed dividend provisions those provisions need to be *ameliorated* to a very considerable degree (and not simply in relation to this example).

(e) The operation of profit ordering mechanisms such as 46G-M can involve the imposition of "double detriments" so that you are presented when you actually pay from a disqualifying account as well as when you notionally pay because of an ordering mistake.

(f) Where a discretionary trust holds shares in a company the flow through of franking credits is generally denied (save for a family trust exception).

(g) If A borrows to acquire shares in company B and company B makes profits those profits generally cannot be offset against the interest incurred by A. The overall position may be that A's interest costs are no more than the profit in B. However B's profits are quarantined and cannot be offset against A's losses.

(h) Generally profits and losses within different entities are quarantined from each other save in cases where "grouping" (or "consolidation") is available.

(i) Where entities derive foreign source income double taxing effects can arise because the income suffers foreign tax but the foreign tax credits do not flow through to shareholders (as they can to beneficiaries of a trust).

(j) Generally capital losses are quarantined so that they cannot be set off against revenue gains.

(k) As dividends flow through a chain of companies they offset (and reduce) losses arising within companies receiving the distribution of dividends.

16.21 The Report should not sanction the ongoing administration of the tax law on a basis which is determined to leave in place very significant double taxing effects. It would be all the more remarkable if it did so whilst concurrently adding enormous complexity in an attempt to address relatively modest deferrals of taxation, and calling stridently for measures against the possibility that multiple losses might be generated for CGT purposes.

CONCLUSIONS

16.22 The Institutes major conclusions in respect of Chapter 20 can therefore be summarised as follows:

(l) This Chapter is to be commended for recognising that a proposal to materially expand the entity system calls for its double tax issues to be addressed.

(m) The simple sale of shares in companies with retained profits demonstrates a fundamental double tax problem arising out of the interaction of the CGT regime with entity taxation.

(n) The measures suggested for buybacks and redemptions reflect a genuine attempt to improve the position in those areas.

(o) The proposed application of the profits first rule to liquidations has impeded the efforts in this Chapter to improve the position.

(p) However the more fundamental limitation of the Chapter is that it has not addressed a wider range of double tax issues (and particularly those arising out of entity taxation) which ought to properly be considered.

Chapter 21 – Consistent treatment of entity income

GENERAL COMMENTS

Reasons Advanced by Report

17.50 The Report argues that Trusts and companies are both "*entities*" and that "*consistency*" and "*simplicity*" will flow from treating most trusts as if they were companies (21-1 and overview at 198). These arguments cannot withstand scrutiny; Trusts are not entities, the proposed regime will deliver much more complexity (rather than less) and increase compliance costs. There will be no greater degree of meaningful consistency. Additionally, the proposal to tax trusts as "entities" is inconsistent with the core principles adopted by the Report itself (namely integration of ownership interests and investment neutrality). Paragraph 200 of the overview asserts that "the simplicity and consistency of the proposed framework over existing arrangements can be appreciated by comparing figure 6 with figure 7." Unfortunately, a *simplistic* comparison of that kind cannot do justice to the real issues.

Private Trusts are not Simply Investment Vehicles

17.51 The Report fails to appreciate that *private trusts* cannot simply be characterised as vehicles for the conduct of business or investment whose function is identical to that of a company. For example private trusts are commonly used to store capital and allocate family *capital* and wealth and for estate planning generational planning and a range of other family purposes of a "non business" character. They are often used to protect assets within the trust from external liabilities (a function which is directly *opposite* to any perception that they protect investors from the liabilities incurred by the trust). These roles or functions *may* run in parallel with an investment function. The role of beneficiaries is often best characterised as "members of the family" rather than "collective investors". In *substance* the proposed form of "entity" regime ultimately treats flows of *capital* from a trust as "prima facie" distributions of income and justifies this by benchmarking against rules designed for companies. The rules designed for companies make a greater (but far from complete) degree of sense in relation to a company, but make little sense in relation to trusts in any general sense. There is (for example) little sense (or fairness) in attempting to apply CGT rules about "cost base" or "value shifting" to objects of a discretionary trust.

Diverse Role and Function of Trusts

17.52 There is also a much broader sense in which the measures described in the Report fail to appreciate the diverse nature role and function of trusts. A trust is no more than a collection of duties, disabilities, rights and powers in relation to property. The trust concept is therefore applied across a vast array of factual situations and is far from being confined to "unit trusts" and "discretionary trusts". The sheer diversity (and pervasiveness) is impossible to capture in a few lines. Nonetheless some sense of this diversity may be gained by mentioning that the trust concept is relevant to deceased estates, testamentary trusts, bare trusts, nominees, constructive trusts (of many and various kinds), stakeholders, superannuation funds, welfare funds, employee benefit funds, charitable trusts, trusts imposed by legislation or similar public act, trusts created by court order including trusts created to afford a remedy, marriage settlements, child maintenance trusts, Everett assignments and sub partnerships. Additionally the trust concept often arises in the course of many commercial agreements including transfers by way of security, trusteeships under debentures and other securities, uncompleted contracts for the purchase of assets (where beneficial interests are said to pass). Accordingly there are very considerable dangers in adopting any general rule that all trusts should be companies with some specified (and limited list of exclusions). The concept is so pervasive and arises in so many contexts (including many which are commonly not even perceived as involving a trust or a separation of beneficial interests) that the proposed course is inherently unsound.

A Simpler (and Fairer) Alternative is Essential

17.53 In our view it is *essential* that alternative measures be identified which are *simpler* and fairer than those in the Report. The tax regime for trusts suggested by the Report will be vastly more complex than the existing system and will include many unfair elements.

Alternative Proposal by the Institute – A "Corporate Rates" Approach

17.54 In order to provide a starting point for discussion the the Institute would like to put forward one such measure for consideration. In our submission most of the legitimate objectives of ANTS in relation to trusts could be achieved by relatively simple measures such as the following (Corporate Rates Approach):

(a) The *income* of trusts (other than those excluded from the regime) could be assessed at *corporate rates* under see 99A or a new equivalent of that provision.

(b) The assessment of the Trustee would generate franking credits for the Trustee, and a franking account which would be used to pay franked dividends from the Trust (carrying the potential for refunds proposed elsewhere in the Report).

(c) The franking rules should accommodate the franked payout of *current year income* so that current year income can continue to be distributed to beneficiaries (as present entitlements) on a franked basis.

(d) The recently enacted denial of use of franking credits by discretionary trusts should be removed.

(e) If (contrary to submissions made elsewhere) there is to be a concept of "tax preferred income" which is to be taxed on distribution, that concept should be appropriately defined and amounts within such definition

<u>assessed under Division 6 on their actual distribution</u>. The way in which this could occur is developed further in Appendix A.

(f) <u>The benefits of foreign tax credits should continue to flow through to beneficiaries</u>.

What this would Achieve

17.55 The Corporate Rates Approach would achieve the Government's objective of taxing trust income at *corporate rates* within each trust (and thus secure any reasonable collection objectives in respect of trust income) and could assess tax preferred income (if that is considered essential).

What this Course would Avoid

17.56 The Corporate Rates Approach would avoid:

(g) forcing trustees to accumulate income generally or pending generation of franking credits (thus further undercutting any residual argument for profits first);

(h) treating each trust as an *entity* (which it is not);

(i) deeming various distributions of *capital* to be dividends (when they are not);

(j) taxing *notional amounts* as deemed dividends (when they are not);

(k) the application of a number of inappropriate (and unfair) regimes to trusts (including the zero cost basing of discretionary trusts);

(l) addition of many new layers of complexity to the taxation law.

It would also reduce (but not eliminate) the need to amend Deeds and the dangers of not identifying constructive and other trusts arising as incidents of various transactions so as to avoid their treatment as "spectral" companies;

17.57 We do not suggest that the Corporate Rates Approach is the only alternative measure which could be adopted to achieve fairness and simplicity. It would (for example) be perfectly feasible to adopt a system under which closely held companies are permitted to deal with income and assets as "look through" entities, and approaches of that kind are more than worthy of further examination. However the Corporate Rates Approach is relatively close to the course suggested by ANTS, and may for that reason be easier to adopt.

Trusts are not Entities

17.58 <u>Given the *repeated* assertion within the Report that Trusts are "*entities*" it seems appropriate to briefly consider the nature of a Trust and some of the ways in which</u>

trusts are conceptually distinct from all entities including companies (Ford and Lee Principles of the Law of Trusts paragraph [1560]).

> *"A fundamental distinction between a body corporate and a trust is that when a body corporate is created, a new legal entity comes into being. Thus a body corporate can own property beneficially can enter contracts.... and dispose of property to its members. On the other hand, when a trust is created it is not accorded legal personality. The trust is no more than a collection of duties, disabilities, rights and powers in relation to some specific property imposed upon or accorded to an existing legal person the trustee."* .
>
> If the tax treatment of a trust is to be determined by the extent to which it is an *"entity,"* a proper characterisation inevitably leads to the conclusion that (like a partnership or individual) it is simply not an entity. Additionally it should be noted that a company owns all of its property *beneficially* and has an unlimited life (whereas beneficiaries often have interests in trust property and the life of a trust is generally limited by the rule against perpetuities) and the rights of a beneficiary are fundamentally different from those of a shareholder.

The Proposed Regime will be more Complex

17.59 There are a number of reasons why the Reports proposals in relation to trusts will not lead to any overall "simplicity". These include the following:

(a) the fictional treatment of a trust or a company will necessitate or lead to a considerable number of further fictions.

(b) the Report proposes the adoption of a number of new and complex measures to be applied to trusts (including deemed distributions, profits first, value shifting and fictional CGT measures);

(c) it is clear that the old trust regime must nonetheless be retained in order to deal with many classes of trust (as is acknowledged by the Report);

(d) it will be essential to work through a transitional regime for existing trusts (as is acknowledged by the Report);

Creation of Additional Fictions

2. It is important to understand that the distinction between "trusts" and "companies" is much more than a "debating point," or a purely "legal distinction" to be dismissed on the basis that the Report intends to use the term "entity" on some other (unexplained) basis. The inevitable consequence of attempting to treat some trusts as "fictional" companies will be a considerable addition to the complexity of the tax legislation. It will become necessary for the legislation to create many additional "fictions" in order to sustain the artificial world which the legislation seeks to create: Some useful examples of this are contained in the Report itself which begins to consider whether additions to the trust create a new entity ***(paragraphs 22-37)*** whether distributions from the trust create a new entity

(paragraphs 22-41) whether variations to the trust create a new entity ***(paragraphs 22-46)*** and whether trusts may be deemed to involve two entities ***(paragraphs 22-31)*** the extent to which a discretionary object should be regarded as a quasi shareholder and if so whether it should have a cost base or no cost base ***(paragraphs 22-68)***. One may add to this questions which arise from the pervasive presence of the trust concept in ordinary transactions such as a contract for the sale of assets (once it is specifically enforceable). The answering of questions of this kind should be recognised as having much in common with theological debates concerning the number of fairies dancing on a pinhead. Legislating for these (and many other) issues will generate complexity and add to compliance costs.

There will be no addition to Consistency

17.60 The proposals will not lead to any greater degree of meaningful "consistency". The only sense in which consistency can be said to be achieved is that the treatment of some trusts will be rendered the same as the treatment of companies (and even that will not be achieved because differences are recognised so as to discriminate against trusts). Consistency in that sense cannot provide the rationale for the measures. Such reasoning is completely *circular*. Ultimately it seeks out an inappropriate benchmark. It would be more conceptually consistent to say that trusts are not entities and should therefore be treated analogously with partnerships (which are not entities). Income flowing through a trust has always been assessed to the beneficiaries on a "look through" basis consistently with partnerships. This reflects the fact that there is no entity in either case.

Principle of Integration of Ownership Interest

17.61 The proposal to tax trusts *contravenes* the principle of "*integration of ownership interests*" adopted by A Strong Foundation ***(at paragraph 6-61)*** and endorsed in the Report at ***paragraph 34***. This principle is said to mean that where individuals invest indirectly through entities of various types, comprehensive income taxation would *look through the entity veil* in order to attribute to each *individual* investor a share of the entities net cash flows. This principle *benchmarks* against the position where an *individual* invests directly. Any such principle must necessarily apply so as to require that the individual pay no more tax when investing via trusts or partnerships (although they are not entities) because those are cases where any such principle is even more obviously applicable. Retention of the current regime dealing with trusts is much more compliant with the "integration of ownership interests principle" than the proposed regime would be. Strong Foundation recognises that the interposition of *capital structures* can place obstacles in the path of the integration approach (paragraph 6-62). In the present case there is in fact no structural obstacle. However, the Report proposes to deem the existence of a (non existent entity) and thus seeks to *create an obstacle* to one of the core principles which it embraces.

Investment Neutrality

17.62 The proposal to tax trusts also *contravenes* the *principle of investment neutrality* embraced by A Strong Foundation at ***paragraph 6-69***. This principle acknowledges that "Income Taxation drives a wedge between the before tax return earned by an *entity* and the after tax return obtained by the *individual investor*. Where that proportions wedge is the same across all types of investments whether held directly by the investor or indirectly through different types of entity, the pattern of investment and hence the allocation of secure economic resources will be unaffected by income taxation." ***(paragraph 6-69)***. As so stated the principle is also clearly *benchmarked* against the tax outcomes which flow in the case of an *individual investor*. Retention of existing treatment of trusts is more consistent with the principle of investment neutrality (as appropriately stated) than the proposed treatment of trusts and companies. However, the Report *reworks* the principle entirely so that it is a *converted* into a principle against "differentially taxing...... the type of *entity* .... or the type of income from entities." This inaccurate version of the neutrality principle is then combined with the incorrect notion that income trusts are entities in order to justify the conclusion that trusts should be treated as companies. The Report therefore resets the benchmark to achieve the desired outcome, apparently without a full appreciation of the shortcomings (and inequities) of the corporate benchmark which it selects. Ultimately it applies a rule which is an "inversion" of the principle which it supported.

Separation of Legal Ownership

17.63 It is probably relevant to mention a further matter which appears to have been advanced by the Report in favour of the view that a trust is analogous to a company. The Report states that "a trust is similar to a company in terms of the separation of the *legal ownership* of property from the underlying interests in the trust. In this respect it differs from a partnership which facilitates a sharing by the parties of direct legal ownership of underlying assets" ***(paragraph 46).*** The Report generally fails to focus on the many significant legal distinctions between a trust and a company in a *meaningful* way (although that would seem essential to the task at hand). However, it ultimately seeks to rely upon the most *technical* distinction provided by the law. The distinction it relies on is whether the ultimate owners have *"legal ownership"* (as distinct from beneficial ownership). That kind of distinction should be *irrelevant* to the debate.

17.64 Reliance upon such a distinction by the Report as the core "*similarity*" between trusts and companies demonstrates the difficulty which the Report has had in identifying any *meaningful* reason to treat trusts as companies. By way of contrast it is simple to identify a considerable body case law which distinguishes the interests which beneficiaries of may trusts have in trust property (on the one hand) from the complete absence of any interest in corporate property vesting in shareholders (on the other hand). In *Charles v FCT (1953-54) 90CLR 598* the High Court held that the provisions of the tax legislation dealing with the taxation of company dividends could have no application to the holder of units in a unit trust. The High Courts reasoning flows from their recognition of the *fundamental differences* between a company and trust. After almost 50 years it remains a timely reminder as we face a renewed attempt to assert a contrary view advanced for the same purpose. Amongst other things the Court said (at page 609):

“A unit held under this trust deed is <u>fundamentally different from a share in a company</u>. A share confers upon the holder no legal or equitable interest in the assets of the company..... But a unit under the trust deed before us confers a proprietary interest in all the property which for the time being is subject to the trust of the deed, so that the question whether monies distributed to unit holders under the trust form part of their income or of their capital must be answered by <u>considering the character of those moneys in the hands of the trustees before the distribution is made</u>.”

Reason Advanced by ANTS – Limited Liability

17.65 Mention should be made of a reason for treating trusts as companies which appears not to be advanced in the Report but which was advanced in the Coalition's Tax Reform Package (at page 109). This states that "companies, fixed trusts, and discretionary trusts, all offer investors the prospect of *limited liability* shielding them from full personal liability for making good the entities financial liabilities." Put shortly taxation as a company is said to be a price of limited liability. <u>If that is an underlying policy basis for the proposal then it is important to appreciate its inherent limitations and shortcomings and the reasons why it should be rejected.</u> These may be summarised as follows:-

(a) Trusts do *not* of themselves provide limited liability. Where individuals (rather than companies) are trustees those individuals are personally liable to the fullest extent. In the case of a fixed trust or unit trust the prima facie position (as a matter of trust law) is that the unit holders have an obligation to *indemnify* the trustee, and therefore obtain no limitation of liability (see *Hardoon v Belilos* 1901AC118);

(b) Trusts with Corporate Trustees and drafting which excludes this kind of indemnity have the prospect of achieving a degree of risk minimisation. However, in the case of *private trusts* which undertake any material degree of borrowing the reality will generally be that lenders reimpose a significant degree of risk through measures such as guarantees and securities.

(c) Many trusts simply hold *passive assets* such as rental property or shares with no gearing or such little gearing that risk minimisation is an irrelevant consideration.

(d) Many trusts are used to hold and protect family assets from liabilities outside the trust rather than to protect beneficiaries from liabilities within the trust (a function which is the direct opposite of that perceived in ANTS).

(e) There is a considerable array of trusts and trust relationships where issues of this kind do not intrude at all.

(f) The existing system denies to a trust any ability to distribute *losses* to beneficiaries. If some price is to be paid for the degree of risk minimisation obtained (in <u>some</u> cases) by the combination of trusts with corporate trustees this feature imposes a *substantial price*. It is a price which is fully adequate and applies selectively in cases where losses result and risk minimisation becomes important.

(g) The value of any limited liability is being constantly eroded by new statutory measures (including measures proposed in the Report itself).

(h) Unlimited liability companies have never been exempted from Australian tax by reason of the absence of "limited liability" protection.

(i) The formulation of tax rules so as to discourage risk minimisation in the context of collective investments appears to be a *bad policy objective*. It fails to appreciate the importance of risk minimisation and establishment of collective investment vehicles.

(j) The "*benefit of incorporation*" argument has (in any event) been widely condemned. It was (for example) described as "far from convincing" by the Asprey Report (Full Report 1975 para 16-11) and is compellingly rejected in Australian Tax Research Foundation Study No 25. Amongst other matters this notes that the argument is derived from a peculiar US constitutional history which has no relevance in Australia. The Benefit of incorporation argument has been accurately described as *"one of the great tax furphies of the modern tax world"* (Tony Rumble "Tax Reform 1998 Investment and Tax action Bulletin Vol 2 No. 10).

17.66 <u>If the "benefits of limited liability" argument is to be used as the conceptual under pinning for the proposal, then it must follow that a considerable number of trusts (and fact situations involving trusts) should be *automatically excluded* from the new regime</u>. For example, it must necessarily follow that any trust with *individual trustees* or any unit trust which allows the trustee to have *recourse* to unit holders or any trust with purely *passive investments* and no gearing (or gearing which is guaranteed) should be excluded from the regime. All deceased estates, testamentary trusts, constructive trustees, stakeholders and others would be excluded without further question. However, there is no analysis of that kind in ANTS (or in the Report). It would therefore seem that this rationale may not be seriously advanced because it has been forgotten entirely by the time analysis of the exclusions occurs.

Classification of Entities

17.67 Chapter 21 deals with the *classification* of entities under the new regime and canvases several options by which one would draw a distinction similar to that which is currently operative between "*private companies*" and "*public companies*". On balance we believe the best course is retention of the current classification for companies and development of a new and appropriate distinction for trusts. (ie.

option 1) is probably the best of the 3 approaches which are canvassed. In relation to option 2 we specially note the undesirability of adopting the distinction between *fixed trusts* and *non fixed trusts* (suggested in option 2) unless careful attention is given to those definitions in order to rectify the anomalous operation which they currently have. As matters currently stand those provisions have potential for a rogue operation which would technically treat many trusts as non fixed trusts which from any substantive view point are fixed trusts. These definitions should be modified in any event. The *uncritical adoption* of those definitions would further extend their rogue operation.

17.68 <u>Discussion of the proposed "classifications" in a purely academic fashion may obscure a fundamental point. The proposals to treat trusts as companies are very squarely directed</u> against <u>*private entities*</u> rather than public entities and will operate *harshly* against small and medium business and family wealth holdings. In order to explain why this is so it is appropriate to consider the "*overall*" effect on discretionary trusts of a number of the provisions envisaged by the Report.

Overall Effect on Discretionary Trusts

17.69 <u>The proposed rules applicable to trusts (envisaged by the Report) will mean that *amounts* will no longer be distributable on a tax free basis to the objects of a discretionary trust.</u> The only apparent exception to this will arise in cases where the grandfathering provisions can be resorted to so as to allow the distribution of *old capital* to discretionary objects, <u>and</u> then only *if* it falls into the definition of contributed capital <u>and</u> it is possible to circumnavigate the constraints within the *profits first rule* <u>and</u> the proposed regime for FBT has no application.

17.70 The provisions which have this *composite effect* are dispersed over various chapters in the Report and include:

(a) The provisions calculating "contributed capital".
(b) The provisions which define distributions of amounts labelled as "profit".
(c) The provisions which superimpose on this the "profits first" rule.
(d) The application of the Capital Gains Tax (CGT) principles.
(e) The "deemed dividend" rules.
(f) A potential for residual operation of FBT rules.

17.71 The features of these provisions to be borne in mind include the following:

(g) The definition of contributed capital is unduly restrictive and (amongst other things) will not include unrealised gains on pre CGT assets. This problem alone will artificially inflate the calculation of profit.

(h) Profit is to be calculated in an artificial difference between two defined amounts (regardless of whether the real source is profit or income or capital).

(i) There is no methodology to allocate contributed capital to discretionary objects so they will always be subject to the profits first rule (save on vesting of the trust). Accordingly for so long as there are any profits no capital can be distributed to the discretionary object (save presumably *some* but not all of the grandfathered amounts).

(j) Discretionary objects will be subject to CGT and will apparently have no cost base (save for grandfathered amounts).

(k) The deemed dividend rules may be applied whenever there are profits (as artificially calculated) whether or not there is capital which could be distributed.

(l) One of the options in Chapter 18 may mean that FBT is payable on certain non cash "benefits" provided by a trust to beneficiaries in their capacity as members (see Option 3 from p 413).

(m) The *combination* of these measures (or for that matter *some* of them in isolation) effectively turn discretionary trusts into engines for the conversion of capital into income.

(n) <u>The substantive composite effect of these proposals is therefore a regime for the taxation of wealth in Trusts, and thus (on distribution) a gift duty</u>.

