Tax Transparent Companies: Striving for tax neutrality?
A legal international comparative study of tax
transparent companies and their potential application
for Australian closely held businesses

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Abstract

An underlying issue which inheres in any taxation framework relates to the manner in which it operates and the actual distribution of its imposts or appropriations. In this respect, a tax system needs to confront two fundamental (and interrelated) questions – first, precisely how the tax or impost should be imposed and, secondly, who should bear the legal obligation or onus of payment. These issues can be conceptualised not only from a purely legal or positivist perspective, in terms of identifying who will incur the obligation to pay tax, but also in terms of a more economic and instrumental standpoint as to which entity or individual should effectively be paying the tax. These alternatives may not result in the same conclusions, particularly for the taxation of business forms. To provide one example, if the business form has separate legal entity status from its members, should the business form, as a legal person, be subject to tax separately from its members? From a legal standpoint the response to this question is that such a business form should bear the impost. However, from an economical perspective it may be preferable that the business income and/or losses are directly allocated to its members. Indeed, tax transparency (aggregate approach) has been argued as an economically superior model, although it is not without its critics.¹ Criticisms against tax transparency include the risk to tax revenue and the potential to distort investment decisions when allocated losses exceed a member's financial exposure.² Despite these criticisms, several foreign jurisdictions have implemented tax transparency in relation to business forms

¹ For example: Vann, RJ. (2001). Australia's Policy on Entity Taxation. *Australian Tax Forum* 16:33, at p 36: "Economists often assume that the ideal for taxing entities and their owners is to ignore the entity and to tax the owner directly on the income derived by the entity. This is reflected in the Ralph Report benchmark referring to integration of ownership interests. Thus it is stated in the first discussion paper". Australia. (1998). A strong foundation (Ralph Report No 1), Canberra, AGPS, at p 74: "comprehensive income taxation would look through the entity veil in order to attribute to each individual investor a share of the entity's net cash flows and the change in its net worth proportionate to that individual's ownership interests. In practice, both valuation requirements and complicated capital structures place significant obstacles in the path of this full integration approach".

² Australia. (1999). A Tax System Redesigned (Ralph Report No 4), Canberra: AGPS, at paragraph 277 of Overview.

that are characterised by separate legal entity status and limited liability for members (referred to as tax transparent companies or transparent companies). Prominent examples include the United States' S Corporations and Limited Liability Companies (LLC), the United Kingdom's Limited Liability Partnerships (LLP) and New Zealand's Loss Attribution Qualifying Companies (LAQC). The Australian government has been reluctant to fully embrace transparent companies, preferring the integrated approach of a full imputation system applying to corporate distributions. However, in response to pressure for reform, the Australian government has recently introduced two transparent companies, although they are not broadly available.³ These Australian transparent companies are incorporated limited partnerships used for venture capital investments (venture capital ILPs) and amendments to controlled foreign hybrid companies (CFC hybrids).

The question that needs to be raised in relation to the introduction of the foreign transparent companies entails precisely *what* were the underlying motivations that prompted their implementation in the first place. In particular, were these entities introduced purely on the basis of promoting tax neutrality, or were other factors or motivations influential in their creation? If, indeed, other factors were at play then this implicates the obvious question regarding the existence of similar factors in Australia – thereby, perhaps, facilitating the creation of the same type of entities in this jurisdiction.

A further interrelated question that needs to be confronted is whether these foreign jurisdictions have ensured that their tax revenue is not prejudiced or affected through the allocation of tax losses to members who do not have full liability exposure. If this is the case, then the consequent concern implicated here is whether Australia's present loss restriction rules would be able (in such a

³ Freudenberg, B. (2006). Are transparent companies the way of the future for Australia? *Australian Tax Review* 35(3): 200.

circumstance) to adequately protect tax revenue in the pursuit of developing such a tax transparent company?

A final concern stemming from the foregoing issues is that, given the purported benefits that accrue to closely held businesses via tax transparent companies, how does transparency influence problems faced by this sector in terms of complexity, financing and governance.

It is these relevant questions to which attention will be focused on in this dissertation. In addressing these pertinent issues, tentative recommendations for policy and legislative reforms will be formulated in the concluding chapters.

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Refereed Publications

Author	Article Title	Journal
B Freudenberg	Losing my Losses: Are the loss restriction rules applying to Australia's tax transparent companies adequate?	Australian Tax Forum Vol 23 (2), 2008, pp 125-163
B Freudenberg	What the new CFC amendments mean: Australians structuring their investments into the United States of America through LLCs	Asia Pacific Tax Bulletin Vol 14 (3), 2008, pp 188-197
B Freudenberg	The Troubled Teen Years: Is the repeal of New Zealand's LAQC regime required?	New Zealand Journal of Taxation Law and Policy Vol 14 (1), 2008, pp 67-97
B Freudenberg	Australia's Struggle with Tax Transparent Companies	Tax Notes International Vol 48(1), 2007, pp 83-102
B Freudenberg	Are transparent companies the way of the future for Australia?	Australian Tax Review Vol 35(3), 2006, pp 200-223
B Freudenberg	Is the New Zealand Qualifying Company regime achieving its original objectives?	New Zealand Journal of Taxation Law and Policy Vol 11 (2), 2005, pp 185-215
B Freudenberg	Entity Taxation: The inconsistency between stated policy and actual application	Journal of the Australasian Tax Teachers Association Vol 1 (2), 2005, pp 458-490

Conference and seminar presentations

Presenter	Presentation Title	Conference/Seminar Series	Date
B Freudenberg	Selected to present PhD Poster: Tax Transparent Companies: Striving for Tax Neutrality	2008 International Fiscal Associations' 2008 Brussels Congress, Belgium	31 August to 5 September 2008
B Freudenberg	Tax Transparent Companies: Striving for tax neutrality. A PhD overview of major findings	University of Sydney Law School (Tax Group): Seminar Series	7 May 2008
B Freudenberg	Losing My Losses: Are the loss restriction rules applying to Australia's tax transparent companies adequate?	Australasian Tax Teachers Conference, Tasmania University, Hobart, Tasmania	January 2008
B Freudenberg	What is Governing Tax Transparent Companies for Closely Held Businesses?	University of Illinois, Corporate Law Program, Champaign-Urbana, United States	13 March 2007
B Freudenberg	What have been driving hybrid business forms and will Australia follow?	Association of American Law Schools (Section on Agency, Partnership, LLCs and Unincorporated Associations), Washington DC, United States	January 2007
B Freudenberg	Hybrid Entities: International Experience – the Australian solution?	International Beau of Fiscal Documentation (IBFD) 5th Annual Meeting for Students of International and Comparative Tax Law, IBFD, Amsterdam, The Netherlands	July 2006

(Continued over)

Presenter	Presentation Title	Conference/Seminar Series	Date
B Freudenberg	Traditional Corporations Out of Steam: Are new hybrid business forms the way of the future?	Australasian Tax Teachers Conference, University of Melbourne, Melbourne, Victoria	January 2006
B Freudenberg	What are driving hybrids? Political and economic forces behind new hybrid business forms	2nd International Business Research Conference, University of Technology Sydney, Sydney, Australia	December 2005
B Freudenberg	Are Qualifying Companies Quality? The lessons to be learnt from New Zealand's hybrid entities for Australia	Australasian Tax Teachers Conference, Victoria University, Wellington, New Zealand	January 2005
B Freudenberg	Hybrid Taxation	PhD workshop Australasian Tax Teachers Conference, Victoria University, Wellington, New Zealand	January 2005

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Abbreviation of Terms

Abbreviation	Full meaning
1986 Tax Reforms	Tax reforms introduced in the United States via the <i>Tax Reform Action 1986</i> (US)
AFOF	Australian Venture Funds of Funds
American states	The various State and District governments that make up the United States of America
Australian government	Australian Federal or Commonwealth government
AVCAL	Australian Venture Capital Association Limited
CFC	Controlled Foreign Company
CGT	Capital Gains Tax
FBT	Fringe Benefits Tax
FIF	Foreign Investment Fund
GDP	Gross domestic product
GmbH	<i>Gesellschaft mit beschränkter Haftung</i> (German private corporation)
GST	Goods and Services Tax
Hamilton Brothers	Hamilton Brothers Oil Company of Denver
ICAA proposal	Institute of Chartered Accountants in Australia and Deloitte's proposal for a flow-through entity
ILP	Incorporated Limited Partnership
International Association	International Association of Corporation Administrators
IRC 1986 (US)	Internal Revenue Code 1986 (US)
ITA 1994 (NZ)	Income Tax Act 1994 (NZ)
ITA 2007 (NZ)	Income Tax Act 2007 (NZ)
ITAA 1936 (Cth)	Income Tax Assessment Act 1936 (Cth)
ITAA 1997 (Cth)	Income Tax Assessment Act 1997 (Cth)
KG	<i>Kommanditgesellschaft auf Aktien</i> (German limited partnership)
LAQC	Loss Attributing Qualifying Company
LLC	Limited Liability Company
LLC Agreement	LLC Operating Agreement
LLP	Limited Liability Partnership
LLP Act 2000 (UK)	Limited Liability Partnership Act 2000 (UK)
LLP Agreement	LLP Operating Agreement
New Zealand Revenue	Inland Revenue (Te Tari Takke)
NIC	National Insurance Contributions (UK)
OECD	Organisation for Economic Co-operation and Development

Abbreviation	Full meaning
QC	Qualifying Company
QCET	Qualifying Company Election Tax
STS	Simplified tax system applying under ITAA 1997 (Cth)
Uniform LLC Act	Uniform Limited Liability Company Act (US Model)
United Kingdom Revenue	HM Revenue and Customs (previously Inland Revenue)
United States	United States of America
United States IRS	Internal Revenue Services (US)
VAT	Value Added Tax
VCLP	Venture Capital Limited Partnership
VCMP	Venture Capital Management Partnership
Venture Capital ILP	Venture Capital Incorporated Limited Partnership

Glossary of Terms

Active member: A member who actively participates in the management of the business. Refer to 'member-management'. Compared to 'passive member'.

Australian Venture Funds of Funds (AFOF): One type of form used to facilitate venture capital investment in Australia. Describes a fund that pools capital and becomes a limited member across a number of venture capital ILPs.

Aggregate approach: The tax treatment of treating a business form and its member(s) as a single whole comprised of all the members of the business, rather than treating the business form as separate from its members. Members are allocated their share of each item of income and/or expenditure, and can be treated as tax owners of the assets held by the business form. Refer to 'tax transparency'. Compared to 'entity approach' and 'integrated approach'.

Allocation: The allocating of income or losses directly to members for tax purposes, even though legally the income and/or losses is earned or incurred by the business form. No actual payment or distribution may have occurred from the business form to the member. Compared to 'distribution'.

Business form: The legal structure that investors (members) adopt to conduct their business activities through. This term is used even though legally the business form may not be a separate legal entity from its members. Also referred to as an 'entity'.

C Corporation: A business form that is assessed in the United States pursuant to Sub-Chapter C *IRC (1986)* (US), that involves an entity tax treatment.

Capital asset: An asset held on the capital account of a business form. Common examples include land and goodwill. Compared to 'revenue asset'.

Capital export neutrality: An investor should pay the same total tax (including domestic and foreign) whether the investor receives a given investment income from foreign or domestic sources.⁴

CFC hybrid amendments: The Australian legislative amendments recognising certain foreign tax transparent companies as general partnerships for Australian tax purposes. Found in Division 830 *ITAA 1997* (Cth).

CFC hybrid: A foreign tax transparent company that is eligible for transparency within Australia's CFC hybrid amendments.

Classical tax system: When the business form is subject to an entity approach for tax purposes, with no recognition of tax paid on subsequent distributions to members, nor concessional tax treatment on distribution, such as dividend deduction. Refer to 'entity approach'.

Closely held business: The qualitative characteristics inherent are that membership interests are not widely dispersed, and they are not publicly traded. A closely held business is normally one that is independently owned and operated. Most, if not all, capital is contributed by members and managers. Members are likely also to participate in the management of the business (member-management).

⁴ Musgrave, R. (1960). Criteria for Foreign Tax Credit in *Taxation and Operations Aboard*, at p 84-85.

Concurrent use of business forms: The use of a number of business forms in the conduct of an enterprise. For example, the use of a corporation to hold valuable assets, with the actual business operations conducted by the trustee of a discretionary trust.

Conduit principle: The concept of an amount received or expended by a business form maintaining its identity and character as it flows through the business form to its members. For example, a receipt which is capital in nature for the entity will be regarded as a capital receipt when allocated to a member.

Constitution: The document or agreement which governs the internal and external relations of a business form. Includes a general partnership agreement, an LLC Agreement and the Articles of Association for a corporation.

Continuity of life: Refer to 'perpetuity'.

Corporation: A business form that involves the incorporation of an entity (the corporation) with its equitable members holding shares in the entity (known as shareholders). The corporation is a separate legal entity from its members and directors, and can provide members with limited liability. A corporation is also known as a 'company' but to reduce confusion with LLCs this term is not used in this dissertation.

Debt: A financial arrangement involving the receipt of a financial benefit, which has effectively a non-contingent obligation to provide a financial benefit. Compared to 'equity'.

Default rules: Rules that apply to a business form automatically pursuant to the legislation that regulates formation of the business form. Default rules may be altered by members' agreement or constitution. Default rules automatically provide a framework to govern the business form and the relationship of the parties involved. Compared to 'mandatory rules'.

Discretionary trust: A trust where the allocation or division of the beneficial interest in the trust property and/or income is left to the absolute discretion of the trustee. The trustee has the power to decide how to apportion both the income and/or the capital of the trust among the beneficiaries from a defined class in the trust instrument. Such beneficiaries are known as 'mere objects'. There is no guarantee that a mere object will be allocated anything.

Disregarded entity: A business form subject to the aggregate approach for tax purposes. Refer to 'tax transparency'. Compared to 'entity approach'.

Distribution: The actual payment or transfer of assets (including money) to members from the business form. Compared to 'allocation'.

Economically efficient: The maximising of economic output given the resources available to the community. This involves not just maximising production but also producing the goods and services that consumers most want. If tax distorts an otherwise economically efficient market, this is known as the excess burden of taxation. The efficiency of a tax refers to both its neutrality as well as the extent to which both compliance and administrative costs associated with the tax are minimised when compared to the tax yield.

Entity acknowledgement: Even if a transparent (aggregate approach) tax system applies to a transparent company, for various matters there may still be some acknowledgement of the business form. For example, the lodgements of an information tax return by the business form, or the making of tax elections for the treatment of plant and equipment. Furthermore, entity acknowledgement can influence the recognition of membership interests in the business form and the holding of assets.

Entity approach: For tax purposes, the business form is treated as a separate taxpayer from its members, with income and/or losses determined at the entity level. Members are not assessed until the business form makes an actual distribution to them. No tax relief is given to members in recognition of the tax already paid by the business form. Refer to 'classical tax system'. Compared to 'aggregate approach' and 'integrated approach'.

Equity: A contribution made by a member to a business form which is not guaranteed a return and instead is contingent on the performance of the business. Compared to 'debt'.

Fiscal transparency: Refer to 'tax transparency' and 'aggregate approach'. Compared to 'entity approach'.

Fixed trust: A trust where the beneficiaries' interests in the income and/or capital of the trust are fixed. Compared to 'discretionary trust'.

Flow-through taxation: Refer to 'tax transparency' and 'aggregate approach'.

Foreign tax transparent company: A tax transparent company that is formed outside of Australia.

Fractional interest: When members are regarded as holding direct fractional interests in the individual assets held by the business form. Fractional interests can arise when an aggregate approach is utilised for tax purposes.

Franked dividend: When a distribution is made by a corporation to a member under an imputation system, which is an example of an integrated approach. A franked dividend represents profits that have been subject to tax at the corporate level and the member is able to offset their tax liability by this prior corporate tax. Refer to 'integrated approach'. Compared to 'unfranked dividend'.

Free transferability of membership interest: When membership interest of a business form is able to be transferred without restriction.

Fully tax transparent company: A business form with the feature that all income (whether distributed to members or retained) is allocated and assessed to members for tax purposes. Similarly, the business form's losses, generated when deductions exceed assessable income, are allocated directly to members. Additionally, a fully tax transparent company provides for limited liability for its members and is treated as a separate legal entity. Other terms used to describe these business forms include 'full integration', 'aggregate approach', 'disregarded entity' and 'flow-through entity'. Compared to 'entity approach' and 'integrated approach'.

Full integration: Refer to 'aggregate approach'.

General member: The member(s) of a general partnership or a limited partnership who have liability exposure for the business activities conducted by the business form.

General partnership: A business form that is not a separate legal entity from each partner (member), with the members jointly and/or severally liable for the partnership's debt and obligations. For Australian tax purposes, a general partnership is subject to an aggregate approach.

Governance law: The direct laws that govern a business form, which can include the formation and governance of the business form. Governance law may include 'mandatory rules' and 'default rules'. These include such as rules restricting distributions; disclosure requirements; imposition of duties of managers and/or members and unfair preference rules.

Import–export neutrality: This term encapsulates both 'capital export neutrality' and 'import neutrality' and exists when a country's tax system provides equivalent treatment to domestic and international investments.

Import neutrality: Capital funds originating in a foreign country are subject to the same level of taxation as the capital originating from within the inbound country.

Incorporation: The charter granted by the state for the creation of a business form. Historically, incorporation was accomplished by specific legislation for each incorporated form. In modern times, this has been simplified by the broad application of one Act under which a document can be lodged petitioning for the creation of a business form. Traditionally, corporations fell within this category. In comparison, sole proprietorships, general partnerships and trusts can be established through the actions of the member(s), without direct participation by the state. It is argued that when there is a requirement for state involvement in the creation of a business – for example through the lodgement of a document – it is preferable to refer to the business form as being ‘incorporated’. The establishment of all of the transparent companies studied require the lodgement of a document, and they are therefore ‘incorporated’ by the state.

Integrated approach: For tax purposes there is some recognition or relief either at the member or business level for the tax ready paid at the entity level. Examples of integrated approaches include the split rate tax system, the deductible distribution system, the exempt distribution system and the imputation system.

Investor: Refer to ‘member’.

LAQC regime: The regulations (including New Zealand tax law) that apply to Loss Attributing Qualifying Companies (LAQC).

Limited liability: A member's exposure for the liabilities and obligations of the business form that a member operates through is limited. The extent of the limitation can vary from the amount of the member's contributed equity to the business form; or through to the liability for debts and obligations arising from the errors and negligence of the member or representatives working under the supervision of the member.

Limited liability partnership (LLP): Refers to the new business form that provides for a separate legal entity and some liability protection for members. This form is available in the United States and the United Kingdom.

Limited member: A member of a business form afforded some liability protection pursuant to the governance laws of the business form. For example, a member of corporation or a limited member of a limited partnership.

Limited recourse loan: A loan which the borrower has only a restricted obligation to repay the creditor. The rights of the creditor against the debtor in the event of default may be restricted to nominated property only or a specified dollar amount.

Limited partnership: A form of partnership which offers limited liability for some members. There can be a requirement to have one member who does not have liability protection, known as a 'general member'. For a limited member the personal liability may be restricted to the amount of capital contributed by them to the partnership. Limited members may be precluded from taking part in the management of the business form. In Australia, limited partnerships are not bodies corporate and do not have separate legal status to members.

LLP Agreement: An operating agreement between the members of an LLP setting out the constitution of the LLP.

Loss Attributing Qualifying Company (LAQC): A corporation that satisfies the eligibility requirements to be treated as a LAQC pursuant to sections HA 1 to HA 9 of the *ITA 2007* (NZ). The LAQC is not a fully transparent company, but instead is a ‘partial loss transparent company’, allowing the direct allocation of losses to members, with income being initially assessed at the entity level. An LAQC falls within the classification of ‘special tax rule company’.

Loss restriction rules: The rules that members of a transparent company must satisfy in order to utilise the losses allocated to them from the transparent company. These rules can relate to membership cost basis, risk, passivity and streaming.

Manager-management: A non-member who is responsible for managing the business form. Compare to ‘member-management’.

Mandatory rules: Rules that apply to a business form under the governance law which cannot be altered by member agreement or the constitution. Compared to ‘default rules’.

Member: An equity investor in a business form. An example of a ‘member’ would be a sole proprietor, partner in a general or limited partnership and a shareholder in a corporation. In this dissertation the term ‘member’ is adopted to ensure consistency and aid understanding when referring to an equity investor.

Member loan: A debt contribution made to a business form by a member. Compared to ‘equity’.

Membership interest: The recognition of the equity investment that a member has in a business form. A membership interest may or may not be a separate asset itself. For example, a membership interest in a corporation is known as a share (or ‘stock’ in the United States).

Member-management: A member who actively takes part in the management of the business form. Also known as an ‘active member’. Compared to ‘passive member’ and ‘manager-management’.

Member-subordinated loan: A member loan to the business form that ranks below both secured and unsecured creditors of the business form for repayment.

Membership cost basis: One of the restrictions imposed on the utilisation of losses by members of a transparent company. The term broadly describes the equity amount that a member has invested in a transparent company. Also known as ‘outside cost basis’ (United States), ‘capital contribution’ (United Kingdom) and ‘cost basis’ (New Zealand).

New form transparent company: A classification of tax transparent companies which is exemplified by the creation of a new business form in the jurisdiction subject to existing tax transparency rules applying to general partnerships. LLCs and LLPs fall within this classification. Compared to ‘special tax rule company’.

Non-active member: Refer to ‘passive member’. Compared to ‘active member’.

Non-recourse loan: Debt for which the creditor has no recourse should the borrower default on the loan.

Opaque: When a business form is taxed separately from its members. Refer to 'entity approach'. Compared to 'aggregate approach'.

Outside loan: A loan to the business form from a third party who is not a member.

Partial loss transparent company: A transparent company that has all the attributes of a 'fully tax transparent company' except that income is initially assessed for tax purpose at the entity level. The losses of this business form are automatically allocated to members. An example is New Zealand's LAQC.

Partnership: Used as an umbrella term to describe the various types of partnerships, such as 'general partnerships', 'limited partnerships', 'limited liability partnerships' and 'incorporated limited partnerships'.

Passive member: A member who does not actively participate in the management of the business form. Compared to 'active member'.

Perpetuity: The legal notion that a business form continues without intermission or interruption forever despite changes to, or loss of legal capacity of, members.

Professional firms: Businesses conducted by professionals, particularly accountants and lawyers. Also referred to as 'professional practice'.

Professional LLP: A United Kingdom LLP that conducts a professional practice. Compare to 'Trade LLP'.

Qualifying company (QC): A New Zealand corporation which satisfies the eligibility requirements to be treated as QC pursuant to sections HA 1 to HA 9 of the *ITA 2007* (NZ).

Revenue asset: An asset held on revenue account by the business form. For example, trading stock or inventory. Compared to 'capital asset'.

Risk rules: A potential restriction on the utilisation of allocated losses by members of a transparent company. A member's risk might be ascertained by quantifying a member's liability on winding-up of the business form, or the exposure of the value of their membership interest due to losses incurred by the transparent company.

S Corporation: An American corporation that satisfies the eligibility requirements pursuant to Sub-Chapter S *IRC (1986)* (US) for tax transparency to apply. An S Corporation falls within the classification of 'special tax rule company'.

Separate legal entity: When a business form is treated at law as a distinct and separate legal entity from its members. This means the business form can own property, enter into contracts in its own name and can be sued in its own name. For example, a corporation is a separate legal entity from its members even if there is only one member. The status of separate legal entity can re-enforce a member's liability protection.

Sole proprietor: When an individual carries on business in his or her own name.

Special partnership: Historically a partnership form similar to 'limited partnership'.

Special tax rule company: An argued classification of tax transparent companies, which is exemplified by the creation of a special set of tax transparent rules applying to certain corporations. S Corporations and LAQCs fall within this classification. Compared to 'new form transparent company'.

Streaming: The differential allocation of income and/or losses by a business form to members in a manner determined by the members' tax profiles. Streamed allocations may not necessarily be representative of members' equity contributions.

Tax-exempt: A taxpayer who is exempt from income taxation.

Tax efficiency: The compliance and administration costs of a tax system should be minimised and the payment of tax should be as easy as possible.

Tax neutrality: A principle of tax system design that specifies that the tax system should be neutral as between alternative business or consumption choices, so that the impact of tax does not influence individual or business choices by distorting or altering the costs of alternatives. Tax neutrality dictates that the tax system should not impede or reduce the productive capacity of the economy. Business decisions should be motivated by economic rather than tax considerations. Taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation. This can be conceptualised in a number of ways: capital import neutrality, capital export neutrality, choice of business form, choice between debt and equity funding, foreign versus domestic funding and retention compared to distribution of profits.

Tax preferences: An amount or receipt that is not included in a taxpayer's (including a business form's) taxable income. Tax preferences may arise because of research and development concessions, exempt income, asset revaluations, capital gains concession (such as the CGT asset being acquired prior to 20 September 1985 in Australia), capital works; accelerated depreciation for plant and equipment, small business concessions, environmental expenditure deductions; water care deductions, and amounts sheltered because of carried forward losses.

Tax profile: The current tax characteristics of a taxpayer, such as their level of assessable income, losses, capital gains, capital losses, residency and tax-exempt status. A taxpayer's tax profile is particularly relevant if streaming is to occur from a business form.

Tax transparency: Where members of a business form are directly allocated the income and/or losses of the business. For tax purposes the business form is, in effect, regarded as an extension of the members. Refer to 'aggregate approach'. Compared to 'entity approach'.

Tax transparent company (or Transparent company): The offspring of the two business forms, being corporations and general partnerships, where attributes of both are combined. The combined attributes present in the transparent company considered are a corporation's separate legal entity status and limited liability, with a general partnership's aggregate tax treatment. The term 'company' is adopted to indicate the characteristics of separate legal entity status and limited liability, even though some jurisdictions have used the term 'partnership' in describing their transparent company (as defined). There are variations of tax transparent companies, refer to 'fully tax transparent company' and 'partial loss transparent company'. The transparent companies studied have been classified as either 'special tax rule companies' or 'new form transparent companies'.

Tax transparent treatment (or transparency or transparent treatment): Refer to 'aggregate approach' or 'tax transparency'. Compared to 'entity approach' and 'integrated approach'.

Trade LLP: A United Kingdom LLP that conducts a non-professional practice. Compared to a 'Professional LLP'.

Traditional business forms: Those business forms that have existed for some time in Australia; including sole proprietors, general partnerships, limited partnerships, trust (both discretionary and unit) and corporations.

Transparent company: Refer to 'tax transparent company'.

Trust: When an entity (the trustee) holds property for the benefit of others (beneficiaries). A trust could be a discretionary trust or fixed trust or a combination of these. The property held on trust could include business assets.

Unfranked dividend: A type of distribution made by a corporation to a member when the integrated approach of imputation applies. An unfranked dividend represents the distribution of corporate profits that have not been subject to tax at the corporate level. Compared with 'franked dividend'.

Unit trust: A trust where the membership interest of beneficiaries is denoted by units, which may have a fixed entitlement to the income and/or capital of the trust.

Unpaid allocations: When a member is assessed on the income of a business form allocated to them for tax purposes without that member receiving a corresponding distribution of income.

Utilisation of losses: When members with allocated losses from a business form are able to offset these losses against their other income.

Widely held business: When the membership interest of a business form is widely dispersed. This could occur when the membership is listed on a stock exchange. A widely held business is likely to be characterised by manager-management. Compared to 'closely held businesses.

Venture capital: There is no precise definition of venture capital. It describes a scenario where private investors invest in a wide range of industries (both traditional and upcoming industries). Venture capital is also known as 'private equity', to distinguish it from businesses raising public funds through listing on the stock market.

Venture capital corporation: Is an Australian corporation which has attracted equity from a venture capital ILP. An integrated approach is taken for the venture capital corporation for Australian tax purposes.

Venture capital ILP: Australia's incorporated limited partnerships (ILP) regime that has been introduced to facilitate venture capital investment into venture capital corporations. There are three types of ILPs included in this term, being VCLP, AFOF and VCMP. An eligible venture capital ILP is subject to tax transparency.

Venture Capital Limited Partnership (VCLP): An Australian venture capital ILP that directly invests into eligible venture capital corporation.

Venture Capital Management Partnership (VCMP): A venture capital ILP that acts as a general member of a number of VCLPs and/or AFOFs.

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Brett Freudenberg

January 2009

Statement of Originality

I hereby certify that the work contained in this dissertation has not previously been submitted for any degree or diploma in a university. To the best of my knowledge and belief, the dissertation contains no material previously published or written by another person except where due reference is made in the dissertation itself.

Signed Brett David Freudenberg

This dissertation is based on the law as at 31 December 2008.

Chapter One: Introduction

Australia is out of step with international best practice, which treats access to limited liability as a special policy issue – not a tax issue ... Perhaps it is time for Australia to align with similar international best practice and adopt a tax transparent limited liability model similar to the US S-Corp.¹

1.1. Aims and Motivation

Over a century and a half ago the United Kingdom Parliament enacted legislation for the introduction of corporations that provided members with limited liability with respect to the corporation's obligations.² Since that time, corporations have been described as the 'greatest single discovery of modern times', even exceeding the contribution of steam and electricity.³ This success has been attributed to their central characteristics of limited liability, continuity and transferable membership interests.⁴ These characteristics have meant that corporations have been perceived as contributing significantly to the economic development of countries.⁵

A key issue is whether tax should be imposed on these separate legal business forms, or their members, or a combination of both. This issue has been complicated by the introduction of new business forms which exhibit 'company' characteristics, specifically limited liability and separate legal status, but which may have internal governance structures more reflective of 'partnerships'. Further complicating this issue is a more generalised 'blurring' of business form

¹ Szekely, L. (2007). Limited Liability for the Sole Trader. *Intax* October, at p 23.

² *Limited Liability Act of 1855* (UK). Note that the incorporation of companies by registration was first authorised in the United Kingdom by the *Joint Stock Companies Act 1844* (UK).

³ Nicholas Murray Butler of Columbia University, quoted by A. L. Diamond in: Elias, S. (1987). *Contemporary Issues in Company Law*, edited by J Farrar, New Zealand: CCH.

⁴ Elias, n 3.

⁵ Harris, PA. (1996). *Corporate/Shareholder Income Taxation and Allocating Taxing Rights Between Countries: A Comparison of Imputation Systems*. Amsterdam: IBFD Publications BV, at p 40. Norr, M. (1982). *The Taxation of Corporations And Shareholders*. Deventer: Kluwer Law And Taxation Publishers, at p 5: "industrialization seems almost inevitably to be marked by an increase in the number and the importance of corporations."

attributes.⁶ These trends challenge policies which consider that there is a universal understanding of the characteristics of business forms and their tax treatment.⁷ Vann argues that this development creates a greater need for an emphasis on economic substance in the taxation of business forms, as opposed to a focus on legal characteristics.⁸

The imposition of taxation on businesses is very influential and has flow-on affects in society more generally. In particular, taxes imposed on businesses can influence market allocations of resources.⁹ Taxes that do not interfere or distort market allocations are referred to as 'neutral' – thereby allowing the market to determine the most efficient allocation of resources.¹⁰ It should be noted that by the close of the twentieth century, governments appeared to give greater priority to achieving the goals of neutrality and efficiency,¹¹ compared to the prior trend of equity.¹² The attainment of tax neutrality can be considered in a number of ways, such as debt-equity funding, distribution-retention policies, export-import neutrality and between business forms.

⁶ Vann, RJ. (2001). Australia's Policy on Entity Taxation. *Australian Tax Forum* 16:33, at p 45.

⁷ For example: Avery Jones, JF, De Broe, L, Ellis, MJ, Miyatake, T, Roberts, SI, Goldberg, SH, Killius, J, Maisto, G, Giuliani, F, Vann, RJ, Ward, DA, and Wiman, B. (2002). Characterization of Other States' Partnerships for Income Tax. *Bulletin – Tax Treaty Monitor* July:288, at p 315: "A problem with this approach is that the OECD Model does not make a distinction between companies and partnerships based on how the body is taxed; thus, as it stands, it would be difficult to fit categorization into the OECD Model. The Commentary assumes that companies are legal entities and that, in most countries, partnerships are not, which may be true generally, but is now subject to numerous exceptions. "Company" is defined in the OECD Model (Art. 3(l)(b)): the term 'company' means any body corporate or any entity that is treated as a body corporate for tax purposes".

⁸ Vann, n 6, at p 45.

⁹ Harris, n 5, at p 8.

¹⁰ Harris, n 5, at p 8.

¹¹ Ganghof, S. (2000). Adjusting National Tax Policy to Economic Internationalization: Strategies and Outcomes. In *Welfare and Work in the Open Economy*, edited by F. W. Scharpf and V. A. Schmidt. Oxford: Oxford University Press, at p 613.

¹² Early in the twentieth century the focus of tax policy appeared more directed to equitable concerns, with consideration as to whether the tax system operated fairly between taxpayers: Radaelli, C. (1999). Taxation as Politics. In *Interdisciplinary Research in Taxation: Research Approaches and Bibliographic Survey*, edited by M. Lamb and A. Lymer. London: Centre for Business Performance, at p 137. The criterion of equity comprises the notions of vertical and horizontal equity. Vertical equity is achieved when taxpayers are taxed according to their ability to pay, which is reflected in the adoption of progressive marginal tax rates for individuals in Australia. Horizontal equity refers to the notion that taxpayers with the same economic wealth should be required to pay the same amount of tax.

In this context, taxation models can be perceived in terms of a continuum from an entity approach to an aggregate approach for business forms. National jurisdictions have sought to implement tax regimes that have been reflective of different points along this continuum.¹³ This can extend from the entity (classical) tax system,¹⁴ to systems that tax the entity but provide for tax relief on distributions (an integrated approach)¹⁵ and to an aggregate approach. This conceptual relationship is presented diagrammatically in Figure 1-0-1, which demonstrates that tax relief for an integrated approach may be granted at either the entity level or the member level. While Australia has adopted a variety of approaches for taxing corporations, it has never provided a complete aggregate approach. Australia's first corporate tax, established in 1915, combined a dividend deduction or split-rate mechanism with a shareholder tax rebate (an integrated approach).¹⁶ This was replaced from 1940 to 1987 with a classical system of corporation taxation (an entity approach).¹⁷ Then, in 1987, Australia returned to an integrated approach, adopting an imputation system for the taxation of corporations.

¹³ Vann, n 6, at p 44.

¹⁴ The classical tax system describes when the business form is subject to an entity approach for tax purposes, with no recognition of this tax paid on subsequent distributions to members, nor concessional tax treatment on distribution, such as dividend deduction.

¹⁵ This tax relief could be a split rate system, deductible distribution, exempt distributions or imputation system. See: The American Law Institute. (1993). *Federal Income Tax Project, Integration of The Individual And Corporate Income Taxes; Reporter's Study of Corporate Tax Integration*, by Alvin C Warren, Jr., Reporter. Philadelphia: The American Law Institute, at pp 50-54.

¹⁶ Harris, n 5, at pp 87 and 94: "The Federal Government of Australia introduced the income tax as a war measure in 1915 Section 16 of the *Income Tax Assessment Act 1915* provided corporations with a full deduction for dividends distributed, dividends being taxed in the hands of shareholders at progressive rates. This early income tax was very sophisticated, incorporating not only a dividend deduction system but also a dividend tax credit system where dividends were distributed from previously retained earnings. However, in the latter case, low rate shareholders were not entitled to a refund of excess dividend tax credits". ... "the imputation system was replaced in 1940 with a classical system, largely as a result of the revenue requirements of the Second World War".

¹⁷ Holub, M. (2001). *Taxes and the Choice of Organisational Form in Australia*. PhD, Department of Accounting and Finance, University of Western Australia, at p 54.

Figure 1-0-1: The continuum of the taxation of business forms¹⁸

An ‘entity’ approach is taken when a jurisdiction recognises a business form as a separate taxpayer from its constituent members, imposing tax on the legal entity.¹⁹ The appropriateness of such an entity approach is predicated on legal theories of corporate personality.²⁰ While the entity approach can be a simple system, such an approach is not without criticism: as the incidence of tax is essentially always on the ‘natural person’,²¹ even if initially bourn by the entity. It should be pointed out that the adoption of an entity approach has the potential to

¹⁸ Figure modified from Cnossen, S. (1984). Alternative Forms of Corporation Tax. *Australian Tax Forum* 1:253, at p 255.

¹⁹ Another term used to describe this treatment is ‘opaque’. Harris, n 5, at pp 43 and 51. Ting, A. (2005). Policy and Membership Requirements for Consolidation: A Comparison between Australia, New Zealand and the US. *British Tax Review* 3:335, at p 311.

²⁰ Maine, JA. (2001). Linking Limited Liability and Entity Taxation: A Critique of the ALI Reporters’ Study on the Taxation of Private Business Enterprises. *University of Pittsburgh Law Review* 62:223, at p 242. Norr, n 5, at p 17.

²¹ Cnossen, n 18, at p 273-274; Kay, JA, and King, MA. (1990). *The British Tax System*. 5 ed. Oxford: Oxford University Press, at p 152 and McNulty, JK. (1992). *Federal Income Taxation of S Corporations*. New York: The Foundation Press Inc, at p 138.

breach tax neutrality, as it can cause a preference for retention of profits and debt funding by the business form.

In contrast to such an approach, economists have advocated for tax transparency (an aggregate approach) as an ideal model, with income and/or losses of the business form directly allocated to members.²² One benefit of tax transparency is improved tax neutrality, as it may reduce the impact of tax on consumption choices.²³ Historically, however, it has been argued the implementation of such an economic ideal is problematic for business forms with limited liability and separate legal entity status. The asserted difficulties relate to the potential of risk to revenue, allocation and administrative issues, complexity and the pressure to distribute money.²⁴ A consequence of this has been that jurisdictions provide for either an entity approach or a form of integration, rather than full transparency to such business forms.

However, there are several examples of foreign jurisdictions embracing a fully tax transparent approach for business forms with separate legal status and liability protection for members. Examples of these tax transparent companies include

²² Another term that can be used to describe an aggregate approach is 'fiscally transparent'. Kwall, JL. (2005). *The Federal Income Taxation of Corporations, Partnerships, Limited Partnerships, Limited Liability Companies, and their Owners*. 3rd ed. New York: Foundation Press, at p 10, and Maine, n 20, at p 240. Head, JG. (1997). Company Tax Systems: From Theory to Practice. In *Company Tax Systems*, edited by J. Head and R. Krever. Burwood: Australian Tax Research Foundation, at p 22: "In the traditional public finance literature, full integration of the corporate income tax with the personal income tax has long been viewed as the relevant 'blueprint' or ideal". Cnossen, n 18, at p 262: "For tax purposes there should be no difference between corporate profits and other capital income, such as interest and rents, or labour income, such as wages and salaries that is solely subject to the individual income tax". Bird, RM. (1987). Corporate–personal tax integration. In *Tax Coordination in the European Community*. Deventer: Kluwer Law and Taxation Publishers, at p 242. Crawford, C, and Freedman, J. (2008). Small Business Taxation. In *Prepared for the Report of a Commission on Reforming the Tax System for the 21st Century*, Chaired by Sir James Mirrless: The Institute of Fiscal Studies, at section III.

²³ Australia. (1975). Taxation Review Committee Full Report, (Asprey, KW Chairman), 31 January, Canberra: AGPS, at p 16.

²⁴ Norr, n 5, at pp 18-19. There has been a greater willingness for jurisdictions, including Australia, to have tax transparency for business forms which do not provide a separate legal entity and liability protection. For example, transparency generally applies to sole proprietors and general partnerships.

the United States' S Corporations and limited liability companies (LLC), the United Kingdom's limited liability partnership (LLP) and New Zealand's Loss Attribution Qualifying Company (LAQC) and its new limited partnership regime. Other tax transparent companies introduced around the world include Singapore's LLP,²⁵ Northern Ireland's LLP²⁶ and Japan's LLP²⁷ and LLC.²⁸ Other jurisdictions have introduced entities with some of these attributes, but these entities currently lack the separate legal entity status.²⁹

The introduction of these tax transparent companies has met with a mixed response in their respective jurisdictions,³⁰ but they are sometimes touted as a benefit to closely held businesses.³¹ The basis for such assertions is not always

²⁵ Introduced in April 2005 by the *Limited Liability Partnership Act* (Chapter 163A)

²⁶ Which is similar to the United Kingdom's LLP, and took effect from 13 September 2004.

²⁷ Commencing 1 April 2005.

²⁸ Known as *Godo Kaisha* 'GK' commencing 1 May 2006. Note it is not clear whether such an entity for Japanese tax purposes has been granted tax transparent treatment.

²⁹ For example: (a) Germany the GmbH&Co.KG which uses a corporation (known as a GmbH) as the general member of a limited partnership (known as a KG); and (b) France the SAS.

³⁰ Levmore, S. (1992). Partnerships, Limited Liability Companies, and Taxes: A Comment on the Survival of Organizational Forms. *Washington University Law Quarterly* 70:489, at p 492, Hamilton, R, and Ribstein, L. (1997) Limited Liability and the Real World – a debate. *Washington and Lee Law Review* 54:687; and Roe, MJ. (1996) Chaos and Evolution in Law and Economics. *Harvard Law Review* 109: 641.

³¹ For LLCs see: Hicks, A, Drury, R, and Smallcombe, J. (1995). Alternative Company Structures for the Small Business. In *ACCA Research Report No 42*. London: Certified Accountants Educational Trust, at p 53. For LLPs see: House of Commons – Select Committee. (1999). *Trade and Industry – Fourth Report: Draft Limited Liability Partnership Bill*, HC 59, at paragraph 65. Morse, G. (2004). Limited Liability Partnerships and Partnership Law Reform in the United Kingdom. In *The Governance of Close Corporations and Partnerships: US and European Perspectives*, edited by J. McCahery, T. Raaijmakers and E. Vermeulen. Oxford: Oxford University Press; Birds, J. (2000). A New Form of Business Association for the Twenty-First Century. *The Company Lawyer* 21 (2):39; Ward, G. (2001). *New Accounting Rules for Limited Liability Partnerships*, Press Release, Institute of Chartered Accountants, 20 July. The Company Law Review Group stated the LLP may be "particularly beneficial for businesses that seek limited liability while preserving the less formal internal governance and decision-taking arrangements familiar to many owner-managed businesses": Company Law Review Steering Group. (2001). *Modern Company Law for a Competitive Economy: Final Report*. London, at paragraph 2.7. However, Freedman questions the validity of this statement given that this Group had not investigated the LLP itself, or studied its characteristics, since this was outside its terms of reference. Other commentators have been less than certain, specifying that LLPs 'at least on the face of it' are ideally suited to closely held businesses: Lower, M. (2003). What's on offer? A consideration of the legal forms available for use by small – and medium – sized enterprises in the United Kingdom. *The Company Lawyer* 24 (6):166, at p 168. Also the Law Commission thought it unlikely that many small and medium sized partnerships would opt for the LLP form: Law Commission Consultation Paper No 159, the Scottish Law Commission Discussion Paper No

clearly specified, although they appear to be based on benefits delivered by the combination of tax transparency with limited liability and separate legal entity status; and, sometimes, flexibility of internal management.³² These claims deserve closer attention given that, collectively, closely held businesses can account for a large percentage of Gross Domestic Product and employment, and can provide a basis for the development for innovation and new techniques.³³

Furthermore, there are criticisms in some of the foreign jurisdictions concerning the lack of due consideration given before the introduction of the relevant transparent company:

There has however been no public document seeking to explain or justify the proposal in any detail; no account of the trends and events which produced the demand for the such a new entity; no public analysis of the experience of other jurisdictions with LLPs; and no extensive discussion of alternative means of producing the desired results.³⁴

Despite the Australian government's reluctance to move beyond the integrated approach of an imputation system to an aggregate approach, it has recently recognised or implemented transparent companies in restricted circumstances. Australia has recognised incorporated limited partnerships used for venture capital investments (venture capital ILPs) and it has passed amendments for controlled foreign hybrid companies (CFC hybrids). It therefore appears that Australia is not immune from this international trend, as these amendments in

111, July 2001, at p 1.15. For the benefit of LAQCS for closely held businesses see: Polson Higgs & Co, and Beattie Rickman. (2003). *Qualifying Companies*. Paper read at Professional Development Course Paper No S 703, June, Institute of Chartered Accountants, Wellington; and Holmes, K. (1992). The Taxation of Closely-Held Companies: Concepts, Legislation and Problems in New Zealand. *Australian Tax Forum* 9:321.

³² Freedman, J. (2001). Limited Liability Partnerships in the United Kingdom – Do They Have a Role For Small Business? *Journal of Corporation Law* 26(4):897, at p 890. Other advantages identified include more flexible maintenance of capital rules, ability to divide management roles, and the ability to keep provisions of LLP Agreement(s) confidential: Thompson, N. (2006). Look before you LLP. *Accountancy Magazine*. January:110, at p 110.

³³ Refer to the discussion in Chapter Two about the contribution of small and closely held businesses to the economy.

³⁴ House of Commons – Select Committee. n 31, at paragraph 6.

part were stated as necessary to ensure that Australia has an ‘internationally competitive framework’³⁵ and to ensure Australian investors were not ‘disadvantaged’.³⁶

Within Australia, there are continued calls for a broader implementation of tax transparent companies, which has come within the Henry Review.³⁷ Should the Australian government respond to such calls and embrace this economic ideal, particularly given the touted benefits for closely held businesses? Indeed, given the extent of global trade, the question needs to be raised whether the adoption of tax transparent companies is an imperative for Australia to remain competitive, especially in terms of achieving import–export neutrality.

In order to properly to consider these issues, a more detailed and critical understanding of these foreign transparent companies needs to be undertaken. This analysis needs to consider whether the introduction and implementation of tax transparent companies is motivated by, and achieves, tax neutrality. In addition, an analysis needs to be undertaken of the allocation losses to limited members of these companies, and whether tax revenue has been jeopardised.

³⁵ Australian Venture Capital Association Ltd, Gilbert and Tobin Lawyers, and Freehills. (2005). *Venture Capital Limited Partnerships: Proposed Amendments to State and Territory Partnership Statutes to Develop a World Best Practice Venture Capital Investment Structure – Revised Submission* 24 April 2003, at p 30 [cited 6 January 2008]. Available from http://www.avcal.com.au/html/public/public_archive.aspx.

³⁶ Explanatory Memorandum accompanying Taxation Laws Amendment Bill (No 7) 2003 (Cth), at paragraph 9.177.

³⁷ Australia. (2008). *Australia's Future Tax System – Consultation Paper*, (Henry, K Chairman), 10 December, Barton: Attorney-General's Department, at pp 150 and 155. For example: Institute of Chartered Accountants in Australia and Deloitte. (2008). *Entity flow-through (EFT) submission*. Sydney: Institute of Chartered Accountants (the ICAA proposal); Szekely, n 1, at p 23. Johns, BL, Dunlop, WC, and Sheehan, WJ. (1989). *Small Business in Australia: Problems and Prospects*. Sydney: Allen & Unwin, at p 163; Hayes, G. (2003). Real Tax Problems Need Real Solutions. *The Australian Financial Review*, 14 October, 50; Stewart, M. (2003). Towards flow through taxation of limited partnerships: It's time to repeal Division 5A. *Australian Tax Review* 32:171, at p 194; Australian Institute of Mining and Metallurgy. (2006). *Pre-Budget Submission 2007-08*, Carlton, November 2006, at pp 6 - 7, [cited 11 March 2005]. Available from www.ausimm.com.au; House of Representatives: Standing Committee on Industry and Resources Exploring. (2003) *Australia's Future – Impediments to increasing investment in minerals and petroleum exploration in Australia*. Canberra: AGPS; and Brooks, N. (1986) Taxation of closely-held corporations: the partnership option and the lower rate of tax. *Australian Tax Forum* 3(4), pp 381-509.

Furthermore, have closely held businesses been aided by the introduction of transparent companies, in terms of dealing with complexity, financing and governance issues?

To date there is no comprehensive academic study addressing the implementation of tax transparent companies on a multi-comparative basis. In particular, there is no prior study focusing on transparent companies from an Australian perspective, even though in the late 1990s there were erroneous reports that Australia already had a fully transparent company.³⁸ The recent proposal for a tax transparent company by the Institute of Chartered Accountants in Australia and Deloitte (the ICAA proposal) does not provide an in-depth analysis of the foreign experience, as it makes only passing comments about a few foreign transparent companies.³⁹

The relevant analysis conducted in other jurisdictions, particularly the United States and the United Kingdom, has tended to focus on historical studies of the experience with transparent companies in the one jurisdiction. Criticisms apparent from these historical accounts of transparent company reforms include the lack of analysis prior to their implementation,⁴⁰ and that they were introduced

³⁸ Department of Trade and Industry Report. (1997). *Limited Liability Partnership – A New Form of Business Association for Professionals*, London: HMSO, at paragraph 25 this report erroneously includes Australia as an example of a jurisdiction with a limited liability partnership.

³⁹ Institute of Chartered Accountants in Australia and Deloitte, n 37. Of course the work behind the ICAA proposal would have involved a broader analysis, but this is not explicitly reflected in the proposal released.

⁴⁰ Friedman, HM. (2004). The Silent LLC Revolution – The Social Cost of Academic Neglect. *Creighton Law Review* 38(1). Vestal, AW. (2004). Drawing Near the Fastness?: The Failed US Experiment in Unincorporated Business Entity Reform. In *The Governance of Close Corporations and Partnerships: US and European Perspectives*, edited by J. McCahery, T. Raaijmakers and E. Vermeulen. Oxford: Oxford University Press, at p 347: “The reform experience in the United States suggests three essential failures. First, our reformers proceeded without an underlying theory to guide their experimentation; they have acted because it was in their power to do so and not because of any consensus-based theoretical justification. Second, the want of an underlying theory led our reformers to engage in non-purposeful grafting and reshaping in their experiments. Third, there has been no justifiable social exchange in the process; social costs have been generated without any demonstrable and compensating social benefit”.

too quickly in response to interest groups resulting in misconceived legislation.⁴¹ While the edited book *'The Governance of Close Corporations and Partnerships: US and European Perspectives'* is a multi-jurisdictional collection of academic writing on transparent companies, still most jurisdictions are considered independently, without meaningfully addressing inter-relationships.⁴² The research by Finch and Freedman, accords an in-depth analysis of the United Kingdom's experience with LLPs, but it is also on the whole intra-jurisdictional.⁴³ Apart from the earlier work of Holmes, there has been very little analysis of New Zealand's experience with its transparent company, the LAQC.

This dissertation will further develop this literature to encompass the United States, the United Kingdom, New Zealand and Australia, with a view to identifying and drawing out various similarities, differences and interactions between the respective jurisdictions' experiences. Furthermore, this dissertation will be prospective in its orientation – considering precisely what would be the implications for Australia in having broader recognition of tax transparent companies.

An analysis of transparent companies is of critical importance to the Australian tax system. The significance of the study is exemplified by the apparent misunderstanding within Australia of what precisely has been achieved by the implementation of tax transparent companies overseas. Some academics speculate that this phenomenon is merely tax-motivated and is unique to the United States, with its entity approach (classical system) applying to corporate

⁴¹ Freedman, J. (1997). The Quest for an Ideal Form for Small Businesses – A Misconceived Enterprise? In *Developments in European Company Law: Volume 2/1997: The Quest for an Ideal Legal Form for Small Business*, edited by B. A. K. Rider and M. Andenas. London: Kluwer Law International Ltd, at p 15.

⁴² McCahery, JA. (2004). Introduction: Governance in Partnership and Close Corporation Law in Europe and the United States. In *The Governance of Close Corporations and Partnerships: US and European Perspectives*, edited by J. McCahery, T. Raaijmakers and E. Vermeulen. Oxford: Oxford University Press.

⁴³ Finch, V, and Freedman, J. (2002). The Limited Liability Partnership: Pick and Mix or Mix-up? *Journal of Business Law* (September):475.

distributions.⁴⁴ This sentiment fails to acknowledge that other jurisdictions with some form of tax integration have also implemented transparent companies which may indicate other factors at work. Also, some reports appear have overlooked the emergence of foreign tax transparent companies, which means they have not been considered in formulating recommendations.⁴⁵

In conclusion, there would appear to be considerable room to undertake an in-depth analysis of the implications and possible consequences of tax transparent companies for Australia through an analysis of the key political and economic drivers for this emerging global trend. The need to maintain Australia as an attractive place for business requires that Australia's tax and corporate regulatory system to be able to adapt to developments in the increasingly global business economy. It is important to consider objectively whether transparent companies offer a superior alternative to the current taxation of business forms in Australia for closely held businesses. This is particularly important in light of criticism that prior tax reforms aimed at assisting this sector appear to have been based on insufficient data, and were therefore ill-conceived.⁴⁶

1.2. Research Questions

Underpinning the research in this dissertation are two key guiding questions with regard to the foreign jurisdictions studied (the United States, the United Kingdom and New Zealand), as well as their relationship with Australia.

⁴⁴ Freedman, J. (2000). Limited Liability: Large Company Theory and Small Firms. *The Modern Law Review* 63 (3):317, at p 350.

⁴⁵ Australia. (1998). Review of Business Taxation: An International Perspective. Canberra: AGPS, at p 42: "No country attempts to integrate fully the income of companies and shareholders since this would involve taxing undistributed profits at the marginal tax rate of the individual shareholders".

⁴⁶ Burton, M. (2006). The Australian small business tax concessions – public choice, public interest or public folly? *Australian Tax Forum* 21 (1):71.

The first key issue which is considered in the dissertation is whether the tax transparent companies studied do have a connection with tax neutrality. The second question guiding the research explores and analyses the ramifications of striving for the economic ideal of tax neutrality through the introduction of the tax transparent companies. The second question involves a consideration of the subsidiary question of how the jurisdictions studied have ensured that tax transparency for a business form with limited liability for members has not jeopardised their tax systems in terms of allocated losses. Given the touted benefits of tax transparent companies for closely held businesses, further subsidiary questions will be considered in relation to the implications of transparency for this sector in terms of complexity, financing and governance.

1.3. Method and Outline

It has previously been recognised that tax can be studied from three disciplines – law, economics and politics⁴⁷ – making for a ‘rich tapestry’ of ideas to be drawn upon.⁴⁸ While each of these three perspectives is considered at various stages, the primary basis for this dissertation is law and legal theory, utilising a comparative legal framework. When references pertain to other disciplines, such as economics and politics, this dissertation does not assert to cover extensively the literature in those fields except as directly relevant.⁴⁹ The application of legal theory to the structure of a tax system focuses on who or what should be taxed.⁵⁰

⁴⁷ Harris, n 5, at p 42, and Oats, LM. (2000). The Evolution of Federal Company and Shareholder Taxation in Australia: 1915 – 1995, Department of Accounting and Finance, University of Western Australia, at p 25

⁴⁸ Lamb, M, and Lymer, A. (1999). Taxation as an Interdisciplinary Research Field – An Introduction. In *Interdisciplinary Research in Taxation: Research Approaches and Bibliographic Survey*, edited by M. Lamb and A. Lymer. London: Centre for Business Performance.

⁴⁹ For example in the discussion in Chapter Four concerning the reasons underlying the introduction of the tax transparent companies both public choice and public interest models of legislation are canvassed.

⁵⁰ Bentley, D. (2007). A Model of Taxpayers' Rights as a Guide to Best Practice in Tax Administration. Doctor of Philosophy, Faculty of Law, Bond University, Gold Coast, at p 15.

Of the three legal research methods identified in the Pearce Report, theoretical and doctrinal research methods are predominately used in this dissertation.⁵¹ For example, in the early chapters theoretical research is used to understand and formulate a conceptual basis of legal and economic rules and the principles to be considered. Subsequently, to understand transparent companies doctrinal research is used to analyse and critically examine these rules and principles, reflecting on how they relate to the established literature and statistical data. That is, there will be a systematic process of identifying, analysing, organising and synthesising legislation, judicial decisions and commentary.⁵² To facilitate this critical analysis a comparative legal framework is utilised, to compare the different legal systems of the jurisdictions studied.⁵³ To ensure some functionality to this comparison a common basis is utilised.⁵⁴ This common basis is how the jurisdictions studied have approached taxing business forms with separate legal entity status and liability protection for members in implementing the economic ideal of tax transparency.

It will be argued that the transparent companies introduced in the United States, the United Kingdom and New Zealand are comparable, since they fulfil the same function of providing a business form with limited liability, separate legal entity and flow-through taxation. It is acknowledged that there are variations in their implementation, although these differences may be pertinent in determining whether there can be universal understanding or whether there are characteristics peculiar to the jurisdictions.

⁵¹ Pearce, D, Campbell, E, and Harding, D. (1987). *Australian Law Schools: A Discipline Assessment for the Commonwealth Tertiary Education Committee*. Canberra: AGPS, at paragraph 9.14.

⁵² Pearce, Campbell, and Harding, n 51, at p 309.

⁵³ Zweigert, K, and Kotz, H. (1998). *Introduction to Comparative Law*. Translated by T. Weir. Oxford: Oxford University Press, at p 46, and Barenfeld, J. (2005). *Taxation of Cross-Border Partnerships: Double Tax Relief in Hybrid and Reverse Hybrid Situations*. Doctor of Laws, Jonkoping International Business School, Jonkoping, at p 16.

⁵⁴ Zweigert, and Kotz, n 53, at p 34.

Comparative analysis will enable common themes and peculiarities to be expressed in terms of the research questions addressed. This illumination may be formative in determining the preferable approach, if any, in Australia. The consideration of possible reforms is identified by the Pearce Report as the third type of legal research method.⁵⁵ Such recommendations are one of the aims of comparative law, as comparative law can inform legal policy.⁵⁶ Through such a method, comparative law may be able to suggest how the specific issue, tax transparent companies, can be solved most appropriately under given Australia's social and economic circumstances.⁵⁷

To provide a basis for this critical analysis, this dissertation draws on a broad range of material across the disciplines and the jurisdictions studied. In particular, this dissertation examines original primary documentation including Acts of Parliament and the official explanatory memoranda accompanying such Acts, as well as secondary contemporaneous documentation including the annual reports of the Commissioner of Taxation to Parliament, the reports of various Royal Commissions and Committees of Enquiry into taxation, as well as treatises, journal articles and seminal papers. Wherever possible, government reports and statistics have been supplemented with publications and data from interest groups outside the government. Additionally, analysis of secondary evidence from experts, practitioners and industry bodies is utilised. To provide a basis for critical evaluation of the operation of the law, prior empirical work is utilised.

In terms of the structure of this dissertation, Chapter Two provides the basis for the comparative study by examining the literature on tax neutrality and how this can be achieved through tax transparency. This chapter will also provide an analysis of prior research identifying the characteristics and issues faced by

⁵⁵ Pearce, Campbell, and Harding, n 51, at paragraph 9.14.

⁵⁶ Zweigert, and Kotz, n 53, at p 11.

⁵⁷ Zweigert, and Kotz, n 53, at p 11.

closely held businesses. These characteristics will be used as the justification for considering the factors of complexity, financing and governance in later chapters.

Outlined in Chapter Three is the definition of ‘tax transparent company’ that will be utilised for the dissertation. It will also be explained how the studied business forms of S Corporations, LLCs, LLPs and LAQCs are examples of tax transparent companies. To determine the extent of the popularity of the transparent companies studied, empirical data on their utilisation will be provided.

To address the first research question, the reasons behind the introduction of the foreign tax transparent companies studied and their relationship with tax neutrality and closely held businesses is analysed in Chapter Four. Chapter Five then reflects upon whether the foreign experience is instructive in determining what has or could be Australia’s future experience with these business forms.

Chapters Six to Nine then address the subsidiary parts of the second research question concerning the implications of striving for the economic ideal. Specifically, within Chapter Six one of the major concerns with tax transparent companies is considered – that is, the risk to revenue due to the allocation of losses to members even though their liability is limited. Such loss utilisation may distort investors’ decisions, and thus create a scenario juxtaposed to the goal of tax neutrality. The restrictions on allocated losses in the foreign jurisdictions will be considered, and compared with Australia’s current loss restriction rules.

The analysis in Chapter Sevens, Eight and Nine considers the common assertion that tax transparent companies are beneficial for closely held businesses. Drawing upon the prior empirical work, this analysis will consider the impact of transparent companies on complexity, financing and governance.

Finally, Chapter Ten summarises the major findings of the dissertation and outlines Australia's possible future relationship with tax transparent companies and how import–export neutrality may be an imperative determinant.

1.4. Scope and Limitation

It is impossible for the comparative analysis conducted in this dissertation to be exhaustive, as this would require an analysis of an extensive number of jurisdictions. Instead, the scope has been to make a comparative study that is extensive enough to identify general similarities and differences from an international perspective in relevant legal areas. Selecting the foreign jurisdictions and transparent companies required some rationalisation about which ones were chosen. The jurisdictions chosen, the United States, the United Kingdom and New Zealand, are significant common law jurisdictions, with profound cultural and trade links with Australia. These countries are also major sources and destinations of capital, and the compete with Australia for investment and business.⁵⁸ Also, both the United Kingdom and the United States have been influential in the restricted recognition or adoption of transparent companies in Australia to date.⁵⁹

Within the United States a number of transparent company forms could have been chosen: to this end the two most popular forms there, the S Corporation and the LLC were chosen.⁶⁰ The choice of the S Corporation was reinforced given that it was considered when New Zealand introduced the LAQC.⁶¹

⁵⁸ Speed, R. (2003). Comment: An Internationally Competitive Tax System for Australia. *Australian Tax Review* 32:51, at p 52. The Review of International Taxation Arrangements Consultations Paper issued by the Commonwealth Department of Treasury refers to the United States, New Zealand, certain European countries and Japan.

⁵⁹ For example the United States was referred in to the implementation of the venture capital ILP reforms. The United Kingdom's LLP and the United States' LLC were the first two foreign hybrids recognised for the CFC hybrid amendments.

⁶⁰ Refer to the data in Chapter Three detailing the extent of utilisation of these two forms. There are other transparent companies in the United States, including LLPs and Limited Liability Limited

The primary focus of this dissertation is tax law and the implications that transparent companies have on this subject matter. However, there will be a brief consideration of the underlying governance rules insofar as it is important to consider the exact nature of the legal form being disregarded for tax purposes. The consideration of governance reinforces the selection of common law jurisdictions, as the civil law's law of agency is very different from the law of mandate and representation.⁶² There are several other pieces of legislation that could influence the operation of a transparent company, such as security laws, bankruptcy laws, employment laws, discrimination, environmental, and indirect taxes such as stamp duty and goods and services tax. These other laws will not be examined in any detail.

Additionally, fully transparent companies are central to this dissertation, although variations, including partial loss transparent companies, will be considered. In the analysis of each jurisdiction's tax system, it is the domestic consequence that is predominately discussed, although there is some reflection where relevant of the international tax implications.

Available research, statistical data and considered legal interpretation provide the basis for analysis. In terms of data for closely held businesses, at times it is necessary to refer to research that concerns 'small' or 'medium' businesses. While this is not perfect, it is argued that the vast majority of small and medium businesses would indeed be closely held, as defined in Chapter Two.

Partnerships (LLLPs). Dickerson, CM. (2004). Bracketed Flexibility: Standards of Performance Level the Playing Field. In *The Governance of Close Corporations and Partnerships: US and European Perspectives*, edited by J. McCahery, T. Raaijmakers and E. Vermeulen. Oxford: Oxford University Press, at p 137: For the LLLP the state's limited partnership statute was amended to allow a limited partnership to register as a limited liability limited partnership under the state's general partnership statute, thus sheltering even the general partner from personal liability.

⁶¹ Refer to the discussion in Chapter Four about the reasons for the introduction of LAQCs in New Zealand.

⁶² Avery Jones, De Broe, Ellis, Miyatake, Roberts, Goldberg, Killius, Maisto, Giuliani, Vann, Ward, and Wiman, n 7, at p 294.

1.5. Conclusion

Creating successful tax policy is a complex task, with a wide range of conflicting and varying goals that prevail over time.⁶³ The growing international utilisation of transparent companies and Australia's recent recognition of them, combined with the pressure for broader implementation, make a thorough analysis of transparent companies in the Australian context timely.

Governments are often under pressure to change aspects of the tax system.⁶⁴ Such pressure can arise from a need to raise additional revenue, the need to stimulate economic activity or the need to implement social policy through the allocative function.⁶⁵ Also the pressure can come from various groups, lobbying for reforms to the regulatory framework governing them.⁶⁶ The need to maintain Australia as an attractive place for business and investment requires that the tax system be continually adaptive to respond to the increasingly integrated global business economy.⁶⁷ However, for such change to be successful there needs to be a clear and precise understanding of what will be achieved and the possible consequences.

To this end, the goal of tax neutrality is an important factor, as it is disturbing that Australia's current tax system may be generating an incentive for investors to adopt suboptimal business forms to conduct their business operations.⁶⁸ Taxpayers should be free to choose the business form that is most appropriate to their needs from a commercial perspective, without bias from the business tax

⁶³ James, S, and Nobes, C. (1999). *The Economics of Taxation*, Dorset: Prentice Hall, at p 132.

⁶⁴ Oats, n 47, at p 17.

⁶⁵ James, and Nobes, n 63, at p 133.

⁶⁶ Known as rent seeking.

⁶⁷ Costello, P (Treasurer). (2002). Review of International Taxation Arrangements – Consultation Paper. In *Press Release No 46*. Canberra: Treasury, at p 1.

⁶⁸ Klein, WA, and Zolt, EM. (1995). Business Form, Limited Liability and Tax Regimes: Lurching Toward a Coherent Outcome? *University of Colorado Law Review* 66, at p 1002.

system.⁶⁹ The breaches of tax neutrality may result in economic costs for businesses, and on the nation as a whole, in the form of less efficient organisations, lower return on investments and wasted resources devoted to maximising tax arbitrages.⁷⁰

It is for these reasons that it is important to critically analyse whether Australia should strive for greater tax neutrality through the broad adoption of a tax transparent company

⁶⁹ Holub, n 17, at p 351.

⁷⁰ Bengel, M, and Robinson, T. (1986). *How to Integrate Company and Shareholder Taxation*. Wellington: Victoria University Press, at p 7.

Chapter Two: Tax neutrality and closely held businesses

2.1 Introduction

This chapter sets out the underlying theoretical rationale for tax neutrality, its relationship with tax transparent companies and the research on closely held businesses. This material will provide a basis for the comparative legal analysis of the tax transparent companies developed in subsequent chapters.

The first section details the maxims that have been developed to critically evaluate tax systems, and demonstrates how tax neutrality is an important aspect of such evaluative criteria. This discussion will include evidence of how breaches of tax neutrality can influence taxpayers' choice of business form. In addition to this discussion, the international implications of tax neutrality will also be the subject of examination. It will be argued that governments are becoming more aware of how tax can distort investment decisions, which can be considered undesirable. Additionally, it will be contended, that due to the elastic nature of capital investment, tax systems lacking import–export neutrality could potentially lead to tax asymmetry, adding to the tax impost and detracting from investment.

The second section will then outline prior literature pertaining to the specification of what precisely constitutes a 'closely held business' and its relationship with associated small and medium business enterprises. Additionally, reference will be made to research that has established characteristics and problems faced by this sector. It will be argued that the particular issues that are faced by closely held businesses and that need to be considered relate to complexity, finance and governance.

This comprehensive discussion of key concepts pertaining to the nature of closely held businesses will enable an analysis and evaluation to be undertaken of tax transparent companies, in terms of tax neutrality and related issues facing closely held businesses.

2.2 Tax Neutrality

In evaluating a country's tax system, Adam Smith articulated four maxims of taxation: being equity, certainty, convenience and economy.¹ It is in Smith's fourth maxim, the economy, that the idea of tax neutrality is evident. This was because Smith was keenly aware of the influence that tax may have on the behaviour of individuals. In this respect, Adam Smith observed that tax:

... may obstruct the industry of the people, and discourage them from applying to certain branches of business which might give maintenance and employment to great multitudes.²

In short, the potential for the tax system to distort investment decisions can be seen as undesirable. Tax neutrality as a principle of tax system design specifies that the tax system should be neutral as between alternative business or consumption choices, so that the imposition of tax does not, in turn, consequently influence individual or business choices by distorting or altering the cost of alternatives. This principle is of extreme importance, as the tax system could impede or reduce the productive capacity of an economy.

It should be acknowledged that modern tax systems are far removed from the ideal models advocated in the public finance literature, as governments may

¹ Smith, A. (1789). *An Inquiry into the Nature and Cause of the Wealth of Nations*, Book V of the Revenue of the Sovereign or Commonwealth, London: A. Strahan and T. Cadell, pp 644 to 645.

²Smith, n 1, p 645. Tax neutrality is an integral part of the criterion of 'efficiency', with other components being the compliance and administrative costs associated with the tax compared to the tax yield. This dissertation will focus on tax neutrality as a part of the efficiency, though it is acknowledged that the other components are also important.

intentionally breach one of the criteria in the belief it will achieve desirable policy goals. For example, tax neutrality can be breached by the introduction of tax concessions for expenditure on research and development to encourage greater expenditure, with the belief it will improve the economy overall. To complicate matters, the criteria in evaluating a tax system can compete against each other. For example, a measure to improve equity in a tax system may be unduly complex.³ Nevertheless, it is argued that it is beneficial to consider these criteria, and analyse the implications of departures from them.