General Entity Loss Framework

17.72 The Report proposes a new "*general entity loss framework*" to be applied to both trusts and companies but recognising the differences between them ***(paragraph 21-7)***. The <u>suggestion in this part of the Report that the *same business test* should be available to trusts is a welcome recommendation. Indeed we would got so far as to say a new "general loss" framework would be welcomed *if* it were appropriately formulated and provided that it recognised the very significant *shortcomings* in the current regimes applicable to *companies* (and trusts) from the perspective of the taxpayer.</u> The shortcomings of the corporate loss regime include the prospect that the same business test might be confined to a very narrow class of "identical" businesses and the recent emergence of views within the ATO contending that the continuity of ownership test should be administered on the basis that it cannot be satisfied when it is necessary to trace the ownership through a discretionary trust (holding shares in the loss company). The effect of that rule is that continuity of ownership is failed in cases where there has been no substantive change whatsoever. In the case of trusts the shortcomings of the loss trust regime are too numerous for this submission to cover in any adequate fashion. However we do note that the majority of the Senate Economics Legislation Committee (whilst recommending that the legislation go forward) <u>acknowledged that all of the non ATO witnesses "held similar views that the legislation is flowed, manifestly unfair, and that it focuses on the loss rather than the trafficking"</u>. We also note that the shortcomings include the unreasonable width of the income injection test and a general inability to trace interests through discretionary trusts (which is ameliorated in some cases through the *family trust* concept).

Need to Remedy Inequities in Loss Regime

17.73 An appropriate general entity loss framework will only be formulated if it *identifies* shortcomings of the kind outlined above and *remedies* them. If the general entity loss regime persists in discriminating against discretionary trusts (by denying losses in those trusts or in companies in which these trusts hold shares) it would adopt a position which is logically bankrupt. On the one hand *consistency* would be alleged to require that each form of entity be taxed in the same way, and that trusts are to be characterised as entities (although they clearly are not) sharing common characteristics. On the other hand it would be alleged to be perfectly proper to discriminate against discretionary trusts because they are different. We should add that an appropriate modification of the continuity of ownership test so as to accommodate discretionary trusts should not be a terribly difficult task. Indeed it is a task which the ATO has repeatedly assured us was achieved in the context of section 160ZZS. If the substantive approach intended by the original sec 160ZZS were given legislative sanction it would form an appropriate basis for resolution of the discrimination against discretionary trusts (in the losses context).

Inconsistency with Entity Approach

17.74 The Institute adds that an approach which insists that companies and trusts are to be taxed as separate legal entities is inconsistent with a view that the carry forward of losses by an entity should be denied on the basis that there have been changes in the composition of the ultimate owners. The inconsistency is compounded by denying the continuity of ownership because technical tracing rules cannot be satisfied. Those fundamental inconsistencies need to be clearly borne in mind when formulating the rules for losses.

Position of Loss Trust Regime and Family Trusts

17.75 There will be a need to clarify the position of the *loss trust regime* generally, and particularly the position of trusts which have elected to be "*family trusts*" (for this and other purposes). The very considerable shortcomings of the loss trust regime mean that many trusts have proceeded for some time on the basis that they are electing to be family trusts (with various cross elections as interposed entities) in order to avoid the unreasonable consequences which might otherwise have flowed and to preserve the ability to cross distribute.

17.76 One of the prices of such elections is that distributions to beneficiaries outside a defined class is subject to FTDT. FTDT itself has considerable potential to operate unreasonably because it taxes all capital and income distributed outside the defined class and is not limited in amount to the benefits obtained through the loss provisions. FTDT should be repealed if the ongoing benefits of any such election are negated or diminished in a material respect. There would be a material diminution if (for example) it were no longer possible for family trusts to distribute current income to all trusts, companies and persons within the family group on the basis that it can be offset against losses of these beneficiaries.

17.77 The Institute appreciate that it is proposed that the family trust concept will have a continuing relevance in the context of the proposals for special consolidation (if they proceed) even if it ceases to be relevant to the loss trust regime **(cf paragraphs 26-24)**. <u>However, it seems unlikely that the group consolidation rules (and issues) will mesh with the principles applied to date for the purposes of making family trust cross elections</u>. A group may not wish to consolidate under the proposed consolidation regime once all of the incidents of that regime are understood (although it was prepared to elect under the loss trust regime) or the members electing to group may be different. For example the extent to which individuals effectively within the family group would wish to elect to consolidate all of their tax affairs ***(as outlined in paragraphs 26-24)*** must be subject to considerable doubt. <u>It would therefore be inappropriate to continue the loss trust regime but remove the family group concessions in relation to the income injection and other tests (as seems to be indicated at ***paragraphs 26-37***)</u>. It seems unlikely that the availability of a consolidated tax regime would remove the need to retain the current grouping provisions ***(as suggested in paragraphs 26-69)***. Additionally we have difficulty reconciling the discussion at ***paragraphs 26-37*** (which assumes continuation of income injection tests) with the discussion of a new general loss regime.

The Conduit Principle

17.78 In order to examine the reasonableness of the proposal to tax trusts as if they were companies, it is necessary to commence with an understanding of the basis upon which amounts have generally not been taxed as they flow through a trust. The core reason for this is that amounts generally do not change their character as they pass through the trust. This principle is commonly referred to as the *conduit principle*. One example of this was the treatment of distributions to holders of units in a fixed trust accorded by *Charles v FCofT*. A more recent example can be found in the treatment of capital gains derived by a trustee. The conduit principle flows from the *basic nature of a trust* and the fact that trusts are not separate legal entities.

17.79 It is one thing to say that trust income should be taxed to the trustee at corporate rates as if it were a company. It is a further step again to say that *all* amounts distributed by the trust are to be re-characterised as dividends, and are thereby deemed to lose the essential character which protected them from tax (and which they continue to retain as a matter of fact).

17.80 <u>Denial of any form of conduit principle to companies arises from the fact that they are *separate legal entities* rather than any soundly based principle of *tax policy*.</u> As a matter of tax policy the problems which companies face should be addressed by some form of look through approach or by amending the definition of dividend and the CGT regime to permit relevant amounts to flow through to shareholders. That view is strongly supported by Australian Tax Research Foundation Study No 25 (1995) which deals with “The Taxation of Company and Business Income”. Denial of conduiting means that in the end result, *tax concessions* granted to companies will generally secure only timing (rather than permanent) advantages. In many cases the basic nature of the concession will not (or should not) have contemplated this kind of withdrawal of its benefits. The only logical exception to this principle arises where the exemption is provided because of the corporate structure itself (rather than the type of activity or investment which the concession seeks to encourage) and even in that case regard must be had to benefits forfeited because of the exemption. Strong arguments can therefore be advanced to the effect that the failure to pass on to shareholders the benefit of many forms of "concession" (such as the tax free indexation component enjoyed at corporate level) is fundamentally inconsistent with a the concept of imputation and any proper principle of investment neutrality. It makes little sense to confer a tax concession for a type of activity, but to cancel the concession where the taxpayer happens to be a company. Nonetheless consequences of this kind flow from the nature of the company itself (unless specifically addressed). In our view that is no reason to deem trusts to have the same structural problem. The extension to trusts involves an "inversion" and reworking of the very principles which the Report claims to adopt.

17.81 It is important to appreciate that the problems which the proposed regime creates for trusts will go well beyond the tax treatment to be accorded to "tax preferred income" (at least if that term is used in its appropriate sense so as to refer to amounts which are in fact *income* but have had the benefit of some concession) (see in Glossary at page 829). In the end the new regime seeks to tax *amounts* distributed to beneficiaries generally as if they were dividends regardless of whether they are in fact sourced from "income" or "capital", whether they represent "tax preferred" amounts or not, and (in some cases) whether or not there is any real distribution. The regime will create some exceptions to this principle using its own (artificial) concept of capital contributions and its own (artificial) concept of "profits first". However it is a misconception to think that the end result is merely to deny the "flow through" of tax preferred income. If a decision to assess tax preferred income is pursued (contrary to our submission) then the measures adopted should focus on the preferred income which is being targeted, and assess that income in a direct simple and transparent fashion. They should not create further structural problems or seek to capture other amounts by stealth.

17.82 The Institute adds that a decision to assess tax preferred amounts on a general basis should only occur if Treasury can support the case for it with some soundly based principle of tax policy which it clearly identifies and which can withstand scrutiny. None of the material in the Report (or which is presently available to us) identifies any such policy. The only "policy" which is apparent is a desire to collect more revenue by deeming trusts to be "entities" so that bad tax policy currently applied to entities can be extended to situations where there is no entity.

Fictional Deemed Dividends

17.83 The Report recognises that one of the principal reasons for distinguishing between public and private trusts is a proposal to extend the operation of "*deemed dividend*" provisions (currently contained in Division 7A) to trusts which are classified as *private*. That is a theme which is pursued more generally within Chapter 18 which suggests a very broad set of provisions the *genesis* for which is very plainly be found in Division 7A. Unfortunately, all of this reflects a relatively *uncritical acceptance* of Division 7A and a failure to appreciate the level of practical difficulty and unfairness which that regime can produce. It also compounds the fictional approach by making deemed dividends out of amounts which are not even distributions.

17.84 Where Division 7A operates it results in a deemed dividend (which is unfranked) and a loss of franking credits. (sec 160AQNC). The "double tax" consequences of this are ameliorated in some relatively simple cases by sec 109ZC which prevents the taxation of dividends already taxed under the Division (where amounts are lent to a shareholder and a subsequent actual distribution is made to the same shareholder). In other circumstances the end result is effectively double *triple tax* totalling more than 100 cents in the dollar.

Shortcomings of Corporate Regime

17.85 Generally the shortcomings (and inequities) of the corporate regime need to be understood and positively addressed (rather than uncritically accepted and extended to trusts). The problems with Division 7A are but one example of the problems of the corporate regime. Some further problems are discussed in the context of the various double tax issues raised by our submissions in relation to Chapter 20. Additionally the concept of "profits" for the purposes of sec 44 has been expanded beyond any appropriate meaning (so that it includes for example amounts gifted to a company). Having regard to problems of this kind it is difficult to understand why the corporate regime is to be applied as the benchmark. Indeed the reality is that the corporate regime as applied to private companies is being adopted a the benchmark for trusts subjected to the regime (which is even worse).

Discriminatory Regimes

17.86 In recent years a number of provisions have been added (and older provisions *reinterpreted*) so as to discriminate against discretionary trusts. The carry forward of losses raises but one example of this. Other examples are to be found (for example) in the provisions which deny the flow of franking credits through a discretionary trust (proposed sec 160APHL) and the provisions now deny the ability of discretionary trusts to satisfy thin capitalisation rules (sec 159GZG(5A)(5B) and (13)). All existing discrimination of this kind should be identified and removed.

17.87 Additionally the new regime would need to be most assiduous in ensuring that it does not (in the end) operate in a discriminatory fashion. In their current form the proposals would operate on a discriminatory basis because (for example) discretionary beneficiaries appear to be accorded *no cost base* under the CGT regime, will obtain *no relief* from the profits first regime, will have an inadequately defined definition for capital, and may be more harshly dealt with under loss carry forward provisions.

Entity has Insufficient Assets

17.88 Chapter 21 also focuses upon the responsibility for payment of tax in circumstances where the entity has *insufficient assets* to meet the liability. As the Report points out in the case of companies this matter is already dealt with by the Taxation (Unpaid Company Tax) Assessment Act and the crimes (Taxation Offences) Act. The suggestion ***(in paragraphs 21-40 and 21-40)*** that there should be an extension of the ability to resort to individuals for payment is not supported by the Institute. The precise nature of the suggestion is unclear. These paragraphs suggest that whenever an individual is a knowingly party to a transaction which has the *effect* that the company is unable to pay its tax the individual will face personal liability regardless of whether he *knew* (or should have known) that transaction has that *effect*. Any proposal of that kind should be firmly rejected. The suggestion that liability be extended to "parties related to such knowing parties" can only be condemned even more vigorously. It is difficult to understand how suggestions of this kind (which seek to brush aside the concept of limited liability and indeed go much further) can even be advanced in the context of a proposal which relies (to any material extent) on a view that entity taxation is the price of limited liability.

Allocation Problems

17.89 The Report recognises ***(at paragraph 21-42)*** that the treatment of trusts as companies will raise *new questions* concerning *allocation* of the *tax burden*. It suggests that one way of dealing with the matter is to allow trustees and relevant beneficiaries to determine which assets are to bear the economic burden of the tax liability in accordance with the trust law. Generally the Institute agree with that as the most appropriate course if the proposal proceeds. However, it should be again emphasised that the fictional treatment of the trust as a company raises a new layer of complexity and fails to appreciate the fact that the trust is not in fact an entity.

17.90 Under many existing trusts the beneficiaries will (by the end of the year of income) be presently entitled to the income of the trust fund, and thus entitled to demand the income as so calculated from the trustee. In many cases the calculation of the amount to which such beneficiaries are entitled does not provide for any deduction of tax from the distributable amount (eg. because the trust law income is defined by reference to the tax law concept of net income). The basis on which the trustee could deduct the tax payable (without an amendment of the Trust Deed) is far from clear. Generally this problem could be solved by amending the definition of net income (assuming of course that the States administering the stamp duty regime do not assert that the changes amount to a "resettlement"). However, if amendments to the trust are for some reason not feasible (or not feasible at the behest of the trustee) and there are no other assets to which the trust can resort, the solution for the trustee is far from obvious.

Pre Implementation Measures

17.91 The letter from John Ralph to the Treasurer of February 22 1999 contained the following paragraph:

"Exploitation of these deficiencies presents a potentially serious revenue risk in the period prior to the introduction of the reform measures. There are also other possible reforms, including transitional arrangements for the taxation of trusts, that could give rise to strategic exploitation prior to their introduction, also with significant implications for expected post-reform revenue.

In response, we recommend that mechanisms be put in place to stop the potential abuse. Different mechanisms may be more suited to different forms of abuse. We will deal with the precise formulation of the arrangements in our final report."

The Institute seek clarification of this paragraph. <u>In particular we seek confirmation that this does not mean that taxpayers cannot dismantle trust structures which are (if the Report is implemented in its present form) to be subjected to an entity tax regime</u>. For reasons discussed in the Report we believe the proposed regime (in its present form) would be unfair and inequitable. We can see no justification to compound that inequity by preventing measures to dismantle trusts or accelerate distributions from them before the new measures commence (in those cases where it is possible to do so).

CONCLUSIONS

17.92 The Institutes major conclusions in respect of Chapter 21 can therefore be summarised as follows:

(o) It is essential to understand that trusts are not entities, serve a diversity of functions, and cannot be simply characterised as vehicles for the conduct of investment.

(p) The measures suggested by the Report will not produce consistency or simplicity and will contravene core principles which the report itself adopts.

(q) Much of the complexity arises from an incorrect assumption that trusts are "entities", a more general failure to focus on the real differences between a trust and a company, and the problems which flow as a consequence.

(r) The composite effect of the measures suggested in the Report will result in severe *discrimination* against trusts and will tax trust *capital* in an unfair way.

(s) In these circumstances the Institute cannot support measures in the form outlined in the Report, and considers that those measures should be abandoned.

(t) In our view most of the legitimate objectives of ANTS in relation to trusts can be achieved by relatively simple measures.

(u) The approach which we would suggest involves assessing the income of trusts (other than excluded trusts) at *corporate rates* under Sec 99A or a new equivalent of that provision.

(v) Although we do not support the taxation of *tax preferred amounts* on any general basis, the assessment of such amounts could be achieved simply by the mechanism outlined in the Appendix to this Chapter.

APPENDIX A

17.93 If (contrary to our submission) a policy decision is made to assess "tax preferred income" upon its distribution by trusts, then the appropriate course would be to:

(a) define the concept of "tax preferred income";

(b) ensure exclusion of grandfathered amounts;

(c) provide for the taxation of tax preferred amounts when distributed to beneficiaries.

(d) deal with this as a simple measure under Division 6.

17.94 The glossary definition of "tax preferred income" is a convenient starting point (although there are questions concerning amounts properly so characterised including the extent to which foreign income should be included in that definition). It is necessary to expressly exclude from that definition all amounts which are "grandfathered" (and to preserve that exclusion as amounts flow through a chain of trusts). Parts of the definition of contributed capital could be used as a starting point for that exclusion. A composite definition based on this approach is set out in para 3 of this Appendix. For ease of comparison the drafting adopts the same *substantive* drafting style used in the Report, and *assumes* that foreign sourced income is to be treated as "tax preferred income" following the Glossary definition. However it is submitted that the benefits of foreign tax credits should continue to flow through to beneficiaries, and the final resolution of this issue will influence the way in which tax preferred income is ultimately defined and dealt with.

17.95 "Tax Preferred Income shall mean income derived after the Date of Commencement not included in taxable income for specified taxpayers (whether resulting from domestic tax incentives or other exemptions or [exempt foreign source income otherwise comparably taxed in a country other than Australia] or from an offsetting of previously accrued losses against current income) provided that it shall not include any Grandfathered Amount."

"Grandfathered Amount shall mean:

(i) any realised gain on pre CGT assets and non CGT assets (not being trading stock);

(ii) any realised gain on post CGT assets held at the Date of Commencement;

(iii) any realised component of a goodwill capital gain which is not assessable under the CGT goodwill concession applying at the time of realisation.

(iv) any realised [or unrealised] inflationary gain on post CGT assets that were held in the trust at the Date of Commencement.

……

(vi) amounts [distributed] from any other trust which are attributable to Grandfathered Amounts in relation to that other Trust (whether by reason of any preceding paragraph or this paragraph)."

17.96 Division 6 could include a provision along the following lines:

"99AB Where at any time during a year of income an amount being Tax Preferred Income of a Trust Estate (other than an Excluded Trust Estate) is paid to or for the benefit of a beneficiary of the Trust Estate (and such amount is not and has not been otherwise treated as assessable income of the beneficiary by any other provision of the Act) the assessable income of the beneficiary shall include that amount (to the extent that it is not and has not been so treated)."

17.97 The "corporate rate approach" would achieve the Government's objective of taxing trust *income* at the *corporate rate* within each trust (and thus secure any reasonable collection objectives in respect of trust income) and could assess tax preferred income (if that is considered essential).

Chapter 22 – Bringing trusts into the new entity regime

GENERAL COMMENTS

18.1 The *first issue* canvassed by this Chapter is the extent of exclusions from the regime which taxes trusts as companies. However when examining this issue the analysis must commence with the *reasons* which are advanced for taxing some trusts as companies. Unfortunately the Report does not approach the matter in this way.

18.2 The *second issue* discussed concerns the need to adhere to situations in which there will be a "*new trust*". In considering this issue it is vital to understand that the term "resettlement" (in the sense which it has come to be discussed in the stamp duty caselaw) is not the same thing as creating a new trust. The incorrect assumption that it has the same meaning leads the analysis in the report into fundamental error.

18.3 A *third issue* discussed concerns the *cost base* of *interests in trusts*. The proposal appear to involve a conclusion that all distributions of a discretionary trust should be fully taxed. The proposal fails to take into account the way in which trusts differ fundamentally from companies. A sum of $100,000 settled on a trust as capital and subsequently distributed would suddenly be taxed to the beneficiary. Discretionary trusts would thus become engines for *converting capital* into *taxable income* (by this measure alone).

SPECIFIC COMMENTS

Excluded Trusts - Generally

18.4 Chapter 22 deals (in part) with identification of trusts which should be excluded from the proposed entity regime. The trusts so identified would be additional to the "collective investment vehicles" identified in Chapter 16 of the Report. The Institutes discussion in this Chapter will generally not deal with the "public" vehicles discussed in the context of Chapter 16 and will focus on private trusts.

18.5 The *starting point* for determining the scope of exclusions must involve an understanding of the *basis* on which the measures are proposed. For reasons outlined in our discussion of Chapter 21 it is not easy to discern that basis. However the principal reason seems to be a view that Trusts are *said* to be "entities" used for the conduct investment (or business) in a fashion which is perceived to be equivalent to that of a company. If that is the basis it should follow that whenever it is impossible to so perceive a trust (or whenever its role is not principally as a vehicle for investment or business) the trust should be *automatically* excluded.

18.6 When focusing on this issue it is of some importance to know whether "liability limitation" is or is not a core reason advanced for the change. If it is a core reason then the starting point for defining exclusions should also *automatically* include the range of situations where no material limitation of liability is achieved. A number of these situations are identified in this submission (in the discussion of Ch 21).

18.7 The situations in 6 and 7 are in any event a useful conceptual starting point for defining the scope of exclusions. In addition to automatic exclusions flowing from the basic policy rationale there will be other instances where exclusion should follow based on particular circumstances or considerations of equity. Considerations of this kind compel the view that family trusts should be excluded especially if the entity regime is to apply in the manner suggested in the Report.

Absolutely Entitled Trusts

18.8 The Institute agrees that trusts with beneficiaries who are absolutely entitled should be excluded from the new regime. It would of course be extraordinary if mere *nominees* (and many other trustees of assets to which beneficiaries are absolutely entitled) were not excluded from the regime. The fact that the new regime should otherwise be so wide as to extend to them speaks volumes for the distance which the "theoretical construct" has moved from reality.

Stakeholders

18.9 <u>The Institute would urges that stakeholder arrangements should not be subject to entity tax</u>, an outcome to which the Report which seems to be at least open. As matters stand the stakeholder may or may not be obliged to pay tax as a trustee having regard to the time at which a crystallising event occurs. There is no need to further complicate matters. We should add that such trusts almost invariably involve the passive investment of the stake to observe interest and no trust liabilities. If "investment vehicle" or "liability limitation" is a rationale then these stakeholders should automatically be excluded.

Constructive Trusts

18.10 The Report also canvasses some of the difficulties which can arise in relation to <u>certain forms of constructive trust</u>. When formulating the principles to be applied it is important to appreciate that the term has come to be used in a wide variety of circumstances *some* of which involve situations in which the beneficiary (and possibly also the Trustee) will have no knowledge of the trust. <u>This particular kind of fact situation gives rise to difficulties regardless of the application of a traditional approach or an entity approach.</u> As noted by the Report situations can arise where the technical position emerges only after the period for making amendments has expired. The recognition of this possibility seems to be the reason behind the suggestion ***(at paragraph 22-18)*** that the exclusion of constructive trusts suggested by ANTS should not be proceeded with. However there seems little reason to doubt that. <u>From a technical perspective the traditional trust provisions will generally apply to allocate income to the beneficiary.</u>

18.11 In the Institutes view constructive trusts should nonetheless be excluded from the entity regime and across the full spectrum of constructive trusts. One possible solution to the particular factual problems raised in the Report might be an appropriate (and limited) power of amendment of past returns. However, those amendments should not simply focus on the problem which the ATO faces (from its perspective). Any such amendment should also seek to create a fair situation for tax payers generally (for example by ensuring that penalties are not imposed and regardless of whether the powers to amend are out of time).

Division 6AA Trusts Generally

18.12 In the Institutes view child maintenance trusts and all of the other trusts which are exempted from division 6AA are suitable candidates for exclusion from the new entity tax regime. The report recognises that the list of possible excluded trusts includes also all of the trusts that are currently exempted from division 6AA. However, it nonetheless suggests retention of division 6AA (to preserve its application in "rare cases") and suggests that child maintenance trusts "could" be subject to entity taxation on the basis that they do not meet the ANTS "principle for exclusion." However, as noted above the ANTS principles for exclusion appear to have lost sight of the very basis which ANTS advanced for entity taxation.

Deceased Estates Specifically

18.13 Appendix A appears to proceed on the basis that *deceased estates* will have the benefit of an exclusion but only in cases where the *administration is completed within 2 years* (unless the Commissioner allows a further period). None of the reasons advanced for treating trusts as companies have any application to a deceased estate regardless of the period of administration. Application of a limited exemption of this kind would mean that many deceased estates would be deemed to be companies once the 2 year period had expired. The consequences of a shift of that kind appears to be quite unresolved ***(see paragraphs 21-35)***.

Infant Beneficiaries

18.14 Distributions to infant beneficiaries of a deceased estate should receive their income from an excluded trust and should not be subject to Division 6AA (regardless of the period of administration). It is not clear to us that this is intended.

Family Trusts

18.15 The concept of the “family trust” (in the technical sense used in the loss trust provisions) has been used in a number of recent cases to create a “safe haven” from very complex provisions which would otherwise operate unfairly in relation to such trusts. This “safe haven” status has come at a price (eg because of the FTDT implications of the election). The provisions from which it provides protection include may of the worst features of the loss trust regime, the failure of continuity tests for corporate losses (where the trust holds matters in a company) and provisions denying the flow through of franking credits via discretionary trusts. In effect the family trust concept has been used to make several (essentially unfair) regimes more workable by providing a carveout from the regime. In the Institutes submission a similar exemption must be provided in the case of the regime taxing trusts as entities (in the event that it does forward in the form suggested by the Report). Such trusts generally cannot be characterised as simply investment vehicles, and the relationship between the trustee and beneficiaries is rarely akin to that of a company and its investing shareholders. Additionally in the Institute submission it is inappropriate to repeal the existing family group concessions (as is contemplated in ***paragraphs 26-37***) on an assumption that the group benefits or the nature of the decision (to elect for grouping) will be the same.

Passive Assets

18.16 Trusts holding passive assets have traditionally been excluded from the corporate trading trust regime. A similar exclusion would be appropriate in the present context.

Other Exclusions

18.17 The Trust concept is so pervasive that there are real dangers in starting with a concept that *all* trusts are included in the entity regime subject only to specific exclusions. For example there are a number of situations involving a degree of separation of legal and beneficial ownership, which are commonly not perceived as involving a trust situation of that kind *include*:

(b) transfers by way of security,
(c) trustees for the issue of debentures,
(d) uncompleted contracts for the purchase of shares and other assets (where the contract is specifically enforceable),
(e) funds lent to a borrower where the lender is both creditor and beneficiary (as in *Barclays Bark Ltd v Quistclose Investments (1970)* AC 567),
(f) on some views the property of a company in liquidation (although that is not the generally accepted view under Australian law).

Examples of this kind suggest that the approach taken in the Report may be fundamentally unsound.

18.18 It is probably useful to explore one of these examples in more detail to illustrate the problems created by the series of fictions. Where a contract for the sale of shares or other assets is specifically enforceable, the purchaser obtains a form of "beneficial ownership" of the asset. However the asset continues to be held by the vendor who continues to have a level of rights and it cannot be said that the vendor holds the asset "absolutely" for the purchaser (so as to attract any exclusion for assets where a beneficiary has an absolute entitlement). This gives rise to a relationship which is sometimes referred to as one of the forms of "constructive trust". One must therefore consider the consequences if the tax law deems such a trust to be a "spectral" company. Those consequences would be entirely impractical and utterly unreasonable. It is likely that there would be substantial dividends if the proposed definition of contributed capital is adopted or if informal liquidation provisions (akin to sec 47(2A) were applicable. It is also difficult to understand how the tax which would be thus imposed would be a tax on income (as it must be to be valid). <u>In reality there would be no gain and no income</u>.

Modifying Division 6

18.19 ***Paragraphs 22-5*** suggests that a modified form of Division 6 could provide for separate but parallel provisions dealing with the right of beneficiaries to income and capital. The Institute agrees that in *a number of situations* (but representing a minority of trusts) it will be desirable to ensure that income and capital beneficiaries under trust law only have a liability for tax for amounts in which they have a beneficial interest. However the difficulty with this concept is that by "quarantining" the two sets of calculations the overall result is likely to be that more tax becomes payable overall. In these circumstances we are not convinced that the approach suggested in ***paragraphs 22-5*** should be adopted on a *compulsory* basis for all trusts.

Cost Base Issues

18.20 The Institute assume (and seeks confirmation) that Excluded Trusts would not be subject to the cost base rules which are proposed as part of the entity tax regime.

Creation of New Trust

18.21 The Report correctly identifies that by treating a trust as a notional entity there will be a renewed (and much more important) focus on the extent to which variations of trust involve the creation of a new trust. This is an issue which is presently relevant for the purposes of determining whether there is a disposal (or event in relation to the assets of the trust for CGT purposes) and the carry forward of losses. However, the implications under the new regime would be much more wide ranging and would presumably include the prospect of an unfranked "dividend" of all of the assets of the trust.

18.22 One of the difficulties with any analysis of this area is that there is an unfortunate temptation to focus upon the word "resettlement" *as if* that had the *same* meaning as creating a new trust, and then seek the meaning of the term "resettlement" from a line of stamp duty cases (which focus on different issues, are notoriously difficult to reconcile, and apply in cases where there is clearly no new trust). <u>This is another instance of inappropriate *labelling* and reflects a line of thinking within the ATO which we believe is of relatively recent origin. In the Institutes view this approach to the matter by the ATO applies logic which is fundamentally flawed. There is other (much more appropriate) income tax case law which focuses on whether there is a new trust (which is the real issue). That case law supports the view that the creation of new trusts will be a *very rare* event</u>.

18.23 As a substantive matter, the stamp duty cases on "resettlement" are not an appropriate line of authority, because they do not approach their task by examining whether there is really a *new trust*. A much more relevant line of authority concerning the substantive issue is to be found in the UK cases. Thus, the decision in Roome v Edwards (1981) 1 ALLER 736 reason that trust property will only become subject to a new settlement if the property becomes subject to an entirely new set of trusts that exhaustively deal with the beneficial interest so that the original trust no longer continues to apply. There must be no room in the future for the revival of the original trusts. *Bond v Pickford* (1983) STC 517 draws a distinction between "narrow powers" (such as powers of appointment) and "wider form powers" (such as express powers to resettle). It suggests that the exercise of a narrow form of power will never create a new settlement. *Swires v Renton* (1991) STC 490 decides that, even if a wide power (authorising a resettlement) is used, there will only be a new settlement where that is the intention of the trustees exercising the power. Application of such reasoning would suggest that the addition of a discretionary object gives rise to no new trust. Additionally, the decision in *Truesdale v FC of T70* ATC 4056 works against the proposition that references to the "creation" of a trust refer to events occurring subsequent to its initial formation. In that case, an assignment of property by an assignor to a trustee of an existing trust was held not to involve any "creation" of the trust by the assignor. Indeed, you might have expected that was precisely why sec. 160M(3A) provided that the *transfer of an asset to a trust is taken* to be "the creation", by settlement, of a trust over the asset. It may also be why CGT event E2 operates "if you transfer a CGT asset to an existing trust."

18.24 Another relevant authority is the recent decision in AAT Case 22/98ATC282. Where the AAT rejected arguments by the ATO that amendments to a superannuation trust deed resulted in a new fund. The AAT held that he power of amendment was exercised as provided in the original deed and could not such terminate the original deed. The AAT also noted that “changes of membership can have no effect. By their very nature the identity of members (or beneficiaries in trust terms) is constantly changing”. The Institute understands that the Commissioner has decided not to appeal that decision.

18.25 The Institute agrees that it would be useful to clarify the circumstances in which a new trust is created. However, the general principle suggested at ***paragraph 22-51*** of the Report is entirely inappropriate. This suggests that a resettlement occurs whenever there has been a "substantial alteration in the interest of existing or potential beneficiaries or discretionary objects." <u>The proposed test demonstrates the very substantial dangers of attempting to transpose the *kinds* of test which might arguably be relevant for *stamp duty* purposes into the present context.</u>

18.26 The test proposed by the Report at ***paragraphs 22-51*** appears to draw from the stamp duty cases (but is ultimately stated in a fashion which is even broader than those cases suggest). <u>Under the stamp duty law it is accepted that you can alter non default objects and transfer units or other interests in the trust without any resettlement. The test proposed in the Report would assert that there is a resettlement in those cases (and thus departs from the very authority on which it relies). The Institute adds that</u> any <u>such test is fundamentally inconsistent with an entity approach so that the proposed test departs (in that sense also) from any underlying principle</u>.

Altering Trusts to Conform New Law

18.27 The question of resettlement is also raised at ***paragraph 22-35*** where the view is expressed that alterations to deeds for the purpose of ensuring conformity with the new law would not "*generally*" result in a "resettlement" for taxation purposes. Whilst we agree with that conclusion, it would be absolutely unreasonable for there to be at any risk whatsoever that there be any exposure for stamp duty purposes (in *any circumstances*). It would be most unfortunate for there to be a replication of the problems which have arisen in the context of the MIC legislation. There are a number of situations in which the recent advancement by the ATO of the kinds of views expressed at ***paragraph 22-51*** creates a risk for funds which are presently altering deeds purely to conform with the new legislation. The Institute understands that opinions or rulings confirming the view that there is no new trust have generally not been available from the ATO (thus leaving taxpayers in an entirely *invidious* position). There have also been problems with State revenue authorities. Although this is more understandable from an abstract perspective (given the different and lower test applicable for stamp duty purposes) it is equally disconcerting.

Value Shifting

18.28 The Report also raises the possibility that the value shifting regime might be applied to Trusts (apparently as an alternative to what it refers to as the "resettlement option"). The Institute agree with the conclusion reached by the Report to the effect that a value shifting rule would not have any appropriate application to discretionary trusts (and for that matter many other forms of trust). However, the *reasons* why the Institute would take that view go well beyond those mentioned in the Report. Trusts cannot be viewed on the basis that they are simple vehicles for collective investment. They are (for example) widely used to store, control and *allocate family assets* and wealth, for estate planning, generational planning and a range of other purposes. Trusts commonly confer on the trustees wide discretionary powers and those powers may be used to favour various beneficiaries (and not benefit others). Put another way, trusts commonly involve the discretionary *allocation of value* between beneficiaries. It is therefore entirely inappropriate that value shifting rules should be applied to trusts on any wide spread basis.

18.29 The *only* trusts in relation to which there could be any sensible application of "value shifting" are those fixed trusts where the beneficiaries are truly collective investors. On the whole private trusts cannot simply be viewed as vehicles for collective investment. The relationship between a private trust and its beneficiaries is a relationship which (by its nature) confers benefits on the beneficiaries and the nature and extent of those benefits is generally not linked to the extent to which the beneficiaries have invested in or paid for their interests. Additionally the beneficiaries (or many of them) often have *no power* to prevent the exercise of a variety of powers by the trustee. In these circumstances it is clear that value shifting rules should *not* be artificially applied.

18.30 Companies are more often vehicles for collective investment, and the corporate structure involves a *fundamentally different relationship* between the company and its shareholders. Amongst other things the shareholders will generally have the capacity to prevent the exercise of powers which would shift value into and out of their shares.

The Cost Base of Interests in Trusts

18.31 The Report also notes that the proposed entity tax regime provides an opportunity to "clarify" the operation of the CGT provisions in relation to beneficiaries. There have of course been many past opportunities to clarify that treatment in a relatively benign environment (such as the TLIP process). However requests by the various professional bodies for benign clarification have been repeatedly ignored.

Denial of Cost Base to Discretionary Objects

18.32 As the Institute understands the Report it effectively suggests that the interests of discretionary beneficiaries should generally be treated *as if* they were *assets* subject to the CGT regime and *as if* they had *no cost base*. The consequence of this (as noted at ***paragraphs 22-76***) would be that "in the case of a discretionary trust… every dollar of contributed *capital* would be *assessed* when distributed." There are suggestions contained elsewhere in the Report that in some cases a discretionary beneficiary would be *deemed* to have a cost base equal to the contributed capital component of the distribution (see page 434). That kind of treatment would be similar to that which has applied for some time in the context of Sec 160ZX(5) and Event E7 - However the understanding which the Institute has from the Report as a whole is that this treatment is proposed only for distributions governed by the *transitional regime*. That is the clear position taken in Chapter 22. If discretionary objects are to be subjected to the CGT regime then the deeming rules will need to be extended so that discretionary objects are effectively protected by appropriate deeming rules on a general basis (and not merely in respect of grandfathered amounts).

18.33 Any suggestion that all distributions of *capital* by a discretionary trust should be fully taxed by the CGT regime on distribution should be dismissed entirely. Suppose a $100,000 is settled as a contribution to the capital of a family trust. The proposed regime would mean that whenever the $100,000 is distributed (and even if the profits first rule is fully observed) the distribution would be deemed fully taxable under the CGT regime. That is an outcome which *cannot possibly be acceptable*. The mere suggestion of that kind of outcome serves to further demonstrate that pursuit of the fictional similarities has been taken too far. Discretionary Trusts would become *engines for converting capital into taxable income*. Application of the proposed regime in this fashion is in substance a *gift duty*. This kind of example may also raise questions concerning the extent to which the provisions can properly be described as no more than a tax on income (which is essential to their validity). The drafting would need to achieve a victory for form over substance to secure validity in such cases.

18.34 The Institute adds that the kind of effect outlined in the preceding paragraph would be *contrary* to the views expressed by the Treasurer in correspondence which we have sighted. That correspondence *emphatically denies* that the distribution to beneficiaries of *gifted capital* of the trust will result in any tax liability.

Testamentary Trusts

18.35 ***Paragraphs 22-89*** correctly notes that there is distinction between an LPR and a trustee for estate and trust law purposes. It goes on to state (unequivocally) that this means that the CGT rollover currently does not apply to asset transfers between a trustee of a testamentary trust and a beneficiary. As Coopers TLIP CGT notes "although the matter is not free from doubt it is submitted that s128-20(1) will apply when ultimately the former executor or administrator (albeit in their capacity as trustee of the testamentary trust) transfers an asset to a beneficiary…provided that the asset was owned by the deceased". The view in the Report is not the view conventionally adopted in relation to these provisions or the meaning which should be given to them. The issue raised by the Report is the very kind of issue which could and should have been cured via the TLIP process via a simple amendment (making it entirely clear that all distributions by a testamentary trust to a beneficiary attract the CGT rollovers). Again the Institute has difficulty accepting that the appropriate way of correcting problems of this kind is to offer partial solutions in the present context.

18.36 ***Paragraphs 22-39 to 22-44*** deal with the way in which entitlements to unpaid income or capital of a trust should be treated under a trust. It suggests that such amounts should either be treated as an *asset* of the original trust (option 1) or as a distribution and *loan back* (option 2). Option 1 is likely to contribute to double tax problems of the kind outlined in Chapter 20. Option 2 may involve a much greater risk that the distribution occurs prior to mechanical steps needed to frank the dividend or prior to the generation of franking credits necessary to frank the distribution. In the Institutes view careful attention needs to be given to some automatic resolution of those issues in any event. For example it may be necessary to ensure that current year income can be distributed on a franked basis relying on the franking credits reasonably expected to be generated by that income. Assuming there is such a resolution then option 2 is probably to be preferred. In reaching this conclusion we assume that provisions such as Sec 100A and Sec 109UB will be repealed or cease to have any operation in relation to such trusts.

Income Averaging (Paragraphs 22.58 to 22.62)

18.37 The review raises the point that trust income would need to retain its primary production nature if the averaging provisions are to continue to be available to beneficiaries.

The option proposed per ***paragraphs 22.62*** appears to achieve the objective of allowing trust beneficiaries to continue to use the averaging provisions. As it is only an option, not a recommendation, we should emphasise that it is essential for the option to be adopted if the averaging provisions are not to be undermined.

As the review states, it would be necessary for adequate records to be kept by the trustee of the primary production income. This is no different to the current position of trustees. In most situations, the primary production business is a family business and all returns and accounts are prepared by one accountant, so the required information is available to all.

Farm Management Deposits (paragraphs 22.63 to 22.67)

18.38 The Institute opinion is much the same as it is on income averaging. The primary production income must flow through to the beneficiaries if the farm management deposits are to be of any use to trust beneficiaries. In this case, the review does not put up an "option". It refers to the amendments that "could" be made to allow beneficiaries to access FMDs. The implication is that such amendments would be appropriate.

CONCLUSIONS

18.39 The Institute major conclusions in respect of Chapter 22 can therefore be summarised as follows:

(a) the exclusions should automatically exempt trusts which do have the characteristics said to justify the new regime.

(b) Application of tests of that kind should compel exclusion of absolutely entitled trusts, constructive trusts, deceased estates and all (or most) of the categories presently exempted by Division 6AA.

(c) Additionally they afford strong arguments for exclusion of various trusts which achieve no material limitation of liability especially if that is a core reason for the proposal.

(d) An approach which treats all trusts as companies (subject to specific exclusions) may be quite inappropriate, particularly once it is recognised that many common transactions involve some form of "trust" relationship.

(e) The Reports analysis of the resettlement issue is fundamentally unsound and proposes a test which is unworkable.

(f) A family trust exception needs to be provided as a haven from the unreasonable operation of the regime (as an issue separate from any prospect of consolidation).

(g) Discretionary Objects should not be brought into the CGT regime (and the general provision of a deemed cost base would be essential if they are nonetheless to be subjected to such a regime)

Chapter 23 – Bringing all co – operatives into the new entity regime

GENERAL COMMENTS

19.1 The tax treatment of co-operatives is one area where the practical benefits of the present tax law should be identified before any change is proposed. A change to tax co-operatives as companies raises timing issues. Also the status of co-operatives as public companies and the principle of mutuality would need to be addressed. There may also be transitional issues if any change were made.

19.2 It is noted that the number of co-operatives is not insignificant. The latest Taxation Statistics (1996-97) state that there are 559, 520 co-operatives as defined in sec 117 ITAA36. These paid $140.3m in tax.

19.3 Before any decision to change the tax treatment of co-operatives and their members is reached, there needs to be some analysis undertaken to establish the extent to which co-operatives are a feature of the business and commercial community and the extent to which the present tax treatment provides in a practical sense needed benefits.

Without such an analysis a proposed change, while justifiable by reference to theoretical considerations, may prove inimical in a practical sense.

19.4 Presumably, submissions will have been made to the Review by co-operatives themselves or their representative bodies on these issues.

SPECIFIC COMMENTS

19.5 Timing issues

If the new entity regime were applied to co-operatives generally this would presumably create some significant timing issues for “tax co-operatives” and their members.

Under the present law, distributions of assessable income by a co-operative to shareholders as rebates or bonuses based on business done by shareholders with the company or distributed among shareholders as interest or dividends, is allowable as a deduction.

No such rebate or bonus in assessable in the hands of the recipient except where the price of the goods so purchased by the recipient is an allowable deduction - typically, where the shareholder buys the goods for re-sale in the course of a business carried on by the shareholder.

Thus where such distributions are made, tax (if any) is simply imposed at the shareholder level. If the new entity regime where applied tax would be paid at the co-operative level so shareholders would receive a net after tax amount, with credit ultimately being allowed on assessment. This would have a cash flow effect for shareholders as they now receive a gross amount. The non-assessablity of rebates or credits in the shareholders hands in certain circumstances would presumably need to be accommodated.

19.6 Public company status

A co-operative as defined for the purposes of Div 9 ITAA 36 is a public company for tax purposes – would this status be altered? Under the present law a co-operative company as defined in sec 117 is a public company (sec103A (2)(b) ITAA 36).

This status should not be disturbed by any change. If the status was changed, difficulties could be encounted by co-operatives and their shareholders in a number of respects - eg under sec 109 ITAA36 and the Div 7A payment and loan rules. Also, the benefit of any future provision which turns on the public/private status of a company would be lost.

19.7 Repayment of Government loans

Although the concession in sec 120(1)(c) ITAA36 for deductions for repayment of government loans may have been recommended to be repealed by the 1932-34 Royal Commission on Taxation and by the 1950-54 Commonwealth Committee on Taxation, the fact is that the scope of the concession was clarified as late as 1996 to overcome what was apparently a restrictive ATO view (see Taxation Laws Amendment Act (No.3) 1996).

Also, the fact is that Parliament rejected an attempt to withdraw the concession as part of the 1996-97 budget.

It is noted that the discussion paper recognises that the concession could remain even if tax co-operatives were otherwise taxed as companies.

19.8 Mutuality

The co-operative provisions provide a method of applying the tax laws to these "mutual" kind of entities. If co-operatives are taxed as companies, would the mutuality principle still be potentially applicable? If the mutuality principle were to be overriden, this would be a change of tax base and, presumably, the reform of business taxation would not be intending to abolish the mutuality principle as such.

19.9 Transitional arrangements

Any changes made would require consideration to be given to what transitional provisions might be needed.

Chapter 24 – Anti – avoidance provisions

GENERAL COMMENTS

20.1 This submission comments on Chapter 24 of "A Platform For Consultation", specifically addressing the anti-avoidance provisions.

Whilst not part of the report titled "A Platform for Consultation", this submission also comments on the letter to the Treasurer by the Chairman of the Review of Business Taxation, John Ralph AO, which recommends that measures be put in place to stop potential abuse of weaknesses in the current system.
Chapter 24 is divided into three parts, as follows:

- A Case for Reform;
- A Strategy for Reform;
- Key Policy Issues

20.2 A Case for Reform

The report notes tax avoidance and evasion have an adverse effect on incentive and are counter to the objective of lowering the company tax rate.

The report also notes specific anti-avoidance provisions have been continually added to prevent taxpayers taking advantage of flaws in the taxation legislation. It observes that the continual addition of specific anti-avoidance measures has added to the complexity and compliance costs for all taxpayers.

The report notes specific anti-avoidance provisions are a poor substitute for addressing structural flaws in the legislation and that anti-avoidance provisions, because of their broad application, increase uncertainty and potentially create further avoidance opportunities.

The Institute agrees with each of the views expressed above.

20.3 A *Strategy* for Reform

The report recommends a more systematic approach to dealing with avoidance issues. This will require the implementation of tax law in accordance with a policy that has appropriate design measures. The implementation of appropriate structural and design measures will subsume the need for specific anti-avoidance provisions, thereby reducing the cost of compliance and complexity and providing certainty. The report notes that in practice some specific anti-avoidance provisions will be required. A balanced approach is required and some of the options outlined elsewhere in the report have the objective of correcting structural flaws in the legislation that give rise to current anti-avoidance provisions. A review of the options in the report will provide an opportunity to re-visit existing anti-avoidance provisions and to determine whether specific anti-avoidance provisions are required. The report notes an evaluation of the various options will include a reformed robust general anti-avoidance provision. Implicit in this comment is that part IVA is deficient. This assumption must be questioned in view of recent decisions dealing with part IVA.

20.4 *Key* Policy Issues

The report suggests that underlying structural flaws in the tax base can be addressed with structural improvement, thereby minimising the need for specific anti-avoidance provisions.

The Institute agrees with the view that the role of a general anti-avoidance should never be that of a primary taxing provision. The recommendation for a robust general anti-avoidance provision is said to eliminate the need for specific anti-avoidance provisions. In the context of self-assessment, certainty is a pre-requisite of the operation of an efficient tax regime, and it is doubtful that an extremely robust general anti-avoidance provision will provide such certainty.

20.5 Specific Issues Requiring Further Examination

The report devotes several pages to a number of specific issues which in many instances relate to existing specific anti-avoidance rules. The discussion of these particular issues is premature in the context of specific anti-avoidance rules. Until such time as the various options elsewhere in the report are considered and decisions made there is little point in considering such issues until the proposed structure is known. Structural reform may well eliminate the need for some specific anti-avoidance provisions as the report acknowledges.