Tax neutrality requires a tax to be judged according to the extent to which it influences the market allocation of resources.⁴ Taxes that do not interfere with such a market allocation are referred to as neutral, thereby allowing the market to determine the most efficient allocation of resources.⁵

Increasingly, governments have acknowledged the importance of tax neutrality,⁶ compared to the prior trend of equity.⁷ Tax neutrality was discussed in the Asprey Report in Australia in the mid 1970s.⁸

³ For example a provision to provide greater vertical equity for lower income earners may have anti-avoidance measures include to ensure that high wealth individuals do not manipulate their circumstances to take advantage of the provision.

⁴ Harris, PA. (1996). *Corporate/Shareholder Income Taxation and Allocating Taxing Rights Between Countries: A Comparison of Imputation Systems*. Amsterdam: IBFD Publications BV, at p 8. Norr, M. (1982). *The Taxation of Corporations And Shareholders*. Deventer: Kluwer Law And Taxation Publishers, at p 55.

⁵ Harris, n 4, at p 8.

⁶ Ganghof, S. (2000). Adjusting National Tax Policy to Economic Internationalization: Strategies and Outcomes. In *Welfare and Work in the Open Economy*, edited by F. W. Scharpf and V. A. Schmidt. Oxford: Oxford University Press, at p 613. Stewart, M. (2001). The Mechanics of Taxing Entity Distributions: A Comparative Perspective. Paper read at Australasian Tax Teachers' Association, 1-3 February, at p 4.

⁷ Early in the twentieth century the focus of tax policy appeared more directed to equitable concerns, with consideration as to whether the tax system operated fairly between taxpayers: Radaelli, C. (1999). Taxation as Politics. In *Interdisciplinary Research in Taxation: Research Approaches and Bibliographic Survey*, edited by M. Lamb and A. Lymer. London: Centre for Business Performance, at p 137.

⁸ Australia. (1975). Taxation Review Committee Full Report, (Asprey, KW Chairman), 31 January, Canberra: AGPS, at p 16: "Tax neutrality principle requires that the tax system should be neutral between alternative business or consumption choices; and in this way the impact of tax will not influence individual or business choices by distorting or altering the costs of alternatives".

More recently, its importance was further emphasised by the Ralph Committee:

...the business tax system should interfere to the least possible extent with, and indeed should promote, the best use of existing national resources, efficient allocation of risk, and long-term economic growth. Ideally, the business tax system should be neutral in its impacts and thus not be a consideration in business decision-making. Poorly designed tax systems can inhibit economic growth by distorting business decisions.⁹

The Henry Review has also reiterated the adverse affect that variation may have:

Business and investors can use a variety of organisational forms, with considerable variation in the income tax treatment of the entity type and the underlying owners ... This sets up the potential for inefficient outcomes that can affect overall business productivity.¹⁰

It is argued that the concept of tax neutrality is embodied in Australia's general anti-avoidance provision, known as 'Part IVA'.¹¹ Part IVA applies when a taxpayer's sole or dominant motivation to enter into a scheme was to obtain a tax benefit.¹² That is, the taxpayer's motivation for entering into a scheme has been unduly influenced by tax arbitrages rather than for commercial, family or other reasons.¹³ However, the Australia's income tax act acknowledges that there may be legislative sanctions of tax distortions which will not breach Part IVA, provided taxpayers did not contrive their position to facilitate access to the legislative distortion.¹⁴

⁹ Australia. (1999). A Tax System Redesigned (Ralph Report No 4), Canberra: AGPS, at p 105.

¹⁰ Australia. (2008). Australia's Future Tax System – Consultation Paper, (Henry, K Chairman), 10 December, Barton: Attorney-General's Department, at p 153.

¹¹ Part IVA of the *Income Tax Assessment Act 1936* (Cth) (*ITAA 1936* (Cth)).

¹² *ITAA 1936* (Cth), section 177F. In these circumstances the Commissioner of Taxation can cancel the tax benefit sought to be obtained.

¹³ *FCT v Peabody* (1994) 181 CLR 359, *FCT v Spotless Services and Or* (1996) 186 CLR 404; *FCT v Consolidated Press Holdings Ltd* (2001) 47 ATR 229.

¹⁴ *ITAA 1936* (Cth), section 177C(2).

While a perfectly neutral tax system may be impossible to devise, as all taxes influence taxpayer behaviour, its potential to distort efficient allocation of resources warrants further analysis. Without tax neutrality, taxpayers may invest in assets only because the after-tax returns make the investment worthwhile, regardless of the pre-tax rate of return.¹⁵ The consequence of this is that it can lead to an allocation of resources yielding less gross income to the economy as a whole as it reduces a country's productivity, gross domestic product (GDP) and job creation.¹⁶ This influence results in economic costs on businesses and on the nation as a whole, in the form of less efficient business structures, lower investment returns, and consequent wasted resources devoted to maximising tax advantages.¹⁷ One manner in which tax distortion can arise is through the tax treatment of different business forms.

2.2.1 Achieving tax neutrality through tax transparent forms

It has been argued, that regardless of the business form adopted, the tax burden should be equivalent.¹⁸ A tax system would be 'neutral' in terms of business form selection if it did not affect choice of business form, decisions on investments, or sources of finance.¹⁹ Tax can be seen as 'driving a wedge' between the gross return on an investment and the net return after taxes on the savings used to finance that investment.²⁰ Theoretically, this 'tax wedge' should be the same, irrespective of the business form adopted, on the basis of facilitating the principle of tax neutrality. The selection of business form can determine, in this respect,

¹⁵ Bevin, P. (1985). *How Should Business Be Taxed? An examination of defects in business taxation and suggestions for reform*. Wellington: Victoria University Press, at p 31.

¹⁶ Holub, M. (2001). Taxes and the Choice of Organisational Form in Australia. PhD, Department of Accounting and Finance, University of Western Australia, at p 341.

¹⁷ Bengel, M, and Robinson, T. (1986). *How to Integrate Company and Shareholder Taxation*. Wellington: Victoria University Press, at p 7.

¹⁸ Kwall, J.L. (2005). *The Federal Income Taxation of Corporations, Partnerships, Limited Partnerships, Limited Liability Companies, and their Owners*. 3rd ed. New York: Foundation Press, at p 10.

¹⁹ Bittker, B.I. (1967). A Comprehensive Tax Base as a goal of income tax reform. *Harvard Law Review* 80(5):925, at p 929. Harris, n 4, at p 107.

²⁰ Bevin, n 15, at p 7.

precisely how ownership risks and returns are shared and how management is controlled. Individuals can be expected to adopt business forms, financial policies and investment options that maximise returns or, conversely, minimise costs (including, for example, the costs of monitoring managers' performance).²¹ According to Scholes and Wolfson this choice essentially involves a trade-off between tax costs and non-tax (transaction) costs, with firms more likely to choose a business form to minimise these (costs).²²

In this respect, Chapter One sought to outline that the precise manner in which countries approach the taxation of business forms can be conceptualised via a continuum, ranging from an 'entity' approach (at one extreme) moving via an 'integrated' approach to an 'aggregated' approach (at the other extreme).²³ The manner in which a country resolves this question can be based on numerous factors, which may vary between various forms' legal characteristics.²⁴ Over time a jurisdiction's treatment of the one business form may move along the continuum. For example Chapter One illustrated how Australia has oscillated from an integrated approach for corporations (1915 to 1940) to an entity approach (1940 to 1987) and then back to an integrated approach (1987 onwards).

The legal indicia of a business form have been very influential in determining this tax treatment, especially if the business form provides liability protection and has its own attendant legal personality. When these 'company characteristics' — that

²¹ Bengt and Robinson, n 17, at p 123.

²² Scholes, MS, and Wolfson, MA. (1986). *Taxes and Organization Theory*, Paper for the Yale Conference on Economics of Organization, as cited in: Guenther, DA. (1990). *The Effect of Income Taxes on the Form of Business Entity*. PhD, University of Washington. Scholes, MS, and Wolfson, MA. (1989). *Issues in the Theory of Optimal Capital Structure*, in *Frontiers of Modern Financial Theory*, ed S. Bhattacharya & G. Constantinides, New Jersey: Rowman & Littlefield, at pp 49-74; and Scholes, MS, and Wolfson, MA. (1992). *Taxes and Business Strategy: A Planning Approach*, New Jersey: Prentice-Hall Inc.

²³ Refer to Figure 1-0-1 of Chapter One.

²⁴ The Commission of the European Communities. (1994). Commission Recommendation of 25 May 1994 concerning the taxation of small and medium-sized enterprises. In *Official Journal L* 177.

is, limited liability and separate legal entity status — are present an entity approach for tax purposes can be advocated as being appropriately based on legal theories of corporate personality.²⁵ With an 'entity' approach the business form is treated as a separate taxpayer from its members: with income and/or losses determined at the *entity* level. Members are not assessed on business profits until there is an actual distribution to them from the business form, with no tax relief given to them in recognition of the tax already paid by the business form.

Such an entity approach was described in the early 1970s as the 'classical system' by Van den Tempel.²⁶ The imposition of tax at the business form level and the member level can, in this respect, be perceived as the price paid for the shielding of members from full liability exposure.²⁷ Also, it has been argued that an entity approach can be more adequately justified or rationalised when membership interests are widely held, because there is a greater separation between ownership and control.²⁸

However, several government reports in various countries, such as the Carter Report,²⁹ the Asprey Committee,³⁰ the Campbell Committee,³¹ and the Draft White Paper,³² along with various academic commentators,³³ have tended to

²⁵ Maine, JA. (2001). Linking Limited Liability and Entity Taxation: A Critique of the ALI Reporters' Study on the Taxation of Private Business Enterprises. *University of Pittsburgh Law Review* 62:223, at p 242.

²⁶ Van den Tempel, AJ. (1970). *Corporation Tax and Individual Income Tax in the European Communities*, EEC Brussels, at p 7. It should be noted, however, that, contrary to what the terminology suggests, the imputation system is of older date in Europe.

²⁷ Maine, n 25, at p 228.

²⁸ Oats, LM. (2000). The Evolution of Federal Company and Shareholder Taxation in Australia: 1915 – 1995, Department of Accounting and Finance, University of Western Australia, at p 34: citing Cnossen, S. (1984). Alternative Forms of Corporation Tax, *Australian Tax Forum*, 1(3), at p 259.

²⁹ Canada. (1966). Royal Commission on Taxation (known as the Carter Commission), Ottawa, at Chapter 19.

³⁰ Australia, n 8, at Chapter 16.

³¹ Australia. (1981). Committee of Inquiry into the Australian Financial System — Final Report, (Campbell, J.K. Chairman), Canberra: AGPS, at Chapter 14.

³² Australian Treasury. (1985). Draft White Paper on the Reform of the Australian Tax System, Canberra: AGPS, at Chapter 17.

highlight the consequent distortions that arise when an entity approach is adopted.

An initial distortion that can arise from an entity approach is that it can favour the retention of profits. This is because the distribution of profits to members results in additional tax being assessed to the member, and therefore it can be perceived as preferable to shelter income in the business form. Such a retention of profits within the business form may have several adverse consequences.³⁴ For example, managers with retained earnings may be able to ‘insulate themselves’ from having to seek such finance from external capital markets which could require better performance indicators.³⁵ Alternatively, these retained profits may mean money is invested inefficiently or less effectively than if the members had received a distribution.³⁶ On a broader scale, excess retained profits may allow businesses to strengthen their market position through mergers, which could reinforce monopolistic tendencies, hampering the entry of new businesses.³⁷ This has led to some jurisdictions introducing ‘undistributed profits tax’ if too much profit is considered to be retained in the business form. However, such measures have been described as leading to ‘adverse economic effects’.³⁸

³³ Bird, RM. (1987). Corporate-personal tax integration. In *Tax Coordination in the European Community*. Deventer: Kluwer Law and Taxation Publishers, at p 243, Vann, RJ. (2001). Australia's Policy on Entity Taxation. *Australian Tax Forum* 16:33, at p 51, Bevin, n 15, at p 7, Cnossen, n 28, at p 274, Goforth, CR. (1995). The Rise of the Limited Liability Company: Evidence of a Race Between the States, But Heading Where? *Syracuse Law Review* 45:1193, at p 1284, Kwall, n 18, at p 10, Yin, GK. (1992). Corporate Ideal. *Tax Law Review* 47:431; Ganghof, S, and Eccleston, R. (2004). Globalisation and the Dilemmas of Income Taxation in Australia. *Australian Journal of Political Science* 39 (3):519, at p 524: “Tax experts and policy makers believed that this system [classical] created serious economic distortions”.

³⁴ Note in Australia this potential distortion when an entity tax system applied was addressed by applying an ‘undistributed profits tax’ on private corporations if they failed to distribute at least a prescribed amount of their after-tax income.

³⁵ Arlens, J, and Weiss, D. (1995). The Political Economy of Corporate Taxation, *Yale Law Journal* 105:325.

³⁶ Harris, n 4, at p 121. McLure, CE. (1979). *Must Corporate Income Be Taxed Twice? A report of a conference sponsored by the Fund for Public Policy Research and the Brookings Institution*. Washington DC: The Brookings Institution.

³⁷ Cnossen, n 28, at p 260.

³⁸ Johns, BL, Dunlop, WC, and Sheehan, WJ. (1974). Taxation and the Small Firm in Australia: A report to the Taxation Review Committee: University of Newcastle, at paragraph 6.4: “The system

Another potential distorting factor of an entity approach is that it can discriminate against equity funding compared to debt because interest on debt for the business form is tax deductible compared to profit distributions to members.³⁹ This favouring of debt could induce greater reliance on debt finance by the business and this may, in turn, result in an increase in the risk of bankruptcy as highly levered businesses jeopardise their solvency, which consequently affects other firms.⁴⁰ Empirical research demonstrates that the efficiency losses arising from distortions of the debt-equity ratio can be the largest.⁴¹ Furthermore, this may mean that new equity can be more expensive than new debt.

Due to the potential increased tax cost, with tax levied at the business form and member level (commonly referred to as double taxation), there can be a distortion in favour of business forms subject to an integrated or a transparent approach. This is because with a transparent approach there is clearly only one layer of tax at the member level. However, it should be acknowledge that the extent of 'double taxation' when an entity approach applies can be mitigated through a number of mechanisms. For example instead of profits being distributed via dividends to members, the corporation's earnings could be decreased with deductible amounts being paid to members via salary, bonuses, interest, rents or royalties, some of which could be determined shortly before the close of the tax year.⁴²

of retention allowances and the comparative inflexibility of their mode of operation may have significant adverse economic effects on the small business sector. In particular, the system probably represents a brake upon the growth of the more enterprising and expanding companies and could lead to liquidity problems for newly established private companies".

³⁹ Bird, n 33, at p 243. Oats, n 28, at p 39.

⁴⁰ Cnossen, n 28, at p 260.

⁴¹ Cnossen, n 28, at p 274.

⁴² Booth, RA. (1997). The Limited Liability Company and the Search for a Bright Line Between Corporations and Partnerships. *Wake Forest Law Review* 32:79, at p 80. Lee, JW. (2000). A Populist Political Perspective of the Business Tax Entities Universe. 'Hey the Stars Might Lie But the Numbers Never Do', *Texas Law Review* 78: 885, at pp 910-922.

Furthermore, when an entity approach applies, there can be perceived problems in terms of capital gains accruing to the business form, with some contention that there is a double taxation of capital gains. This is based on the assumption that the capital growth can be taxed to the business form and subsequently again on the disposal of membership interests. While Vann demonstrates that this double taxation of capital gains is incorrect provided that the value of the membership interest is based on retained profits,⁴³ such a valuation will not always be the case. This is because, in practice, the price of members' interests are influenced by many different factors in the short term, including the prospects of takeovers; unexpected information about future profitability; changes in other security markets such as changes in interest rates; and associated labour market conditions.⁴⁴ These other factors could easily subsume or 'swamp' the effect of retained earnings on prices of membership interest.⁴⁵

However, a tax distortion in favour of an entity approach for a taxpayer is that, while income is sheltered at the business form, it may be subjected to a lower tax rate than if it had been allocated to a member. Furthermore, by sheltering income within the business form, members may convert the retained profits into a capital receipt through the disposal of their membership interest. Such capital growth may thus benefit from deferral, as well as a concessional capital tax rate compared to income receipts.⁴⁶ In comparison, with a transparent approach members are assessed, to a large extent, on the capital growth through the allocation of profits each year.⁴⁷ This largely removes the deferral advantage of an entity approach, as well as any concessional capital tax treatment.

⁴³ Vann, n 33, at p 38: "The example shows that in the simple case presented there is no double tax on retentions to the owner under the CGT to the extent that value is based on retentions (putting aside the problem of matching the dividends and the capital loss for the purchaser). Thus the double taxation of retentions is a myth".

⁴⁴ Bengé, and Robinson, n 17, at p 77.

⁴⁵ Bengé, and Robinson, n 17, at p 77.

⁴⁶ For example, in Australia individuals only have to include 50 per cent of a capital gain if the CGT asset has been held greater than 12 months, see: *ITAA 1997* (Cth), Division 115.

⁴⁷ Although, transparent treatment would not totally eliminate the need for capital gains, as there may be other factors which will not be accounted for such as the growth of goodwill and

Furthermore, an entity approach could produce distortions between foreign and domestic equity investment. This undesirable consequence may be attributable to the foreign jurisdiction taxing members' equity investments differently to the home jurisdiction or, alternatively, not giving credit for the underlying tax paid by the business form. This could thus increase the cost of raising equity from foreign members, and thereby necessitate compensatory higher returns. This treatment of business taxes across countries can lead to an inefficient allocation of economic activity and to an excessive amount of resources being devoted to tax compliance and tax planning.⁴⁸

Acknowledgement of these potential distortions is of importance as it can be assumed that the business form which dominates in a market does so because it has found the most economical mix of production and transaction costs, given the current technology available.⁴⁹ To the extent that taxes or other regulatory policies interfere with the achievement of the most efficient business form, real costs will be imposed on the economy.⁵⁰

In the context of an entity approach, even though the business form may have legal liability for the payment of tax, it is argued that the economic incidence will fall on individuals, depending upon how it is 'shifted'.⁵¹ In particular, the relevant individuals affected may be the members of the business form through lower distribution of profits; or they may be consumers through higher prices for goods or services from the business; or, finally, employees through lower wages. Due to this process of 'shifting', it has been argued that it is individuals, particularly the members, who should be taxed directly – rather than indirectly via the business

intellectual property rights. Simons, HC. (1938). *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy*. Chicago: The University of Chicago Press, at p 194.

⁴⁸ Slemrod, J. (1996). Tax Cacophony and the Benefits of Free Trade. In *Fair Trade and Harmonization: Prerequisites for Free Trade?* edited by J. Bhagwati and R. E. Hudec. Palatino: Massachusetts Institute of Technology, at p 288.

⁴⁹ Bevin, n 15, at p 52.

⁵⁰ Bevin, n 15, at p 52.

⁵¹ Bengtsson, and Robinson, n 17, at p 8.

form.⁵² From an economic perspective, a business form can be seen as a collection of members, managers and employees. Normally, the members are the residual claimants to the business form's profits after the satisfaction of all other claimants, being the secured and unsecured creditors.⁵³ It is on this basis that it is argued that a business form may be regarded as economically integrated with its members,⁵⁴ and therefore it is the members who should be taxed on the business income.⁵⁵ For this reason tax transparency (an aggregate approach) of a business form that disregards the business form and assesses members directly has been identified as 'conceptually' the preferable system.⁵⁶

From this fiscal point of view, the business form has no separate existence, so income and expenditure should retain their characteristics when allocated to members (the conduit theory).⁵⁷ For example, if the business form derives exempt income, then the allocation of this to the member would retain its exempt status.⁵⁸ Tax transparency is stated to improve or enhance the tax neutrality and equity of a tax system, compared to an entity approach.⁵⁹

⁵² Mintz, J. (1996). The Corporation Tax. In *The Economics of Tax Policy*, edited by M. Devereux. Oxford: Oxford University Press, at p 138.

⁵³ Bengé, and Robinson, n 17, at p 123.

⁵⁴ Ting, A. (2005). Policy and Membership Requirements for Consolidation: A Comparison between Australia, New Zealand and the US. *British Tax Review* 3:335.

⁵⁵ Bengé, and Robinson, n 17, at p 123.

⁵⁶ Consultative Committee on the Taxation of Income from Capital. (1991). *Taxation of Distributions from Companies: Final Report*, Auckland, July, at p 14, Vann, n 33, at p 36, Kwall, n 18, at p 10 and Australia. (1998). A strong foundation (Ralph Report No 1), Canberra: AGPS, at p 74.

⁵⁷ McLure, n 36, at p 35.

⁵⁸ Similarly the derivation of a capital gain would remain a capital receipt in the hands of the member.

⁵⁹ Bevin, n 15, at p 96. Harris, n 4, at p 107. Yin, n 33, at p 433.

The Organisation for Economic Co-operation and Development (OECD) in its 1991 report espoused a preference for transparency:

Equity and neutrality would best be achieved under a tax system in which there were no taxes on organizations as such, and all individuals and families holding interests in organizations were taxed on the accrued net gains from such interests on the same basis as all other net gains.⁶⁰

The adoption of tax transparent treatment can achieve greater horizontal and vertical equity and this is because there is an alignment in the taxation of business profits with the notion of the capacity to pay tax.⁶¹ This can also be specifically explained on the basis that tax transparency is closer to achieving the so-called 'Haig-Simons' comprehensive income tax framework.⁶² The Simons' definition of 'personal income' is the algebraic sum of '(a) the market value of the rights exercised in consumption and (b) the change in value of the sum of property rights between the beginning and end of the period in question'.⁶³ That is, 'income is the money value of the net accretion to one's economic power between two points of time'.⁶⁴ Tax transparency — with the direct allocation of income and losses to members — comes close to achieving this, although it does not include unrealised capital growth in assets held by the business form.⁶⁵

⁶⁰ OECD. (1991). *Taxing Profits in a Global Economy: Domestic and International Issues*, OECD, at p 23.

⁶¹ Yin, GK, and Shakow, DJ. (1999). Taxation of Private Business Enterprises. In *Federal Income Tax Project*. Philadelphia: The American Law Institute, at p 70. Oats, n 28, at p 39: "This presupposes profitability as an acceptable measure of ability to pay tax".

⁶² Head, JG. (1997). Company Tax Systems: From Theory to Practice. In *Company Tax Systems*, edited by J. Head and R. Krever. Burwood: Australian Tax Research Foundation, at p 22

⁶³ Simons, n 47. Haig defined personal income as the 'money value of the net accretion to one's economic power between two points of time', a formulation that was intended to include a taxpayer's consumption, and that was thought by Simons to be interchangeable with his own: Bittker, n 19, at p 932.

⁶⁴ Haig, RM. (1959). The Concept of Income - Economic and Legal Aspects. In *Readings in the Economics of Taxation: Selected by a Committee of the American Economic Association*, edited by R. Musgrave and C. Shoup. Homewood: Richard D Irwin Inc, at p 59.

⁶⁵ Note, how this formulation of 'income' related to a taxpayer who has membership interest in a business form is questionable as Haig-Simons did not identify what was the 'tax unit'. See: Bittker, n 19, at p 977.

In this way, transparency removes the incentive for members to use a business form to shelter their business income, to avoid having to pay individual marginal tax rates.⁶⁶ In Australia, the sheltering and splitting of income was highlighted by the High Wealth Individual Taskforce, which found the average rate of tax for these individuals to be 20 per cent even though the top marginal tax rate at the time was 47 per cent.⁶⁷ Bittker argues that if tax transparency achieves a more comprehensive tax base, this in turn may afford an opportunity to reduce the upper bracket rates and thereby mitigate the degree of progression.⁶⁸ Reduced progression may reduce the incentive for high wealth taxpayers to shelter and/or split income.

Furthermore, full integration can achieve greater equivalent tax treatment on debt and equity.⁶⁹ This means that a business choice for debt or equity funding is less influenced by tax and therefore the problems previously alluded to are reduced.

2.2.1.1 Studies on tax neutrality and business taxation

Although tax transparency is argued to improve tax neutrality between business forms, the question needs to be raised as to whether there is any evidence to support the contention that taxpayers would be motivated in their choice of business form due to its tax treatment. In Australia there are several cases that have held that Part IVA (or its predecessor) applied to the creation of a business

⁶⁶ Cnossen, n 28, at p 261.

⁶⁷ Findings of the High Wealth Individual Taskforce in 1997-98: Australian National Audit Office. (2000). *High Wealth Individuals Taskforce – Australian Taxation Office* (Audit Report No 46 1999-2000), Canberra: AGPS: This figure is confounding when one considers that for individuals, Australia has progressive marginal income tax rates, with the highest marginal tax of 47 per cent being imposed on incomes, at that time, in excess of \$50,000.

⁶⁸ Bittker, n 19, at p 959.

⁶⁹ Bevin, n 15, at p 96, and Bird, n 33, at p 235.

form, as a taxpayer's primary or dominate motivation was to achieve a tax benefit through this.⁷⁰

Several studies have also illustrated that there is a potential for this to occur. These studies have observed or predicted changes in the utilisation of certain business forms given changes in the tax system. In the United States, Scholes and Wolfson, Ayers et al. and Gordon and Mackie-Mason considered the effect on business form choice due to the United States' *Tax Reform Act 1986* (US) (referred to as the 1986 Tax Reforms). In Australia, Holub analysed the utilisation of public unit trusts given changes to their tax treatment. While not conclusive, these studies tend to support the argument that taxpayers' choice of business form can be influenced by tax arbitrages.

As previously stated, Scholes and Wolfson theorised that the choice of business form is a trade-off between tax costs and transaction costs, with firms choosing their business form to minimise these costs.⁷¹ This initial decision may be adversely affected due to subsequent changes in tax rules. These changes may result in increased tax costs, which may make reorganisation to an alternative business form desirable.⁷²

Sub-optimal decisions may be made if tax and transaction costs are not both considered. Scholes and Wolfson argued:

[I]n a world of costly transacting, tax minimization no more leads, in general, to efficient organizations than does transaction cost minimization in the face of taxes.⁷³

⁷⁰ For example: *FCT v Gulland*; *Watson v FCT*; *Pincus v FCT* (1985) 160 CLR 55; *FCT v Phillips* (1978) 8 ATR 783; *Tupicoff v FCT* (1984) 56 ALR 151; and *Case 2/2004 AATA* 349.

⁷¹ Scholes and Wolfson (1986), n 22. Scholes and Wolfson (1989), n 22, pp 49-74; and Scholes and Wolfson (1992), n 22.

⁷² Holub, n 16, at p 3.

⁷³ Scholes and Wolfson (1986), n 22, at p 5.

Studying the United States' experience, Scholes and Wolfson considered⁷⁴ whether the 1986 Tax Reforms caused corporations to be replaced as a business form by general partnerships.⁷⁵ Compared to the transparency that applied to general partnerships, the 1986 Tax Reforms increased the tax cost of the entity approach that applied to corporations (known as C Corporations) subject to Sub-Chapter C of the *Internal Revenue Code 1986* (US). In particular, the 1986 Tax Reforms caused the top C Corporation tax rate to exceed the top individual rate, eliminated the lower capital gains rate on the disposals of membership interests, and repealed the general utilities doctrine for the tax free transfer of long-term capital gains.⁷⁶ Also, certain integrity measures were introduced.⁷⁷

Due to this tax differential between the entity approach and the transparent approach, a C Corporation would need a greater pre-tax return to allow for members in receipt of distributions after tax to be equal to their counterparts investing via a general partnership.⁷⁸ Using 1986 tax rates, Scholes and Wolfson demonstrated that the required before-tax, risk-adjusted return on new investments in C Corporations was 12.95 per cent, compared to 9 per cent for a general partnership.⁷⁹ Disregarding reorganisation costs, Scholes and Wolfson considered this differential could induce C Corporations to reorganise as general partnerships.⁸⁰ They concluded that the non-tax advantages of the C

⁷⁴ Disregarding transaction costs.

⁷⁵ Scholes and Wolfson (1989), n 22, at p 63.

⁷⁶ Nadeau, SJ, and Strauss, RP. (1997). Observations on the U.S. Corporate Tax Policy and the 1992 U.S. Treasury Report on Integration. In *Company Tax Systems*, edited by J. Head and R. Krever. Burwood: Australian Tax Research Foundation, at p 97. The general utilities doctrine allowed for long term capital gains to be disregarded entirely, as it was possible to transfer capital assets tax free to corporate members. See: Sinn, H-W. (1987). The Policy of Tax-Cut-cum-Base-Broadening. Paper read at 43rd Congress of the International Institute of Public Finance, at Paris, at p 167: previously only 40 per cent of a realised capital gain was included in the personal income tax base.

⁷⁷ The rules introduced by the 1986 tax reforms include passive loss rules, the at-risk rule and tightening the corporation alternative minimum tax.

⁷⁸ Scholes and Wolfson (1986), n 22, at p 27.

⁷⁹ Scholes and Wolfson (1986), n 22, at p 27.

⁸⁰ Scholes and Wolfson (1986), n 22, at p 32.

Corporations would have to be ‘enormous’ to see their continued growth compared to general partnerships.⁸¹

However, non-tax distortions between C Corporations and general partnerships, such as C Corporations having limited liability and ease of transferability of membership interest, would also influence this decision.⁸² It will be demonstrated in Chapter Three that, while the utilisation rate of C Corporations did decline after the 1986 Tax Reforms, so did general partnerships. Instead the S Corporation underwent a surge in utilisation. In the United States it is possible for a corporation to access tax transparency through the making of an S Corporation election under Sub-Chapter S of the *Internal Revenue Code 1986* (US).⁸³ In this way the non-tax characteristics can be retained while circumventing entity tax treatment. Gordon and MacKie-Mason observed a massive surge in S Corporation elections following the 1986 tax reforms,⁸⁴ although they recognised that the number of business forms is not indicative of economic activity with a majority of assets remaining with C Corporations. This surge in the number of S Corporations is illustrated later in the discussion about the utilisation of the various transparent companies.⁸⁵

An empirical study by Ayers et al. considered both tax and non-tax factors by studying a sample of small businesses in the United States.⁸⁶ Their results suggested that non-tax factors such as business risk, ownership structure, firm size and age are all important in the selection of a business form. The authors concluded that the higher the relative risk of operations and the existence of

⁸¹ Scholes and Wolfson (1986), n 22, at p 31.

⁸² Holub, n 16, at p 26.

⁸³ Note this status is not freely available as there are eligibility requirements.

⁸⁴ Gordon, RH, and MacKie-Mason, JK. (1990). Effects of the Tax Reform Act of 1986 on Corporate Financial Policy and Organizational Form, in *Do Taxes Matter? The Impact of the Tax Reform Act of 1986*, ed J. Slemrod, Chapter 4, Massachusetts Institute of Technology Press, at p 118.

⁸⁵ See Chapter Three: Figure 3-0-1.

⁸⁶ Ayers, B, Cloyd, CB, and Robinson, JR. (1996). Organizational Form and Taxes: An Empirical Analysis of Small Businesses, *Journal of the American Taxation Association*, 18 (Supplement): 49, at p 50.

multi-members, and the larger the operations, the more likely the business will be organised as a C Corporation.⁸⁷ However, they found only partial support for the hypothesis that taxes were an important consideration. Their evidence suggested that members used S Corporations, rather than C corporations, for businesses that realise losses in the early years of their operation and this is entirely understandable given the flow-through of consequent losses with S Corporations. Finally, the authors found that owners of businesses in tax-shelter industries utilised unincorporated entities (such as general partnerships) rather than specifically corporations *per se*.

Utilising the theory espoused by Scholes and Wolfson, Holub studied the utilisation of public unit trusts in Australia during the 1980s, where initially public unit trusts were subject to partial tax transparency, with income allocated to unit holders and losses trapped within the business form. This tax treatment changed after government intervention, which then taxed public unit trusts as corporations with an imputation system applying.⁸⁸ Holub considered that given that both forms were now subject to the same tax treatment, the preferred business form between the public unit trust and corporation would be the one that had the greater non-tax advantages.⁸⁹ He studied the eight public unit trusts in Australia to see their response to the change in their tax treatment. The author found that, of the public unit trusts studied, all but one chose to re-organise/re-constitute to a corporation after the government amendments.⁹⁰ Holub observed that high reorganisational costs were instrumental for the one non-converting trust, although it did make changes to its trust deed to provide greater flexibility in raising equity capital, similar to a corporation. He concluded that his finding supported the Scholes and Wolfson theory, which contends that firms unable to reorganise to a favoured business form will initiate changes that result in its

⁸⁷ Ayers, Cloyd and Robinson, n 86, at p 51.

⁸⁸ ITAA 1936 (Cth), Division 6C: enacted in 1985.

⁸⁹ Holub, n 16, at p 328.

⁹⁰ There were only eight public unit trusts within the study, though this was the extent of the Australian public unit trust market. Only the Breakwater Island Trust chose to continue operating as a trust.

approximating the favoured business form. The author also suggested that the high percentage of conversions (seven out of eight) meant that the non-tax advantages of the corporate form were greater than for unit trusts.⁹¹ Had the non-tax advantages of the public unit trust form been greater than or equivalent to those of corporations, the businesses would have continued as public unit trusts.⁹² Furthermore, it would appear from Holub's findings that the initial choice to use the public unit trust prior to the tax changes must have been largely based on tax considerations, and not on their non-tax advantages.⁹³

Based on the analysis above it is argued that breaches of tax neutrality in terms of business forms can distort taxpayers' investment decisions, although the study by Ayers et al. found only partial support for this. Theoretically the best way to improve tax neutrality is with tax transparency applying to the business form. Nevertheless, there are perceived impediments for jurisdictions in adopting transparency for company forms.

2.2.1.2 Arguments against

Given it is argued that tax transparency is the ideal in improving tax neutrality, why isn't it more widely implemented? This may be due to problems that have been identified and mooted with it. Historically, Simons in 1936 identified that 'it would involve serious administrative difficulties'.⁹⁴ These problems include how gains or losses on the sale of membership interest would be apportioned,⁹⁵ and how and at what date would members' share of the transparent company's

⁹¹ Holub, n 16, at p 328

⁹² Holub, n 16, at p 328.

⁹³ Holub, n 16, at p 330. Similarly, prior to the introduction of the full imputation system in Australia, an entity system applied to corporations resulting in a greater breach of tax neutrality. It has been suggested that the reason why the Australian government introduced the imputation system was in part due businesses of the day adopting forms other than corporations to circumvent the entity tax treatment and the higher tax burden. See: Stewart, n 6, at p 3 and Australian Treasury, n 32, at paragraphs 17.7 and 17.8.

⁹⁴ Simons, n 47, at pp 189 to 196. Bittker, n 19. McLure, n 36, at p 35.

⁹⁵ Simons, n 47, at p 193.

income or losses be calculated.⁹⁶ Furthermore, subsequent changes to a business form's profit or loss for a year would impact all members who have been previously allocated, and not just the business form.⁹⁷

Another potential problem is the assessment of members to allocated business income when they have not received any distribution from the business form. This would mean members would have to self-fund their tax liability for unpaid allocations. Also a difficulty could arise when in subsequent years the retained earnings are distributed to different members, although earlier the profit was assessed to another member.⁹⁸ Such a selected distribution would be an example of 'streaming'. This allocation concern can be further aggravated if there are multiple classes of members' interest in a transparent company.⁹⁹ In principle, retained earnings should be allocated to membership interest which rises in value because of retained earnings.¹⁰⁰ This is because it is these members who benefit from the retained earnings and the market considers that they are entitled to the income.¹⁰¹

⁹⁶ Although one suggestion put forward is that a transparent company's profits or losses be allocated to members on a day of record. In the 1977 Blueprints for Tax Reform, the United States' Treasury recommended that this day of record be the beginning of a transparent company's financial year. This was considered to reduce the scope for high-rate taxpayers to purchase membership interests in loss-making transparent companies and low-rate taxpayers to purchase member's interest of transparent companies with high levels of profits: Bengé, and Robinson, n 17, at p 75.

⁹⁷ Such an amendment may arise due to an audit by the relevant tax authority. Bevin, n 15, at p 99.

⁹⁸ Holmes, K. (1992). The Taxation of Closely-Held Companies: Concepts, Legislation and Problems in New Zealand. *Australian Tax Forum* 9:321, at p 331.

⁹⁹ Vann, n 33, at p 36. The variety of securities through which people may have an interest in the profits of a corporation is probably unlimited. Securities include rights issues, options, ordinary shares (with or without voting rights), specified preference shares, ordinary preference shares, shares qualifying only for deferred dividends and convertible notes. Bengé, and Robinson, n 17, at p 77.

¹⁰⁰ Bengé, and Robinson, n 17, at p 77.

¹⁰¹ Bengé, and Robinson, n 17, at p 77.

Of course, tax transparency of itself does not necessarily remove all tax distortions. This can be particularly the case if transparency does not apply to all business forms, or has different applications.¹⁰²

Beyond these problems, a major concern with the introduction of tax transparent companies is the potential risk to tax revenue it creates when tax transparency is granted to a business form that provides members with liability protection. This risk was recognised by the Carter Commission in 1966,¹⁰³ the Australian Treasury in 1974,¹⁰⁴ the Australian government in the Draft White Paper in 1985,¹⁰⁵ and the Ralph Committee in 1999.¹⁰⁶

The potential risk to revenue arises in a number of ways. Firstly, tax revenue can be at risk if losses are allocated to members in excess of their liability exposure for the operations of the business form. The free availability of losses could distort investment decisions by encouraging investors into arrangements whereby small amounts of equity investment allow access to a large amount of tax losses. These tax losses could offset investors' other income, and thus reducing their overall tax liability, and in this way create a positive return. In such circumstances the tax system could be seen as funding the investment.¹⁰⁷ Furthermore, tax revenue can be jeopardised due to the removal of tax at the business form level, with the allocation of income and/or losses to members who

¹⁰² For example the New Zealand transparent company, the LAQC, there are a number of inconsistencies between general partnerships and the LAQC, such as the treatment of partial year losses, even though the goal was to have an equivalent outcome. See: Freudenberg, B. (2005). Is the New Zealand Qualifying Company regime achieving its original objectives? *New Zealand Journal of Taxation Law and Policy* 11(2):185.

¹⁰³ Canada, n 29.

¹⁰⁴ Australian Treasury. (1974). *Taxation Paper No 1*, Canberra: AGPS.

¹⁰⁵ Australian Treasury, n 32.

¹⁰⁶ Australia, n 9, at paragraph 277 of Overview.

¹⁰⁷ Smith, AMC, and Dunbar, DG. (2005). Tax Avoidance Schemes in New Zealand: Limited-Recourse Loans and the Deferred-Deduction Rule. *Bulletin* June: 249. See Chapter Six for an illustrated example of how access tax losses can fund an investment.

may be tax-exempt¹⁰⁸ or not assessable due to non-residency.¹⁰⁹ With Australia being a capital-importing country, tax transparency could transfer revenue and national income to capital-exporting countries.¹¹⁰ Additionally, tax revenue collected could be lower due to the flow-through of tax preferences to members, instead of it being ‘clawed back’ on distribution with an entity or an integrated approach.

2.2.1.3 Implementation

Due to these concerns there has been a reluctance to embrace tax transparency for business forms with company characteristics, particularly when compared to general partnerships.¹¹¹ However, the economic ideals of transparency have been recognised, with many jurisdictions having, at the very least, some form of integration approach towards the taxation of business forms with company characteristics. Indeed, an entity approach — as exemplified by the classical tax system — is the exception rather than the rule among OECD countries,¹¹² as only four of 24 countries adhere to a classic system, with the other 20 countries having some form of ‘integration’. This integration can be through a number of mechanisms, such as imputation, dividend deduction,¹¹³ split rate¹¹⁴ or dividend exemption.¹¹⁵ Even the United States currently has a temporary tax relief for its

¹⁰⁸ Referring to the fact that if exempt bodies invest via corporations, then the corporate earnings are taxed at corporate level, and while dividends to tax-exempt entities are not assessed, then there has been some tax revenue collected on the economic activity at the corporate level.

¹⁰⁹ Oats, n 28, at p 41.

¹¹⁰ Australian Treasury, n 32, at paragraph 17.10.

¹¹¹ Avery Jones, JF, De Broe, L, Ellis, MJ, Miyatake, T, Roberts, SI, Goldberg, SH, Killius, J, Maisto, G, Giuliani, F, Vann, RJ, Ward, DA, and Wiman, B. (2002). Characterization of Other States' Partnerships for Income Tax. *Bulletin - Tax Treaty Monitor*, July:288.

¹¹² Slemrod, n 48, at p 291.

¹¹³ Bengé, and Robinson, n 17, at p 40: “Under a dividend-deduction system, some proportion of distributed profit is deductible for company tax purposes”.

¹¹⁴ Bengé, and Robinson, n 17, at p 41: “The split-rate system taxes distributed profits at a lower rate than Undistributed profits”.

¹¹⁵ Bengé, and Robinson, n 17, at p 41: “Under the dividend-exemption system, company assessable income is subject to company tax at ordinary rates, but dividends are wholly or partially exempted from personal income tax”.

classical tax system applying to C Corporation distributions, with distributions taxed at a concessional rate of 15 per cent rather than the normal individual tax rate.¹¹⁶

An imputation system is the most sophisticated of the integrated approaches, providing members with credit for the tax paid at the business form level when there is a distribution of profits. Such a distribution, with attached tax credits, can be referred to as 'franked' or 'imputed' distribution. The member in receipt of such a franked distribution will in effect gross-up the distribution to the pre-tax amount, calculate their own tax, and then offset this with the tax previously paid at the business level.

However, even the most sophisticated imputation system does not remove the potential for the tax system to distort investment decisions.¹¹⁷ For example, Holub observed that, due to continued differences between Australia's imputation system for corporations and the transparency for general partnerships, corporations had to earn approximately 33 per cent more than general partnerships to give the same after-tax return.¹¹⁸ While not tax neutral, the imputation system is more favourable than the prior entity approach which required the corporate earnings to be 75 per cent more.

An imputation system continues the distortion of exempt income and tax preferences. This is because unfranked distributions (which represent exempt

¹¹⁶ Refer to Chapter Eight's discussion about these temporary measures.

¹¹⁷ Vann, n 33, at p 54: Imputation and other distribution related forms of relief ameliorate but do not remove the inequity and biases of the classical system. See also: Australia, n 8, at Chapter 16; and Australia, n 56, at pp 74-75.

¹¹⁸ Holub, n 16, at p 69: "The dividend imputation reforms reduced the tax disadvantage of the corporate form but not enough to change the preference for the partnership form. For example, during fiscal 1988, the first year of dividend imputation, corporate projects having a 10 year investment horizon and a 4% dividend yield were required to earn a before-tax return of 13.29% pa in order to compete with a partnership return of 10% pa. In other words, corporate projects needed to earn approximately 33% more than partnership projects in order to remain competitive. Notably, this was a significant reduction from 1987, when corporate projects were required to earn approximately 75% more than partnership projects".

income or income sheltered from tax) are fully assessed to members, and thus tax preferences are 'clawed back'. This means there can be an incentive to retain, exempt or shelter income in the corporate form to avoid this claw back.¹¹⁹ Bengé states that '[t]his reintroduces the intersectoral and intrasectoral biases that full imputation was designed to avoid'.¹²⁰ Also an imputation system does not completely remove the distortion between debt and equity funding, which can be illustrated by the introduction of Australia's debt-equity rules, particularly for international transactions.¹²¹ Another distortion that can exist with an imputation system is in respect of domestic and foreign members, thus breaching import-export neutrality. A reason for this is that an imputation system is mainly devised to overcome domestic distortions and therefore can introduce an international bias.¹²² With imputation, foreign members are generally not able to take full advantage of the imputation credits, as it is unlikely that their home jurisdiction will provide a foreign tax credit for tax paid by a different entity (the corporation) in a foreign jurisdiction. Also, the receipt of a franked distribution may effectively mean that an overall higher rate of tax is paid, compared to the rate if an unfranked distribution subject to a lower withholding tax had been received.¹²³ The problem of a domestic bias for an imputation system has seen moves by members of the European Union away from an imputation system to other integration approaches. This is in response to cases that have held that imputation systems may restrict the movement of capital in member states of the

¹¹⁹ Cnossen, n 28, at p 271.

¹²⁰ Bengé, M. (1995). Company Tax Integration: Did We Get it Right? Paper presented at the Tax Summit Conference, Canberra, 20 September 1995, at p 12.

¹²¹ ITAA 1997 (Cth), Division 974.

¹²² Vann, n 33, at p 55. Taylor, C.J. (2006). An Old Tax Is A Simple Tax: A Back To The Future Suggestion For The Simplification Of Australian Corporate-Shareholder Taxation. *Journal of the Australasian Tax Teachers Association* 2(1):30.

¹²³ For example, in Australia the receipt by a foreign member of a fully franked dividend means for Australian tax purposes the receipt is neither assessable or exempt income, and it is not subject to withholding tax. This is because the underlying corporate profits have already been subject to 30 per cent tax rate in Australia. In comparison, the receipt of an unfranked dividend (that is the underlying corporate profits have not been subject to tax in Australia) will be subject to withholding tax (with the rate varying from 5 per cent to 30 per cent)

European Union, or may discriminate between member states.¹²⁴ For example, the United Kingdom has replaced its partial imputation system with a notional dividend tax credit system.¹²⁵

Given the increase in globalisation of trade and capital movements, it is argued that breaches of import–export neutrality may grow in significance.¹²⁶ In the last four decades this increased economic integration has been facilitated by the practical disappearance of capital and exchange controls, which protected most countries' domestic financial markets in the early 1970s.¹²⁷ This has been assisted by the liberalisation of financial services and the deregulation of domestic financial markets by many countries.¹²⁸ Facilitating this is the lowering of the tariffs and quantitative restrictions protecting countries' markets.¹²⁹ In

¹²⁴ Hamaekers, H. (2003). Taxation trends in Europe. *Asia-Pacific Tax Bulletin* (Feb):42, at p 49. Barenfeld, J. (2005). Taxation of Cross-Border Partnerships: Double Tax Relief in Hybrid and Reverse Hybrid Situations. Doctor of Laws, Jonkoping International Business School, Jonkoping, at p 97: "Within the EU, additional pressure has been applied due to recent case law. In the Verkooijen case, [Case C-35/98 *Staatssecretaris van Financiën v B.G.M. Verkooijen* [2000] ECR I-4071] the European Court of Justice (ECJ) held that make a grant of a tax advantage (in the current case a dividend exemption relating to taxation of income held by shareholders who were natural persons), subject to the condition that the dividends are paid by companies established within the national territory, is a restriction on the free movement of capital".

¹²⁵ Harris, PA. (1998). An International Comparison of Flow-Through Regimes: How Does New Zealand's New Regime Rate? *Bulletin* 52 (3):102, at p 102. Collison, D. and Tiley, J. (2005). *Simon's Tiley and Collision UK Tax Guide 2005-06*. London: LexisNexis Butterworths, at p 1008. The United Kingdom had an imputation system from 1973 to 1997. The rate of imputation was set equal to the basic rate of income tax. It was only a 'partial imputation' system since only a part of the corporation tax paid by the corporation was imputed to the member. In order to ensure that the tax used as a credit by the member represented tax paid by the corporation, the corporation when paying the dividend (or any other qualifying distribution) had to pay advance corporation tax (ACT) to the Inland Revenue. Liability to pay ACT arose whether or not the corporation was liable to pay corporation tax, for example through lack of profits. The ACT was set against the corporation's liability to corporation tax.

¹²⁶ The degree of international economic integration has now reached and exceeded levels that had existed in the years prior to World War One. Thatcher, M. (2002). *Statecraft: Strategies for a Changing World*. London: Harper Collins Publishers, at p 459: Citing: Ian Vasquz, 'The Return to a Global Economy', *Ideas on Liberty*, November 2000; Wolf, 'Will the Nation-State Survive Globalisation?', *Foreign Affairs*, January–February 2001. Scharpf, FW, and Schmidt, VA. (2000). Introduction. In *Welfare and Work in the Open Economy*, edited by F. W. Scharpf and V. A. Schmidt. Oxford: Oxford University Press, at p 7.

¹²⁷ Scharpf and Schmidt, n 126, at p 7.

¹²⁸ Including members of the European Union, the United States and Australia. See: Scharpf and Schmidt, n 126, at p 7.

¹²⁹ Due to successive rounds of General Agreements on Tariffs and Trade and World Trade Organisation negotiations. See: Scharpf and Schmidt, n 126, at p 7.

addition, the advances in telecommunications and associated technologies have diminished the significance of countries' boundaries in trade and economic activity.¹³⁰

The combination of these factors means that there is an increase in the international integration between countries' economies, with financial capital largely internationally mobile.¹³¹ Commentators have stated that this increasing economic globalisation will translate into an increasingly competitive environment for businesses, including Australian businesses.¹³² Governments are recognised as having a key role in facilitating or inhibiting this competition. The Henry Review recently highlighted the significance of globalisation on tax planning:

Increasing globalisation, particularly among more developed economies means social systems and economic infrastructure are becoming more uniform and tax settings may become relatively more important in decisions about where to invest and work.¹³³

There have been fears that this international competition may lead to a 'race to the bottom' in terms of tax policy, as governments compete for mobile economic resources.¹³⁴ That is, tax competition can exert a downward pressure on income tax rates, especially capital and corporate tax rates.

It has been observed that all OECD countries have felt the need to keep their rates in line with their competitors, with small, capital-dependent economies being especially vulnerable to the pressures of international tax competition.¹³⁵ Another global trend has been the reduction in the statutory corporate tax rates

¹³⁰ Pinto, D. (2002). Through the World's Eye: Governance in a Globalised World. *Murdoch University Electronic Journal of Law* 9 (3):1, at p 10.

¹³¹ Quiggin, J. (2001). Globalization and Economic Sovereignty. *Journal of Political Philosophy* 9 (1):56, at p 2.

¹³² Pinto, n 130, at p 10.

¹³³ Australia, n 10, at p 20.

¹³⁴ Garrett, G. (1998). Global Markets and National Politics: Collision Course or Virtuous Circle? *International Organization* 52 (4):787, at p 788: Citing: Andrews 1994; Cerny 1990; Gill and Law 1989; Kurzer 1993; McKenzie and Lee 1991; Moses 1994; Scharpf 1991; and Schwartz 1994.

¹³⁵ Ganghof and Eccleston, n 33, at p 531.

from 1986. As demonstrated, the average statutory corporate tax rates for 18 OECD countries in 1986 was 48 per cent; by 1998 this was only 37 per cent, with the coefficient of variation between the countries being only 0.14 and 0.19 respectively.¹³⁶ However, this decrease in statutory corporate tax rate does not necessarily mean a decrease in effective tax rates.¹³⁷

However, the magnitude of these reforms may not be as extensive as first feared. This is because most countries have used base broadening to make these reforms more or less revenue neutral for them.¹³⁸ This has meant that on average, there has not been a very strong downward trend in 'effective' statutory corporate tax rates compared to the statutory rate.¹³⁹ Such a trend can be illustrated by the Australian corporate tax reforms in the late 1990s, which saw the lowering of the corporate tax rate at the same time as the removal of accelerated depreciation. In advanced OECD countries neither income tax revenues, nor total tax revenues have shown an average downward trend.¹⁴⁰ Swank and Steinmo's findings offer some support for the view that, while globalisation contributed to the shift in the 'content' of tax policy, it has not resulted in reductions in actual tax burdens on capital.¹⁴¹ This is because domestic economic and budgetary forces can exert strong pressures on a government's tax policy.¹⁴² These findings indicate that globalisation is not the only factor motivating government policies, and therefore a so-called 'race to the bottom' is not inevitable.¹⁴³ Through these mechanisms, governments have been able to defend their revenue base and/or increase their attractiveness for direct

¹³⁶ Ganghof, n 6, at p 612.

¹³⁷ Ganghof and Eccleston, n 33.

¹³⁸ Ganghof, n 6, at p 611.

¹³⁹ Ganghof, n 6, at p 609: this study focused on 1979 to 1994. More recently this was confirmed by the Henry Review: Australia, n 10, at p 126.

¹⁴⁰ Ganghof, n 6, at p 597.

¹⁴¹ Swank, D, and Steinmo, S. (2002). The New Political Economy of Taxation in Advanced Capitalist Democracies. *American Journal of Political Science* 46 (3):642, at p 650. This content can relate to tax mix, the revenue mix and the budget size. Ganghof, n 6, at p 624.

¹⁴² Swank and Steinmo, n 141, at p 651: "This is because governments can, and do, pursue moderately extensive social protection and public goods provision when they and their electorates so choose".

¹⁴³ Swank and Steinmo, n 141, at p 651.

investment.¹⁴⁴ For example, in a specifically Australian context, it has been observed that one driving force behind recent tax reforms have been a diffusion of ideas in relation to what constitutes 'good' tax policy and domestic policy learning.¹⁴⁵ That is, domestic policy makers in effect chose to cut corporate and personal income tax rates and broaden the tax bases in order to achieve the goal of a more 'neutral' or 'market-conforming' tax base.¹⁴⁶

What appears to be replacing the fear of lost revenue from international tax competition is the fear of lost revenue from an uncompetitive international tax system.¹⁴⁷ This is because the poor co-ordination of countries' tax systems can produce international double taxation through asymmetrical tax treatment.¹⁴⁸

Furthermore, for a capital-importing country such as Australia, it is important to realise that it is inefficient to levy a tax burden on factors of production which are in perfectly elastic supply.¹⁴⁹ One such elastic factor is capital. Due to the mobility of capital, breaches of import–export neutrality may lead to unduly high levels of overall tax, which could lead to capital being invested elsewhere. This is because investment capital is more mobile and more sensitive to tax asymmetries and tax arbitrages. Capital is then seen as having no ultimate loyalty to any country or community, with its main purpose to generate profits.¹⁵⁰

Both large and small countries can no longer set economic policies without considering, firstly, how their decisions affect others and, secondly how the

¹⁴⁴ Ganghof, n 6, at p 603.

¹⁴⁵ Ganghof S and Eccleston, n 33, at p 520.

¹⁴⁶ Ganghof S and Eccleston, n 33, at p 520.

¹⁴⁷ Speed, R. (2003). Comment: An Internationally Competitive Tax System for Australia. *Australian Tax Review* 32:51, at p 51.

¹⁴⁸ Radaelli, n 7, at p 139.

¹⁴⁹ Sorensen, PB. (1998). Recent Innovations in Nordic Tax Policy: From the Global Income Tax to the Dual Income Tax. In *Tax Policy in the Nordic Countries*, edited by P. Sorensen. London: MacMillan Press Ltd, at p 15.

¹⁵⁰ Sikka, P. (2008). Globalization and its Discontents: Accounting Firms Buy Limited Liability Partnership Legislation in Jersey, *Accounting, Auditing and Accountability Journal* 21(3): 398.

decisions of others affect them.¹⁵¹ This may mean economic choices being severely constrained by decisions which are taken outside countries' borders.¹⁵² Owens argues that this greater interdependence between countries could severely limit the freedom of domestic policy-makers to determine their own economic policies irrespective of what is happening outside their borders.¹⁵³

This mobility has been identified as the cause of the burden of taxation being shifted onto non-mobile factors, such as low skilled labour¹⁵⁴ and investments by domestic businesses.¹⁵⁵ If capital moves abroad, then the tax burden will have to be carried by the immobile domestic factors.¹⁵⁶

What this means is that globalisation demands a much more pro-active and ongoing process of tax reform than has been practised in the past,¹⁵⁷ as governments need to consider whether their tax system results in unforeseen asymmetrical tax treatment. This is reflected in the call for changes by the Deputy Secretary of the United States Department of Treasury to make the United States more internationally competitive, stating 'that the sad truth of US international tax rules is that they no longer service the national interest of the US'.¹⁵⁸ For this reason, Swank and Steinmo argue that policy makers face intensifying pressure to reform tax policies to promote tax neutrality in terms of

¹⁵¹ Hallerberg, M, and Basinger, S. (1998). Internationalization and Changes in Tax Policy in OECD Countries: The Importance of Domestic Veto Players. *Comparative Political Studies* 31 (3):321, at p 322: citing Andrews, 1994; Moses, 1994, and Owens, J. (1993). Globalisation: The Implications for Tax Policies. *Fiscal Studies* 14 (3):21, at p 21.

¹⁵² Owens, n 151, at p 21.

¹⁵³ Owens, n 151, at p 22.

¹⁵⁴ Radaelli, n 7, at p 139.

¹⁵⁵ Ganghof S and Eccleston, n 33, at p 530.

¹⁵⁶ Sorensen, n 149, at p 15.

¹⁵⁷ Ernst and Young. (2002). Review of International Tax Arrangements: Submission to the Board of Taxation, at p 1.

¹⁵⁸ Speed, n 147, at p 51: quoting Dam KW, Deputy Secretary, United States Department of Treasury (Tax Council Legislative Lunch, Washington DC, 8 October 2002).

import–export neutrality.¹⁵⁹ This goal has led some commentators to state that economic policies across countries have begun to converge.¹⁶⁰

Accordingly, it is argued that the goal of tax neutrality is an important criterion with which to assess a country's tax system, as without it a tax system may adversely influence investment decisions. One aspect of this is how business forms are taxed, with 'entity' treatment being argued as imposing the greatest potential for distortion compared to the alternate aggregate (transparent) approach. Case law and studies have demonstrated how the tax system can influence the choice of business form. However, there are concerns with the aggregate approach, which include administrative difficulties and the potential risk to revenue when transparency is granted to a business form that provides members with liability protection. It appears that for these reasons many countries have compromised by adopting an integrated approach, although not removing all distortions. Given the increase in global trade and the sensitivity of capital, it was argued that a country's tax system should strive for greater neutrality.

2.3 Closely held businesses

It can be argued that, in addition to their economic benefits, tax transparent companies are advantageous for closely held businesses,¹⁶¹ although this is

¹⁵⁹ Swank and Steinmo, n 141, at p 651.

¹⁶⁰ Hallerberg and Basinger, n 151, at p 322; Andrews, 1994; Moses, 1994. Slemrod has stated that it is possible, even in the absence of an explicit multilateral agreement to harmonise taxes, that tax competition among countries will accomplish harmonisation: Slemrod, n 48, at p 306. Hamaekers, n 124, pp 42 – 50.

¹⁶¹ For LLCs see: Hicks, A, Drury, R, and Smallcombe, J. (1995). *Alternative Company Structures for the Small Business*. In *ACCA Research Report No 42*. London: Certified Accountants Educational Trust, at p 53. For LLPs see: House of Commons – Select Committee. (1999). *Trade and Industry – Fourth Report: Draft Limited Liability Partnership Bill*, HC 59, at paragraph 65: heard evidence that LLPs might be attractive to small general partnerships and corporations. Morse, G. (2004). *Limited Liability Partnerships and Partnership Law Reform in the United Kingdom*. In *The Governance of Close Corporations and Partnerships: US and European Perspectives*, edited by J. McCahery, T. Raaijmakers and E. Vermeulen. Oxford: Oxford

questioned by some.¹⁶² Three factors need to be established to ascertain whether tax transparent companies are advantageous: what is meant by a 'closely held business', what their relationship is with small and medium enterprises, and what is their significance to the economy. To illuminate these factors the following section will review the literature on closely held businesses.

2.3.2 Definition

Classifying businesses can be problematic. Businesses can be classified according to size, industry, membership structure or business form. The criterion of size may be further measured by such things as turnover, asset holdings, employee numbers or equity raising. Furthermore, closely held businesses are heterogeneous, and it can be misleading to represent them as anything else.¹⁶³ For example there can be different levels of member activity, ranging from a

University Press. Birds, J. (2000). A New Form of Business Association for the Twenty-First Century. *The Company Lawyer* 21 (2):39; Ward, G. (2001). *New Accounting Rules for Limited Liability Partnerships*, Press Release, Institute of Chartered Accountants, 20 July.. The Company Law Review Group stated the LLP may be "particularly beneficial for businesses that seek limited liability while preserving the less formal internal governance and decision-taking arrangements familiar to many owner-managed businesses": Company Law Review Steering Group. (2001). *Modern Company Law for a Competitive Economy: Final Report*. London, at paragraph 2.7. However, Freedman questions the validity of this statement given that this Group had not investigated the LLP itself, or studied its characteristics, since this was outside its terms of reference. Other commentators have been less than certain, specifying that LLPs 'at least on the face of it' are ideally suited to closely held businesses: Lower, M. (2003). What's on offer? A consideration of the legal forms available for use by small – and medium – sized enterprises in the United Kingdom. *The Company Lawyer* 24 (6):166, at p 168. Also the Law Commission thought it unlikely that many small and medium sized partnerships would opt for the LLP form: Law Commission Consultation Paper No 159, the Scottish Law Commission Discussion Paper No 111, July 2001, at p 1.15. For the benefit of LAQCS for closely held businesses see: Polson Higgs & Co, and Beattie Rickman. (2003). *Qualifying Companies*. Paper read at Professional Development Course Paper No S 703, June, Institute of Chartered Accountants, Wellington; and Holmes, n 98.

¹⁶² Finch, V, and Freedman, J. (2002). The Limited Liability Partnership: Pick and Mix or Mix-up? *Journal of Business Law* (September):475. Lower, n 161, at p 168. Law Commission Consultation Paper No 159, the Scottish Law Commission Discussion Paper No 111, July 2001, at p 1.15: the Law Commission thought it unlikely that many small and medium sized partnerships would opt for the LLP form.

¹⁶³ Holmes, S, and Gibson, B. (2001). Definition of Small Business: The University of Newcastle, at p 8; and Freedman, J. (2003). Small Business Taxation: Policy Issues and the UK. *Taxing Small Business: Developing Good Tax Policies* Australian Tax Research Foundation: Sydney (Conference Series 23):13, at p 18.

single-member coffee shop to a ten member publicity firm or a 100 member accounting firm.¹⁶⁴ An implication of this heterogeneity is that the political strength of closely held businesses can be fragmented, thereby reducing their ability to influence policy makers.¹⁶⁵ It can also be difficult to introduce policies that have equal application to such a diverse group. For example, while uniformity would simplify policy making, such uniformity (of taxes and regulations) can impose very different burdens on businesses depending upon their size, industry and/or geographic location.¹⁶⁶

Several lobby groups have been formed to represent small businesses,¹⁶⁷ emerging as a major political issue,¹⁶⁸ although Burton has questioned the effectiveness of the reforms implemented.¹⁶⁹ This can be frustrated by government focus on publicly held corporations in terms of policy reforms.¹⁷⁰

For the purposes of this dissertation, the qualitative characteristics inherent for a 'closely held business' is that membership interest is not widely dispersed, and that it is not publicly traded.¹⁷¹ Normally, a closely held business is one that is independently owned and operated, with most, if not all, capital contributed by

¹⁶⁴ Hillman, RW. (1992). Limited Liability and Externalization of Risk: A Comment on the Death of Partnership. *Washington University Law Quarterly* 70:477, at p 485.

¹⁶⁵ McMahon, RGP. (1989). *Small Business, Australia: A Research Companion*. Sydney: AFM Scholarships & Publications Fund, at p 92.

¹⁶⁶ Hendy, P. (2003). Threats to Small and Medium Enterprises from Tax and other Regulations. *Taxing Small Business: Developing Good Tax Policies*, Australian Tax Research Foundation: Sydney (Conference Series 23):113, at p 126.

¹⁶⁷ McMahon, n 165, at p 92: Others include: Australian Association of Independent Businesses; ACC Small Business Association (Australian Chamber of Commerce); Small Business Association of Western Australia (WA Chamber of commerce and Industry); Small Business Combined Association of NSW; National Small Business Council (Metal Trades Industry association); Council of Small Business Organisations of Australia.

¹⁶⁸ McMahon, n 165, at p 46.

¹⁶⁹ Burton, M. (2006). The Australian small business tax concessions – public choice, public interest or public folly? *Australian Tax Forum* 21 (1):71.

¹⁷⁰ McCahery, JA, and Vermeulen, EPM. (2003). Business Organization Law and Venture Capital. In *Venture Capital Contracting and the Valuation of High-technology Firms*, edited by J. McCahery and L. Renneboog. Oxford: Oxford University Press, at p 166.

¹⁷¹ Holmes and Gibson, n 163, at p 8; Coleman, C, and Evans, C. (2003). Tax Compliance Issues for Small Business in Australia. *Taxing Small Business: Developing Good Tax Policies*, Australian Tax Research Foundation: Sydney (Conference Series 23):147, at p 149; Small Business Deregulation Task Force. (1996). *Time for Business*, AGPS: Canberra, at p 13.

members and managers. Furthermore, members are likely to participate in the management of the business (member-management).¹⁷² Due to these characteristics it has been stated that ‘it is difficult to view closely held’ businesses regardless of the structure used as ‘economic entities independent of their owners’.¹⁷³

For Australian tax purposes there is minimal direct use of the notion of ‘closely held’ business.¹⁷⁴ However, there is reference to this concept through the definition of ‘private company [corporation]’ which by exclusion means a non-listed corporation;¹⁷⁵ or a listed corporation with a few members (less than 20) holding a vast majority of the membership interest (greater than 75 per cent).¹⁷⁶ This definition of ‘private corporation’ is consistent with the notion of closely held business that is used for this dissertation.

The Australian Government recognises that closely held businesses are characterised by member-management and has recently amended the small business CGT concessions to better facilitate this through a ‘significant individual’ test:

The small business concessions are intended for active participants in a small business, and the significant individual test represents a readily verifiable proxy for active participation. This reflects the fact that there is typically minimal separation between significant underlying ownership and

¹⁷² Harris, n 4, at p 47.

¹⁷³ Harris, n 4, at p 47.

¹⁷⁴ Closely held is referred to for value shifting: *ITAA 1997* (Cth), sections 725-65 and 727-15. As well as for closely held trusts, *ITAA 1936* (Cth), Division 6D, and for trust loss rules, *ITAA 1936* (Cth), Schedule 2F.

¹⁷⁵ Or a subsidiary of one.

¹⁷⁶ *ITAA 1936* (Cth), section 103A(1). Such a private corporation is subject to special tax provisions which on the whole are anti-avoidance measures trying to address the potential for tax abuses due to the ability to manipulate the corporation as a separate taxpayer from its members. For example: *ITAA 1936* (Cth), section 65: Payments to associated persons; sections 45A and 45B: Dividend and Capital streaming; section 108 (previously): Loans to shareholders; section 109: Excess payments to shareholders or associates; Division 7A: Distributions to shareholders; and *ITAA 1997* (Cth): section 202-45: unfrankable dividends; section 295-550: non-arm’s length income of a superannuation fund.

management in small business. Put more simply, those who own a small business tend to run the business.¹⁷⁷

While the qualitative characteristics of a closely held business may be explicit, there is a tendency to utilise quantitative measures to describe 'small' and 'medium' businesses, such as having turnover less than \$10 million;¹⁷⁸ or having fewer than 20 employees for non-manufacturing.¹⁷⁹

The use of quantitative measures to distinguish between sizes is exemplified in the Australian income tax acts. For example, the uniform definition of 'small business entity' relies on aggregate turnover being less than \$2 million.¹⁸⁰ In addition to this, other measures of 'small' are used for tax purposes, such as 'net CGT assets worth \$6 million or less';¹⁸¹ ordinary income less than \$10 million;¹⁸² turnover less than \$75,000;¹⁸³ or turnover less than \$1 million.¹⁸⁴ For Australian corporation's law purposes, a corporation is classified as small for the year if it satisfies two of the following: (a) gross operating revenue less than \$10 million; (b) gross assets less than \$5 million; or (c) fewer than 50 employees.¹⁸⁵

While it is acknowledged that 'closely held' and 'small business' are not *per se* interchangeable, the vast majority of closely held businesses will nonetheless be small to medium enterprises.¹⁸⁶ However, there can be a number of closely held

¹⁷⁷ Explanatory Memorandum accompanying Taxation Laws Amendment (2006 Measures No 7) Act (Cth), at paragraph 1.19.

¹⁷⁸ Small Business Deregulation Task Force, n 171, at p 13: Bell Report.

¹⁷⁹ Less than 100 employees for manufacturing. Holmes and Gibson, n 163, at p 9. The Australian Bureau of Statistics defines a small business as employing fewer than 20 employees.

¹⁸⁰ ITAA 1997 (Cth), Division 328.

¹⁸¹ ITAA 1997 (Cth), section 152-15: small business capital gains tax concessions.

¹⁸² *Fringe Benefits Tax Assessment Act 1986* (Cth), section 58GA: exempt car parking fringe benefit.

¹⁸³ *A New Tax System (Goods and Services Tax) Act 1999* (Cth), section 23-15: to determine the requirement for GST registration.

¹⁸⁴ *A New Tax System (Goods and Services Tax) Act 1999* (Cth), section 29-40: to determine the whether the cash method can be used for GST purposes.

¹⁸⁵ *Corporations Act* (Cth), section 45A.