20.6 Views have previously been expressed by professional bodies, including the Institute, regarding the *practice* of legislation by press release. It is unfortunate that the objectives of transparency and certainty which are reflected in the report, "A Strong Foundation" and the report, "A Platform for Consultation", are not reflected in the letter to the Treasurer by the Chairman of the Review of Business Taxation.

The report highlights certain transactions which, it is suggested by the Chairman, that measures should be put in place to stop any potential abuse. This is on the basis that some activities are arguably outside the current anti-avoidance rules.

Such an approach hardly provides any certainty. The report and accompanying letter provides no basis for supporting the view such transactions may be outside the current anti-avoidance rules. If the transactions are questionable then they should be tested under the existing anti-avoidance issues.

Alternatively, if the transactions are not caught by the existing rules but are perceived by the legislators to warrant remedial action, the proposed announcement provides no certainty for any taxpayer. Legislation by press release is unacceptable for a number of reasons and should only be used in exceptional circumstances. No detailed statement has been provided outlining those arrangements which are unacceptable. The approach is contrary to the systematic approach referred to in the report as a basis for providing a sound framework for a taxation system. One of the criticisms of the current system referred to in “A Strong Foundation” is that the existing system is not based on a coherent set of principles and has been added to in an ad hoc manner. This criticism is equally valid for the proposals in the Chairman’s letter.

SPECIFIC COMMENTS

20.7 Part IVA

Implicit in the report is the inference that the existing general anti-avoidance provision, Part IVA, needs revision. This needs to be addressed in the light of recent decisions involving Part IVA and the principles that can be extracted from those decisions.

Fundamental to Part IVA are the concepts of:
- a scheme;
- a reasonable expectation;
- dominant purpose.

It is now accepted that a scheme can exist within a scheme. The Commissioner was unsuccessful in *Peabody* as there was no reasonable expectation that Mrs Peabody would have derived a tax benefit. In the Full Federal Court in *Spotless* the dissenting Judge found for the Commissioner on the basis that the dominant purpose test was satisfied. On appeal to the High Court it was found that the dominant purpose test was indeed satisfied.

More recently in *Consolidated Press*, Hill J made a number of comments assuming Part IVA applied to the transaction. Much media criticism was made of the decision in favour of the taxpayer, generated in all probability because of the public profile of persons associated with the company.

Hill J noted, after analysing the facts, there was clearly a scheme relying on the decision in *Peabody*. Turning to the question whether there was a reasonable expectation that a tax benefit would be obtained he referred to *Peabody* and said,

“The test of reasonable expectation required to be satisfied will be satisfied where it can be predicted that if the relevant scheme had not been entered into or carried out ACP would have done something which would give rise to a deduction being allowable to it and the prediction is sufficiently reliable as to be regarded as reasonable”.

He concluded that this expectation had been met. Having thus concluded he then considered the purpose tests in Section 177D. Again, he noted the resolution in *Spotless* of the problem of co-existent commercial and tax purposes. He then concluded that based on an objective consideration of the facts, the dominant purpose was that of avoiding the effect of Section 79D and that Part IVA would, therefore, have applied but for the finding by him that Section 79D had no application. Accordingly, if these views on Part IVA are correct it would only be necessary for the finding that Part IVA did not apply to be changed for the taxpayer to lose on appeal. The Institute does not accept the present anti-avoidance provision contained in Part IVA is effective.

20.8 As indicated earlier there is an over-reliance on specific anti-avoidance provisions. While acknowledging that tax avoidance and evasion are adverse to an effective tax system there is little doubt specific anti-avoidance provisions added to on an ad hoc basis have increased compliance costs, complexity and uncertainty. Such provisions will invariably have broader application than that intended thereby creating uncertainty and the need for remedial action. These comments were made both in "A Strong Foundation" and "A Platform for Consultation" and are endorsed by the the Institute.

20.9 Remedial action may be taken in the form of announcements by the Commissioner, administrative practices or by the issue of rulings or determinations. None of these steps is satisfactory. An example of a specific anti-avoidance provision that was poorly drafted, *exceedingly* complex and required remedial action is Division 7A. Draft legislation was not available for public comment prior to its introduction and this resulted in subsequent announcements by the Treasurer regarding the unintended consequences of the proposed legislation and the need for remedial legislation to overcome these deficiencies. This legislation has resulted in considerable uncertainty much of which could have been avoided if the legislation had been available for public comment prior to its introduction.

20.10 The trust loss legislation was announced by the previous Labour Government, however, the bill lapsed due to the Federal Election in 1996. The incoming Liberal Government issued a further exposure draft followed by an amended bill, the result of which was the passing of legislation some *period* of almost three years after the first announcement. The differing dates of effect hardly create an atmosphere for certainty and promote complexity and additional compliance costs. It is clear that tax law must be developed consistently with an appropriate policy and design features.

20.11 The Institute acknowledges that specific anti-avoidance provisions will be required in certain situations. Section 82 KZM is an example of such a provision and is easily understood.

20.12 The need for specific anti-avoidance provisions will, ultimately, depend on a consideration of the various options *outlined* elsewhere in the Ralph report. These options are designed to rectify structural flaws identified in specific areas on the existing legislation. Consideration of the various options will provide the opportunity for the existing current specific anti-avoidance provisions to be examined to determine their appropriateness.

Aligned with this will be a consideration of the existing general anti-avoidance provision. A balance must be struck between general and specific anti-avoidance provisions. A robust anti-avoidance provision as suggested would eliminate the need for many specific anti-avoidance measures. Particular care needs to be taken to ensure that such a provision is workable and will not be read down by courts to make it unworkable. It must also provide some degree of certainty.

20.13 It was earlier commented that the report implies the existing general anti-avoidance provision, Part IVA is ineffective. This submission suggests that the opposite may be in fact the case.

Recent decisions have, in fact, established that Part IVA does work. These decisions have considered the various elements of Part IVA and provide some guidance on their meaning. It would be unfortunate if the existing provision is replaced without having first identified it as being ineffective. Existing case law provides some degree of certainty as to how the existing section should be applied and interpreted. An entirely new provision would need to be interpreted in accordance with the wording of that provision. This would hardly promote any certainty given the Commissioner is unlikely to provide any ruling on Part IVA and, more significantly, it may be many years before the courts could give guidance on the new provision.

20.14 The report refers to a number of specific issues and makes a number of general comments on each issue. These issues include:

- debt equity issues;
- tax exempt transactions;
- transfer of entity losses;
- unfranked dividend streaming;
- franking credit trading;
- dividend stripping;
- dividend substitution;
- capital streaming;
- capitalisation of profits
- redeemable preference shares.

It should be reiterated that the Ralph Report is an options paper. Until such time as the general framework of the proposed legislation is determined, it is too early to say whether some or any of these specific anti-avoidance provisions will be required.

It is, therefore, inappropriate to comment on each of these headings until the overall design framework, objectives and principles are known. The Institute agrees that there is a need for consistency based on a principled approach for a general provision to handle asset transfers for inadequate consideration. Presently, there are numerous provisions within the existing legislation which could be eliminated by adopting a high level principle.

20.15 The reference to transfer of entity losses is perhaps misleading. The succeeding paragraphs under that heading essentially deal with an income injection test for companies. The report makes the following observations:

- the need for an income injection test should be assessed given that the possible taxation of trusts as companies; and

- if an income injection test is to be retained consistency of tax treatment should see the same test applying to companies, trusts and limited partnerships.

The Institute agrees that if trusts are to be taxed as companies, some consistency of treatment of losses is essential to promote certainty and reduce complexity. Standardisation is one of the legislative design principles espoused in “A Strong Foundation”.

20.16 Purpose Test

It is significant to note the recent amendments to Part IVA to include Section 177EA. These provisions clearly lower the evidentiary test in determining whether the section has application in contrast to the dominant purpose test elsewhere in Part IVA. Subject to other conditions being satisfied, the section will apply if it would be concluded that the person who entered into this scheme did so for a purpose of enabling the relevant tax payer to obtain a franking credit benefit. The previous requirement that the purpose be the dominant purpose has now been eroded and this appears to be a trend elsewhere in other recent specific anti-avoidance provisions.

The Institute considers any anti-avoidance provision, whether general or specific, should be based on a dominant purpose rather than a not-incidental purpose. The latter test is too broad and is likely to result in increased uncertainty and should be resisted.

20.17 General *anti* - avoidance

It is appropriate to comment on the proposed general anti-avoidance provisions contained in Division 165 of the “A New Tax System (Goods and Services Tax) Bill 1998”. The introduction of the GST bills is a direct result of the announcements by the Government in August, Tax Reform: Not a New Tax, a New Tax System. The GST anti-avoidance provision proposes a principle effect test. The result is that situations where the principle effect of a scheme results in a GST benefit it will apply regardless of the purpose of the scheme.

The report recognises that any general anti-avoidance provision must not assume the role of a primary taxing provision. Clearly, if a principle effect criteria is utilised in any proposed income tax anti-avoidance provisions this objective will not be met. Where a transaction that complies with the legislation and is not driven by tax considerations but otherwise complies with the legislation there is no justification for the Commissioner having the power to impose tax and penalties because of the results of the particular transaction. Such a provision is too general and provides no certainty.

Policy transparency is another legislative design principle referred to in “A Strong Foundation”. Adopting an in principle effect test for GST purposes and a dominant purpose test for income tax purposes is hardly consistent with national objectives and policy design principles.

A general anti-avoidance is one of the legislative design principles in "A Strong Foundation", however, the proposition that such a provision should be sufficiently robust to do without specific anti-avoidance provisions is perhaps idealistic. It is difficult to envisage a general provision which could achieve the result intended by Section 82 KZM.

20.18 Conclusion

The Institute agrees with the view expressed that there is an over-reliance on specific anti-avoidance provisions in the existing legislation. Such measures generally have a broader application than intended and this is clearly evident by the recent specific amendments to Division 7A. It is clear that the introduction of specific anti-avoidance measures by governments do not address the fundamental structural flaws in the existing legislative framework.

The proposed strategy for reform is welcomed. It adopts a systematic approach by considering the structure and design process. By implementing an appropriate and legislative and design structure the need for many specific anti-avoidance provisions will be eliminated.

While the Ralph Report outlines a number of specific anti-avoidance provisions, it is not appropriate to comment on the need for these provisions until such time as the overall design framework, objectives and principles have been determined. As the Ralph Report is merely an options paper the identification of any specific anti-avoidance provisions required will ultimately depend upon determination of these issues.

Any tax system must have certainty for its efficient application and, in this regard, the structure of a general anti-avoidance provision needs careful consideration. If the provision is too broad, for example, it relies on a principle effect rather than a dominant purpose test, it will catch transactions which are not tax driven but which have an effect of reducing tax. It is not appropriate to have a general anti-avoidance provision which relies on a principle effect. Such a provision is contrary to principles of certainty and transparency.

No arguments have been put forward that the present Part IVA is not effective. Recent decisions have indicated that the provision is capable of operating effectively and the courts have now considered on a number of occasions the main elements of Part IVA which form a basis for guidance for both taxpayers and the Commissioner. To introduce a new provision would eliminate any certainty gained from recent cases. It may well be in excess of a decade before the views of the High Court are expressed on any new anti-avoidance provision. In the intervening period the operation of the provision is devoid of any certainty.

In the interests of certainty, the comments of the Chairman contained in the letter to the Treasurer of 22 February are to be resisted. There is no justification for legislation by press release. It should first be established that such transactions are not caught by the existing anti-avoidance provisions before the need for remedial legislation is introduced. Alternatively, if the interests of the revenue at issue are significant, those transactions that are considered suspect should be adequately described to provide some minimal level of certainty. Taxpayers are entitled to operate under the law as it is presently enacted in formulating transactions rather than being subject to a press release lacking in detail.

Taxation of entity groups

Taxation of entity groups

Chapter 25 – a case for consolidation
Chapter 26 – a framework for consolidation
Chapter 27 – determining the cost base for the disposal of equity

GENERAL COMMENTS

A case for consolidation

21.1 Subject to the principles discussed in the Executive Summary being incorporated in a tax consolidation regime and associated legislation, the Institute supports the introduction of such a regime.

21.2 The Institute endorses the seven reasons for introducing a consolidation regime set out at ***paragraph 25.3*** of *Platform*, but with some qualifications.

21.3 It should be recognised that rules addressing the problems set out at 25.3 are likely to be introduced which will operate independently of consolidation. For example, changes to timing rules in particular arising from the taxation of physical assets and financial assets and liabilities as envisaged in Chapters 1 to 7 will reduce the ability of taxpayers to avoid tax through intra-group dealings. This is not to endorse all of the various options discussed in those chapters, and is merely to comment that some of those options, or a variant of them, are likely to be adopted and will limit tax avoidance through intra-group dealings.

21.4 The Institute endorses all of the comments at ***paragraphs 25.8 to 25.17*** of *Platform*. In particular, the Institute supports the introduction of further Corporations Law amendments as discussed at ***paragraphs 25.15*** to assist group restructuring.

21.5 A consolidation regime could assist business through reduced compliance costs and reduce impediments to group restructuring and would promote greater equity by eliminating double taxation and loss duplication on the part of those entities that were members of the consolidated group. There would, however, be additional compliance costs arising from consolidation (particularly when group members exit from groups subject to the "entity approach" as contrasted to the "asset approach"). Policy options should be preferred which will minimise those additional compliance costs, subject to equity and efficiency objectives being satisfied.

Foreign owned groups – should a resident holding company be a requirement?

21.6 *Platform* at 26.3 states that the decision to be taxed as a single consolidated entity or to continue to be taxed as separate entities should be optional. The TIA endorses this view.

21.7 *Platform* then states: "Those groups choosing to enter the consolidation regime would be required to have a resident holding entity at the head of the group in order to give practical meaning to the concept of a single Australian taxpayer." What is intended by "practical meaning" is not explained. Presumably the main concern is in relation to determining the cost base for disposal of equity when a company exits from the group.

21.8 The Institute believes a number of mechanisms could deal with this concern. Assume a foreign owned group comprises the companies shown in Figure 1, with only Y and Z being Australian resident companies. There is what may be called a "multiple entry problem". Under the "all-in" principle all 100% owned resident entities must join a consolidated group if there is an election to consolidate. Y and Z cannot consolidate as they do not have a resident holding company. Nor could Y and Z form two consolidated groups with their respective subsidiaries (not s*h*own in Figure 1) under a strict application of the "all-in" principle, as there would be resident 100% owned entities outside each respective group. The Institute supports "selective grouping" (explained in this submission at pages 11-16). "Selective grouping", if it were adopted would partly solve this problem as it would allow Y to form a consolidated group with its 100% subsidiaries, and Z and its 100% subsidiaries to form another group. However this would not provide a complete solution to the multiple entry problem as it would not permit Y and Z to consolidate – which might be a legitimate commercial objective if Y and Z operate under common management and as a "virtual company".

21.9 The Institute is of the view the multiple entry problem can be solved in the following way. If Y and Z elect to consolidate, a condition of the consolidation regime could be that B and C must also join in the election although they would not become members of the consolidated group. The effect of B and C being signatories to the election would be that B and C would agree to the consolidation rules applying on the exit of Y or Z from the consolidated group in respect of the determination of the cost base of Y and Z and so that if assets were shifted from Y to Z or vice versa, the cost base of B and C in their underlying subsidiaries would be determined under the consolidation rules and not under the general capital gains tax rules.

Figure 1

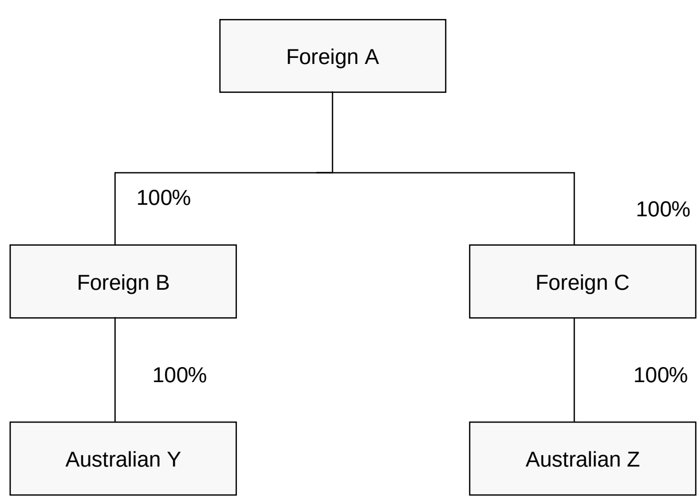
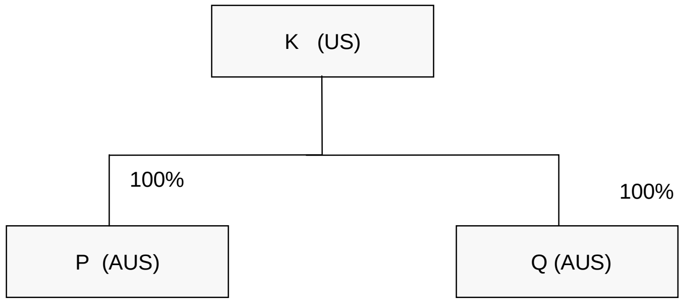
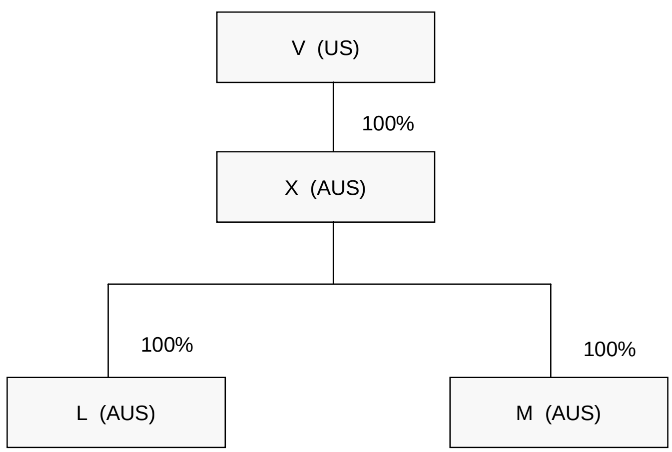


Figure 2



1

Figure 3



21.10 As will be explained shortly, there would be additional rules applying on the disposal of an interest in Y or Z as top companies of the consolidated group, although on a disposal by Y or Z of any of their subsidiaries, the normal consolidation rules would apply.

21.11 The legislation might also provide that where B and C are signatories to the election, there would be joint and several liability on the part of B and C for any capital gains tax of the other in the event of a group member exiting. For example, assume that Y is sold and B does not pay the capital gains tax on the sale in accordance with the consolidation regime. C would also be liable for the unpaid capital gains tax, and the ATO would have a claim against C's assets in Australia, in particular, Z. This would give the ATO recovery rights for unpaid tax similar to those it would have if there had been an interposed holding company in Australia that held all of the shares in Y and Z.

21.12 *Platform* suggests at 26.50 that Australia might be prepared to give special roll-over relief to allow a resident holding company to be interposed, where at present there is no Australian resident holding company for foreign owned groups that currently enjoy the grouping concessions. The effectiveness of this roll-over relief would be dependent upon other countries also allowing roll-over relief.

21.13 This relief would not be available under Australia's own capital gains tax rules if an Australian owned consolidated group were seeking to reorganise in a foreign country to take advantage of group consolidation relief in that country. Australia should not assume that other countries will provide relief for such reorganisations, when equivalent relief is not available here.

21.14 The Institute is aware from comments of its members that there may be a number of foreign owned groups in Australia that do not have a common holding company and currently rely on grouping concessions. Not all of these groups may be able to reorganise so that there is a common holding company, nor should they have to do this when a simpler and less expensive solution is available that provides equivalent recovery rights for unpaid tax.

21.15 The Institute acknowledges that there are two concerns that the government has with allowing a foreign group to consolidate without a resident holding entity. The first of these concerns is the difficulty in verifying whether the members of the group are in fact 100% owned. A concern has been expressed that where there is separate ownership of Australian members through chains of foreign companies it may be difficult to detect minority offshore shareholdings that might cause failure of the 100% ownership requirement.

21.16 The Institute points out that this does not seem to have been a problem with the transfer of losses between a foreign owned group of companies under former section 80G of the ITAA 1936. Section 80G was introduced in 1984 and is a provision of long standing. Consolidation is a more radical step than loss transfers under section 80G, and it might be appropriate for the public officer of a consolidated foreign group lacking a resident holding company to file an undertaking, accompanying the election to consolidate, stating that the 100% ownership test has been satisfied and setting out the evidence that he or she has obtained to confirm that all group members are 100% owned. Each year the public officer could be required to renew this undertaking.

21.17 A second concern has been raised in discussions with government. This is a potential capital gains tax advantage that could arise when a consolidated foreign-owned group exits from Australia and there is no Australian holding company. The tax advantage could occur in the following way. Assume as in Figure 2, that a US company K has two 100% directly owned Australian subsidiaries P and Q. P and Q are capitalised at $100 each, being $200 paid up capital overall. Assume P and Q are part of a consolidated group under the proposal here. P employs its $100 capital to make a $900 profit after tax. This $900 profit is reinvested by P and is not distributed to its US parent, K. K's cost base in P will therefore be $1000 under the asset method. Assume K wishes to sell off both of its Australian subsidiaries and that Q's value has remained unchanged. Its cost base under the asset method for both subsidiaries will be $1,100 overall.

21.18 This may be contrasted with the position shown in Figure 3, if a US holding company V holds an Australian subsidiary X which is capitalised as to $200. X has 2 Australian subsidiaries, L and M. which are capitalised at $100 each, being $200 overall. Assume L makes an after tax profit of $900 which it reinvests so that X's cost base under the asset method is $1000. The US company V decides to exit from Australia by selling X. Its cost base in the Australian group will be $200 and there would be a substantial capital gain if X is sold for $1,100, being the underlying value of its assets, resulting in double tax.

21.19 It may be pointed out that it is unlikely that V would sell X in this way. It is more likely that L would distribute the $900 after tax profits to X which would in turn distribute those profits to V free of withholding tax as they are fully franked. Assuming that the taxed profits of V were distributed in this way, a sale of X would produce an identical tax result to a sale of P and Q as described above subject to an exception. If X were sold after all taxed profits were distributed, X would no longer have any franking credits whereas P would still have valuable franking credits.

21.20 The asset-based model and entity-based model proposed in *Platform* already appear to deal adequately with tax preference amounts to the extent to which they recognise depreciation and capital allowances by way of an erosion of the holding company's cost base in subsidiaries. Further work is required for dealing with any other tax preferences identified and the following approach may be relevant in this regard. Where there is a disposal of equity in an Australian group member that is held *directly* by foreign interests, (i.e. there is no interposed Australian holding company) to the extent that the cost base under the asset method exceeds the historic cost base, there should be an appropriate debit to the franking account. To the extent that the franking account is insufficient, for example if some part of the $900 profit in P had been untaxed, capital gains tax would be payable in respect of the difference attributable to the shortfall in the franking account.

21.21 The effect of such a rule would be in effect to make P and Q into joint holding companies. This rule would not apply in respect of the disposal of subsidiaries of P and Q as each would in effect be a holding company for the group.

21.22 Where there is a resident holding for a consolidated group, the tax attributes of the group, namely franking credits and losses, belong to the holding company. In the case of a foreign owned group where there is no resident holding company, the tax attributes of the group should belong to no group member in particular and should be accessible to all members of the group, for example when paying dividends to foreign holding companies. As members exit from the group, the tax attributes of the group would ultimately accrue to the last surviving member of the group, which should continue to have the benefit of those attributes if and when it is disposed of. This would place the sole surviving resident member in a similar situation to a resident holding company.