¹⁸⁶ Freedman, J, and Ward, J. (2000). Taxation of Small and Medium-Sized Enterprises. *European Taxation* May:158, at p 159.

businesses that are large. Also, corporate groups with subsidiary companies could themselves be regarded as closely held. To a large extent this dissertation will focus on small and medium closely held businesses, although at times the implications for larger closely held businesses will be raised. This is important as there may be important differences between closely held businesses due to their size and their relationship with transparent companies.

2.3.3 Importance of small businesses

It is difficult to obtain data on the contribution of closely held businesses to Australia's economy, as much of the data on the significance of businesses is determined by their size rather than membership structure. However, if it is accepted that most small and medium enterprises are closely held, then when aggregated they can account for a large percentage of a country's economic activity. For example, it was estimated that in Australia there were 1,233,200 private sector small businesses¹⁸⁷ during 2000–2001, representing 97 per cent of all private sector businesses and employing almost 3.6 million people (49 per cent of all private sector employment).¹⁸⁸ Small businesses account for around 30 per cent of Australia's gross domestic product.¹⁸⁹ For this reason, this sector has been described as 'the engine room of the Australian economy'.¹⁹⁰ The Australian government appreciates their importance and has provided them with a number of tax concessions in an attempt to assist them.¹⁹¹

¹⁸⁷ Defined to be businesses that employ less than 20 people.

¹⁸⁸ Australian Bureau of Statistics. (2002). *Small Business in Australia 2001*, Canberra: AGPS.

¹⁸⁹ Australian Bureau of Statistics, n 188. Warren, N (ED). (2003). Foreword. *Taxing Small Business: Developing Good Tax Policies*, Australian Tax Research Foundation: Sydney (Conference Series 23):11–12, at p 11; and Coleman and Evans, n 171, at p 147.

¹⁹⁰ Howard, J (Prime Minister). (1997). *More Time for Business*: 24 March 1997, Canberra: AGPS.

¹⁹¹ For the 2006–2007 year it was estimated that the value of small business tax concessions was over \$1 billion: Treasury. (2006). *Tax Expenditures Statement*, Commonwealth of Australia, Canberra.

In the foreign jurisdictions studied, small businesses similarly account for a large percentage of economical activity. For example, in the United States they generate 58 per cent of the non-farm workforce, 43 per cent of sales, and 51 per cent of private GDP.¹⁹² Of the United States' non-farm companies in 2001, 99 per cent were small businesses.¹⁹³ Similarly, in the United Kingdom small and medium enterprises¹⁹⁴ account for 56 per cent of total employment in 1998, with small firms¹⁹⁵ accounting for 45 per cent of total employment.¹⁹⁶ In the United Kingdom in 2001 there were approximately 3.7 million small businesses (incorporated and unincorporated), which increased to 4.5 million by 2006.¹⁹⁷ In New Zealand, the dominance of this sector is also great, with small and medium enterprises accounting for 96 per cent of all businesses.¹⁹⁸

Apart from their contribution to a country's current GDP, small closely held businesses are seen as important for future economic performance, being described as the 'seed bed for a country's future economic growth'.¹⁹⁹ For example in the United States, small businesses have 13 times more patents per employee than large corporations, and employ 39 per cent of the high tech workforce.²⁰⁰ It has been stated:

¹⁹² Karlinsky, S. (2003). How Does U.S. Income Tax Law Define a Small Business? Let Me Count the Ways. *Taxing Small Business: Developing Good Tax Policies*, Australian Tax Research Foundation: Sydney (Conference Series 23):45, at p 45.

¹⁹³ Karlinsky, n 192, at p 45.

¹⁹⁴ Defined as firms with fewer than 250 employees.

¹⁹⁵ Defined as fewer than 50 employees.

¹⁹⁶ Institute for Fiscal Studies. (2000). *The IFS Green Budget: January 2000*, edited by L. Chennells, A. Dilnot and C. Emmerson, at p 121.

¹⁹⁷ The relatively small size of these businesses is reflected in the fact that approximately 3 million businesses in the 2006 in the United Kingdom do not have any employees. Statistics are from the start of 2001 and taken from the UK government Small Business Service website www.sbs.gov.uk. Crawford, C, and Freedman, J. (2008). *Small Business Taxation*. In *Prepared for the Report of a Commission on Reforming the Tax System for the 21st Century*, Chaired by Sir James Mirrless: The Institute of Fiscal Studies.

¹⁹⁸ Ministry of Economic Development. (2005). *SMEs in Zealand, Structure and Dynamics Report*, Wellington.

¹⁹⁹ Barkoczy, S, and Sandler, D. (2007). *Government Venture Capital Incentives: A multi-jurisdiction comparative analysis*, Research Study No 46. Sydney: Australian Tax Research Foundation, at p 19.

²⁰⁰ Karlinsky, n 192, at p 45 referring to the Office of Advocacy, Small Business Administration.

Evidence suggests small business can play a key role in diffusing new ideas and technologies as they operate in 'innovative networks', providing specialist equipment and services to boost the innovation potential of large firms.²⁰¹

Closely held businesses can have a range of advantages for the economy, as they can be flexible, perform important sub-contractor functions and be a source of new ideas and innovation.²⁰² It is argued, that due to their current and future influence on a country's economy, it is important to consider the issues confronting this sector. With an understanding of these issues, then it is possible to try to ascertain whether tax transparency does or does not assist closely held businesses.

2.3.4 Closely held business issues

Despite their aggregate importance, small closely held businesses can confront a number of challenges. This is not to say they are not without their advantages, such as competitive advantages due to being able to respond quicker to the market or accessing tax concessions.²⁰³ The challenges that can face closely held businesses include complexity, financing and governance, each of which is discussed below.²⁰⁴

²⁰¹ HM Treasury. (2004). *Small companies, the self-employed and the tax system*. Norwich: HM Treasury, at p 6.

²⁰² Holmes and Gibson, n 163, at p 1, and Hendy, n 166, at pp 116-117.

²⁰³ Burton, n 169, at p 119.

²⁰⁴ It is not advocated that closely held businesses should be given preferential tax treatment. The analysis that follows considers how tax transparency potentially influences the challenges faced by closely held businesses.

2.3.4.1 Complexity

A problem that has been highlighted by research is that when closely held businesses operations are small they have the least capacity to cope with the burden of regulations.²⁰⁵ This can lead to the compliance cost for small businesses being regressive.²⁰⁶ Even if not regressive, compliance costs can detract from the economic efficiency of a business form, especially if there are insufficient benefits obtained from the compliance activity.²⁰⁷ Also compliance costs are not just purely financial, as non-financial costs can include stress and lost time.²⁰⁸ However, these findings need to be balanced against arguments that small businesses may have greater non-compliance, which to an extent, may offset the regressive nature of compliance costs.²⁰⁹

The Australian compliance cost study by Evans et al. found that small business personnel devoted an average of 3.6 hours per month to tax compliance matters, with 2.4 hours of that total being devoted to income tax compliance.²¹⁰ It has

²⁰⁵ Small Business Deregulation Task Force, n 171, at p 19.

²⁰⁶ Evans, C, Ritchie, K, Tran-Nam, B, and Walpole, M. (1997). A Report into Taxpayer Costs of Compliance. Canberra: AGPS. Coleman and Evans, n 171. Ritchie, K. (2002). *New Zealand Small Business Tax Compliance Costs – Some Empirical Evidence*. Wellington: Inland Revenue.

²⁰⁷ Chittenden, F, Kauser, S, and Poutziouris, P. (2000). *Regulatory Burdens of Small Business: A Literature Review*. University of Manchester, at p 10: Sandford et al. define compliance costs to include: “for individuals, the cost of acquiring sufficient knowledge to meet their legal requirements; of compiling the necessary receipts and other data and of completing tax returns; payments to professional advisors for tax advice; and incidental costs of postage, telephone and travel in order to communicate with tax advisors or the tax office. For a business, the compliance costs include the cost of collecting, remitting and accounting for tax on the products or profits of the business and on the wages and salaries of its employees together with the costs of acquiring the knowledge to enable this work to be done including knowledge of their legal obligations and penalties”. Sandford, G, and Hardwick, P. (1989). *Administrative and Compliance Costs of Taxation*, Bath: Fiscal Publications.

²⁰⁸ Board of Taxation. (2007). *Scoping study of small business tax compliance costs: A report to the Treasurer*, Attorney-General’s Department, Canberra, December, at p 7: Finding 6. Other costs can include psychological, temporal, opportunity and transitional.

²⁰⁹ Slemrod, J. (2004). Small Business and the Tax System, in H. Aaron & J. Slemrod (ed), *The Crisis in Tax Administration*, Washington DC: Brookings Institute Press.

²¹⁰ Evans C, Ritchie, K, Tran-Nam, B and Walpole, M. (1996) A Report into the Incremental Costs of Taxpayer Compliance, AGPS, Canberra, Table 7.62, at p 129.

been estimated that taxation accounts for roughly two thirds (or 141 hours per annum) of all time spent on compliance activities by small businesses in Australia.²¹¹

The regressive nature of compliance cost was demonstrated by Evans et al.: small businesses average compliance cost per \$1000 of turnover was \$34.13, whereas for a large business it was \$1.84. While this improved once tax deductibility of costs was factored, there still remained a large differential. These findings are detailed in Table 2-0-1.

Of course tax is not the only compliance cost for businesses, and the *Working Overtime Survey* found that on average small businesses spend 16 hours a week on administrative activities.²¹² Of this total, 12 hours are taken up with accounts, bookkeeping and paying wages, 4 hours are spent doing paperwork; with 3 hours on taxation matters. This study concluded that total compliance costs for small business were estimated to average A\$7000 a year. Of this, A\$3000 was spent on external advice. In terms of managing tax compliance costs, businesses can outsource their tax compliance by engaging a tax agent and/or bookkeeper to assist them, with 95 per cent of Australian small businesses having a tax agent to prepare their income tax returns.²¹³

²¹¹ Small Business Deregulation Task Force, n 171, at p 12.

²¹² Small Business Deregulation Task Force, n 171.

²¹³ Board of Taxation, n 208, at p 34.

Table 2-0-1: AUS: Average compliance cost

Type of Business	Small (<A\$100,000)	Medium (100,000 to A\$9,999,999)	Large (> A\$10 million)
Sole Trader	27.72	1.28	N/A
Partnerships	31.74	1.54	0.72
Trusts	65.44	1.55	0.32
Superannuation Funds	32.08	1.78	1.49
Companies	36.68	1.98	1.93
Overall Compliance Costs	34.13	1.74	1.84
Overall Compliance Costs After Tax Deductions	26.96	1.18	1.34
Overall Average Compliance Costs	24.71	0.98	0.60

Source: Evans C, Ritchie, K, Tran-Nam, B and Walpole, M. (1996) A Report into the Incremental Costs of Taxpayer Compliance, AGPS, Canberra. The average compliance cost is reported per A\$000 of turnover in 1994-95.

The Australian example is indicative of the international experience, with compliance costs being regressive.²¹⁴ For example in the United States the research by Crain and Hopkins demonstrated the cost of regulation per employee is higher for smaller firms than for larger. Table 2-0-2 demonstrates that for firms with less than 20 employees the cost of tax regulation per employee was US\$1,202, whereas for firms with greater than 500 employees it was only US\$562 per employee.²¹⁵

²¹⁴ For a comprehensive review of compliance cost studies see: Chittenden, F, Kauser, S, and Poutziouris, P. (2003). Tax Regulation and Small Business in the USA, UK, Australia and New Zealand. *International Small Business Journal* 21:93.

²¹⁵ Crain, WM, and Hopkins, TD. (2001). *The Impact of Regulatory Costs for Small Firms*, U.S. Small Business Administrators; and Selmrod, J, and Sorum, N. (1984). The Compliance Cost of the U.S. Individual Income Tax System, *National Tax Journal* 37: pp 461-474.

Table 2-0-2: US: Cost of regulation per employee

	All firms	< 20 employees	20 -499 employees	> 500 employees
Environmental	US\$1213	US\$3328	US\$1173	US\$717
Economic	US\$688	US\$539	US\$549	US\$828
Workplace	US\$231	US\$254	US\$257	US\$205
Tax	US\$665	US\$1202	US\$625	US\$562
Total	US\$2798	US\$5322	US\$2604	US\$2313

Source: Crain, W.M. and Hopkins, T.D. (2001). *The Impact of Regulatory Costs for Small Firms*, U.S. Small Business Administrators.

Similarly a United Kingdom study estimated that tax compliance costs for small firms were 3.36 per cent of turnover while larger firms' costs reflected 0.17 per cent of turnover.²¹⁶ Studies in New Zealand have also highlighted the regressive nature of compliance costs.²¹⁷

Compliance cost is an issue for all business and it appears that the choice of business form can have some relationship with compliance costs. The research by Evans et al. in terms of taxpayer compliance cost demonstrates that greater compliance costs can be experienced when a discretionary trust structure is adopted compared to other business forms. Figure 2-0-1 demonstrates that an Australian small business operating through a trust structure has on average 178 per cent greater compliance cost than one operating through a corporation, and 206 per cent greater than a general partnership. Once the tax deduction for compliance cost is taken into account, businesses operating as a trust have on average 194 per cent greater compliance cost than corporations.

²¹⁶ Sandford and Hardwick, n 207.

²¹⁷ Chittenden, Kauser and Poutziouris, n 207, at pp 48-49. Sandford, C, and Hasseldine, J. (1992). *The Compliance Costs of Business Taxes in New Zealand*, Institute of Policy Studies, Wellington. Wong, P. (Chairperson). (1998). *Commerce Sub-committee on the Inquiry into Compliance Costs for Business*, Interim Report, NZ House of Representatives, May; Ritchie, n 206.

Figure 2-0-1: AUS: Average small business compliance cost

Source: Australian Taxation Office. (1997). Taxpayer Cost of Compliance. Canberra: Commonwealth of Australia.

Furthermore, compliance cost can alter during the life-cycle of a business, as new businesses may commence with a simple structure and over time as the business grows more sophisticated business structures are utilised, with the effect of increasing compliance costs.²¹⁸ The Board of Taxation has identified that the choice of a complex business structure can be one of the factors that drive up tax compliance costs.²¹⁹

It is not clear whether the governance regime for the business form itself is the cause of this additional compliance cost, or whether more sophisticated operations are attracted to certain business forms. Also, governments may

²¹⁸ Board of Taxation, n 208, at p 8: Finding 11.

²¹⁹ Board of Taxation, n 208, at p 48. The factors identified as driving up compliance cost include employment of staff, industry, complexity of tax system, excessive choice, inconsistent law applying across taxing jurisdictions and use of tax system for non-tax measures. Factors identified as driving down compliance costs were business confidence in tax professional, spread of cheap advanced technology and computerisation and greater use of para-professionals (such as bookkeepers).

introduce tax integrity measures targeting certain business forms if there is concern about aggressive tax planning.²²⁰

Complexity can also be influenced by the frequency of changes made to tax laws.²²¹ Another concern with compliance costs for closely held businesses is that regulations are likely to be dealt with by the principal decision maker of the business, which can distract the person from the decision maker's core role.²²² In this regard it is important to appreciate that these figures do not capture the lost opportunities and disincentive effects created by the compliance burdens. Furthermore, the complexity of the tax legislation may cause inadvertent non compliance.²²³ Also, the application of other regulations can increase overall compliance cost burden, such as employment issues, superannuation, occupation health and safety, and workplace relations legislation.²²⁴

2.3.4.2 Financing

Another problem confronting closely held businesses can be in terms of financing, whether this be from internal or external sources. To an extent the financing problem can be self-inflicted. While the problems discussed could have

²²⁰ For example, the Australian government's proposals for the reform of the taxation of trusts, see: Freudenberg, B. (2005). Entity Taxation: The inconsistency between stated policy and actual application, *Journal of the Australasian Tax Teachers Association*, 1 (2):458. However, it should be acknowledge that the extent of compliance costs may be offset by tax planning, evasion or avoidance by closely held businesses, see: Johns, BL, Dunlop, WC, and Sheehan, WJ. (1983). *Small Business in Australia: Problems and Prospects*. Sydney: George Allen & Unwin, at p 152.

²²¹ Australian Chamber of Commerce and Industry. (2003). Business Tax Reform: A Process that is Never Complete. In *ACCI Review* No 102. Barton, at p 2: "Small, medium and large sized businesses all found that the complexity of the tax system and the frequency of changes made was the greatest problem facing their businesses while the level of taxation came a close second".

²²² Banks, G. (2003). Reducing the Business Costs of Regulation. Paper read at Address to Small Business Coalition, 20 March 2003, at Brassey House, Canberra, at p 5.

²²³ McKercher, M. (2003). *Impact of Complexity upon Tax Compliance: A Study of Australian Personal Taxpayers*, Australian Tax Research Foundation, Research Study No 39, Sydney. Coleman and Evans, n 171, at p 151.

²²⁴ Board of Taxation, n 208, at pp 105 – 108.

equal application to widely held business, it is argued that inherently they can be more evident for closely held businesses, particularly with small operations.

Research demonstrates that very few small corporations attract any equity other than from active members.²²⁵ Consequently, equity finance from active members can be an essential source of financing, especially in the early years of operation.²²⁶ Some research has indicated that equity (including retained profits) is a less important source of finance for small businesses when compared to that of widely held corporations.²²⁷ However, this research must be qualified, as much of the long-term debt for closely held business is in the form of member loans,²²⁸ with member guarantees and personal assets used as security not being recorded on the balance sheet.

An inhibitor to attracting additional equity investment is that existing members may want to retain control and can resist attracting additional members because of concerns with the dilution of control.²²⁹ This can apply when operations are small or large, as there can be a 'high value' placed on freedom and the opportunity to control.²³⁰ For some closely held businesses there may be little desire for business growth.²³¹ In Australia, it is estimated that 70 per cent of small and medium enterprises are 'traditional', following a low growth path, with

²²⁵ Hicks, A. (1997). Legislating for the Needs of the Small Business. In *Developments in European Company Law: Volume 2/1997: The Quest for an Ideal Legal Form for Small Business*, edited by B. A. K. Rider and M. Andenas. London: Kluwer Law International Ltd, at p 58.

²²⁶ In the years of operation the business may not have the 'track record' to satisfy creditors, nor have tangible assets which can stand as security for the loans.

²²⁷ Johns, Dunlop and Sheehan, n 220, at p 110: referring to Table 7.1.

²²⁸ Johns, Dunlop and Sheehan, n 220, at p 110: Note the study refers to 'director loans' however this appears to be a mistake in the correct nature of the loans given the prior discussion in the document.

²²⁹ Johns, Dunlop and Sheehan, n 220, at p 29. Freedman, J. (1994). Small Business and the Corporate Form: Burden or Privilege. *The Modern Law Review* 57 (July):555, at p 581: "Small business research has shown clearly that one of the major barriers to growth of small firms is the desire for independence and the unwillingness to part with control, particularly by the alienation of equity in a company" citing: Curran, B. (1986). *Fifteen Years On: A Review and Analysis of Small Business Research in Britain, 1971—1986*. London: Small Business Research Trust.

²³⁰ Naude, S.J. (1982). The need for a new legal form for small business. *Modern Business Law* 4:5, at p 5. Johns, Dunlop and Sheehan, n 220, at p 29.

²³¹ Johns, Dunlop and Sheehan, n 220, at p 29.

few if any growth aspirations, and exist principally to provide their members with a source of employment.²³² However, for those businesses wanting to expand, this financing problem means that they may not possess sufficient capital or retained earnings to carry their development opportunities to fruition.²³³

In respect of sourcing outside loans there can be a number of intrinsic problems.²³⁴ Regardless of size, external financiers may be reluctant to finance closely held businesses, particularly if there is no tangible property to secure the finance and/or a viable business track record.²³⁵ Another factor is that such outside loans are often regarded as risky, so financial institutions may charge a 'funding premium' (often in the form of higher interest rates), particularly if operations are small. This means closely held businesses can face higher borrowing costs than larger businesses. Also, this can mean that such businesses do not qualify for normal business loans.²³⁶ Additionally, outside loans will generally require interest to be paid regularly, whereas a business that raises capital through equity will not be required to make regular distributions, except in unusual circumstances. Regular payments to an external financier require a matching of cash flows to obligations and this can present difficulties for closely held businesses which may have lumpy cash flows or may be unsophisticated in carrying out the precise provisioning required. This can lead to defaults on outside loans, even though the business is expanding.

²³² Australian Chamber of Commerce and Industry. (2003). Evaluation of Small Business Assistance Programs: ACCI Submissions to the Office of Small Business. Barton, at p 6: Senate Report on Small Business Employment [Employment, Workplace Relations and Education References Committee, Small Business Employment, February 2003].

²³³ Barkoczy and Sandler, n 199, at p 20. Howard, J (Prime Minister), n 190: "Many small businesses are constrained in their development and growth by a lack of access to appropriate sources of finance. If small businesses are to innovate, take up new technology and export, they need an accessible financial market that offers a wide range of financial products".

²³⁴ Barkoczy and Sandler, n 199, at p 20.

²³⁵ It has been said that the finance gap is for 'new and start-up' businesses rather than small businesses: Graham, T. (2004). *Graham Review of the Small Firms Loan Guarantee: Recommendations*, London: HMSO.

²³⁶ Mann, N. (2003). The Tax Office and the Challenges for Small to Medium Enterprises. *Taxing Small Business: Developing Good Tax Policies*, Australian Tax Research Foundation: Sydney (Conference Series 23):183, at p 127: "Banks in lending to SMEs often incorporate a substantial risk margin. This can increase SME variable rates by up to 5 percentage-lending points".

These circumstances can lead to small closely held business relying more heavily on overdraft facilities, which may result in a higher level of cost due to charges.²³⁷ Furthermore, to support outside loans, members may be required to give personal guarantees for such debt, or to offer personal assets as security.²³⁸ Such personal guarantees would prejudice on the limited liability protection that may be provided by the business form, as the guarantee makes the member liable for principal and interest payments on default.

In Australia it appears that taxes also hinder financing, as taxes are identified as the primary constraint on investment for small and medium enterprises.²³⁹ This is reinforced by the fact that small businesses account for two-third of unpaid taxes to the Australian Tax Office.²⁴⁰

2.3.4.3 Governance

A related issue for closely held businesses is compliance with the governance regime that regulates the business form. This can be because the governance regime can be drafted for when membership is widely held, with non-active members and a separation between management and members. Such

²³⁷ Bisacre, J. (1997). A European Perspective on Small Business and the Law. In *Developments in European Company Law: Volume 2/1997: The Quest for an Ideal Legal Form for Small Business*, edited by B. A. K. Rider and M. Andenas. London: Kluwer Law International Ltd, at p 89.

²³⁸ Johns, Dunlop and Sheehan, n 220, at p 113. Which, given that they are not recorded in the balance sheet can sometimes give the misleading impression that the bank is providing more funds to start the business than the member.

²³⁹ Australian Chamber of Commerce and Industry. (2003). Survey of Small Business: Identifying Trends and Conditions within the Small Business Sector, at p 7: "Top five constraints on investment: Small Business: Business Taxes and charges; Availability of suitably qualified employees; wage costs; state government regulations; non-wage labour costs. Medium Business: business taxes and government charges; availability of suitably qualified employees; local competition; non-wage labour costs; state government regulation. Large business: federal government regulations; availability of suitably qualified employees; state government regulations; wage costs; business taxes and government regulations".

²⁴⁰ Brinsden, C. (2007). Small business account for two-thirds of unpaid taxes. 13 June.

characteristics are not indicative of many closely held businesses, and therefore they can be an 'ill fit'.

The governance regime for a transparent company will necessarily be more complicated than for simpler business forms such as sole proprietorships and general partnerships, as it provides members with some liability protection. When a business form provides limited liability, it is perceived as necessary for legislation to provide rules to protect against potential abuse. Rules have been formulated for the protection of creditors and tortfeasors, as well as the protection of members. These governance rules may be mandatory or default rules that can be amended.

Mandatory rules can restrict distributions, require disclosure, impose duties on managers and/or members, and provide for unfair preference rules and the minimum membership number. Also rules have been introduced to protect members, particularly members who have no role management (non-active members) to reduce agency cost.²⁴¹ It is argued that mandatory rules have the greatest impact on a business form's complexity and compliance cost, as they largely cannot be contracted around. This is because even if the firm can be seen as a series of contracts,²⁴² the governing legislation removes the ability for individual contracting in relation to mandatory rules.

The extent to which mandatory rules are required and/or are effective is contentious. In particular, mandatory rules could impose requirements that are not necessary or excessive, compared to the benefits they deliver for closely held businesses. For example, the rules to protect against agency cost may be superfluous when there are member-managers (active members), because in

²⁴¹ Agency theory applies where there is a separation of ownership and control and describes how misalignment can occur resulting in conflicts between the interests of those in control of the business form and the those who own it: Berle, A, and Means, G. (1952). *The Modern Corporation and Private Property*, New York: Harcourt Brace & World Inc.

²⁴² Jensen, MC, and Meckling, WH. (1976). Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure. *Journal of Financial Economics* 3:305, at pp 305 – 360.

these circumstances the interests of the managers are more in line with the members. In relation to the characteristic of limited liability, Dugan et al. argues that the minimum rules required are for the filing of the most basic information; and for distributions to be subject to a balance sheet solvency test.²⁴³ The mandatory rules for the transparent companies studied extend well beyond this argued position. It is beyond the scope of this dissertation to formulate the optimal minimum rules. Instead, this dissertation will describe the rules for the transparent companies studied and how they compare to each other, and their potential ramifications for closely held businesses.

Business legislation can also provide default rules that can deal with such issues as management, membership interest and duties. These default rules can automatically provide a framework to govern the business form and the relationship of the parties involved. It is argued that the suitability of default rules can be of particular importance for closely held businesses when their operations are small. This is because incomplete advice may be obtained on formation,²⁴⁴ as research has demonstrated that small closely held businesses may not adopt tailored governance rules due to the limited availability of financial resources, uncertainty about future operations, paucity of understanding about business forms²⁴⁵ and the use of accountants for formation.²⁴⁶ An OECD study of

²⁴³ No information required of members, only managers. Subsequent filing is only required when there is a change in registered agent, registered office or dissolution: Dugan, R, McKenzie, P, and Patterson, D. (2000). *Closely Held Companies: Legal and Tax Issues*. Auckland: CCH New Zealand Limited, at p 700.

²⁴⁴ Hicks, Drury and Smallcombe, n 161.

²⁴⁵ The lack of understanding has been demonstrated in a number of studies and statements. See: Great Britain. (1971). *Small Firms: Report of the Committee of Inquiry on Small Firms* (J E Bolton Chairman), London: Secretary of State for Trade and Industry: point out that small business owners often have low levels of formal education. Warren, n 189, at p 11. CPA Australia. (2003). *Discussion Paper: Small Business Policy – Where to from here?* Melbourne, at p 7.

²⁴⁶ Hicks, Drury and Smallcombe, n 161, at pp 16 and 28: reported that 70 per cent of corporations were incorporated by accountants, 13 per cent by corporation registration agents and 12 per cent by lawyers. It is argued that the use of accountants for formation may indicate the client has not been fully advised on the compliance issues for the business form adopted. Formal advices as to whether the business should be a corporation was only received in 36 per cent of cases; in which 97 per cent of the source of this advice was from accountants. In terms of general partnerships and sole proprietorships, 37 and 31 per cent respectively took advice as to business

Australian businesses found that 59 to 69 per cent of businesses had trouble understanding regulations.²⁴⁷ It appears that small business owners often have a poor understanding of regulatory requirements, with 62 to 75 per cent of businesses stating it is not possible to comply with all the regulations they should.²⁴⁸ Furthermore, in the absence of default rules, there may be no precise rules determining the resolution of disputes, which could lead to management paralysis,²⁴⁹ requiring courts to 'fill gaps' or impose expensive and lengthy periods of dispute or litigation.²⁵⁰ It is argued that if default rules are not entirely appropriate to a given circumstance, it is not as detrimental as mandatory rules, as default rules can be contracted round, although this involves extra costs.

Easterbrook and Fischel have argued that in the absence of transaction costs the supply of clear and simple default rules will be regarded as value enhancing.²⁵¹ Even though their work mainly concerned widely held corporations, it is argued that similar principles apply to closely held firms. An advantage of default rules is

form. With general partnerships 43 per cent have a formal agreement, with 85 per cent of these drafted by lawyers and 15 per cent by accountants. Johns, Dunlop and Sheehan, n 220, at p 32: Limited financial resources of small firms can preclude the employment of experts to give the best management advice.

²⁴⁷ OECD. (2000). *The OECD Public Management Services Multi-Country Business Survey: Benchmarking Regulatory and Administrative Business Environments in Small and Medium Enterprises*, OECD.

²⁴⁸ OECD, n 247.

²⁴⁹ McCahery, JA, and Vermeulen, EPM. (2004). *The Evolution of Closely Held Business Forms in Europe*. In *The Governance of Close Corporations and Partnerships: US and European Perspectives*, edited by J. McCahery, T. Raaijmakers and E. Vermeulen. Oxford: Oxford University Press, at p 220. Although parties could later negotiate further governance rules after formation. Cheffins, BR. (1997). *Company Law: Theory, Structure, and Operation*. New York: Clarendon Press, at p 26: "Like other areas of commercial endeavour, the law's role in company affairs is often a marginal one. Examples arise in a variety of contexts. Individuals who decide to incorporate a business are often more concerned with saving money on professional fees than they are about the precise legal structure of the company. Consequently, it is reasonably common for incorporators to pay a company formation agency to set up their company using a 'standard form' corporate constitution rather than relying upon a solicitor. They act in this way because they believe it is not worthwhile to pay for the specialized advice which a lawyer might provide".

²⁵⁰ Finch and Freedman, n 162, at p 490.

²⁵¹ Easterbrook, FH, and Fischel, DR. (1991). *The Economic Structure of Corporate Law*. Cambridge: Harvard University Press. Compared with Ribstein, LE. (1992). Efficiency, Regulation and Competition: A comment on Easterbrook & Fischel's *Economic Structure of Corporate Law*. *Northwestern University Law Review* 87 (1):254. Freedman, J. (2001). Limited Liability Partnerships in the United Kingdom – Do They Have a Role For Small Business? *Journal of Corporation Law* 26(4):897, at p 902.

the ability to develop 'network externality benefits'.²⁵² This refers to the idea that enacting laws to govern business forms can reduce transaction costs.²⁵³ That is, as case law considering the standard set of rules develops, there is understanding and improved certainty about how the provisions will be applied in the future.²⁵⁴ These networking benefits extend to third parties, such as trade creditors, dealing with the business form as they have improved understanding about the governance of the business form.²⁵⁵

However, as previously noted, closely held businesses are heterogeneous so default rules are likely to require customisation. This necessarily involves cost and could diminish networking benefits if variations to the standard set of rules are substantial. If operations are small such customisation costs could be regressive. However, the alternative, of no default rules, means that businesses would be required to establish their own customised terms. It is argued that such comprehensive customisation would involve higher drafting costs, risks of negotiating or drafting errors, uncertainty regarding certain terms' validity, lack of judicial precedent addressing a term's meaning or effect, and an ongoing lack of familiarity with the terms.²⁵⁶ Also for third parties this could impose greater costs in dealing with the business, which could be reflected in higher charges.

Research into corporation constitutions in New Zealand questions whether the development of standard form constitutions by the market has occurred in a

²⁵² Callison, JW. (2000-01). Venture Capital and Corporate Governance: Evolving the Limited Liability Company to Finance the Entrepreneurial Business. *Journal of Corporation Law* Fall (26):97, at p 117: that is, the build-up of precedent and decisions.

²⁵³ Hansmann, H, and Kraakman, R. (2004). The Essential Role of Organisational Law. In *The Governance of Close Corporations and Partnerships: US and European Perspectives*, edited by J. McCahery, T. Raaijmakers and E. Vermeulen. Oxford: Oxford University Press. This can include 'affirmative asset partitioning' and 'defensive asset partitioning'.

²⁵⁴ Of course, it could be possible to argue that judicial interpretations at times do not create certainty, and instead uncertainty. Ribstein, LE. (1995). Statutory Forms for Closely Held Firms: Theories and Evidence from LLCs. *Washington University Law Quarterly* 73 (2):369, at p 376.

²⁵⁵ Ribstein, n 254, at p 375.

²⁵⁶ Kahan, M, and Klausner, M. (1996). Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior and Cognitive Biases, *Washington University Law Quarterly* 74:347, at p 350.

meaningful way. Dugan et al.'s review of corporation constitutions concluded that the constitutions were 'replete with redundant material, errors and ambiguities and revealed no serious attempt to adopt the rules of the Act to the circumstances.'²⁵⁷ This could reflect the possibility that closely held business cannot afford, or perceive it to be too expensive, to pay for tailored rules at the set up stage. Their research may highlight the important role that the government can play in providing a standard set of default rules for closely held businesses.

It is argued that for closely held businesses it is preferable to have a number of default rules for a business form, particularly addressing the issues that commonly arise,²⁵⁸ even though these may require customisation.

This dissertation will compare and contrast the transparent companies' governance regimes in terms of capital protection rules, single membership, default rules, member-management, and transferability of membership interest.

²⁵⁷ Dugan, McKenzie and Patterson, n 243, at pp 119, and 274-275: "the majority of provisions in the typical standard form constitution, which usually make up 90 to 95% of the document, consists of quoted or restated sections of the 1993 Act, particularly section 131-145; 45-47; 58-61; 76-78; 84-85; 150-155; and First Schedule rules for meetings". It appears this is a similar situation in the United Kingdom: Freedman, J. (1997). *The Quest for an Ideal Form for Small Businesses - A Misconceived Enterprise?* In *Developments in European Company Law: Volume 2/1997: The Quest for an Ideal Legal Form for Small Business*, edited by B. A. K. Rider and M. Andenas. London: Kluwer Law International Ltd, at p 27: "The ESRC survey corporate respondents were asked questions about their company's constitution. Only 8 per cent reported that the articles were tailored to their own requirements and most of these also had a written shareholders' agreement".

²⁵⁸ Goddard, D. (1998). *Company Law Reform - Lessons from the New Zealand Experience. Company and Securities Law Journal* 16:236, at p 252. Dugan et al. has argued that the following default rules are preferable for closely held business: unless all members consent to a transfer, the transferee is entitled only to the transferor's share of profits and not management rights, and unless the operating agreement provides for a manager, the management rest with members in proportion of their membership interest; default, and debts are contracted on behalf of the business by the manager, or if member-managed then members: Dugan, McKenzie and Patterson, n 243.

2.4 Conclusion

Through the analysis presented in this chapter it has been argued that tax neutrality is an important characteristic of a tax system. This is because breaches of tax neutrality can distort investment decisions, the choice of business form and how investments are structured. Also, given the increase in the global economy, breaches of tax import–export neutrality may adversely impact on the ability of a jurisdiction to attract mobile capital investment.

It is argued that greater tax neutrality can be achieved by the adoption of tax transparent companies, where income and/or losses are directly allocated to members.

To gain a greater understanding of closely held businesses, prior literature regarding their characteristics was discussed. Furthermore, it was highlighted that, while the vast majority of closely held businesses are likely to have small or medium operations, some can be large. It was argued that particular issues faced by closely held businesses can relate to complexity, finance and governance.

It is through this analysis that subsequent chapters will consider what has been the experience of the transparent companies studied, and what their potential implications for Australia are.

Chapter Three: Tax transparent companies

3.1 Introduction

This chapter develops the definition of ‘tax transparent companies’ for the purpose of this dissertation and seeks to demonstrate how the foreign transparent companies studied exemplify this. It will be argued that transparent companies can be divided into two classifications. In terms of the first classification, ‘special tax rule companies’, tax transparency is achieved by providing special tax rules to corporations satisfying certain eligibility requirements. S Corporations and Loss Attributing Qualifying Companies (LAQCs) come within this classification. The second classification, ‘new form transparent companies’, represent the introduction of a new business form subject to the existing tax transparency provided to general partnerships. Both limited liability companies (LLCs) and limited liability partnerships (LLPs) are examples of new form transparent companies. It will also be demonstrated how Australia’s restricted recognition of transparent companies exemplify this definition and classification.

To gain an understanding of the popularity of transparent companies, utilisation rates of the studied tax transparent companies will be considered. The data demonstrates that, excluding sole proprietorships, the transparent companies studied in the United States (S Corporations and LLCs) account for a majority of the business forms there; New Zealand’s transparent company, the LAQC, represents approximately 12 per cent of business forms there (excluding sole proprietors). The utilisation of the United Kingdom’s LLP is not as prevalent as in the other jurisdictions, although this could be attributed from its recent introduction. It will be argued that the tax transparent companies studied have become popular business forms, thereby justifying closer analysis and academic attention.

3.2 Tax Transparent Companies

Before undertaking a more general analysis and consideration of tax transparent companies, it is first necessary to define the term ‘transparent company’ for the purpose of this dissertation. Academic focus on transparent companies is not new, and reference to them can be found internationally in the various jurisdictions. For example: Canada: Carter Commission in 1966;¹ Germany in 1971;² the United States: Blueprints for Basic Tax Reform in 1977, and in 1992³ and the American Law Institute Federal Income Tax Project – Taxation of Private Business Enterprises in 1999;⁴ New Zealand: the Valabh Committee in 1990,⁵ and the Tax Review in 2001;⁶ in France in 1992;⁷ the United Kingdom in the Bolton Report in 1971⁸ and in Department of Trade and Industry Report in 1997;⁹ Singapore in 2003¹⁰ and Japan in 2006.¹¹

¹ Canada. (1966). Royal Commission on Taxation (known as the Carter Commission), Ottawa.

² Bevin, P. (1985). *How Should Business Be Taxed? An examination of defects in business taxation and suggestions for reform*. Wellington: Victoria University Press, at p 92.

³ US Department of Treasury. (1977). Blueprints for Basic Tax Reform (Treasury 1). US Treasury Department. (1992). Report of the Department of the Treasury on Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once. There is also an early Treasury document back in 1946/1948 that discussed transparency: Postwar Taxation by Growes.

⁴ Yin, GK, and Shakow, DJ. (1999). Taxation of Private Business Enterprises. In *Federal Income Tax Project*. Philadelphia: The American Law Institute. Under the proposal, a simplified conduit system, which resembles a liberalized version of Subchapter S, would be available to certain private firms.

⁵ Consultative Committee on the Taxation of Income from Capital. (1990). *Taxation of Distributions from Companies*, Auckland, November, and Consultative Committee on the Taxation of Income from Capital. (1991). *Taxation of Distributions from Companies: Final Report*, Auckland, July.

⁶ McLeod, R, Patterson, D, Jones, S, Chatterjee, S, and Sieper, E. (2001). *Tax Review 2001 - Final Paper*. Wellington: recommended general partnership treatment for closely held (five or less members) and then company (entity) tax treatment for widely held.

⁷ Hicks, A, Drury, R, and Smallcombe, J. (1995). Alternative Company Structures for the Small Business. In *ACCA Research Report No 42*. London: Certified Accountants Educational Trust, at p 36: French law has provided that certain *Société à Responsabilité Limitée* (SARLs) which is equivalent to a private corporation can opt to be subjected to the taxation regime applicable to partnerships. This is an option for those SARLs which have a family basis in their membership (*caractere familiale accuse*) which is either specified in their constitution, or since 1993 in a separate legal document.

⁸ Great Britain. (1971). Small Firms: Report of the Committee of Inquiry on Small Firms (J E Bolton Chairman), London: Secretary of State for Trade and Industry, Cmnd 4811. (known as the ‘Bolton Report’); at paragraph 13.58: recommended that close companies should be allowed to elect, by unanimous decision of the shareholders, to be taxed as partnerships to prevent taxation from deterring businessmen from incorporation and obtaining the benefits of limited liability”.

In Australia, reference to tax transparent companies has been quite pervasive: in the 1975 Asprey Report,¹² the 1981 Campbell Committee's¹³ enquiry into the Australian financial system, and the Government's 1985 Draft White Paper.¹⁴ It should also be noted that in 1998 the Ralph Committee referred to the tax transparent treatment of corporations.¹⁵ More recently the Australian government announced that the proposal for a tax transparent company by the Institute of Chartered Accountants in Australia and Deloitte (the ICAA proposal) will be considered in the Henry Tax Review.¹⁶

3.2.1 Definition

Tax transparent companies can be seen as a hybrid of business forms, and thus can be conceptualised in various forms. The Oxford Dictionary defines the word

⁹ Department of Trade and Industry. (1997). *Limited Liability Partnerships, A Consultation Document*, London: HMSO.

¹⁰ Singapore Ministry of Finance. (2003). Consultation Papers in respect of both limited partnerships and LLPs. [cited 6 January 2008]. Available from www.mof.gov.sg/cor/public_LP-LLP.html.

¹¹ Roose, EN, Shikuma, MH, Mizutani, T, and Ohashi, K. (2006). Tax Consequences of Japan's New Companies Law (Part II). *Tax Notes International* February: 637.

¹² Australia. (1975). Taxation Review Committee Full Report, (Asprey, KW Chairman), 31 January, Canberra: AGPS, at paragraphs 16.79 to 16.96. The Asprey Committee did not regard the scheme as being primarily directed to assisting small companies (paragraph 16.85) or available to the subsidiaries of large or foreign companies (paragraph 16.89)

¹³ Australia. (1981). Committee of Inquiry into the Australian Financial System — Final Report, (Campbell, J.K. Chairman), Canberra: AGPS, at p 223. The Campbell Inquiry recommended full integration in the interests of equity and neutrality, stating that the fact that companies and their shareholders were separate did not justify their separate tax treatment. It was not convinced that operation of an enterprise under limited liability should result in an additional tax burden.

¹⁴ Australian Treasury. (1985). Draft White Paper on the Reform of the Australian Tax System, Canberra: AGPS.

¹⁵ Australia. (1998). A strong foundation (Ralph Report No 1), Canberra: AGPS, at paragraph 277 of Overview.

¹⁶ Australia. (2008). Australia's Future Tax System – Consultation Paper, (Henry, K Chairman), 10 December, Barton: Attorney-General's Department, at p 155. Emerson, C. (Innovation, Industry, Science and Research Minister). (2008). Media Release: Simplifying Small Business Taxation Under Consideration by Rudd Government. Canberra: Australian Government.

'hybrid' to mean the 'offspring of two...different species', or a 'crossbreed'.¹⁷ In this dissertation the term 'tax transparent company' is used to describe the product of the two business species, corporations and general partnerships, whereby attributes of both species of business are combined. The combined attributes present in the transparent company considered are a corporation's separate legal entity status¹⁸ and limited liability, with a general partnership's flow-through taxation treatment.¹⁹ It is these three core characteristics that define the nature of a tax transparent company (or transparent company). This definition is based primarily on Australia's historical characteristics of business forms and tax treatment, which are similar in several jurisdictions.²⁰ The term 'company' is adopted to indicate the characteristics of separate legal entity status and limited liability,²¹ even though some jurisdictions have used the term 'partnership' in describing their transparent company (as defined). The term 'member' is used in this dissertation to describe an equity investor in the business form, even though they might be known as 'shareholder' or 'partner' or otherwise.

With these company characteristics, the transparent company continues to exist despite changes in its membership, holds property in its own name, and can

¹⁷ Fowler, HW and Fowler, FG (Eds). (1967). *The Concise Oxford Dictionary*, Clarendon Press. Compared with: Dugan, R. (1994). *Company Law: A transactional approach*. Wellington: Butterworths, at p 52: The term 'hybrid' has been used to describe a number of mixings – such as hybrid securities (membership interests that carry preferential rights which make them virtually indistinguishable from debt securities).

¹⁸ Or legal personality.

¹⁹ Tax transparent treatment is argued to be an attribute of general partnerships, particularly in the Australian context. However, this has not always been the case as between 1915 to 1922 general partnerships (and trusts) were subjected to an entity tax treatment: Taylor, CJ. (2006). An Old Tax Is A Simple Tax: A Back To The Future Suggestion For The Simplification Of Australian Corporate-Shareholder Taxation. *Journal of the Australasian Tax Teachers Association* 2(1):30, at p 34.

²⁰ Avery Jones, JF, De Broe, L, Ellis, MJ, Miyatake, T, Roberts, SI, Goldberg, SH, Killius, J, Maisto, G, Giuliani, F, Vann, RJ, Ward, DA, and Wiman, B. (2002). Characterization of Other States' Partnerships for Income Tax. *Bulletin - Tax Treaty Monitor*, July: 288. Of course, it is quite possible to have corporate characteristics without limited liability, as in the case of unlimited companies and to have separate legal personality without the other characteristics of a company, as in the case of Scottish and of United States general partnerships: *Uniform Partnerships Act 1996* (US), section 201(a).

²¹ Note the two features do not always exist with companies. For example in Australia it is possible to have unlimited companies where members do have liability exposure.

enter into its own contracts. Separate legal entity status can reinforce the member's limited liability protection, particularly when a transparent company has foreign operations.²²

It is possible that the additional attribute of general partnership's internal governance rules could be included to narrow the transparent company defined. These internal governance rules are normally based on a contractual principle between partners, as well as additional fiduciary and agency relationships. However, this additional attribute is not included in this analysis, as its absence enables a broader review. This broader review may help determine whether some types of transparent companies provide advantages that others do not. Also, recent law reforms have relaxed corporations' internal governance rules, so the differences in internal governance between general partnerships and corporations have been reduced, although not eliminated.²³ Additionally, through drafting a business form's constitution and members' agreements, similar governance rules may be achieved even though established under different legislation. Further, it can be difficult to categorise a transparent company's internal governance rules as based on general partnerships or corporations or both. For example, some commentators have stated that the internal governance rules of the United States' LLC appear to be moving from a general partnership model to a corporate one.²⁴ In addition, the United Kingdom's LLP generally utilises a corporation model for external rules, though a few default rules are based on general partnership principles. This has led Freedman to state that the

²² Cullen, M (Minister of Finance), and Dunne, P (Minister of Revenue). (2006). General and limited partnerships — proposed tax changes: A government discussion document. Wellington, at p 5.

²³ For example the Corporations Law Simplification Program was established in December 1993 by the former Attorney-General, who appointed a four-member Task Force to oversee the Program. See: Kollar, M. (1997). Corporate Law Economic Reform Program: A fundamental change or more of the same. *Australian Corporate News* 9:129, at p 131.

²⁴ Friedman, HM. (2004). The Silent LLC Revolution - The Social Cost of Academic Neglect. *Creighton Law Review* 38(1).

use of the term 'partnership' in describing the United Kingdom's LLP is somewhat of a 'misnomer'.²⁵

For the reasons stated above the definition of transparent company in the dissertation will exclude the characteristic of internal governance, and instead focus on three abovementioned attributes, being separate legal entity status, limited liability and tax transparent treatment. Important terms associated with tax transparency are 'allocations' and 'distributions'. 'Allocations' refer to the allocating of income or losses for tax purposes directly to members even though, legally, the income and/or loss may have been earned or been incurred by the business form. 'Distributions' refers to the payment or the transfer of assets (including money) to members of the transparent company.

Utilising these attributes, a 'fully transparent company' allows for all income and losses of the transparent company to flow-through directly to its members.²⁶ In other words, all of the transparent company's income (whether distributed to members or retained) is allocated and assessed for tax purposes to members. The transparent company's losses, when deductions exceed assessable income, are similarly directly allocated to members. Normally, in this respect, a conduit principle applies to these allocations, so that receipts and expenditure items of the business form retain their identity for members.²⁷ Note even though transparency applies, at times there can be recognition of the business form for tax purposes (referred to as entity acknowledgement), such as the lodgement of information returns by the business form.

²⁵ Freedman, J. (2001). Limited Liability Partnerships in the United Kingdom – Do They Have a Role For Small Business? *Journal of Corporation Law* 26(4):897, at p 899. Other commentators have also expressed that the United Kingdom's LLP is closer to a corporation than a general partnership: Linsell, R. (2000). Limited Liability Partnerships: Yes or No? *Solicitors Journal* Nov: 994, at p 994.

²⁶ Referred to as aggregate approach, transparency or flow-through taxation.

²⁷ For example if the transparent company sold a capital asset, the proceeds of that sale would be regarded as capital in nature in the hands of the member(s). This would mean that the member(s) might be able to access any capital gain concession, such as the 50 per cent discount: *Income Tax Assessment Act 1997* (Cth) (*ITAA 1997*), Division 115.

In relation to the continuum conceptualised in Figure 1-0-1 pertaining to the taxing of business forms, a fully transparent company represents the aggregate approach. However, the fully transparent company, unlike a general partnership, also provides for limited liability²⁸ and is a separate legal entity from its constituent members. A fully transparent company can also be distinguished from limited partnerships, which are in Australia and other jurisdictions a special form of partnership that offer limited liability for some members. The personal liability of all members, except for one, may be limited to the amount of capital contributed by them to the limited partnership.²⁹ However, these limited partners are generally precluded from taking part in the management of the business and have no power to bind the business.³⁰ A limited partnership does not provide complete limitation of liability, since there must be at least one general partner bearing the unlimited liability of the business.³¹ To reduce this liability exposure a corporation can be used as the general partner and thus providing limited liability for the member operating through a 'corporate' general partner. This practice of using a corporate general partner is utilised in a number of jurisdictions, for example the German private corporation (known as a GmbH)³² can be used as the general partner of its limited partnership (known as a KG).³³ An important

²⁸ The extent of limited liability protection does vary amongst transparent companies.

²⁹ *Partnership Act 1892* (NSW), section 60; *Partnership Act 1958* (Vic), section 60; *Partnership Act 1891* (SA), section 58; *Partnership (Limited Liability) Act 1988* (Qld), section 10; *Limited Partnerships Act 1909* (WA), section 4(2) and *Limited Partnerships Act 1908* (Tas), section 4(2).

³⁰ *Partnership Act 1892* (NSW), section 67(1); *Partnership Act 1958* (Vic), section 67(1); *Partnership Act 1891* (SA), section 65(1); *Partnership (Limited Liability) Act 1988* (Qld), section 16(1); *Limited Partnerships Act 1909* (WA), section 6(1) and *Limited Partnerships Act 1908* (Tas), section 6(1). If the limited partner does participate in management, then the limited partner will be liable as the same as the general partner(s) for all firm liabilities incurred while management participation occurred: *Partnership Act 1892* (NSW), section 67(2); *Partnership Act 1958* (Vic), section 67(2); *Partnership Act 1891* (SA), section 65(2); *Partnership (Limited Liability) Act 1988* (Qld), section 16(2); *Limited Partnerships Act 1909* (WA), section 6(1) and *Limited Partnerships Act 1908* (Tas), section 6(3).

³¹ Historically in the United States there was some case law in 1970s that ruled against this practice however it has now in the United States been ratified by legislative amendments.

³² 'GmbH' meaning *Gesellschaft mit beschränkter Haftung*.

³³ 'KG' meaning for *Kommanditgesellschaft auf Aktien*. The legality of this is confirmed by the decision of *Bundesgerichtshof* of 24 Feb 1997 which decided that a body corporate could be the general partner of a *Kommanditgesellschaft auf Aktien*. Avery Jones, De Broe, Ellis, Miyatake, Roberts, Goldberg, Killius, Maisto, Giuliani, Vann, Ward, and Wiman, n 20, at p 306: "a German formal partnership (limited partnership) does not have legal personality, but has continuity of life".

distinction with transparent companies, as defined, is that limited partnerships are not bodies corporate and, like general partnerships generally, have no separate legal existence from the partners.³⁴

It is argued, in this respect, that the United States' S Corporation and LLC, as well as the United Kingdom's LLP, are fully tax transparent companies. Discussed below is how these transparent companies demonstrate each of the three outlined characteristics.

3.2.1.1 S Corporations and LLCs

The S Corporation is not a new business form; instead it is essentially a set of special tax rules for closely held corporations. These special tax rules are located in Sub-Chapter S of the *Internal Revenue Code 1986* (US) (IRC 1986 (US)), and therefore the name 'S Corporations' for closely held corporations electing to be taxed according to Sub-Chapter S. S Corporations possess the same non-tax characteristics as regular corporations, such as limited liability³⁵ and separate legal entity status.³⁶ The regulatory framework for the United States' S Corporations is governed by the various corporation acts in each American state. There are many variations amongst the state corporation acts although, in an endeavour to provide some consistency, there is the *Revised Model Business Corporation Act 1994* (the *Model Corporation Act*) on which states can base their legislation.³⁷ The precise governance framework for S Corporations, as well as

³⁴ *Partnership Act 1892* (NSW), section 50; *Partnership Act 1958* (Vic), section 49(3); *Partnership Act 1891* (SA), section 48; *Partnership (Limited Liability) Act 1988* (Qld), section 4(2); *Limited Partnerships Act 1909* (WA), section 7 and *Limited Partnerships Act 1908* (Tas), section 7.

³⁵ *Model Business Corporation Act*, section 6.22(a).

³⁶ While not specifically stated it is implied in *Model Business Corporation Act*, section 3.02: "Corporation has perpetual duration and succession in its corporate name and has the same powers as an individual".

³⁷ The Model is merely a form of legislation suggested by the American Bar Association adopted by the Committee on Corporate Laws of the Section of Business Law with support of the American Bar Foundation. States are free to adopt it in total, in part, or not at all. Alternative model which is adopted by some states is the *Delaware Business Corporation Act*.

for the other transparent companies studied, is analysed in more detail in Chapter Nine.

Broadly, for S Corporation status to be obtained, the corporation³⁸ itself and its members must be United States residents with only one class of membership interest, its membership must not exceed 100, and it must have a valid election for S Corporation status.³⁹ Additionally, certain trading activities and asset holdings are prohibited.⁴⁰ In these circumstances, tax transparency applies rather than the entity approach for corporations under Sub-Chapter C *IRC 1986* (US) (referred to as C Corporations).

LLCs are new business forms that have been legislated by various American states. There has been an attempt to provide consistency between the states with a recommended uniform act, which recently has been updated by the *Revised Uniform Limited Liability Company Act 2006 (Revised ULLC Act)* replacing the previous *Uniform LLC Act 1996*.⁴¹ The legal characteristics of a LLC provide members with limited liability⁴² and separate legal entity status.⁴³

For federal taxation purposes from 1997, an LLC can simply 'Check-the-Box' for tax transparency⁴⁴ provided it is not a state corporation (which by its nature it is not),⁴⁵ a publicly traded entity,⁴⁶ or certain foreign business forms.⁴⁷

³⁸ Note technically the business form does not have to be a 'corporation' as described in this dissertation. It just needs to be a business form that is taxed pursuant to Sub-Chapter C. Thus it is possible for an LLC to Check-the-Box for C Corporation treatment and then elect for Sub-Chapter S to apply if all the eligibility requirements are satisfied.

³⁹ *IRC 1986* (US), section 1361.

⁴⁰ For example ineligible members include financial institutions using reserve method of accounting, insurance companies, possession corporations, Domestic International Sales Corporation (DISC) and former DISCs.

⁴¹ The *Revised ULLC Act* replaces the prior uniform act of 1996, the *Uniform Limited Liability Company Act 1996 (ULLC Act)*. On 13 July 2006 the National Conference of Commissioner on Uniform State Laws approved the *Revised ULLC Act*. It is now being submitted to the states for approval.

⁴² *Revised ULLC Act*, section 304.

⁴³ *Revised ULLC Act*, section 104.

⁴⁴ Technically by default a multi-member LLC would be classified as a general partnership: Treasury Regulation, section 301.7701-2(c)(1) and (2). A single-member LLC for tax purposes

In terms of their tax treatment, there is some 'entity acknowledgement' as each tax year S Corporations and LLCs must compute and report their income, although not pay tax on this reported income.⁴⁸ This calculation would include capital gains. Also, both S Corporations and LLCs make elections concerning the inventory and accounting methods to be used for tax.⁴⁹

Even with this entity acknowledgement, tax transparency applies, as instead of the S Corporation or the LLC paying tax on their reported income, it is allocated directly to members independently of actual distributions. Both transparent companies provide a statement to their members detailing what they have been allocated.⁵⁰ Members are potentially assessed on their allocated amount regardless of whether there has been any distribution to them.⁵¹ The allocated income, or loss, retains its character as it flows through the S Corporation and LLC (the conduit principle).⁵² That is specifically why certain items have to be stated to the member (such as capital gains), as their character could affect the

can be classified as a corporation [An association] or can elect for the LLC to be disregarded as an entity separate from its owner.

⁴⁵ A state corporation would be taxed under Subchapter C unless the entity qualifies and elects to be taxed under Subchapter S: Treasury Regulation, 301.7701-2(b). State law corporations (are corporations formed under Corporation Acts such as one based on the Model Corporation Act).

⁴⁶ IRC 1986 (US), section 7704. An example of a 'publicly traded partnership' is one which has partnership interests that are either (a) traded on established securities markets, (b) readily traded on a secondary market. Regulations provide safe harbours for a partnership to avoid being classified as publicly traded one is (a) all interests issued in a transaction/s are not registered under the Securities Act of 1933, and (b) not greater than 100 members during the year: Treasury Regulation, section 1.7704.

⁴⁷ The United States lists a number of foreign entities which are always taxed as C Corporations. Normally, only one type of body is treated as a C Corporation in a particular country, for example, Australia: public limited company; Canada: corporation and company; France: SA and SAS; Germany: AG; Italy: società per azioni; Japan: kabushiki-kaisha; Netherlands: NV; Sweden: publik.a aktiebolag, Switzerland: AG; United Kingdom: plc.

⁴⁸ IRC 1986 (US), sections 1363(b) [S Corporation]; and 703(a) [LLC].

⁴⁹ IRC 1986 (US), section 1363(c)(1) and 703(b). See also Proposed Treasury Regulation, section 1.1363-1(c). Except for those few fixed for individualized shareholder elections, such as the creditability of foreign taxes: IRC 1986 (US), section 1363(c)(2).

⁵⁰ IRC 1986 (US), section 1366(a) and 702 referred to as a 'distributive share'.

⁵¹ IRC 1986 (US), section 706(a); Treasury Regulation, section 1.706-1(a)(1). Note the decision of *Knott v Commissioner United States Tax Court*, 1991. 62 T.C.M. 287 confirmed that the income of an S Corporation need not be distributed in order to be included in the taxable income of the member.

⁵² IRC 1986 (US), sections 1366(b) and 702(b).

member's tax liability. Also, tax-exempt income would flow-through to the S corporations' or LLCs' members and keep its tax-exempt character in the hands of the member.

For an S Corporation, each item⁵³ is allocated pro rata to members on a per membership interest per day basis.⁵⁴ Unlike S Corporations, LLCs do not have the limitation of having one class of membership interests: this enables LLCs greater flexibility with respect to attributing specific tax attributes.⁵⁵ However, LLC allocations will need to satisfy the 'substantial economic effect' rule.⁵⁶ Actual distributions by S Corporations and LLCs to members may not subject to tax due to the members' prior assessment of allocated amounts which is represented by the 'membership cost basis'.⁵⁷

If an S Corporation or an LLC incurs losses then these are similarly allocated to members, although to be able to utilise them the member needs to satisfy a series of requirements, such as the outside cost basis rule, the at-risk rule, the passivity rule and the substantial economic effect rule. These loss restriction rules are analysed in detail in Chapter Six.

⁵³ Of income, losses, deductions and credits.

⁵⁴ *IRC 1986* (US), section 1377(a)(1).

⁵⁵ Altieri, MP, and Cenker, WJ. (2002). Partnerships, LLCs, LLPs and S Corporations. *The CPA Journal* 72 (10):40, at p 42.

⁵⁶ *IRC 1986* (US), section 704. The 'substantial economic effect' is elaborately defined in the regulations promulgated: Treasury Regulation, section 1.704-1. If an allocation lacks substantial economic effect then it is modified to conform to the economic arrangement. This rule is discussed in more detail in Chapter Six.

⁵⁷ For S Corporations this is referred to as 'shareholder's adjusted basis': *IRC 1986* (US), section 1368(b)(1). For LLCs this is: *IRC 1986* (US), section 1368(b)(1) – unless there is the distribution of certain 'hot assets' which is described in Chapter Seven. Note there are separate rules if the S Corporation has prior C Corporation earnings – as then a Accumulated Adjustment Account is required: *IRC 1986* (US), section 1368(e)(1). For a more detailed description of the tax treatment of S Corporations and LLCs see: American Bar Association, Section of Taxation, Committee on S Corporations and Partnerships. (1991). Report on the Comparison of S Corporations and Partnerships: Part I. *The Tax Lawyer* 44(2):483.

3.2.1.2 LLPs

The creation of LLPs in the United Kingdom required the introduction of new legislation for their establishment and governance. This legislation was known as the *Limited Liability Partnerships Act 2000* (UK) (the *LLP Act 2000* (UK)),⁵⁸ In addition to this, LLPs and their members are required to comply with modified sections of the *Companies Act 1985* or *2006* (UK),⁵⁹ the *Insolvency Act 1986* (UK), the *Company Directors Disqualification Act 1986* (UK) and the *Financial Services and Markets Act 2000* (UK).

Once formed, the LLP is a body corporate which exists as a legal person separate from its members.⁶⁰ The *LLP Act* (UK) has no express limitation of liability for members, compared to, for example, members of an Australian corporation where the liability of members is specified to be limited to the amount (if any) unpaid on the membership interests held by them.⁶¹ However, the liability of LLP members is intended to be limited due to the corporate nature of the LLP,⁶² but this liability limitation is not complete or certain, especially in relation to tortious claims.⁶³ However, an LLP member is exposed to liability in the

⁵⁸ Commencing 6 April 2001. For Northern Ireland similar legislation took effect from 13 September 2004.

⁵⁹ *Companies Act 1985* (UK) is to be superseded in parts by the *Companies Act 2006* (UK), which is planned to occur in full by October 2009.

⁶⁰ *LLP Act 2000* (UK), section 1(2).

⁶¹ *Corporations Act 2001* (Cth), section 9.

⁶² Explanatory Notes of *LLP Act 2000* (UK), state that “limited liability is possible because an LLP is a legal person separate from its members” and that this “makes it more akin to a company than to a partnership”. This is a similar rationale underlying the *Rayner* decision where the House of Lords found that members of the International Tin Council were not liable for the council’s liabilities because the creating legislation provided that the council was a separate legal person. *J.H. Rayner v Department of Trade* [1990] 2 AC 418; quoting the Australian decision *Chaff and Hay Acquisitions Committee v J.A. Hemphill and Sons Proprietary Ltd* (1947) 74 CLR 375, at p 385. Finch, V and Freedman, J. (2002). The Limited Liability Partnership: Pick and Mix or Mix-up? *Journal of Business Law* (September):475, at p 481.

⁶³ This uncertainty is illustrated by some commentators specifying that LLP members retain unlimited liability for negligence. For example see recent articles published: Khiara, R. (2005). Over the limit. *The Lawyer* 5:24, at p 24 and Shohet, P, and Jenner, A. (2005). Get you teeth into LLPs. *Accountancy Magazine* May:73, at p 74; Morse, G et al. (2002). *Palmer’s Limited Liability Law*. London: Sweet & Maxwell, at p 187. Whereas others specify that the LLP may provide some negligence protection: Pinfold, L, ed. (2005). *Tolley’s Tax Planning 2005–06*. Vol. 1. London:

circumstances that the LLP carries on business with only one member for more than six months.⁶⁴

Since the LLP is essentially a body corporate, it is prima facie subject to United Kingdom corporation tax,⁶⁵ but this is qualified by legislation, so that for most tax purposes an LLP will be treated instead as a general partnership when the LLP carries on a trade, profession, or other business with a view to profit.⁶⁶ This means for the LLP to be taxed as a general partnership a business must be carried on and not just have passive investments, also there must be a profit

LexisNexis Butterworths, at p 1360, and Freedman, n 25, at pp 910-912. Part of the confusion could be in focusing on negligent misstatement as compared to other tortious claims. As Morse specifies that "in the case of most torts there will be no problem, since normal principles of liability will make both the member involved and the LLP liable, either vicariously or as joint tortfeasors, but the position is more complex in connection with the tort of negligent misstatement": Morse, G. (2004). *Limited Liability Partnerships and Partnership Law Reform in the United Kingdom*. In *The Governance of Close Corporations and Partnerships: US and European Perspectives*, edited by J. McCahery, T. Raaijmakers and E. Vermeulen. Oxford: Oxford University Press, at p 326. *Daido Asia Japan Co Ltd v Ines Charlotte Rothen*, 27/7/01 (Ch). It appears that it was the Department of Trade and Industry's intention that an LLP and an individual member, acting as agent, will be jointly liable for torts: House of Commons – Select Committee. (1999). *Trade and Industry – Fourth Report: Draft Limited Liability Partnership Bill*, HC 59, at paragraph 11: referring to submissions made to it by the Department of Trade and Industry. This uncertainty seems bewildering given that a reason for the introduction of LLPs was concern about professional practitioners', particularly auditors', liability for negligence: Refer to the upcoming discussion in Chapter Four about the drivers for the introduction of LLPs in the United Kingdom. It appears that the more considered conclusion is that the LLP is liable to third parties for tortious actions, provided the wrongful act or omission was in the course of the LLP's business: *LLP Act 2000* (UK), section 6(4). For a discussion of 'in the course of the business' for a general partnership see: *Dubai Aluminium Co Ltd v Salaam* [2003] 2 AC 366. Nevertheless, the Explanatory Notes to the *LLP Act 2000* (UK) states there could be a separate cause of action against an individual member in tort: Explanatory Notes of *LLP Act 2000* (UK), at paragraphs 15-16. The explanatory notes states there could be two causes of action when there is negligence by a member, being either contractual (There could be an action for breach of contract for failure to deliver service at the agreed quality) or tort (The tortious claim could be a breach of duty of care.). However, because the contract will normally be between the client and the LLP, only the tortious action could be available against the member. In the recent negligence decision of *Eversheds LLP*, negligence was admitted by the solicitors' LLP, so the issue focused only on the quantum of damages and did not analyse in any detail whether an LLP member would also have any liability: *Keydon Estates Limited v Eversheds LLP* [2005] EWHC 972 (Ch) (20 May 2005).

⁶⁴ *Companies Act 1985* (UK), section 24. In these circumstances that single-member, if knowingly the only member, is liable, jointly and severally with the LLP, for payment of the LLP's debts contracted after the six months have passed.

⁶⁵ *Income and Corporation Taxes Act 1988* (UK), section 832(1).

⁶⁶ *LLP Act 2000* (UK), the *Finance Act 2001* (UK) and *Income and Corporation Taxes Act 1988* (UK), section 114 provide that LLPs be classified as tax partnerships. *Income and Corporation Taxes Act 1988* (UK), section 118ZA.

motive.⁶⁷ For the purposes of this dissertation it is assumed that the LLP meets this requirement. An LLP's tax transparency will cease if it fails to meet these criteria: a specific example of this is where the LLP goes into liquidation.⁶⁸

Similar to other transparent companies, there is some entity acknowledgement as the LLP will report its annual taxable income or loss and details of individual members' share of this to the HM Revenue and Customs (the United Kingdom Revenue).⁶⁹ However, the LLP itself will not generally be liable for tax on any income amount. Instead, its members who have been allocated amounts will be. Members of the LLP are treated as having direct fractional interest in capital assets held by the LLP, so any capital gains occur at the member level and not the LLP level (an aggregate approach). If the LLP incurs losses these are also allocated to members, and for members of an LLP that conducts a trade, certain loss restriction rules must be satisfied.⁷⁰

3.2.1.3 LAQC

A variation to a fully transparent company is the 'partial loss transparent company', describing when only the losses are automatically allocated to members, with income initially taxed to the business form. This is not a common transparent company, but an example is New Zealand's LAQC. Similar to the fully transparent company, the partial loss transparent company also provides for limited liability and the notion of a separate legal entity. Because losses are automatically allocated to members, the LAQC is included in this analysis.

⁶⁷ For example those of clubs and societies if in a LLP will be subject to corporation tax.

⁶⁸ CG28008 – Limited Liability Partnerships: Liquidation. *Finance Act 2001* (UK), section 75(2)(6).

⁶⁹ Whittaker, J, and Machell, J. (2001). *Limited Liability Partnerships: The new law*. Bristol: Jordans, at p 197.

⁷⁰ These rules are discussed in detail in Chapter Six.

An LAQC is a New Zealand corporation that meets certain eligibility requirements and elects for the application of special tax rules to provide for some tax transparency rather than for the adoption of a corporate imputation system.⁷¹ Broadly, the eligibility requirements for LAQC status include requirements that the corporation must be a New Zealand resident with no greater than five members,⁷² a member and director election and one class of membership interest. There are also restrictions on foreign income and on certain entities being members.⁷³

The LAQC's regulatory framework is governed by *Companies Act 1993* (NZ),⁷⁴ and therefore the LAQC has a separate legal entity status from members,⁷⁵ and

⁷¹ New Zealand's regime created two types of entities, with LAQCs being a subset of Qualifying Companies (QC). QCs have their own eligibility requirements, with LAQCs having four requirements additional to these. The focus of this dissertation will be primarily on LAQCs.

⁷² There is some concessional treatment of family members in determining the restriction of five members. Also there are a number of special rules that allow more than five members, including the treatment of blood relations, nominees, corporate members and trustee members. In determining the number of members of a LAQC, members related by blood or marriage to within one degree of relationship are deemed one member. If one of those persons dies or divorces, the remaining person will still be treated as one member provided they were treated as one prior to the death. Inland Revenue – New Zealand. (2001) *Qualifying Companies: A guide to qualifying corporation tax law*. Inland Revenue, March 2001, at p 13 [cited 6 January 2008]. Available from <http://www.ird.govt.nz/forms-guides/keyword/businessincometax/companies/ir435-guide-qualifying-companies.html>; *Tax Information Bulletin* Vol 7, No 3, September 1995, at p 24. For example a parent and child are deemed one member, as is a husband and wife.

⁷³ *ITA 2004* (NZ), sections HG 14 and OB 3. *Income Tax Act 2007* (ITA 2007) (NZ), sections HA 1 to HA 9 essentially prescribes ten eligibility requirements which need to be satisfied at all times of the year for a corporation to be treated as a QC. Firstly, the corporation must be a New Zealand resident, with no greater than five members. The members must make either a unanimous election or a majority election that the corporation becomes a Qualifying Company (QC), and that members are liable for the corporation's tax liability. Also all directors of the corporation must agree for the corporation to become a QC, and if there is a corporate member, then that corporate member must itself be a QC. To maintain QC status all dividends derived by a trustee member must be beneficiary income. Other requirements exclude a unit trust becoming a QC, and no more than NZ\$10,000 non-dividend income can be sourced outside New Zealand. In addition to the ten eligibility requirements for a QC, for a corporation to become an LAQC, there must be only one class of share, a further member and director election, no avoidance arrangement, and at all times the corporation must be a QC: *ITA 2007* (NZ), sections HA 5 and HA 10.

⁷⁴ The *Companies Act 1993* (NZ) replaced the *Companies Act 1955* (NZ), and was effective from 1 July 1994.

⁷⁵ *Companies Act 1993* (NZ), section 15: company is a legal entity in its own right.

provides them limited liability protection.⁷⁶ However, this liability protection is prejudiced by the requirement that members elect to be personally liable for the LAQC's income tax liability.⁷⁷

The LAQC provides for the direct allocation of losses to members, with income being initially assessed at the entity level. An LAQC can still choose to distribute its income to its members via dividends, with this receipt either exempt or assessable to members.⁷⁸ While a conduit principle does not directly apply to distributions by a partial loss transparent company, tax preferences may effectively flow through to members due to the exempt nature of unfranked or unimputed dividends.⁷⁹ For losses allocated to LAQC members to be available the value of the membership must be exposed to movements due to the losses.⁸⁰ The losses are allocated to members in ratio of their shareholding to

⁷⁶ *Companies Act 1993* (NZ), section 97 (2). This potential liability includes (a) amounts unpaid on the membership interest, (b) if the terms of the membership interest provide that the member does have a liability (see section 36(2)); (c) liability for return of wrongful distributions and liability for acts or omissions in conduct of the business; (d) agreement outside the Act. Note if the member is also a director, then directors can be potentially liable for various breaches. See: *Companies Act 1993* (NZ), sections 131 to 137, and section 458 for fraudulent trading.

⁷⁷ If a unanimous election has been made, then members share this in accordance with their effective interests in the LAQC. However, if the member has made a majority election then, they can also be liable for those minority members who have not made the election.

⁷⁸ Freudenberg, B. (2005). Is the New Zealand Qualifying Company regime achieving its original objectives? *New Zealand Journal of Taxation Law and Policy* 11(2):185. An imputation system applies to the LAQC and other New Zealand corporations. This means that the payment of corporate tax is recorded in the LAQC's imputation credit account: *ITA 2007* (NZ), section OB 4. The imputation credits are then attached to the dividends paid out: *ITA 2007* (NZ), section OB 30. An LAQC member is only assessable on an LAQC's taxable income after an actual payment of a dividend. The LAQC must impute any dividend payment to the fullest extent possible, known as an imputed dividend: *ITA 2007* (NZ), section HA 15. A member receiving an imputed dividend from an LAQC will include the dividend in their assessable income. The imputation credit is also included in their assessable income. The member can then offset their tax liability on the receipt of this dividend with the imputation credit: *ITA 2007* (NZ), sections HA 14 and HA 15. The top individual marginal tax rate is currently 39 per cent, so for an individual on the top marginal rate an effective additional six per cent tax rate would apply to the receipt of a fully imputed dividend. From 1 April 2008 this differential is nine per cent when the corporate tax rate dropped to 30 per cent.

⁷⁹ An LAQC member receiving an unimputed dividend is regarded as receiving exempt income and is therefore not assessable on it: *ITA 2007* (NZ), sections HA 16 and CW 15.

⁸⁰ The loss restriction rules applying to LAQCs are analysed in Chapter Six.

the number of shares held by all members during an income year on a per share, per day basis, known as their 'effective interest'.⁸¹

3.2.2 Australian Transparent Companies

Despite its prior opposition to transparent companies, the Australian government has recently introduced two transparent regimes, although these are not broadly available. The first of is to encourage venture capital investment; the other is to provide greater symmetrical tax treatment for Australian residents investing in foreign transparent companies. Each of these is described below to illustrate how they come within the definition and parameters of a 'tax transparent company'.

3.2.2.1 Venture Capital ILP

Commencing on 1 July 2002, the introduction of venture capital incorporated limited partnerships (venture capital ILPs) involved both state and federal governments of Australia enacting relevant legislation.⁸² At the federal level, the government enacted legislation establishing a new tightly regulated regime for the venture capital industry in Australia⁸³ which, if satisfied, applies tax transparency as well as certain tax concessions for non-resident investors.⁸⁴

⁸¹ For a comprehensive discussion about the mechanics behind the LAQC regime see: Freudenberg, n 78, at pp 191-194.

⁸² While the venture capital industry is very fluid in terms of what it exactly entails, venture capitalists have been described as 'investors who focus on financing high risk, potentially high-reward, projects in private companies and who actively participate in developing those businesses'. While not always the case, 'venture capitalist often endeavour to seek out SMEs that are involved in the development of new technologies and groundbreaking discoveries': Barkoczy, S, and Sandler, D. (2007). *Government Venture Capital Incentives: A multi-jurisdiction comparative analysis, Research Study No 46*. Sydney: Australian Tax Research Foundation, at p 6-7.

⁸³ ITAA 1997 (Cth), Sub-Division 118-F. The new venture capital regime was introduced on 1 July 2002 by two pieces of legislation, being: *Venture Capital Act 2002* (Cth) and *Taxation Laws Amendment (Venture Capital) Act 2002* (Cth). Australia has two other venture capital programs being (a) PDF program introduced in 1992; and (b) the Foreign Superannuation Fund program introduced in 1999. These prior programs have been criticised as being flawed in a number of

To address concerns with the current limited partnership regimes available in Australia, every state government except Western Australia has enacted legislation to establish a new business form, the ILP.⁸⁵ This saw the creation of a discrete business form that could utilise the federal income tax provisions for the venture capital industry, as ILPs are available only for venture capital investment.⁸⁶

The venture capital ILP provides, among other things, for a separate legal entity⁸⁷ and limited liability for limited members,⁸⁸ with general members having

ways. See: Ernst and Young. (2002). Review of International Tax Arrangements: Submission to the Board of Taxation, at p 87 [cited 22 December 2005]. Available from <http://www.taxboard.gov.au/submissions.asp>.

⁸⁴ The venture capital tax concessions are aimed primarily at capital gains by non-resident investors. In contrast, Australian investors would be taxed under normal rules. There has been a recent amendment to this regime, with the Early Stage Venture Capital Limited Partnership (ESVCLP) that will progressively replace the Pool Development Fund program: *Tax Laws Amendment (2007 Measures No 2) Act 2007* (Cth). This has seen New South Wales recently introduce amendments to its *Partnership Act 1892* (NSW) to allow such ESVCLPs to be regarded as ILPs: *Partnership Amendment (Venture Capital) Act 2007* (NSW); enacted in October 2007. This dissertation does not consider ESVCLPs in any detail as it does not allow members to claim losses. That is, its loss restriction rule is absolute: *ITAA 1997* (Cth), section 26-68.

⁸⁵ New South Wales the *Partnership Amendment (Venture Capital Funds) Act 2004* (NSW) amending the *Partnership Act 1892* (NSW); Victoria the *Partnership Venture Capital Funds Act 2003* (Vic) amending the *Partnership Act 1958* (Vic); and Queensland the *Partnership and Other Acts Amendment Act 2004* (Qld) amending the *Partnership Act 1891* (Qld); Australian Capital Territory the *Partnership (Venture Capital Funds) Amendment Act 2004* (ACT) amending the *Partnership Act 1963* (ACT); South Australia the *Partnership (Venture Capital Funds) Amendment Act 2005* (SA) amending the *Partnership Act 1891* (SA); and Northern Territory the *Partnership Amendment (Venture Capital Funds) Act 2006* (NT) amending the *Partnership Act 1997* (NT).

⁸⁶ *Partnership Act 1892* (NSW), section 53D(3); *Partnership Act 1958* (Vic), section 87(2); *Partnership Act 1891* (Qld), section 75; *Partnership Act 1963* (ACT), section 57(2); *Partnership Act 1891* (SA), section 51D(3); and *Partnership Act 1997* (NT), section 55(2). Note every state except for Queensland provides for ILPs to be used for other purposes as provided by regulation (which there are none at the moment).

⁸⁷ *Partnership Act 1892* (NSW), section 53; *Partnership Act 1958* (Vic), section 84; *Partnership Act 1891* (Qld), section 72; *Partnership Act 1963* (ACT), section 54; *Partnership Act 1891* (SA), section 51; and *Partnership Act 1997* (NT), section 52.

⁸⁸ Although there are broader allowances for participation in management without losing limited liability protection: *Partnership Act 1892* (NSW), sections 66A and 67A; *Partnership Act 1958* (Vic), sections 97 and 98; *Partnership Act 1891* (Qld), sections 86 and 87; *Partnership Act 1963* (ACT), sections 67 and 68; *Partnership Act 1891* (SA), sections 64A and 65A; and *Partnership Act 1997* (NT), sections 65 and 66. Even with the reforms, members are not allowed full management without infringing their liability protection unlike the reforms for the United States'

liability exposure. The separate legal entity status is distinctive from other limited partnerships in Australia, and is adopted to re-enforce liability protection for limited members.⁸⁹ The limited member is normally a passive investor, with participation in the management of an ILP restricted, as this can diminish their liability protection.⁹⁰

With the financing of venture capital investments, it is common for the general member to contribute one per cent of the equity into the venture capital ILP, with limited members contributing the remaining 99 per cent.⁹¹ The venture capital ILP then makes investments, typically in the form of membership interests,⁹² in an underlying eligible corporation (the venture capital corporation) that conducts the business activity.⁹³ In addition to equity contributions in the venture capital corporation, benefits such as business experience, special expertise and mentoring can be provided by the ILP to the venture capital corporation.⁹⁴

It should be noted that tax transparency does not automatically apply to venture capital ILPs, as they must qualify for registration with the Australian government's Venture Capital Registration Board (the Board),⁹⁵ and (further) comply with the registration requirements of the *Venture Capital Act 2002* (Cth).⁹⁶ There are two types of venture capital ILPs that can register with the Board: Venture Capital

Uniform Limited Partnership Act (2001), section 303. Drafted by the National Conference of Commissioners of Uniform State Law.

⁸⁹ With no agency relationship between the limited member and either the general member or the ILP: *Partnership Act 1892* (NSW), section 53C; *Partnership Act 1958* (Vic), section 96; *Partnership Act 1891* (Qld), section 84; *Partnership Act 1963* (ACT), section 66; *Partnership Act 1891* (SA), section 51C; and *Partnership Act 1997* (NT), section 64.

⁹⁰ However, there are broader safe harbour provisions to limited members some participation without exposing them to liability. These are discussed later in the dissertation.

⁹¹ For a comprehension discussion about the venture capital industry see: Stewart, M. (2005). Venture Capital Tax Reform in Australia and New Zealand. *New Zealand Journal of Taxation Law and Policy* 11 (2):216, at p 226.

⁹² Or options to acquire shares.

⁹³ From 1 July 2007 this is now extended to investments in unit trusts.

⁹⁴ Barkoczy and Sandler, n 82, at p 7.

⁹⁵ Previously known as the Pooled Development Fund Board up to 21 June 2007.

⁹⁶ *Venture Capital Act 2002* (Cth), sections 9-1 and 9-5.

Limited Partnerships (VCLP)⁹⁷ and Australian Venture Funds of Funds (AFOF).⁹⁸ A VCLP directly invests into eligible venture capital corporations, whereas the AFOF pools capital and becomes a limited member across a number of VCLPs.

It is important to note here that there is also a third type of investment provided for being a Venture Capital Management Partnership (VCMP) which is a limited partnership that acts as the general member of a number of VCLPs and/or AFOFs.⁹⁹ VCMPs do not need to separately register, because they are indirectly registered through their participation in VCLPs and AFOFs which are themselves registered. To assist in understanding these various types of investment, the Appendix provides a diagrammatic representation of the different ways that venture capital investment can be facilitated in Australia. For the purposes of this

⁹⁷ To be able to register as a VCLP, the venture capital ILP must comply with a number of requirements: These requirements are found in the *Venture Capital Act 2002* (Cth), sections 9-1 and 13-1. Firstly, the venture capital ILP must be formed under a law in Australia or a Double Tax Agreement Country (Prior to 1 July 2007 this was more restricted to Six Listed Countries being Canada, France, Germany, Japan, the United Kingdom or the United States.); with the general member resident in either Australia or Double Tax Agreement Country. Also the partnership agreement must specify that the venture capital ILP will be in existence for at least five years but not more than 15 years, and the partnership will be carrying on activities related to eligible venture capital investment. Furthermore, there must be committed capital of at least \$10 million (Prior to 1 July 2007 this was \$20 million), with investments only in eligible venture capital investments, particularly venture capital corporations (From 1 July 2007 this can now extend to unit trusts as well). Finally, the only debt interests of the limited partnership in the eligible venture capital investment must be permitted loans (These are defined as either (a) loans repayable within six months if no eligible venture capital investment; or (b) loans where there is at least 10 per cent of equity in eligible venture capital investment. See *Venture Capital Act 2002* (Cth), section 9-10), and the general member must notify the Board that it holds sufficient funds to begin its investment program.

⁹⁸ For a limited partnership to be able to register as an AFOF, the venture capital ILP must meet slightly different requirements. *Venture Capital Act 2002* (Cth), sections 9-5 and 13-5. One notable difference is that an AFOF can remain in existence for 20 years, compared to only 15 for a VCLP. These registration requirements include that the limited partnership: (a) must be formed in Australia; (b) that every general member must be an Australian resident; (c) that the partnership agreement specifies that the partnership is to remain in existence for at least five years but not greater than 20 years, (d) only carry on activities related to eligible venture capital investment, (e) only invests in a VCLP, or a corporation in which a VCLP (that the AFOF is a partner) already holds an investment, (f) only has debt interests that are permitted loans; and (g) must notify the Board, through the general partner, that the AFOF has sufficient funds to begin its investment program.

⁹⁹ *ITAA 1936* (Cth), section 94D(3) defines a VCMP as a general member of one or more VCLPs and/or AFOFs, and only carries on activities relating to being such a general partner.

dissertation, VCLPs, AFOFs and VCMPs fall within the overarching umbrella term of 'venture capital ILPs' unless otherwise specified.

If the above requirements are satisfied then venture capital ILPs, unlike other limited partnerships in Australia,¹⁰⁰ are taxed as general partnerships.¹⁰¹ Being taxed as a general partnership has the consequent effect that the 'net income' of the partnership is calculated as the assessable income of the partnership less allowable deductions calculated as if the partnership was a resident taxpayer.¹⁰² Even with this entity acknowledgement, the venture capital ILP itself would not pay income tax on this net income.¹⁰³ This 'net income' calculation would exclude any capital gains, because members make any capital gains or capital losses in relation to CGT assets held through the venture capital ILP individually (fractional interest).¹⁰⁴ An obvious CGT asset that could be held through a venture capital ILP is the membership interest in the venture capital corporation.¹⁰⁵

¹⁰⁰ A limited partnership is defined for tax purposes as either: (a) an association of persons (other than a company) carrying on business as partners or in receipt of ordinary income or statutory income jointly, where the liability of at least one of these persons is limited; or (b) an association of persons with a separate legal personality that was formed solely for the purpose of becoming a VCLP, an AFOF or a VCMP and to carry on activities that are carried on by a body of that kind: *ITAA 1997* (Cth), section 995-1.

¹⁰¹ *ITAA 1936* (Cth), Division 5 governs the taxation of general partnerships, with essentially each member including their share of the net income of the partnership in their own assessable income: see *ITAA 1936* (Cth), section 92. Note this treatment of VCLP, AFOF and VCMP as general partnerships is achieved through a number of definitions: the definition of 'companies' excludes partnership (*ITAA 1936* (Cth), section 6(1)), and the definition of 'partnership' includes a limited partnership (*ITAA 1997* (Cth), section 995-1), and then the definition of 'limited partnership' is defined to include a VCLP, AFOF and VCMP (*ITAA 1997* (Cth), section 995-1), and *ITAA 1997* (Cth), section 960-115 confirms these entity types are not corporate tax entities.

¹⁰² *ITAA 1936* (Cth), section 90.

¹⁰³ *ITAA 1936* (Cth), section 91.

¹⁰⁴ *ITAA 1997* (Cth), sections 106-5 and 108-5(2)(c). For capital gains tax (CGT) purposes each member is treated as having acquired an individual fractional interest in the assets held by the partnership. This is because for Australian tax purposes members of a partnership are treated as having direct 'fractional interests' in the CGT assets held.

¹⁰⁵ However, there is some contention as to whether this membership interest is held on revenue or capital account by the members of the venture capital ILP. It could be argued that the sale of shares in the eligible venture capital corporation are revenue in nature and not capital, particularly as they are acquired for the purpose of resale within ten to 15 years. See: Stewart, n 91, at p 233. This issue requires clarification, because if a membership interest is held on revenue account then the concessional tax treatment applying to capital gains does not apply.

This net income calculation can be either positive or negative: in this respect, each member would include their share of net income or loss in their own assessable income.¹⁰⁶ When 'net income' is negative — that is losses are generated — then pursuant to industry practice a greater percentage of these losses are allocated to limited members.¹⁰⁷ These allocated losses would then be potentially available to offset the limited member's other income, subject to the new loss restriction rule for limited members.¹⁰⁸

There are a number of concessions available for capital gains made through a venture capital ILP. Capital gains by limited members of a VCLP or AFOF are potentially disregarded¹⁰⁹ if, in addition to meeting registration requirements with the Board and holding the investment for 12 months, the taxpayer is an 'eligible venture capital partner',¹¹⁰ and the relevant CGT event must relate to an 'eligible venture capital investment'.¹¹¹

¹⁰⁶ *ITAA 1936* (Cth), section 92. Note the partners' share would be determined by the partnership agreement. When 'net income' is positive, there are no specific tax concessions given to these net income receipts.

¹⁰⁷ These deductions may relate to the management fees paid to the general member and interest paid on financial borrowings. However, given the restrictions on venture capital ILPs in terms of borrowings, investments, and treatment of capital gains/losses, the quantum of revenue losses may be comparatively small.

¹⁰⁸ *ITAA 1936* (Cth), section 92(2AA).

¹⁰⁹ Given the recent reforms to the taxation of non-residents' capital gains in Australia, the value of this venture capital exemption may be diminished, because the membership interest in the venture capital corporation may no longer be a taxable Australian property for non-resident members anyway — thereby having the consequent effect of not being subject to CGT. *ITAA 1997* (Cth), section 855-15: commencing 12 December 2006. Previously membership interests in a private corporation would have been regarded as taxable Australian property: *ITAA 1997* (Cth), section 136-25. With the application of the new definition, as a general rule membership interests in private corporations will not be taxable Australian property, unless the value of the entity's assets is principally derived from Australian real property and there is a 10 per cent or greater holding: *Tax laws Amendment (2006 Measures No 4) Act 2006* (Cth).

¹¹⁰ Essentially, an 'eligible venture capital partner' is either a tax-exempt non-resident of a Double Tax Agreement Country [*ITAA 1997* (Cth), sections 118-415, 118-420(1) and (3)]; a non-resident investing through certain foreign venture capital funds of funds with no partner's committed capital greater than 30 per cent [*ITAA 1997* (Cth) sections 118-410, and 118-420(1) and (4)]; a limited partnership establish in one of the Six Listed Countries, with every general member resident in the one of the Six Listed Countries and the partnership is not a general member of a VCLP — with the partner's and entities connected committed capital [Defined in *ITAA 1997* (Cth), section 118-445] not exceeding 30 per cent of the partnership's committed capital; or a taxable non-resident of certain countries holding less than 10 per cent equity interest in the venture capital ILP [*ITAA 1997* (Cth) sections 118-405 and 118-420(1)(c)]. This definition of 'eligible venture capital partner' does not include a general member and therefore a general member could not disregard a capital

The Australian Government has also provided some concessional treatment to general members,¹¹² through recognising that general members provide ‘hands-on expertise’ which (thereby) increases the success and growth of the venture capital corporation.¹¹³ This concessional treatment is achieved by deeming a general member’s share of a successful venture capital investment as a capital gain rather than as income.¹¹⁴ Due to this deeming, CGT event K9 applies for a

gain pursuant to this division, whereas a limited member might [ITAA 1997 (Cth) sections 118-420(1)(c); 118-420(3) and 118-420(4)]. Also, in related context, this exemption does not apply to Australian tax residents. In comparison, the new ESVCLP provides that capital gains or losses can be disregarded for both limited and general members who are resident in Australia or a Double Tax Agreement Country: ITAA 1997 (Cth) sections 118-407(2).

¹¹¹ This requires that the investment be held at-risk [Defined in ITAA 1997 (Cth), section 118-430] — through the acquisition of shares in a non-listed Australian resident corporation [Or options to acquire shares. Note in some circumstances investments in a holding corporation can be eligible. ITAA 1997 (Cth), sections 118-425 and 118-435]. To elaborate, such an investment is ‘at-risk’ if the entity owning the investment had no arrangement regarding either the maintenance of the value of the membership interest or the maintenance of any earnings or other return that might be made from owing the membership interests: ITAA 1997 (Cth), sections 118-430. If the gain is regarded as ordinary income, this also disregarded. ITAA 1997 (Cth), section 51-55. Note any losses whether capital or revenue in nature are also disregarded: ITAA 1997 (Cth), Sub-division 118-F and section 26-68.

¹¹² Managers will be the general members of VCLP and AFOF, although they could be the limited member of a VCMP.

¹¹³ *Explanatory Memorandum to Taxation Laws Amendment (Venture Capital) Bill 2002 (Cth)*, at paragraph 4.2.

¹¹⁴ ITAA 1997 (Cth), section 104-255. However, it is argued that this ‘deeming’ processes may not be required, as the sale of the membership interest in the venture capital corporation will in effect be a capital gain for the general member — irrespective of CGT event K9. Other commentators appear to accept that CGT event K9 is required for general members: Barkoczy and Sandler, n 82, at p 73. For a brief discussion of the United States and United Kingdom as a comparison with Australia see: Chua, T. (2007). Getting carried away - income tax treatment of carried interests in private equity funds. *Taxation in Australia* 42 (4):221. However, it should be pointed out that this argument, though not central to this dissertation, leads to a similar tax consequence. This is because the calculation of ‘net income’, ‘exempt income’ or ‘partnership loss’ must be made by reference to the activities of the partnership and not by reference to the personal circumstances of the members. Similar reasoning would apparently apply to determining whether an asset is held on revenue or capital account: See: *Poole and Dight v Federal Commissioner of Taxation* (1970) 122 CLR 427, 70 ATC 4047, and *Tikva Investments Pty Ltd v Federal Commissioner of Taxation* (1972) 128 CLR 158. In this circumstance the character of the sale of the membership interest in the venture capital corporation, as either revenue or capital, would need to be determined for the venture capital ILP as a whole. As limited members with 99 per cent of the equity invested in the venture capital ILP could be said to hold their interest on capital account, compared to the one per cent interest of the general member that would be revenue account, overwhelming the disposal of the membership interest would depend on the characterisation for the limited members. This characteristic is likely to be capital as the venture capitalists are not ‘trading’ in the membership interests and therefore hold them on capital account. See: Barkoczy and Sandler, n 82, at p 43. Although it is possible to argue that it is on

general member of VCLP or an AFOF¹¹⁵ *when* the general member becomes entitled to receive a payment of a 'carried interest'.¹¹⁶ To explain, a carried interest is defined as the general member's entitlement to a distribution from a VCLP or AFOF, to the extent that the distribution is contingent upon the limited member's profitability.¹¹⁷ As a capital gain, the general member may thus be able to take advantage of concessional tax treatment of capital gains.¹¹⁸ If a general member is a non-resident then this may have the ultimate (desirable) effect that the entire capital gain is exempt and this is because membership interests in private corporations are generally no longer taxable Australian property for CGT purposes.¹¹⁹

revenue account as the venture capitalists acquire the shares for the purpose of ultimately selling them at a profit (rather than deriving any regular dividend yield). See: Stewart, n 91, at p 233 and *Californian Copper Syndicate v Harris (Surveyor of Taxes)* [1904] SC 89; (1904) 5 TC 159 and *London Australia Investments Co Ltd v FC of T* (1977) 138 CLR 106. Also, any arguable revenue profit on the disposal is specified to be exempt income. *ITAA 1997* (Cth) sections 51-54 and 118-405. Additionally, *ITAA 1997* (Cth), section 26-68 specifies a taxpayer cannot deduct a loss on sale of eligible venture capital investment.

¹¹⁵ Or a limited member of VCMP.

¹¹⁶ *ITAA 1997* (Cth), section 104-255.

¹¹⁷ *ITAA 1997* (Cth), section 104-255(4). For limited members in a VCMP a carried interest is the partner's entitlement to a distribution from the VCMP to the extent that the distribution is contingent upon the limited partners' profitability in the VCLP or AFOF in which the VCMP is a general member: *ITAA 1997* (Cth), section 104-255(5). It should be recalled that a VCMP is a limited partnership that itself becomes a general member of a number of VCLPs and or AFOFs. CGT event K9 will not occur for the payment of management fees nor distributions allocated to equity interest in limited partnerships: *ITAA 1997* (Cth), section 104-255(6). 'Equity Interest' for a partnership is defined in *ITAA 1997* (Cth), section 820-930 which refers to Division 974 with modifications. Note such a receipt will only be a capital gain under CGT event K9 and not ordinary income also: *ITAA 1997* (Cth), section 118-21. This section also specifies such a receipt will not a profit-making undertaking (*ITAA 1997* (Cth), section 15-15) or other statutory income provisions (*ITAA 1997* (Cth), section 6-10). Similarly, deductions are denied for the VCLP and AFOF in respect of carried interest payments, making such payments equivalent to profit sharing between partners: *ITAA 1997* (Cth), section 26-68.

¹¹⁸ Division 115 *ITAA 1997*: 50 per cent discounts for individuals. Note there have been amendments to Division 115 to take into account its potential application to CGT event K9, including (a) that no cost base is needed for a K9 gain (s 115-20(3)); and (b) the 12 month period is calculated by reference to the date of the existence of the partnership agreement (*ITAA 1997* (Cth), section 115-25(2A)).

¹¹⁹ The prior *ITAA 1997* (Cth), section 136-25 specified that membership interests in a private corporation were assets with the necessary connection with Australia and therefore potentially subject to tax in Australia for a non-resident. This section was repealed from 12 December 2006 by *Act No 168 of 2006* (Cth). The new section, *ITAA 1997* (Cth), section 855-15 specifies that there are five categories of CGT assets are taxable Australian property, including 'taxable Australian real property' (being real property in Australia or a mining right), or an indirect Australian real property interest, or a CGT asset used in carrying on a business through a permanent establishment in Australia.

3.2.2.2 CFC Hybrids

The other restricted recognition of transparent companies in Australia relates to the CFC hybrids. Commencing 1 July 2003, the CFC hybrid amendments were introduced to address the asymmetrical tax treatment applying to Australian residents investing in certain foreign transparent companies. To briefly summarise, asymmetrical tax treatment was produced between the country of origin (where tax transparency applied)¹²⁰ and Australia with the business form being taxed separately and independently from its members as a corporation. In legal and commercial discourse, such asymmetrical treatment between jurisdictions has been commonly referred to as ‘hybrid’ treatment.¹²¹

To address these difficulties, the CFC hybrid amendments specify that certain foreign transparent companies are to be taxed as ‘general partnerships’ rather than as ‘corporations’ *per se*. This mechanism produces the consequent effect that such CFC hybrids will be subject to tax transparency in Australia — hence, more aligned with their foreign treatment but not necessarily identical.¹²²

¹²⁰ Particularly the United States and the United Kingdom.

¹²¹ In Larking, B, ed. (2005). *IBFD International Tax Glossary*. 5th ed. Amsterdam: IBFD defines a ‘hybrid entity’ as an “entity that is characterized as transparent for tax purposes (eg as a partnership) in one jurisdiction and non-transparent (eg as a corporation) in another jurisdiction”. It is argued that this an unfortunate use of the term ‘hybrid’ and is not an appropriate given the English meaning of the word. This is because the IBFD describes the one entity being treated differently in two jurisdictions, rather than the one entity that has characteristics of two different species. For a similar use of the term of hybrid to describe asymmetrical treatment of a business form see Barenfeld, J. (2005). Taxation of Cross-Border Partnerships: Double Tax Relief in Hybrid and Reverse Hybrid Situations. Doctor of Laws, Jonkoping International Business School, Jonkoping, at p 130. Benson, DM, Rollinson, MA, O’Connor, MM, and Baik, SA. (1991). Hybrid Entities — Practical Application Under the Check-the-Box Regime, *Tax Management International Journal* 26(8): 363, at p 364. Connors, PJ, and Femia, RV. (2006). Application of U.S. Treaties to Hybrid Entities. *Tax Management International Journal* 35 (3):147, at p 148.

¹²² See: Freudenberg, B. (2008). Losing My Losses: Are the Loss Restriction Rules Applying to Australia’s Tax Transparent Companies Adequate? *Australian Tax Forum* 23(2), at p 125. Whether the amendments will achieve the elimination of all problems is questionable given that Australian members of the LLC will be treated as having fractional interests in the LLC’s assets, although for United States’ tax purposes this is not the case: Explanatory Memorandum accompanying Taxation Laws Amendment Bill (No 7) 2003 (Cth), at paragraph 9.21: Table; and

Recognised CFC hybrids include a 'foreign hybrid limited partnership'¹²³ and a 'foreign hybrid company'¹²⁴ which are defined by statute and regulation.¹²⁵

To gain tax transparency as a CFC hybrid, the requirements are that a 'limited partnership' has been formed in a foreign country, with foreign tax imposed on income or profits by foreign law on members not the limited partnership, and at no time is the limited partnership resident of a foreign country that would impose tax on the entity. Additional requirements are that at no time is the limited partnership an Australian tax resident, that there is an income attributable percentage greater than zero under the CFC provisions,¹²⁶ and that the member has elected for the relevant entity to be a foreign hybrid limited partnership.¹²⁷ Accordingly, it can be seen that these CFC hybrid amendments do not eliminate asymmetrical treatment for Australian members who do not have an income attributable percentage for the CFC measures, with (in effect) these businesses subject to transparency overseas and entity treatment in Australia.¹²⁸ It should be noted, in this respect, that when the CFC hybrid is a 'company' rather than a 'limited partnership', similar requirements apply — such as the case for foreign limited partnerships.¹²⁹

paragraph 9.46. This inconsistency means that there is the potential for double tax: Explanatory Memorandum accompanying Taxation Laws Amendment Bill (No 7) 2003 (Cth), at paragraph 9.46 to 9.48. This is attempted to be dealt with in section 830-75(1) and (2).

¹²³ ITAA 1997 (Cth), section 830-10.

¹²⁴ ITAA 1997 (Cth), section 830-20.

¹²⁵ ITAA 1997 (Cth), section 830-15(2)(b). Broadly these require, apart from other things, that members be subject to tax and not the entity 'as a partnership'. Currently included as CFC hybrids are the United States' LLC and the United Kingdom's LLP. The German KG is also included: Australian Taxation Office. (2007). ATO Interpretive Decision: ATO ID 2007/47: Classification of a German KG for Australian income tax purposes.

¹²⁶ ITAA 1997 (Cth), section 830-10(1).

¹²⁷ ITAA 1997 (Cth), section 830-10(2).

¹²⁸ Explanatory Memorandum accompanying Taxation Laws Amendment Bill (No 7) 2003 (Cth), at paragraph 9.28: "Finally, the limited partnership must be a CFC with at least one attributable taxpayer having an attribution percentage greater than nil. Generally, this means that there must be at least one Australian taxpayer who has a direct or indirect interest of at least 10% in the limited partnership".

¹²⁹ ITAA 1997 (Cth), section 830-15(1), (2), (3) and (5). That is at no time is the company resident of a foreign country that would impose tax on it as an entity, at no time is the company an Australian resident, in relation to another taxpayer (probably Australian members of the company) the company is a CFC with income attributable to the taxpayer at a percentage greater than zero, with the member making an election to treat as a foreign hybrid company. Furthermore, either the

Similar to the nature of venture capital ILPs, when the CFC hybrid amendments apply then, for Australian tax purposes, the foreign transparent company calculates its 'net income' as a general partnership,¹³⁰ with the constituent members including their share of it in their own assessable income.¹³¹ When a net income loss or a capital loss is generated, then the CFC hybrid members must satisfy a restriction rule, known as the 'loss exposure amount'. This rule is distinct from those applying to venture capital ILPs.¹³² If revenue and capital losses are within this amount then the limited member is either allowed a deduction or makes a capital loss.¹³³ If the loss exposure amount is exceeded, then the amount of revenue and/or capital losses to be utilised for the year is reduced to the loss exposure amount,¹³⁴ and any excess is carried forward until the rule is satisfied in the future.¹³⁵

3.2.3 Classification of Transparent Companies

It is argued that the tax transparent companies studied can be classified into two distinct paradigms. The first classification pertains to whether the tax transparent company was produced by introducing a special set of tax rules to an existing business form, the corporation, referred to as 'special tax rule company'. The second classification specifically relates to when the transparent company represents the creation of an entirely new business form that is subjected to existing tax rules, referred to as a 'new form transparent company'. To enhance

company must be formed in the United States and is treated as a partnership or a disregarded entity if single membership, or is a company formed in a foreign country that is treated as a partnership and relevant regulations are satisfied.

¹³⁰ *ITAA 1997* (Cth), section 830-20 specifies to treat the company as partnership.

¹³¹ *ITAA 1936* (Cth), section 90 and 92. Similar to other general partnerships, this net income would not include capital gains as these are determined at the individual member level.

¹³² *ITAA 1997* (Cth), section 830-45.

¹³³ *ITAA 1997* (Cth), section 104-270: CGT event K12.

¹³⁴ *ITAA 1997* (Cth), section 830-45(2) and 830-50(3).

¹³⁵ *ITAA 1997* (Cth), section 830-65 for outstanding revenue losses and 830-70 for outstanding capital losses.

understanding of these paradigmatic classifications, Table 3-0-1 details the categorisation of the transparent companies studied.

The S Corporation and the LAQC fall within the ‘special tax rule companies’ classification, since both of these entities are essentially corporations for which the respective governments have introduced a special tax transparent regime for particular closely held corporations.

In contrast, LLCs and LLPs are categorised within the second classification, ‘new form transparent companies’, since both of these entities required the introduction of new legislation for their formation and governance, with transparency provided by the application of existing general partnership tax rules.

Table 3-0-1: Classifications of tax transparent companies

Classification	Description	Example
Special tax rule companies	The transparent company was introduced by providing a special set of tax transparency rules to corporations.	S Corporation LAQC
New form transparent companies	The creation of an entirely new business form that is subject to existing tax transparent rules for general partnerships.	LLC LLP Venture capital ILP CFC hybrids

It needs to be pointed out here that Australia’s transparent companies — the venture capital ILPs and the CFC hybrids come within the second classification, new form transparent companies. They would not fall within the classification of ‘special tax rule companies’, as they do not involve tax transparency applying to existing corporate forms. For example, venture capital ILPs involved the introduction of legislation to create a new business form that would be subject to existing transparency applying to general partnerships. The CFC hybrid

amendments currently apply only to Australians investing in foreign new form transparent companies studied. In particular, the CFC hybrid amendments do not apply to Australian investors in S Corporations and LAQCs, as these entities do not come within the term ‘foreign hybrid company’, since neither the United States or the New Zealand tax system treats them for tax purposes ‘as a partnership’.¹³⁶

The identification of these two classifications is important since there may be differences in the circumstances behind their introduction. These differences may be critical in determining the benefits of the various transparent companies. Furthermore, an associated issue is whether one classification is more likely to support claims of transparent companies having improved governance. This analysis will be further explored in the discussion of the actual operational rules of the various transparent companies in Chapters Six to Nine. Such findings are vital, given the dissertation’s central goal of evaluating whether Australia should adopt a tax transparent company.

3.2.4 Utilisation of transparent companies

To determine whether tax transparent companies have been popular in their respective jurisdictions, it is helpful to ascertain to what extent they are utilised. It should be noted that there are a number of limitations in drawing conclusions about the suitability of transparent companies from the available data. For example, the available data does not prove transparent companies are beneficial for closely held businesses — particularly in view of the fact that the data does not distinguish between membership number nor does it distinguish in terms of the size of trading activity. Also (and complicating this issue), it needs to be pointed out that the utilisation of transparent companies could be due to a several factors, such as governance rules and tax arbitrages. Nevertheless,

¹³⁶ ITAA 1997 (Cth), section 830-15(2)(b).

despite these difficulties, the relevant data does provide empirical insights into whether transparent companies can be considered popular in the jurisdictions studied.

3.2.4.1 United States

In terms of comparative data, Figure 3-0-1 demonstrates that in the United States the number of S Corporations exceeded the number of LLCs filing tax returns up until 2003.¹³⁷ The popularity of S Corporations might be expected, given that they have been a well-established business form in the United States for nearly 50 years,¹³⁸ compared to the relative recent introduction of LLCs.¹³⁹ However, this data needs to be interpreted cautiously, as the tax figures could under-report the number of LLCs. This is because single-member LLCs with tax transparent treatment are treated by the Internal Revenue Services (US) (United States IRS) as a 'disregarded entity'. Disregarded entities are not reported in this tax data as LLCs, but are instead included in the figures relating to the member's own status.¹⁴⁰ A compounding factor is that from 1997 LLCs may elect for tax treatment as a C Corporation or S Corporation, and would be reported as such.

To ascertain more accurately the actual number of LLCs, relevant tax filings are compared to the data of LLC formation in the individual American states compiled by the International Association of Corporation Administrators (the International Association). This comparison demonstrates that in 2003 the estimated number of LLCs formed was approximately 3 million, compared to the 1 million represented in the tax data: Figure 3-0-2. While there are inherent

¹³⁷ Note the most popular business form for tax purposes was the sole proprietor with 19,710,079 (non-primary production) filing tax returns in the 2003 year. Sole proprietors have been excluded from the Figure to enable better detail about the other forms to be demonstrated.

¹³⁸ First introduced in 1958. Refer to the discussion in Chapter Four.

¹³⁹ First introduced by Wyoming in 1977. Refer to the discussion in Chapter Four.

¹⁴⁰ This could mean that the single-member LLC is included in the figures as a sole proprietor, C Corporation, trust or a holding LLC.

problems with the International Association's data collection, previously detailed by Friedman,¹⁴¹ the comparison of these two data sets would imply that around 2 million LLCs may have only one member being a 'disregarded entity' for tax purposes, or may have elected for S Corporation or C Corporation treatment. It is understood that this ability of single-member LLCs to 'disappear' for tax purposes¹⁴² has been raised by foreign jurisdictions as problematic in obtaining information from the United States IRS to validate taxpayer's activities.¹⁴³

In terms of corporations, the International Association's data indicates that the total number of business and private corporations with good standing or active is approximately 6.6 million for 2004 and 7.1 million for 2005. While these figures are greater than the data for corporate tax filing of 5.4 million for 2003, they tend to suggest that the data sets for corporations are more comparable. The discrepancy in figures could relate to corporations that do not have to file tax returns or have failed to do so.

Accordingly, the tax data needs to be read cautiously, as it may under-report the number of entities, although it is the only source of S Corporation filings. It has been reported that 80 per cent of S Corporations were owned by a single member, or a single member had greater than 50 per cent of the membership interest.¹⁴⁴

¹⁴¹ Friedman, HM.(2004). The Silent LLC Revolution – The Social Cost of Academic Neglect. *Creighton Law Review* 38(1).

¹⁴² As the LLC itself does not have to file an information return.

¹⁴³ That is when a foreign jurisdiction is told that certain activities are conducted by an United States LLC, the United States IRS cannot provide information to the foreign jurisdiction as it will have no information on the single-member LLC; instead the information is 'lost' within the member's data. It is argued that to enable tracing by both foreign and domestic governments, and to report more accurate data it would be preferable to have separate tax reporting by a single-member LLCs, even though all income and/or losses is allocated to one member.

¹⁴⁴ Crawford, C, and Freedman, J. (2008). Small Business Taxation. In *Prepared for the Report of a Commission on Reforming the Tax System for the 21st Century*, Chaired by Sir James Mirrless: The Institute of Fiscal Studies. Note there is no reference as to the source of the data given in this report.

Figure 3-0-1: US: Business form tax return lodgements

Source: Internal Revenue Service (US). (1986 – 2003) Tax Statistics Returns Filed for Individuals, Corporations and Partnerships. Available at: <http://www.irs.gov/taxstats/index.html>. The figure excludes the returns lodged for sole proprietors.

Specifically, Figure 3-0-1 demonstrates that after the 1986 Tax Reforms S Corporations experienced accelerating growth while C Corporations declined in number in each following year up until 1993. As previously discussed in Chapter Two, these findings support the hypothesis that the 1986 Tax Reforms in the United States made the entity (classical) tax system applying to C Corporations more costly and consequently made flow-through taxation more attractive.¹⁴⁵ However, the filings of general partnerships declined after the 1986 Tax Reforms. This would tend to suggest that other non-tax costs, such as their lack of limited

¹⁴⁵ Gordon, RH, and MacKie-Mason, JK. (1990). Effects of the Tax Reform Act of 1986 on Corporate Financial Policy and Organizational Form, in *Do Taxes Matter? The Impact of the Tax Reform Act of 1986*, ed J. Slemrod, Chapter 4, Massachusetts Institute of Technology Press, at pp 91-140; and Ayers, B, Cloyd, CB, and Robinson, JR. (1996). Organizational Form and Taxes: An Empirical Analysis of Small Businesses, *Journal of the American Taxation Association*, 18 (Supplement): at p 49.

liability, did not make this business form attractive.¹⁴⁶ Also the growth in LLCs may represent the utilisation of this form in preference to general partnerships.

Figure 3-0-2: US: Comparison of LLC data sources

Source: 2000 – 2006 Annual Reports of the Jurisdictions of the International Association of Corporation Administrators; and Internal Revenue Service (US). (2002 – 2003) Tax Statistics Returns Filed for Individuals, Corporations and Partnerships. Available at: <http://www.irs.gov/taxstats/index.html>

The tax data demonstrates that the growth of LLCs was gradual until the mid-1990s. In this context, Chapter Four will argue that this gradual growth may be due to the uncertainty surrounding the tax treatment of LLCs, because of the application of the Kintner Regulations. Significantly, this uncertainty was largely removed with the introduction of the Check-the-Box regulations in 1996 that allowed LLCs to automatically have flow-through treatment, rather than having to satisfy the Kintner Regulations.

¹⁴⁶ Scholes, MS, and Wolfson, MA. (1986). Taxes and Organization Theory, Paper for the Yale Conference on Economics of Organization, as cited in: Guenther, DA. (1990). The Effect of Income Taxes on the Form of Business Entity. PhD, University of Washington. Scholes, MS, and Wolfson, MA. (1989). Issues in the Theory of Optimal Capital Structure, in *Frontiers of Modern Financial Theory*, ed S. Bhattacharya & G. Constantinides, New Jersey: Rowman & Littlefield, at pp 49-74. Scholes, MS, and Wolfson, MA. (1992). *Taxes and Business Strategy: A Planning Approach*, New Jersey: Prentice-Hall Inc.

While there is an increase in the popularity of LLCs, this has not caused a concomitant reduction in the utilisation of S Corporations. Since the mid-1990s both S Corporations and LLCs tax filings have increased. While the rate of increase of tax filings for LLCs was initially greater, it has dropped from 2001 to approximately a 15 per cent annual increase.¹⁴⁷ S Corporations utilisation has had a steady growth rate of approximately 6 per cent per annum since 1994.¹⁴⁸ It is argued that, given the continued growth in S Corporation tax filings, there must be some important distinctions with S Corporations relative to LLCs. These distinctions will be analysed in later chapters, particularly in relation to loss allocations (Chapter Six); complexity (Chapter Seven); tax impost, particularly for active members (Chapter Eight) and governance (Chapter Nine).

In considering other business forms in the United States, the number of LLPs is relatively low compared to the number of S Corporations and LLCs. This could be because LLPs are mainly utilised by professionals.¹⁴⁹ In 2003 there were only 88,000 LLPs filing information returns with the United States IRS. The number of limited partnerships has remained relatively stable, with 378,921 filing information

¹⁴⁷ The annual rates of increase for LLCs for tax purposes have been: 1994: 176%; 1995: 148%; 1996: 87%; 1997: 58%; 1998: 35%; 1999: 25%; 2000: 22%; 2001: 13%; 2002: 17% and 2003: 15%. According to the International Association's data, the growth rate of LLCs from 2001 appears to be 2002: 37 per cent, 2003: 22 per cent; 2004: 19 per cent; 2005: 17 per cent. However this data for the 2001 to 2003 is overstated as it includes both domestic and foreign LLCs as they would include where one LLC is registered in more than one jurisdiction. In absolute terms there appears to be a 19 per cent increase in total domestic LLC on file (good standing or active) for the 2004:2005 period. This is based on estimates of the total number of LLCs as reported in the *2006 Annual Reports of the Jurisdictions of the International Association of Corporation Administrators*. The allocation has been done on the percentage of new foreign and domestic filings for the 2005 year. This growth rate is slightly greater than that demonstrated by the tax data lodgements of 15 per cent for the 2003 year.

¹⁴⁸ The annual rates of increase for S Corporations have been: 1994: 6%; 1995: 6%; 1996: 7%; 1997: 6%; 1998: 6%; 1999: 5%; 2000: 5%; 2001: 4%; 2002: 6% and 2003: 6%.

¹⁴⁹ Limited liability partnerships became popular with law firms and accounting firms. See. Wolfram, CR. (1998). Inherent Powers in the Crucible of Lawyer Self-Protection: Reflections on the LLP Campaign, *S. Texas Law Review* 39:359; Macey, J, and Sale, HA. (2003). Observations on the Role of Commodification, Independence, and Governance in the Accounting Industry, *Villanova Law Review* 48:1167.

returns in 2003.¹⁵⁰ It appears that the number of general partnerships in the United States is declining; the implications of this will be discussed in Chapter Nine.¹⁵¹ The popularity of sole proprietors in the United States could represent the large percentage of business operations conducted on an informal basis.

Figure 3-0-3: US: Business form net assets held

Source: Internal Revenue Service (US). (1986-2003) Tax Statistics Returns Filed for Corporations and Partnerships. Available at: <http://www.irs.gov/taxstats/index.html>

The sheer quantity of business forms utilising a particular structure can be a poor measure of the amount of economic activity these business forms undertake. To this extent, a more informative measure would be their asset values. While the data is limited, it appears that the LLCs, in aggregate, do indeed hold substantially more assets than S Corporations, although falling well short of C Corporations.

¹⁵⁰ Friedman, n 141, at pp 9-10. Limited partnerships are widely used in oil and gas exploration, real estate investment, equipment leasing, motion picture financing and other tax shelters.

¹⁵¹ The annual rates of decline for general partnerships have been: 1994: 0%; 1995: 0%; 1996: 0%; 1997: -4%; 1998: -1%; 1999: -5%; 2000: 0%; 2001: -6%; 2002: 0% and 2003: -3%.

Figure 3-0-3 demonstrates that in 2003 S Corporations held US\$604 billion worth of assets, while LLCs held US\$3,416 billion. It is not clear why this is the case, but it could be due to the LLC form being favoured in certain industries with greater asset holdings, as it appears that greater investment income is being derived through LLCs. LLCs may be the preferred investment vehicle for real estate, due to possible tax deferral through rollovers, non-application of the at-risk rule and a cost basis increase on death.¹⁵² Also, if the favouring of LLCs may relate to compliance cost issues in different industries. For 2003 LLCs generated USD\$64 billion from non-investment income, and USD\$92 billion from investment income. In comparison, S Corporations generated more net income from non-investment activities (USD\$213 billion), with an actual loss of investment income (USD\$63.5billion). Refer to Figure 3-0-4.

Figure 3-0-4: US: Business form net income derived

Source: Internal Revenue Service (US). (1986 – 2003) Tax Statistics Returns Filed for Corporations and Partnerships. Available at: <http://www.irs.gov/taxstats/index.html>. The figures included investment income as well.

¹⁵² The at-risk rule is discussed further in Chapter Six.

3.2.4.2 United Kingdom

In terms of the United Kingdom, Figure 3-0-5 demonstrates that the private corporation predominates as the most popular organised business form, with over two million registered in 2006. However, when private corporations are excluded it becomes clear that there is growing utilisation of LLPs since their introduction in 2001: Figure 3-0-6. There are a total of 17,499 LLPs registered in 2006, although this figure falls short of the original estimate of 60,000 by the Department of Trade and Industry (UK) when they were introduced.¹⁵³ The United Kingdom's registration of LLPs spiked at a 129 per cent increase in 2003, with registration increasing now between 60 and 40 per cent per annum. Even with these large increases, the total number of LLPs registered in 2006 represents less than one per cent of the total number of private corporations.¹⁵⁴ Indeed, the introduction of LLPs has not hindered the growth of private corporation registration, as since 2003 private corporation numbers have increased at an average annual rate of 9.5 per cent. In the unlikely event that LLPs continue to increase at a rate of 50 per cent per annum, it would take until 2018 for LLPs to reach the current 2006 utilisation of private corporations in the United Kingdom. However, it is unlikely that LLPs will continue to increase at such a large growth rate.¹⁵⁵

In comparison, after the first five years of New Zealand's transparent company there were 31,000 LAQCs even though New Zealand's economy is smaller than that of the United Kingdom.¹⁵⁶ However, the utilisation of LLPs in the United Kingdom compares favourably to the initial slow utilisation of LLCs in the United

¹⁵³ House of Commons – Select Committee, n 62, at paragraph 27.

¹⁵⁴ For the 2006 year the amount of LLPs registered represent 0.8 per cent of private corporations registered. (17,499 LLPs : 2 million corporations)

¹⁵⁵ It should be acknowledged that in absolute terms the percentages can be misleading when starting from such a low base.

¹⁵⁶ Given that the United Kingdom's economy is larger than New Zealand, the differences in utilisation means there is a large disparity.

States.¹⁵⁷ This may be attributable to the greater initial certainty about the tax treatment of the United Kingdom's LLP compared with LLCs, as well as the fact that only two American states provided an LLC statute, as of 1988.¹⁵⁸

Figure 3-0-5: UK: Business forms registered

Source: Department of Trade and Industry. (2001 – 2006). Reports for the year ended 31 March presented pursuant to the Companies Act 1985 section 729.

To validate this data, comparisons have been made to the United Kingdom's Value Added Tax (VAT) registration. Even though in 2006 there were over two million private corporations registered with the Department of Trade and Industry, only approximately 800,000 of these were registered for the United Kingdom's VAT. This would indicate that the remaining corporations are dormant or have no business trading activity, or that their level of trading activities falls below the VAT

¹⁵⁷ LLCs were originally introduced in 1977 by one American state, Wyoming. Refer to the discussion in Chapter Four.

¹⁵⁸ Wyoming and Florida. Refer to the discussion in Chapter Four.

registration requirement.¹⁵⁹ Even so, Figure 3-0-7 re-enforces the dominance of the corporate form in the United Kingdom, compared to sole proprietors and partnerships. Unfortunately, the VAT data does not distinguish between the different partnership types available in the United Kingdom.

Figure 3-0-6: UK: Business forms (excl. private corporations)

Source: Department of Trade and Industry. (2001 – 2006). Reports for the year ended 31 March presented pursuant to the Companies Act 1985 section 729.

¹⁵⁹ These estimates are back-up by statements within Crawford and Freedman, J. n 142.

Figure 3-0-7: UK: VAT registered business forms

Source: Office of National Statistics. (2006 – 2001) UK Business Activity, Size and Location. Office of National Statistics, London. Tables on Number of VAT based Enterprises

Figure 3-0-6 also demonstrates that limited partnerships utilisation is on the increase, and public corporations are steady. The increase in limited partnership may be generated from venture capital incentives, as limited partnerships are the vehicle of choice for such investments.

Unfortunately, there is no readily accessible data on the actual income or assets levels of specific United Kingdom business forms. It is therefore not possible to ascertain the extent of the economic activity within each of these business forms.

3.2.4.3 New Zealand

From the limited data available, it appears that LAQCs since being introduced in 1992 have become a popular business form in New Zealand. LAQCs account for approximately one-quarter of corporate tax return lodgements, with 91,450

lodgements in 2005. This compares to 301,560 for other corporations, 208,670 for trusts,¹⁶⁰ 144,990 for general partnerships, and 170 for special partnerships. Sole proprietors accounted for the largest number of tax return lodgements, with 472,800 in 2005. Overall, excluding sole proprietors, LAQCs represent 12 per cent of business tax return lodgements.

Figure 3-0-8 demonstrates that in the first five years of their introduction, the number of LAQCs grew from approximately 15,000 in 1994 to 31,000 in 1998. This growth continued up until 2005, as Figure 3-0-9 demonstrates an increasing trend for all business forms except for sole proprietors lodging tax returns between 1997 and 2005.

Figure 3-0-8: NZ: Number of LAQCs

Source: Inland Revenue (NZ). (1999). Supplementary Briefing Papers Volume 1: Tax Policy. Wellington, at p 42.

¹⁶⁰ Of course not all trusts would be used for conducting business operations. Unfortunately, the data did not disclose the trusts' activity.

Figure 3-0-9: NZ: Tax lodgements

Source: Email correspondence from Inland Revenue (NZ) dated 22 March 2007; detailing the number of entities filing tax returns (that is active)

Unfortunately, there is no readily accessible data on the actual income or assets levels of the New Zealand business forms. It is therefore not possible to ascertain precisely the extent of the economic activity within each of these structures.

3.2.4.4 Australia

Given the recent introduction of transparent companies in Australia, there is only limited data available to demonstrate the number of venture ILPs that have been formed. Unfortunately it is not possible to ascertain how many taxpayers are utilising the CFC hybrid provisions.

Currently, according to data from AusIndustry there are 28 ILPs registered pursuant to the venture capital provisions, and another seven with conditional registration. This means there is currently a total of 35 venture ILPs in Australia,

with a vast majority of these registered in New South Wales (69 per cent) and Victoria (20 per cent), and the Queensland (6 per cent) and South Australia and Australia Capital Territory having one registered each. This data is detailed in Table 3-0-2.

Table 3-0-2: AUS: Venture capital ILPs registered

	New South Wales	Victoria	Queensland	Australian Capital Territory	South Australia
ILPs registered under the Venture Capital Act	18	6	2	1	1
ILPs conditionally registered	6	1			
Total ILPs	24	7	2	1	1

Source: AusIndustry. (2008). VCLP Registration List - representing limited partnerships registered with Innovation Australia under section 13-1 of the Venture Capital Act as venture capital limited partnerships at 17 June 2008: available at <http://www.ausindustry.gov.au/content/level3index.cfm?ObjectID=4E139D96-0AAC-4CC7-95F556C2B237CA31&L2Parent=AEB901E5-7CB8-4143-A3BF33B2423F9DA6> [viewed 3 July 2008]

As at 30 June 2005 investors had \$11.2 billion committed to venture capital investment vehicles (an increase of 25 per cent on the previous year) and \$6.1 billion committed funds had been drawn-down (an increase of 20 per cent on the previous year).¹⁶¹ Most of the equity investment for venture capital ILPs comes from Australian residents, even though their tax concessions are not as great as non-residents. For example, VCLPs had capital commitments of \$1,024 million, of this approximately 87 per cent (\$887 million) was from domestic sources and 13 per cent (\$137 million) from foreign sources. As at 30 June 2005, VCLPs had drawn down \$77 million of their committed capital and invested \$57 million in

¹⁶¹ Barkoczy and Sandler, n 82, at p 18: In its sixth annual survey of venture capital in Australia, the Australian Bureau of Statistics.

nine companies.¹⁶² Therefore, it is uncertain how successful the regime has been in attracting foreign investment to Australia.

3.3 Conclusion

To enhance understanding and comprehension of the notion of tax transparent companies, this chapter sought firstly to articulate a precise definition of 'tax transparent company', for this in turn to provide the foundation for subsequent analysis in the following chapters of the dissertation. The characteristics of tax transparent companies were specified as being separate legal entity status, limited liability for members and tax transparent treatment. It was then described how each of the transparent companies studied exemplifies these characteristics, although it was noted that the LAQC is only a partial loss transparent company.

Subsequently, it was argued that the transparent companies studied could be classified into two different and distinct classifications — those being 'special tax rule companies' and 'new form transparent companies'. It was suggested that the identification of these two classifications may be informative for the later analysis.

To determine whether the transparent companies have been popular in their respective jurisdictions, an analysis of their utilisation rates was then undertaken. It appeared that the transparent companies are popular compared with other business forms in the United States and New Zealand, although sole proprietors are generally the most numerous. Based on tax lodgements, in the United States, S Corporations and LLCs represent 57 per cent of business forms (excluding sole proprietorships), and in New Zealand LAQCs represent 12 per cent of all business forms (excluding sole proprietors). Whereas the United Kingdom's LLP, based on registration data, represents less than one per cent of

¹⁶² Barkoczy and Sandler, n 82, at p 18: In its sixth annual survey of venture capital in Australia, the Australian Bureau of Statistics.

businesses compared to private corporations. This popularity in the United States and New Zealand would suggest that the tax transparent companies must provide some benefit to businesses; however, whether this is based on tax reasons or otherwise is unclear. Currently in Australia there is only low utilisation of the venture capital ILPs.

Chapter Four will consider the reasons for the introduction of the foreign transparent companies, and reflect upon whether there is any relationship to tax neutrality and closely held businesses.

Chapter Four: Striving for tax neutrality?

4.1 Introduction

Chapter Two outlined various economic arguments to support the notion that tax transparency can achieve greater tax neutrality for business forms. However, the question needs to be raised as to whether the introduction of the transparent companies studied been to realise this economic ideal or are other reasons are more explanative. Furthermore, what legislative and policy focus has been accorded to closely held businesses with their introduction. An understanding of the reasons behind their introduction may assist in determining what factors are likely to influence transparent company reform in Australia. In particular, the question needs to be raised as to whether this analysis can establish any similarities among the jurisdictions studied.

Initially, the United States' experience will be considered in relation to S Corporations and limited liability companies (LLCs). Following this analysis, attention will shift to the implementation of limited liability partnerships (LLPs) in the United Kingdom. Finally, the motivating factors behind the introduction of New Zealand's transparent company, the Loss Attributing Qualifying Companies (LAQC), will be discussed. Through this analysis it will be argued that there is a discernable relationship between the classifications of transparent companies established in Chapter Three tax neutrality and closely held businesses.

For the 'special tax rule companies' — which encompasses S Corporations and LAQCs — the desire for improved tax neutrality between business forms when membership is closely held was explicit with their introduction. In this respect, both the United States and New Zealand governments sought (explicitly) to reduce the tax system's influence over the choice of a corporation or a general partnership for closely held businesses.

In terms of the ‘new form transparent company’ paradigm — which encompasses both LLCs and LLPs — the attainment of tax neutrality is not as explicit as with special tax rule companies. However, it should be noted that breaches of tax neutrality between business forms did underpin the reform. The combination of factors led initially to large closely held businesses to lobby for the introduction of LLCs and LLPs, and this in turn prompted competition among jurisdictions — particularly once one jurisdiction had introduced this new form.

4.2 United States: S Corporations

In terms of the ‘special tax rule company model’, the United States first introduced the S Corporation in 1958, with the regime subject to extensive reforms in the 1980s,¹ and then again in the 1990s. To review, Chapter Three demonstrated that the S Corporation is not a new business form; but instead a set of special tax rules for closely held corporations, taking its name from the location of these rules in Sub-Chapter S of the *Internal Revenue Code 1986* (US) (IRC 1986 (US)).

The notion of tax neutrality and the consideration of closely held businesses are very explicit, with the introduction of S Corporations. In particular, the United States Congress referred to the pursuit of tax neutrality in the original enactment of Sub-Chapter S, as the explicit purpose was to permit ‘a business to select its

¹ *Subchapter S Revision Act of 1982* (US). These reforms included that a new member accepts S Corporation status as the member finds it; 50 per cent of members can elect to terminate S Corporation election; differences in voting rights do not create a second class of share; unused losses can be carried forward indefinitely; relaxing the passive investment income limitation and the removal of the termination because of 80 per cent or more foreign income. See: Klein, WA, and Zolt, EM. (1995). Business Form, Limited Liability, and Tax Regimes: Lurching Toward a Coherent Outcome? *University of Colorado Law Review* 66(4):1001, at p 1004. Note there are currently further amendments to Sub-Chapter S being considered. See: *S Corporation Reform Bill 2005* (US).

legal form without the necessity of taking into account major differences in tax consequences'.²

In this way closely held businesses could choose their business form based on regulatory requirements and other legal characteristics rather than on the tax consequences.³ This was because a corporation or a general partnership form could be adopted, and in either circumstance transparent treatment could apply.⁴ In this respect, the goal of enhanced tax neutrality appeared to be sincere and genuine, as Sub-Chapter R, which allowed general partnerships to elect for entity tax treatment, was also introduced in 1958.⁵ However, as was discussed in Chapter Three, for a corporation to be eligible for transparency as an S Corporation, strict eligibility criteria must be satisfied.

Another explicit goal underpinning the introduction of S Corporations related to relieving businesses from the United States' entity tax treatment of C Corporations, which provided no tax integration between corporations and their members. Also it should be noted that the ability of members to take immediate advantage of corporate losses was expressed as an outcome with the introduction of S Corporations.⁶

The focus on closely held businesses with the introduction of S Corporation is evident through the initial eligibility requirements that membership could not exceed ten. While this restriction has been relaxed over the years to now allow

² S. Rep. No. 1983, 85th Cong, 2d Sess. 85-89 (1958). Klein and Zolt, n 1, at p 1004, and Callison, JW. (2004). Federalism, Regulatory Competition, and the Limited Liability Movement: The Coyote Howled and the Herd Stampeded. In *The Governance of Close Corporations and Partnerships: US and European Perspectives*, edited by J. McCahery, T. Raaijmakers and E. Vermeulen. Oxford: Oxford University Press, at p 251.

³ McNulty, JK. (1992). *Federal Income Taxation of S Corporations*. New York: The Foundation Press Inc, at p 1.

⁴ However, they are not exactly the same as their tax transparency is facilitated under different Sub-Chapters of the *IRC (US)* 1986.

⁵ Note Sub-Chapter R was subsequently repealed.

⁶ McNulty, n 3, at p 1.

for 100 members, it is not possible for the membership interest of an S Corporation to be publicly traded.⁷

Furthermore when the S Corporation regime was subjected to extensive legislative reforms in 1982, the goals of tax neutrality as well as legislative simplification were emphasised.⁸ There is some academic debate that the 1982 reforms were also a response to the changes that had occurred with the limited partnerships governance regimes,⁹ with some commentators, indeed, being cynical as to what part 'tax neutrality' really played.¹⁰ It appears the 2004 reforms were in part to offer more incentives to S Corporations because of their reduced tax advantage because of the temporary tax relief on dividends paid by C Corporations.¹¹

Nevertheless, it is beyond dispute that the goal of tax neutrality for closely held businesses appears to have been the overarching aim with the introduction of S Corporations. Whether tax neutrality has been achieved or realised is debatable. Despite this Sub-Chapter S is regarded as a substantial aid to closely held businesses, and facilitative of tax neutrality.¹²

⁷ Originally, back in 1958 initially only ten members were allowed; subsequent amendments raised the number to 15 (1976), then 25 (1981), then one year later to 35 (1982), then 75 (1997) and finally 100 (Starting 1 January 2005: Amended by section 232 of *American Jobs Creation Act 2004* (US), amending *IRC 1986* (US), section 1361(b)(1)(A)). This limitation applies to the number of members at any one time during the taxable year.

⁸ *Subchapter S Revision Act of 1982* (US). Eustice JS. (1983-84). Subchapter S Corporations and Partnerships: A search for the pass through paradigm (some preliminary proposals). *Tax Law Review* 39: 345, at p 347.

⁹ Ribstein, LE. (2005). The Important Role of Non-Organization Law. In *Illinois Law and Economics Working Paper Series: Working Paper No. LE05-014*. Champaign: University of Illinois College of Law, at p 16 reports that the 1982 reforms were in response to the reforms that had occurred in the states with limited partnerships.

¹⁰ Eustice, JS. (1983-1984). Subchapter S Corporations and Partnerships: A search for the pass through paradigm (some preliminary proposals). *Tax Law Review* 39:345, at p 347: 'the 1982 revision it also gave lip service to the tax neutrality goal'.

¹¹ Landau, Z. (2005). Recent Reform and Simplifications for S Corporations. *The CPA Journal* [cited 6 January 2008]. Available from <http://www.nysscpa.org/cpajournal/2005/1105/essentials/p46.htm>: referring to Speakers at the congressional session.

¹² Caplin, MM. (1961). Income Tax Pressures on the Form of Business Organization: Is it time for a 'doing business' tax? *Virginia Law Review* 47:249, at p 249.

4.3 United States: LLCs

In contrast to S Corporations, the introduction of LLCs in the United States has been more complex and multi-faceted. The legislative creation of LLCs has fueled debate within the United States about its precise origin, tax treatment and governance. Several commentators, indeed, have considered the emergence of LLCs at length, such as Bratton and McCahery,¹³ Callison,¹⁴ Goforth,¹⁵ Ribstein¹⁶ and Hamill.¹⁷ While this dissertation will draw upon the findings of these prior studies, it will do so from the point of view of tax neutrality and closely held businesses. While these themes are alluded to in the prior literature they have not served as a major focal point. Indeed, it will be argued that breaches of tax neutrality and the role of large closely held businesses are central factors that are informative and explanative of the introduction of LLCs. These factors also promoted competition among the American states — particularly once the tax transparent treatment of LLCs was assured. There has been some debate that this process may have resulted in a business form with improved governance. Each of these contentions is in turn explored below.

¹³ Bratton, WW, and McCahery, JA. (1997). An Inquiry into the Efficiency of the Limited Liability Company: Of Theory of the Firm and Regulatory Competition. *Washington and Lee University Law Review* 54:629.

¹⁴ Callison, n 2.

¹⁵ Goforth, CR. (1995). The Rise of the Limited Liability Company: Evidence of a Race Between the States, But Heading Where? *Syracuse Law Review* 45:1193.

¹⁶ Ribstein, LE. (1995). Statutory Forms for Closely Held Firms: Theories and Evidence from LLCs. *Washington University Law Quarterly* 73 (2):369.

¹⁷ Hamill, SP. (2005). The Story of LLCs: Combining the Best Features of a Flawed Business Tax Structure. In *Business Tax Stories: An In-depth look at ten leading developments in Corporate and Partnership taxation*. Foundation Press.

4.3.1 Breaches of tax neutrality

The central contention of this section is that breaches of tax neutrality between business forms in the United States, which was ‘aggravated’ by the entity approach adopted for C Corporations, acted as a significant catalyst for change.¹⁸

It should be recalled that the United States’ 1986 Tax Reforms accentuated the double taxation with C Corporations by causing the top corporate tax rate to exceed the top individual rate and eliminating the lower capital gains tax (CGT) rate on the disposal of membership interests.¹⁹ Prior to 1986 the corporate tax rate was lower than that of individuals, so the effect of an entity tax system in the United States could be mitigated by corporations retaining income, and members realising their gains through lower taxed capital amounts — or even nil if membership interests were held until death.²⁰

This entity tax approach that applied to C Corporations had the effect of producing breaches of tax neutrality, particularly compared to business forms subject to tax transparency (or the aggregate approach). Also, there were breaches of tax neutrality in terms of both debt versus equity funding and retention versus distribution. When the first LLC was legislated, tax transparency applied only to sole proprietors, partnerships (including general and limited partnerships) and S Corporations. For various reasons these transparent forms could be problematic and not available to all businesses. Hence, in adopting

¹⁸ Outlined in Chapter Two was the entity tax treatment that applies to United States’ corporations — known as C Corporations — with tax levied at the business form and then subsequently again to members on the distribution of profits.