21.23 A final issue to consider is whether the proposal here to allow consolidation of foreign owned companies without a resident holding company should be a transitional measure available only for groups existing at the commencement of the consolidation regime. Assuming that rules can be designed that will place such groups in a similar position to foreign owned groups that have a resident holding company, there is no reason why this consolidation option should be made available only to existing foreign owned groups. A situation might occur where there is a merger of two foreign multinationals, each of which has its own consolidated group of Australian subsidiaries. It might be commercially difficult for these two groups to consolidate. This option of special consolidation rules for foreign owned groups in Australia lacking a common Australian holding company should therefore be available prospectively as well as for existing groups. The greater complexity of the rules necessary for this option mean that it is likely that many multinationals when they invest in Australia will prefer to invest in Australia through a single parent company and that some existing groups might wish to interpose a holding company where this did not cause problems in the country of residence of the ultimate holding company.

21.24 By way of summary the Institute believes the multiple entry problem can be solved in the following way:

- Selective grouping would partly solve the problem, as foreign-owned groups with two or more Australian holding companies could form separate consolidated groups under each Australian holding company.

- Roll-over relief should be available to allow foreign groups to interpose a common Australian holding company which would then allow all eligible Australian subsidiaries to join the consolidated group and be taxed under the general consolidated tax rules.

- Additional and stricter rules should be enacted to allow foreign-owned groups to consolidate without a common Australian holding company. The additional rigour of these rules would encourage foreign-owned groups to avail themselves of the roll-over relief at (2) above – but some foreign-owned groups may be unable to interpose a common Australian holding company – as this may cause problems in the country of residence of the ultimate holding company. For this reason (3) should be available.

- The special consolidation rules available under (3) for foreign groups with no common Australian holding company should not be limited to groups in existence at the commencement of the regime. This should be a permanent feature of the Australian tax system.

"All-in" versus "selective grouping"

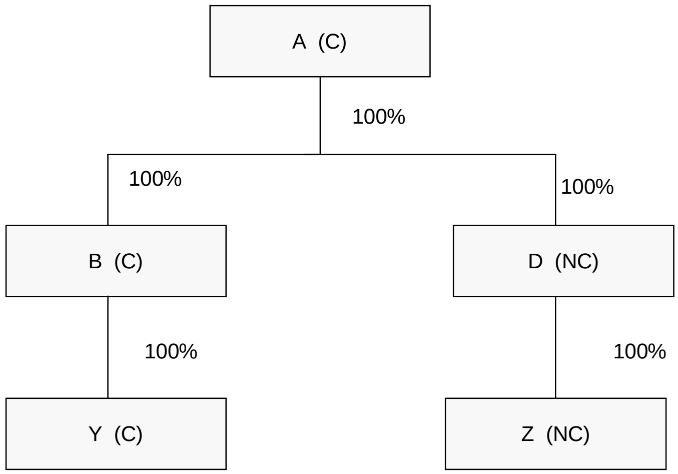
21.25 *Platform* at 26.4 states: "Robust arrangements require all of a holding entity's Australian wholly owned companies and trusts, including entities acquired in the future, to be included in the consolidated group. This is referred to as the 'all-in' principle." Concerns are expressed in *Platform* regarding potential exploitation if selective grouping were allowed with some wholly owned entities being absent from the group and taxed separately.

21.26 The Institute is of the view that the "all-in" principle is not essential to "robust arrangements" and supports "selective grouping", but with appropriate restrictions that would make selective grouping "robust" from a revenue viewpoint. The restriction should be that sister companies can only consolidate if their immediate common parent is also a member of the consolidated group. An exception to this rule would be where the sister companies are owned by a foreign parent that has made an election as recommended at pages 5 to 8.

21.27 Figure 4 is an example of how selective grouping could work. A, B and Y would be a consolidated group as indicated by "(C)" appearing in their boxes. However, companies D and Z would not form part of the consolidated group as indicated by ("NC") appearing in the boxes in respect of those companies. Under selective grouping rules, if D is not consolidated, then its subsidiary Z should not be able to consolidate either. However, if D elected to consolidate, then Z should also be able to elect to consolidate, provided 100% of its equity is held by a member of the consolidated group. If selective grouping along these lines is permitted, it should also be possible for D and Z themselves to form a consolidated group if they so chose while A, B and Y formed another consolidated group.

2

Figure 4



21.28 The selective grouping rule proposed here is more restrictive than the selective grouping that is available in New Zealand. New Zealand would allow Z to form a consolidated group with B, Y and A even if D was not a member of the group. New Zealand does not have a capital gains tax regime which is why a generous selective grouping rule does not appear to cause a revenue problem there.

21.29 Selective grouping that incorporates a principle that sister companies can only consolidate if their immediate common parent is also consolidated with that group would provide, in the Institute's view, a "robust arrangement". The immediate parent company rule would only be waived in the case of foreign groups where there is no common Australian holding company and alternative, but equivalent, safeguards would apply.

21.30 The New Zealand Government has explained why it has such a liberal regime for selective grouping in these terms:

"Finally, there will be no requirement that one member of the consolidated group be a parent company with all other companies in the group being direct or indirect subsidiaries of that parent. It will thus be possible for two sister companies to consolidate with the parent being outside the consolidated group. This will enable New Zealand resident subsidiaries of a non-resident company to elect to be taxed under the consolidation option.

21.31 Compared with the requirements of overseas consolidation regimes, these rules are relatively generous. For example, the USA requires that every company in a group that meets the consolidation criteria must be included in the consolidated group if a consolidation option is adopted. Similarly, the USA, Germany, France and other countries having consolidation regimes, normally require consolidation with a parent and do not allow consolidation of two sister companies without the parent. It is considered unnecessary to impose such strict criteria in the context of the New Zealand proposals and the New Zealand tax system. ***Any attempt to force consolidation would also encourage companies that did not wish to be included within a consolidated group to structure so that they did not meet the consolidation criteria."*** [emphasis added][1]

21.32 New Zealand has a 100% common ownership requirement for consolidation. An "all-in" principle combined with a 100% common ownership threshold test could be easily evaded by having a small minority shareholding in companies that were to remain outside the group. The countries mentioned by the New Zealand Government in its comments as having an all-in requirement all have a threshold for consolidation of less than 100%. Where the threshold was lower it would be more difficult to exclude a company from a consolidated group in this way as it would be necessary to increase the level of outsider shareholdings, to ensure that the excluded company fell below the threshold. The reasoning that caused New Zealand to adopt selective grouping applies also in Australia with Australia's proposed 100% threshold.

21.33 Another reason why New Zealand rejected the all-in principle may have been that it lacks a capital gains tax. The Institute believes that the requirement that an immediate parent company join in the group, if two sister companies elect to also group, satisfies this concern.

21.34 There are a number of commercial reasons not directly related to Australian tax why a 100% owned group might wish to exclude some eligible members:

- The joint and several liability obligations for Australian tax may create borrowing problems for a member that wishes to borrow independently of the group.

- A member of a group may be a life insurance company, general insurance company or bank and have to satisfy certain regulatory and prudential requirements that may be inconsistent with joint and several liabilities for tax of a large and complex group of companies.

- *Platform* at pages 728 to 733 discusses the option of allocating franking credits of a life insurance policy between shareholders and policy-holders. This proposal would be inconsistent with consolidation where the franking account was held by the top company in the consolidated group. Depending on how this allocation of franking credits might operate in practice, it might be necessary to exclude a life insurance company from a consolidated group to escape from the common franking account rules that would apply to a consolidated group.

- It is acknowledged in *Platform* at page 555 that consolidation might cause difficulties for foreign owned consolidated groups:

[1] Honourable Ruth Richardson and Honourable Wyatt Creetch *Supplement on Business Tax Policy 1991*, 30 July 1991, Chapter 5 at page 8 (Electronic copy)

"First, the Australian consolidation regime, as outlined, would disregard for Australian taxation purposes income earned by a subsidiary – that is designated by another country as a CFC – from another company within the consolidated group. The CFC rules of another country could seek to tax part of the CFC-designated subsidiary's income even though the CFC does not directly pay Australian tax on this income.

Second, since the Australian consolidation regime would make a consolidated group's holding entity liable for tax, the group's member entities may be regarded by the CFC rules of another country as escaping Australian tax. Were this to occur, the CFC's non-resident shareholders could become liable for additional tax in the foreign jurisdiction.

In these cases it is also questionable whether a credit would be allowed under another country's CFC rules for tax paid by the Australian resident holding company on profits referable to activities of a CFC-designated subsidiary. Even if a credit were allowed, it could be difficult in practice to ascertain the tax paid by the holding company on behalf of the subsidiary. Problems could therefore arise in determining the amount of a credit that can be claimed. "

Platform goes on to say:

"In cases where the CFC type regimes of other countries were incompatible, would it be necessary for affected company groups to remain outside the consolidation regime? What would be the consequences for investment in Australia by such company groups?"

Selective grouping would reduce the significance of these problems discussed in *Platform*. For example, a consolidated foreign owned group in Australia might exclude those eligible companies which were likely to give rise to the difficulties described.

- Another foreign tax reason why a foreign-owned group may wish to exclude some eligible companies from the consolidated group would be where an eligible company is in losses and the foreign group wishes to pay maximum Australian tax up to the level of foreign tax credits available in the country of residence of its ultimate parent.

21.35 There are also some legitimate Australian tax reasons why some eligible companies should be permitted to remain outside a consolidated group:

- A group member may be in losses. The top company in the group may wish to frank dividends paid to shareholders. If the loss company forms part of the consolidated group, the grouping of losses may reduce the top company's ability to frank dividends. Under existing rules Australian groups may choose not to transfer all available losses to the top company *so* that *they can pay more Australian tax with a view to increasing the franked amount of dividends.*

Typically, this might be the case with a listed group, whose shareholders have come to expect a certain level of franked dividends. Selective grouping would allow a consolidated group to exclude a loss company, in order to maintain a flow of franked dividends to shareholders. A similar situation may arise with a foreign-owned group which may wish to maximise Australian tax up to the level that foreign tax credits are available in the country of residence of the ultimate holding company. Foreign-owned groups may therefore also wish to take advantage of selective grouping *so that they can pay more Australian tax.*

- A company that is not a member of a consolidated group may wish to acquire a consolidated group. Under the all-in principle, if this company acquires 100% of a consolidated group, this will trigger de-consolidation, which may cause commercially unacceptable tax consequences for the consolidated group. The proposed acquirer may therefore be inhibited from acquiring the consolidated group. This impediment to acquiring the group would not apply, for example, to an individual or non-resident entity acquiring the group.

- At present where a tax paying company is acquired with debt, it may be possible to structure the acquisition in such a way that there is no wastage of dividend rebates in relation to dividends paid by the acquired company. Unless the rules regarding dividend rebates are changed, as suggested at pages 3 and 25 to 26 there may be a problem with wastage of dividend rebates if a tax paying company is acquired by a consolidated group with debt finance.

21.36 The reasons given at 26.5 in favour of the "all-in" principle are that it would:

- prevent the exploitation of intra-group transactions to defer tax by, for example transactions between the consolidated part of a group and unconsolidated parts to allow a later recognition of income and earlier recognition of expenses;

- Prevent loss duplication and value shifting and shifting; and

- overcome the re-characterisation of interest expenses in order to claim a deduction against tax-exempt income.

21.37 *Platform* has suggested options which would in general address all of the problems outlined at *26.5.* For example, if the rules for the taxation of physical assets and financial assets and liabilities are aligned more closely with economic values as proposed in chapters 1 to 7 of *Platform* the ability to exploit the later recognition of income and earlier recognition of expenses in intra group transactions will diminish. Rules to attack loss duplication and value shifting are proposed in chapters 28 and 29 of *Platform* that would apply to all groups of entities, not just 100% owned groups. *Platform* at 33.28 proposes that interest deductibility will be denied in highly geared control cases, which is presumably the issue referred to in the re-characterisation of interest expenses to obtain a tax deduction against tax-exempt income . Overall the Institute considers that using the all-in principle to attack these problems is inappropriate.

Should minor holdings preclude consolidation?

21.38 The Institute has been advised by government representatives that a 100% common ownership test has been preferred as lower thresholds require more complex rules to prevent streaming, and intra-group adjustments are more complex. There is an inconsistency between the 90% common ownership test for GST groups and the 100% common ownership requirement for income tax consolidation.

21.39 Notwithstanding this inconsistency, the Institute is prepared to support a 100% common ownership test for income tax consolidation of groups if it can be established that more complex rules and adjustments would be required if the threshold were below 100%. The New Zealand government, when deciding on a 100% common ownership test, referred to a 95% common ownership test in France, 99% for the Netherlands, the single economic entity requirement for Germany and the 80% requirement for the US, and commented that:

> "Generally, the higher the degree of common ownership required, the simpler and more comprehensive is the consolidation approach. For example, the relatively low threshold required by the USA results in a system that is less than full consolidation with only some intra-group transactions being ignored for tax purposes."[2]

21.40 There is a remaining issue as to whether there should be a departure from the 100% requirement to allow limited employee share ownership, special purpose finance shares and non-voting preference shares. It is more common in practice for all of these types of shares to be issued by the holding company than by subsidiaries. Even in the case of foreign owned groups, it is normal for Australian employees to be given employee shares in the top foreign entity. It is possible that an employer may want to give options or employee shares in a particular subsidiary where an employee or group of employees are making a major contribution to the business of that subsidiary. Where this is the case, it is likely that the shares or the options given to employees would constitute more than a nominal amount such as 2% or 3% of the issued capital. Any meaningful issue of employee shares or options in a subsidiary is likely to exceed the de minimis holding that would be permitted for employee shareholders under a 100% test.

21.41 Overall the Institute is of the view that a de minimis exception for employee shares, although desirable in principle, might be used only infrequently, notwithstanding the fact that the New Zealand Government came to an opposite conclusion[3]. There is no obvious policy reason why the 100% requirement should be relaxed to allow the issue of special purpose shares or non-voting preference shares by a subsidiary member of a consolidated group. Nevertheless some shares of this type exist and there is no obvious policy reason why company groups that have subsidiaries which

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[2] Ibid, Chapter 5 at page 6 (electronic copy)
[3] R D Judge and P Barrand *Officials' Report to Finance and Expenditure Select Committee*, 19 June 1992 at para 22.

have issued such shares to non-members should not be allowed to consolidate, where the issue of these shares is by way of a financial arrangement.

The inclusion of trusts in a consolidated group

21.42 The Institute strongly agrees with the discussion in *Platform* at 26.8 to 26.9 that where the only objects of a discretionary or hybrid trust are members of a consolidated group of companies, the trust should also be included in the group, at the election of the trust on the basis that "selective grouping" is available.

21.43 The Institute agrees that if a member of a consolidated group is an object of a discretionary trust and the consolidated group controls the trust, the trust should be included in the consolidated group, subject to the trust electing to be consolidated, assuming that "selective grouping" is available.

21.44 The Institute agrees that, subject to the selective grouping principle, a hybrid trust should be included in a consolidated group if the group members hold all fixed entitlements and, at least one member is a discretionary object of the hybrid trust and the group controls the trust.

21.45 A "tiebreaker rule" is discussed at 26.14 of *Platform*. The TIA would prefer a "tiebreaker rule" based on an election rather than on the prior history of distributions.

21.46 The Institute agrees with the option at 26.17 in *Platform* that penalty tax should be imposed if a discretionary or hybrid trust heads a consolidated group and distributions are made by any other trust within the group to a non-group member, subject to the exemption proposed in paragraph 26.35.

21.47 The Institute agrees with the suggestions at 26.20 and 26.21 of the *Platform* that "tagging" would be desirable in respect of goodwill where there is a group consisting of companies and trusts.

21.48 The Institute disagrees with the proposal 26.22 of *Platform* that groups of family trusts and companies be consolidated under general rules. Instead the Institute would prefer a special optional regime as proposed at 26.23 details of which are set out at 26.24 to 26.30. The Institute also would strongly support that in the event of such an optional regime being adopted it is essential that adequate rollover rules be introduced to facilitate the restructuring of family trusts and companies as a consolidated group. This rollover rule should be available for family group restructures occurring before 1 July 2003, or possibly a later date, depending on the commencement date of a consolidation regime. *Platform* at 26.32 suggests a period of 2 years after the introduction of consolidation regime. Assuming this was introduced on 1 July 2000, and that state stamp duties are repealed (except for real estate) only as at 1 July 2001, a 2 year period to facilitate rollovers from 1 July 2001 would be appropriate.

21.49 The Institute agrees with the proposals set out at 26.35 and 26.36 of *Platform* permitting distributions direct to family members who elect to consolidate, rather than indirectly through the head entity, subject to penalty tax being payable on distributions to other than family members.

21.50 *Platform* at 26.37 comments that with the introduction of a consolidation regime, the family group concessions in relation to the income injection test and the deduction of certain losses and debt deductions would be removed. The family group concession is available for family trusts that make an election and where there is only one family trust with family members who are beneficiaries. It would be inappropriate to repeal family group concessions completely and a family group concession should be retained for stand-alone family trusts which distribute only to natural persons who come within the family group as defined in the legislation. The effect of this would be that family trust distributions tax would be payable where there was a distribution by such a trust to another trust or family entity that might currently qualify as a family group member under existing rules.

21.51 Family trust rules are especially relevant for small and medium firms of tax practitioners. The pace of tax reform in recent years has caused difficulties for many of these small and medium sized firms. Practitioners in these firms, unlike specialists in large firms, must have a working knowledge of all of the regulatory and tax issues that may arise for their clients. Preparing their clients for the GST will require a major effort. The existing family trust rules are complex and it is likely that further changes to these rules flowing from the introduction of a consolidation regime will not be understood well at first by many tax practitioners.

21.52 What is needed are some transitional rules limited to an introduction period of perhaps 3 years to allow elections to be made out of time and the reversal of distributions and elections made through inadvertence or misunderstanding during this transitional period. The Commissioner should be given a broad discretion in such cases so that abuse does not result. Where a distribution is reversed and a tax deferral has occurred, some interest might be assessed.

Once a group elects to consolidate, should the election be irrevocable?

21.53 *Platform* at 26.38 states: "Once a group elects to consolidate it would not be able to revoke its election subsequently. Moreover, if a consolidated group is purchased by an entity that is part of a group which is not consolidated, deconsolidation would be triggered".

21.54 The Institute disagrees strongly with the second sentence in this quotation, as the Institute supports "selective grouping" which would be inconsistent with automatic deconsolidation occurr-ing when a consolidated group was acquired by a member of an unconsolidated group.

21.55 Under New Zealand law a company that is a member of a consolidated group can simply cease to be a member by giving a written notice to the New Zealand commissioner: section FD8 of the Income Tax Act 1994 (New Zealand). *Platform* gives no reason for making an election to consolidate irrevocable. Fairly clearly, if an election has been made to group for a particular year, this election should not be revocable. However, no policy reason is given for opposing a prospective revocation of an election to consolidate. The New Zealand Government's 1992 Briefing Paper on Consolidation did not discuss why an election to leave a consolidated group was provided. Presumably, this is allowed in New Zealand because a 100% common ownership rule makes it easy for a group member to deconsolidate merely by issuing a small number of shares to a minority shareholder. A prohibition against prospective revocation is impossible to enforce in practice where there is a 100% ownership test and should not be a feature of the Australian consolidation regime.

21.56 There may be valid commercial reasons why a group member may elect to deconsolidate. For example there may be an intention of selling the group member at some point of time in the future. Buyers may be cautious about purchasing a company that is jointly and severally liable for the tax debts of the group. The company may be more commercially attractive if it has not been part of a consolidated group for some time prior to the sale. Deconsolidating a year or so before the sale may also allow a clean deconsolidation at year end. A sale of the company mid year may cause complexity, if there are part year consolidation rules.

21.57 A group member that has temporarily gone into losses may wish to deconsolidate if the consolidated group wants to continue paying existing levels of Australian tax so that it can maintain a flow of fully franked dividends that its shareholders have come to expect. A foreign-owned group may find itself in a similar position if it wants to pay Australian tax up to the permitted level of foreign tax credits allowed for its ultimate holding company in its country of residence.

21.58 The Institute therefore would support the enactment of a provision along the lines of section FD8(1)(a) of the Income Tax Act 1994 (New Zealand).

Consolidated groups treated as a single entity

21.59 In broad terms the Institute agrees with the comments of *Platform* at 26.40 to 26.67.

21.60 *Platform* at 26.43 states: "Members of a consolidated group would lose their separate tax identity on entry to the consolidation regime and subsequently acquire a new tax identity when they exit. Non-preservation of tax identity could pose problems especially in relation to recognising taxable income and ascertaining deductions". An example is given of a trade debt acquired prior to an entity entering a consolidated group, but after entry the group seeks to write-off the debt owed and claim a tax deduction.

21.61 The Institute is of the view that tax attributes acquired by an entity while it is 100% owned by a group should transfer to the group when that entity becomes a member of the consolidated group. This situation could arise in relation to existing company groups when the consolidation regime commences. It might also arise if option 6 discussed at 26.99 of *Platform* were adopted. This option would leave wholly owned loss entities outside a consolidated group until the carry-forward losses are recouped. It might also arise if selective grouping is adopted. If selective grouping is permitted, tax attributes acquired by an entity after it becomes eligible to join the group, should transfer to the group once the eligible entity joins.

21.62 The Institute broadly agrees that when a member exits from a group, tax attributes such as foreign tax credits, losses and franking credits should remain with the group.

21.63 There are also wider characterisation issues which require examination. How will a consolidated group's tax return be prepared? If a consolidated return is prepared by aggregating the notional income tax returns of group members, with intra-group transactions being ignored, there may still be characterisation problems. For example, a group member may purchase plant which is used by other members for producing assessable income. If no payment is received from other group members for the use of the plant, depreciation would not be claimable by the plant owner, as the plant will not be income-producing for the group member. Additional legislative rules for deductions by members of a consolidated group would provide a solution for this problem.

21.64 An alternative to the aggregation of notional tax returns by individual members would be a "top-down" approach. This would treat the group as being a single entity with each of the members being divisions. *Platform* at 25.7 suggested that a tax consolidation regime would "simplify the tax system and reduce compliance costs". The New Zealand government came to an opposite conclusion, finding that "the one tax return requirement will marginally increase the costs of groups that elect to consolidate."[4] It is not entirely clear from *Platform* what differences there may be between the Australian and New Zealand approaches that will cause an expected reduction of compliance costs in Australia from consolidation, while the New Zealand government expected a slight increase in costs. Two possible differences are the treatment of intra-group transactions and the preparation of separate accounts by each entity in the group. When announcing its intention of introducing a consolidation regime, the New Zealand government stated:

21.65 "Only one consolidated income tax return will be required covering all members of the group… Attached to the return will be the tax accounts for each group member. Those accounts will include all intra-group transactions. The actual consolidated return will be the sum of income/losses of each member less intra-group transactions.

21.66 "Intra-group transactions will not be automatically self-cancelling within the group. That is because a number of transactions can result in income and expenditure between two taxpayers being recognised in different periods since the time income is derived is not necessarily the same in which expenditure is incurred…

[4] Ibid at para 44.