¹⁹ *Tax Reform Action Act 1986* (US). For a more detailed discussion of this refer back to Chapter Two.

²⁰ Friedman, HM.(2004). The Silent LLC Revolution - The Social Cost of Academic Neglect. *Creighton Law Review* 38(1), at pp 7-8: A membership interest held until death could get a stepped-up cost basis and the capital gain would not be taxed. *IRC 1986* (US), section 1014 provides that membership interest acquired from a decedent will acquire a basis equal to its fair market value at the date of the member’s death.

Scholes and Wolfson's discourse, there may have been an uneasy trade-off between 'tax costs' and 'transaction costs' in choosing between the different business forms.²¹

As an illustration of this point, with sole proprietors and partnership forms the transaction costs may have been too high when compared with the tax savings available via transparency. The transaction costs may have related to the lack of liability protection for members and separate legal entity status.²² Similarly, for limited partnerships, there were concerns that courts would not fully recognise the reforms in the United States that improved the liability position of limited members. Furthermore, restrictions on the place of business and the number of members could have served to increase their transaction costs.²³ While S Corporations had similar transaction costs to C Corporations — particularly in terms of limited liability for members and the governance framework — the eligibility restrictions for transparency meant that S Corporations were not widely available.

Indeed, the United States' entity system has been described as 'aggravating' biases with respect to choice of business form, capital structure and profit distributions.²⁴ It is argued that this so-called 'aggravation', due to breaches of tax neutrality, served as a catalyst for change to provide a business form that provided a preferable balance between tax and transaction costs. This is supported by Hamill's conclusion that the LLC company form resulted from 'sparks of unpredictable human creativity being ignited'.²⁵

²¹ Refer back to Chapter Two's detailed discussion of Scholes and Wolfson's theory: Scholes, MS, and Wolfson, MA. (1992). *Taxes and Business Strategy: A Planning Approach*, New Jersey: Prentice-Hall Inc.

²² Note there have been some reforms in the United States to provide general partnerships with separate legal entity status.

²³ Hamill, n 17, at p 295.

²⁴ Klein and Zolt, n 1, at p 1016.

²⁵ Hamill, SP. (1996). The Limited Liability Company: A Catalyst Exposing the Corporate Integration Question, *Michigan Law Review* 95:393, at p 397.

LLCs represent the creation of a new business form — one that is distinct from corporations, general partnerships and limited partnerships, although sharing some characteristics. Obviously, this required the enactment of legislation which allowed for the establishment of LLCs. Wyoming was the first American state to enact LLC legislation in 1977.²⁶ Pivotal to Wyoming's enactment of the LLC legislation was the federal tax treatment of this new business form. This is particularly highlighted by the fact that the interest group who was successful in obtaining the enactment of the Wyoming LLC quickly applied to the United States Internal Revenue Service (United States IRS) that the LLC should be taxed as a general partnership with, importantly, tax transparency applying.²⁷ The attainment of transparency through general partnership tax treatment under Sub-Chapter K of *IRC 1986* (US) would address breaches of tax neutrality within the United States.

However, the taxation of the Wyoming LLC as a general partnership was not certain because the LLC possessed some significantly *corporate* characteristics — particularly that corporate characteristic of limited liability. In 1977 a revenue ruling of the United States IRS applied a four factor test to determine whether a business form was a corporation for tax purposes.²⁸ These regulations were popularly known as the Kintner Regulations, with the four factors being continuity of life,²⁹ free transferability of interests,³⁰ centralised management,³¹ and limited

²⁶ Wyoming. STAT. section, 917.15.101 to 17-15-136 (1977).

²⁷ Goforth, n 15, at p 1200.

²⁸ Treasury Regulation, section 301.7701-2(a) (2). The rules governing whether a particular business organisation will be classified as a certain form for tax purposes can be traced back to the Supreme Court in *Morrissey v. Commissioner* 296 U.S. 344 (1935). Note there were actually six characteristics but two of the characteristics (a) associates and (b) objective to carry on business for joint profit were common to both general partnerships and corporations, so these two were disregarded.

²⁹ Treasury Regulation section 301.7701-2(b)(i): The characteristic of continuity of life exists when the entity continues to exist after the death, retirement, resignation, incapacity, bankruptcy or insolvency of one or more of its members. Goforth, n 15, at p 1212: "The IRS has indicated that so long as the affirmative vote of at least a majority of the remaining members is required to continue the LLC in existence, the LLC will still lack the characteristic of continuity of life: *Glensder Textile Co. v. Comm'r*, 46 B.T.A. 176 (1942)".

³⁰ Treasury Regulation, section 301.7701-2(e)(1): Free transferability of interests requires that substantially all owners have the power to transfer all attributes of ownership, including the right

liability. One possible interpretation of these regulations was that they required the presence of at least two of these corporate factors, in addition to limited liability, for a business form to be taxable as a corporation. It is appropriate at this juncture to refer back to the continuum outlined in Figure 1-0-1 of Chapter One. Significantly, the United States IRS used the factors specified in the Kintner Regulations to determine precisely *where* on the continuum the business form would be taxed. If sufficient corporate factors were present then the business form would be subject to an entity tax approach, otherwise, an aggregate (transparent) tax approach would apply.

The Wyoming LLC was purposefully drafted so it possessed limited liability and centralised management but lacked continuity of life and free transferability of interests. Accordingly, if the four factors of the Kintner Regulations were equally weighted, it was argued that the Wyoming LLC should be tax transparent as a general partnership.

Initially, the United States IRS issued a private letter ruling specifying that the Wyoming LLC would be subject to tax transparency as a partnership.³² However, the United States IRS promptly proposed regulations which signalled that the presence of limited liability alone could cause a business form to be considered a corporation for tax purposes.³³ The ruling stated that the proposed regulations were not effective until 1 January 1983 and applied to organisations formed on or after 17 November 1980.

Due to widespread and pervasive criticism, the United States IRS withdrew these proposed regulations in 1983, announcing it was undertaking a 'study of the

to participate in management, without obtaining consent from any other owner. Free transferability will not exist if the member has the right to transfer only the right to participate in distributions and not in management.

³¹ Treasury Regulation, section 301.7701-2(c)(3): Centralization of management requires concentration of continuing exclusive authority to manage the entity without the approval of other members.

³² Private Letter Ruling 81-06-082 (Nov. 18, 1980).

³³ Proposed Treasury Regulation, section 301.7701-2; 45.

rules'.³⁴ There was then a period of uncertainty as the United States IRS would not issue other private rulings on the classification of other LLCs.³⁵ Eventually, eleven years after Wyoming enacted its LLC, the United States IRS decided how the LLC would be characterised for tax purposes. In 1988 the United States IRS ruled that the Wyoming LLC would be classified as a general partnership for tax purposes, and thereby facilitate tax transparency.³⁶ After this ruling there was a rapid move to lobby for the enactment of LLCs across the United States. In particular, lobbying saw LLCs enacted from two states in 1988 to *all* fifty states of the United States (as well as the District of Columbia) only seven years later.³⁷

Accordingly, it is argued that tax transparency was critical for the introduction of the LLC. This is re-enforced by the fact that the LLC statutes were drafted to ensure, pursuant to the Kintner Regulations' four factor test, that tax transparency should apply. Research by Ribstein demonstrates the existence of provisions in the various statutes to ensure that the LLC would not be classified as a corporation for tax purposes.³⁸ In fact, the influence of the Kintner Regulations is explicit in many of the LLC statutes. Some statutes provided that they should be applied to 'permit a limited liability company to qualify for taxation as an entity that is not an association taxable as a corporation under the *IRC* (US) of 1986'.³⁹ Federow argues that the influence of the Kintner Regulations to ensure tax transparency may have compromised the drafting of the LLC

³⁴ IRS. (1982). *News Release IR-82-145* (16 Dec); *IRS Announcement* 83-4, 1983-2 IRS. 30 (14 Jan. 1983).

³⁵ Revenue Proc. 83-15, 1983-1 C.B. 676. Issued 14 March 1983.

³⁶ Revenue Ruling 88-76, 1988-2 C.B. 361. Relying on the Tax Court's holding in *Larson v. Commissioner*, 66 T.C. 159 (1976) that each corporate characteristic must be given equal weight.

³⁷ Hamill, SP. (1995). The Taxation of Domestic Limited Liability Companies and Limited Partnerships: A Case For Eliminating the Partnership Classification Regulations. *Washington University Law Quarterly* 73:565, at p 566. The number and timing of states introducing LLCs, where: 1977: One state, 1982: One State; 1990: Two states; 1991: Four states; 1992: Ten states; 1993: 18 states; 1994: 12 states; 1995: 3 states.

³⁸ Ribstein, n 16, at p 384: 15 PA. CONS. STAT. 8915 (Supp. 1994).

³⁹ Ribstein, n 16, at p 384: 15 PA. CONS. STAT. 8915 (Supp. 1994).

legislation.⁴⁰ The potential adverse influence of the Kintner Regulations is considered in more detail in the analysis in Chapter Nine concerning governance.

However, the ambiguity concerning the presence or not of the four factors in the Kintner Regulations and the variations among the American states saw business taxation in ‘conceptual disarray’.⁴¹ For example, an LLC was taken to lack the corporate characteristic of ‘continuity of life’ if on the death of one of its members there was a required vote of the majority of remaining members for the LLC to continue.⁴² Variations among LLC legislation made it harder for the United States IRS to justify when tax transparency would or would not apply. That is, the formulation of tax neutrality of the basis of the Kintner Regulations was increasingly difficult to justify. This ambiguity meant taxpayers, their advisers and the United States IRS expended a tremendous amount of resources on determining the appropriate tax treatment of LLCs.⁴³

In 1996, this uncertainty led the United States IRS to release new regulations that allowed many business forms to simply elect whether they would be taxed as C Corporations or as general partnerships.⁴⁴ This became known as the so-

⁴⁰ Ribstein, LE, and Sargent MA, eds. (1996). Check-the-Box and Beyond: The Future of Limited Liability Entities. *The Business Lawyer* 52, at p 612: per Federow.

⁴¹ Maine, JA. (2001). Linking Limited Liability and Entity Taxation: A Critique of the ALI Reporters' Study on the Taxation of Private Business Enterprises. *University of Pittsburgh Law Review* 62:223, at p 236. For example, as some states had flexible LLC acts which permitted businesses the freedom to organise LLCs in a variety of patterns, including characteristics that would mean failure to qualify as a partnership for federal tax purposes: Goforth, n 15, at p 1206.

⁴² Treasury Regulation, section 301.7701-2(b)(l).

⁴³ Snider, K, and Spiro, D. (2005). Tax Planning for U.S. Limited Liability Companies Investing in Canada. *Tax Notes International* July:151, at p 1153: For example, between the time that Revenue Ruling 88-76 was issued and when Notice 95-14 was promulgated, the United States IRS issued 17 revenue rulings analysing various state LLC acts, in addition to issuing numerous revenue procedures and letter rulings. Hamill, n 37, at p 589.

⁴⁴ Treasury Regulation, section 301.7701-2(b); commencing 1 January 1997. Kwall, JL. (2005). *The Federal Income Taxation of Corporations, Partnerships, Limited Partnerships, Limited Liability Companies, and their Owners*. 3rd ed. New York: Foundation Press, at p 189: “In 1996, regulations were promulgated that automatically tax most non-publicly traded, unincorporated enterprises with at least two members as partnerships, unless the enterprise elects to be taxed as an association. Also an eligible entity with a single member can be classified as an association or can be disregarded as an entity separate from its member. Initially this was announced in I.R.S. Notice 95-14, 1995-14 IRB. in response to President Clinton’s February 21, 1995 announcement

called federal ‘Check-the-Box’ regulation. As already outlined in Chapter Three, despite the presence of this Check-the-Box regulation, certain business forms must be classified as a corporation for tax purposes — including entities actually incorporated under state law, a publicly traded entity, and certain foreign business forms. The exclusion of ‘state law corporations’⁴⁵ means that corporations formed within the United States cannot simply *Check-the-Box* for tax transparent treatment in the United States, and must instead meet Sub-Chapter S eligibility requirements to achieve tax transparency.⁴⁶ However, for LLCs there was improved tax certainty with the introduction of the Check-the-Box regulation, which saw their continued utilisation, as already illustrated by the increased tax filings in Chapter Three: Figure 3-0-1.

This sequence of events would tend to indicate that the LLCs’ tax treatment was, indeed, a motivating factor for their rapid spread across the United States. Tax transparency, applying to LLCs, meant greater tax neutrality achieved within this form,⁴⁷ as well as between business forms in the United States.

The conclusion that the tax treatment of the LLCs was, in fact, pivotal to its introduction in the United States is a very significant one and requires elaboration. This is because the United States utilises an entity (classical) tax

to identify, regulations that have become obsolete or unduly burdensome: President’s Remarks on Regulatory Reforms, 31 Weekly Comp Press (Feb. 21, 1995)”.

⁴⁵ State law corporations are corporations formed under corporation’s acts, such as those based on the *Model Corporation Act*. Business entities formed in the United States are always taxable as corporations if they are described in one of the following categories (a) the entity is formed under a federal or state legislation, or under a legislation of a federally; (b) recognized Indian tribe, and the legislation describes or refers to the entity as incorporated or as a corporation, body corporate, or body politic; (c) the entity is organized under a state legislation which describes the entity as a joint-stock company or joint-stock organization; (d) the entity is an insurance company; (e) the entity is a state-chartered business entity conducting banking activities and has deposits insured under the Federal Deposit Insurance Act or a similar legislation; (f) the entity is a business entity wholly owned by a state or political subdivision of a state; or the entity is taxable as a corporation under other provisions of the Internal Revenue Code (for example, real estate investment trusts and regulated investment companies): Treasury Regulation, section 301.7701-2(b)(1)-(7).

⁴⁶ Treasury Regulation, section 301.7701-2(b)(1)-(7).

⁴⁷ For example, the application of tax transparency would lead to great tax neutrality between debt and equity funding.

system for its C Corporations, although it should be noted that this has been subject to temporary legislative relief from 2003 to 2010.⁴⁸ This entity approach is juxtaposed with the economic ideal that it should be the members of the corporation itself who are assessed *directly* on the income or losses of a business. Many other countries afford corporations or their members with some integrated tax relief — be it via imputation, dividend deduction or a split rate system.⁴⁹ Consequently, the appeal of a transparent company in countries with an integrated system may not be as substantial as found in the United States. However, in this regard it is interesting to consider the United Kingdom's and New Zealand's enactment of a transparent company, as both of these jurisdictions have an integrated tax system for corporate distributions. Therefore, an analysis of the economic impact of these jurisdictions' introduction of a transparent company may highlight important attributes.

4.3.2 Interest groups

The question needs to be raised, then, that if breaches of tax neutrality were the impetus and driving motivation behind the introduction of LLCs, who — or which pressure groups — lobbied for its introduction and implementation in the United States? It is argued that there are two distinctive stages in the lobbying for LLCs; the pre- and post- 1988 Revenue Rulings. Each of these stages is discussed below.

⁴⁸ There is temporary tax relief for the receipt of dividends and a 15 per cent rate applies until 2010. *IRC 1986* (US), section 1(h)(11) originally introduced by the *Jobs and Growth Tax Relief Reconciliation Act* (US) 2003 (passed May 2003). This reduced the top capital gains tax and dividend tax rate to 15 per cent (or 5 per cent for low income families and 0 per cent for the 2008 year only) for the period 1 January 2003 to 31 December 2008. This has now been extended to 2010 through the *Tax Increase Prevention and Reconciliation Act 2005* (US).

⁴⁹ Refer to the discussion in Chapter Two.

4.3.2.1 Pre-1988 Revenue Ruling

The actions of one large closely held business was instrumental and the driving force behind the enactment of the first LLC legislation. This business was the Hamilton Brothers Oil Company of Denver (the Hamilton Brothers), who operated as an independent oil exporter.⁵⁰ During the 1960s and 1970s, the Hamilton Brothers had used the Panamanian *Limitada* for foreign operations. The use of the *Limitada* meant that tax transparency applied as this was a general partnership for United States tax purposes even though it afforded some liability protection. However, utilisation of this foreign business form become problematic due to capital and quota restrictions, as well as concerns about whether the *Limitada's* liability shield would be recognised by jurisdictions outside of Panama.⁵¹ To address these concerns, the Hamilton Brothers wanted a United States business form that provided limited liability as well as affording tax transparent treatment. In this context, the United States' limited partnership was not an appropriate entity given that liability was imposed on general members,⁵² and that there was a legislative prohibition on limited members being actively involved in the business.⁵³ While there is still some academic contention regarding this point, the eligibility requirements for S Corporation status may have also contributed to a prohibition on their utilisation — particularly the requirements for one class of membership interest and United States residency for all members.

The Hamilton Brother's adviser, Frank M. Burke Junior, drafted the LLC legislation and with others initially approached the Alaskan government in 1975

⁵⁰ Callison, n 2, at p 242.

⁵¹ Hamill, n 17, at p 298.

⁵² However, at additional cost a corporation could have been used as the general member and satisfied certain net worth requirements of the United States IRS.

⁵³ This is even with the changes in the mid 70s and 80s with *Revised Uniform Limited Partnership Act*, particularly section 303.

and 1976 to introduce the legislation. However, the Alaskan government did not enact the legislation due to unrelated political reasons.⁵⁴

Subsequently, the Wyoming legislature was approached and this formal approach has been described as 'significant' in the academic literature.⁵⁵ This was because 'Wyoming is the least populated state in the United States, and has a small, informal, and accessible legislature'.⁵⁶ The Wyoming LLC received formal legislative recognition quickly in 1977 within one day after being introduced. It should be pointed out in this context that no committee hearings were held.⁵⁷ The speed of this legislative enactment is curious given that Wyoming was introducing a business form not previously available in any other American state. Callison raises the pertinent point as to whether in a more populous state oppositional forces would have mobilised, suggesting that Wyoming was 'the perfect state' for a well-organised interest group to introduce legislation.⁵⁸ There appears to have been little publicity or controversy concerning the legislation because of the support of a major state business.⁵⁹ Once Wyoming legislated for the LLC then, as previously discussed, the Hamilton Brothers approached the United States IRS advocating that tax transparency apply.

Between the enactment of the Wyoming LLC in 1977 and the 1988 Revenue Ruling there was little legislative movement or growth on Wyoming's LLC, as its tax treatment was being debated with the United States IRS. In the period from 1977 to 1988 only one other American state — Florida⁶⁰ — introduced similar LLC legislation and less than 100 businesses filed as LLCs in Wyoming.⁶¹

⁵⁴ H.R. 403 (Alaska); 1975 Reg. Sess. Hamill, n 17, at p 299.

⁵⁵ Callison, n 2, at p 242.

⁵⁶ Callison, n 2, at p 242.

⁵⁷ Callison, n 2, at p 242.

⁵⁸ Callison, n 2, at p 242.

⁵⁹ Carney, WJ. (1995). Limited Liability Companies: Origins and Antecedents. *University of Colorado Law Review* 66 (4):855, at p 857.

⁶⁰ In 1982. Fla. Stat. Ann. section 608.401 to 608.471 (West 1982). Goforth, n 15, at p 1200: Note the United States IRS issued a letter ruling on the Florida LLC and concluded that it should be

4.3.2.2 Post-1988 Revenue Ruling

Once the United States IRS issued its 1988 ruling that the Wyoming LLC would be taxed as a general partnership, there was a significant proliferation of LLC statutes across the United States. Recall that by 1988, the 1986 Tax Reforms had been legislated and the tax transparency applicable to LLCs meant that there was an alternative business form with liability protection that could circumvent the entity tax treatment of C Corporations. Other interest groups, particularly business lawyers, played an active part in the proliferation of LLC statutes across all fifty states and the District of Columbia within seven years of the 1988 Revenue Ruling.

Hamill has noted that two individuals, Barbara Spudis and Bob Keatinge, were particularly instrumental in the rise and coordination of LLC enactments across the United States in the early 1990s. These individuals established sub-committees on LLCs in the 'Tax' and 'Business' sections of the American Bar Association, leading efforts to study the LLC and successfully convince the Commissioners on the Uniform State Laws to produce a uniform LLC statute.⁶²

To analyse this proliferation, Bratton and McCahery⁶³ have applied interest group theory, arguing that business lawyers were a force in LLC enactments and noting Macey's observations that 'potential negative voices, specifically state treasurers, bankers, and the tort plaintiffs' bar, were not vocal'.⁶⁴ In this context, Bratton and McCahery point to the incentive that business lawyers may have had to support the legislation in order to increase their own fees.⁶⁵ In many instances the

taxed as a corporation, even though it largely mirrored the Wyoming LLC. Private Letter Ruling 83.04-138.

⁶¹ Ribstein, n 9, at p 296.

⁶² Hamill, n 17, at p 300.

⁶³ Bratton and McCahery, n 13, at pp 664-666.

⁶⁴ Macey, JR. (1995). The Limited Liability Company: Lessons for Corporate Law. *Washington University Law Quarterly* 73:433, at pp 452-453.

⁶⁵ Bratton and McCahery, n 13, at p 664.

involvement of business lawyers in the enactment of the LLC legislation was intimate as business lawyers or their associations served the drafting function as well as the lobbying function.⁶⁶

State bar associations were involved in lobbying for LLC legislation in several states such as Arizona and Delaware.⁶⁷ In other states, such as Indiana and New Hampshire, attorneys were equally significant in the drafting process.⁶⁸ Also accountants played a key role in supporting the legislation; for example in Alabama and Kentucky the Certified Public Accountants' groups supported the LLC legislation.⁶⁹

The legal professionals' interest in the introduction of the LLCs in their own state may have extended beyond their clients' interest, as the LLC represented a new business form with liability protection and transparency for their own operations.⁷⁰ In addition to professionals, local business groups were also supportive of LLCs, actively lobbying for them in a number of states.⁷¹

Bratton and McCahery's analysis notes that the possible dissenting voices of state treasurers were not significant even though the LLC implied decreased revenues for them. Their analysis concludes that this was because the income

⁶⁶ Bratton and McCahery, n 13, at p 664.

⁶⁷ Goforth, n 15, at pp 1272-73: State Bar Association committees or groups were involved in the drafting process for LLC legislation in Arizona, Connecticut, Delaware, Georgia, Iowa, Maryland, Michigan, and Minnesota. Montana, New Jersey, New Mexico, North Carolina, North Dakota, Ohio, Oregon, Oklahoma, Rhode Island, South Dakota, Tennessee, Texas. Virginia. Washington, and Wisconsin.

⁶⁸ Goforth, n 15, at pp 1272-73: See for example, Indiana, New Hampshire, and Arkansas. In other states, the State Bar Association was active in reviewing or lobbying for the LLC legislation, even though they were not involved in the actual drafting: Missouri, Nebraska and Nevada.

⁶⁹ Goforth, n 15, at p 1274: Accountants played an especially important role in Alabama, Arizona, Arkansas, Connecticut, Indiana, Kentucky, Louisiana, Michigan, Mississippi, Missouri, Montana, New Hampshire, New Jersey, New Mexico, North Carolina, North Dakota, Ohio, South Carolina, South Dakota, Tennessee, Utah, and Washington.

⁷⁰ However, in some states professionals are excluded from using the LLC form: Hillman, RW. *Organizational Choices of Professional Service Firms: An Empirical Study*. Davis: University of California, at p 10: for example California Corporation Code, section 17375.

⁷¹ Goforth, n 15, at p 1274: The role of business groups such as the Chamber of Commerce appears to have been particularly significant in Connecticut, Montana, New Hampshire, Utah and West Virginia.

tax revenue losses for state governments would be relatively trivial due to the fact that most corporate candidates for LLC reorganisation were already, presumably, S Corporations, with tax transparency.⁷² Whether this conclusion is entirely correct is questionable. It is predicated on the questionable assumption that corporations would have been eligible to elect for S Corporation status, despite the fact that eligibility requirements are restrictive.

However, in some states, concerns for the potential for lost revenue were raised and this was the most significant obstacle to the enactment of LLCs in New York,⁷³ with estimates placing the potential cost at \$50 million in five years.⁷⁴ The Department of Taxation in Rhode Island also raised questions about the revenue impact, although the possibility of attracting new business and other revenues to the state outweighed any potential costs.⁷⁵ Similarly, in the states of North Carolina and Tennessee the revenue authorities expressed concerns which led to fees being added to their LLC Acts to make them more revenue neutral.⁷⁶

Bratton and McCahery identified that banks may also have been a potential dissenting voice.⁷⁷ However, the writers concluded that banks could adjust their cost of credit to compensate for any additional risk presented by LLCs. Also, according to the two authors, banks could request additional securities, such as personal guarantees or mortgages, to provide them with more protection. By adopting these strategies, Bratton and McCahery thought that this explained precisely *why* banks would not expend financial resources and political capital on an opposition campaign.⁷⁸ Another reason in this respect may have been that some banks wanted *themselves* to access tax transparent treatment by lobbying

⁷² Bratton and McCahery, n 13, at p 664.

⁷³ Goforth, n 15, at p 1276.

⁷⁴ Cummins, H. (1994). State Considers the Un-Corporation Setups Good for Small Businesses, *Newsday*, Jan. 28, at p 43.

⁷⁵ Goforth, n 15, at p 1275.

⁷⁶ Goforth, n 15, at p 1275.

⁷⁷ Bratton and McCahery, n 13, at p 665.

⁷⁸ Bratton and McCahery, n 13, at p 665.

for reforms to the S Corporation eligibility requirements — which eventually succeeded in 1996.⁷⁹

In a small number of states other concerns were further raised about the LLC.⁸⁰ In particular, in New Hampshire and Arizona concern was expressed over protection of investors,⁸¹ which led the state legislative assembly of New Hampshire to legislate that LLC membership interests would be classified as ‘securities’.⁸² Arizona resolved this by imposing additional disclosure obligations.⁸³

In this context, Callison concludes that LLCs were not the product of the public interest model of legislation. According to him, if LLCs were predicated on a public interest model then the legislation providing for their enactment would have been considered in a forum to identify public values and acting towards those specific ends.⁸⁴ Instead Callison contends that LLC legislation was the product of the public choice model of legislation, in which (individual) private interests prevailed over a single overriding or overarching public interest conception.⁸⁵ This is supported by Bratton and McCahery who observe that the historical proliferation of LLC legislation was attributed to ‘the initiative of state bar committees rather than to the initiative of the legislators themselves’.⁸⁶

⁷⁹ From 1996 financial institutions which do not use the reserve method of accounting for bad debts are now able to make S Corporation elections.

⁸⁰ Goforth, n 15, at p 1274: For example, in North Dakota, the Farm Bureau expressed concern over the creation of LLCs because of a fear that they might be used to circumvent restrictions on ownership of agricultural land in the state.

⁸¹ Goforth, n 15, at p 1276.

⁸² Goforth, n 15, at p 1276: N.H. Rev. Stat. Ann. section 421-B:11 (Supp. 1994). Classification as a ‘security’ meant that the LLC membership interest could be subjected to New Hampshire’s ‘blue sky laws’.

⁸³ Goforth, n 15, at p 1276: Ariz. Rev. Stat. Ann. section 29-607 (Supp. 1993).

⁸⁴ Callison, n 2, at p 253.

⁸⁵ Callison, n 2, at p 253: citing Michelman, Fl. (1977). Political Markets and Community Self-Determination: Competing Models of Local Government Legitimacy, *Ind LR* 53:145, at pp 147-153. Public choice model is described as all substantive values and ends are regarded as private and subjective, and the legislature is considered as a marketplace where votes are the medium of exchange.

⁸⁶ Bratton and McCahery, n 13, at p 666 referring to Ribstein.

However, it is argued that it is not necessarily the case that the public interest would *not* benefit from LLCs being a product of a public choice model. In this context, it is argued that in the United States the public interest could benefit via the implementation of LLCs through (in particular) the achievement of greater tax neutrality. Indeed, the transparency applying to LLCs can be seen as rectifying the failure of the United States government to implement a tax system for corporations that adequately took into account economic ideals with the taxation of business forms.

4.3.3 Limited liability

An important characteristic that was involved with the introduction of the LLC was the provision of limited liability to members. Some commentators have argued that the spread and influence of LLC statutes reflected closely held firms' increasing need for limited liability because of increased tort and malpractice litigation in the United States.⁸⁷ Ribstein has observed that there was only limited resistance against LLC statutes in respect of tort and professional liability laws.⁸⁸ Those states with the most obvious resistance were Missouri, Ohio, Tennessee, Washington, Oklahoma, and California,⁸⁹ although in the end this resistance was not effective.⁹⁰

In interpreting and understanding this professional resistance, Hamill argues that lawyers' resistance to LLCs' liability protection for members can be considered from a purely self-interested perspective. This is because liability limitations could

⁸⁷ Ribstein, LE. (2004). The Evolving Partnership. In *The Governance of Close Corporations and Partnerships: US and European Perspectives*, edited by J. McCahery, T. Raaijmakers and E. Vermeulen. Oxford: Oxford University Press, at p 169.

⁸⁸ Ribstein, n 87, at p 169; Goforth, n 15, at pp1271-5, 1279-81.

⁸⁹ Ribstein, n 87, at p 169; Goforth, n 15, at pp 1271-5, 1279-81.

⁹⁰ Bratton and McCahery, n 13, at p 665.

reduce contingency fees and discourage litigation in general, thereby reducing trial lawyers' work.⁹¹

However, it is argued that it is unlikely that a pent-up demand for limited liability was a primary driver or motivating factor for the introduction of LLCs. This is because the S Corporation already provided members with limited liability and tax transparency, as did limited partnerships — to some extent. However, both of these alternative transparent forms have their associated problems, such as eligibility restrictions, as well as uncertainty about liability protection for members. Accordingly, then, it is submitted that the rapid implementation of LLCs was not due to limited liability issues alone, although this was obviously an important feature.

4.3.4 Jurisdictional competition

Another explanation for the widespread legislative enactment of LLCs across the United States is inter-state competition.⁹² This is particularly evident with the Wyoming enactment, as the perception was that legislation would attract new business as well as trade and commerce to the state. It has been stated that the spread of LLCs indicates that most states were 'responsive to competitive forces in the drafting and enactment of these business organization laws'.⁹³ In this context, it appears that states were *proactive* in enacting LLCs to attract and retain closely held businesses.⁹⁴

⁹¹ Hamill, n 17.

⁹² Bratton and McCahery, n 13, at p 657.

⁹³ McCahery, JA, and Vermeulen, EPM. (2004). The Evolution of Closely Held Business Forms in Europe. In *The Governance of Close Corporations and Partnerships: US and European Perspectives*, edited by J. McCahery, T. Raaijmakers and E. Vermeulen. Oxford: Oxford University Press, at p 214; Goforth, n 15, at pp 1271-2; Macey, n 64, at p 447.

⁹⁴ McCahery and Vermeulen, n 93, at p 214.

In this context, competition is clearly apparent and visible, with California's enactment of its LLC statute prescribing that:

This act is an urgency statute necessary for the immediate preservation of the public peace, health, or safety within the meaning of Article IV of the Constitution and shall go into immediate effect. The facts constituting the necessity are limited liability companies may presently do business in at least 43 of the United States. It is essential to the Californian economy that the state provide an attractive business environment, which includes provision for limited liability companies. In order to help stem the flow of business and jobs from California, protect the rights of Californians dealing with limited liability companies, and improve California's business climate and tax base, it is necessary that this act go into effect immediately.⁹⁵

This motive of attracting business and revenue to the state, or avoiding the loss to other states, is prevalent in approximately 50 per cent of the LLC enactments.⁹⁶ Also many states expressed the desire to be on the forefront of the trend to attract new businesses,⁹⁷ or not to be left behind when other states were enacting LLCs.⁹⁸ Additionally, the LLC was seen as a potential business form to accommodate foreign investment from Central and South America.⁹⁹

⁹⁵ Ribstein, n 16, at p 400.

⁹⁶ Goforth, n 15, at p 1272: Attracting business and revenue was cited as being one of the moving factors by those involved in the legislative process in Alabama, Arizona, and Arkansas. Connecticut, Florida, Georgia, Illinois. Iowa. Kansas, Missouri, Nevada, New Hampshire, New Jersey, North Carolina, North Dakota, Oklahoma, Rhode Island, South Carolina, South Dakota, Texas, Utah. Virginia. West Virginia, and Wisconsin.

⁹⁷ Goforth, n 15, at p 1272: The importance of offering an alternative form of business not available in neighbouring states was expressly cited as being important to the legislation in Iowa, Kansas, Rhode Island, and Texas.

⁹⁸ Goforth, n 15, at p 1272: Staying competitive with other states was cited as being important to the legislative process in Alabama. Connecticut, Indiana, Kentucky, Louisiana. Maine, Maryland, Michigan, Mississippi, Missouri, Nebraska, Nevada, New Hampshire, New Mexico, North Dakota, Ohio, Oklahoma, South Carolina, Texas, Washington, and Wisconsin.

⁹⁹ Goforth, n 15, at p 1201: Johnson, R. (1983). Comment, The Limited Liability Company Act. *Fla St. U. L. Rev.* 11:387, at p 387. "The Floridian committee reports discussing LLCs specifically noted that LLCs were similar to a form of business organization prevalent in Central and South America's and might therefore be particularly attractive to international investors. Other States to mention the desire to attract foreign investment included Illinois, New Mexico, Oregon and Wisconsin".

The proliferation of LLC statutes across the United States, which are perceived as more relevant to closely held firms, seems contrary to theories that there are weak financial incentives for states to compete for closely held firms. Such theories would suggest that competitive lawmaking has no influence on the evolution of business forms.¹⁰⁰ However, the ability to undertake interstate business, in turn, gives states incentives to recognise other states' business forms.¹⁰¹ This can particularly arise within a large country such as the United States, with a common language and law which decreases the transactional costs that might otherwise arise. Interest groups or firms in each state stand to gain or lose in the resulting interstate competition. Hence, this can in turn provide an incentive for interest groups to lobby for rules that make their jurisdictions inviting to — or at least not repelling — interstate firms.¹⁰² It is argued that the tax savings available through LLCs' tax transparent treatment also aided or facilitated this interstate competition as there were discrete tax savings possible.¹⁰³

The competition between American states was particularly important in relation to the speed of proliferation of LLCs across the United States. However, this competition appears to be secondary to the initial impetus of the tax treatment of the LLC. It seems that a critical factor for the introduction of LLCs was their tax transparency. In this respect, competition between the states led to their quick enactment across the American states — once tax transparency was assured or guaranteed.

¹⁰⁰ McCahery and Vermeulen, n 93, at p 214; Bratton and McCahery, n 13, at p 675.

¹⁰¹ Ribstein, n 87, at p 160

¹⁰² Ribstein, n 87, at p 160: Ribstein, LE, and Kobayashi, BH. (2001). Choice of Form and Network Externalities. *William and Mary Law Review* 43:79.

¹⁰³ The discrete tax savings available through an LLC is canvassed in Chapter Eight.

4.3.5 Governance

A final factor that could assist in explaining the proliferation of LLCs in the United States is efficiency through improved governance regimes. Efficiency arguments are based upon the premise that more efficient rules, particularly LLC statutes, can emerge from jurisdictional competition for business formations. Ribstein argues in this context that jurisdictional competition can lead to an 'evolutionary' process in which more efficient business forms become prevalent, with other forms falling into disuse.¹⁰⁴ An integral factor to this claim is the ability of parties to contract for the applicable law, including choosing a firm's internal governance rules through choice of state of formation.¹⁰⁵

This competition between American states has been described by Ribstein as 'horizontal choice', as at a low cost firms can choose the rules that govern their internal structure by incorporating in a favourable state even if they do business or locate assets in one or more other states.¹⁰⁶ However, it should be queried whether the cost of this horizontal choice will always be low, as it may turn out to be regressive if operations are small outweighing any perceived gains.¹⁰⁷ In this context, it should be noted that predictions that the United Kingdom's introduction of an LLP would create pressures for the introduction of tax transparent companies across continental Europe has not eventuated.¹⁰⁸ This is in part is

¹⁰⁴ Ribstein, n 87, at p 154: citing Kobayashi, BH, and Ribstein, LE. (1999). Uniformity, Choice of Law and Software Sales. *George Mason Law Review* 8:261, and Ribstein, LE, and Kobayashi, BH. (1995). Uniform Laws, Model Laws and ULLCA. *Colorado Law Review* 66:947.

¹⁰⁵ Ribstein, n 87, at p 154: O'Hara, EA, and Ribstein, LE. (2000). From Politics to Efficiency in Choice of Law. *The University of Chicago Law Review* 67:1151.

¹⁰⁶ Ribstein, n 87, at p 158.

¹⁰⁷ Such cost could include engaging lawyers/advisers from another jurisdiction, comprehension of other jurisdictions law, and issue of later disputes being governed by the laws of the other jurisdiction. Ribstein, n 9, at p 12 is an example of the benefits of choice being stated, with little discussion about the cost of this.

¹⁰⁸ McCahery, JA. (2004). Introduction: Governance in Partnership and Close Corporation Law in Europe and the United States. In *The Governance of Close Corporations and Partnerships: US and European Perspectives*, edited by J. McCahery, T. Raaijmakers and E. Vermeulen. Oxford: Oxford University Press, at p 5.

attributable to significant barriers to such a development occurring,¹⁰⁹ such as linguistic and cultural factors, as well as the 'real seat doctrine'.¹¹⁰

Given that the tax treatment of LLCs was a motivating force behind its introduction, it is interesting to consider the status of S Corporations that also offer transparency, although under a different Sub-Chapter of the *IRC 1986* (US).¹¹¹ If a business wanted limited liability for its members, separate legal entity status and tax transparency, the S Corporation was already available in the United States. What other characteristics do LLCs have compared with S Corporations? Or is it that the S Corporations' eligibility requirements mean that many businesses cannot utilise them and they needed a more widely available transparent company. The data in Chapter Three demonstrates that there has been continued growth of S Corporations, even with the growth in the popularity of LLCs.

The other LLC characteristics may relate to the flexibility of their internal management rules compared to S Corporations. The flexibility of LLCs was highlighted by the Alberta Municipal Affairs Registries:

The obvious advantage to creating an LLC is that the members can tailor the operating agreement to suit their individual needs. This offers the members tremendous flexibility over their internal governance. This allows the members to choose their own procedures for matters like calling of meetings, voting, and quorums.¹¹²

¹⁰⁹ Lower, M. (2003). What's on offer? A consideration of the legal forms available for use by small - and medium - sized enterprises in the United Kingdom. *The Company Lawyer* 24 (6):166, at p 169.

¹¹⁰ Relating to when a business re-incorporates in another jurisdiction but controlled in the original place of formation. But the decision of Case C-212/97, *Centros Ltd v Erhvervs-og-Selskabsstyrelsen* [1999] ECR I-1459 has opened up the way for start-ups to incorporate in any European member state even though they have no intention of doing business there or of having their head-quarters there.

¹¹¹ LLCs are taxed as partnerships pursuant to Sub-Chapter K (Partnerships), whereas S Corporations are taxed pursuant to Sub-Chapter S.

¹¹² Alberta Law Reform Institute. (1998). Limited Liability Partnerships and other Hybrid Business Entities. In *Issues Paper No 4*. Edmonton, Alberta, at p 172,: citing Alberta Registries 1995 at 24-

Whether, then, LLCs do provide an improved governance regime for closely held businesses, particularly compared to S Corporations, will be carefully considered in the analysis in Chapter Nine.

In summary, it has been argued that a key motivating reason for the introduction of LLCs was their tax transparent treatment, as this addressed the breaches in tax neutrality that particularly occurred due to the United States entity tax approach for C Corporations. This entity treatment was further exacerbated by the 1986 Tax Reforms. A large closely held business was instrumental to the first LLC enactment. However, once the transparency of the LLC was assured, this then (in turn) led to other interest groups to lobby for other states to legislate for the creation of LLCs. This subsequently invoked competition among the American states. It is submitted that limited liability, while an important feature of a LLC, is *not* a significant factor in isolation for their proliferation, as other business forms already provided limited liability.

4.4 United Kingdom: LLPs

The role of large closely held businesses and tax neutrality was important with the introduction of LLPs in the United Kingdom, as was limited liability provided to members. Accountancy and law firms (professional firms) in the United Kingdom sought a business form that improved members' liability protection and retained tax transparency. In this way, there would be greater tax neutrality between business forms in the United Kingdom. After initial lobbying of the United Kingdom government was unsuccessful, attention shifted to foreign jurisdictions through which to introduce the LLP. Once successful there, this was then used as leverage on the United Kingdom government to reconsider its position.

25 [cited 6 January 2008]. Available from <http://www.law.ualberta.ca/alri/Publications/Issues-Papers.php>.

It is this combination of factors that led to the introduction of LLPs in the United Kingdom, which is discussed below.

4.4.1 Regulatory and tax considerations

Professional firms had lobbied the United Kingdom government for limitation of their liability, which had historically been exposed through the requirement to use general partnerships. While there had been reforms to allow solicitors and auditors to obtain liability protection, this was through the process of incorporation.¹¹³ The attainment of limited liability through incorporation had some adverse tax and regulatory consequences.¹¹⁴ The adverse tax consequences included, in particular, the higher impost of the National Insurance Contribution (NIC) for active members of a corporation compared to a general partnership.¹¹⁵ Regulatory concerns for incorporation included the requisite financial disclosure and a layer of meeting requirements and controls that were designed for separate ownership and management.¹¹⁶ A consequence of this was that there were breaches of tax neutrality between those professional firms

¹¹³ House of Commons - Select Committee. (1999). *Trade and Industry - Fourth Report: Draft Limited Liability Partnership Bill*. HC 59, at paragraph 23: Solicitors have been able to incorporate since 1992 and auditors since 1989. At 1999 only estimated 20 solicitor firms and 100 accountancy firms had done so. Sikka, P. (2008). Globalization and its Discontents: Accounting Firms Buy Limited Liability Partnership Legislation in Jersey, *Accounting, Auditing and Accountability Journal* 21(3):398, at p 410: Following extensive lobbying by accountancy firms and the United Kingdom professional bodies, the law was changed and the *Companies Act 1989* (UK) (consolidated into the *Companies Act 1985*) permitted auditing firms to trade as corporations. Section 137 of the *Companies Act 1989* (which became Section 310(3)(a) of the *Companies Act 1985*), enabled companies to buy insurance to cover their auditor's liability, should they so wish. For example KPMG had incorporated its audit practice.

¹¹⁴ Freedman, J. (2003). Small Business Taxation: Policy Issues and the UK. *Taxing Small Business: Developing Good Tax Policies* Australian Tax Research Foundation: Sydney (Conference Series 23):13, at p 35.

¹¹⁵ The National Insurance Contribution (NIC) is a hypothecated tax to pay most of the cost of retirement pensions and unemployment and sickness benefit. The normal rate of NIC is 9 per cent for employees and 10.45 per cent for employers. Self-employed are charged up to 9 per cent plus weekly flat charge of 2.10 pounds. This is discussed in greater detail in Chapter Eight.

¹¹⁶ Freedman, J. (2001). Limited Liability Partnerships in the United Kingdom - Do They Have a Role For Small Business? *Journal of Corporation Law* 26(4):897, at p 900.

remaining as general partnerships and those who incorporated. This was even despite the fact that the United Kingdom provided some tax integration for corporate distributions to members.¹¹⁷

Since the idea of proportionate liability for members trading as a general partnership had been rejected by the United Kingdom Law Commission,¹¹⁸ members of professional firms conducted through a general partnership had unlimited liability irrespective of the degree of their personal involvement.¹¹⁹ This exposure was exacerbated by several negligence actions that were initiated in the 1990s in relation to accounting and audit functions,¹²⁰ leading to increased costs in defending such negligence claims and insurance premiums.¹²¹

A similar situation arose in the United States after the collapse of the real estate and energy prices in the late 1980s that saw professionals in that country exposed to liability.¹²² This exposure led to the introduction of an LLP form across American states, commencing with Texas in 1991.¹²³ The origins of the United Kingdom's LLP may bear some similarities to the United States' LLP, although the resulting legal creation of this structure in the United Kingdom is described as being 'very different'.¹²⁴

¹¹⁷ United Kingdom now has a notional dividend tax credit system. This is discussed in detail in Chapter Eight.

¹¹⁸ House of Commons - Select Committee, n 113, at paragraph 21.

¹¹⁹ Institute of Chartered Accountants in England and Wales. (1996). *Joint and Several Liability – Finding a Fair Solution*. London, ICAEW.

¹²⁰ See: *Caparo Industries v Dickman* [1990] 1 ALL ER HL 568, 2 AC 605, 1 ACSR 636; *Galoo Ltd (in liq) v Bright Grahame Murray (a firm)* [1995] 1 All ER 16, 1 WLR 1360; *ADT Limited v BDO Binder Hamlyn* [1996] BCC 808. Referring to the fact that aggrieved creditors or investors of a failed corporation may seek redress against the corporation's auditors.

¹²¹ Association of Chartered Certified Accountants. (2001). *Limited Liability Partnerships*. London: The Certified Accountants Educational Trust, at p 3.

¹²² This was because of lawyers and accountants potential negligence in the collapse of banks. Hamilton, n 122, RW. (1995). *Registered Limited Liability Partnerships: Present at the Birth (Nearly)*. *University of Colorado Law Review* 66, at p 1069.

¹²³ The first LLP was created in Texas (United States) on 26 August 1991, when *Texas House Bill* 278. This may be attributed to the fact that Texas led the United States in bank and savings and loan failures during the 1980s, with more than one-third of all United States' bank failures: Hamilton, n 122, at p 1069.

¹²⁴ Freedman, n 116, at p 899.

It was stated that this potential exposure to unlimited liability had various adverse effects for professional firms in the United Kingdom, particularly an inability to attract new younger members, expensive professional indemnity insurance and defensive audit work.¹²⁵ Despite these concerns by professional firms, the United Kingdom government was unmoved, that is, until a close foreign jurisdiction legislated for an LLP form.

4.4.2 Jurisdictional competition and interest groups

It is argued that international competition acted as a catalyst for change in the United Kingdom after the professional firms had been initially unsuccessful in lobbying for LLP legislative reform. Years later when the House of Commons Committee¹²⁶ was considering the proposed LLP legislation, the United Kingdom government argued that the legislation was urgent due to the competition from Jersey and other jurisdictions which were prepared to provide LLPs,¹²⁷ even though previously it thought there was insufficient justification.¹²⁸

However, close analysis of what occurred with the Jersey legislation reveals the prominent role of large professional firms. Indeed, two large British accounting firms, Ernst & Young and Price Waterhouse,¹²⁹ provided a draft LLC statute to the Jersey government¹³⁰ at a private cost of more than 1 million GBP.¹³¹ The two firms did not act alone, as 25 other professional firms supported their

¹²⁵ House of Commons - Select Committee, n 113, at paragraph 15.

¹²⁶ House of Commons - Select Committee, n 113.

¹²⁷ Freedman, J. (2004). Limited Liability Partnerships in the United Kingdom: Do They Have a Role for Small Firms? In *The Governance of Close Corporations and Partnerships: US and European Perspectives*, edited by J. McCahery, T. Raaijmakers and E. Vermeulen. Oxford: Oxford University Press, at p 302, and McCahery and Vermeulen, n 93, at p 200.

¹²⁸ Pinfold, L, ed. (2005). *Tolley's Tax Planning 2005-06*. Vol. 1. London: LexisNexis Butterworths, at p 1359.

¹²⁹ Now PricewaterhouseCoopers.

¹³⁰ Jersey is a British Crown dependency.

¹³¹ Sikka, n 113, at p 5.

endeavours.¹³² It is argued that these professional firms have the characteristics of closely held businesses, particularly member-management, even though their membership can be substantial. Eventually, the professional firms were successful and Jersey enacted the *Limited Liability Partnership Act Liability (Jersey) Law 1997*.¹³³

Through this enactment it was thought that United Kingdom professional firms would reconstitute themselves as Jersey LLPs.¹³⁴ The Jersey government hoped that, through these prestigious registrations, this would have a flow-on effect, attracting other high level financial services work to Jersey.¹³⁵

The actions of the Jersey government have led some to conclude that Jersey was offering its 'legislature for hire',¹³⁶ especially as the Jersey government's actions were not, indeed, a direct consequence of local business interests.¹³⁷ However, Sikka's detailed analysis of the drafting process within Jersey reveals that there was some resistance within Jersey, especially from the Law Draughtsman and a number of members of the Jersey parliament.¹³⁸ Furthermore, it appears that professional firms approached Jersey because clients saw it as reputable and that it had a stable and predictable body of law.¹³⁹

¹³² Financial Times, 17 April 1996, p 8. Sikka, n 113, at p 412.

¹³³ The Jersey Act came into force from November 1997.

¹³⁴ Sikka, n 113.

¹³⁵ Morris, P, and Stevenson, J. (1997). The Jersey Limited Liability Partnership: A New Legal Vehicle for Professional Practice. *The Modern Law Review* 60 (4):538, at p 543: Statement of Richard Syvret, Director of the States of Jersey Financial Services Department in a personal interview on 3 December 1996. See: States of Jersey Policy and Resources Committee, 2000 and Beyond Strategic Policy Review 1995, Part 1 (Jersey, 1995), where it is observed that the finance sector provides 50 per cent of national income and over 60 per cent of tax revenues, leading the report to conclude that "it is upon the performance of the finance industry that the Island's overall economic strength has depended in recent times and continues to depend".

¹³⁶ Hampton, MP, and Christensen, J. (1999). A Legislature for Hire: The Capture of the State in Jersey's Offshore Finance Centre, in MP. Hampton and JP. Abbott (Eds), *Offshore Finance Centres and Tax Havens: the Rise of Global Capital*, Basingstoke, Macmillan.

¹³⁷ Sikka, n 113.

¹³⁸ Sikka, n 113.

¹³⁹ Sikka, n 113: Letter from Ian James (Mourant du Feu & Jeune partners to Senator Pierre Horsfall, President of Jersey's Finance and Economics Committee. 19 October 1995: "The executive committee of the partners of PW are determined that the jurisdiction must be one which

Unfortunately for Jersey, the goal of its *LLP Act* attracting professionals to re-organise in Jersey did not eventuate. This is because there were high transaction costs for United Kingdom professional firms to reconstitute as a Jersey LLP, and doubts about the prospective benefits. Particularly, in this context, the United Kingdom's tax treatment of the Jersey LLP was unclear. The Jersey LLP would be viable only if it was treated as a general partnership rather than as a corporation for United Kingdom tax purposes, because most of the business income would still be derived from the United Kingdom. Professional firms sought clarification in relation to the Jersey LLP's tax treatment, but the United Kingdom Revenue (now known as HM Revenue and Customs) refused to provide assurances.¹⁴⁰ Professional firms even attempted to bring a hypothetical test case in the United Kingdom to determine the appropriate tax treatment. However, the Courts refused to deal with the matter on a hypothetical basis.¹⁴¹ Due to this uncertainty, professional firms were hesitant to reorganise as Jersey LLPs.

With Jersey enacting its LLP, the issue gained focus in the run up to the 1997 United Kingdom general election. In a change to prior positions, both main political parties sought to demonstrate that they were business friendly, and promised that a United Kingdom LLP would be introduced.¹⁴² Sikka argues that this represents business enterprises becoming so powerful that they eventually 'make legislative, financial and political demands on elected governments' which, if not meet, will cause them 'to up-root and locate elsewhere'.¹⁴³

Freedman supports this contention, remarking that the events in the United Kingdom illustrate that it is 'all too easy for the most dominant pressure group to

has a stable and predictable body of law and which in terms of its reputation will be acceptable both to its partners and also to its clients".

¹⁴⁰ Finch, V and Freedman, J. (2002). The Limited Liability Partnership: Pick and Mix or Mix-up? *Journal of Business Law* (September):475, at p 481.

¹⁴¹ *R v. IRC ex parte Bishopp* [1999] STC 531, 11 ALR 575.

¹⁴² Freedman, n 116, at p 905.

¹⁴³ Sikka, n 113, at p 400.

shape policy'.¹⁴⁴ Indeed, after years of stalling, the LLP reforms were 'fast tracked' by the United Kingdom's Department of Trade and Industry. The House of Commons Select Committee was critical of the fact that the LLP proposals were not included in other law reform exercises that were occurring at that time, being the Law Commission and the Company Law Review Steering Group.¹⁴⁵

In fact, the House of Commons Select Committee was somewhat ambivalent about the actual need for an LLP. It stated that 'there was a failure by the Department of Trade and Industry to set out a convincing case for its introduction',¹⁴⁶ although the Committee did note the 'very real possibility' of professionals firms registering offshore.¹⁴⁷

While originally, the LLP was to be available to professional firms only, this was subsequently altered, because the term 'professional firm' was difficult to define and it was hard to justify such a restriction.¹⁴⁸ Consequently, all businesses, including small and medium enterprises, can now potentially utilise the LLP business form.

One commentator has stated that the United Kingdom Government was effectively influenced and captured by professional firms in an attempt not to be 'wrong-footed by Jersey'.¹⁴⁹ This factor was freely acknowledged by a senior partner of Ernst and Young, who declared that:

¹⁴⁴ Freedman, J. (1997). The Quest for an Ideal Form for Small Businesses - A Misconceived Enterprise? In *Developments in European Company Law: Volume 2/1997: The Quest for an Ideal Legal Form for Small Business*, edited by B. A. K. Rider and M. Andenas. London: Kluwer Law International Ltd, at p 15.

¹⁴⁵ House of Commons - Select Committee, n 113, at paragraph 10.

¹⁴⁶ House of Commons - Select Committee, n 113, paragraph 6.

¹⁴⁷ House of Commons - Select Committee, n 113, paragraph 26.

¹⁴⁸ House of Commons - Select Committee, n 113, at paragraph 38.

¹⁴⁹ Hicks, A. (1997). Legislating for the Needs of the Small Business. In *Developments in European Company Law: Volume 2/1997: The Quest for an Ideal Legal Form for Small Business*, edited by B. A. K. Rider and M. Andenas. London: Kluwer Law International Ltd, at p 64.

I have no doubt whatsoever that ourselves and Price Waterhouse drove it [the LLP] onto the [United Kingdom] government's agenda because of the Jersey idea.¹⁵⁰

To this extent the Jersey legislative process has similarities to Wyoming enacting its LLC, but in a global context. Both Wyoming and Jersey are small jurisdictions where interest groups can be very influential and effective in lobbying. Particularly, both jurisdictions appeared to have been influenced by large closely held businesses that provided the jurisdictions with drafted legislation for the new business form. Sassen argues that the power of major businesses has increased due to government's dependence on capital to simulate economic activity.¹⁵¹ This influence can be accentuated when the jurisdiction has only limited wealth. For these reasons, Wyoming and Jersey can be seen as 'accessible jurisdictions'. These accessible jurisdictions have pioneered transparent companies, and consequently acted as a catalyst for the enacting of transparent companies elsewhere.

However, it appears that neither Wyoming nor Jersey has been able to capitalise on the reforms that each initiated. In 2005, Wyoming has only approximately 10,904 domestic LLCs of good standing on file, of the total of 4,110,527 across the United States, thus representing just 0.3 per cent of all LLCs.¹⁵² In Jersey,

¹⁵⁰ *Accountancy Age*, 29 March 2001, p 22.

¹⁵¹ Sassen, S. (1998). *Globalization and Its Discontents: Essays on the New Mobility of People and Money*, New York, New Press.

¹⁵² It appears that Florida and Delaware are currently the dominate place of LLC formation, accounting for 17.4 per cent of LLCs between them. According to the 2006 Annual Report of the Jurisdictions of the International Association of Corporation Administrators, in 2005 the top 10 states for LLC formation were: Delaware 8 per cent; California 7.2 per cent; Florida 6.9 per cent; New York 6.3 per cent; Michigan 6.0 per cent; Texas 4.6 per cent, Ohio 4.4 per cent; Arizona 4.2 per cent; Georgia 3.5 per cent and an equal tie between Illinois 3.25 and Colorado 3.2 per cent. Note Wyoming, the first state to introduce the LLC, only accounted for 0.3 per cent. Sourced from the 2000 - 2006 Annual Reports of the Jurisdictions of the International Association of Corporation Administrators.

the position is worse with no LLPs having been registered there. This has led to a current public consultation of the Jersey *LLP Act* to see if this can be rectified.¹⁵³

While the introduction of LLPs in the United Kingdom may appear to be due to international competition, it can be argued that professional firms within the United Kingdom orchestrated this perception.¹⁵⁴ This is supported by the observation that some of the professional firms actually drafted the relevant legislation for Jersey. Accordingly, the actions of large closely held professional firms were instrumental in the adoption of the LLP in the United Kingdom. They sought a business form that provided liability protection and tax transparent treatment. This is reflected by the fact that Ernst and Young became the first practice to adopt the LLP form in 2001.¹⁵⁵ This is not surprising given its involvement in the introduction of the LLP, particularly drafting the original Jersey LLP legislation. In this way, the LLP shares similar ties to the LLC, as the actions of large closely held businesses were instrumental with their initial introduction.

4.5 New Zealand: LAQCs

The interplay of tax neutrality and closely held businesses is evident with the introduction of New Zealand's tax transparent company, the LAQC, in 1992. Instead of opting for an entirely new business form, New Zealand introduced

¹⁵³ States of Jersey. (2008). Economic Development Department Green Paper: LLP (Jersey) Law 1997, at pp 3-4. [cited 31 May 2008]. Available from: www.gov.je/EconomicDevelopment/local+Finance+Industry. Three possible reasons are outlined in the consultation document; being (a) the LLP is required to give financial security; (b) the United Kingdom LLP legislation; and (c) the United Kingdom corporate tax treatment of a Jersey LLP.

¹⁵⁴ A similar argument is made by Freedman: Freedman, n 116, at p 898.

¹⁵⁵ Shohet, P, and Jenner, A. (2005). Get you teeth into LLPs. *Accountancy Magazine* May: 73, at p 73. In August 2001 only 20 per cent of LLP registrations had been for professional firms of solicitors and accountants; meaning that the remaining 80 per cent must have been for different businesses. The low utilisation by professional was attributed to the dislike the disclosure requirement, including the remuneration of the highest-paid member: Freedman, n 127, at p 299. By 2006 it was reported that nearly half of the top 60 accountancy firms operating in the United Kingdom had converted to LLPs, with others incorporating: Percy, S. (2006). Partners: an endangered species? *Accountancy Magazine* July: 40, at p 40.

special tax rules for closely held corporations. Accordingly, the LAQC is an example of the 'special tax rule company' model of transparent companies. New Zealand's LAQC has similarities to the other special tax rule company studied, the United States' S Corporation. In fact, New Zealand did consider S Corporations, but the relevant committee rejected them as unacceptably complex, and developed their own transparent company form instead.¹⁵⁶

The LAQC's origins stem from a review of New Zealand's tax system by the Valabh Committee, which proposed a special regime for closely held corporations.¹⁵⁷ The Committee's initial proposal in November 1990 did not include allocations of losses to members because of concerns about complexities with multiple classes of membership interest, and perceived avoidance opportunities.¹⁵⁸ However, the Valabh Committee's position was altered after receiving external submissions, and the committee's final report to the New Zealand government recommended the introduction of rules to allow for the allocation of losses to members.¹⁵⁹ In fact, two tax entities were introduced by the New Zealand Government in response to these recommendations. These two entities were Qualifying Companies (QC) and, as a sub-set of the QC, the LAQC. The QC does not provide for the allocation of losses to members, although unimputed dividends paid to members are classified as exempt income. The focus of this dissertation's analysis, however, is on the LAQC, because this

¹⁵⁶ Consultative Committee on the Taxation of Income from Capital. (1991). *Taxation of Distributions from Companies: Final Report*, Auckland, July; and Holmes, K. (1992). *The Taxation of Closely-Held Companies: Concepts, Legislation and Problems in New Zealand*. *Australian Tax Forum* 9:321, at p 350. Hooper, K, Somerfield, J, Greenheld, J, and Ritchie, K. (1998). *Tax Policy and Principles: A New Zealand Perspective*. Wellington: Brooker's Ltd, at pp 116-117. Valabh Committee released three reports: 1st, 2nd *Taxation of Distributions from Companies* (1990, Nov); and 3rd (1991, July).

¹⁵⁷ Consultative Committee on the Taxation of Income and Capital; appointed in 1989 and chaired by Mr Arthur Valabh. Consultative Committee on the Taxation of Income from Capital, n 156, at pp 7 to 22.

¹⁵⁸ Polson Higgs & Co, and Beattie Rickman. (2003). *Qualifying Companies*. Paper read at Professional Development Course Paper No S 703, June, Institute of Chartered Accountants, Wellington, at p 1; and Holmes, n 156, at p 345.

¹⁵⁹ Consultative Committee on the Taxation of Income from Capital, n 156, at p 9.

entity represents more of a transparent company — though not a fully transparent company as previously defined.¹⁶⁰

This raises the important question as to why the Valabh Committee recommended the introduction of LAQCs. The reason turned on the concept of tax neutrality for closely held businesses. The Valabh Committee observed breaches of tax neutrality for closely held businesses if conducted through a corporation rather than a general partnership or sole proprietor. An example of this breach was the treatment of capital gains arising from the disposal of business assets. New Zealand does not tax capital profits; therefore disposal of capital assets is not assessable for a sole proprietor or general partnership.¹⁶¹ Compared to if a corporation disposed of the capital assets, while the capital gain would not be assessable to the corporation, it would be effectively taxed once the corporation distributed this untaxed profit to its members. This is because the untaxed capital gain would be distributed as an unfranked dividend, and would be fully assessable to the receiving member(s).¹⁶²

Another inconsistency arose in terms of losses generated by a business. For sole proprietors and general partnerships, losses could be directly offset by members against their other assessable income in the year in which the losses were incurred. In contrast, a corporation's losses are trapped within that entity, and not transferable to members. Consequently, the corporation would have to carry forward its losses to future income years, where they could be deducted from its future assessable income.¹⁶³

¹⁶⁰ Refer to Chapter Three's discussion of the definition of 'transparent company' for this dissertation.

¹⁶¹ While New Zealand does not have a comprehensive capital gains tax it does have *ITA 2007* (NZ), section DB 26 which assesses amounts from profit-making undertakings.

¹⁶² An imputation system applies to New Zealand corporations. This means that the payment of corporate tax is recorded in the corporation's imputation credit account: *ITA 2007* (NZ), section OB 4. The imputation credits are then attached to the dividends paid out: *ITA 2007* (NZ), section OB 30.

¹⁶³ *ITA 2007* (NZ), section IA(4).

Yet another inconsistency arose in the tax treatment of in-kind benefits obtained by the members under each business structure.¹⁶⁴ A member of a general partnership or a sole proprietor would not be permitted a deduction for expenditure incurred in deriving a private benefit.¹⁶⁵ On the other hand, fringe benefits tax (FBT) would arise for a member who was also an employee of a corporation. Expenditure incurred by the corporation in providing a fringe benefit to an employee-member would be deductible to it.

These breaches of tax neutrality arose even though the operations of closely held corporations were not seen as different from those of general partnerships or sole proprietors, and the membership structure could be very similar.¹⁶⁶

These inconsistencies were considered out of step with the New Zealand government's well-iterated policy position that the tax system should be neutral in the context of business decision-making.¹⁶⁷ However, it should be acknowledged that the New Zealand government's view towards tax neutrality and its relationship with business forms has not always been consistent. This can be illustrated by the New Zealand government effectively eliminating transparency for special partnerships, starting from 1986, by prohibiting the allocation losses directly to members.¹⁶⁸ With the introduction of LAQC the focus was very much

¹⁶⁴ Holmes, n 156 at p 328.

¹⁶⁵ *ITA 1994* (NZ), section 106(1)(j).

¹⁶⁶ Holmes, K. (1992). Taxation of Closely Held Companies: The New Zealand Model. *Bulletin* October:506, at p 507.

¹⁶⁷ Holmes, n 166, at p 507.

¹⁶⁸ Starting from the 1986-87 income tax year, by the *Income Tax Amendment Act (No 4) 1986* (NZ). Limited Partnerships are governed by Part II of the *Partnership Act 1908* (NZ). Instead the losses were required to be carried forward in the special partnership to offset against its future assessable income (known as the 'loss limitation rule'). *ITA94* (NZ), section HC 1: A partner in a special partnership cannot claim a share of any 'partnership losses sustained by the partnerships. These amendments were thought necessary to counter tax shelter arrangements. See: Stewart, M. (2005). Venture Capital Tax Reform in Australia and New Zealand. *New Zealand Journal of Taxation Law and Policy* 11 (2):216, at pp 235 to 239. Prior to these amendments, special partnerships offered both limited liability and the ability to pass-through losses on to members, and were a popular structure for investors in films and livestock: Committee of Experts on Tax Compliance. (1998) *Tax Compliance: Report to the Treasurer and the Minister of Revenue*: Chapter 6 – Tax Mitigation, Avoidance and Evasion, Wellington, at p 144

on closely held businesses. This is reflected in the eligibility requirement that there cannot be greater than five members of an LAQC.¹⁶⁹

Consequently, it appears that the key driver for the introduction of New Zealand's transparent company was for improved tax neutrality for closely held businesses. Whether the introduction of the LAQC has increased tax neutrality is debatable since there are still a number of inconsistencies between LAQCs, general partnerships and sole proprietors. These inconsistencies include the treatment of part-year losses, foreign income, fringe benefits and non-resident members.¹⁷⁰

4.6 Overall themes

Within this chapter it has been illustrated how the consideration of tax neutrality and closely held businesses was instructive with, and a motivating factor behind, the introduction of the transparent companies studied. Using the two classifications of tax transparent companies formulated in Chapter Three, it is argued that there are similarities across the jurisdictions. For both the United States and New Zealand governments in introducing their 'special tax rule companies', the S Corporation and the LAQC respectively, the goal of providing improved tax neutrality for closely held businesses was prominent. The relationship with closely held businesses was evident through the membership restriction imposed when they were introduced, being ten and five respectively.¹⁷¹

Accordingly, the aim of these special tax rule corporations was to reduce the tax system's influence on whether a business opted for an incorporated or an

¹⁶⁹ *ITA 2007* (NZ), section HA 6.

¹⁷⁰ Freudenberg, B. (2005). Is the Qualifying Company regime achieving its original objectives? *New Zealand Journal of Taxation Law and Policy* 11(2) 185.

¹⁷¹ While LAQC membership has not been adjusted since implementation, the S Corporation membership has been increased a number of times to now 100, with also a relaxation on the counting of family members (up to six generations).

unincorporated form. That is, closely held firms would choose incorporation or not based on non-tax reasons.¹⁷² The implementation of special tax rule companies is an example of the respective governments adopting the economic ideal of taxing business forms. However, a cynical explanation for the introduction of these special tax rule companies could be to provide closely held corporations with a 'carve-out' from the normal corporate tax regime, thus decreasing the tax impost. This carve-out includes the direct allocation of losses, as well as in the United States relief from the entity tax system applying to C Corporations; and in New Zealand the allowance of the flow-through of exempt capital gains to members. This carve-out may have been justified to offset the regressive compliance costs that can be faced by closely held businesses when their operations are small. It may also be to assist with their financing problem.¹⁷³ However, it should be acknowledged that if this cynical explanation is correct then it is inconsistent with the idea of improving tax neutrality and reducing the influence of tax on investment decisions.

This idea of tax transparent companies being a carve-out for closely held corporations will be explored in later Chapters. Another observation with the implementation of special tax rule companies is the more proactive role of the respective governments. This may be attributed to the fact that this model requires only the introduction of special tax rules, compared with legislating for a whole new business form.

For new form transparent companies, LLCs and LLPs, there was a market drive for the introduction of a new business form subject to existing transparency rules for general partnerships. It was important that this new business form provided members with liability protection. This resulted in interest groups lobbying for its introduction, and this subsequently led to competition among jurisdictions.

¹⁷² Such as the regulatory framework, including the provision of limited liability and the governance regime.

¹⁷³ Refer to Chapter Two's discussions about the empirical studies that demonstrate that for small businesses compliance costs can be regressive.

For new form transparent companies the role of large closely held businesses was instrumental for their initial introduction. Indeed the action of interest groups was important as governments appeared initially passive to the reform. Furthermore, tax neutrality was important, because breaches of it acted as a catalyst for change. Without these breaches in tax neutrality, there may not be impetus for business to spend the resources to lobby for reform. In both the United States and the United Kingdom the introduction of the transparent companies achieved greater tax neutrality between general partnerships and the new form that provided limited liability protection to members.

Competition among jurisdictions was also important with the introduction of new form transparent companies. In the United States this competition was largely internal, with competition among the various American states. Hamill highlights the importance of the American states in creating the availability of LLCs compared to the United States Federal government.¹⁷⁴ In contrast, for the United Kingdom the competition appeared to be external to the country, although this was largely orchestrated by internal groups. This relationship between the classifications of the tax transparent companies and the reasons behind their introduction is detailed in Table 4-0-1.