"The requirement to provide separate accounts for each company in the group is considered necessary for the proper policing and administration of the income tax system."[5]

21.67 By way of contrast *Platform* at 26.41 states: "Under the consolidation regime, all transactions between members of a consolidated group would be ignored for tax purposes." It is apparent from this comment that even where there are timing differences, it is currently proposed that under an Australian consolidation regime all intra-group transactions will be self-cancelling without exception.

21.68 *Platform* also makes no reference to a requirement for separate accounts. Some Australian consolidated groups do not prepare separate statutory accounts that are audited for each member (although separate unaudited accounting records are kept for each member) and a dispensation from a requirement to keep separate accounts would be a compliance saving as compared to New Zealand.

21.69 At this stage the Institute does not have a concluded view as to how a consolidated return should be prepared and what detailed rules may be necessary. An approach should be adopted that takes into account the differences that may exist between the accounting systems of different company groups and that will not require companies to redesign their accounting systems. Some flexibility should be allowed, provided this produces the same set of numbers in the tax return.

21.70 There is no discussion within *Platform* of the details of joint and several liability. Section HB 1(2) of the Income Tax Act 1994 (NZ) in broad terms states the joint and several liability for an assessment of a particular year will not apply to a member that leaves a group where the Commissioner has issued an assessment after the member has left the group, and the Commissioner is satisfied that excluding the exiting member from liability will not prejudice recovery of income tax for the year. The nominated company of a consolidated group may also apply under section HB 1(3) before an assessment of income tax for the relevant year that only one or more companies in the group be treated as jointly and severally liable for the income tax liability of the group. The Commissioner may grant this application subject to the recoverability of the income tax not being significantly prejudiced by this limitation on liability. The Institute strongly agrees with similar discretions being given to the Commissioner under an Australian consolidation regime.

21.71 The sale of a group member, unless the sale is for less than market value, should not in itself prejudice the ability of the Commissioner to recover unpaid tax, as the proceeds of the sale will leave the overall value of the group, and the group's capacity to pay unpaid tax, undiminished.

Replacing the existing carry forward loss rules for all entities

21.72 A problem arises with the same business test if the "top down" approach is adopted. Some consolidated groups may consist of hundreds of companies and such a group

[5] Op cit, footnote 1, chapter 5 at page 9 (electronic copy).

will rarely if ever be able to satisfy the same business test on a year-to-year basis if its tax return is prepared on the basis that it is a single entity. This problem is referred to by *Platform* at 26.84. With listed companies that have volatile share registers there may be changes in majority ownership over a period of a few years where there has been no change in the control of the group. A change in majority ownership may occur simply because of portfolio shareholders coming and going.

21.73 There is a major compliance problem for listed companies in tracking changes in majority ownership from year to year. Tracking these changes may be impossible for some foreign owned groups which issue bearer shares. The information may simply not be available. The same business test has been criticised in a recent article by Gordon Longhouse, on the basis that it may lead to economically inefficient outcomes, for example where a company does not introduce new business methods for fear of failing the same business test.[6]

21.74 Where the vendors of the entire shareholding of a company have obtained a deductible capital loss on the sale broadly equal to the company's undeducted revenue losses, there is no policy justification for allowing the new shareholders to obtain the benefit of the carry-forward losses in the company. However, situations may occur where the deduction of carry-forward losses may be justified, notwithstanding a change in ownership:

- For example, the vendors of a company with undeducted losses (for tax and accounting purposes) may sell their shares for more than the shares' paid up value and may be liable for capital gains tax on the sale because it is anticipated that the company will earn profits in the future. The vendors will in effect be taxed on the company's future profits. When those profits are later earned they will be taxed again in the hands of the company unless the carry-forward losses are deducted.

- Vendors may pay capital gains tax on the sale of shares in a company with tax losses (but not accounting losses) where the company has accounting profits, and the tax losses result from accelerated tax depreciation or accelerated tax amortisation of capital assets. The accounting losses will only emerge in later years when the economic value of the capital assets in fact reduces. In such a case the new owners of the company should not be deprived of carry-forward losses, which were accelerated and incurred for tax purposes during the period of ownership of the previous owners, but which are incurred in an economic sense, during their period of ownership.

- Particularly with listed companies a change in the underlying majority ownership may result from normal turnover on the share register by portfolio investors. There may be no change in the management or control of the company. In this

[6] Gordon Longhouse the "same business" test and Cleopatra's Ark. Australian Tax Review, Volume 28, Number 1, 1999, Pages 4 to 12.

situation, a rule that prevents the company from deducting carry-forward losses will be unfair to continuing shareholders.

21.75 In the third of these examples losses will be unavailable when there has been a change in the ownership of just 51%, if the same business test cannot be satisfied. This will be unfair to the remaining shareholders holding 49% of the company. Rules to deny the carry-forward of losses were developed to discourage loss trafficking. Loss trafficking is difficult to define, although in practice the loss trafficker is often easily identified. The majority ownership test and the same business test were developed as objective tests to deter loss trafficking. They are clearly a failure. They may prevent losses being carried forward, where there has been no trafficking in losses, and they may allow losses to be carried forward and deducted, where the same business test has been satisfied, and the dominant purpose of the new owner of the company was to access the losses. As Longhouse has pointed out, the same business test may deter companies from re-organising their businesses to achieve greater efficiency. In recent years the administrative practice of the ATO and amendments to tax legislation seem to have lost sight of the original objective of the carry-forward of loss rules – which was to deter loss trafficking. As a result, tracking changes in majority underlying ownership has become an administrative nightmare for many listed companies.

21.76 *Platform* at 26.85 suggests that a "similar business test" might replace the same business test, but "it would have major revenue implications." The Institute is also concerned about those revenue implications and agrees that such a test would "go well beyond the policy rationale for the SBT [same business test]." The Institute believes another test could be implemented which would directly attack loss trafficking and would be more effective than existing rules in implementing an appropriate policy rationale. The existing rules for carry-forward losses should be replaced by a new set of rules which allow losses to be carried forward by entities except where there has been a change in the ownership of the entity and it can be established on the basis of objective criteria that the dominant purpose of the new owners when acquiring their interests in the entity was to access the losses. These objective criteria could include:

- the extent of the change or changes in the underlying ownership of the entity since the losses were incurred and the way in which that change or those changes occurred;

- the extent to which the prices paid by the new owners to acquire the interests is attributable to the value of the tax losses, and the extent to which the prices paid reflect the value of business assets such as goodwill and intellectual property in particular – in applying this criterion readily realisable assets, such as cash and portfolio interests in listed entities would be ignored;

- the manner in which the loss entity carries on its business after the relevant change or changes in underlying ownership, and the extent to which the loss entity's income after those changes is attributable to new sources of income, and in particular whether those new sources of income include businesses carried on, or assets owned, by the new owners before the change either directly or through other entities.

21.77 If it were established that this change in the loss carry-forward rules had unacceptable revenue implications, some consideration could be given to an appropriate expiry date for carry-forward losses, that takes into account the fact that the previous period – seven years – failed to take into account the length of time required for some investments, typically in infrastructure, mining and technology, to become profitable. It is also possible a loss trafficking rule to *replace* the existing carry-forward rules might have positive revenue implications. Formal compliance with the same business test may at present not be difficult depending on the circumstances of the new owner of a loss company.

Inter-company dividend rebates

21.78 *Platform* at 26.71 proposes the repeal of the inter-corporate dividend rebate where an unfranked dividend is paid between non-electing 100% commonly owned companies. New Zealand's original consolidation proposal also proposed to repeal the inter-corporate dividend exemption for 100% commonly owned companies, but this repeal did not proceed. The *Officials' Report to Finance and Expenditure Select Committee* stated:

"13. It appears that a substantial portion of the criticism that has been directed at the consolidation regime can be attributed to the link between consolidation and removal of the inter-corporate dividend exemption. In informal discussions with practitioners, it became clear that the consolidation regime is going to be characterised as a form of blackmail because, in their view, 100% commonly-owned groups (ie, specified groups) are being forced to consolidate in order to retain the inter-corporate dividend exemption.

"14. The government has decided to retain the inter-corporate dividend exemption for dividends between 100% commonly-owned companies that have the same balance date. This is expected to reduce, at least to some extent, the criticism that will be directed at the consolidation regime because 100% commonly-owned companies will not be required to consolidate in order to retain the inter-corporate dividend exemption."[7]

21.79 The New Zealand requirement for companies to have the same balance date was to limit the ability of *commonly* owned groups to defer income by transferring revenue to late balance date companies.

21.80 The Institute opposes the repeal of the inter-corporate dividend rebate for unfranked dividends as *proposed* by *Platform* at 26.71. The Institute would however support

[7] Op cit footnote 3 at paras 13 and 14.

the replacement of dividend rebates by a different mechanism for addressing the multiple taxation of dividends flowing between companies.

21.81 Where a company receiving a dividend is in a tax loss position, and is entitled to an intercorporate dividend rebate (either because the dividend is fully franked, or if it is unfranked, because the company paying the dividend has 100% common ownership) the dividend, to the extent that it does not exceed the tax loss, is not taxable and is offset against the tax loss and the dividend rebate is unused. Unused rebates are not refundable and cannot be carried forward.

21.82 At present company groups control dividend flows to ensure that rebatable dividends are not paid to companies with tax losses. Often the ultimate holding company has this role as it may not have an active business that can give rise to losses. Controlling dividend flows in this way will not be possible in the case of consolidated groups that have an overall loss situation, where every eligible company is a member of the group as proposed under the "all-in" principle, or where the holding company is a group member, as proposed in the model for "selective grouping" recommended here.

21.83 Some *mechanism* to prevent this wastage of dividend rebates is needed. There are three possibilities:

- Unused dividend rebates could be carried forward – or else, as is proposed by the government in the case of excess franking rebates paid to low rate taxpayers – there should be a refund of tax equal to the amount of the unused rebate.

- Dividend rebates could be replaced by the US system of allowing the recipient company a deduction for dividends.

- Dividend rebates could be replaced by exemption, subject to two provisos: (1) the rule that offsets losses against exempt income did not apply to these exempt dividends; and (2) expenditure, such as interest on borrowings, incurred in earning such dividends would continue to be deductible.

Should grouping concessions continue outside consolidation?

21.84 *Platform* states at 26.68 that once the consolidation regime commences, the current grouping provisions should be repealed, except non-concessional elements. Subject to rules being introduced that will effectively prevent the double counting of losses outside consolidated groups, the Institute opposes the repeal of existing rules that permit 100% commonly owned entities to transfer revenue and capital losses and supports the retention of these rules for companies that do not consolidate. In particular some foreign-owned groups may not be able to consolidate because tax consolidation in Australia would cause problems in the country of residence of the ultimate holding company. There may also be commercial problems for some Australian groups if they consolidate. The existing rules for the transfer of revenue and capital losses are restrictive and the Institute believes that the majority of 100%

commonly owned groups will prefer to consolidate rather than remain outside the consolidation regime. The existing concessions for transferring revenue and capital losses should therefore remain.

Bringing losses and franking account balances into the consolidated group

21.85 *Platform* at 26.90 to 26.99 discusses six options for bring losses into a consolidated group.

21.86 Option 1 proposes that as a transitional measure losses which can be grouped under existing rules may be brought into a consolidated group when a consolidation regime commences. The Institute agrees with this aspect of Option 1. Secondly, Option 1 proposes that losses which cannot be transferred, because they arose prior to the group member becoming 100% commonly-owned, but are still available to that group member should be brought into the consolidated group, because under the "all-in" principle that member would be effectively compelled to join the group and those losses would otherwise be lost. The Institute agrees with this aspect of Option 1, assuming that the "all-in" principle is adopted. If it is not adopted, this aspect of Option 1 is unnecessary, as an eligible company could remain outside the consolidated group under the "selective grouping" proposal until such time as it had absorbed its losses – or it concluded that the benefits of consolidation were greater than the benefits of accessing its prior losses.

21.87 Options 2 and 3 propose allowing carry-forward losses to be brought into a consolidated group subject to a modified same business test, with one tenth of the losses being brought into the pool of losses over a ten year period. The Institute does not support either of these options as they lack any clear policy rationale apart from rationing losses to limit the revenue loss.

21.88 Option 4 has a policy rationale – namely to look through to the underlying "owners" of the loss – and allow the preservation of losses based on the proportion of the group's interest in the loss entity when the loss was incurred. However this rule is arbitrary to the extent that there is likely to be a change in the underlying ownership of the acquiring group and the loss entity and this underlying ownership will continue to change as the losses are offset, assuming that the losses are offset over more than one year. In general the Institute does not support this option.

21.89 The Institute strongly supports Option 5, which would quarantine carry-forward losses within a group, so that a consolidated loss entity would carry-forward the loss, reducing its own notional taxable income without offsetting the losses against the notional taxable income of other group members.

21.90 The Institute also supports Option 6, which is also compatible with "selective grouping".

21.91 The Institute agrees with the comments in *Platform* at 26.102, which propose that existing franking account balances and carry-forward foreign tax credits be brought into a consolidated group.

21.92 On exit of a member, losses and franking account balances remain with the consolidated group

21.93 The Institute agrees with the comments at 26.103 and 26.104 that carry-forward losses and franking account balances remain with the consolidated group on the exit for a member.

Determine the cost base for disposal of equity

21.94 The Institute agrees with the analysis the respective advantages and disadvantages of the entity-based model and asset-based model in Chapter 27 of *Platform* for the determination of the cost base of equity in a member when it exits from the group.

21.95 The asset-based method is superior, as acknowledged by *Platform* at 27.36. In some cases the entity-based model only eliminates double tax on the disposal of the entity. Double taxation does not arise under the asset-based model. Value shifting rules are required for the entity-based model in respect of assets held on entry into consolidation. This does not arise under the asset-based model. The asset-based method would simplify compliance in the longer term, although there would be an initial valuation cost in resetting the cost base of the various assets, including goodwill, of the acquired entity on entry into consolidation to equal the acquisition cost of the entity. In many cases this valuation cost may already have been incurred by a purchaser on a due diligence.

21.96 As discussed by *Platform* at 27.31 to 27.37, the entity-based method will be more appropriate for existing groups that elect to consolidate at the commencement of the consolidation regime. There may also be a problem with the asset-based method where there is incremental acquisition of an entity as discussed at 27.42. Because of the superiority of the asset-based method, consolidating groups should be able to elect for the asset-based method, subject to the Commissioner's approval, in situations where the entity-based method might normally apply.

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Chapter 28 – Towards single recognition of losses and gains

GENERAL AND SPECIFIC COMMENTS

Proposal to remove the same business test

22.1 At ***paragraph 28.3*** of the *Platform*, it is pointed out that the same business test was introduced prior to the introduction of the capital gains tax system at a time when a capital loss could not be claimed on disposal of equity interests in a "loss company". Consequently, it is noted that in a capital gains tax environment, the same business test results in loss duplication.

22.2 The loss duplication apparently caused by the same business test appears to be the catalyst for the following definitive statement at ***paragraph 28.22*** calling for the removal of the same business test:

> "The continuity of ownership test allows access to realised but unrecouped losses incurred by an entity during the tenure of an owner by allowing that owner a tax loss on the disposal of equity. To prevent duplication, the entity being sold should be denied the ability to carry-forward its tax losses if it fails the continuity of ownership test (discussed in chapter 26). Thus, the same business test needs to be removed to prevent duplication."

22.3 The Institute strongly disagree with the proposal at ***paragraph 28.22*** that the same business test should be removed. Indeed, we believe that the retention of the same business test (and in fact its updating and broadening) is essential as not only does the same business test not result in the duplication of losses, but as will be demonstrated, its existence prevents the duplication of gains.

22.4 In stating that the same business test results in loss duplication where a vendor sells a "loss company" to a purchaser, the Review of Business Taxation Committee ("RBT Committee") appears to stop short in its analysis. No mention is made of the fact that "loss company" may in fact be able to successfully continue trading under the control of the purchaser, thereby recouping all of its same business test losses. In this situation, "loss company" will in fact turn into "gain company", the sale of which by the purchaser will result in a capital gain. Economically therefore, the capital loss that the original vendor claimed on the sale of "loss company" is in fact negated by the gain that is made by the purchaser when it subsequently sells "loss company" as "gain company" after it has turned profitable. In this scenario, which is not uncommon, in totality no loss duplication occurs to justify the removal of the same business test.

22.5 Further, the Institute is also of the view that the limited analysis in the Platform fails to recognise that in many ways a company's tax loss may not represent an economic loss, particularly where the tax loss results from accelerated depreciation or capital allowance deductions. In such cases, although a company may be profitable and trading strongly, the availability of accelerated depreciation and capital allowance deductions can result in a tax loss position.

22.6 To jeopardise tax losses that have arisen from the availability of such tax concessions by removing the same business test would, therefore, be completely inequitable. Furthermore, it could significantly disadvantage companies that have embarked on major capital projects based on such "incentive" type deductions.

22.7 In the situation described at Items 5 and 6 above, a capital loss would not arise on the sale by the vendor of the company in a tax loss position because economically, no loss exists.

22.8 In addition, it is noted that even if tax losses in a company relate to an economic loss, in many cases the vendor of the "loss company" will not be eligible to claim a capital loss in respect of the sale of the shares. The vendor's ineligibility may result from the fact that it is a non-resident without any direct ownership of Australian assets or that the shares in the "loss company" may have pre-CGT exempt status. Even if a capital loss could be claimed, the restriction placed on the utilisation of capital losses may not entitle the vendor to utilise them until a capital gain arises, and this may take many years.

22.9 The abolition of the same business test would also create significant inequities and anomalies in relation to continuing shareholders in the loss company (ie. those shareholders who held an interest in a company during the "loss period" and a subsequent "gain period") and due to potential double tax imposts associated with the interaction with other tax provisions (eg. recouped depreciation and the proposed debt forgiveness provisions).

22.10 The Institute believes there are, however, strong grounds for the view that the same business test should be modified and in fact extended. In particular, the existing requirement in Section 165-210(2)(b) that a company not enter into a transaction of a kind that it had not previously entered into is generally accepted as being unrealistically restrictive and impractical in the current commercial and industrial environment of innovation and technical change.

Proposals to reform the continuity of ownership test

22.11 ***Paragraphs 28.20 and 28.21*** propose effecting substantial amendments to the existing continuity of ownership test. It is suggested in those paragraphs that the existing continuity of ownership test has a defect stemming from the lack of any requirement to test for proportionate changes in shareholding among a continuing group.

22.12 It is proposed to correct this defect by requiring the owners, at the time the loss is recouped, to hold equity that they held when the loss was incurred and that the aggregate of such equity be more than 50% of the equity of the entity on each occasion.

22.13 In effect what is proposed is to extend the Division 166 continuity of ownership test for public companies, which requires continued ownership at all material times between the loss year and the recoupment year, to proprietary companies. The Division 165 test for proprietary companies only requires the same ownership test to be satisfied in the loss year and the recoupment year but not in the intervening period.

22.14 The example given in Table 28.1 is not an accurate reflection of the existing treatment of continuity of ownership requirement in the existing tax law. The existing tax law focuses on the identity of the owners of equity in a company at the time the loss is incurred and at the time the loss is recouped but, in the case of non-public companies, is not concerned with what the situation is in the intervening period. Table 28.1 suggests misleadingly that the existing law is not concerned with ownership at the date the loss is incurred and the date when the loss is recouped but suggests that the proposed new continuity of ownership test would be so concerned.

22.15 There is a lack of clarity of thought in these two paragraphs relating to the avoidance of the duplication of realised losses.

Proposals to prevent duplication of realised and unrealised losses

22.16 With reference to the proposals for preventing duplication of unrealised losses, Chapter 28 provides two options: a Canadian-based approach and a United Kingdom-based approach. It is submitted that the better approach to adopt is option 1: the Canadian-based approach. Despite the need for market valuations on a change of majority underlying ownership, which is a distinct disadvantage of this approach, this approach is consistent with the existing tax regime dealing with current year capital and revenue losses on a change in majority underlying ownership in a company. This option is also consistent with the proposed treatment of realised losses on the removal of the same business test (as to which see above in relation to the qualification for transitional problems on the removal of the same business test).

22.17 The problem with option 2: the United Kingdom-based approach is that the determination of pre-acquisition net losses is arbitrary and may well throw up a figure which is less than the true loss that would have been realised had the loss not been extinguished on the change in majority underlying ownership, but rather realised later on on the disposal of a loss asset.

22.18 Notwithstanding the above comments, for the same reasons as noted above in relation to the same business test, the Institute is strongly of the view that where a same business test can be satisfied (albeit modified) then unrealised losses relating to a period prior to a change in ownership and an entity should in fact be able to be claimed in full on subsequent realisation. As such, in these circumstances the Institute believes it would be inappropriate to attempt to restrict such losses by way of either the Canadian-based approach or the United Kingdom-based approach.

Proposals to avoid duplication of realised losses and gains

22.19 With reference to the proposals to avoid duplication of realised losses and gains in majority ownership cases referred to in ***paragraphs 28.40-28.46***, it is submitted that the better of the two options discussed for the purposes of avoiding such duplication is option 2: adjusting equity cost bases using the asset-based model. In this regard reference is made to the prior discussion in this submission regarding the relevant merits of the asset-based model and the entity-based model in the context of the proposed consolidation regime relating to chapter 27 of the Platform.

Chapter 29 – Towards a systemic solution to CGT value shifting

GENERAL COMMENTS

As a general comment, it is apparent that the Discussion Paper contains significant proposals for changes to the CGT landscape. Thus, for example, the proposals to provide for corporate consolidation would eliminate the ability of unconsolidated group companies to transfer capital losses.

Revamping value shifting

23.1 Chapter 29 seeks a systematic solution to CGT value shifting. It would appear that the *reforms* considered by this Chapter are driven by concerns of the Revenue rather than by the concerns of the business sector. However, the Institute does not argue with the statement early in the Chapter that the present provisions dealing with value shifting in the as yet unrewritten Division 19A and Division 140 of the rewrite are "extremely complex".

23.2 The Discussion Paper's treatment of value shifting is different from other topics dealt with, in that although it seeks to set out some "options", what it in fact is proposing is that there should be a broad general rule applying to a much greater range of value shifting circumstances than presently is the case, with some specific rules, as necessary.

23.3 The Discussion Paper defines value shifting arrangements as any situation where shifts in the value of tangible and intangible assets arise which distort the calculation of gains and losses when assets are sold, scrapped or otherwise come to an end. Broad as this approach is, it is of some relief that some appropriate thresholds are still contemplated (a *de minimis* exception). Also contemplated is the use of an "associate-inclusive" control test to apply to the general anti-value shifting rule. This test would significantly extend the current scope of Division 19A

23.4 Under the approach contemplated, value shifting rules would also apply to trusts and other entities covered by the entity tax regime.

An example used in the Discussion Paper of an area not covered by the present rules is where rights are created at market value over an asset which cause it to decrease in value - such as a licence over property. The Institute questions whether the granting of commercial licences ought to be seen as value shifting. It is unlikely that *de minimis* thresholds would help here.

SPECIFIC COMMENTS

Specific anti-avoidance rules

23.5 The point to be noted is that the Discussion Paper approaches the topic from the perspective of the need to design a specific broad anti-avoidance rule that is not confined to cases where tax avoidance is a motive. This is at odds with the Government's previously expressed desire, as set out in the 13 August 1998 ANTS White Paper, to make Part IVA more robust and to eliminate specific anti-avoidance provisions.