¹⁷⁴ Hamill, n 17, at p 303.

Table 4-0-1: Transparent classification and introduction

Model Type	Example	Introduction
Special tax rule companies	S Corporation LAQC	Increased neutrality in the tax system for closely held businesses. May be also to provide an alternative mechanism to tax closely held corporations, providing some relief to the tax system otherwise applying to corporations.
New form transparent companies	LLC LLP	Market drive for the introduction of a new business form with a different set of regulatory rules for an entity with liability protection. Critical for this new business form was transparent taxation. This caused interest groups (initially large closely held businesses) to lobby for its introduction, and subsequently led to competition among jurisdictions.

4.7 Conclusion

Within this chapter the reasons underlying the introduction of the foreign transparent companies have been considered, particularly the role of tax neutrality and closely held businesses.

With respect to special tax rule companies it was established that the aim for improved tax neutrality for closely held businesses was an overarching goal. For new form transparent companies, breaches of tax neutrality with business forms acted as a catalyst for closely held businesses to lobby for the introduction of a new business with limited liability and tax transparent treatment. After small jurisdictions had introduced them, competition amongst jurisdictions was also instrumental in terms of the speed in which subsequent jurisdictions introduced them.

With an understanding of the factors involved with the introduction of the transparent companies studied, it will be considered in Chapter Five whether such factors are present in Australia. An understanding of the reasons surrounding the introduction of the foreign transparent companies is important because the Australian government needs to ensure that the consequences are fully considered before any reforms are introduced.

Chapter Five: Transparency transpiring in Australia?

5.1 Introduction

Proceedings of the House of Commons in 1999 documented erroneously that Australia had introduced a transparent entity similar to the United Kingdom's limited liability partnership (LLP).¹ This is not the case, and Australia continues to have no broadly available transparent company similar to that of the LLP.² This chapter will consider if this state of affairs is likely to remain the case, by examining whether the conditions identified in Chapter Four that were present in foreign jurisdictions are extant in Australia. Specifically, this review will consider the role of tax neutrality and closely held businesses, as well as Australia's restricted recognition of transparent companies to date.

The chapter's central contention is that it is imperative to consider these motivating factors, not only in terms of ascertaining what could potentially occur in Australia, but also to address criticisms in foreign jurisdictions about the failure to reflect on what was being achieved through the introduction of transparent companies.³

Through utilising the classifications of tax transparency identified and conceptualised in Chapter Three, this chapter will initially consider whether

¹ House of Commons – Select Committee. (1999). *Trade and Industry – Fourth Report: Draft Limited Liability Partnership Bill*, HC 59, at paragraph 25: “LLP statutes has also been introduced in other jurisdictions, including Australia”. The source of the DTI's information is not clear, though there is reference to an Australian academic later in the report referring to limited partnerships in Australia (at paragraph 67). This mistake might be a misunderstanding of the description of different business forms.

² However, there has been restricted recognition in Australia in terms of the controlled foreign companies (CFC) provisions and venture capital industry.

³ There has been criticisms in the foreign jurisdictions about poor policy implementation in terms of their transparent companies. For example: Vestal, AW. (2004). 'Drawing Near the Fastness?': The Failed US Experiment in Unincorporated Business Entity Reform. In *The Governance of Close Corporations and Partnerships: US and European Perspectives*, edited by J. McCahery, T. Raaijmakers and E. Vermeulen. Oxford: Oxford University Press, at p 347.

similar conditions prevail for the introduction of a 'special tax rule company'. Focus then shifts from this analysis to the Australian government's position *vis-à-vis* 'new form transparent companies'.

It will be argued that in terms of special tax rule companies, the Australian government's approach to tax neutrality for business forms is a significant obstacle, as the government has been hesitant to allow tax transparency when limited liability is available. However, despite this, it will be contended that this position may change *if* the government is satisfied with the integrity measures underpinning tax transparency reforms.

In terms of implementing a new form transparent company, while there have been breaches of tax neutrality for Australian business forms, these are not nearly as significant as those in the foreign jurisdictions. This is in part due to the existence of Australia's full tax imputation system for corporations and the utilisation of discretionary trusts for business operations. This reduced breach of tax neutrality may explain the minimal lobbying for the broad introduction of a new form of tax transparent company in Australia. If the foreign experience is instructive, this market drive is instrumental with the introduction of a new form transparent company. However, despite this lack of domestic motivation it will be argued that international dimensions might be persuasive for introducing a transparent company in Australia.

5.2 Special tax rule companies

Special tax rule companies have been identified as resulting from the application of tax transparency to particular closely held corporations satisfying eligibility requirements. The analysis in the preceding chapter stipulated that the central reason behind the introduction of the special tax rule companies studied — being

S Corporations and the Loss Attributing Qualifying Companies (LAQCs) – was to enhance tax neutrality for closely held businesses.

Currently, in Australia, breaches or infringements of tax neutrality are particularly evident between different business forms. Utilising the continuum of taxation model illustrated in Chapter One: Figure 1-0-1 tax transparency is available in Australia for sole proprietors and general partnerships only. An integrated tax system applies to limited partnerships,⁴ public unit trusts and corporations, with a full imputation system applying to these business forms and their members.⁵ Pursuant to this imputation system, losses are specifically confined to the entity level and subject to carry-forward rules. The tax treatment of discretionary and non-public fixed trusts lies between full tax transparency and the integrated system. Using the definition of ‘transparent companies’ presented in Chapter Three, a trust could be defined as a ‘partial income transparent company’. This is because income can be assessed directly to members (beneficiaries), but losses are confined within the trusts themselves, and tax preferences do not always flow through to them.⁶

Accordingly, in Australia there is some recognition and implementation of the economic ideals espoused in Chapter Two. Due to this, breaches of tax neutrality are not nearly as significant as those documented in the jurisdictions studied. However, breaches of tax neutrality are still evident. In particular, an example where tax neutrality has been breached is evident in equity versus debt funding

⁴ Except for the tightly regulated venture capital incorporated limited partnerships: *ITAA 1936* (Cth), section 94D (2) excludes them from the definition of ‘corporate limited partnership’.

⁵ This imputation system means that the business is taxed separately from its members, with members assessable on actual distributions paid to them. Members are able to claim imputation credits for tax already paid at the entity level on the receipt of franked dividends, and if imputation credits exceed the member’s tax liability then these excess credits may be refundable. *ITAA 1997* (Cth), Division 67.

⁶ Note a trust is not a transparent company as defined since it does not provide for a separate legal entity; nor does it have full tax transparency as losses are trapped at the trust level. With fixed or unit trusts, tax preferences are unlikely to be able to flow-through to members. See: Freudenberg, B and McDermott, P. (2005). The Forgotten CGT events: Are asset revaluations reserve distributions by trustees of discretionary trusts taxable? *Australian Tax Review*, 34(2): 67.

and retention versus distribution. In this respect Chapter Two highlighted how breaches of tax neutrality in Australia have been acknowledged, with the Ralph Committee emphasising the importance of striving for improved tax neutrality with different business forms.⁷ The Australian government agreed with this sentiment proposing to improve tax neutrality with the introduction of a unified entity regime for businesses.⁸ However, the government's approach to tax neutrality in these reforms highlighted the tension that can arise between 'legal' and 'economic' notions associated with the taxation of business forms.

Importantly, the Australian government's approach to tax neutrality under the proposed unified entity regime was influenced by members' liability protection provided by the business form.⁹ Where the business provided¹⁰ liability protection for members, an integrated tax system was to apply.¹¹ That is, the business form was to be taxed separately from its members, with an imputation system applying to distributions.¹² Accordingly, the Australia government considered that, in these circumstances, it was preferable to depart from economic ideals and follow legal notions of taxation, although with some integration.

⁷ Australia. (1999). A Tax System Redesigned (Ralph Report No 4), Canberra: AGPS, at p 105.

⁸ Treasurer Press Release No 58. (1999). *The New Business Tax System*, Treasury, Canberra. See generally: Freudenberg, B. (2005). Entity Taxation: The inconsistency between stated policy and actual application, *Journal of Australasian Tax Teachers' Association* 1(2) 458; and Vann, R.J. (2001). Australia's Policy on Entity Taxation. *Australian Tax Forum* 16:33, at p 43.

⁹ The Government considered that corporations, limited partnerships, fixed trusts, non-fixed trusts, life insurers and cooperatives provided members with liability protection, and therefore should be taxed pursuant to the same set of rules.

¹⁰ Or was perceived to provide.

¹¹ Australian Treasury. (1985). Draft White Paper on the Reform of the Australian Tax System, Canberra: AGPS, at p 13-54: "Similarly, family trusts are a close substitute for private companies as a vehicle for operating businesses and making investments, and they can ... confer the benefits of limited liability on the persons involved. Taxing such trusts like companies would assist in preventing further erosion of the company tax base".

¹² Australia. (1998). Tax Reform: Not a new tax, A new tax system (The Howard Government's Plan for a New Tax System), Canberra: AGPS, at p 113.

In contrast, tax transparency was to apply only to those business forms where members bore the liability for the losses in their businesses 'directly'.¹³ Sole proprietors and general partnerships were seen as the only business forms with this direct liability exposure for members, and therefore entitled to tax transparency. Consequently, only when there was liability exposure was the Australian government prepared to embrace the economic ideal of tax transparency.

The unified entity regime proposal can be seen as the antithesis of transparent companies. This is because if the business form provided limited liability then tax transparency would be excluded, as members were not seen as bearing the financial risk of the business activity. The Australian government's subsequent withdrawal of the proposed unified entity tax regime was not because of a change of position in relation to limited liability and tax neutrality, but rather was due to political concerns that the draft legislation released was 'unworkable'.¹⁴

This is not the first time that the Australian government has determined the tax treatment of a business form based on legal ideals by considering members' liability protection. For example, around the time New Zealand introduced LAQCs, the Australian government legislated that limited partnerships were to be taxed as corporations rather than having transparent treatment.¹⁵ This was in part because limited partnerships provided 'limited liability',¹⁶ and that there was a renewed market interest in them.¹⁷

¹³ Australia, n 12, at p 109.

¹⁴ Treasurer Press Release No 8. (2001). *Entity Taxation*, Treasury, Canberra. For a comprehensive discussion of the Government's proposed entity tax system and its subsequent back-down see: Freudenberg, n 8. Reasons included opposition to the profits first rule.

¹⁵ The flow-through treatment of limited partnerships was eliminated by the introduction of *ITAA 1936* (Cth), Division 5A with limited partnerships being defined as 'corporate limited partnerships'. The proposed legislation appeared in *Taxation Laws Amendment Bill (No. 6) 1992* (Cth) and resulted in a new Division 5A being inserted into Part III of the *ITAA 1936* (Cth).

¹⁶ Australia. (1992). *Budget Measures 1992: Budget Paper No 1* Canberra: Commonwealth of Australia, at paragraph 4.8, as cited in: Butterworths. (1992). *Weekly Tax Bulletin*, No. 42, at paragraph 804.

¹⁷ Historically limited partnerships had not been a popular business form in Australia. This renewed market interest saw a number of Australian state governments introduce limited

Consequently, the approach to tax neutrality in the United States and New Zealand, in introducing their special tax rule companies, is diametrically opposed to that which is evident in Australia, with the unified entity regime and the taxation of limited partnerships. This is even though all governments reflected the desire 'to improve tax neutrality' among business forms. The difference in outcomes can be explained by the various governments' *approaches to tax neutrality*. In the United States and New Zealand, the approach to tax neutrality was to reduce anomalies in tax treatment of 'closely held businesses' operating as either a general partnership or a corporation. By comparison, the Australian government considered that the appropriate tax treatment should be delineated by members' risk exposure, rather than one predicated on the specific membership structure of the business form. Thus, in Australia, legal notions of a business are highly influential in the determination of its tax treatment. However, the full imputation system for corporations and limited partnerships illustrates that the Australian government is not totally dismissive of economic ideals in the taxation of business forms. Nevertheless, it is argued that the Australian government is reluctant to fully embrace such economic ideals when the member is provided liability protection by the business form.

Several other provisions illustrate the Australian government's focus on members' risk exposure as determinants of the appropriate tax treatment of business forms. For example, the taxation of public unit trusts as corporations because of the availability of limited liability for members.¹⁸

partnership legislation, which they did not previously have, to allow the utilisation of these forms. Holub, M. (2001). *Taxes and the Choice of Organisational Form in Australia*. PhD, Department of Accounting and Finance, University of Western Australia, at p 76. This can be compared to the United States and the United Kingdom, where limited partnerships have been a common vehicle for raising capital and investing, especially venture capital. Refer to the data provided in Chapter Three about the utilisation of limited partnerships in these jurisdictions.

¹⁸ A further illustration of this government policy is the 45-day holding rule provides that shares in a corporation must be held at-risk to enable the member to utilise imputation credits attached to a franked dividend: *ITAA 1997* (Cth), section 207-145 and *ITAA 1936* (Cth), section 160APHL. Other examples of this policy can be found in the rules for corporations and trusts carrying forward their losses. For example a corporation must first look at the continuity of ownership test

However, the Australian government's policy appears to be on the basis of 'perceived' availability of limited liability provided by the business form, even though, in reality, a member's financial exposure could be vastly different. For example, a sole proprietor and members of a general partnership may effectively limit their liability exposure through insurance coverage and subsequently claim deductions for doing so.¹⁹ Alternatively, the sole proprietor or members of a general partnership may place their assets in a discretionary trust arrangement beyond the practical reach of a trustee in bankruptcy.²⁰ Alternatively, if non-recourse loans are used to finance the purchase of assets, then the sole proprietor or members of a general partnership could claim depreciation deductions even though the economic risk in the financed asset effectively is with the financier.²¹

In contrast, a member of a closely held corporation may be forced to give a guarantee for the corporation's obligations to secure working capital or long-term leases. Alternatively, if a corporation's member is actively involved in the business, then the member could be exposed to liability as a director or employee. For such a corporation member, the existence of limited liability may be nominal, since the member's personal assets are effectively at risk.²² Also,

under *ITAA 1997* (Cth), section 165-12. Note if this cannot be satisfied then the same business test may be utilised: see *ITAA 1997* (Cth), section 165-13. The trust loss measures are found within Schedule 2F *ITAA 1936*. An additional requirement is that trust losses of previous years that have been recouped from corpus are not deductible in calculating the net income of the trust estate in the case of beneficiaries, or life tenants, who have no beneficial interest in the corpus of the trust estate: *ITAA 1936* (Cth), section 95 definition of 'net income'. The object of this provision is to ensure that a beneficiary, who will not have to bear the effect of any past loss because the loss is met out of corpus in which the beneficiary has no interest, will not get the tax benefit of that loss.

¹⁹ However, it should be acknowledged that the cost of such insurance is likely to be prohibitive. See: Bratton, WW, and McCahery, JA. (1997). An Inquiry into the Efficiency of the Limited Liability Company: Of Theory of the Firm and Regulatory Competition. *Washington and Lee University Law Review* 54:629, at p 654.

²⁰ Although this is not certain: *ASIC v Carey* (no 6) [2006] FCA 814.

²¹ Although on termination if the depreciation deductions have been 'excessive' then Division 243 *ITAA 1997* (Cth) could apply.

²² Note that the member will still have limited liability protection in respect of other creditors where no personal guarantee has been granted, and in respect of tortfeasors.

the taxation of limited partnerships as corporations does not recognise the fact that the general member, as opposed to the limited member, has no liability protection afforded by the business form.²³ However, general members of a limited partnership are not able to benefit from tax transparency even though they have similar liability exposure to members of a general partnership.

Furthermore, the broad application of the Australian government's policy fails to acknowledge that members of most types of business forms²⁴ will nevertheless have some liability exposure. For example, in the most basic of circumstances a member of a corporation will have, at risk, the amount of their equity investment and the amount unpaid on their membership interest.²⁵ It needs to be acknowledged here that 'limited' liability is not equivalent to 'no' liability.

Consequently, the Australian government's approach to tax neutrality as reflected by the unified entity system would provide a substantial impediment to the broad introduction of a transparent company. It is argued that part of the Australian government's focus on limited liability is that the unrestricted allocation of losses and tax preferences to members could result in the tax system distorting economic investments, as well as eroding tax revenue.²⁶ For example, reasons stated for the taxation of limited partnerships as corporations were concerns about the creation of artificial losses,²⁷ and the 'potential to erode the

²³ *Partnership Act 1892* (NSW), section 60, *Partnership Act 1958* (Vic), section 60, *Partnership Act 1891* (SA), section 58, *Partnership Act 1891* (Qld), section 49, *Limited Partnership Act 1909* (WA), section 4(2), and *Limited Partnerships Act 1908* (Tas), section 4(2). Note there is nothing prohibiting the general partner being a corporate form, and thus providing limited liability for the member operating through a 'corporate form' general member.

²⁴ An exception to this would be the no liability corporation compared with the limited liability corporation.

²⁵ *Corporations Act* (Cth) 2001, section 9.

²⁶ Refer to the example provided in Chapter Six that demonstrated how the tax system could distort investment decisions if there are no loss restriction rules.

²⁷ This concern seemed to relate to an earlier United Kingdom decision which held that a limited member of limited partnership could deduct tax losses in excess of their liability exposure: *Reed v Young* HL 1986, 59 TC 196, STC 285. This case held that the allocation of a loss to a limited member was not restricted to the amount of the member's capital contribution to the limited partnership. This decision gave rise to a number of film schemes, in which limited members' provided capital for the making of a film by a limited partnership. The allocation of most of the

[tax] revenue'.²⁸ While these concerns are valid, it is questionable whether the optimal policy solution has been implemented. In this respect, a preferable reform would be to introduce loss restriction rules that apply to all tax transparent business forms in order to ensure that access to tax losses and/or preferences is restricted to a member's financial exposure.

If a loss restriction rule were indeed implemented with an Australian transparent company, then this could alleviate the Australian government's concern about fully embracing the economic ideal. Furthermore, it is argued that the Australian government could be convinced that for closely held businesses the existence of limited liability is seldom complete, regardless of the business form adopted. Therefore, losses should flow-through to such members, subject to the satisfaction of a loss restriction rule.²⁹ This may explain why the Australian government has announced that the proposal for a tax transparent company by the Institute of Chartered Accountants in Australia and Deloitte (the ICAA proposal) will be considered by the Henry Tax Review, as the proposal has specifically included a loss restriction rule.³⁰

Furthermore, loss restriction rules have been utilised with Australia's own incorporated limited partnerships used for venture capital (venture capital ILP) as

losses to the limited member, would enable them to offset their other income, and the value of this tax saving could exceed their contributed capital.

²⁸ The Australian government considered that the tax transparent treatment applying to limited partnerships meant they were vehicles for artificial tax avoidance arrangements, and it raised the issue of taxing them as corporations in its 1985 Draft White Paper: Australian Treasury, n 11. "Limited partnerships are comparable to corporations in providing limited liability investment vehicles ... In this light it is considered that the tax advantages over a company structure are inappropriate and have the potential to erode the revenue base unduly": Budget Paper No.1, 1992 at paragraph 4.8, as cited in: Butterworths, *Weekly Tax Bulletin*, No. 42, 1992, paragraph 804.

²⁹ Stewart submits a similar argument in her proposals to repeal Division 5A: Stewart, M. (2003). Towards flow through taxation of limited partnerships: It's time to repeal Division 5A. *Australian Tax Review* 32:171, at p 194. Chapter Six will demonstrate that the flow-through of a transparent company's losses in foreign jurisdictions is restricted due to the application of a number of provisions, such as membership cost basis, at-risk rule, streaming and passivity tests.

³⁰ Emerson, C. (Innovation, Industry, Science and Research Minister). (2008). Media Release: Simplifying Small Business Taxation Under Consideration by Rudd Government. Canberra: Australian Government. Institute of Chartered Accountants in Australia and Deloitte. (2008). Entity flow-through (EFT) submission. Sydney: Institute of Chartered Accountants.

well as the recognition of some foreign hybrids as general partnerships for controlled foreign corporations (CFC) and foreign investment funds (FIF) purposes (collectively referred to as CFC hybrids).³¹ These existing loss restriction rules may already provide a sufficient framework for the broader implementation of a transparent company. The adequacy of the Australian loss restriction rules is analysed in Chapter Six.

While strong market lobbying was associated with the introduction of LLCs and LLPs, the introduction of S Corporations and LAQCs was largely government driven. This being the case, the absence of widespread lobbying may not prevent the introduction of a special tax rule company if the Australian government considers that benefits, especially enhanced tax neutrality, may be facilitated through their introduction. It should be recognised that the Australian government sometimes uses tax transparency to improve tax neutrality and as an integrity measure to restrict taxpayers manipulating legal forms. For example, to address the sheltering of income in a business entity, the personal services income provisions disregard the business form for tax purposes and allocate the income and or losses directly to the member performing the personal services.³² Another example of transparency as an integrity measure is the tax consolidations of corporate groups, as it disregards, for tax purposes, the separate legal entities (of corporations) and allocates all income and losses to the head corporation.³³ Tax consolidations was introduced as an integrity measure to stop members of a corporate group manipulating transactions between them that could result, for

³¹ Members of recognised foreign hybrids can claim losses only to the extent of their loss exposure amount. Defined in *ITAA 1997* (Cth), section 830-60 introduced by *Taxation Laws Amendment Act (No 1) 2004* (Cth).

³² The operation of these provisions restrict taxpayer's ability to shelter personal services income in an entity taxed at a lower rate, to split income among a number of taxpayers, and the ability to access concessional fringe benefits and superannuation provided to employee-members. *ITAA 1997* (Cth), section 86-15. The personal services income provisions are contained in Division 84, 85 and 86. It appears that if these provisions do apply then it is possible for losses to be allocated to the personal services provider. While section 86-20(1) provides it is not possible for deductions to be allocated in excess of income amounts, section 86-27 subsequently provides excess deductions can be allowed.

³³ *ITAA 1997* (Cth), Division 700.

example, in loss cascading.³⁴ Another example is the CFC and FIF provisions which endeavour to address taxpayers sheltering income overseas in a foreign legal entity by allocating the income to the member even though there has been no distribution.³⁵ Given that tax transparency can be used to improve tax integrity, the Australian government may find this persuasive for the broader recognition of a transparent company.

Additionally, the tax advantages facilitated through transparency could replace or supplement existing tax concessions for small businesses, which some argue are 'ill-conceived'.³⁶ One such provision is the simplified tax system (STS) which has had problems in achieving its goal of reducing complexity for small businesses.³⁷ Furthermore, the application of tax transparency could remove the need for the application of complex integrity measures imposed to address the disguised distribution of profits from private corporations, and thereby reduce compliance costs. It is such arguments that underpin the ICAA proposal for a tax transparent company, arguing that Division 7A and fringe benefits tax (FBT) need not apply to distributions to members.³⁸ Division 7A was reported by the Board of Taxation as being a significant compliance cost issue.³⁹ Other complex provisions that need not necessarily apply to a transparent company could include share value shifting,⁴⁰ tracing capital gain discounts,⁴¹ and tracing rules for capital assets acquired prior to 20 September 1985.⁴² Furthermore, a tax transparent company could provide an alternative form of tax consolidations, which can be problematic for small businesses.⁴³ It is these compliance cost savings that may indeed be

³⁴ Vann, n 8, at p 46.

³⁵ ITAA 1936 (Cth), section 316: CFCs, and ITAA 1936 (Cth), section 468 (Part XI): FIF.

³⁶ Burton, M. (2006). The Australian small business tax concessions – public choice, public interest or public folly? *Australian Tax Forum* 21 (1):71. Pizzacalla, M. (2008). Global SME tax policy conundrum. *Australian Tax Forum* 23(1):40.

³⁷ Institute of Chartered Accountants in Australia and Deloitte, n 20, at p 11.

³⁸ Institute of Chartered Accountants in Australia and Deloitte, n 20, at p 9.

³⁹ Board of Taxation. (2007). *Scoping study of small business tax compliance costs: A report to the Treasurer*, Attorney-General's Department, Canberra, December, at p 100.

⁴⁰ ITAA 1997 (Cth), Division 723 to 727.

⁴¹ ITAA 1997 (Cth), section 115-40.

⁴² ITAA 1997 (Cth), CGT event K6.

⁴³ Institute of Chartered Accountants in Australia and Deloitte, n 20, at p 10.

the most significant advantage represented by the implementation of a tax transparent company. However, it should be acknowledged that the application of a loss restriction rule would undoubtedly increase complexity. Also, the argument that a tax transparent company might achieve compliance cost savings needs to be carefully analysed, as Chapter Seven will present empirical evidence to the contrary in the foreign jurisdictions.

Australia's restricted recognition of transparent companies with the venture capital ILPs and the CFC hybrids would not fall within the 'special tax rule companies' classification as these reforms do not involve tax transparency applying to existing corporate forms. Instead they are examples of new form transparent companies and are considered in the analysis which follows.

5.3 New form transparent companies

New form transparent companies have been described as the introduction of a new business form subject to the existing tax transparency rules applying to general partnerships. Chapter Four argued that the introduction of the studied new form transparent companies was associated with a market drive for the introduction of a whole new business form so as to address breaches of tax neutrality. These factors led to large closely held businesses lobbying for their introduction, which then led to competition among jurisdictions. The Australian position will now be considered. Also, whether the foreign experience is insightful for Australia's enactment of venture capital ILPs and the associated CFC hybrids will be considered.

5.3.1 Breaches of tax neutrality

Fundamentally, it was argued that breaches of tax neutrality acted as a ‘catalyst’ for reform in foreign jurisdictions, as there was demand for a business form with limited liability, as well as for tax transparency. The conclusion that tax transparency applying to LLCs was important in their introduction is a significant one as an entity (classical) tax system applies to C Corporations in the United States with no permanent integration of tax relief between members and the C Corporation.⁴⁴ This has the implication that tax transparency in the United States can decrease the overall taxation burden applying to the business form and its members.⁴⁵

However, as was previously documented, the existence of the full imputation system in Australia for corporations improves tax neutrality. Consequently, breaches of tax neutrality may not be substantial enough to act as a catalyst for interest groups to lobby for reforms. Indeed, tax transparency in Australia could result in higher tax burdens for members. Such a realisation contributed to Canada not adopting a transparent company form.⁴⁶ Also, Table 5-0-1 demonstrates that corporations are the second most utilised business form in Australia by small businesses. Currently in Australia, the main small business structures utilised are sole proprietors (33 per cent), corporations (29 per cent), partnerships (21 per cent) and trusts (16.6 per cent).

⁴⁴ However, there is some temporary dividend and CGT relief until 2010. See Chapter Eight.

⁴⁵ In Chapter Eight, Figure 8-1 demonstrates as a percentage the tax savings that are potentially available through one level of taxation compared to the two that can arise through the classical tax system applying to C Corporation distributions.

⁴⁶ McLure, CE. (1979). *Must Corporate Income Be Taxed Twice?* A report of a conference sponsored by the Fund for Public Policy Research and the Brookings Institution. Washington DC: The Brookings Institution, at p 46: “In addition, integration was strongly opposed by owners of small businesses in Canada. Whereas under pre-existing law these businessmen benefited from the advantages of a preferential rate of corporate tax on income up to a certain level, under integration all corporate income, including that earned in such businesses, would be taxed at the marginal tax rates of the owners”.

Table 5-0-1: AUS: Small business forms

Business form	Non-employing	1 – 4 employees	5 – 19 employees	Total small businesses
Sole proprietor	500,876	76,495	19,672	597,043
Corporations	180,636	245,729	98,858	525,223
Partnerships	267,630	75,410	35,338	378,378
Trusts	172,658	81,089	44,033	297,780
Total	1,121,800	478,723	197,901	1,798,424

Source: Australian Bureau of Statistics Cat. No 8165.0 Counts of Australian Businesses. Data includes businesses with turnover less than \$2 million and employing less than 20 people.

However, the imputation system does not eliminate all potential tax savings and breaches of tax neutrality. Tax transparency can still provide additional benefits, including the flow-through of tax preferences and tax losses to members, and the single layer of tax on capital gains. Also, tax transparency can be advantageous for foreign members, who cannot fully utilise imputation credits and cannot obtain foreign tax credits in their own jurisdictions for the tax represented by imputation credits.

Also, the presence of an integrated corporate tax system does not prevent the introduction of a transparent company. For example, two of the jurisdictions studied, the United Kingdom and New Zealand, adopted transparent companies even though both countries do contain integrated corporate tax systems. This raises the questions as to whether there are circumstances peculiar to the United Kingdom and New Zealand influencing the relationship between tax transparency and their corporate integration systems.

It is argued that a peculiarity in the United Kingdom is the application of the National Insurance Contribution (NIC) scheme and the instrumental role that professional firms played in lobbying for the introduction of LLPs.⁴⁷ In the United

⁴⁷ The NIC is a hypothecated tax to pay most of the cost of retirement pensions, unemployment benefits and sickness benefits. The different application of NIC between the two entities results from NIC rates depending upon whether an employment or self-employment relationship exists.

Kingdom, tax transparency for LLPs has meant that a more favourable rate of NIC is applied to professionals as self-employed persons, compared to corporations and their employee-members.⁴⁸ The application of the NIC could be significant, given that members of a professional firm are likely to be active in their business. This discrete tax saving for professionals encouraged them to lobby for the LLP to have transparent treatment.⁴⁹ In Australia there is also differing tax treatment applying to self-employed persons compared to employee-members. Generally, the status of being an employee for an active member can be beneficial as it may increase access to concessional tax fringe benefits and preferable superannuation treatment.⁵⁰ However, wages⁵¹ paid to an active member could be subject to payroll taxes levied by the various Australian states and territories, whereas the allocation of profits would not be.⁵² Overall, then, the status as an 'employee' for active members can be beneficial and the Australian government considers some practices to achieve this status as abusive.⁵³ Currently, it is not possible for a sole proprietor or a member of a general or limited partnership to obtain employee status,⁵⁴ while it is possible for an active member of a corporation or a beneficiary of trust to do so. The ICAA proposal argues that the introduction of a transparent company could have the effect of

See: Kay, JA, and King, MA. (1990). *The British Tax System*. 5 ed. Oxford: Oxford University Press, at pp 22-23.

⁴⁸ Refer to the examples provided in the Appendix to Chapter Eight.

⁴⁹ Also the conversion for established professional firms from general partnerships to corporations could be costly due to the application of capital gains tax (CGT), which does not occur with conversions to an LLP.

⁵⁰ However, this is subject to many qualifications and legislative changes. For example commencing 1 July 2007, a self-employed person can now claim a 100 per cent deduction on contributions made to a qualifying superannuation fund. *ITAA 1997* (Cth), section 290-170.

⁵¹ Including fringe benefits and superannuation.

⁵² However, this payroll tax can be mitigated through the manipulation of the wage level paid to active members.

⁵³ For example, the Australian government introduced Personal Services Business provisions, which restrict the extent that the benefits can be obtained: *ITAA 1997* (Cth), Division 84 to 87. Also there have been introduced caps on the extent of salary packaging allowed for employees of tax-exempt employers.

⁵⁴ However, it appears that it is possible for 'salaried partners' who are not equity members of a general partnership to obtain 'employee' status.

reducing the additional compliance cost due to the non-application of FBT to benefits provided to employee-members.⁵⁵

In later chapters it will be argued that there are breaches of tax neutrality between active members as ‘employees’ or ‘self-employed’ in the foreign jurisdictions studied. For the special tax rule companies the active member obtains ‘employee’ status, whereas for new form transparent companies there is the potential, indeed, for ‘self-employment’ status. Chapter Eight argues that the status of an active member of a transparent company as ‘self-employed’ would be more consistent with the overall policy objective of tax transparency. In the Australian context, if tax transparency did result in ‘self-employment’ rather than ‘employee’ status for an active member, then this may have the effect of increasing the overall tax burden for the business. Such a conclusion would mean that the peculiarity in the United Kingdom in terms of the application of a lower rate of NIC for self-employed persons would not apply in Australia. It is argued that this could have negative implications for the introduction of a new form transparent company in Australia.

Peculiarities of the New Zealand tax model relate to the access to tax losses and tax preferences. Chapter Six will discuss, in particular, how New Zealand does not have any substantive loss restriction rules based on members’ contributed equity to the LAQC.⁵⁶ This means that tax transparency in New Zealand can provide, to an extent, the unfettered access to losses for LAQC members.⁵⁷ The other peculiarity in New Zealand is its large tax preference of the non-taxation of capital gains,⁵⁸ with LAQC members being able to access this tax preference.⁵⁹

⁵⁵ Institute of Chartered Accountants in Australia and Deloitte, n 20, at p 12.

⁵⁶ Chapter Six outlines that there is a risk rule but this did not restrict access to losses based on any notions of membership cost basis.

⁵⁷ Freudenberg, B. (2008). ‘The Troubled Teen Years’: Is the repeal of New Zealand’s LAQC regime required? *New Zealand Journal of Taxation Law and Policy* 14(1): 67, at p 75.

⁵⁸ While New Zealand does not have a comprehensive capital gains tax it does have section DB 26 *ITA 2007* (NZ), which assesses amounts from profit-making undertakings.

⁵⁹ *ITA 2007* (NZ), section HA 16 and CW 15. Freudenberg, n 57, at p 69.

It was previously argued that the Australian government would require the application of a loss restriction rule to a transparent company.⁶⁰ Furthermore, since 1985 Australia has included most capital gains in taxpayers' assessable income, thereby having the effect of reducing the extent of this tax preference. Due to the combination of these factors, the peculiarities in the New Zealand model are generally not replicable in Australia, although there is some concessional treatment of capital gains.⁶¹

Consequently, then, the structure of the Australian tax system compared to the United Kingdom and the New Zealand may mean that breaches of tax neutrality are nearly not as significant or decisive.

Another influential factor in the introduction of transparent companies in Australia is the popularity of discretionary trusts for the undertaking of business operations. In Australia discretionary trusts have increasingly been adopted as an alternative business structure,⁶² with 39 per cent of trusts in the property industry, 29 per cent in finance, insurance, real estate and business service industry, and six per cent in the retail trade and primary production industry, respectively.⁶³ Small businesses account for the vast majority of the use of trusts, as 85 per cent of trading trusts operate within the \$1 to \$1 million business income range.⁶⁴ Table 5-0-2 illustrates the overall popularity of trusts in Australia.

⁶⁰ This is reflected with the introduction of venture capital ILPs and the CFC hybrid amendments. See: Freudenberg, B. (2006). Are transparent companies the way of the future for Australia? *Australian Tax Review* 35(3): 200, at p 216.

⁶¹ For example the 50 per cent discount provided to capital gains for CGT assets held greater than 12 months: *ITAA 1997* (Cth), Division 115.

⁶² Coopers and Lybrand and the Property Council of Australia. (1997). *The taxation of trusts – Dispelling the Myth*, at <http://www.propertyoz.com.au/data/national/advoc/subs/971119tt.pdf>.

⁶³ Australian Taxation Office. (2001). *Taxation Statistics 1998-99: A summary of taxation and superannuation statistics*. Canberra, AGPS.

⁶⁴ The Board of Taxation. (2002). *Taxation of Discretionary Trusts: A Report to the Treasurer and the Minister for Revenue and Assistant Treasurer*, AGPS, Canberra, at p 30.

Table 5-0-2: AUS: Number of trusts

Source: Board of Taxation. (2002). *Taxation of Discretionary Trusts: A Report to the Treasurer and the Minister for Revenue and Assistant Treasurer*, Canberra: AGPS, at p 25.

In terms of taxation, discretionary trusts produce substantial flexibility in the distributing and splitting of income. In part this is due to the trustee being able to choose among the beneficiaries (mere objects) prescribed in the trust deed.⁶⁵ In choosing which beneficiary(ies) will be presently entitled to trust income, the trustee may consider a beneficiary's tax profile for the year to minimize the overall tax burden.⁶⁶ Over recent years the tax flexibility of discretionary trusts

⁶⁵ The general basis of taxation of a discretionary trust and its members is found in Division 6 of Part III of the *ITAA 1936* (Cth). The number of beneficiaries prescribed can be very broad and need not be static, as beneficiaries could be introduced through birth, marriages and the purchase of membership interest in other entities. For example a trust deed could provide that 'beneficiaries include Cooper and any corporations that Cooper holds membership interest in'.

⁶⁶ For example the level of income, availability of losses (revenue or capital in nature). Distributions to individuals less than 18 years of age can be restricted due to the penal rates that apply pursuant to Division 6AA *ITAA 1936* (Cth). To facilitate accessing the low 30 per cent rate applying to corporations, a corporation may be a potential beneficiary. Due to the penal rates applying to trust income with no present entitlement [Unless the Commissioner exercises a

has been eroded, especially if a family trust election is required. A family trust election could be required if the trust has carried forward losses, or wishes to pass imputation credits through to beneficiaries, or if the trustee holds shares in a corporation with carried forward losses.⁶⁷ When a family trust election is made, then it is only tax effective for beneficiaries of the 'family', as statutory defined, to be presently entitled to the net income of the trust. Present entitlement of beneficiaries outside this 'family' results in the application of a penal tax rate.⁶⁸

While losses are trapped within a discretionary trust, tax preferences are able to flow-through to beneficiaries, as a conduit principle may apply to distributions provided sufficient records are maintained. Such a conduit principle means that trust receipts retain their character in the hands of the beneficiary,⁶⁹ thereby enabling beneficiaries to take advantage of concessional treatment applying to different receipts.⁷⁰

discretion not to apply *ITAA 1936* (Cth), section 99A], retention of money within the trust can be achieved through the loan back from beneficiary or for a beneficiary's present entitlement to remain unpaid. Such an unpaid present entitlement may be treated as held on separate trust by the trustee for the beneficiary.

⁶⁷ A family trust election could be required to allow imputation credits to pass through to beneficiaries. Pursuant to the 45-day holding rule, discretionary trusts and their beneficiaries are deemed to have a delta of negative one in respect of shares acquired from 1 January 1999: *ITAA 1997* (Cth), section 207-145: not a 'qualified person' under Part III of *ITAA 1936* (Cth), section 160APHL(10). With a delta of negative one, discretionary trusts and their beneficiaries are deemed to have no risk in holding shares, and therefore limiting their ability to utilise franking credits. An exception is for trusts that have made a Family Trust election: *ITAA 1936* (Cth), section 160APHL. Would exclude shares acquired prior to 31 December 1997, or when an individual beneficiaries imputation credits are less than \$5,000 for the year. To determine whether a corporation can carry forward its losses, the continuity of ownership test must be satisfied, which is difficult when a discretionary trust holds the shares in the corporation. Relief is given if a family trust election has been made by the trust shareholder: *ITAA 1997* (Cth), section 165-207.

⁶⁸ If a distribution is to a non-'family' member (as defined) then the tax will be at the flat top marginal tax rate plus Medicare.

⁶⁹ For example a capital gain realised by a trustee will be treated as a capital gain in the hands of a beneficiary presently entitled to it. For a discussion about the conduit theories application to discretionary trusts see: Freudenberg, B and McDermott, P. (2005). The Forgotten CGT events: Are asset revaluations reserve distributions by trustees of discretionary trusts taxable? *Australian Tax Review*, 34(2): 67.

⁷⁰ In some circumstances the flow-through of tax preferences will be tax free receipts for beneficiaries. For example when accounting income exceeds taxable income: Freudenberg, B. (2005). Are asset revaluation reserve distributions 'ordinary income' for discretionary beneficiaries? *Australian Tax Forum*, 20(1):3. In comparison, for a beneficiary of a fixed trust the receipt of a tax preference could result in the decrease of the cost base of their membership interest: *ITAA 1997* (Cth), section 104-70. However, there is some uncertainty about the flow-

Overall, it is argued that the combination of Australia's full imputation system for corporations and the partial transparency applying to discretionary trusts diminish the potential tax savings available through a transparent company. Such a conclusion is incongruous with prior concerns of perusing the economic ideal. For example, the Ralph Committee noted that it was not feasible from a revenue viewpoint to allow for the flow-through of tax preferences with corporations.⁷¹ Unfortunately, the Ralph Committee provided no estimates as to why precisely this was the case.⁷² It may have been that the Ralph Committee in coming to this conclusion considered the level of tax losses carried forward by corporations. However, given the lack of any data or in-depth reasoning for their conclusion, it is not possible to undertake a definitive analysis.

Whether, and to what extent, there would be a loss of tax revenue depends upon the precise rules applying to any transparent company introduced. The allocation of losses to individual members could be the largest cost to revenue, since allocated tax losses would be sheltering income at individual marginal tax rates, rather than at the corporate tax rate of 30 per cent. However, the ultimate effect of allocated losses could be mitigated through restricting the utilisation of the losses to members' financial exposure amount. If such a loss restriction rule had universal application to all Australian taxpayers and not just transparent company members, then this may save tax revenue for the Australian government. For example, if a loss restriction rule could restrict the ability of individuals to use non-recourse borrowings to access tax losses, then this could protect tax revenue.⁷³

through of capital receipts. The problems of capital receipts flowing through trust is highlighted in the ICAA proposal: Institute of Chartered Accountants in Australia and Deloitte, n 20, at paragraph 2.2.11.

⁷¹ Australia, n 7, at paragraph 277 of Overview.

⁷² Other reviews, such as the Canadian Carter Commission, have also reiterated similar concerns: Canada. (1966). Royal Commission on Taxation (known as the Carter Commission), Ottawa, Chapter 19.

⁷³ Chapter Six analyses the appropriateness of Australia's existing loss restriction rules compared to the foreign jurisdictions studied.

The effect that transparency has on tax revenue is uncertain because, even if there is a loss of tax at the business level, it could be offset by an increase in individual member's tax payments.⁷⁴ However, this depends on members' tax profiles, as they could be low rate taxpayers, non-residents or tax-exempt bodies.⁷⁵ The Australian 1985 Draft White Paper noted that a particular concern with tax transparency was in relation to non-resident members, which could result in a transfer of revenue and national income to other countries.⁷⁶ However, it is argued that this concern could be addressed by applying a withholding tax obligation for allocations to non-resident members, which already occurs with other business forms.⁷⁷ Alternatively, if there was concern about the collection of tax from a vast array of members rather than from one business entity, then a partial loss transparent company, such as the LAQC, could be adopted.⁷⁸

While the cost to tax revenue is a valid and important concern, it is imperative that a real attempt to estimate this cost is conducted, rather than ad hoc statements being made by various governments or reviews. It is argued that a

⁷⁴ For example, individual marginal tax rates can be greater than the corporate tax rate and the allocation of income to individual members may increase tax revenue collected. Note the recent 2006 Federal Budget lowered the highest marginal tax rate to 45 per cent and increasing to \$150,000 to which it applies: Australia. (2006) *Budget Measures 2006-07: Budget Paper No 2*, Canberra: Commonwealth of Australia. From 1 July 2008 the highest marginal tax rate will apply to taxable income greater than \$180,000 per annum.

⁷⁵ This would occur in the circumstance that an exempt body or association held membership interest in a transparent company.

⁷⁶ Australian Treasury, n 11.

⁷⁷ For a non-resident member of a discretionary trust or unit trust, then the trustee is liable to pay tax on their behalf: *ITAA 1936* (Cth), sections 93(3) and (4). From 1 July 2006 this will also apply to distributions to non-resident trustee beneficiaries. The member is still also assessed on the present entitlement amount, and receives a credit for the tax already paid by the trustee on their behalf: *ITAA 1936* (Cth), section 98A. For a limited partnership and corporation with a non-resident member, then entity is obliged to withhold tax on any unfranked distributions made: *ITAA 1936* (Cth), section 128B (4). Although the amounts of withholding tax can vary depending whether there exists a relevant Double Tax Agreement, or to the extent the distribution is franked no withholding tax is applicable to the distribution: *ITAA 1936* (Cth), section 128B(3)(ga). Note for the non-resident member the receipt of either a franked distribution or one subject to withholding tax, will be non-assessable income for Australian tax purposes: *ITAA 1936* (Cth), section 128D.

⁷⁸ For a partial loss transparent company, tax is initially collected at the entity level on taxable income generated, with this mechanism acting as a withholding tax until profits are paid out to members.

loss of tax revenue is not necessarily a consequence with the broad introduction of a transparent company. Indeed, the ICAA proposal concludes that its transparent company would ‘result in addition[al] revenue’ for the government, excluding capital gains.⁷⁹ A tax revenue advantage for a government that is facilitated by transparency is that capital growth of membership interest may be taxed on a timelier basis, particularly when individual marginal tax rates are greater than corporate rates.⁸⁰ This is because members of a transparent company are assessed each year on the earnings of the transparent company, regardless of actual payments to them. This yearly taxation of the transparent company’s earnings regardless of distributions means that the growth in the business is largely taxed to members on an annual basis.⁸¹ Such tax treatment improves tax neutrality and equity of the tax system.

In terms of Australia’s restricted transparency recognition to date, breaches of tax neutrality have been important considerations, although the actions of closely held businesses are not as evident.

Breaches of tax neutrality were clearly implicated in the introduction of the venture capital ILPs. Tax transparency was to achieve the economic ideal of improved tax neutrality in terms of debt and equity funding and import–export neutrality. If an entity tax system or an imputation system applied to venture capital ILPs then this could tax equity funding more heavily than debt. This larger tax burden is due to equity and profit payments not being deductible, whereas the payment of interest on debt is. Also, non-resident members may not be able

⁷⁹ Institute of Chartered Accountants in Australia and Deloitte, n 20, at paragraph 2.5.18.

⁸⁰ This is because, with the imputation system, corporate members are not normally assessed on the increase in value of their membership interest until its disposal, which may be in many years. A more timely taxation of capital growth may reduce the ‘lumpiness’ of capital gains, although assessed members would not fully benefit from the concessional treatment provided for capital gains. Currently individuals holding membership interests greater than 12 months can access a 50 per cent discount: *ITAA 1997* (Cth), Division 115. Vann, n 8, at p 35: “For example, theory suggests that capital gains should be taxed as they accrue year by year and not as they are realised but this is not generally practical for several reasons and taxation by realisation is used”.

⁸¹ However, the appreciation in value of assets held by the transparent company would not be allocated to members until they were realised.

to claim foreign tax credits in their home jurisdiction for tax paid at the entity level. Additionally, tax transparency allows non-taxable entities to be members without tax being imposed at the entity level.⁸² It is argued that tax transparency for venture capital investments is best understood in terms of trying to achieve improved tax neutrality between equity and debt funding for non-resident members rather than just the flow-through of losses and tax preferences.

Normally breaches of tax neutrality between debt and equity funding can result in a preference for an investment to be structured as debt rather than equity.⁸³ However, for emerging businesses wanting to attract investment, venture capital, the use of debt funding can be problematic for several reasons. For example, the requirement of regular interest payments can be difficult prior to the establishment of a steady cash flow from sales when a product is in its initial development stage. Also, an emerging business may have minimal tangible assets to offer as security for such debt.⁸⁴ In these circumstances, despite the tax disincentive, equity investment may be the only viable option. It is for such reasons that venture capital investment can be referred to as 'private equity'.⁸⁵ In the absence of tax transparency, the greater tax cost of equity funding could deter investments from occurring, as investors may consider that the overall returns (after tax) are not sufficient, particularly if there are high risks that are associated with the investment. Tax transparency applying to venture capital investment can assist in reducing the breaches of tax neutrality between equity and debt funding. Also, the access to tax losses may decrease a member's overall tax burden, thereby increasing their return even if the business does not

⁸² Barkoczy, S, and Sandler, D. (2007). *Government Venture Capital Incentives: A multi-jurisdiction comparative analysis*, Research Study No 46. Sydney: Australian Tax Research Foundation, at p 16: quoting Sandler, D. (2004). *Venture Capital and Tax Incentives: A Comparative Study of Canada and the United States*, Canadian Tax Paper No 108, Canadian Tax Foundation, Toronto, at p 9.

⁸³ Of course subject to thin capitalisation rules.

⁸⁴ This can be especially the case if intellectual property is being developed.

⁸⁵ Barkoczy and Sandler, n 82, at p 5: "Central to the notion of venture capital is the principle that it involves the making of equity or 'near equity' investments in private companies. Because of this characteristic, the term 'venture capital' is sometimes interchanged with the expression 'private equity'".

succeed.⁸⁶ While this is a multi-faceted issue, it is argued that improved tax neutrality was an important consideration for the introduction of the venture capital ILP.

The goal to improve import–export tax neutrality was central to the CFC hybrid amendments. Without such amendments, asymmetrical tax treatment occurred between the country of origin — where transparency applied to the foreign transparent company — and Australia, where it was taxed separately from its members as a corporation.⁸⁷

This asymmetrical tax treatment resulted in several problems and the potential for double taxation. Particularly, the tax treatment of the ‘foreign transparent company’ in Australia as a ‘corporation’ meant its members could be subject to Australia’s CFC and FIF provisions.⁸⁸ The application of the CFC or the FIF measures to a foreign transparent company results in an exception to the entity tax treatment of a corporation, with the entity’s income or losses being allocated

⁸⁶ However, the benefit of access to losses may be exaggerated because, if an entity tax system applied, then an equity investor could sell their membership interest and realise a loss through this. However, this loss is likely to be capital in nature, which can restrict the member’s ability to utilise it. Of course, this requires divestment and breaking continuity of membership interests. Also with venture capital investments, while the general member (manager) is likely to be a taxable entity, industry practice is that a general member receives a small percentage of losses, whereas limited members get a larger percentage. However, limited members can be tax-exempt or subject to passivity rules restricting their utilisation of losses. The immediate flow-through of losses provides a significant timing advantage as there is immediate access to losses, and the nature of the losses may be more likely to be revenue in nature rather than capital, which may increase the ability to utilise it. See: Stewart, M. (2005). *Venture Capital Tax Reform in Australia and New Zealand*. *New Zealand Journal of Taxation Law and Policy* 11 (2):216, at pp 246 to 247.

⁸⁷ This treatment in Australia is because of the definition of a ‘company’ [corporation] in subsection 6(1) *ITAA 1936* (Cth), which includes all bodies or associations corporate or incorporate; but does not include partnerships or non-entity joint ventures. Such foreign transparent companies would not have previously come within the exclusion of a ‘partnership’, as a partnership is defined for tax purposes as an association of persons carrying on business as partners or in receipt of income jointly, but does not include a company: *ITAA 1936* (Cth), subsection 6(1). While these definitions are circular, the considered opinion is that since these transparent companies provide a separate legal entity that for Australian tax purposes they would be regarded as a company, and therefore excluded from being a partnership.

⁸⁸ *ITAA 1936* (Cth), section 316: CFCs, and *ITAA 1936* (Cth), section 468 (Part XI): FIF. The CFC and FIF provisions are integrity measures that try to address taxpayers sheltering income overseas in a foreign legal entity by allocating income to the member even though there has been no distribution.

for Australian tax purposes to the Australian member. Initially, one might consider that this treatment would therefore eliminate asymmetry as a form of tax transparency applies in both jurisdictions. However, the CFC or FIF provisions do not facilitate any credit for the foreign tax paid directly by a member, for example the United States' tax directly assessed to an LLC member.⁸⁹ Another problem with the CFC and FIF provisions is the allocation of a wider range of income, as the active income test and the allocation of comparably taxed income test cannot be used.⁹⁰ The operation of the CFC provisions to foreign transparent companies in this way was stated to lead to the 'risk of double taxation', 'increased uncertainty' and 'significant compliance costs'.⁹¹ Consequently, the CFC hybrid amendments are best understood as improving import–export tax neutrality.

5.3.2 Interest groups

The argument in Chapter Four, that breaches of tax neutrality and other associated regulatory issues were a key driving force behind the activities of particular interest groups in the United States and the United Kingdom, provides a useful background when determining whether there are interest groups in Australia who would lobby for the introduction of a transparent company. However, as previously argued, the breaches of tax neutrality in Australia may not be significant enough to act as a 'catalyst' for change.

In fact, in Australia there does not appear to be overwhelming demand for the introduction of a transparent company. One specific pocket of demand has been

⁸⁹ Explanatory Memorandum accompanying Taxation Laws Amendment Bill (No 7) 2003 (Cth), at paragraph 9.10. This was because the CFC and FIF provisions were drafted on the premise that the business entity paid the foreign tax not the member, and therefore no credit was provided for member's own payment of foreign tax.

⁹⁰ Explanatory Memorandum accompanying Taxation Laws Amendment Bill (No 7) 2003 (Cth), at paragraph 9.5. This is because income could have been comparably taxed but in the hands of a different taxpayer.

⁹¹ Explanatory Memorandum accompanying Taxation Laws Amendment Bill (No 7) 2003 (Cth), at paragraph 9.5.

the resource industry, which is similar to the Hamilton Brothers Oil Company in lobbying for the LLCs.⁹² The benefit of tax transparency for the resource industry is the flow-through of losses and the depreciation of high cost machinery in the early years of operation, as well as claiming exploration expenditure which may never be recouped. Also, in Australia there has been some advocacy for the introduction of transparent companies by small business commentators⁹³ and academics.⁹⁴ More recently the ICAA proposal has argued for the introduction of a transparent company.⁹⁵ While there has been positive response to this⁹⁶ with it

⁹² Australian Institute of Mining and Metallurgy. (2006). Pre-Budget Submission 2007-08, Carlton, November 2006, at pp 6-7, [cited 11 March 2005]. Available at www.ausimm.com.au. Coonan, H (Minister for Revenue and the Assistant Treasurer). (2003). *Taxation Reform and the Exploration Industry – Laying the Foundations for Future Success*. Paper read at Speech to the APPEA Tax and Finance Conference, at Barossa Valley: “flow through shares is a topic that has attracted particular attention across the mining and exploration sectors. Proponents of such a scheme tout its ability so raise additional capital for explorations”. House of Representatives: Standing Committee on Industry and Resources. (2003). *Exploring: Australia's Future*. Canberra: The Parliament of the Commonwealth of Australia, at paragraph 3.62: “There was widespread support in submissions and statements by witnesses for the introduction of a flow-through share scheme to assist junior exploration companies in both the minerals and petroleum sectors to raise exploration capital”. City of Kalgoorlie-Boulder, Submission No 47; Queensland Mining Council, Submission No 60; Newmont Australia Submission No 71, Chamber of Minerals and Energy of Western Australia Submission no 78; Deloitte Touche Tohmatsu Submission No 12, Australian Petroleum Production and Exploration Association Ltd Sub No 96]. Australasian Institute of Mining and Metallurgy, (2006). *Pre-Budget Submission 2007-08*. Carlton: AusIMM, at pp 6-7: not complete flow through but flow through of research and development concession. Hooke, MH. (2006). *The case for a Flow Through Share Scheme for minerals exploration*: Minerals Council of Australia.

⁹³ Szekely, L. (2007). Limited liability for the sole trader. *Intax* October, at 23. Johns, BL, Dunlop, WC, and Sheehan, WJ. (1983). *Small Business in Australia: Problems and Prospects*. Sydney: George Allen & Unwin, at p 163: “The existing distinction for taxation purposes between private companies and partnerships could be abolished. We suggest that all private companies be treated as partnerships and the shareholders taxed accordingly”. Hayes, G. (2003). Real Tax Problems Need Real Solutions. *The Australian Financial Review*, 14 October, 50. Appears that the Business Coalition for Tax Reform proposal to tax corporations as trust was in a sense lobbying for a transparent company: Submission to the Review of Business Taxation on ‘A Platform for Consultation’, 19 April 1999, at <http://www.bctr.org>. Hicks, A. (1997). Legislating for the Needs of the Small Business. In *Developments in European Company Law: Volume 2/1997: The Quest for an Ideal Legal Form for Small Business*, edited by B. A. K. Rider and M. Andenas. London: Kluwer Law International Ltd, at pp 61-62. Yin, GK, and Shakow, DJ. (1999). Taxation of Private Business Enterprises. In *Federal Income Tax Project*. Philadelphia: The American Law Institute. Also note that Dwyer and Dwyer argue that it would be better to allow trusts to be taxed as general partnerships: Holub, n 17, at p 372.

⁹⁴ Stewart, n 29, at p 194. Fletcher, K. (2004). Incorporated Limited Partnerships: Venture capital's contribution to legal development. *Australian Journal of Corporate Law* 71:157, at p 172: though Fletcher does not specify whether flow through taxation should apply. Brooks, N. (1986) Taxation of closely-held corporations: the partnership option and the lower rate of tax. *Australian Tax Forum* 3(4), p 381-509.

⁹⁵ Institute of Chartered Accountants in Australia and Deloitte, n 20.

being considered by the Henry Review, it may not be enough to provide the requisite political motivation for its implementation.⁹⁷

Professional firms in the United States and the United Kingdom, particularly those of lawyers and accountants, played an important part in lobbying for the introduction of transparent companies. Indeed in a number of circumstances they played a major role in the drafting of the provisions. Professional firms' interest in lobbying for the introduction of transparent companies related to both their clients and their own business structures.⁹⁸ Currently in Australia there is no concerted move by professional firms for the introduction and implementation of a transparent company for themselves, with the ICAA proposal focusing on closely held businesses. However, in terms of their own practices, professional firms may alter their position with increased scrutiny of the use of service trusts by professionals in their practice structure⁹⁹ and amendments to bankruptcy laws.¹⁰⁰

Currently, Australian professional firms may utilise a discretionary trust as a service provider to the professionals' general partnership, allowing for greater asset protection¹⁰¹ and flexibility in splitting income.¹⁰² The Australian Tax Office

⁹⁶ Szekeley, L. (2008). Simple but radical tax reform. *Intax* June, at p 22.

⁹⁷ Hasseldine, J, and Hite, PA. (2003). The Effects of Attribute Framing and Political Party Affiliation on Taxpayer Preferences. *eJournal of Tax Research* 1 (1):5, at p 5: "For tax reform to occur, a major political party must support the reform, but this is not likely to happen unless politicians believe the reforms will be embraced by the voting public".

⁹⁸ Particularly in the United Kingdom, the LLP was initially intended to be used only by professionals.

⁹⁹ Taxation Ruling TR 2006/2: *Income tax: deductibility of service fees paid to associated service entities: Phillips arrangements*.

¹⁰⁰ See *Bankruptcy Legislation Amendment (Anti-avoidance) Act 2006* (Cth) (commencing 31 May 2006) which is to strengthen the claw-back provisions in the *Bankruptcy Act 1966* (Cth).

¹⁰¹ This structure facilitates asset protection since the beneficiaries of the service trust can be other discretionary trusts, which themselves can hold substantial assets.

¹⁰² The services provided may include staff hire and recruitment services, clerical and administrative services, premises, plant and/or equipment. The discretionary trust provides the use of buildings, equipment and staff for a fee to the general partnership. The splitting of income can be achieved by the service trust's profit decreasing the profit to be shared by the members of the general partnership that runs the professional practice. The profit generated by the discretionary trust can then be widely distributed among its potential beneficiaries. These beneficiaries could include other discretionary trusts, family members and corporations controlled by members of the general partnership.

is currently reviewing the use of service trusts by professional firms to ensure that the prices charged to the general partnership are commercial, and not excessive.¹⁰³ Furthermore, professional firms have expressed concerns at the changes to bankruptcy laws.¹⁰⁴ Substantial reforms to bankruptcy laws, as well as scrutiny of service trusts, may in this respect encourage professional firms in the future to lobby for the implementation of a transparent company form in Australia if their current business structures become unviable.¹⁰⁵

It is argued that the underlying desire to adopt the attributes of a transparent company is reflected through the concurrent use of business forms in Australia: this is because it is naïve to consider the business forms in isolation of each other. The concurrent use of business forms is utilised to provide members with desired qualities related to tax and non-tax attributes, such as improved asset protection, as well as the sharing of losses. An example of this is where a trustee of a discretionary trust may conduct business operations,¹⁰⁶ with the actual business assets held by a corporation that leases the assets to the trustee of the discretionary trust.¹⁰⁷

This concurrent use of business forms ensures that the relevant assets are protected from claims made by creditors or tortfeasors against the operating entity. Alternatively, combinations of business forms may be employed to allow for the sharing of profits and losses amongst members of an enterprise. For example, there may be a general partnership of two or more discretionary trusts operating a business. Such a combination would allow for the profits or losses of the general partnership's business to flow-through to the discretionary trusts. This combination would also provide some liability protection for members using

¹⁰³ Taxation Ruling *TR 2006/2: Income tax: deductibility of service fees paid to associated service entities: Phillips arrangements*.

¹⁰⁴ *Bankruptcy Legislation Amendment (Anti-avoidance) Act 2006* (Cth) (commencing 31 May 2006) which is to strengthen the claw-back provisions in the *Bankruptcy Act 1966* (Cth).

¹⁰⁵ Note: for existing professionals to convert to a transparent company some CGT and stamp duty exemption would be required, otherwise the tax costs for conversion could be prohibitive.

¹⁰⁶ Such as a restaurant operation.

¹⁰⁷ Such as the land and buildings in which the restaurant business is conducted.

discretionary trusts with corporate trustees.¹⁰⁸ The Australian government recognises this concurrent use of business forms and has allowed, for example, general partnerships and trusts to be part of a consolidated group of corporations,¹⁰⁹ and has allowed the small business CGT concessions to apply to the renting of assets between related entities to still be regarded as 'active'.¹¹⁰

Evidence demonstrates that those businesses with larger turnovers are more likely to utilise concurrent business forms.¹¹¹ In such circumstances, the concurrent use of business forms is likely to increase compliance costs, although the savings and the advantages may outweigh any additional cost. For those businesses with smaller turnovers, the additional compliance costs for concurrent use may exceed the benefits. Lehmann has acknowledged that the corporations' tax consolidation regime has been criticised as too complex for small businesses,¹¹² which can occur because of concurrent business form use.¹¹³ However, Lehmann queries what sympathy there should be when this arises because businesses set up complex structures to minimize tax or frustrate creditors.¹¹⁴

¹⁰⁸ Also the example professional firms using a combination of a general partnership with one or more service trusts is an example of concurrent business use. Another illustration would be the use of a corporation as the general partner of a limited partnership, thereby providing some liability protection for the member investing as the general partner.

¹⁰⁹ Ting, A. (2005). Policy and Membership Requirements for Consolidation: A Comparison between Australia, New Zealand and the US. *British Tax Review* 3:335, at p 324.

¹¹⁰ ITAA 1997 (Cth), section 154-40.

¹¹¹ Mann, N. (2003). The Tax Office and the Challenges for Small to Medium Enterprises. *Taxing Small Business: Developing Good Tax Policies* Australian Tax Research Foundation (Conference Series 23):183, at p 186: "Those with larger turnovers, above AUD\$10m, are likely to be more sophisticated and often involve a number of related entities. There are about 12,000 groups within this market segment. Most of these groups have between 2 and 6 member entities and most have a self-managed super fund. Typically, small to medium enterprises with annual turnovers less than AUD\$10m use simple structures with most being single entity private companies".

¹¹² Lehmann, G. (2007). An assessment of Australia's tax consolidation regime, in *Business Tax Reform – Meet the Critics*: Papers and material emerging from a conference of tax practitioners and academics. Lehmann, G (ed). Conference Series No 24. Australian Tax Research Foundation, Sydney, at p 291.

¹¹³ Indeed, the complexity of consolidations is one of the reasons underlying the ICAA proposal.

¹¹⁴ Lehmann, n 112, at p 292. Lehmann identifies that small business may adopt complex structures also for family tax planning and asset protection.

It is argued that the concurrent use of business forms demonstrates an underlying demand for transparent company attributes. That is, this practice shows there is a demand for the attributes of transparent taxation, limited liability and, to a lesser extent, separate legal entity status. It may be that the threat to tax revenue with the introduction of a transparent company is not great. This is because transparent company attributes are already being obtained through the concurrent use of different business forms in Australia. However, this existing practice of the concurrent use of business forms may limit the overt push for the introduction of a separate transparent company business form, since the market has already achieved this, and it may not see sufficient benefits in changing the *status quo*.

Nevertheless, it is argued that the introduction of a transparent company form may simplify matters, since the one business form may provide the qualities that investors are trying to obtain through the concurrent use of different business forms. In this way, a transparent company could be more efficient and reduce compliance costs. This could especially be the case, as concurrent business forms can be more expensive to set up, as well as being difficult to understand and to monitor. Furthermore, concurrent business form use can have excessive exit costs when the structure is being sold or wound down. However, it should be recognised that, even with the introduction of a transparent company, there would still be the need for concurrent business forms to improve asset protection by the isolation of asset holdings from the business operations.¹¹⁵

In the foreign jurisdictions studied professionals had a prominent role in drafting the legislation for LLCs and LLPs.¹¹⁶ In Australia, the ICAA proposal includes

¹¹⁵ An infamous example of concurrent business forms to provide asset protection is illustrated by what occurred with the James Hardy group of corporations. See: *Briggs v James Hardie & Co Pty Ltd* (1989) 16 NSWLR 549.

¹¹⁶ Recalled that in the United Kingdom it was estimated that the initial draft of the Jersey LLP cost \$1M GBP for the professional firms.

eleven pages of such draft legislation for its transparent company.¹¹⁷ The support by professionals for the introduction of a transparent company would appear to be critical, as research demonstrates that a large majority of small business taxpayers use tax agents for the lodgement of their tax returns and advice for business formations.¹¹⁸ If tax agents do not perceive that a transparent company will provide a benefit to their clients, then they may not recommend it to their clients.

Furthermore, reform exhaustion could be another factor that could prejudice interest groups from lobbying for a transparent company. In Australia over the last ten years there have been significant reforms to the tax system, including the introduction of GST, the move to corporation consolidations, as well as new methods for imputation and superannuation. These extensive reforms could weaken the desire for more change unless significant advantages accruing from these reforms were obtainable.¹¹⁹ However, it should be noted that with the election of the new Federal government there is currently a comprehensive review of Australia's tax system to be headed by Treasury Secretary, Ken Henry, which will consider the ICAA proposal.¹²⁰

Regardless of interest group lobbying, the Australian government itself may support the introduction of a transparent company. One reason for this support could be as a measure to curtail what it perceives as abusive practices of using discretionary trusts. In this manner, the Australian government could be a

¹¹⁷ Institute of Chartered Accountants in Australia and Deloitte, n 20, at pp 57 to 68.

¹¹⁸ Pursuant to the Australian Tax Office Updated Compliance Program 2005-2006, around 75 per cent of individual tax returns and 97 per cent of business tax returns are lodged through a tax agent. See: www.ato.gov.au/corporate.content.asp?doc=/content/61826htm&pge=138 [cited 8 August 2008].

¹¹⁹ For example, the superannuation reforms have been largely accepted due to the potential tax savings that they entail. Surveys have found that small businesses want 'simplicity and certainty' in taxation matters. Furthermore, complexities can arise because of uncertainty of the law, the frequency of changes: Small Business Deregulation Task Force. (1996). *Time for Business*, Canberra: AGPS, at p 2. Other difficulties include that the system is too complex in terms of the number of taxes, the difficulty of interpretation, the burden of record keeping and the costs of compliance.

¹²⁰ Emerson, n 30.

motivating force behind the introduction of a transparent company as a more appropriate business form to replace discretionary trusts. However, such a measure could face great resistance, similar to that experienced by the Australian government with its proposed unified entity regime.¹²¹ The ICAA proposal does not advocate altering the treatment of discretionary trusts. This failure to advocate such a proposal is justified on the basis that beneficiaries of a discretionary trust do not hold 'interests' in the discretionary trust.¹²² However, it is queried whether the basis is predicated more on political expediency rather than legal nuances. For example, it could be possible to deem for tax purposes that beneficiaries of a trust that has made a 'family trust election' do have a membership interest.¹²³

The actions of interest groups were instrumental in gaining Australia's restricted recognition of transparent companies. The venture capital industry, represented by Australian Venture Capital Association Limited (AVCAL), was successful in lobbying for the introduction of a transparent company, although in tightly regulated circumstances.¹²⁴ The industry argued that if Australia wanted to attract foreign venture capital investment, then it needed to provide a modern governance regime for limited partnerships and tax transparent treatment for the investment vehicle.¹²⁵ While closely held businesses may benefit from the

¹²¹ See generally: Freudenberg, n 8.

¹²² Institute of Chartered Accountants in Australia and Deloitte, n 20, at paragraph 3.6.3.

¹²³ The measurement of this deemed membership cost basis may be based on unpaid present entitlements owing to the beneficiary if they rank below other unsecured creditors.

¹²⁴ Australian venture Capital Association Ltd (Public Policy Committee). (2001). Stimulating Economic Growth: Flow Through Investment Structures for Venture Capital, [cited 6 January 2008]. Available from http://www.avcal.com.au/html/public/public_archive.aspx. McCahery, JA, and Vermeulen, EPM. (2003). Business Organization Law and Venture Capital. In *Venture Capital Contracting and the Valuation of High-technology Firms*, edited by J. McCahery and L. Renneboog. Oxford: Oxford University Press, at p 179: identified that the alliance of market sector interest groups, especially those groups tied to or affiliated to the venture capitalists themselves, may emerge as a strong lobby group. These restrictions include registration with the Pooled Development Fund Board. However, the Government recently announced these restrictions are to be eased slightly: Australia. (2006) *Budget Measures 2006-07: Budget Paper No 2* Canberra: Commonwealth of Australia.

¹²⁵ In terms of the reforms lobbied for, the United States' experience was influential as it is a major source of venture capital finance, and American investors were stated as demanding a certain business form and tax transparency.

venture capital investment, it is argued that AVCAL was lobbying more for the large international investors who would be the source of funds.¹²⁶

The CFC hybrid amendments appear to be in response to submissions to the Australian government expressing concerns that Australians were avoiding undertaking investments particularly in foreign transparent companies because of asymmetrical tax treatment. It is understood that this lobbying came from larger corporate entities that have investment holdings through LLCs or LLPs in the United States and the United Kingdom respectively.¹²⁷

5.3.3 Jurisdictional competition

Regulatory competition has been part of the reason for the exponential growth in the use overseas of transparent companies.¹²⁸ Given the globalisation of economic relations, the existence of transparent companies overseas may result in competition and increased pressure for Australia to broaden its transparent company recognition. Globalisation can result in greater interdependence, as well as associated policy transfers. Australia has already been influenced by the combination of these economic interactions with the introduction of venture capital ILPs and the CFC hybrid amendments. The introduction of venture capital ILPs related to the desire to attract greater foreign venture capital investment into

¹²⁶ While the venture capital industry is very fluid in terms of what it exactly entails, venture capitalists have been described as “investors who focus on financing high risk, potentially high-reward, projects in private companies and who actively participate in developing those businesses’. While not always the case, ‘venture capitalists often endeavour to seek out SMEs that are involved in the development of new technologies and groundbreaking discoveries’: Barkoczy and Sandler, n 82, at pp 6-7.

¹²⁷ Explanatory Memorandum accompanying Taxation Laws Amendment Bill (No 7) 2003 (Cth), at paragraph 9.157: “We conservatively estimate that at most 100 taxpayers may be affected by the measure. Based on the profile of the submissions received to the ATO’s draft tax determination TD 2001/D14, we expect these taxpayers to be large corporate taxpayers with sophisticated investment structures”.

¹²⁸ Especially within the United States. Nevertheless, the United Kingdom’s introduction of the LLP was caused in part by the perceived competition posed by other jurisdictions, particularly Jersey.

Australia.¹²⁹ This foreign investment was perceived as being a necessary precondition to commercialise research and development within Australia and to stimulate economic growth.¹³⁰ Given the fluidity of world capital markets, the Australian government may be more responsive to reforms that effect capital. The CFC hybrid amendments were to enable Australian investors to compete more effectively with foreign investors when investing in overseas transparent companies.

Given Australia's responses already, increases in globalisation may exert further pressure to expand recognition of transparency. Australia, as a medium-sized capital-importing economy, may be required to introduce reforms to attract foreign investment. Recent amendments demonstrate the desire to attract foreign investment, including changes to capital gains to reduce the assets that non-residents are assessed on¹³¹ and to exclude temporary residents from CGT, and the flow-through regime for Australia holding corporations of foreign subsidiaries.¹³² For example, the capital gains reforms referred to the objects of improving 'Australia's status as an attractive place for business and investments',¹³³ and 'aligning Australia's taxation laws with international practice'.¹³⁴

¹²⁹ *Explanatory Memorandum to Taxation Laws Amendment (Venture Capital) Bill 2002 (Cth) and Venture Capital Bill 2002 (Cth)*, paragraph 7.1. The provisions were essentially drafted for non-resident investors.

¹³⁰ *Explanatory Memorandum to Taxation Laws Amendment (Venture Capital) Bill 2002 (Cth) and Venture Capital Bill 2002 (Cth)*, paragraph 7.1. Whether this will be successful, particularly for start-up corporations, is questionable, see: Stewart, n 86. Venture capital is considered an important source of equity funds for start-up and expanding businesses, and without it these businesses may have limited growth prospects. Australian Venture Capital Association Ltd, Gilbert and Tobin Lawyers, and Freehills. (2005). *Venture Capital Limited Partnerships: Proposed Amendments to State and Territory Partnership Statutes to Develop a World Best Practice Venture Capital Investment Structure - Revised Submission 24 April 2003*, at p 42 [cited 6 January 2008]. Available from

http://www.avcal.com.au/html/public/public_archive.aspx. Barkoczy, S. (2006). *Structuring Tax Expenditures to Promote Venture Capital Investment*. Paper read at Australasian Tax Teachers' Conference, at University of Melbourne, at p 2.

¹³¹ *ITAA 1997 (Cth)*, Division 855.

¹³² *Tax Laws Amendment (Measures No 4) Act 2006 (Cth)*.

¹³³ *ITAA 1997 (Cth)*, section 855-5(1)(a).

¹³⁴ *ITAA 1997 (Cth)*, section 855-5(2).

Indeed, international pressure was behind Japan's recent introduction of an LLC, due to pressure from United States investors wanting a Japanese business form that provided limited liability and would be eligible as a foreign entity to Check-the-Box for transparency in the United States.¹³⁵ Prior to this, Japanese business forms were either not eligible for Check-the-Box transparency,¹³⁶ or provided insufficient liability protection or governance regimes. It is argued that it is unlikely for similar pressures to be exerted by United States investors for the introduction of an LLC in Australia for this reason alone. This is because, unlike Japan, Australia's private corporation is eligible to Check-the-Box for transparent treatment, thereby facilitating a number of tax planning strategies.¹³⁷

In terms of competition, the actions of small accessible jurisdictions, Wyoming and Jersey, respectively, played a key role with the introduction of a new transparent business form in both the United States and the United Kingdom. While New Zealand, a smaller jurisdiction compared with Australia, has introduced a transparent company, this has not itself created direct pressure for a transparent company to be introduced in Australia. The lack of influence from New Zealand could be due to the tax treatment of LAQCs effectively restricting

¹³⁵ Roose, EN, Shikuma, MH, Mizutani, T, and Ohashi, K. (2006). Tax Consequences of Japan's New Companies Law (Part II). *Tax Notes International* February:637.

¹³⁶ The Japanese 'kabushiki-kaisha' is a public corporation and is mandated as a C Corporation for United States tax treatment. Treasury Regulation, 301.7701-2(b). 168. Avery Jones, JF, De Broe, L, Ellis, MJ, Miyatake, T, Roberts, SI, Goldberg, SH, Killius, J, Maisto, G, Giuliani, F, Vann, RJ, Ward, DA, and Wiman, B. (2002). Characterization of Other States' Partnerships for Income Tax. *Bulletin – Tax Treaty Monitor* July:288, at p 306.

¹³⁷ For United States investors, the ability of foreign entities to have tax transparency under Check-the-Box can provide a number of benefits for United States tax purposes, such as the non-application of CFC rules, increasing the availability of losses, and foreign tax credits. Freudenberg, B. (2008). What the new CFC amendments mean: Australians structuring their investments into the United States of America through LLCs. *Asia Pacific Tax Bulletin* 14(3):188. Postlewaite, PF. (2006). Treasury creates a monster. Australia, beware the hybrid entity! *Revenue Law Journal* 16:156. The Commissioner of Inland Revenue has expressed concern with how the Check-the-Box regulations could allow foreign tax credits, even though no foreign income was being assessed in the United States: Holland, D. (2005). U.S. Check-the-Box Rules in the Cross-Border Context. *Tax Notes* September: 1151, at p 1153, citing the case of *Guardian Industries Corp and Subsidiaries v United States*, 2006-5058 United States Court of Appeals for the Federal Court, 23 February 2007 Decided, 2007 U.S. App Lexis 3927.

them to domestic operations and membership.¹³⁸ Indeed, the ICAA proposal fails to refer to the LAQC regime at all. This is an unfortunate oversight, as New Zealand has an imputation system applying to corporations similar to Australia, which may provide some beneficial insight as to how to implement a transparent system along side such an integrated system.

Part of the competition within the United States related to competition among the various American states enacting LLC legislation. In Australia, the competition among states is comparatively restrained although it does exist. This can be reflected in the activity that occurred in the 1980s and early 1990s in respect of the states reforming or introducing limited partnership legislation; and then, more recently, with the introduction of ILPs to enable investors to utilise the Federal government's venture capital tax concessions.¹³⁹ Nevertheless, this internal competition among the various states and territories is restrained by the Federal government's control of income tax laws.¹⁴⁰ Accordingly, while states could legislate for a new business form, as has been done recently in respect of ILPs, federal laws dictate the actual income tax treatment.¹⁴¹ Currently, a transparent company, as defined in this dissertation,¹⁴² would be taxed as a corporation for

¹³⁸ This is because of the effective increase in tax liability for foreign members investing in an LAQC compared to a general partnership, and the likely inability of foreign members being able to utilise losses attributed to them in their home jurisdiction. See: Freudenberg, B. (2005). Is the New Zealand Qualifying Company regime achieving its original objectives? *New Zealand Journal of Taxation Law and Policy* 11(2):185.

¹³⁹ The belief being if a state's ILP form is used for the venture capital investment then the economic activity associated with the investment may also be located in the state, although this is not necessarily the case. However, the introduction of some of the ILPs rather than denoting competition amongst Australian states is stated facilitate a 'consistent national regime'. For example: Tonyne (Justice and Attorney-General) (NT). (2006). Second Reading of Partnership Amendment (Venture Capital Funds) Bill 2006 (NT), 14 February: "I do not expect that these provisions will have a profound short term effect on the NT [Northern Territory], but they do assist in setting in place a consistent national regime that facilitates investment in Australia".

¹⁴⁰ For a discussion of the declining role of Australian states: Zines, L. (1991). *Constitutional Change in the Commonwealth*, Cambridge University Press, Cambridge, at pp 79, 86 to 98. Gibbs, H. (1994). The Decline in Federalism, 18 *University of Queensland Law Journal* 1.

¹⁴¹ This is illustrated by what occurred in the 1990s with limited partnerships, state governments started to provide these alternative vehicles but then the Federal Government stepped in and taxed limited partnerships as corporations.

¹⁴² A business form with separate legal status to members, limited liability and flow-through taxation.

Australian income tax purposes and not as a general partnership with tax transparency. Such a consequence could diminish the incentives for the Australian states in adopting a new ‘company’ business form. However, this did not prevent Wyoming in the United States originally introducing the LLC, with a subsequent protracted 11 year of negotiations with the United States Internal Revenue Services (the United States IRS) in relation to the appropriate tax treatment. It should be recalled that there was specific legal ambiguity about the appropriate tax treatment of LLCs due to the United States IRS applying a four-factor test to determine whether a business form was a corporation for tax purposes — known as the Kintner regulations.¹⁴³ In Australia, there is unlikely to be such ambiguity as the characteristics of a transparent company with separate legal entity status and limited liability for members would see it classified as a corporation for tax purposes.

5.3.4 Improved governance

Another motivating factor behind the introduction of new form transparent companies was one based on arguments for improved internal governance, especially for closely held businesses.¹⁴⁴ In Australia, there is an appreciation of the importance of closely held businesses and the challenges they face.¹⁴⁵

In the late 1980s the Australian government attempted to introduce the *Australian Close Corporations Act 1989* (Cth), which provided for a distinct corporate model for closely held businesses.¹⁴⁶ However, when the suite of legislation was ruled

¹⁴³ Treasury Regulation, section 301.7701-2(a) (2). The four factors in the Kintner regulations were: continuity of life; free transferability of interests; centralised management; and limited liability.

¹⁴⁴ Chapter Nine will analyse whether this was the case, particularly when compared to corporations.

¹⁴⁵ For example: Small Business Deregulation Task Force, n 119.

¹⁴⁶ The *Close Corporations Act* was part of a suite of legislation for unification of corporate law in Australia. This legislation was based on a South African model, which itself was based on earlier recommendations in the United Kingdom by Professor Gower, reported in 1981 by the

by the High Court as being unconstitutional, the *Close Corporation* rules were subsequently removed in the negotiations that occurred between the states and the Federal government.¹⁴⁷ It is hard to ascertain whether the motivations behind this removal of the *Close Corporation* rules were based on considered argument or, rather, were a compromise to gain the states' agreement to a new unified corporate regime.¹⁴⁸ The *Close Corporations* rules have been described as 'lost' in the negotiations after the High Court decision.¹⁴⁹

Nevertheless, an extensive and comprehensive corporations' law simplification program¹⁵⁰ has been undertaken, as evidenced in the *Corporations Act 2001* (Cth). Apart from single member-manager corporations, the *Corporations Act 2001* (Cth) does not specify internal governance rules, particularly for closely held corporations. Instead there is a set of replaceable rules in the Act that all corporations can adopt or, rather, alter through the adoption of their own specific

Department of Trade and Industry. Department of Trade, A New Form of Incorporation for Small Firms (1981) Cmnd 8171. The recommendations were never proceeded with in the United Kingdom.

¹⁴⁷ Lipton, P, and Herzberg, A. (2003). *Understanding Company Law*. 11th ed. Pyrmont: Lawbook Co, at p 4: "This approach to the interpretation of section 51 (xx) was followed by the High Court in *New South Wales v Commonwealth* (1990) 8 ACLC 120. This case concerned a challenge by several States to the constitutional validity of certain sections of the Commonwealth Corporations Act 1989 which provided among other things for the incorporation of trading and financial corporations. By a six to one majority, the High Court held that section 51(xx) did not empower the Commonwealth to make laws with respect to the incorporation of trading and financial corporations. Consequently, provisions that related to incorporation were invalid".

¹⁴⁸ Freedman, J. (1994). Small Business and the Corporate Form: Burden or Privilege. *The Modern Law Review* 57 (July):555, at pp 579-580: "When the Act failed for constitutional reasons, the opportunity was used to argue for modifications of the close corporation concept. It became apparent that if the changes being urged on the Government were adopted, there would be little distinction between the new form proposed and other proprietary companies. Therefore, the Attorney-General's Department published new proposals to simplify the existing general law on proprietary companies".

¹⁴⁹ Freedman, n 148, at p 579 states: "Few tears were shed when the Australian Close Corporations Act 1989 was lost as a result of constitutional problems": Henning, JJ. (1995). Closely Held Corporations: Perspectives on Developments in Four Jurisdictions. *THRHR* 58:100, at p 104.

¹⁵⁰ The Corporations Law Simplification Program was established in December 1993 by the former Attorney-General, who appointed a four-member Task Force to oversee the Program. See Kollar, M. (1997). Corporate Law Economic Reform Program: A fundamental change or more of the same. *Australian Corporate News* 9:129, at p 131.

internal constitutional rules.¹⁵¹ For a single member-managed corporation¹⁵² there are a specific set of mandatory rules that apply, with the replaceable rules excluded.¹⁵³ These mandatory rules include that the business of the corporation is to be managed by the director.¹⁵⁴

Whether these reforms sufficiently address the concerns of closely held businesses is questionable, as the Australian corporate model is criticised as still providing an 'unsuitable framework' in cases where there are present member-management structures.¹⁵⁵ Also, there is the continued popularity of trusts, sole proprietorships and general partnerships which may represent a preference for their governance rules. In terms of lodgement of tax returns, the number of

¹⁵¹ Hanrahan, P, Ramsay, I and Stapledon, G. (2004). *Commercial Applications of Company Law*. 6 ed. Sydney: CCH, at paragraph 4-500. *Corporations Act 2001* (Cth), section 140. The corporation's constitution (if any) and any replaceable rules that apply to the corporation have effect as a contract: (a) between the corporation and each member; and (b) between the corporation and each director and corporation secretary; and (c) between a member and each other member. A corporation limited by shares can be classified as either public or proprietary. There are some reporting concessions provided to proprietary corporations compared to public corporations. A public corporation has more onerous obligations. For example a public corporation must have annual financial statements, directors' reports and audits. These documents are lodged with the Australian Securities and Investment Commission, and therefore are available to the public generally. A public corporation is generally one that is listed on the stock exchange, or has greater than 50 members, or issues membership interests to the public. Proprietary corporations are not permitted to have more than 50 members and are not allowed to undertake certain fundraising activities that require the issue of a prospectus.

¹⁵² Since 1998 it is possible to have one member who can also be the director and secretary of the corporation. *Corporations Act 2001* (Cth), section 114.

¹⁵³ *Corporations Act 2001* (Cth), section 135: provides that the replaceable rules do not apply to a proprietary corporation while the same person is both its sole director and sole member.

¹⁵⁴ The mandatory rules that apply to a single member-director corporation include that: *Corporations Act 2001* (Cth), section 201F: The director may appoint another director by recording the appointment and signing the record; section 198E: The director may exercise all of the powers of the corporation except any powers that the Corporations Act or the corporation's constitution (if any) requires the corporation to exercise in general meeting; section 198E: The business of the corporation is to be managed by or under the direction of the director; section 198E: The director may execute a negotiable instrument such as a cheque, and may determine that a negotiable instrument may be executed in a different way; section 202C: The director is to be paid any remuneration for being a director that the corporation determines by resolution. The corporation may also pay director's travelling and other expenses properly incurred by the director in connection with the corporation's business; and section 249B: Where something must be done by the member of a single director/shareholder corporation in their capacity as a member, it can be done by the member recording a resolution in writing and signing it. The resolution must be recorded in the corporation's minute book: section 251A.

¹⁵⁵ Farrar, JH. (2001). *Corporate Governance in Australia and New Zealand*. South Melbourne: Oxford University Press.

business forms is corporations: 664,164; partnerships: 451, 380; trusts: 470, 945 and sole proprietors (individuals conducting business operations): 1,095,574.¹⁵⁶ However, the popularity of these other business forms may be based on other reasons, particularly tax and asset protection.

Australia also has an established alternative business form, the discretionary trust.¹⁵⁷ Discretionary trusts have a different governance regime compared to corporations,¹⁵⁸ which may be considered more flexible. Discretionary trusts are governed essentially by three things, the trust instrument,¹⁵⁹ the state and territory legislation;¹⁶⁰ and the trustee's fiduciary obligations.¹⁶¹

¹⁵⁶ Australian Taxation Office. (2005). *Taxation Statistics 2002-03: A Summary of taxation, superannuation and industry benchmark statistics 2002-03 and 2003-04*, Canberra: Australian Taxation Office, at p 8.

¹⁵⁷ In the United States and the United Kingdom, trusts historically have not been a popular business form, which appears to be due to adverse tax treatment applying. In the United States a discretionary trust would be subject to tax as a C Corporation, and in the United Kingdom there could be adverse inheritance tax consequences. However, in the United States this is currently changing due to the increase use of Statutory Business Trusts, that is trust established pursuant to a piece of legislation compared to the common law.

¹⁵⁸ Although if a corporation is used as the trustee of the discretionary trust then the Corporations Act needs to be abided by in terms of the trustee itself.

¹⁵⁹ Also known as the trust deed.

¹⁶⁰ Note each State and Territory in Australia has its own Trust Act. These are the *Trusts Act 1973* (Qld), *Trustee Act 1958* (Vic), *Trustee Act 1925* (NSW), *Trustee Act 1936* (SA), *Trustee Act 1898* (Tas), *Trustee Act 1962* (WA), *Trustee Act 1925* (ACT) and *Trustee Act 1893* (NT).

¹⁶¹ For example a trustee in fulfilling its duty to keep proper accounts will have to prepare financial accounts: *Freeman v Fairlie* (1817) 3 Mer 27, at 42. This can be traced to the trustee's fiduciary obligations and the trust instrument. These financial accounts are in addition to other records, such as a minute book recording the exercise of the trustee's discretion. Not only do trustees have to keep proper accounts, they must also be ready to render accounts when required by beneficiaries, [*Kemp v Burn* (1863) 66 ER 40] even a discretionary object [*Spellson v George* (1987) 11 NSWLR 300, at 316]. In modern trust instruments the trustee's powers are widely drafted. If the trust instrument is silent in relation to a power, then the trustee legislation can confer additional powers and obligations on the trustee, unless a contrary intention is expressed in the trust instrument: *Trusts Act 1973* (Qld), section 4, *Trustee Act 1958* (Vic), sub-section 2(3), *Trustee Act 1925* (NSW), section 14A – 14D, *Trustee Act 1898* (Tas), sub-section 5(1), *Trustee Act 1962* (WA), sub-section 5(2), *Trustee Act 1925* (ACT), section 14, and *Trustee Act 1893* (NT), section 5. However, in some circumstances the trustee legislation can override the trust instrument: *Trusts Act 1973* (Qld), sub-section 21(1)(e). Constraining this general power are the obligations and duties to which the trustee must comply with. These obligations include adhering to the trust instrument, to act equitably, honestly and impartially (particularly as between beneficiaries and classes of beneficiaries), and to exercise reasonable care: Betts, RW. et al. (1979). *Corporate Trustees: Disclosure, Taxation and the Liability of Officers*, CCH Australia Limited, Sydney, at p 41. The precise powers detailed in a trust's instrument will vary significantly from trust to trust. The management of a trust is with the trustee, who could be an individual, a corporation or a number of entities acting together as trustee.

However, a number of characteristics of discretionary trusts can prove problematic for closely held businesses, including understanding the legal relationships and duties that are central to a trust. Another problem is with single-member management, as it is not possible for the one person to be trustee and the only beneficiary, thereby requiring additional beneficiaries to be appointed.¹⁶² Furthermore, trusts do not provide a business form with a separate legal entity, which means that actions and contracts would need to be done in the name of the trustee acting on behalf of the trust.¹⁶³ Furthermore, except for trusts formed in South Australia, trusts do not provide a business form with perpetuity.¹⁶⁴

Additionally, it is not possible for beneficiaries of a discretionary trust to transfer their 'membership interest',¹⁶⁵ since they are not regarded as having an interest in the discretionary trust.¹⁶⁶ This lack of membership interest can hinder the raising of additional equity due to the inability to issue new membership interests to incoming investors. While the trust deed could be amended to add new

¹⁶² This is because the one entity will have both the equitable and legal title in the property. This can be circumvented with the use of a separate entity, such as a corporate trustee, as trustee.

¹⁶³ For example, ABD Ltd as Trustee for the ABD Trust. Due to potential risk in terms of governance, outside lenders could also require additional security with trustee borrowings, such as guarantees from beneficiaries and mortgages over real property.

¹⁶⁴ In Australia all trusts established, except those in South Australia, have to vest within a certain period. This is known as the rule against perpetuity, which means that for most trusts they do not provide members a business form with perpetuity: Fullarton, AR. (2002). *The Common Law and Taxation of Trusts in Australia in the Twenty First Century*, at 16, [cited 11 January 2006]. Available from www.arfullartonassociates.com.au/trusts%20paper.htm. The consequence of statutory replacement ultimately ensures the property of the trust vests in the beneficiary (ies) within a maximum of 80 years.

¹⁶⁵ This is because cases have held that a discretionary beneficiary has no beneficial interest in either the income or capital of the trust until an appropriate resolution by a trustee or an act of default has occurred. At best the discretionary beneficiary can call upon the trustee to decide whether to exercise its discretion or, if the discretion has been exercised, to complain to the court on behalf of the trust that it has been exercised in bad faith for purposes outside the purpose of the trust. See: *Gartside v Inland Revenue Commissioners* [1968] AC 553; [1968] 1 All ER 121 and *Chief Commissioner of Stamp Duties (NSW) v Buckle* (1998) 192 CLR 226; 72 ALJR 243; 98 ATC 4103. For a thorough discussion of the nature of discretionary beneficiaries' interest see: Freudenberg, B and McDermott, P. (2005). The Forgotten CGT events: Are asset revaluations reserve distributions by trustees of discretionary trusts taxable? *Australian Tax Review*, 34(2):67.

¹⁶⁶ However, this lack of 'interest' can have beneficial tax (particularly the non-application of CGT event E4) and bankruptcy consequences. *ITAA 1997* (Cth), section 104-70.

members as potential beneficiaries,¹⁶⁷ a new member may require other mechanisms to be assured of distributions being made.¹⁶⁸ Furthermore, amendments to the Trust Deed run the risk of 'resettling' the trust, which can have adverse CGT and stamp duty consequences.¹⁶⁹

Accordingly, while it can be argued that the governance of discretionary trusts may provide some flexibility; there are also converse problems associated with closely held businesses, especially in terms of complexity, lack of extensive default rules and fiduciary obligations. In this respect, the Australian tax compliance cost study outlined in Chapter Two demonstrated, quite conclusively, that greater compliance costs can be experienced when a discretionary trust structure is adopted, compared to other business forms. Consequently, there could be a persuasive argument presented that closely held businesses in Australia may benefit from the introduction of a new form transparent company if its governance rules were more suitable.

Improved governance can be seen as a motivating force behind the introduction of the venture capital ILP. This is because the existing limited partnership regimes were criticised as being, 'inadequate' to cater for the modern venture capital market.¹⁷⁰ Several deficiencies with existing limited partnership regimes in Australia were specifically enumerated. These deficiencies included the lack of separate legal entity status; problems associated with the mutual recognition of limited partnerships formed in other jurisdictions; the extent of limited liability;

¹⁶⁷ The lack of a distinct membership interest can prevent the conversion of a discretionary trust to a widely circumstances. Additionally, the alteration of the trust deed could have adverse CGT and stamp duty consequences if the amendment results in a resettlement of the trust.

¹⁶⁸ This could be addressed by the new member also acquiring membership interest in a corporate trustee which is in control of the trust, or being appointed a co-trustee.

¹⁶⁹ Australian Taxation Office. (2006). *Taxation Ruling TR 2006/4: Income tax: capital gains: meaning of the words 'the beneficiaries and terms of both trusts are the same' in paragraphs 104-55(5)(b) and 104-60(5)(b) of the Income Tax Assessment Act 1997*, Canberra.

¹⁷⁰ Australian Venture Capital Association Ltd, Gilbert and Tobin Lawyers, and Freehills, n 130, at pp 1.

participation in management by limited members;¹⁷¹ the impact of agency laws in respect of general members' actions for the limited members; the proper party for litigation; and the status of partnerships of limited partnerships.¹⁷²

Instead of amending the governance regimes of limited partnerships, all Australian states and territory governments (except Western Australia) have enacted an ILP.¹⁷³ This may have been to create a discrete business form that could, in turn, utilise the Federal income tax provisions for the venture capital industry, as ILPs are only available for venture capital investment.¹⁷⁴ Consequently, the problems identified with the limited partnership regimes would seem to persist, with little indication that these deficiencies will be addressed and corrected in the immediate future.

In relation to whether the CFC hybrid amendments reflect notions of governance, the Australian government was concerned that Australians were avoiding foreign transparent companies which could have placed them at a significant competitive

¹⁷¹ For example, the status of limited members of limited partnerships sits 'poorly' with modern notions of corporate governance and sound management, which recognises that passive investors should not merely delegate absolute power to management, but ought to have liability to prudently monitor and oversee the way management performs its duties: Australian Venture Capital Association Ltd, Gilbert and Tobin Lawyers, and Freehills, n 130, at p 30.

¹⁷² Australian Venture Capital Association Ltd, Gilbert and Tobin Lawyers, and Freehills, n 130, at pp 3-4.

¹⁷³ A number of states in Australia have introduced the regulatory framework for ILPs: New South Wales the *Partnership Amendment (Venture Capital Funds) Act 2004* (NSW) amending the *Partnership Act 1892* (NSW); Victoria the *Partnership Venture Capital Funds Act 2003* (Vic) amending the *Partnership Act 1958* (Vic); and Queensland the *Partnership and Other Acts Amendment Act 2004* (Qld) amending the *Partnership Act 1891* (Qld); Australian Capital Territory the *Partnership (Venture Capital Funds) Amendment Act 2004* (ACT) amending the *Partnership Act 1963* (ACT); South Australia the *Partnership (Venture Capital Funds) Amendment Act 2005* (SA) amending the *Partnership Act 1891* (SA); and Northern Territory the *Partnership Amendment (Venture Capital Funds) Bill No 2 2006* (NT) proposing to amend the *Partnership Act 1997* (NT). It is understood that these are based in part on the Delaware limited partnership model.

¹⁷⁴ *Partnership Act 1892* (NSW), section 53D(3); *Partnership Act 1958* (Vic), section 87(2); *Partnership Act 1891* (Qld), section 75; *Partnership Act 1963* (ACT), section 57(2); *Partnership Act 1891* (SA), section 51D(3); and *Partnership Act 1997* (NT) proposed, section 55(2). Note every state except for Queensland provides for ILPs to be used for other purposes as provided by regulation (which there are none at the moment). Fletcher has queried why the various state governments did not take the opportunity to address concerns in their original and still existing limited partnership provisions: Fletcher, n 94, at pp 172-173.

disadvantage to other investors. It was stated in this particular context that Australian investors may have adopted an 'alternative higher cost business structure' than the industry norm.¹⁷⁵ This statement implies that transparent companies have become the industry norm overseas.¹⁷⁶ The utilisation of LLCs in the United States appears to support this conclusion, although LLPs have not reached such an appropriate status in the United Kingdom. It is not clear whether the 'competitive disadvantage' relates to governance issues or tax savings due to tax transparency or a combination. Given the particular reference to LLCs in the statement, it is argued that the 'competitive disadvantage' is likely to relate to tax savings obtainable.¹⁷⁷ Consequently, it is argued that governance issues were not central to the CFC hybrid amendments.

5.3.5 Limited liability

Another factor that has influenced the introduction of new form transparent companies was their characteristic of affording members limited liability. In Australia, limited liability is available for members through the governance regimes for corporations, with some liability protection provided by limited partnerships and trusts. In contrast, sole proprietors and general partnerships fail to accord limited liability for members. In this respect, the Australian government appears to be encouraging businesses to adopt limited liability forms, particularly in regards to the corporation. This is reflected by the recent decrease of corporation registration fees by 50 per cent to \$200, as well as by the corporate law simplification process.¹⁷⁸ These incentives appear to be based on the notion

¹⁷⁵ Explanatory Memorandum accompanying Taxation Laws Amendment Bill (No 7) 2003 (Cth), at p 152 at paragraph 9.177.

¹⁷⁶ Explanatory Memorandum accompanying Taxation Laws Amendment Bill (No 7) 2003 (Cth), at p 152 at paragraph 9.177.

¹⁷⁷ This is compared to the entity (classical) tax system applying to C Corporations in the United States.

¹⁷⁸ Note the current encouragement of business to use the corporate form could also be to broaden the application of the Federal Government's employment relations legislation, which relies on its corporation powers.

that the use of corporations enhances business operations and can have positive economic effects.¹⁷⁹ Consequently, it would appear that the Australian government, and businesses, would be receptive to the limited liability characteristic of a transparent company provided there were adequate capital protection rules.

In the United Kingdom, professional firms lobbied for the introduction of the LLP in part to provide them with a limited liability business form. In Australia, the progressive introduction of legislation has allowed for professional firms (both accounting and law) to gain liability protection through incorporation.¹⁸⁰ Indeed an incorporated law firm, Slater & Gordon, has been floated on the Australian stock exchange.¹⁸¹ However, similar to the United Kingdom, Australian professional firms can be reluctant to incorporate. This can be attributed to adverse CGT and stamp duty consequences for established firms to reorganise from a general partnership to a corporation. While there is narrow CGT rollover relief provided by the Federal government for the conversion from a general partnership to a corporation,¹⁸² some state governments have not been willing to provide stamp duty relief for the conversion.¹⁸³ Also, due to the use of discretionary trusts as service providers, the utilisation of the CGT rollover relief

¹⁷⁹ Whether this is the case is debatable as some would argue that limited liability can have negative cost that are not adequately taken into account, especially in relation to tortfeasors.

¹⁸⁰ For example the *Legal Profession Act 2004* (Qld); *Legal Profession Act 1987* (NSW), *Legal Profession Practice Act 1958* (Vic); *Legal Practitioners Act 1981* (SA); and *Legal Practitioners Act 1993* (Tas); *Legal Profession Bill 2006* (ACT). In addition to this has been the introduction of Professional Standards Legislation which caps liability on civil liability arising in tort, contract or otherwise. Generally a person seeking to rely upon the cap must have an insurance policy insuring against occupational liability and the amount payable under the policy must not be less than the person's specified capped liability. For example see: *Professional Standards Act (1994)* (NSW), *Professional Standards Act (2004)* (Vic), *Professional Standards Act (2004)* (Qld) and *Professional Standards Act (1997)* (WA).

¹⁸¹ Priest, M. (2006). New chapter as firms go public. *The Australian Financial Review*, 13 October, 54.

¹⁸² There are some CGT roll-over provisions that may allow for the CGT on conversion to be disregarded: *ITAA 1997* (Cth), Subdivision 122-B and 124N.

¹⁸³ Some states, such as New South Wales, allow for stamp duty exemption for conversion to a corporation, though others, such as Queensland, do not. For example it is understood that the Queensland Treasury Department believes stamp duty relief should not be granted to professional firms converting from the general partnership model to a corporate one.

can be problematic.¹⁸⁴ The failure of a coordinated approach by various levels of government in Australia to facilitate the conversion of established professional firms undermines the effectiveness of the reforms to provide incorporation. Even without the adverse taxation costs, professional firms may be reluctant to incorporate due to the income splitting available through a discretionary trust used as a service provider.¹⁸⁵ Also, members of professional firms may be comfortable with their current level of liability exposure using insurance and asset sheltering in other business forms.¹⁸⁶

In terms of limited liability, one benefit that a transparent company may provide is increased certainty about member liability protection, particularly compared to the position of beneficiaries of discretionary trusts, and limited members of a limited partnership. Trustees are personally liable for debts incurred on behalf of the trust, although generally the trustee will have a right to be indemnified (or reimbursed) out of trust assets for the claim.¹⁸⁷ To re-enforce limited liability protection, a corporation can be appointed as trustee; however, this then necessitates greater costs and complexity as there is concurrent use of business forms. Beneficiaries do not generally obtain rights against or incur liabilities to third parties because of transactions or actions undertaken by the trustee in exercising its powers and carrying out its duties as a trustee. However, a beneficiary will be liable if specific directions were given to the trustee and the debt arises because the trustee has acted in accordance with those directions.¹⁸⁸ However, a recent case stated that in some circumstances a beneficiary could

¹⁸⁴ This is because the rollover relief facilitates a simple general partnership conversion into a corporation

¹⁸⁵ This is because if a corporation runs the professional business, then membership of the corporation may be limited to actual professionals. This means that profit distributions could go only to the professional member, not spouse, child or related entity. This removes the ability to income split among a number of taxpayers. However, there may be room for income splitting to be achieved by having a discretionary trust as a service provider to the corporation, similar to what occurs currently with general partnerships.

¹⁸⁶ However, changes to bankruptcy laws may reduce this level of comfort.

¹⁸⁷ Hanrahan, Ramsay and Stapledon, n 151, at p 57: A trustee may lose its right of indemnity where it has acted in breach of trust, or is excluded by agreement.

¹⁸⁸ Hanrahan, Ramsay and Stapledon, n 151, at p 57.

have a 'proprietary interest' where the beneficiary exercises effective control over the trustee.¹⁸⁹ In these circumstances, the trust assets can be exposed to actions by creditors of the beneficiary.¹⁹⁰

Limited liability was an important characteristic for the venture capital ILPs, in addressing concerns with the limited partnership regime. Improved liability protection was sought through separate legal entity status of the ILP¹⁹¹ and broader safe harbour provisions allowing the limited member some participation in the management without losing liability protection.¹⁹²

For the CFC hybrid amendments, the availability of limited liability for members was not stated as an express issue, although its existence may have been important in facilitating foreign investment by Australians.

¹⁸⁹ *ASIC v Carey (No 6)* [2006] FCA 814.

¹⁹⁰ The liability protection afforded by discretionary trusts is unclear as courts have held that beneficiaries, at least those who have full capacity, can be personally liable to indemnify the trustee for those liabilities which are properly incurred and which relate to administration of the trust for the benefit of the particular beneficiary sought to be made liable. See: *JW Broomhead (Vic) Pty Ltd v JW Broomhead Pty Ltd* [1985] VR 891. Vann, n 8, at p 43. Also the recent case of *ASIC v Carey (No 6)* [2006] FCA 814 it was held that in certain circumstances a beneficiary of a discretionary trust could have a 'proprietary interest' in the trust for purposes of section 1323 of the Corporations Act where the beneficiaries are able to act as though they are absolute owners of the trust. Beneficiaries' effective control of the trustee's power of selection could arise when the beneficiary is (a) the trustee (or one of them); (b) in control of the trustee; (c) the appointer of the trustee; (d) in control of the appointer of the trustee; or (e) the sole beneficiary. This means the effectiveness of discretionary trusts in shielding assets from creditors must be questioned where a person who is the subject of the receiver orders under the Corporations Act is a beneficiary under a discretionary trust and has an 'interest' in the trust sufficient to characterise it as property within the meaning of the *Corporations Act 2001* (Cth).

¹⁹¹ *Partnership Act 1892* (NSW), section 53; *Partnership Act 1958* (Vic), section 84; *Partnership Act 1891* (Qld), section 72; *Partnership Act 1963* (ACT), section 54; *Partnership Act 1891* (SA), section 51; and *Partnership Act 1997* (NT) proposed, section 52.

¹⁹² *Partnership Act 1892* (NSW), sections 66A and 67A; *Partnership Act 1958* (Vic), sections 97 and 98; *Partnership Act 1891* (Qld), sections 86 and 87; *Partnership Act 1963* (ACT), sections 67 and 68; *Partnership Act 1891* (SA), sections 64A and 65A; and *Partnership Act 1997* (NT) proposed, sections 65 and 66. Refer to the previous comments about whether there are still concerns with the ILPs governance. Even with the reforms, members are not allowed full management without infringing their liability protection unlike the reforms for the United States' *Uniform Limited Partnership Act (2001)*. *Uniform Limited Partnership Act 2001*, section 303. Drafted by the National Conference of Commissioners of Uniform State Law.

5.4 Conclusion

As has been documented in this chapter, the reasons behind the introduction of the foreign transparent companies are to some degree present in Australia, and are reflected in Australia's restricted recognition to date.

In terms of special tax rule companies, it was argued that the Australian government's approach to tax neutrality appears incongruent to that used in the United States and New Zealand Governments with their introduction of S Corporations and LAQCs. Historically, the Australian government's approach to tax neutrality has been based on the starting point of whether the business form provides limited liability, rather than whether membership is closely held. However, if adequate loss restriction rules were a part of the transparent company regime then the Australian government may be persuaded to alter its approach. This is precisely because such rules *could* address concerns relating to the unfettered access to losses which have the (undesirable) potential to distort investment decisions.

Domestically, for new form transparent companies, the extent of breaches of tax neutrality in Australia is influenced by two factors — the full imputation system applying to corporations and the use of discretionary trusts for business operations. While transparent companies may provide additional benefits compared to these forms, they may not be sufficient to act as a 'catalyst' for change.

In terms of the United Kingdom and New Zealand, which introduced a transparent company while already having some corporate dividend relief, it is argued that characteristics unique to those jurisdictions are not replicable in Australia. These unique characteristics included the application of the United Kingdom's NIC and New Zealand's lack of a loss restriction rule based on a membership cost basis and the absence of a comprehensive CGT.

It may be for these reasons that there is no great drive, in the domestic context, for the introduction of a transparent company — although, it needs to be noted, that the recent ICAA proposal is on the agenda.¹⁹³ However, it was suggested, in this respect, that a transparent company could, indeed, provide an improved governance regime, as well as one that reduces the concurrent use of business forms.

Despite the low domestic demand within Australia, pressure for the introduction of a transparent company could transpire from increased international finance and investment. Such increases may result in pressure from foreign investors who utilise transparent companies in their home jurisdictions and desire the existence of a similar entity in Australia — or at least symmetrical tax treatment.¹⁹⁴ Indeed, it was international implications that were instrumental in Australia's restricted recognition of transparent companies with the venture capital ILPs and the CFC hybrids. The introduction of these two transparent measures was to improve tax neutrality in terms of debt and equity and import–export neutrality. It should be recalled that jurisdiction competition played an important role in the United States and the United Kingdom. Similar international pressure could result in the demand for the broader recognition of transparent companies in Australia. Such demands could be based on reasons that a transparent company could facilitate an increase of trade and investment between jurisdictions and thereby improve Australia's economic position, and that asymmetrical tax treatment could hinder investment. This could be further facilitated by the recent Free Trade Agreement between the United States and Australia, which could result in increases in trade between the two countries, and in greater policy diffusion. Also, questions may arise as to why Australia fails to offer transparent company regimes similar to the United States, the United

¹⁹³ However, it should be acknowledged that the ICAA proposal is for a special tax rule company rather than a new form transparent company.

¹⁹⁴ Note while the S Corporations have been around for nearly 50 years and LAQCs for 14 years, due to their domestic focus they might not have provoked similar pressures.

Kingdom or New Zealand. Australia's restricted recognition of transparent companies, in itself, may provide a greater leverage for future lobbying to demand a wider implementation, resulting in 'policy creep'.

It has been argued that the Australian government's approach to tax neutrality may alter if it was satisfied with rules to ensure that there was not unfettered access to losses by members of a transparent company. Chapter Six will now shift the focus of academic attention to inquire whether the Australian loss restriction measures introduced for the venture capital ILPs and the CFC hybrid amendments are *adequate* to support the broad adoption of a transparent company in Australia.

Chapter Six: Are the Australian loss rules adequate?

6.1 Introduction

It was argued that the Australian government has so far been reluctant to allow for the flow-through of losses to members when the business form operates as a separate legal entity and comprises the characteristic of limited liability.¹ This reluctance of the Australian government stems from concerns arising out of the potential for loss of tax revenue, particularly if members are allowed to deduct losses (including tax preferences) in excess of their financial exposure.² The Australian Treasury recognised this potential for loss of tax revenue as early as 1974,³ and then subsequently in its 1985 Draft White Paper when the focus of discussion centred directly on tax transparent companies.⁴ The concern in relation to loss of tax revenue was again reiterated in the Ralph Review, which went so far as to emphasise the impracticality and unfeasibility of allowing the flow-through of loss to shareholders.⁵ This concern about unfettered access to losses is epitomised by Australia's 1990s reforms to tax limited partnerships as corporations rather than on a flow-through basis.⁶

Particular legal characteristics or indicia of different business forms may warrant certain distinctive political interventions and integrity measures in order to promote the overriding objective of tax neutrality between business forms. For example, one specific characteristic of tax transparent companies is the liability

¹ Refer to the discussion in Chapter Five and Freudenberg, B. (2006). Are transparent companies the way of the future for Australia? *Australian Tax Review* 35(3):200, at pp 214-215.

² Stewart, M. (2003). Towards flow through taxation of limited partnerships: It's time to repeal Division 5A. 32 *Australian Tax Review* 171, at p 179.

³ Australian Treasury. (1974). Taxation Paper No 1, Canberra: AGPS.

⁴ Australian Treasury. (1985). Draft White Paper on the Reform of the Australian Tax System, Canberra: AGPS.

⁵ Australia. (1999). A Tax System Redesigned (Ralph Report No 4), Canberra: AGPS, at paragraph 277 of Overview.

⁶ *Income Tax Assessment Act (ITAA) 1936* (Cth), Division 5A. Refer to the discussion in Chapter Five of these reforms.

protection that is accorded to members, and with it there is the potential for investment decisions to be distorted when allocated losses exceed a member's financial exposure.⁷ The presence of this distinctive aspect of tax transparent companies, raises the question as to precisely *what* legal measures have foreign jurisdictions implemented to ensure that the pursuit of this economic ideal does not distort investment decisions in terms of allocated losses.

Even in a contemporary political and legal context, legal restrictions have been specifically imposed on losses allocated through Australia's narrow recognition of transparent companies. However, are these Australian loss restriction rules adequate or, alternatively, too rigorous? In view of these issues, this chapter will analyse the appropriateness of Australia's legal framework in relation to tax transparent companies, with a view to comparing and contrasting it to the (legal) frameworks that are extant in the foreign jurisdictions studied.

Attention will first turn to illustrating precisely *how* the unfettered allocation of losses to limited members could potentially distort investment decisions. The focus of examination will then shift to comparing and contrasting the Australian loss restriction rules to those which apply to S Corporations and limited liability companies (LLCs) in the United States; the United Kingdom's limited liability partnerships (LLPs); and, finally, to New Zealand's Loss Attributing Qualifying Companies (LAQCs). As a means of highlighting and contrasting the legal rules that have been imposed on LAQCs, the analysis in the chapter will further consider the structure of the loss restriction rules introduced for the new limited partnership regime in New Zealand. Through this examination, it will be argued that, with minor amendments, the legal framework comprising Australia's loss restriction rules, which apply to controlled foreign hybrid companies (CFC hybrids), are indeed adequate and are the preferable rule set for Australia. It will be argued that with the recommended changes these loss restrictions rules are adequate to facilitate the broad availability of tax transparency in Australia. Such

⁷ Australia, n 5, at paragraph 277 of Overview.

integrity measures were previously argued as an important characteristic to gain Australian government support for such broad availability.

6.2 Unfettered access to losses

An example will now be considered to illustrate how a country's tax framework can impact on the decisions of investors and consequently distort overall levels of investment. This hypothetical example will be built upon later in the chapter to demonstrate the application of the various loss restriction rules. Example 6-0-1 provides a simple scenario to demonstrate how unfettered access to losses can in effect result in the tax system distorting a member's return on his or her investment in a transparent company.

Example 6-0-1: Losses and distortion

Assume that a member (Cooper) on the highest marginal tax rate (46.5%) invests \$10,000 into a tax transparent company. The \$10,000 represents the extent of Cooper's financial exposure for the overall business operations. The transparent company borrows another \$40,000 from a third party. The business invests the money and generates tax losses of \$50,000 for the first three years. After three years it is projected that the business may generate income.

If Cooper were able to utilise these tax losses to offset against other assessable income, Cooper would not pay tax on \$50,000 of income, because the \$50,000 worth of tax losses could be offset against assessable income of \$50,000. Over the three years this would amount to a tax saving of \$23,250 (being $\$50,000 \times 46.5\%$).

Example 6-0-1 illustrates, that irrespective of whether the investment ever produces positive returns to the hypothetical 'Cooper', with the consequent tax savings Cooper has an effective return of \$23,250 over the first three years. That is, Cooper is able to recover the initial \$10,000 investment, plus an additional \$13,250, and this ultimately represents a return of 132.5 per cent. This return is produced by the tax system funding the investment by lowering Cooper's overall tax burden. If not for the tax savings, Cooper may not have even made the

decision to invest. Such a hypothetical scenario demonstrates precisely how a country's tax system can fund or decrease the effective cost of capital for an investor, thereby distorting investment decisions. Such a result is juxtaposed to the ideal of tax transparency achieving greater tax neutrality.

Of course, individuals who invest in their own name can achieve similar returns, although a fundamental difference is that an individual would have full liability exposure for a poor investment decision. However, when the investment is made via a transparent company, then the member's liability can be limited. It is this lack of full financial exposure that raises inherent concerns with tax transparent companies.

When a business form provides limited liability to members, the tax system can act, in effect, as a 'reverse' externality, in the sense that transfer payments, through the mechanism of the tax system, can artificially inflate returns and thus distort economic investments. The importance of an appropriate loss restriction rule was recently highlighted in the specific context of New Zealand's new limited partnerships, when the view was expressed that:

[The] ...absence of loss limitation rules is likely to distort efficient risk-bearing decision-making and efficient resource allocation by encouraging investors to enter arrangements or schemes whereby small amounts of capital are invested to get access to larger net losses. This could result in abuse ... may potentially create large fiscal costs to the government.⁸

In acknowledging the potential deficiencies that inhere in the LAQC regime, the New Zealand government, in direct response, has sought to introduce a different set of loss restriction rules for its new limited partnership regime which commenced from 1 April 2008. It is for this precise reason that these alternative

⁸ Cullen, M (Minister of Finance), and Dunne, P (Minister of Revenue). (2006). General and limited partnerships — proposed tax changes: A government discussion document. Wellington, at p 34.

rules applicable to New Zealand's new limited partnerships are also the subject of critical analysis in the discussion below.

6.3 Quantum of allocated losses

Before analysing the loss restriction rules in detail, it is useful to ascertain the exact amount of losses being allocated through the transparent companies studied. Data from the Internal Revenue Services (US) (United States IRS) demonstrates that since 1999 more losses have flowed through LLCs compared to S Corporations, with \$91.6 billion worth of losses flowing through in 2003 compared to \$62.85 billion for S Corporations. In this context, Figure 6-0-1 displays the quantum of losses made by all the different business forms except for C Corporations.⁹ The growth in losses for LLCs has been significant, with an average annual growth of 70 per cent from 1994 to 2003, whereas for S Corporations it was 7 per cent. However, these figures do not disclose to what extent members of these entities were able to utilise these allocated losses.

Unfortunately, there is no readily available public data on the quantum of losses flowing through LLPs in the United Kingdom. In New Zealand there is some limited data demonstrating the amount of losses flowing through LAQCs during the 1990s, as replicated in Figure 6-0-2. This data demonstrates that there was NZ\$360 million worth of losses following through LAQCs in 1998, the result of an average annual increase from 1994 of 16 per cent.

⁹ The data set or figures pertaining to C Corporations have been excluded so the overall trend in other business forms is more clearly depicted and illustrated. This is because the greatest quantum of losses is generated by C Corporations, with \$417.66 billion worth of losses in the 2002 year; with these losses being captured at the entity level unless the entity is part of a consolidated group of corporations.

Figure 6-0-1: US: Losses (deficits) in business forms

Source: Internal Revenue Service (US). (1986 – 2003) Tax Statistics Returns Filed for Individuals, Corporations and Partnerships. Available at: <http://www.irs.gov/taxstats/index.html>. The figure excludes data for C Corporations

Figure 6-0-2: NZ: LAQC Losses

Source: Inland Revenue (NZ). 1999. Supplementary Briefing Papers Volume 1: Tax Policy. Wellington, at p 42.

6.3 Loss restriction rules

To maintain the integrity of their tax systems the jurisdictions studied have implemented a range of loss restriction rules. In particular, the United States has several overlapping rules. In contrast, the United Kingdom has a more targeted but somewhat ad hoc approach to allocated tax losses. It is argued, however, that New Zealand currently has the weakest rules for LAQCs and this explains why it introduced rules with its new limited partnership regime.¹⁰

Within these foreign jurisdictions it is argued that there are four categories of loss restrictions rules: membership cost basis, risk rules, passivity, and streaming. The first restriction, relating to the category of membership cost basis, involves the notion that members are able to utilise allocated losses to the extent of their equity investment in the transparent company (membership cost basis). The next restriction, pertaining to the category of risk rules, considers the level of a member's risk exposure in terms of their equity investment in the transparent company or in terms of being exposed to movements in value of their membership interest. The third restriction is associated with the category of passivity and considers the extent of a member's involvement in the transparent company's business. The final restriction relates to the ability or capacity of transparent companies to stream losses preferentially to particular members. Each of these restrictions is now analysed in detail and compared to the framework of Australian rules that were specifically introduced for incorporated limited partnerships for venture capital investments (venture capital ILPs) and CFC hybrids.

¹⁰ The new limited partnership regime will replace New Zealand's 'special partnership', which is similar to the limited partnership, although it requires re-registration every seven years. The new limited partnership provides for a separate legal entity and limited liability for some members who are not active in management: Cullen, M (Minister of Finance), and Dunne, P (Minister of Revenue), n 8. This was finalised by the *Limited Partnerships Act 2008* (assented to 13 March 2008), commencing 1 April 2008.

Through the description that follows it will become evident that loss restriction rules increase complexity and thereby compliance costs. This characteristic will be further explored in the analysis of Chapter Seven, in terms of compliance cost burden due to transparency.

6.3.1 Membership cost basis

The United States and the United Kingdom provide for a membership cost basis restriction for allocated losses.¹¹ However, the United Kingdom applies its rule only to Trade LLPs and not to Professional LLPs.¹² New Zealand does not have such a restriction for LAQCs, although it does for its new limited partnerships.¹³

A membership cost basis restriction allows members to utilise allocated losses only to the extent of their actual membership cost basis. Generally, if allocated losses exceed this amount, then excess losses may be carried forward until the membership cost basis increases or the transparent company allocates profit. Such a mechanism could reduce the risk of transparent companies being used for mass marketed tax planning schemes.

To illustrate the application of a membership cost basis rule, the case scenario presented in Example 6-0-1 will again be utilised. In the context of that particular fact scenario, Cooper would be entitled to claim only \$10,000 in losses and

¹¹ *Internal Revenue Code 1986 (US) (IRC 1986 (US))*, sections 1366 and section 704.

¹² *Income and Corporation Taxes Act (UK)*, section 117. It is not clear why the United Kingdom distinguishes between Trade and Professional LLPs, although it may be due to uncertainties about the completeness of liability protection offered by the Professional LLP to its members; however such uncertainty would equally apply to Trade LLPs. The differentiation between a 'trade' and a 'profession' is a question of fact, with a profession involving the idea of an occupation requiring either purely intellectual skill, or of manual skill controlled, which is distinguishable from a trade occupation which substantially involves the production or sale of commodities. See: *Erichsen v Last* (1881) 8 QBD 414, at p 420 per Brett LJ and *Ransom v Higgs* [1974] 3 All ER 949, per Lord Wilberforce.

¹³ *ITA 2007 (NZ)*, new section HG 11 inserted by *Taxation (Limited Partnerships) Act 2008 (NZ)*. Referred to as a 'partner's basis' in the legislation.

would thus save tax of \$4,650. Cooper would carry forward the remaining \$40,000 of allocated losses until either an increase in membership cost basis or the transparent company allocates income. Due to this restriction Cooper to date has received only \$4,650 of the initial \$10,000 investment, with no specific guarantee of further returns. This means that up until this point in time Cooper's return has reduced significantly from \$23,250 to \$4,650.

Broadly, the membership cost basis represents the equity a member has invested in the business form and could potentially lose, even with the liability protection offered by the transparent company. Measuring this equity contribution can be contentious and there are variations between the jurisdictions studied.

For both S Corporations and LLCs, membership cost basis equals the initial contribution for membership interest,¹⁴ the additional capital contributions,¹⁵ and the allocated income¹⁶ less both allocated deductions and actual distributions.¹⁷ This implies the important point that allocation of income or losses immediately adjusts the membership cost basis. In this respect, the increasing adjustment for allocated income recognises the potential tax assessment for an S Corporation or LLC member.¹⁸ Recognising, in turn, the potential tax deductibility to a member, allocated expenses — whether deductible or not — will decrease the membership cost basis.¹⁹ An actual distribution (whether cash or property) to a

¹⁴ *IRC 1986* (US), section 351 for S Corporations and section 722 for LLCs. Further capital contributions made by a member would increase their outside cost basis. Such contributions could be made by cash, property [property would include real estate and secret processes and formulas: Revenue Ruling 64-56] and/or future services: *Model Corporation Act*, section 6.21(b). *Revised ULLC Act*, section 402, and *IRC 1986* (US), section 722 for LLCs.

¹⁵ Treasury Regulations, section 1.446-1(a)(4).

¹⁶ *IRC 1986* (US), sections 1366, 1367 and 702.

¹⁷ *IRC 1986* (US), sections 1367(a)(1), 705 and 752.

¹⁸ *IRC 1986* (US), sections 1366 and 1367(a)(1) and LLCs *IRC 1986* (US), sections 702 and 705(a)(1).

¹⁹ For S Corporations *IRC 1986* (US), section 1367(a)(1) and LLCs *IRC 1986* (US), section 705. For example a fine or penalty while non-deductible would decrease the outside cost basis: *IRC 1986* (US), section 162(f).

member made by an S Corporation or an LLC will normally decrease the membership cost basis.²⁰

In the United Kingdom, Trade LLP members' allocated losses cannot exceed the amount of each member's 'contribution' to the LLP at the end of the year in which the loss is sustained, less the total of all losses previously utilised by the member from the same trade.²¹ A Trade LLP member's 'contribution' at any time is the greater of the amount subscribed or the member's liability on a winding-up of the LLP.²² It is argued in this context that the term 'amount subscribed' is equivalent to, and synonymous with, the 'membership cost basis'. The amount subscribed is what has been contributed to the LLP as capital,²³ less any previously withdrawn or repaid capital (directly or indirectly),²⁴ any withdrawal that was undertaken in the following five years,²⁵ any amounts the member is entitled to withdraw (but has not actually withdrawn),²⁶ and any reimbursement amounts that the member may be entitled to require from another person.²⁷

²⁰ For members of S Corporations their respective cost basis in their membership interest must be reduced by the amount of actual distributions: *IRC 1986* (US), sections 1368(b)(1) and 1367(a)(2)(A). The adjustments to the cost basis of a membership interest because of allocations of current year S Corporation income or losses must occur prior to determining the tax treatment of actual distributions to members: *IRC 1986* (US), sections 1368(d)(1), 1366(d)(1) and 1367(a)(1); Treasury Regulation, section 1.1368—1(e)(1). Although when an S Corporation makes a distribution in a loss year, the distribution reduces the cost basis of the member's interest before the S Corporation's loss is allocated to the members: *IRC 1986* (US), sections 1366(d)(1)(A) and 1368(d). The amount of any distribution to a member is equal to the amount of cash plus the fair market value of any property distributed.

²¹ *Income and Corporation Taxes Act* (UK), section 117(1)-(2). A similar loss restriction rule applies for corporations which are limited partners: *Income and Corporation Taxes Act* (UK), section 118(1)-(2). Note in the United Kingdom the terminology used is 'unrelieved capital contribution'.

²² *Income and Corporation Taxes Act 1988* (UK), section 118ZC(2).

²³ *Income and Corporation Taxes Act 1988* (UK), section 118ZC(2)(a).

²⁴ *Income and Corporation Taxes Act 1988* (UK), section 118ZC(3).

²⁵ The five years beginning at the relevant time. The 'draws out or receives back' five year rule is stated to prevent a member increasing their capital contributions temporarily to inflate the amount of trading losses that they can set against their other income or gains. If the member withdraws any capital from the LLP within five years of the time that their contribution was calculated for loss relief purposes, the extent to which they can claim loss relief under *Income and Corporation Taxes Act 1988* (UK), sections 380 or 381 is reduced.

²⁶ Pinfeld, L, ed. (2005). *Tolley's Tax Planning 2005-06*. Vol. 1. London: LexisNexis Butterworths, at p 1350 argues that this is penal but then acknowledges that the United Kingdom Revenue may have concerns that a limited partner could artificially increase this contribution at little cost, for

In the context of New Zealand's new limited partnerships, the membership cost basis is the addition of 'investments' and 'income' less 'distributions', 'deductions' and 'disallowed amounts'.²⁸ Each of these terms is then defined. In terms of 'investments', this is defined as being the sum of the (a) market value of contributions; (b) the amounts paid for assignments of capital contribution; and (c) secured amounts.²⁹ Term 'income' is defined to include (a) income in current and previous years allocated to the member; (b) capital gain amounts in the current or prior years if the member is treated as a corporation;³⁰ and (c) income allocated to the member due to contributions to the partnership.³¹ The term 'distribution' is defined to include (a) the market value of distributions; and (b) the amounts paid because of assignment of capital contributions to others.³² 'Deductions' are defined as being (a) the expenditure allowed in prior years (except those denied pursuant to the loss restriction rule); (b) capital losses in current and prior years if the member is treated as a corporation;³³ and (c) deductions allowed in prior years due to certain assessable income amounts.³⁴ Finally 'disallowed amounts' is defined as an investment that is made by a member within 60 days of the last day of income year if the investment is distributed or reduced within 60 days after year end.³⁵

In the context of Australia's venture capital ILP, the loss restriction rule that is applicable to the limited member is calculated via the amount contributed less the sum of amounts repaid, the deductions previously allowed and the amounts of all

example by providing a letter of credit where the underlying intention was to create a loss, but not to draw on the limited member's money to the full extent.

²⁷ *Income and Corporation Taxes Act 1988* (UK), section 118ZC(3).

²⁸ *ITA 2007* (NZ), section HG 11(3) inserted by *Taxation (Limited Partnerships) Act 2008* (NZ).

²⁹ *ITA 2007* (NZ), section HG 11(5) inserted by *Taxation (Limited Partnerships) Act 2008* (NZ).

³⁰ Referring to *ITA 2007* (NZ), section CD 44(7)(a).

³¹ *ITA 2007* (NZ), section HG 11(5) inserted by *Taxation (Limited Partnerships) Act 2008* (NZ).

³² *ITA 2007* (NZ), section HG 11(6) inserted by *Taxation (Limited Partnerships) Act 2008* (NZ).

³³ Referring to *ITA 2007* (NZ), section CD 44(7)(a).

³⁴ *ITA 2007* (NZ), section HG 11(8) inserted by *Taxation (Limited Partnerships) Act 2008* (NZ).

³⁵ *ITA 2007* (NZ), section HG 11(9) inserted by *Taxation (Limited Partnerships) Act 2008* (NZ).

debt interests issued by the member (insofar as they are secured by the member's interest in the venture capital ILP).³⁶

Australia's CFC hybrids have their own distinctive or particular loss restriction rule known as the 'loss exposure amount.'³⁷ This is defined to be the addition of amounts or market value of member contributions that at the end of the year have not been repaid or returned, and that have been contributed for at least 180 days.³⁸ From this calculation the following are subtracted: (a) all limited recourse debts owed by the member at the end of the income year to the extent that borrowings were for the purpose of enabling the member to make contributions and are secured by the membership interest in the foreign hybrid;³⁹ (b) previous years revenue losses claimed by the member; (c) previous years net capital losses claimed by the member; and, finally, (d) subsequent deductions under outstanding revenue losses⁴⁰ or capital loss from previous years.⁴¹

When an analysis is undertaken across the various jurisdictions, several discrepancies or anomalies become apparent. These specifically relate to (a) member loans to the transparent company (including unpaid allocations) (member loans); (b) member guarantees of the transparent company's obligations; (c) loans to the transparent company from third parties (outside loans); and (d) the use of non-recourse or limited recourse financing by the

³⁶ *ITAA 1936* (Cth), section 92(2AA).

³⁷ When the CFC hybrids were originally introduced the explanatory memorandum suggested that foreign losses of a CFC hybrid would not be subject to Australian loss restriction rules at all, as at that time a rule applied to restrict foreign losses to foreign income: Explanatory Memorandum accompanying Taxation Laws Amendment Bill (No 7) 2003 (Cth), at paragraph 9.54, referring to *ITAA 1936* (Cth), section 79D. However, this rule is to be repealed and such foreign losses would then be subject to the loss restriction rule: *Tax Law Amendment (Measures No 4) Act 2007* (Cth): Act 143 of 2007: from 1 July 2008 repeals section 79D.

³⁸ Or intended to remain contributed for at least 180 days. *ITAA 1997* (Cth), section 830-60: Step One.

³⁹ The term used is 'limited recourse debt' and this is defined in *ITAA 1997* (Cth), section 243-20.

⁴⁰ *ITAA 1997* (Cth), section 830-50(2) or (3).

⁴¹ *ITAA 1997* (Cth), section 830-60: Step Two. *ITAA 1997* (Cth), section 104-270: foreign hybrid loss exposure adjustment. CGT event K12 refers to carried forward capital losses that previously could not be used because of the loss exposure amount. CGT event K12 occurs when these carried forward losses are subsequently made available in a future income tax year.

member to fund their equity contribution to the transparent company. Each of these issues is considered in the discussion below.

6.3.1.1 Member loans (including unpaid allocations)

Fundamental to determining the membership cost basis, indeed, is whether a member contribution is considered to be ‘equity’ or, alternately, ‘debt’. For Australia tax purposes, definitions of equity and debt have been formulated for corporations⁴² and are then, in turn, applied with modification to partnerships and trusts.⁴³ These definitions are predicated on substantive economic perspectives rather than simply on mere legal formalism.⁴⁴ Given that the entire concept of tax transparency is essentially grounded in, and reflective of, substantive *economic*, as opposed to *legal*, perspectives,⁴⁵ this focus is consistent with the notions underpinning tax transparency. For corporations and partnerships, equity has been defined in terms of an interest in the business that is contingent on the economic performance of the business.⁴⁶ In comparison, a debt interest has essentially been defined in terms of a financial arrangement⁴⁷ involving the receipt of a financial benefit,⁴⁸ which has in effect a non-contingent legal obligation to provide a financial benefit.⁴⁹ Accordingly, the concept of ‘contingency’ tends to be determinative in distinguishing between the notions of equity and debt. This definition has the potential to treat a member’s at call loan without a fixed term as an equity interest rather than a debt *per se* for tax

⁴² ITAA 1997 (Cth), section 974-20 defining ‘debt interest’, section 974-75 defining ‘equity’. In the event that an instrument is included in both definitions, then the tie breaker rule is that it will be regarded as debt: ITAA 1997 (Cth), section 974-5(4).

⁴³ ITAA 1997 (Cth), section 820-930 applies Div 974 with modifications to partnerships and trusts.

⁴⁴ ITAA 1997 (Cth), section 974-5.

⁴⁵ That is, disregarding the legal form and allocating income and or losses to the economic owners of the business activity compared to the legal owner being the business entity itself.

⁴⁶ ITAA 1997 (Cth), section 974-75(1).

⁴⁷ ITAA 1997 (Cth), section 974-130.

⁴⁸ ITAA 1997 (Cth), section 974-30.

⁴⁹ ITAA 1997 (Cth), section 974-135(3): defines this as an obligation not contingent on any event, condition or situation (including economic performance of the entity); other than the ability or willingness of that entity to meet the obligations.

purposes.⁵⁰ If, pursuant to this Australian tax definition, an amount is regarded as ‘equity’, then it appears uncontentious that it should be included in the membership cost basis. However, this in turn implicates the following important question: if a member contribution is regarded as debt, should this ‘member loan’ also increase the membership cost basis?

In terms of the United States, an LLC member loan automatically increases the membership costs basis,⁵¹ even though this does not occur for an equivalent S Corporation.⁵² This fundamental inconsistency between the United States’ transparent companies arises because an LLC’s transparency is conferred by the application of the general partnership tax provisions in Sub-Chapter K rather than Sub-Chapter S of the *IRC 1986* (US) for S Corporations. However, this discrepancy is largely in turn mitigated, as S Corporation members are able to use allocated losses to the extent of their membership cost basis *plus* member loans.⁵³

In comparison, a member loan for the United Kingdom’s LLP does not count towards the membership cost basis.⁵⁴ While LAQCs do not have a membership cost basis restriction, the rule for New Zealand’s new limited partnership does not include member loans.⁵⁵

In the Australian context, the loss restriction rule for venture capital ILPs refers to ‘member contributions’ without clearly specifying whether these are ‘equity’ or

⁵⁰ *ITAA 1997* (Cth), section 974-75(4). An ‘at call loan’ is defined as a loan to a business form by a connected entity; the loan does not have a fixed term and either (i) the loan is repayable on demand of the connected entity and repayment required immediately or within a reasonable period; or (ii) loan is repayable on death of connected entity. There are certain exclusions for loans prior to 30 June 2005 or when business’s turnover is less than \$20 million: section 974-75(4) and (6).

⁵¹ *IRC 1986* (US), section 752. Treasury Regulation, section 1.752-1(e).

⁵² Altieri, MP, and Cenker, WJ. (2002). Partnerships, LLCs, LLPs and S Corporations. *The CPA Journal* 72 (10):40, at p 45.

⁵³ Altieri and Cenker, n 52, at p 45.

⁵⁴ BIM72625 – Partnerships: loss relief restrictions: LLP members.

⁵⁵ *ITA 2007* (NZ), new section HG 11 inserted by *Taxation (Limited Partnerships) Act 2008* (NZ).

‘debt’ contributions by the member.⁵⁶ However, the Explanatory Memorandum does refer to the amount of ‘capital contributed by the limited partners’.⁵⁷ Similarly, for CFC hybrids the ‘loss exposure amount’ is defined to include ‘member contributions’⁵⁸ without distinguishing between the concepts of ‘equity’ and ‘debt’. Again, the Explanatory Memorandum appears to indicate that Parliament’s intention was that these should be ‘equity’ contributions.⁵⁹ However, this is not conclusive as later examples in the Explanatory Memorandum specify that certain debt contributions by a member are included in the membership cost basis.⁶⁰

It is suggested in this respect that for both Australian transparent companies it would have been preferable if the legislation had used the term ‘equity’ if the intention was to include only members’ equity contributions. This is particularly the case as Parliament has been at pains to define ‘debt’ and ‘equity’ in Division 974.

A related issue that is implicated here is the treatment of unpaid profit allocations to members,⁶¹ which could be regarded as a member loan, further equity contribution or, indeed, something else.⁶² In terms of S Corporations and LLCs in the United States, unpaid profit allocations automatically increase membership cost basis, as such allocations are perceived as an amount of retained profits in

⁵⁶ *ITAA 1936* (Cth), section 92(2AA).

⁵⁷ Explanatory Memorandum accompanying Venture Capital Bill 2002 Taxation Laws Amendment (Venture Capital) Bill 2002 (Cth), at paragraph 2.15.

⁵⁸ *ITAA 1997* (Cth), section 830-60. Note in the circumstance of buying a pre-existing membership interest then the purchase price is taken to be a contribution: section 830-60(2).

⁵⁹ Explanatory Memorandum accompanying Taxation Laws Amendment Bill (No 7) 2003 (Cth), at paragraph 9.58, refers to members ‘capital contributions’ which are reflected in the various partner’s capital accounts of the foreign hybrid.