Conceptually, the Discussion Paper seeks to "treat the transfer of value from one asset to another as if the transfer had not occurred, *but without a taxing point* (emphasis supplied)". Presumably this means that the preference is for cost base adjustment rather than CGT events occurring at the time of the value shifting arrangement. A "design feature" of the proposed new rules would be to address value shifting at both the "direct" asset level and "indirectly" through entities. The Discussion Paper also notes that the value shifting provisions would need to be interrelated with other provisions such as debt forgiveness, bonus plan issues, ordinary realisation rules, generic gain and loss duplication rules and the possible generalised asset regime discussed in the Overview (dealing with write-offs for capital assets).

23.6 The Institute supports the suggestion in the Discussion Paper that capital losses could be recognised in respect of the holder of an asset that had been decreased in value which is not presently permitted. Perhaps surprisingly, the Discussion Paper notes that it can be argued that adjustments should be able to be made in cases where value is shifted *from* a pre-CGT asset to a post CGT asset. Presumably this could happen in relation to minority interests, but not frequently in practice.

23.7 The Discussion Paper contemplates a list of exceptions to apply to the proposed general rule, such as capital and profit distributions which do not affect the relative values of entity interests, value transfers down a chain of entities, and "safe harbours" such as the provision of intra-entity services made at full cost.

Exceptions to the general rule

23.8 The Discussion Paper lists 3 possible options for making adjustments where there has been a value shift. These are:

- the capital <u>proceeds</u> can be adjusted at the time of later realisation;
- the amount of capital <u>gain</u> or <u>loss</u> on ultimate realisation can be adjusted;
- the cost base of the interest can be adjusted to take account of the value shift.

The Discussion Paper clearly favours cost base adjustments but notes that they cannot always effect an appropriate adjustment in "an interest in entity level".

23.9 It must be said that whilst any attempt to rationalise the current regimes to help reduce complexity is welcome, the lasting impression contained in the Discussion Paper of the value shifting proposals is not of one of great progress likely to be able to be made. Any wholesale broadening of the current rules is likely to create a greater need for exceptions and thus added complexity. The Institute is not of the view that adjustments in relation to value shifting arrangements should generally only be appropriate where the purpose or motive for an arrangement is one of tax avoidance.

[1]

Taxation of international income

Chapter 30 – Investment in Australia by non -residents

GENERAL COMMENTS

24.1 As ***paragraph 30.5*** notes, the issues addressed in Chapter 30 depend on our view of the "entity" taxation issues addressed in Chapters 15 and 16. The Institute's comments on Chapter 30 are based on those comments.

24.2 The Institute agrees with the statement in ***paragraph 30.16*** that the "NRITC" system would be preferable to Option 1 as described in ***paragraphs 30.14 and 30.15***. It should be acknowledged that NRITC presents certain compliance issues, like identifying non-residents to whom "supplementary dividends" are to be paid. The present DWT system relies primarily on the payer making a preliminary identification of a payee's residence status by reference to the registered addresses of shareholders or authorised places of payment (s. 221YL <u>Income Tax Assessment Act</u> 1936). Obviously, that system is somewhat imprecise. Presumably, the same system could be used for NRITC. The imprecision of the s. 221YL mechanism may, in fact, be less serious when money is being only notionally paid out by way of "supplementary dividends" than when it relates to collection of money (on unfranked dividends) in the first place. Introduction of NRITC will also have a one-off compliance cost for entities reviewing the constituent documents to ensure that they have power to "pay" supplementary dividends to some but not all shareholders (or beneficiaries).

Nevertheless, as the figures set out in Chapter 30 itself show, failing to introduce the NRITC could constitute a significant penalty on non-resident investors, without any corresponding benefit to the Australian revenue. It is submitted that this issue is of overwhelming importance, and that if it is desired to introduce a system by which full Australian company rate tax is charged, on what would currently usually be subject only to 15% tax (ie "unfranked" dividends paid to shareholders resident in treaty countries), the NRITC system is preferable to Option 1.

SPECIAL COMMENTS

Collective Investment Vehicles

24.3 The Institute supports the "flow-through tax treatment" of Collective Investment Vehicles being made available to all investors, whether resident or non-resident (refer to the comments in this submission on Chapter 16). Accordingly the Institute favours the option described in ***paragraph 30.44,*** rather than the option described in ***paragraphs 30.38-30.43.***

Branch profits tax

24.4 The branch profits tax proposal outlined in ***paragraphs 30.46 and 30.47*** would present huge compliance problems, as its predecessor did. It is comparatively easy to identify when a subsidiary has made a distribution to its parent, but locating the dividend-equivalent amount for branches will prove enormously difficult.

Attempts to analyse what payments into or withdrawals from which particular bank account or the like are "remittances" (and in particular, which are remittances of tax-preferred income) would be much more difficult. The complexities of such a system would go well beyond any current requirements upon non-branches (eg the need, occasionally, to examine the accounts of the branch for thin capitalisation purposes), and runs contrary to the general principle that transactions between a branch and a head office do not count for tax purposes (as in Max Factor & Co. v FCT (1984) 84 ATC 4060).

Expanding the non-resident withholding tax

24.5 A broad scope non-resident withholding tax would add yet another layer of complexity to normal transactions. It would require either some form of bureaucratic registration system of residents to whom payments might safely be made without withholding, or for a payer to have to make judgements about the tax status of a payee (eg is the payee a non-resident, and if so, is the payee a resident of a tax treaty country, and is the payee operating in Australia through a permanent establishment?). Some aspects of that complexity may arise under the proposed GST system with its rules concerning "taxable importations" and collection of withholding tax on services not "connected with Australia." In turn, though, those rules will to some extent alleviate any fears concerning tax evasion, since those rules will at least require in most circumstances that GST be paid by the recipient of the goods or services. The Institute questions, therefore, whether the added complexity of a non-resident withholding tax is worth it.

Indirect transfers of assets

24.6 The proposals for enforcement of tax on indirect transfers of Australian assets raise enormous practical problems. For example, obviously, there will be immense difficulty in monitoring transactions which might fall within the system. Even if such transactions can be identified adequately, the proposal that any relevant tax liability be enforced against the Australian assets themselves ignores the position of innocent minorities whose direct or indirect interests in the assets would be adversely affected by such enforcement. Consideration would also need to be given to a form of "foreign tax credit" where a bona fide sale of an offshore entity gave rise to foreign tax in the relevant offshore jurisdiction.

Chapter 31 – Conduit investment through Australia

SPECIFIC COMMENTS

25.1 How should conduit treatment be provided for CIVs that invest on behalf of non-resident investors?

The Institute strongly supports flow-through treatment for all CIVs

Dedicated non-resident investment funds could be used if CIVs are taxed under the entity regime. The Institute's preferred position would be to retain CIVs as flow through vehicles.

25.2 How should conduit income derived by other resident entities be taxed by Australia?

Extend the current conduit provision using a foreign income account – Agree strongly. The further policy issues relating to the mechanics of the conduit provisions do not go far enough. The Institute should pursue allowing Australian companies to stream foreign profits to foreign shareholder and franked dividends to resident shareholders, or to allow franking credits for foreign taxes (both direct and indirect).

25.3 Should franking credits be available to residents investing in Australia via non-resident entities – the"triangular case"?

The Institute supports allowing franking credits to "flow" through non-resident companies but does not believe that this should be a high priority issue.

Chapter 32 - Foreign source income of residents

SPECIFIC COMMENTS

Impact of entity taxation on foreign source income derived through trusts

26.1 The proposition that under an entity taxation regime distributions of foreign income derived through trusts should be treated as dividends is generally supported (subject to an appropriate exclusion from entity taxation for CIVs operating as trusts).

26.2 Deemed distribution rules for loans made by foreign trusts to Australian beneficiaries should be based on the Division 7A provisions or the proposals contained in Chapter 18 for the exclusion of loans based on normal commercial terms. That is, if a loan satisfies the conditions for a genuine loan (based on either Division 7A or the Chapter 18 proposals) then it should be excluded from the deemed distribution rules.

The Institute also supports the proposals that under an entity taxation regime resident trusts deriving foreign source income should be allowed foreign tax credits for underlying tax in the same way that Australian resident companies are allowed and a foreign tax credit for foreign dividend withholding tax for portfolio foreign dividends. The Institute also supports the proposal to extend the non portfolio dividend exemption to resident trusts.

Imputation credits for foreign taxes

26.3 The proposal to allow imputation credits for non portfolio foreign dividend withholding tax for both Australian resident trusts and companies is supported. This will largely reduce the existing disincentive for Australian multinationals to repatriate profits from foreign subsidiaries in listed countries because of the imposition of non creditable foreign dividend withholding tax.

However, the particular proposal raises a much more fundamental issue concerning the lack of recognition of imputation credits in Australia for foreign tax paid by Australian multinationals with foreign operations in listed comparable tax countries. A fundamental structural flaw with the existing business tax system is the double taxation of foreign source income derived by Australian resident companies through non resident subsidiaries operating in listed comparable tax countries.

That is, such income is taxed in the foreign country at a comparable tax rate and is also subject to further Australian tax when distributed (either Australian income tax when eventually distributed to Australian resident individuals or possibly Australian withholding tax when distributed to non resident shareholders). The options paper recognises that Australia should not cause foreign income to be double taxed.

This issue may not be as significant if full streaming of foreign profits to foreign shareholders is permitted. The clear preference is to allow full streaming of foreign profits to foreign shareholders. However, the option of allowing imputation credits for comparable foreign tax paid could be considered as an alternative.

The Federal Government has agreed to consider the issue of reciprocal imputation credits for underlying tax with New Zealand under the Trans Tasman Closer Economic Relations treaty with New Zealand (Treasurer's Press Release No.100, 25 September 1996). It is submitted that this issue should be considered in a broader sense with other listed countries if full streaming of foreign profits to foreign shareholders is not accepted.

Improving anti tax deferral rules

26.4 The Institute does not support the option to remove the active business exemption for foreign investment funds ("FIFs"). This would substantially increase the compliance burden for many Australian investors investing in foreign interests.

There are two options considered to replace the active business exemption for interests in FIFs. These options are considered in the context of non portfolio and portfolio foreign investments.

26.5 The exemption option for non portfolio foreign investments is to exempt all non portfolio foreign investments which satisfy an active income test similar to that applicable to controlled foreign companies in Part X. The Institute does not support this option on the basis that it may be difficult for some non portfolio investors who do not have sufficient control of the foreign entity (eg. investors with an ownership interest in the relevant FIF of, say, between 10% - 20 %) to obtain sufficient information to be able to determine whether the active income test has been satisfied.

The FIF regime is recognised as a set of overly complex provisions creating an enormous compliance burden for many Australian multinationals and other investors. In general terms, the compliance costs in relation to the FIF provisions are substantial. As a consequence, the Institute favours an exemption for all interests in FIFs that are resident for tax purposes in broad exemption countries (or which are subject to tax in a broad exemption country). Additionally, interests in FIFs owned through Australian CFCs which are resident in broad exemption countries should also be exempt on the basis that most, if not all, broad exemption countries have some form of anti-deferral rules which will result in the relevant share of the FIF income being subject to tax in the relevant broad exemption country on a current basis.

Currently, the existing anti deferral rules dealing with the taxation of income of foreign trusts are extremely complex. This raises the issue of whether they are all necessary to counter perceived deferral of Australian tax. An Australian resident investor who has an interest in a foreign trust needs to consider the application of the deemed present entitlement rules in sections 96B/96C, the transfer trust rules in Division 6AAA and the FIF rules in Part XI. In same cases, these provisions have effectively discouraged Australian investors investing in foreign funds simply because of the onerous compliance issues. The Institute favours the option of removing the deemed present entitlement rules and using the FIF measures as the sole anti tax deferral regime for taxing interests in foreign fixed trusts.

26.6 The Institute also favours the option of applying only the transferor trust rules to interests in discretionary trusts if an Australian resident transferor can be identified. The Institute would also favour the application of an interest charge regime to distributions from foreign based discretionary trusts, in the absence of an identified Australian resident transferor.

The Institute does not favour the removal of exemptions from the transferor trust rules for transfers made prior to the operation of the rules, transfers made before a taxpayer becomes an Australian resident and transfers made under the terms of deceased estates. This would be inequitable and therefore not consistent with the good design principles of a tax system.

Recommendations

26.7 In summary, the Institute makes the following recommendations:

Retain the active business exemption under the FIF regime.

Allow an exemption for interests in FIF which are resident in broad exemption countries (or which are subject to tax in a broad exemption country).

Allow an exemption for interests in FIF held through Australian CFCs which are resident in broad exemption countries.

Remove the deemed present entitlement rules and apply the FIF measures as the sole deferral regime for taxing interests in foreign fixed trusts.

Apply the transferor trust rules to interests in discretionary trusts if an Australian resident transferor can be identified, otherwise apply an interest charge regime.

Hidden trusts

26.8 The proposal to introduce specific rules for “hidden trusts” requires further consideration. The concept of a hidden trust should be explained further before any assessment is made as to whether any specific anti avoidance type rules are required. As a very general comment, if the concern is tax avoidance and evasion, one would have thought that the existing provisions in Part IVA and the existing anti tax deferral measures would be sufficient.

Chapter 33 - Allocating world wide taxable income between countries

SPECIFIC COMMENTS

Source of income

27.1 The Institute generally supports the need for clearer rules to determine the source of income. This is especially the case for cross border electronic commerce transactions and other transactions where the party deriving the income can initiate, negotiate and conclude the transactions over the Internet without having a physical presence in the particular jurisdiction in which the counter party is located.

In order to provide a greater degree of certainty, the Institute supports specific source of income rules for specific types of income based on the OECD model convention source rules. The specific source rules should be periodically reviewed and revised as appropriate to ensure that they keep pace with technological developments and other commercial innovations.

Domestic thin capitalisation rules

27.2 The Institute does not support the option of introducing a "domestic thin capitalisation" rule to deny a deduction for interest incurred on borrowings used by Australian owned multinational companies to finance Australian operations which is in excess of a prescribed limit. The Institute also does not support the adoption of an arm's length test for determining whether an Australian multinational's domestic gearing ratio, which exceeds the group's world wide gearing ratio, is reasonable.

These options would be have a draconian effect on Australian multinationals, introduce new uncertainties for Australian multinationals and be totally inconsistent with the business taxation systems in other countries.

The options paper suggests that the dividend imputation system creates an incentive for Australian multinationals to pay Australian tax rather than foreign tax. Yet in the same section the options paper raises the contradiction that Australian operations of Australian multinationals could be highly geared and the offshore operations of such entities could be lightly geared solely in order to reduce the group's overall tax liability.

To impose an arbitrarily determined fixed gearing ratio for the Australian operations of Australian multinationals is likely to impede the management of the capital structures of such entities and consequently may have a negative impact on the way that Australian multinationals operate domestically. Such measures may even cause Australian multinationals to be at a competitive disadvantage to their international peers.

There are likely to be genuine commercial reasons for Australian multinationals borrowing funds domestically including access to cheaper funds because of the better name recognition in the Australian capital markets or borrowing restrictions imposed in some of the foreign countries in which investments are held.

Deductibility of financing costs for foreign investments

27.3 The lack of an Australian deduction for financing costs incurred by Australian multinationals in respect of non portfolio investments in foreign companies located in listed countries is a major concern.

At present, Australian multinationals are not entitled to a deduction for interest incurred on borrowings used to fund direct non portfolio investments in listed countries. The rationale being that the profits repatriated from such countries are exempt from Australian tax (on the basis that such profits would have been taxed at a corporate tax rate comparable to the Australian rate).

This is a major concern for acquisitive Australian multinationals as the non deductibility or quarantining of interest may be a potential significant additional cost that may impede international expansion or may require the Australian company to raise other forms of capital which may not be as cost effective.

There may also be some genuine commercial reasons as to why Australian multinationals would seek domestic debt funding for offshore acquisitions. For example, it may be more cost effective for an Australian multinational to raise debt capital domestically rather than in the foreign country in which the investment is contemplated, or the foreign country itself may impose restrictions which make it impossible for the Australian group to borrow funds in that country.

For UK and US based multinationals this is not a concern because countries such as the UK and US have a full foreign tax credit system. Therefore, such multinationals have a competitive advantage over Australian multinationals in international capital and business markets.

An option that may be worthy of consideration is to allow Australian multinationals to elect to be subject to either an exemption system or the foreign tax credit system in respect of foreign countries that have a tax system that is comparable to Australia’s.

Thin Capitalisation rules

27.4 The options dealing with the existing thin capitalisation rules should be considered further. The thin capitalisation rules were amended with effect from 1 July 1997. These amendments included a reduction in the permissible foreign debt to equity ratio for non financial institutions to 2:1. There seems to be a further push to tighten the thin capitalisation rules even further and give them a more broader focus. In the absence of clear evidence that there is a real threat to the Australian revenue, there should be further consultation to determine whether this proposal is considered necessary.

Nevertheless if following further consultation, a more restrictive debt equity ratio is considered necessary, the Taxation Institute would favour a combination of the world wide group gearing option and the fixed gearing option. The world wide gearing option contained in the options paper would allow a deduction for interest up to the world wide gearing ratio of the group, however, interest in excess of this would be deductible subject to the domestic gearing level passing an arm's length test. Introducing an arm's length test may create some uncertainty for foreign multinationals, including how to identify and measure "industry" gearing ratios and possibly increase the compliance burden for some multinationals.

Under the fixed gearing ratio option a deduction would only be allowed for interest on borrowings up to the world wide gearing ratio of the group, if the stand alone gearing ratio of the Australian operations exceeds a safe harbour ratio.

As a variation to the two options, and as an alternative to an arm's length test, consideration should be given to allowing a maximum permissible gearing ratio based on a percentage of the world wide gearing ratio of the group (say 110%), provided that the gearing ratio of the relevant entity exceeds say 75% of the entity's total assets (this is similar to the New Zealand thin capitalisation regime).

As part of any necessary tightening of the thin capitalisation rules, the Institute also supports an increase in the ownership/control test from 15% to more than 50%.

Transfer pricing

27.5 The option of providing a self assessment system for transfer pricing is supported in principle by the Institute. A self assessment system should not be unduly prescriptive. For example, there should be sufficient flexibility for taxpayers to determine the most appropriate arm's length pricing methodologies for specific cross border related party dealings. The rules may set out generally acceptable arm's length pricing methodologies, but should not prescribe specific arm's length pricing methodologies for specific transactions or classes of transactions. There should also be sufficient flexibility in relation to record keeping requirements. The safe harbour rules contained in TR 1999/1 for intra group services should also have legislative backing if a self assessment system is introduced.

Separate entity taxation of Australian branches

27.6 The option of treating Australian branches of non residents as separate entities in calculating the Australian taxable income of such branches is also supported in principle by the Institute on the basis of the neutrality principle. The choice that non residents have between operating through an Australian branch or Australian subsidiary based on the Australian tax consequences would generally be eliminated. In considering such measures, the Australian Government should consider the interaction of such measures with Australia's double tax treaties. In particular, appropriate double tax relief must be available.

The Institute, in general, does not support the option of denying a deduction for expenses paid by an Australian entity to a related entity resident in a low tax jurisdiction where insufficient information is provided to support the expense claimed. Where such related party entities are Australian CFCs, it is likely that the income of such entities would be subject to attribution under the Australian CFC rules in Part X. Accordingly, this option would be unnecessary in such circumstances. Other circumstances that would fall within the ambit of such an option are likely to be rare and therefore, from a pure revenue perspective, the need for such measures is questionable.

Taxation of life insurance

Taxation of life insurance

Chapter 34 – Building a more consistent regime for life insurers
Chapter 35 – Life insurance policyholders
Chapter 36 – Pooled superannuation trusts
Chapter 37 – Implications for superannuation funds and approved deposit funds

GENERAL COMMENTS

Superannuation

28.1 The various proposals contained in the Discussion Paper No. 2 in respect of the treatment of superannuation where it is invested in the form of pooled superannuation trusts ("PSTs") and life insurance companies are noted. The proposal to treat such investments as falling within the entity regime is considered wholly inappropriate. Superannuation investments, whether they are undertaken directly by a superannuation fund or via investments in collective vehicles such as PSTs and life insurance policies, should bear the same treatment for taxation purposes. To do otherwise would be contrary to one of the foundation principles contained in the Review's first discussion paper that one should look to the economic substance of transactions and ensure that they are taxed in a similar fashion. To apply a different taxation regime to PSTs and investments in life insurance policies would give rise to an unlevel playing field or, put another way, would not be competitively neutral.

SPECIFIC COMMENTS

PSTs

28.2 The two options outlined in Chapter 36 of the second discussion paper seek to use as the benchmark the entity regime. This is clearly inappropriate. The benchmark for PST taxation should be determined by reference to the treatment of similar investments undertaken directly by a superannuation fund. Additionally, any regime by which PSTs are subject to taxation that effectively claws back any of the tax preferences (that will continue to be enjoyed by superannuation funds investing directly) are likely to result in investments being directed other than through PSTs. Given that PSTs exist as an efficient and cost effective investment vehicle providing economies of scale and access to asset classes otherwise unavailable to smaller superannuation funds, such a taxation regime would operate to the detriment of the economy as a whole and the efficient allocation of resources. Accordingly, it is the Institute's view that the taxation of PSTs should remain as it is currently and should not result in a taxation regime that causes a fundamental change in the nature of investments.

Superannuation life policies

28.3 For similar reasons to those expressed above, the taxation of what is essentially the superannuation fund's investment via a life policy should not be altered from the regime currently applying. To have the superannuation fund's investment taxed at the corporate tax rate and an administratively cumbersome (and one would suspect inefficient) mechanism by which refunds of excessive tax are made is likely to result in a flight of funds from life insurance investments to a more appropriate regime which allows for the simple levying of tax at the appropriate rate and without the attendant loss of preferences that are otherwise granted by the tax regime to direct superannuation investment. The Institute submits that whatever mechanism is ultimately applied for the taxation of life insurance companies in terms of the profits available to shareholders, a mechanism needs to be found to ensure that the taxation of superannuation fund policyholders is not detrimentally effected. The RBT team should work with the life insurance industry to ensure this outcome is achieved.

Transfers of taxable contributions

28.4 We understand that some practical difficulties have been identified in relation to transfers of taxable contributions by superannuation funds to PSTs and life offices under s.275 of the Income Tax Assessment Act 1936. Some of the difficulties as we understand it relate to changes to the determination of the actual taxable contribution to be transferred and that some superannuation funds make errors in this regard. If some superannuation funds do make such errors, doing away with s.275 transfers will not overcome those errors. Rather, the ATO are likely to be repository of numerous amendment requests which, at the moment, are effectively being channelled through the life companies and PSTs that receive such transfer agreements. We also understand that anecdotally there is not a significant amount of contributions tax liability that is being transferred but rather there are a number of smaller funds who enjoy the use of this option. There seems little advantage of withdrawing this concession to any of the parties involved. To the extent that there are difficulties in the administration of s.275 transfers, it is suggested that the Review or Treasury and ATO work together with industry and the profession to overcome such difficulties.

Life insurance non-superannuation policies

28.5 From the point of view of the policyholders who have entered into contracts with life insurance companies other than in relation to a superannuation fund, the proposal to apply a corporate rate of tax to the investment earnings of those policyholders is substantially little different to the present regime. The utilisation of a refundable credit regime seems to the Institute to be an appropriate mechanism to ensure that the proper tax rate is levied on a policy holder in respect of their investment. This will overcome the present regime's deficiencies by which low rate policyholders are suffering an effective high rate of marginal tax on their investment earnings.

However, we note that a number of investors deliberately invest in such policies for the purpose of simplifying their tax affairs (eg. not having to worry about provisional tax etc.) and are willing to trade off the higher tax rate for this benefit. In this regard, it is the Institute's submission that existing life policies should retain the current treatment under the Tax Act. We note the option contained in the paper that would provide policyholders with an ability to elect. We suspect that such an election may have some administration costs which the Insitute is concerned may ultimately be borne by the policyholders themselves. Accordingly, the Insitute recommends that the Review work with the life insurance industry to ensure that if such an option is proceeded with, such costs be minimised. We suspect, however, that it may be simpler and more efficacious to simply continue with the existing treatment for existing policyholders. Should a policy holder wish to avail themselves with the new regime, we suspect that life insurance companies could be encouraged to provide a low cost change over option.

Life insurance corporate tax

28.6 The Institute agrees that it is appropriate that the profits of a life insurance company that are attributable to the shareholders should be taxed at the corporate rate. Having said that, the Insitute notes that it has been a long standing policy of various governments (running back to pre-commonwealth taxation) that life insurance represents a special place in the long term savings of the nation. In this regard, it is often seen as a social good by which persons who take out insurance relieve the public purse in the event of the insured event arising. That is, the widows or orphan children of an insured deceased person would not be a drain on the public purse where such cover has been taken out. However, the Institute recognises that if this is to continue to be a policy of government, it should be dealt with by specific concession to the policy holder through some form of tax relief (eg. deduction or rebate).

Nonetheless, the Institute notes that, particularly in the case of former mutual companies (but also across industry generally), many long term and fixed style contracts may have been entered into which effectively passed on the benefit of the lower tax rate on shareholder profits to the policy holder. The Institute suspects that the imposition of taxation at the corporate rate immediately on shareholder profits may simply result in an additional cost to policyholders. Alternatively, it may well make some products uncompetitive.

In this context, the Institute submits that some form of phasing in or grandfathering needs to be considered. The Institute believes that the details of any such grandfathering or phase-in needs to be determined in conjunction with the life insurance industry.

Taxation of fringe benefits

Taxation of fringe benefits

Chapter 38 – Towards a better regime for taxing fringe benefits

GENERAL COMMENTS

29.1 Chapter 38 of the Discussion Paper 2, entitled "Towards A Better Regime For Taxing Fringe Benefits", identifies a number of concerns with the current arrangements for the taxation of fringe benefits. In particular, the Review found that the existing FBT regime is unduly complex, inequitable, burdensome on employers and a source of dissatisfaction to employers. The Review suggests strategies for improving the fairness and equity to taxpayers arising from the taxation of fringe benefits, simplifying compliance and improving the efficiency of fringe benefit taxation.

29.2 The FBT Legislation was enacted in 1986 in order to overcome the perceived inadequacies of Section 26(e) of the ITAA36. This Section sought to subject to income tax the value of non-cash benefits received by employees as a consequence of their employment.

29.3 The fundamental difference between Section 26(e) of the ITAA36 and the FBT legislation was that employers were now liable to taxation in respect of benefits provided to employees.

29.4 Since 1986, numerous amendments have been made to the original legislation. Most of these amendments were designed to rectify flaws in the original legislation, widen the scope of the legislation, simplify the application of the legislation or to reduce the costs of complying with the legislation.

29.5 It is submitted that through these continual amendments to the FBT legislation, the FBT regime has become inequitable, too complex and too costly to comply with. Accordingly, the Institute is in favour of the reformation of the FBT regime and agrees with the general conclusion of the Review that a serious case exists for reforming the taxation of fringe benefits.

However, further attempts to make piece-meal modifications to the existing legislation are likely to worsen the situation. It would be preferable and more sensible to undertake a complete overhaul of the FBT legislation. Fundamental issues such as, the structure of the legislation, the use of plain English, simplicity, benefit valuation methodology, consistency with domestic and international taxation principles and liability to taxation ought to be considered. Such an overhaul would be consistent with the Government's tax reform agenda and tax laws simplification project.

29.6 The Review also acknowledges that the existing arrangements facilitate the avoidance of income tax and social security related obligations and the ability to obtain undue access to government benefits through salary packaging. The Review outlines the Government's recent tax reform initiatives relating to the reporting of fringe benefits on group certificates, limiting concessions and exemptions for certain non profit organisations and public benevolent institutions and the extension of the FBT regime to shareholders and trust beneficiaries. However, the Review does not evaluate these recent initiatives, nor does it outline any alternative recommendations.

The Institute has enunciated its views on these particular initiatives, including the Bills relating to group certificate disclosure of fringe benefits in an earlier submission. Accordingly, this submission will not address the merits of these particular initiatives. A copy of the Institute's earlier submission is included in Appendix 1 of this submission.

SPECIFIC COMMENTS

29.7 The Discussion Paper 2 identifies the following material concerns with the current FBT regime:

- inequity;
- administrative complexity; and
- inefficiency.

The Review proposes a number of strategies to overcome these concerns. These are:

- impose tax on the employee rather than the employer;
- specify a list of benefits subject to tax;
- remove entertainment and car parking from FBT coverage;
- align the FBT year with the standard income tax year;
- modify the statutory formula method for taxing cars.

These strategies are outlined and assessed in further detail below.

Imposing tax on the employee rather than the employer

29.8 The Review proposes that, in order to improve equity, the liability to taxation in respect of the provision of fringe benefits could be transferred from the employer to the employee. Further, it is suggested that employees would then be subject to tax on the value of the fringe benefits received at their marginal rates of income tax. The Review also outlines the option of introducing a de-minimis threshold of $1,000, consistent with the group certificate reporting Bill, whereby employees would only be subject to tax if the value of fringe benefits received during a year exceed $1,000 per employee.

It is stated that this measure would bring the taxation of fringe benefits into line with the taxing of all other elements of employee taxpayers' remuneration which is consistent with most foreign developed countries.

It is estimated that the cost in lost revenue to the Government would be in the order of $435 million per annum. If the $1,000 de-minimus threshold option were to be adopted, the cost in lost revenue is estimated to be in the vicinity of $1.6 billion per annum.

The Institute considers that the de-minimis threshold of $1,000 must be maintained particularly if a system of specific inclusion is not adopted. If a system of specific inclusion is adopted, consideration could be given to the removal of the threshold, however, this will increase administrative costs associated with the proposed group certificate disclosure of fringe benefits and should, therefore, be resisted.

The Institute agrees with the principle of subjecting employees to tax in respect of the provision of fringe benefits. It is submitted that transferring the tax liability arising from fringe benefits from employers to employees will restore equity and fairness to the taxation of low to middle income earners, enhance the transparency of taxation in decision making, reduce the burden on employers and improve Australia's international competitiveness.

Restoration of equity and fairness

Equity and fairness will be restored to the taxation system by taxing fringe benefits at the recipients' marginal rates of tax, rather than discriminating against employees on marginal rates below 48.5% and non-resident taxpayers. Taxing employees at marginal rates ensures that each employee pays his or her fair share of tax irrespective of how the employee's remuneration package is structured.

From 1 April, 1999, casual, part-time, short term and low paid employees receiving non-discretionary fringe benefits may be unfairly disadvantaged as a result of the proposed group certificate disclosure rules. The value of these fringe benefits will be grossed up by 194% thus increasing the exposure of such employees to the superannuation and medicare levy surcharges, other tax related obligations and decreasing the capacity to receive government benefits. Taxing employees at marginal rates would no longer necessitate the grossing up of fringe benefits for determining means tested obligations and benefits.

Similarly, fairness would be restored to employers as they would not be exposed to penalties for underpayment of FBT arising from an employee's failure to obtain and/or furnish documentation and declarations or for falsifying a declaration or similar document.

Enhance transparency

Fringe benefits would be taxed in the same manner as salary and wages thus significantly reducing or eliminating taxation aspects from decision making. This would lead to sound business decisions concerning the efficient allocation of resources.

Employers would be able to provide a mix of cash and non-cash remuneration that would achieve its objectives, without impacting on the employee's liability to income tax.

Similarly employees would be able to evaluate whether, and to what extent, to receive non-cash benefits based on considerations that exclude taxation.

Reduce the burden on employers

As the liability for payment of tax on fringe benefits passes to employees, employers would no longer be required to make FBT payments to the ATO, annually or quarterly. This would assist employers in maximising their cash flow positions and reduce the amount of resources required to ensure that tax payments are met in full and on time. It is also submitted that employers would not be penalised for wrongful actions or errors caused by employees or former employees.

Improve Australia's competitiveness

Incorporating fringe benefits into the taxable income of employees should entitle expatriate employees to receive credits for tax paid in Australia, therefore avoiding the double taxation of fringe benefits. Currently, this does not occur as FBT is not a creditable tax under the double tax agreements concluded with various countries, except New Zealand. Further, it is highly unlikely that FBT would be a creditable tax under the domestic income tax legislation of all other countries. The threat of double taxation of non-cash benefits may persuade overseas companies to locate particular oversees operations to countries other than Australia. Accordingly, taxing employees on the value of fringe benefits in the same manner as cash remuneration would remove the threat of double taxation and should therefore improve Australia's ability to attract oversees corporations wishing to establish operations off shore.

Unfortunately, the recent comments by the Treasurer casts real doubt on the transfer of liability to individual employees being an option the Government would give serious consideration.

Specify a list of benefits subject to tax

29.9 It is asserted in Discussion Paper 2 that the present approach to FBT of including all fringe benefits unless specifically excluded is too complex. Rather, it is suggested that the FBT regime could be simplified by adopting a system of specific inclusion. This would entail specifying a comprehensive list of fringe benefits that are subject to tax. The Review also expresses caution that such an approach, if not monitored regularly, could lead to substantial growth in the use of benefits not specifically listed.

The Institute recognises that compliance costs associated with FBT are far too high. Anecdotal evidence exists supporting the conclusion that many employers overstate their FBT liabilities, rather than expend resources on attempting to fully comply with the FBT requirements. Therefore, the Institute is in favour of reducing complexity and business compliance costs through adopting a system of specific inclusion of fringe benefits.

The Institute also submits that a system of specific inclusion would eliminate the need for numerous exemptions, including benefits not normally considered benefits. Accordingly, this would result in greater certainty and reduce the demand on administrative resources.

In order to reduce the complexity and difficulties with the FBT regime, it would be necessary to specify specific fringe benefits, rather than categories of benefits. It would also be necessary to remove the Residual Fringe Benefits category from the proposed list of taxable fringe benefits as this category is designed to capture any other benefit not identified under the present arrangements. Including, within the list of benefits subject to tax, provisions such as "…any other benefit" or "…or similar types of benefits" will defeat the purpose of specifying individual benefits as employers will be faced with the complex task of determining whether a particular benefit is captured by these types of provisions.

As mentioned in the Discussion Paper 2, monitoring the list of taxable fringe benefits will need to be done regularly and swiftly. Therefore, it is suggested that the list of benefits could either be governed by Regulations or by Determination of the Treasurer.

Amending the list of taxable fringe benefits through the passing of legislation is likely to be a slow and cumbersome process. Further, given that amendments to legislation may apply retrospectively, prospectively or upon receiving Royal Assent, the benefits of adopting a system of specific inclusion will be reduced if taxpayers are unable to determine, readily and simplistically, if and when a particular fringe benefit is taxable.

Empowering the Commissioner of Taxation with the authority and responsibility of maintaining a list of taxable fringe benefits would seem to be the most effective method of ensuring swift action. However, this option gives rise to a serious dilemma in that the Commissioner of Taxation could dictate, or could be seen to be dictating, rather than administering, Government policy on taxation by having the power to determine which benefits are subject to tax. Therefore, this option ought to be rejected.

Accordingly, the Institute is in favour of adopting a system of specific inclusion whereby all significant fringe benefits subject to tax are governed by Regulations or Treasury Determination.

Remove entertainment and car parking from FBT coverage

29.10 The Review recommends that benefits which are difficult to determine, value and attribute to individuals be removed from the FBT regime. In particular, it is suggested entertainment and car parking as benefits which should not be covered by the FBT regime.

It is suggested that the tax treatment of entertainment revert to the pre-1995 position, whereby entertainment expenditure was non-tax deductible.

This option is preferred by the Institute as the costs of complying with all forms of entertainment are likely to outweigh the revenue collected via the FBT system. Employers are required to analyse voluminous amounts of data to determine whether a benefit is non-meal entertainment or meal entertainment, whether it is subject to FBT or exempt, whether the costs of providing that entertainment are tax deductible and, as from 1 April 1999, attribute non-meal entertainment to individual employees.

The Institute submits that both meal and non-meal entertainment be excluded from FBT. This would allow for the removal of the requirement to dissect entertainment into meal and non-meal entertainment, to determine the extent to which meal and non-meal entertainment are subject to FBT or exempt and the requirement to attribute non-meal entertainment fringe benefits to individual employees. To only exclude meal entertainment would do little to reduce the complexity of FBT and business compliance costs as employers would still be required to isolate non-meal entertainment, determine the extent to which it is subject to FBT and attribute to individual employees.

The Institute further submits that the income tax and FBT legislation be amended so as to clearly define the meaning of entertainment. Currently entertainment is not defined, save for extending the meaning of entertainment to include recreation and related travel and accommodation expenditure. Employers are provided with little guidance, other than relying on Tax Office Rulings and Determinations. Most employers are required to expend resources on obtaining professional advice in order to ascertain the correct classification of expenses. It is suggested that a detailed definition of entertainment be introduced into the income tax and FBT legislation. Alternatively, the Institute recommends adopting a specific inclusion approach for classification of entertainment expenditure.

The Institute is also in favour of the abolition of on-premises car parking from FBT coverage. It also supports the view that car parking costs should remain income tax deductible. This measure will result in a significant reduction in business compliance costs at little cost to the Government. Accordingly, a sensible outcome is reached.

The FBT exemption should apply to all employers. In addition, in order to maintain administrative simplicity, the exemption should also extend to situations where employers lease parking spaces from commercial car parks in order to garage fleet vehicles used principally for work related purposes. As these vehicles are unlikely to be used for private travel by employees, and therefore theoretically not subject to FBT, there would be little cost to the Government of excluding such car parking from FBT coverage.

Alternatively, it is submitted that all car parking fringe benefits be excluded from FBT, except where, pursuant to a salary package, award or employment agreement, the employee is entitled to receive free or subsidised “off-site” car parking in respect of a car used principally for private purposes. That is, car parking would only be subject to FBT where an employee is able to salary package “off-site” car parking benefits or where the car parking benefits are assigned a monetary value as part of an employee’s remuneration package. Business compliance cost would be significantly reduced as the value of car parking for FBT purposes could be determined from information disclosed in each employee’s remuneration package.

Align the FBT year with the standard income tax year

29.11 The Discussion Paper 2 raises the issue of aligning the FBT year with the personal income tax year. It is agreed that the misalignment adds to the complexity of tax compliance for businesses. An analysis of the pros and cons of aligning the FBT and income tax years has not been undertaken by the Review of Business Taxation. However, it is recognised that employers may face difficulties in determining employees’ reportable fringe benefits amounts for inclusion in group certificates within the required time limits.

The Institute, prima facie, is in favour of aligning the FBT and personal income tax years for the reasons outlined below:

- Most financial reporting and payroll systems operate on a June year end basis. Therefore, the production and analysis of data for the period 1 April to 31 March can be complex, difficult and costly.
- Most employers use the July to June period for the basis for determining employees; remuneration packages. Alignment of the FBT year would simplify the process of identifying and reconciling the provision of salary packaged fringe benefits for FBT return preparation and group certificate disclosure purposes.
- Employees will experience difficulties in planning and forecasting their tax positions. For example, employees may understate their exposure to the superannuation surcharge levy as the liability to the superannuation surcharge will be effectively determined on the value of fringe benefits received in the year ended 31 March, rather than in the income tax year.
- The difficulties expected to be experienced with respect to issuing timely group certificates could be avoided by allowing employers more time within which to issue year end group certificates. In addition, by introducing a system of specific inclusion of fringe benefits and exempting the first $1,000 of benefits from group certificate disclosure would simplify and quicken the preparation of FBT returns.

Nevertheless, a number of employers would prefer to retain the FBT year so as to evenly spread reporting deadlines during the year or because an alternate financial or tax accounting period has been adopted. Therefore, the Institute advocates the need for a comprehensive survey of small to large employers to conclusively determine whether or not to align the FBT year with the personal income tax year.

Modify the statutory formula method for taxing cars

29.12 It is argued in Discussion Paper 2 that the best way to promote efficient decision making regarding the provision of fringe benefits is to ensure that taxation does not distort the cost of providing fringe benefits. It suggests that the appropriate method of valuing fringe benefits is to approximate the market value of each benefit. It further suggests that the current statutory formula method for the valuation of car fringe benefits, while designed to reduce compliance and administration costs, does not result in a close approximation of the real value to a person of receiving a car. This is predicated on the findings contained at ***paragraph 38.27*** wherein an analysis of the annual operating costs of a standard passenger vehicle travelling 15,000 kilometres was conducted.

Further, it is said that the current formula is clearly concessional. Accordingly, the Review suggests that a case exists for modifying the current statutory formula so that the resultant FBT values more closely approximate the real value of the benefit involved.

The Review outlines a number of alternative formulae for the taxation of car fringe benefits, in preference to the existing formula. These options are:

- adopting an incremental scale of fractions from 25% to 35%; or
- adopting a flat fraction of 25%.
- adopting a schedule of costs and presuming a business usage of 50%;
- adopting a schedule of costs and presuming a business usage of 20%;

The Institute is fully supportive of the principle that the taxation of fringe benefits should be representative of the market value of the particular benefit being provided. However, given that the philosophy of the FBT regime is to stop taxpayers acquiring goods and services of a private or domestic nature using pre-tax income, the taxation of fringe benefits should exclude the value attributable to any work-related or income producing use.

The statutory formula method is designed to be a simple method for determining the value of FBT in respect of a particular car. As with all formulae, it is based on generic assumptions and averages. The fundamental assumption underlying the statutory formula method is that the proportion of work-related use of a car increases the more it is the car is used. Hence the reason why the current statutory fraction scales decrease as the distance travelled increases.

The Review questions this hypothesis and concludes, without supporting material, that it is incorrect. The Institute disagrees with this view of the Review of Business Taxation. Rather, the Institute submits that if a person's use of a car were to increase from say 10,000 kilometres per annum, to 20,000 kilometres per annum, the increase in usage would reasonably lead to the conclusion that the car was being used for work-related activities. Further, if the average person were to drive his or her car more than 40,000 kilometres per year (or 110 kilometres each day) it would be reasonable to suggest that the car would have been used for work-related purposes. It is submitted that, on average, the majority of employees would be unlikely to travel more than 40 kilometres per day (or 9,600 kilometres per year) between home and work, let alone 110 kilometres per day.

The Institute acknowledges that where a person travels at least 15,000 kilometres per year and only uses his or her car for private travel, there may be an after tax saving to that person if he or she were to be provided with the use of the same car as a fringe benefit. However, this is probably an exceptional scenario and it must be accepted that the use of the statutory formula method will unfairly advantage or disadvantage a minority of the population.

The Review suggests that the current statutory formula scales should be increased from 11% to 35% once a car travels 25,000 kilometres. Imposing tax under these circumstances would severely penalise most employers operating a fleet of “work horse” cars, as these cars are likely to be used at least 75% for business purposes. The proposed scales would increase, rather than decrease the incentive to receive a car as a fringe benefit where the car will be used solely for private purposes for less than 15,000 kilometres per year.

Further, the use of a flat scale of 25% is seen as being inflexible and inequitable. It would be unfair to impose the same level of FBT on a car that is used solely for business purposes and a car used solely for private purposes. In essence the suggested flat scale approach would be contrary to the spirit of taxation of fringe benefits as it fails to exclude the value attributable to any work-related or income producing use.

Accordingly, the Institute is not in favour of modifying the current statutory formula scales.

Alternatively, it is suggested in the Review that a schedule of pre-determined operating costs in conjunction with a prescribed level of business use, either at 50% or 20%, could be adopted. It is hard to accept how adopting either of these approaches would satisfactorily address the situation where a car, received as a fringe benefit, is used exclusively for private purposes. The more the car is used for private purposes, the greater the benefit. Conversely, it will penalise many employers whose cars are used in excess of 20% (or 50%) for business purposes. In such cases, it will render the statutory formula method obsolete.

Moreover, it will be difficult to monitor the costs of all the numerous types of cars that currently exist and which will be introduced into the Australian market. The ATO will be required to determine standard operating costs either at a national basis or on a state by state basis. Given that the ATO abandoned attempts to classify vehicles between those subject to FBT and those exempt as commercial vehicles, it is hard to see how the ATO will be able to maintain an up to date listing of the operating costs of various vehicles.
It is submitted that a statutory formula based on standard operating costs and a prescribed level of business use is inequitable and practically unworkable.

Alternatively, there ought to be some consideration given to modifying the operating cost method so that employers could adopt standard operating costs and/or a minimum prescribed business use if unwilling or unable to obtain appropriate documentary evidence.

Shareholder benefits

29.13 The Review does not discuss the feasibility of extending the FBT regime to company shareholders and trust beneficiaries. This reform initiative was raised in the Government's white paper "Not A New Tax: A New Tax System.

Any requirement to prepare and disclose the value of fringe benefits provided to shareholders will be complex and costly. New systems will be required to document every transaction involving discounts or benefits to shareholders and prepare group certificates as required. The cost of developing a system to meet these requirements would be significant.

Legislation has recently been passed with has the effect of taxing shareholders on the value of certain non-cash benefits (Division 7A of the Income Tax Assessment Act 1936). Therefore, extending the operation of these provisions so as to tax shareholders and trust beneficiaries on the value of fringe benefits should be considered. This option would also ensure that non-cash benefits provided to shareholders and trust beneficiaries would be taxed in the same manner as dividends and cash distributions. This would require methodologies to value the various types of benefits. Such legislation would be complex and it would be preferable for this reform initiative not to be proceeded with.

Conclusion

29.14 The Revew's review of the FBT regime is welcomed by the Institute. A complete overhaul of the existing FBT regime is overdue. The Institute supports most of the recommendations for reformation of the FBT regime with the exception of the proposed changes to the formula for the taxation of car fringe benefits.

In particular, the Institute is in favour of transferring the liability for FBT from employers to employees, aligning the FBT and personal income tax years, adopting a system of specific inclusion for taxing fringe benefits and excluding entertainment and on premise car parking from FBT coverage.

In addition, the Institute recommends that a detailed definition of entertainment be incorporated into the FBT legislation, the removal from FBT coverage of "off-site" car parking for primarily "work horse" cars and that a comprehensive employer survey be conducted with respect to the alignment of the FBT and personal income tax years.

The Institute also recommends that the Government review proposed initiatives to extend the FBT regime to shareholders and trust beneficiaries and suggests that any provisions to tax non-cash benefits in the hands of the shareholders and trust beneficiaries would be exceedingly complex and require formulation of valuation methodologies. The Institute recommends such initiatives should not be proceeded with.