⁶⁰ Explanatory Memorandum accompanying Taxation Laws Amendment Bill (No 7) 2003 (Cth), at paragraph 9.59.

⁶¹ That is, the transparent company has allocated profit to the members which the member has been assessed on but currently the profit remains within the transparent company.

⁶² For example with a discretionary trust it has been argued that an unpaid present entitlement of a beneficiary is held on separate trust for the beneficiary.

the business form.⁶³ This is despite the fact that members with unpaid allocations might technically rank equally with unsecured creditors upon winding up.⁶⁴ The allocation of the United Kingdom LLP's income to a member will not automatically increase the membership cost basis even if the allocation is unpaid.⁶⁵ What is required in the United Kingdom is that the LLP Agreement must specifically provide that an unpaid allocation becomes part of a member's capital contribution.⁶⁶

In this context, it is argued that the operation of the LLP rules is excessively harsh insofar as it fails adequately to take account of the additional 'adjustment to withdrawals' rule to which LLPs and their members are subject.⁶⁷ Put simply, the adjustment to withdrawal rule is a capital protection rule designed to protect creditors against the LLP being stripped of its assets and profits. However, it needs to be pointed out here that the definition of 'withdrawals' extends *beyond* distributions of profit and capital to include the repayment of member loans.⁶⁸ This has the potential consequence that a member may have to re-contribute the loan repayment even in spite of the fact that it represents the payment of prior allocated profit.⁶⁹ It is argued that, due to the operation of the withdrawal rule, a member loan representing an unpaid allocation ranks lower than other unsecured creditors of the LLP, and therefore is more akin to equity rather than to debt.

⁶³ Joint Committee on Taxation. (2006). Present Law and Background Relating to Selected Business Tax Issues. Washington DC: Senate Committee on Finance, at p 8.

⁶⁴ *Model Corporation Act* (US), section 6.40(f) and *Revised ULLC Act* (US), section 405(d).

⁶⁵ Inland Revenue (UK). (2000). Limited Liability Partnerships, *Inland Revenue Tax Bulletin – Issue 50*, at p 802. [cited 20 September 2006]. Available from: <http://www.hmrc.gov.uk/bulletins/tb50.htm#2>.

⁶⁶ Whittaker, J, and Machell, J. (2001). *Limited Liability Partnerships: The new law*. Bristol: Jordans, at p 200.

⁶⁷ *Insolvency Act 1986* (UK), section 214A: Members may have to contribute on a winding up if they withdrew property from the LLP over the two years preceding winding up at a time when they knew or had reasonable grounds for believing that the LLP was or would thereby become unable to pay its debts.

⁶⁸ Regulation pursuant to *Insolvency Act 1986* (UK), section 214A.

⁶⁹ Regulation pursuant to *Insolvency Act 1986* (UK), section 214A.

Given this lower ranking, an unpaid allocation should automatically increase a membership cost basis.⁷⁰

In terms of the legal framework applicable to New Zealand's LAQCs, while they do not have a membership cost basis restriction, the relevant rule for the new limited partnership does automatically include unpaid profit allocations in the measurement of the cost basis.⁷¹

For Australia's venture capital ILPs, unpaid allocations to members are not automatically included in the membership cost basis, and would be included only if considered 'equity' contribution pursuant to the tax rules distinguishing debt and equity interests, as previously discussed. In terms of CFC hybrids, if the foreign entity is a limited partnership, as opposed to an LLC, the Explanatory Memorandum indicates that a member's access to losses will be increased by a member's share of 'undrawn profits' in the foreign hybrid.⁷² However, it should be pointed out that the Explanatory Memorandum is silent as to whether this would extend to a CFC hybrid that is a company (such as the LLC). However, it does appear that the underlying intention is that it will not extend to such hybrids.

It is argued that if, legally, member loans (including unpaid allocations) are indeed debt owing by the transparent company to the member and are ranked equally with unsecured creditors, then these loans should *not* be included in the membership cost basis. If instead a member loan ranks below unsecured creditors then such a loan should *increase* membership cost basis (referred to as a member-subordinated loan). This is precisely because such a member-subordinated loan is at greater risk and is more akin to equity, due to the underlying requirement or need to satisfy unsecured creditors prior to its

⁷⁰ The capital protection rules applying to the LLP, as well as the other foreign transparent companies studied, are discussed in more detail in Chapter Nine.

⁷¹ *ITA 2007 (NZ)*, new section HG 11 (7)(a) inserted by *Taxation (Limited Partnerships) Act 2008 (NZ)*.

⁷² Explanatory Memorandum accompanying Taxation Laws Amendment Bill (No 7) 2003 (Cth), at paragraph 9.59.

payment. In determining the ranking of a member loan, all of the relevant regulatory provisions would need to be considered — particularly the capital protection rules.

A consequence of this argued position is that such an ordering could be complicated and would of necessity add to tax compliance costs. However, the idea of including member-subordinated loans in the membership cost basis is supported by the Explanatory Memorandum accompanying the CFC hybrid amendments. The Explanatory Memorandum, indeed, explicitly specifies that other amounts considered to be contributed by limited members includes ‘subordinated debt’ contributed by the member which is not a debt interest issued by the foreign hybrid and which, in the event of liquidation, ranks after claims by all other creditors (both secured and unsecured).⁷³ The interaction of unpaid allocations and governance rules is further analysed in Chapter Nine in terms of the capital protection rules.

6.3.1.2 Member guarantees

Also a matter of contention is whether member guarantees of the transparent company’s obligations should be included in the membership cost basis. This is an important consideration, given that member guarantees can be a common occurrence for closely held businesses, securing such things as premises leases, equipment financing and overdraft facilities. Within the jurisdictions studied, only New Zealand’s new limited partnerships provide for the inclusion of member guarantees for the transparent company’s obligations in the membership cost basis.⁷⁴

⁷³ Explanatory Memorandum accompanying Taxation Laws Amendment Bill (No 7) 2003 (Cth), at paragraph 9.59.

⁷⁴ ITA 2007 (NZ), new section HG 11 (12) definition of ‘secured amounts’ inserted by *Taxation (Limited Partnerships) Act 2008* (NZ).

It is argued that the compelling or overriding consideration should be whether a member guarantee is regarded as a debt or equity contribution by the member, or as something else. If it is debt, then consideration should be given to whether it ranks equally or below unsecured creditors on winding-up. If the ranking priority is lower than unsecured creditors, then the relevant obligation should increase the membership cost basis. In the specific context of the debt ranking equal to or above unsecured creditors, it should not increase the membership cost basis.

This conclusion implies the need to consider the legal nature of a guarantee. Indeed, a member's guarantee may be best regarded as neither equity nor debt, and instead is only a 'contingent' debt until called upon. If the guarantee is called upon and payment is made, then it is likely that the member would have a right of reimbursement from the transparent company through the rules of subrogation and contribution.⁷⁵ These rights, insofar as they relate to the transparent company, could then be treated *at this later date* as an equity contribution.⁷⁶

For members of Australia's venture capital ILPs it would appear that member guarantees do not consequently increase the membership cost basis. Similarly, for CFC hybrids the notion of contributions does not appear to extend to member guarantees. This is re-enforced by the Explanatory Memorandum; which states that typical contributions include cash, goods or marketable assets like land and buildings, with no reference made to guarantees.⁷⁷

6.3.1.3 Outside loans

Given the prior analysis, it may seem a foregone conclusion that outside loans borrowed by the transparent company from third parties would not be included in

⁷⁵ Now the reimbursement right is essentially a member loan.

⁷⁶ However, there could be problems with quantification because of the rules of contribution.

⁷⁷ Explanatory Memorandum accompanying Taxation Laws Amendment Bill (No 7) 2003 (Cth), at paragraph 9.58.

the membership cost basis. Indeed an outside loan represents a debt contribution by an outside party rather than by a member, and therefore represents an amount that the outside party has at-risk.

Notwithstanding this, curiously members of the United States' LLC can increase their membership cost basis by outside loans.⁷⁸ This appears to occur because LLCs are granted transparency through the general partnership tax provisions that cater for a business form in which traditionally members would have joint and separate liability for debts.⁷⁹ For the other transparent companies studied — S Corporations, the United Kingdom's LLPs and New Zealand's LAQC and new limited partnership — outside loans do not increase the membership cost basis.

Pursuant to the Australian tax legislative definitions of 'debt' and 'equity', an 'outside loan' to the transparent company is a debt of the transparent company and not an equity contribution by a member. This conclusion is not altered by the member providing a personal guarantee as security for the repayment of the outside loan to the transparent company.

In terms of venture capital ILPs, outside loans would not be a 'contribution' by a member and therefore are not included in the membership cost basis. While the United States' LLC could be a foreign entity treated as a CFC hybrid, it does not appear that the Australian membership cost basis for such an LLC is increased by outside loans. Therefore, an Australian member of an LLC could have a different membership cost basis in the United States to that for Australian tax purposes. It is argued that outside loans should not be part of the membership cost basis.

⁷⁸ Which are shared among members pursuant to their profit sharing ratios: Treasury Regulation, 1.752-3(a)(3).

⁷⁹ Although given the business reform in the United States over the last 20 years, the entities eligible for general partnership tax treatment have expanded to include such entities as LLCs, LLPs and LLLPs.

6.3.1.4 Non-recourse borrowings

Central to the membership cost basis restriction is that the greater the equity a member has invested in a transparent company, the greater should be their ability to use allocated losses. This is because such equity is at risk to creditors, despite the liability protection provided by the business form. However, this raises the question regarding what the tax situation should be if members increase their equity contribution without necessarily in turn increasing the amount of their financial exposure. In short, members can achieve this outcome by borrowing on non-recourse or limited recourse terms,⁸⁰ and then using these borrowed funds to subscribe for further membership interests in the transparent company. When a member does not meet their obligations to repay a limited recourse loan, then the creditor has recourse against the secured asset only and the member incurs no further personal liability.⁸¹ Through such mechanisms, the member's other assets are not at risk if default does arise. If the asset used as security for the limited recourse loan is only the subscribed membership interest itself, then the member can increase their equity contribution without actually increasing their overall economic exposure. Limited recourse borrowings of this nature can achieve financial exposure for the member similar to where the transparent company had raised finance through an outside loan. This is because the member's financial exposure to the outside loan is only as great as their equity contribution.⁸²

Members' ability to increase their membership cost basis by such non-recourse or limited recourse borrowings — thereby increasing access to allocated losses — is inconsistent with the treatment of outside loans generally, and thus breaches the desirable objective of tax neutrality. Also the use of non-recourse or limited

⁸⁰ If member borrowings are on a limited basis, this means that specific property has been pledged as sole security for the loan.

⁸¹ Note the courts can look through this in the United States when there has been bad faith: *Nippon Credit Bank Ltd v 1333 North California Boulevard* 86 Cal. App 4th 486 (2001).

⁸² Of course this is in the absence of the member providing a guarantee for such an outside loan.

recourse borrowings by members could artificially inflate tax deductions (losses), and thereby lead to the tax system distorting investment decisions.

Both of the United States' transparent companies allow for an increase in the membership cost basis through non-recourse borrowings.⁸³ The United Kingdom has rules to exclude member contributions that have been financed through non-recourse or limited recourse borrowings by the member.⁸⁴ These provisions were introduced because it was felt that investment businesses could be motivated to adopt an LLP structure for tax reasons rather than to obtain limited liability.⁸⁵ This in turn led to the introduction of rules to prevent the use of non-recourse and limited recourse borrowings⁸⁶ to increase capital contributed by a member of a Trade LLPs used for investment⁸⁷ and property investment.⁸⁸

Also excluded from capital contributions in the United Kingdom are liabilities incurred if the financial burden of meeting the liability is or may be borne, assumed or released by someone else. Failing this, there is a *de facto* test excluding finance procured if the member's loan repayment costs over any

⁸³ In the United States such a non-recourse or limited recourse borrowing by a member to contribute equity appears to allow for an increase in membership cost basis, and therefore greater utilisation of losses. However, this is then reversed by the application of another loss restriction rule, the 'at-risk rule': *IRC 1986* (US), section 465(b)(2).

⁸⁴ The United Kingdom Government has introduced a number of provisions to deal with the use of non-recourse borrowings. For example from 2 December 2004, a membership cost basis will not include amounts where the member does not bear the financial costs of contributing: *Income and Corporation Taxes Act 1988* (UK), sections 118ZB, 118ZC and 118ZN. *Finance Act 2005* (UK) and the *Partnership (Restrictions on Contributions to a Trade) Regulations*, SI 2005 No 2017.

⁸⁵ HM Revenue and Customs. (2004). Tax avoidance using film and partnership relief. published as part of the Pre-Budget Report on 2 December 2004 [cited 6 January 2008]. Available from www.hmrc.gov.uk/pbr2004/sup_ta_film.pdf.

⁸⁶ The member is said not to be at-risk because with a 'limited recourse' loan the borrower can be required to use only certain money, assets or revenues identified in the loan document to repay the debt. With a 'non-recourse' debt the borrower is not personally liable for the repayment of the debt at all. This can be compared to a recourse loan, where the lender can require the borrower to use its own funds, assets or revenues to pay a debt.

⁸⁷ An 'investment LLP' means a LLP whose business consists wholly or mainly in the making of investments and the principal part of whose income is derived therefrom.

⁸⁸ A 'property investment LLP' means a LLP whose business consists wholly or mainly in the making of investments in land and the principal part of whose income is derived therefrom. *Income and Corporation Taxes Act 1988* (UK), section 842; *Taxation of Chargeable Gains Act 1992* (UK), section 288, *Finance Act 2001* (UK), schedule 25, paragraph 1.

period of five years are less than they would be on arm's length commercial terms.⁸⁹

With New Zealand's new limited partnership regime, the membership cost basis could be increased through such limited recourse borrowings by the member to fund their capital contribution.⁹⁰ However, New Zealand does have deferred deduction rules, which require a taxpayer to defer deductions or losses arising from a transaction involving the acquisition of certain intangible property or software which is financed by a majority of limited recourse loans.⁹¹ These deferred deduction rules have only a narrow scope and would not prevent limited recourse loans from increasing the membership cost basis as described.⁹²

For Australia's transparent companies there are several provisions that consider non-recourse borrowings. Firstly, there are limited recourse debt provisions which apply to all taxpayers.⁹³ These provisions include in a taxpayer's assessable income an amount at the termination of a limited recourse debt⁹⁴

⁸⁹ This could cover the situation where arrangements are made so that the financial cost, to the member, of contributing can be reimbursed by someone else. To ensure there is no 'back dating', the United Kingdom has an integrity measure that addresses when the contractual terms of borrowings are altered from recourse to a non-recourse nature. If a Trade LLP member has claimed loss relief and then borrowings terms are altered from recourse to non-recourse, there will be a chargeable event triggering an amount of 'miscellaneous income' for the member. See: BIM72680 – Partnerships: loss relief restrictions: recovery of excess relief.

⁹⁰ ITA 2007 (NZ), new section HG 11(5) inserted by *Taxation (Limited Partnerships) Act 2008* (NZ).

⁹¹ ITA 2007 (NZ), sections GB 45 to 48. The New Zealand deferred deduction rules require a taxpayer to defer deductions or losses arising from a transaction involving the acquisition of certain intangible property and software that is financed by a majority of limited recourse loans, when gross income from the arrangement is less than the total deductions or losses. In such circumstances, losses are deferred until income arises from the arrangement, or if no income arises, the deferral will become permanent. Smith, A, and Dunbar, D. (2005). *Tax Avoidance Schemes in New Zealand: Limited Recourse Loans and the Deferred Deduction Rule*. Paper read at 17th Annual Australasian Tax Teachers Association Conference, January 2005, at Victoria University of Wellington, at p 13.

⁹² Refer to: Freudenberg, B. (2008). The Troubled Teen Years: Is the repeal of New Zealand's LAQC regime required? *New Zealand Journal of Taxation Law and Policy* 14(1):67.

⁹³ ITAA 1997 (Cth), Division 243.

⁹⁴ ITAA 1997 (Cth), section 243-20 defines 'limited recourse debt' as being where the rights of the creditor as against the debtor in the event of default are limited wholly or predominantly to: (a) rights to (i) debt property (being property that is the financed property i.e. the finance has been used to acquire or create the property: section 243-30(1) - (3); (ii) goods produced ... by means of

arrangement when the capital allowance (depreciation) deductions that have been obtained for expenditure that are funded by the debt are excessive⁹⁵ given the amount of the debt that was repaid. The rationale or justification behind this provision is similar to that which lies behind the United Kingdom's rules — that is, it specifically applies to the situation when borrowing terms are altered from recourse to non-recourse (borrowings).⁹⁶

While these Australian provisions apply to all taxpayers, their actual operation is restricted to financing capital allowance deductions (and not other deductions); and they specifically operate only at the end of the arrangement.⁹⁷ Also, there is some ambiguity in their application regarding what precisely does amount to 'excessive' deductions. Consequently, this rule's application to members of Australia's transparent companies is not without difficulty.

In addition to this rule, there are some specific measures in the membership cost basis to reduce the impact of limited recourse financing. For venture capital ILPs, the membership cost basis is reduced by limited recourse loans to the member if they are secured by the membership interest in the venture capital ILP.⁹⁸ Similarly, the CFC hybrids reduce the membership cost basis by limited recourse debts to the member when used to contribute to the foreign hybrid and the debt is secured by the member's interest in the foreign hybrid.⁹⁹

These rules thereby exclude such limited recourse loans from funding increases to the membership cost basis, and equate them to the treatment of outside loans. However, these restrictions do not appear to prevent a member securing a non-

the debt property; (iii) loss or disposal of debt property or debtor's interest in a debt property; (b) rights in respect of a mortgage or other security over the debt property; (c) rights that arise out of any arrangement relating to financial obligations of an end user of the financed property towards the debtor. Sections 243-20(2) and (3) expand the definition to limited recourse debt.

⁹⁵ *ITAA 1997* (Cth), section 243-35 details how to work out if deductions have been excessive.

⁹⁶ *Income and Corporation Taxes Act 1988* (UK), section 362.

⁹⁷ This may make recovery harsher and the time value of money.

⁹⁸ *ITAA 1936* (Cth), section 92(2AA) (b): Step 4 in the method statement.

⁹⁹ *ITAA 1997* (Cth), section 830-60(1): Step 2 (a) in the method statement.

recourse loan — compared with that of a limited recourse loan — to increase their membership cost basis. It is argued, in this respect, that non-recourse loans used by a member to fund a subscription for membership interest should also be excluded from increasing membership cost basis for Australia's transparent companies. Example 6-0-2 provides a comparison of the various membership cost basis rules operating in Australia and the foreign jurisdictions studied.

Example 6-0-2 demonstrates that Australian loss restriction rules, as they apply to venture capital ILPs and CFC hybrids, are very conservative compared to the foreign jurisdictions studied. The Australian measures are equivalent to the rules in the United Kingdom. Differences that do exist between Australia and the United States, primarily relate to the treatment of limited recourse borrowings and unpaid allocations. The Australian rules compare favourably to New Zealand's measures for its new limited partnerships. In terms of both the United Kingdom's Professional LLPs and New Zealand's LAQCs, the membership cost basis does not appear to influence members' ability to utilise allocated losses.¹⁰⁰ In this context, it is not exactly clear why Professional LLPs are not subjected to a membership cost basis rule, although it might be that Professional LLPs by their nature are not perceived as a tax planning vehicle, since members are likely to be part of a professional organisation. While lobbying by professional firms was a key motivating factor for the introduction and implementation of LLPs in the United Kingdom, it does not appear that this differentiation resulted from their lobbying. Instead, the restriction on Trade LLPs may be a safeguard introduced because of the late broadening of LLPs to be available beyond professionals to all businesses.

¹⁰⁰ However, the subsequent application of a jurisdiction's risk rules can alter the overall access to losses.

Example 6-0-2: Membership cost basis

Assume the following has occurred:

- Cooper has contributed \$10,000 cash as equity to the transparent company;
- The transparent company has borrowed \$40,000 from a third party (outside loan) for which Cooper has provided a personal guarantee;
- Currently the transparent company has allocated income to Cooper of \$5,000 which has not been paid (unpaid allocation);
- Cooper has borrowed \$3,000 to contribute further equity to the transparent company on a limited recourse basis. Only Cooper's membership interest in the transparent company stands as security for the repayment of this limited recourse borrowing.

Cooper's membership cost basis pursuant to the jurisdictions studied is as follows:

Description	Venture ILP (Aust)	CFC Hybrid (Aust)	S Corp (USA)	LLC (USA)	Trade LLP (UK)	Prof LLP (UK)	LAQC (NZ)	New limited partnership (NZ)
Member equity cash contribution — \$10,000	\$10,000	\$10,000	\$10,000	\$10,000	\$10,000	NA	NA	\$10,000
Outside loan — \$40,000	Nil	Nil	Nil	\$40,000	Nil	NA	NA	Nil
Member guarantee — \$40,000	Nil	Nil	Nil	Nil	Nil	NA	NA	\$40,000
Unpaid allocation — \$5,000	Nil	Potentially #	\$5,000	\$5,000	Nil	NA	NA	\$5,000
Limited recourse borrowings — \$3,000	Nil	Nil	\$3,000	\$3,000	Nil	NA	NA	\$3,000
Total membership cost basis	\$10,000	\$10,000	\$18,000	\$58,000	\$10,000	NA	NA	\$58,000

If foreign hybrid is an LLP then an unpaid allocation according to the Explanatory Memorandum would increase the membership cost basis.

A potential reason for the absence of a membership cost basis rule for LAQCs could be that it is a partial loss transparent company without income being automatically allocated members. The application of a membership cost basis

rule would therefore require some mechanism for LAQC members to track or trace their membership cost basis, even though profits are not taxed annually to them.¹⁰¹ Furthermore, the Government may have considered that the eligibility requirement of one class of membership interest would reduce the potential for the manipulation of loss allocation through LAQCs.¹⁰²

Irrespective of the reason behind the absence to include a cost membership basis rule, the ultimate consequence of this failure for Professional LLPs and LAQCs members in the United Kingdom and New Zealand may have been to compromise the integrity and neutrality of each country's respective tax systems.

6.3.2 Risk rules

Further restrictions imposed on the utilisation of losses are rules that consider and take account of a member's risk. Within the jurisdictions studied, these risk rules are on different occasions either integrated into the membership cost basis rule or entirely separate of the membership cost basis.

In the United States the 'at-risk rule' is a separate rule that applies in addition to the membership cost basis rule.¹⁰³ A member's at-risk amount equals the sum of the cash or the adjusted basis of non-cash property contributed to the business. In addition to this, it further includes most recourse borrowings by the business for which the member has personal liability or has secured by property unconnected with the business,¹⁰⁴ as well as the member's share of amounts

¹⁰¹ To facilitate a cost basis rule it may be necessary to make a notional allocation of profits to members to increase their cost basis.

¹⁰² *ITA 2007* (NZ), section HA 10.

¹⁰³ *IRC 1986* (US), section 465.

¹⁰⁴ Most outside loans would be regarded as non-recourse for both S Corporation and LLC members, because third party creditors would not have recourse to the assets held personally by members.

borrowed for use in the business that are qualified non-recourse financing,¹⁰⁵ plus the member's share of allocated income items.¹⁰⁶ This calculation is then *decreased* by actual distributions to the member, the member's share of allocated (and deducted) loss items, and the repayment of loans that had earlier increased the member's at-risk amount.¹⁰⁷ Excluded from this calculation are non-recourse recourse borrowings and guarantees provided by members.¹⁰⁸ The application of the United States' at-risk rule reverses some of the anomalies detailed previously in the membership cost basis rule.¹⁰⁹ However, it should be pointed out that the real estate industry in the United States is given some concessional treatment due to the definition of 'qualified non-recourse financing'.¹¹⁰

It is argued that the United Kingdom's risk rule is embedded in the second limb of determining a Trade LLP member's 'contribution', in terms of the quantum of the member's liability on winding-up of the LLP.¹¹¹

¹⁰⁵ *IRC 1986* (US), section 465(b)(6). Qualified non-recourse financing is present if the business has non-recourse debt collateralised with real property it uses in its business. This is because real estate non-recourse financing provided by a bank, retirement plan, or similar party or by a Federal, state, or local government generally is deemed to be at-risk.

¹⁰⁶ *IRC 1986* (US), section 465(b)(1) and (2).

¹⁰⁷ *IRC 1986* (US), section 465.

¹⁰⁸ *IRC 1986* (US), section 465(b)(4).

¹⁰⁹ Such as outside loans increasing an LLC members access to losses and limited recourse borrowings secured over the membership interest

¹¹⁰ Section 465(b)(6) *IRC 1986*. The exclusion of the real estate industry may be better understood through lobbying rather than formulaic tax policy. Indeed this carve out means that it is possible for the LLC's assets to be borrowed against on a non-recourse basis which increases the membership cost basis, so the borrowed funds can be distributed out to members tax free. Such a borrowing and distribution by an S Corporation would result in an assessable distribution to members, as S Corporation membership basis is not increased by borrowings of the S Corporation. Due to the carve out provided to the real estate industry in the United States it may be the case that the tax system is funding poor economic investments. This can be further aggravated by the fact that if rollovers are utilised and the assets are held until death, then the inheritors can have a step up in value, resulting in little or no tax ever being paid.

¹¹¹ *Income and Corporation Taxes Act 1988* (UK), section 118ZC(2). A Trade LLP member's 'liability on a winding-up' is defined as the amount the member is liable to contribute to the Trade LLP's assets upon winding-up; and to which the member remains liable for at least five years from the end of the year of loss or until winding up, if earlier: *Income and Corporation Taxes Act 1988* (UK), section 118ZC(4). BIM72625 – Partnerships: loss relief restrictions: LLP members: for losses sustained by non-active members of LLPs and by non-active general partners.

New Zealand's risk rule for LAQCs is different from that used in the United States and the United Kingdom. The New Zealand rule takes specific consideration of whether the value of the membership interest in a LAQC is exposed to changes due to the LAQC's losses.¹¹² In this context, New Zealand's new limited partnership regime does not seek to include a separate at-risk rule, with only the membership cost basis determining a member's potential to utilise allocated losses.¹¹³ However, there is some acknowledgment of financial exposure, as the membership cost basis rule largely applies to limited members only and not general members of the new limited partnership.¹¹⁴

The notion of risk manifests in several different forms within the Australian rules. For example, one manifestation can be seen in Australia's legislative approach, which has been to combine the 'risk' notion within the membership cost basis rule by excluding limited recourse borrowings secured on the membership interest for both venture capital ILPs¹¹⁵ and foreign hybrids.¹¹⁶ In this respect, it is argued that the Australian legislative approach ultimately reflects more concise drafting, compared from its American legislative counterpart with its at-risk rule

¹¹² *ITA 2007* (NZ), section HA 27. The rule is not satisfied if the LAQC's losses result in a reduction in the value of the membership interests in the LAQC and a member suffers no, or almost no part, of any such reduction. For example, because of any factors, such as the right of a member over any other person to sell any thing or any right of any other person to require the member or other person to sell any thing. This calculation of 'effective interest' is also important for determining member's liability and allocation of losses. Where voting interests vary during the income year, they are calculated on a weighted average basis for the whole of the year. However, to ensure that membership interests are not unduly manipulated, where a member's economic interest in a corporation is not accurately reflected by their voting interest because of other specific factors, the member's effective interest is calculated as the average of the member's voting interest and market value interest in the corporation.

¹¹³ *ITA 2007* (NZ), new section HG 11 inserted by *Taxation (Limited Partnerships) Act 2008* (NZ).

¹¹⁴ This has been slightly extended to general members when there has been switching in membership status: this still acknowledges that general members have liability exposure. *ITA 2007* (NZ), section HG 11(1)(b) inserted by *Taxation (Limited Partnerships) Act 2008* (NZ). A general member is subject to the loss restriction rule when they have been a limited member within the last 60 days of the income year and continue to be so 60 days after the year end. This change, in part, appears to acknowledge that the membership cost basis rule for New Zealand's limited partnership does not only include capital contributions, but it includes other things such as guarantee amounts and allocated income. Through the inclusion of these other amounts a general member could have a membership cost basis in the limited partnership and therefore could utilise allocated losses.

¹¹⁵ *ITAA 1936* (Cth), section 92(2AA).

¹¹⁶ *ITAA 1997* (Cth), section 830-60(1).

being separate from the membership cost basis rule. The Australian rules appear to be similar to that adopted in the United Kingdom, although the United Kingdom does acknowledge a member's expanded liability for five years from winding-up of the LLP.¹¹⁷ Given Australia's broadening of its bankruptcy rules, such an extended liability period would appear to be eminently reasonable. Finally, in this respect, it is argued that such liability, after winding up, should be taken into account in determining Australia's membership cost basis.¹¹⁸

The notion of risk is also integrated with the Australian loss restriction rules, insofar as they apply to 'limited' members¹¹⁹ as opposed to general members.¹²⁰ This acknowledges the significant fact that general members do not receive liability protection through the venture capital ILP or CFC hybrid structure itself.¹²¹ This tax treatment of venture capital ILPs and CFC hybrids is a more consistent implementation of policy compared to what does occur for general members of other limited partnerships in Australia.¹²²

However, whether the loss limitation rules apply to all members of Australia's transparent companies, regardless of whether their status is as a limited or general member, needs to be considered. It needs to be acknowledged that the business structure is not the only means for members to reduce or limit their liability exposure. In the pursuit of tax neutrality, if a consistent policy is to be

¹¹⁷ *Income and Corporation Taxes Act 1988* (UK), section 118ZC(4). BIM72625 – Partnerships: loss relief restrictions: LLP members: for losses sustained by non-active members of LLPs and by non-active general partners.

¹¹⁸ This could be facilitated through the lodgement of an amended return.

¹¹⁹ *ITAA 1997* (Cth), section 995-1 definition of 'limited partner' means a member of a limited partnership whose liability is limited.

¹²⁰ *ITAA 1936* (Cth), section 92(2AA). Note *ITAA 1997* (Cth), section 995-1 defines a "general partner" as a member of a limited partnership whose liability is not limited. *ITAA 1997* (Cth), section 830-45: CFC hybrids.

¹²¹ Explanatory Memorandum accompanying Taxation Laws Amendment Bill (No 7) 2003 (Cth), at paragraph 9.53 states that "this is consistent with the policy principle of limiting deductions for losses to amounts to which a partner is exposed".

¹²² *ITAA 1936* (Cth), Division 5A. Refer to Chapter Five's discussion about these reforms. This is because since 1992 limited partnerships in Australia have been excluded from tax transparent treatment and are taxed in a similar manner to corporations, even though general members do not have liability protection afforded by the business structure.

applied, losses should be restricted to the amount of equity that members really, in effect, have at-risk, irrespective of their status as limited or general member. Furthermore, legal application to all members could prevent manipulation such as members changing status between 'limited' and 'general' at times when losses may be generated.

The notion of risk is also present in providing for exempt capital gains of venture capital ILPs in the eligible venture capital investments. To be an 'eligible venture capital investment',¹²³ the investment must be held at risk¹²⁴ through the acquisition of shares in a non-listed Australian resident corporation.¹²⁵ An investment will be held 'at-risk' in this context if the entity owning the investment has no arrangement about either the maintenance of the value of the membership interest or the maintenance of any earnings.¹²⁶ In comparison to the risk notion that is utilised for revenue losses, this rule tends to focus more on whether the value of membership interest is affected by the investments made. This assessment of risk is similar to the rule used in New Zealand in relation to LAQC membership interests.

Example 6-0-3 further develops the scenario outlined in Example 6-0-2 to consider the application of the risk rules. This example demonstrates that, after considering the 'risk rules', there is greater consistency between Australia, United States and the United Kingdom. New Zealand's new limited partnership regime still has the greatest access to losses and may signal that the New Zealand rules are inadequate. Also, the mechanism of the New Zealand's risk rule for LAQCs is

¹²³ Subdivision 118-F ITAA97: see Howe, B, and Howell B. (2004). Amendments of the Venture Capital Regime, 8(1) *The Tax Specialist* 23, at p 24.

¹²⁴ Defined in *ITAA 1997* (Cth), section 118-430.

¹²⁵ Or options to acquire shares. Note in some circumstances investments in a holding corporation can be eligible. *ITAA 1997*, sections 118-425 and 118-435.

¹²⁶ Refer to the overview in Chapter Three of the tax rules applying to venture capital ILPs.

difficult to quantify and, perhaps, is part of the reason why repeal of the LAQC regime has been consideration from time to time.¹²⁷

Example 6-0-3: Risk rules

Refer to the facts for Example 6-0-2: Membership cost basis now also applying the jurisdictions' risk rules. Cooper's risk amount would be as follows:								
Description	Venture ILP (Aust)	CFC Hybrid (Aust)	S Corp (USA)	LLC (USA)	Trade LLP (UK)	Prof LLP (UK)	LAQC (NZ)	New limited partnership (NZ)
Member cash contribution — \$10,000	\$10,000	\$10,000	\$10,000	\$10,000	\$10,000	NA	NA	\$10,000
Outside loan — \$40,000	Nil	Nil	Nil	Nil	Nil	NA	NA	Nil
Member guarantee — \$40,000	Nil	Nil	Nil	Nil	Nil	NA	NA	\$40,000
Unpaid allocation — \$5,000	Nil	Potentially	\$5,000	\$5,000	Nil	NA	NA	\$5,000
Limited recourse borrowings — \$3,000	Nil	Nil	Nil	Nil	Nil	NA	NA	\$3,000
At-risk amount	\$10,000	\$10,000	\$15,000	\$15,000	\$10,000	NA	NA	\$58,000

6.3.3 Passivity

In determining the utilisation of losses, some of the jurisdictions studied distinguish whether or not a member is active in the transparent company's business. If a member is not active in the business, then the losses can be regarded as 'passive' and may only offset other passive income of the member.

¹²⁷ For the most recent consideration see: Cullen, M (Minister of Finance), and Dunne, P (Minister of Revenue), n 8.

While these passivity rules do not eliminate the losses allocated, they restrict what income the losses can offset. The quarantining of losses in this manner may prevent a member from the timely utilisation of losses if there is not sufficient passive income.

The United States applies passive loss rules to most taxpayers, including both S Corporation and LLC members.¹²⁸ These passivity rules are considered in addition to the membership cost basis and the at-risk rule. One way to determine if a member is 'active' is if the member has worked 500 hours in the year with the business.¹²⁹ In the United Kingdom if a Trade LLP member is regarded as non-active in the first four years of operation,¹³⁰ then only the amounts actually contributed on a winding-up count towards the second cap in determining the utilisation of losses.¹³¹ To be regarded as active, a Trade LLP member must devote a 'significant amount of time' to the trade in a tax year.¹³² This occurs when a member spends an average of at least ten hours a week personally

¹²⁸ The passive activity loss rules apply to individuals, a corporation in which five or fewer individuals own more than 50 per cent of the membership interest or to corporations or a corporation engaged in rendering certain professional services and in which the employees of the corporation own more than 10 per cent of the membership interest: *IRC 1986* (US), section 469(a)(2).

¹²⁹ In terms of the United States, for losses allocated from a transparent company to be regarded as active, the member must have a material participation in the business on a regular, continual and substantial basis. There are several tests to determine whether the member has material participation, including a need to participate in the activity for more than 500 hours during the taxable year (being approximately 10 hours per week for a 50 week working year): Treasury Regulations, section 1.469-5T(a).

¹³⁰ *Income and Corporation Taxes Act* (UK), section 118ZE(3). The restriction applies to loss sustained in the tax year in which the member first carries on the trade and in any of the next three years. The *Partnerships (Restrictions on Contributions to a Trade) Regulations 2005* (SI 2005:20 7) came into force on 22 July 2005. The non-active member restrictions apply to members of LLPs, and do so in priority to *Income and Corporation Taxes Act 1988* (UK), section 117 where both sets of restrictions would otherwise apply to the same loss (or interest). BIM72640 – Partnerships: loss relief restrictions: non-active partners.

¹³¹ Rule applies from 10 February 2004. BIM72640 – Partnerships: loss relief restrictions: non-active partners. Pinfold, L, ed., n 26, at p 1351: 'Capital withdrawn' is widely defined (*Income and Corporation Taxes Act 1988* (UK), section 118ZG(4)) to include capital which the taxpayer receives back during a five-year period following the time when the 'contribution to the trade' test is applied (*Income and Corporation Taxes Act 1988* (UK), section 118ZG(1)) and also includes any amount he is or may be entitled to draw out at any time. No amount drawn out on which income tax is payable will fall to be treated as withdrawn capital: *Income and Corporation Taxes Act 1988* (UK), section 118ZG(5).

¹³² *Income and Corporation Taxes Act* (UK), section 118ZH defines 'significant amount of time'.

engaged in activities of the Trade LLP.¹³³ This ten hour per week threshold is similar to the requirements that exist in the legislative counterpart of the United States. Accordingly, the United Kingdom uses passivity to restrict the ‘quantum’ of losses to be utilised, whereas the United States use passivity to ‘quarantine’ passive losses.

New Zealand does not seek to impose any broad rules that distinguish between active and passive losses flowing through a LAQC to members. However, it should be pointed out that if an allocated loss is in respect of CFCs or FIF losses, it can be offset only against income of a similar nature.¹³⁴ Previously, a rule was in place for special partnerships requiring forfeiture of tax losses if in the same year no income was earned in New Zealand.¹³⁵ The absence of any broad passivity rule is unlikely to alter with the introduction of the new limited partnership regime in New Zealand.

Australia has no restriction on the use of domestic passive losses against other income. Indeed, a popular passive loss in Australia is the negative gearing of rental properties, which have been widely used by individual taxpayers to decrease their tax payable on other income. For example, the quantum of the Australian rental losses for individuals in 2005 was \$4,101 million.¹³⁶ Curiously, while passive losses are freely available in Australia there is the potential for

¹³³ *Income and Corporation Taxes Act* (UK), section 118ZH: For a part year calculation: If the basis period is less than six months because the tax year is the one in which the individual joined or left the partnership, the requirement must instead be met by reference to the six months beginning with his commencement date or ending with his cessation date. The Explanatory Notes to the 2004 Finance Bill suggest that “personal engagement in the activities of the trade may include, for example, a management or service role such as personnel, accountancy or purchasing, but does not include time spent deciding whether or not to invest, and/or how much to invest, in the partnership or its trade”: Explanatory Notes of *LLP Act 2000* (UK)

¹³⁴ *ITA 2007* (NZ), section HA 24. Committee of Experts on Tax Compliance. (1998). *Tax Compliance: Report to the Treasurer and the Minister of Revenue*: Chapter 6 – Tax Mitigation, Avoidance and Evasion, Wellington, at p 26.

¹³⁵ *ITA 2004* (NZ), section IE 1 (2B).

¹³⁶ Australian Tax Office. (2007). *Taxation Statistics 2004-05: A summary of income tax returns for the 2004-05 income year and other reported tax information for the 2005-06 financial year*, Canberra: Australian Tax Office, at p 13.

active business losses conducted by an individual¹³⁷ to be quarantined if one of the commerciality tests in Division 35 *ITAA 1997* (Cth) is not satisfied.¹³⁸ These rules are directed at operations that are technically businesses, but not of a commercial scale to warrant the use of the business losses against other income of the taxpayer.

At first consideration this Australian preference for passivity would appear to be reiterated with venture capital ILPs, as the vast majority of losses are allocated to limited members, who by the nature of a limited partnership will be passive.¹³⁹ General members of the venture capital ILP would likely be active in the venture capital ILP; but their allocated losses are only one per cent pursuant to industry practice.¹⁴⁰ However, it is argued that there is an indirect restriction on passive losses generated through the venture capital provisions. This is because any losses generated within the venture capital corporation (that is, the corporation in which the venture capital ILP has invested) are trapped within that corporation and are not allocated to its members (which include the venture capital ILP).¹⁴¹ The quantum of losses generated by the venture capital corporation may be much higher than at the venture capital ILP level. The venture capital corporation is the entity conducting an active business; it is taxed as a separate legal entity with no transparency, compared to the venture capital ILP that facilitates equity

¹³⁷ Either in the individual's own name or as a member of a general partnership.

¹³⁸ *ITAA 1997* (Cth), Division 35.

¹³⁹ Limited members are excluded from participation in the business activity of the venture capital ILP to retain their liability shield. Of course a feature of the new venture capital ILPs are the broader safe harbour provisions that are provided for, to allow the limited member some participation in the management without losing liability protection: *Partnership Act 1892* (NSW), sections 66A and 67A; *Partnership Act 1958* (Vic), sections 97 and 98; *Partnership Act 1891* (Qld), sections 86 and 87; *Partnership Act 1963* (ACT), sections 67 and 68; *Partnership Act 1891* (SA), sections 64A and 65A; and *Partnership Act 1997* (NT), sections 65 and 66. Of course if the limited member is resident of a foreign jurisdiction with a passivity test, such as the United States, the member would have to comply with the foreign jurisdiction's passivity tests.

¹⁴⁰ If the venture capital ILP's investment in the venture capital corporation fails and a loss is generated, then pursuant to standard agreements the general member is entitled to one per cent of the loss, with the limited members entitled to the remaining 99 per cent. See: Stewart, M. (2005). Venture Capital Tax Reform in Australia and New Zealand. *New Zealand Journal of Taxation Law and Policy* 11 (2):216, at p 226.

¹⁴¹ This treatment has not been altered with the extension of eligible investments to include unit trusts, as losses would be trapped within this forms as well. *Venture Capital Act 2002* (Cth), and *ITAA 1997* (Cth), section 118-427. Operative from 1 July 2007.

investments.¹⁴² Instead the integrated imputation system would apply to the venture capital corporation. The practical operation of the venture capital tax provisions in this way places a restriction on active losses compared to passive losses.

In this context, Stewart has noted that the most valuable tax losses generated in an eligible venture capital corporation are trapped within the entity itself and do not reach the venture capital ILP.¹⁴³ Furthermore, it should be noted here that for a corporation to have the status of being an ‘venture capital corporation’ it can pursue only minor passive activities, because certain passive or finance activities — such as property development, rental, banking, leasing, and securitisation — cannot be 25 per cent or greater of its business.¹⁴⁴

Unlike the venture capital ILPs, the CFC hybrid amendments do not implicitly contain any passivity tests in terms of losses allocated to members. For example, while the loss restriction rules apply only to limited members, in some of the foreign entities included as CFC hybrids, such as LLCs and LLPs, limited members can be actively involved in the business without impinging their liability protection.¹⁴⁵

¹⁴² Losses are to be generated within the eligible venture capital corporation due to the level of risk in venture capital operations. For example an eligible venture capital corporation is likely to be in losses for several years at the early stage of its operations. The revenue losses could comprise deductible expenditures on salaries, trading stock and depreciation.

¹⁴³ Stewart, M. (2005). Venture Capital Tax Reform in Australia and New Zealand. *New Zealand Journal of Taxation Law and Policy* 11 (2):216, at p 226.

¹⁴⁴ ITAA 1997 (Cth), section 118-425 (2): 75 per cent or more of the corporation's business cannot be ‘ineligible’ activities. To satisfy this the corporation must meet at least two of these requirements: (a) more than 75 per cent of the company's assets (determined by value) must be used primarily in activities that are not ineligible activities mentioned in subsection (13); or (b) more than 75 per cent of the company's employees must be engaged primarily in activities that are not ineligible activities mentioned in subsection (13); or (c) more than 75 per cent of the company's total assessable income, exempt income and non-assessable non-exempt income must come from activities that are not ineligible activities mentioned in subsection (13). ITAA 1997 (Cth), section 118-425(13): Ineligible activities include (a) property development, land ownership, (b) finance activities of banking, providing capital to others, leasing; factoring and securitisation, (c) insurance, (d) construction or infrastructure facilities, (e) investments that derive income in the nature of interest, rents, dividends, royalties or lease payments.

¹⁴⁵ For example LLCs: *Uniform LLC Act*, section 201 and United Kingdom's LLP: *LLP Act 2000* (UK), section 1(4).

Example 6-0-4 demonstrates how the passivity test can impose additional restrictions on losses allocated across the various jurisdictions studied. Specifically, the jurisdictions of Australia and New Zealand did not use members' activity to determine the ability or capacity to use allocated losses, whereas in the United States and the United Kingdom a member's involvement may ultimately influence the utilisation of losses.

Example 6-0-4: Passivity rules

Refer to the assumptions given in Example 6-0-2 with the following additional scenarios: <ul style="list-style-type: none"> Cooper is actively engaged in the business for approximately 30 hours per week (active member); and Cooper has little involvement in the business for approximately one hour per week (passive member) 								
Description	Venture ILP (Aust)	CFC Hybrid (Aust)	S Corp (USA)	LLC (USA)	Trade LLP (UK)	Prof LLP (UK)	LAQC (NZ)	New limited partnership (NZ)
Active member	NA – but could adversely affect liability protection	NA	Available #	Available #	Available #	NA	NA	NA – but could adversely affect liability protection
Passive member	NA	NA	Quaran- tined *	Quaran- tined *	Could affect amount counted towards winding up	NA	NA	NA

Key:

subject to membership cost basis and risk rule.

* subject to membership cost basis and at-risk rule and quarantined for offset against passive income only.

6.3.4 Streaming rules

Another integrity measure introduced in connection with transparent companies is the ability to stream losses preferentially to some members. In any year a member's ability to utilise allocated losses (or other tax preferences) may vary due to their specific tax profile. For example, a transparent company with losses may have two members, namely Cooper and Jodi. In this context, Cooper will have no other income for three years, whereas Jodi will have substantial other income. In these circumstances there will be a *greater* tax benefit if the losses for the first three years are allocated only to Jodi who can immediately utilise them.¹⁴⁶ In comparison, Cooper would have to wait three years to utilise any allocated losses. The allocation of losses (or income) according to a member's tax profile is referred to as 'streaming'.¹⁴⁷ It is arguable that streaming can be perceived as infringing the integrity of a tax system because it facilitates the exploitation of losses and tax preferences. An alternative view to this, however, is that streaming enables the most effective utilisation of resources between members, thereby promoting or facilitating the integrity of the tax system. In the jurisdictions studied several mechanisms are present to restrict or circumscribe the streaming of losses from transparent companies. These include the initial eligibility requirements for transparency and the special allocation rules.

The eligibility requirements for the S Corporation and the LAQC to have only one class of membership interest is one way streaming can be addressed.¹⁴⁸ This is because all membership interest in these transparent companies must carry the

¹⁴⁶ Of course this depends upon Jodi being able to satisfy any loss restriction rules that might operate in the relevant jurisdiction.

¹⁴⁷ There are a number of factors that could affect a member's ability to utilise allocated losses, such as their membership cost basis, their at-risk amount, whether the member is active or passive in the business, and whether the member is a tax resident or not. For further examples of streaming see: Inland Revenue (NZ) (Policy Advice Division). (2007) *Officials' Report on Parts 5 and 6 of the Limited Partnerships Bill: Tax Aspects*, Wellington, at p 6.

¹⁴⁸ United States: *IRC 1986* (US), section 1361. New Zealand: *ITA 2007* (NZ), section HA 10.

same entitlement to losses according to the number of days the members hold their membership interest.¹⁴⁹ However, it is argued that the requirement for one class of membership interest does not entirely eliminate the potential for streaming. For example, streaming could still occur by issuing more membership interests to members best able to utilise losses. For this strategy to be effective the membership interests would have to be issued at the beginning of the loss year, and not part way through or at the end of the year when it becomes apparent that a tax loss will be generated.¹⁵⁰ Additionally, the payment of reasonable wages and other deductible expenses to members could be used to manipulate the overall allocation of losses.¹⁵¹

In contrast to S Corporations and LAQCs, the LLC does not require the one class of membership interest for transparency to apply. In this respect, all that is required is for the LLC to meet the requirements for a Check-the-Box election.¹⁵² While LLC's Operating Agreement (LLC Agreement)¹⁵³ can allow for the special allocations¹⁵⁴ of income, deductions, losses or tax credits to different members,¹⁵⁵ for such allocations to be recognised for United States' tax

¹⁴⁹ LAQC losses are allocated to members in the ratio of the number of shares held by all members during an income year on a per share, per day basis, known as their 'effective interest'. There is no option in relation to the treatment of an LAQC's losses, as any losses incurred while a corporation is an LAQC must be directly allocated to its members: *ITA 2007 (NZ)*, section HA 20. Once allocated, the losses are no longer available to the corporation [*ITA 2007 (NZ)*, section HA 21], nor can the LAQC offset the losses to other group corporations prior to attributing them to its members: *ITA 2007 (NZ)*, section HA 22.

¹⁵⁰ This is because a member's allocation is calculated on a per day basis of the year.

¹⁵¹ For example, if one member were paid wages or lease payments by the transparent company, this would effectively allocate more profit to this member, resulting in less profit in the transparent company to be allocated amongst members.

¹⁵² Since 1997, an LLC can simply 'Check-the-Box' for tax transparent treatment. Technically by default a multi-member LLC would be classified as a general partnership: Treasury Regulations, section 301.7701-2(c)(1) and (2).

¹⁵³ *IRC 1986 (US)*, section 704(a).

¹⁵⁴ For example special allocations could allow for capital gains or depreciation deductions to be allocated disproportionately to one member whose tax profile results in a more effective utilisation of them: Friedman, HM. (2004). *The Silent LLC Revolution - The Social Cost of Academic Neglect*. *Creighton Law Review* 38(1), at p 23.

¹⁵⁵ There are regulations to restrict 'shifting tax consequence rule' for foreign members: Treasury Regulation, section 1.704-1(b)(2)(iii)(b).

purposes they must first satisfy the ‘substantial economic rule’.¹⁵⁶ Such a rule requires that the LLC Agreement must, amongst other things, unconditionally oblige any member with a deficit in a capital account to restore the deficit upon the liquidation of the LLC, or when the member leaves the LLC.¹⁵⁷ This unconditional obligation adversely impacts on, or prejudices, the member’s limited liability protection.¹⁵⁸ Accordingly, if LLC members desire unrestrained special allocations, they must thereby forgo complete liability protection. The regulations allow an alternative: if LLC members want to retain their limited liability, then no deficit can be created in a member’s capital account.¹⁵⁹ This essentially means that special allocations are restricted to the amount of members’ capital account, which is similar to the membership cost basis.¹⁶⁰

The United Kingdom’s LLP have some ability to stream losses. The default rule is that LLP members share equally in the capital and profits of the LLP;¹⁶¹ however,

¹⁵⁶ *IRC 1986* (US), section 704. The ‘substantial economic effect’ is elaborately defined in the regulations promulgated: Treasury Regulation, section 1.704-1. If an allocation lacks substantial economic effect then it is modified to conform to the economic arrangement. Yin, GK, and Shakow, DJ. (1999). Taxation of Private Business Enterprises. In *Federal Income Tax Project*. Philadelphia: The American Law Institute, at p 80: The regulations interpret ‘substantial economic effect’ as encompassing two requirements: the allocation must have ‘economic effect’ and must pass a ‘substantiality’ test.

¹⁵⁷ Treasury Regulation, section 1.704—1(b)(2)(ii)(b). The other things the LLC Agreement must specify for substantial economic effect to exist are: (a) for the maintenance of a capital account for each member pursuant to the rules set forth in the regulations, (b) allocations of tax items be reflected in those accounts; and (c) LLC assets be distributed amongst members upon liquidation of the LLC based on the members’ capital account.

¹⁵⁸ Kwall, JL. (2005). *The Federal Income Taxation of Corporations, Partnerships, Limited Partnerships, Limited Liability Companies, and their Owners*. 3rd ed. New York: Foundation Press, at p 161. Internal Bureau of Fiscal Documentation. (2006). *Partnerships*. IBFD 2006 [cited 1 August 2006]. Available from //online2.ibfd.org/data/igp/cs/igp_za0002.html, at paragraph 5.3.2. Yin and Shakow, n 156, at p 82: “Capital accounts provide at best a mere static snapshot of the economic situation of the partners whereas their real situation may well be based on dynamic, multi-year expectations”.

¹⁵⁹ Treasury Regulation, section 1.704-1(b)(2)(ii)(b),(d): An alternative test provided by the regulations is if the LLC Operating Agreement includes a ‘qualified income offset’ provides (a) that capital accounts will be maintained in accordance with the regulations, (b) that allocations of tax items will be reflected in capital accounts, (c) that liquidating distributions will be made in accordance with positive capital account balances, and (d) the LLC Agreement must provide that no deficit may be created in a member’s capital account, and that if one is inadvertently created, the member must be allocated gross income in order to eliminate it as quickly as possible.

¹⁶⁰ Also, for the ‘substantiality’ requirement to be satisfied, the allocation at issue cannot be offset by another allocation in the same or later year: Treasury Regulation, section 1.704-1(b).

¹⁶¹ *LLP Act 2000* (UK), section 15(c) and *LLP Regulations 2001* (UK), regulation 7.

this does not mean that this occurs for tax purposes.¹⁶² Unfortunately, it is not entirely clear how to calculate each member's entitlement,¹⁶³ but it would be determined according to the interest of the member during the accounting period, with trading profits likely to be calculated on an accrual basis.¹⁶⁴

Furthermore, in the United Kingdom, members may not assign their income right to others,¹⁶⁵ nor can a member's current year allocation relate to a future profit sharing ratio.¹⁶⁶ However, at the same time, there is nothing prohibiting members changing their profit sharing ratio for future allocations, and thereby allowing for special allocations.¹⁶⁷ This change in allocation rights can occur without immediately realising a chargeable gain or loss even though the change could result in a part disposal of members' fractional interests in the LLP's assets. This

¹⁶² Legal opinion of Robin Potts QC in Appendix 3 of Institute of Chartered Accountants in England and Wales. (2005). Technical Release: TECH 56/05: Accounting by Limited Liability Partnerships: Institute of Chartered Accountants in England and Wales.

¹⁶³ Hoozemans, MA. (2002). The Taxation of Income Derived by a Netherlands, German and US Investor Through a UK Limited Liability Partnership. *European Taxation* February:72, at p 73: referring to Young, J. (2000). Limited Liability Partnerships – A chance for peace of mind. *Business Law Review* 21(11), at p 251.

¹⁶⁴ Hoozemans, n 163, at p 77. If the notional salary to a member causes some LLP members to have a loss, when previously the LLP was profitable then there can be adjustments. Where the LLP as a whole makes a profit (as adjusted for tax purposes), but, after the allocation of notional salaries the result is that an individual member makes a loss, the loss-making member cannot claim tax relief for the loss. See: HMRC Business Income Manual BIM 72245, and are given statutory effect for 2005/06 onwards: *Income Tax (Trading and Other Income) Act 2005* (UK), section 850(2)-(6). Instead, the loss-making member is treated as making neither profit nor loss, and the 'loss' is reallocated to the profit-making member in proportion to the profits already allocated to them.

¹⁶⁵ *Hadlee and Another v Commissioner of Inland Revenue (NZ)* PC, [1993] STC 294). Compared to the Australian decision of *Commissioner of Taxation v Everett* (1980) 143 CLR 440. Smailes, D, Flint, A, and Walton, K. (2005). *Tolley's Income Tax*. London: LexisNexis Butterworths, at p 717: "The *Hadlee* decision which would govern the United Kingdom LLP held the assignment by a member of part of his share in the general partnership was ineffective for displacing his liability to income tax on that part of his share of general partnership profits".

¹⁶⁶ Collison, D, and Tiley, J. (2005). *Tiley and Collison UK Tax Guide 2005-06*. London: LexisNexis Butterworths, at p 449.

¹⁶⁷ This is likely to depend upon the LLP Agreement. *CG27181- Partnerships: Statement of Practice D12: How to work out a fractional share*: "In deciding if a fractional share has changed, you need to keep these tests in mind. The three tests are: (a) is there any written agreement which sets out how you allocate capital assets? (b) is there any written agreement which sets out how capital profits will be shared or any evidence showing how they are shared? (c) is there any written agreement which sets out how income profits will be shared or any evidence showing how they are shared? The final test, which applies in the absence of any of these three, allocates equal shares to all the members".

is because the change can be treated as taking place at a consideration that gives rise to neither a gain nor a loss.¹⁶⁸ However, a member whose profit share was reduced would carry forward a smaller fractional interest in the LLP's assets and thereby have a greater capital gain on any ultimate disposal.¹⁶⁹ If there is an adjustment through the LLP accounts prior to the change in sharing, such a deferral of gain or loss will not be possible.¹⁷⁰

The New Zealand Government is eager to restrict the ability of streaming with the new limited partnerships.¹⁷¹ This is illustrated by the rule that income, expenditure, losses and other items will be allocated to members in the proportion determined by the member's share in the partnership income.¹⁷² Further, it needs to be pointed out here that the 60-day rule — as part of the membership cost basis rule — prevents members artificially inflating their cost basis temporary at year end and then quickly reducing it in the following year.¹⁷³

¹⁶⁸ Inland Revenue (UK). (1975). *Statement of Practice D12* (revised October 2002). [cited 20 September 2006]. Available from <http://www.hmrc.gov.uk>. The disposal is treated as made for a consideration equal to the member's CGT cost, and therefore there will be no chargeable gain or allowable loss at this point.

¹⁶⁹ Inland Revenue (UK). (1975). *Statement of Practice D12* (revised October 2002). [cited 20 September 2006]. Available from <http://www.hmrc.gov.uk>. The normal rules for part disposal apportionments are not applied; instead a fractional basis is used: *Taxation of Chargeable Gains Act 1992* (UK), section 42. A member whose share is increased carries forward a larger proportion of such costs.

¹⁷⁰ Similarly the deferral will not be possible if payment is made outside the accounts; or if the transfer is between persons who are 'connected persons' otherwise than through the LLP: Inland Revenue (UK). (1975). *Statement of Practice D12* (revised October 2002). [cited 20 September 2006]. Available from <http://www.hmrc.gov.uk>. Collison and Tiley, n 166, at p 949. For example, by revaluing assets, coupled with a corresponding increase or decrease in the member's current or capital account at some date between the member's acquisition and the reduction in his or her share. Such a revaluation could occur because LLPs have to comply with Generally Accepted Accounting Practice and Statement of Recommended Practice.

¹⁷¹ Cullen, M (Minister of Finance), and Dunne, P (Minister of Revenue), n 8, at p 2.

¹⁷² *ITA 2007* (NZ), new section HG 2(2) inserted by *Taxation (Limited Partnerships) Act 2008* (NZ). The Inland Revenue (NZ) reported that it should be made clear that the rule applies to 'losses', which is now in the November Bill: Inland Revenue (NZ) (Policy Advice Division). (2007) *Officials' Report on Parts 5 and 6 of the Limited Partnerships Bill: Tax Aspects*, Wellington, at p 10.

¹⁷³ *ITA 2007* (NZ), new section HG 11(9) inserted by *Taxation (Limited Partnerships) Act 2008* (NZ). Refer to the prior discussion about the membership cost basis rule.

The Australian government has implemented a number of rules to try to restrict the preferred allocation of income and or capital to taxpayers by business entities. For example there are provisions restricting corporations from the streaming of income and capital¹⁷⁴ or dividends.¹⁷⁵ A similar intention appears to underlie the denial of imputation credits to members who do not have sufficient economic interest in the entity,¹⁷⁶ or where imputation benefits are streamed to certain members ahead of others.¹⁷⁷ The imputation benchmark rules also try to achieve this,¹⁷⁸ as does the dividend-stripping rule.¹⁷⁹ The ability of a general partnership to manipulate profit distributions, and particularly the creation of losses due to notional member salaries, has been ruled against by the Australian Tax Office.¹⁸⁰

However, in terms of the venture capital ILPs there does not appear to be any prohibition *per se* on streaming of amounts to different members. Indeed it is the venture capital industry practice to stream net losses and income to different member types. For example, it is common practice for the general member to contribute only one per cent of the equity into the limited partnership, but to be entitled to 20 per cent of the profit, with the limited members receiving the remaining 80 per cent.¹⁸¹ Due to this dichotomy between equity investment and entitlement to profit, the general member's equity in the venture capital industry is referred to as the 'carried interest', as the general members are effectively 'carried' by the limited members.¹⁸² Contrast this situation to that where the

¹⁷⁴ *ITAA 1936* (Cth), sections 45A, 45B and 45C.

¹⁷⁵ *ITAA 1936* (Cth), section 177EA.

¹⁷⁶ *ITAA 1936* (Cth), section 177EA.

¹⁷⁷ *ITAA 1997* (Cth), Division 209.

¹⁷⁸ *ITAA 1997* (Cth), section 203-15.

¹⁷⁹ *ITAA 1997* (Cth), section 207-145. For a discussion of other examples see: Stewart, n 2, at pp 192-193.

¹⁸⁰ Commissioner of Taxation. (2005). Tax Ruling TR 2005/7, Canberra.

¹⁸¹ Stewart, n 143, at p 226.

¹⁸² This 'profit' is normally generated by selling the membership interests in the venture capital corporation in an initial public offering or the sale back of the membership interest to the original members. Alternatively profit may be generated through the receipt of dividends paid from the venture capital corporation.

venture capital ILP generates a loss; then, pursuant to the agreement, the loss is allocated more in line with equity contributions.¹⁸³

In terms of the CFC hybrids there is some ability for streaming since the provisions indicate that the allocations are primarily made pursuant to the business form's constitution.¹⁸⁴ However, the streaming of precise items of income and/or deductions to individual members is not possible, as each member needs to calculate their overall percentage of profits for the year and then apply this percentage to the net income.¹⁸⁵ This is similar to the rules applying to New Zealand's new limited partnerships.¹⁸⁶

Also, CFC hybrids have the 180-day component of the 'loss exposure amount', which prevents half-year increases in the membership cost basis to access losses.¹⁸⁷ Again, this rule is similar to the 60-day rule adopted for New Zealand's new limited partnership.¹⁸⁸

Prior to providing overall conclusions about the adequacy of the Australian loss restriction rules, this study will briefly consider restrictions on capital losses.

¹⁸³ Stewart, n 143, at p 226. General member is entitled to one per cent of the loss, with the limited members entitled to the remaining 99 per cent.

¹⁸⁴ *ITAA 1997* (Cth), section 830-30. For a hybrid company, the interest of a member in its net income or loss is equal to the percentage of the company's profit distributed at the end of the year in accordance with its constitution (or if none as dividends) what the member could reasonably expect to receive. A member's interest in a hybrid company's assets is equal to the percentage that the member could reasonably be expected to receive of the total distribution on the winding up of the company at the end of the income year. *ITAA 1997* (Cth), section 830-35. This is supported by the example provided in the Explanatory Memorandum accompanying Taxation Laws Amendment Bill (No 7) 2003 (Cth), at paragraph 9.43, example 9.1.

¹⁸⁵ *ITAA 1997* (Cth), section 830-30.

¹⁸⁶ *ITA 2007* (NZ), new section HG 2(2) inserted by *Taxation (Limited Partnerships) Act 2008* (NZ).

¹⁸⁷ *ITAA 1997* (Cth), section 830-60: Step One. The 'loss exposure amount' requires that member contributions have been contributed for at least 180 days or are intended to remain contributed for at least 180 days.

¹⁸⁸ *ITA 2007* (NZ), new section HG 11(9) inserted by *Taxation (Limited Partnerships) Act 2008* (NZ).

6.4 **Capital losses**

It is important to consider the treatment of capital losses, as opposed to revenue losses, and the adequacy of restrictions on their utilisation. It does not appear that the foreign jurisdictions studied impose additional or special rules for capital losses through their transparent companies, apart from quarantining.¹⁸⁹ In the United States, capital losses would be subject to the same rules outlined for revenue losses. For the United Kingdom, losses of a capital nature would occur at the member level of the LLP, due to the fractional interest approach applying to capital assets held by general partnerships there. Due to the absence of a comprehensive capital gains tax in New Zealand, there is no separate consideration of capital losses there.

In Australia, one initial broad restriction on capital losses is their quarantining, with capital losses able to offset only capital gains and not revenue gains.¹⁹⁰ For venture capital ILPs the loss restriction rule in section 92(2AA) does not apply to capital losses. However, this does not mean there is unfettered access to capital losses. Indeed, the restriction is absolute, because if a capital loss occurs then it is totally disregarded for Australian tax purposes.¹⁹¹ Consequently, members of a venture capital ILP cannot use capital losses to offset other capital gains that they may have.¹⁹² The severity of this restriction is counter-balanced insofar as limited members may be entitled to totally disregard capital gains made through the venture capital ILP.¹⁹³

¹⁸⁹ Generally capital losses are quarantined from other revenue receipts, and only offset capital gains.

¹⁹⁰ *ITAA 1997* (Cth), section 100-50 and 102-10(2).

¹⁹¹ Note any losses whether capital or revenue in nature is also disregarded: Sub-division 118-F *ITAA 1997* (Cth) and section 26-68.

¹⁹² *ITAA 1997* (Cth), sections 118-405 VCLPs, 118-410 AFOFs and 118-415 for foreign investors.

¹⁹³ VCLP or AFOF. *ITAA 1997* (Cth), Sub-Division 118-F.

The CFC hybrid loss restriction rule is a holistic rule applying to both revenue and capital losses.¹⁹⁴ In the event of members exceeding their loss exposure amount when they have both revenue and capital losses, then they must choose how much of the reduction applies to revenue and/or capital loss amounts.¹⁹⁵

6.5 Adequacy of Australia's loss restriction rules

Through the analysis in this chapter it has been demonstrated that Australia's loss restriction rules applying to the venture capital ILP and CFC hybrids share similar characteristics to those of the foreign jurisdictions studied. Indeed, Example 6-0-2 to Example 6-0-4 demonstrate that the Australian rules appear to provide conservative access to losses, equalling the United Kingdom's rules for Trade LLPs. However, it is argued that this does not necessarily imply that the Australian rules are perfect.

In retrospect, it is unfortunate that one universal loss restriction was not implemented in Australia to cover both venture capital ILPs and CFC hybrids. The reason for separate rules may be attributable to the desire to provide discrete concessional tax rules for the venture capital industry.¹⁹⁶ Nevertheless, it is argued that this could have been achieved by referring to a universal loss restriction rule.

In terms of Australia's transparent companies, it is argued that the rules applying to CFC hybrids appear more thorough and comprehensive. In particular, the CFC hybrid rules apply a sophisticated rule with application to both revenue and capital losses, and it combines within one measure membership cost basis, risk and streaming principles. This evidences more coherence and clarity than the

¹⁹⁴ ITAA 1997 (Cth), section 830-45.

¹⁹⁵ ITAA 1997 (Cth), section 830-45(2).

¹⁹⁶ The venture capital ILP rules probably apply only to revenue losses, as the government's desire to provide concessional tax treatment to capital gains realised by venture capital investors.

counterpart frameworks in some foreign jurisdictions — particularly that of the United States, which has an array of discrete separate rules applying.

The proposal by the Institute of Chartered Accountants in Australia and Deloitte (the ICAA proposal) instead suggests that the venture capital ILP loss restriction should apply to its suggested transparent company based on simplicity grounds.¹⁹⁷ However, in the proposal, the reasoning for this is not explicitly articulated with any clarity nor, indeed, does it consider the adequacy or efficacy of the restriction in any meaningful way. It is argued that the CFC hybrid rules are not significantly more complex than the venture capital ILPs.¹⁹⁸

However, it is argued that several amendments should, in fact, be considered for the CFC hybrid loss rules. Firstly, with regard to the membership cost basis, there should be legislative clarification about which member ‘contributions’ are included in the membership cost basis, and whether it extends beyond equity contributions to member loans. It is suggested that both equity and member-subordinated loans should be included in the membership cost basis, as both of these contributions are at greater risk than the unsecured creditors of the entity. Members’ loans that rank equally or above unsecured creditors should not be included in the calculation. The current exclusion of member guarantees should continue, being included potentially only once the guarantee is later called upon and fulfilled. This would also apply to when the member provides private property as security for an outside loan granted to the transparent company.

Given that the CFC hybrid rules apply to foreign entities which may allow for the inclusion of outside loans in membership cost basis,¹⁹⁹ it should be specified that

¹⁹⁷ Institute of Chartered Accountants in Australia and Deloitte. (2008). *Entity flow-through (EFT) submission*. Sydney: Institute of Chartered Accountants, at paragraph 3.15.6.

¹⁹⁸ The relationship between complexity and loss restriction rules is discussed in Chapter Seven.

¹⁹⁹ Particularly LLCs.

outside loans to the transparent company do not increase the membership cost basis for Australian tax purposes.²⁰⁰

In terms of the risk component of the CFC hybrid rules, in addition to excluding limited recourse loans secured over the membership interest, the exclusion should be extended to non-recourse loans used to increase a membership cost basis. It is suggested that the loss restriction rule should then apply to all members and not just too limited members — thereby having the effect of excluding the potential of members having short-term change of status to access losses. Also, it is further contended that consideration needs to be given to allowing for adjustments if the member is liable for further contributions on the winding-up of the entity (for example) under the bankruptcy laws.²⁰¹

With respect to the particular issue of passivity, Australia would appear to have more restrictions on ‘activity’ than on ‘passivity’.²⁰² It is not apparent why this dichotomy exists, and it is argued that if passive investors are allowed transparency there does not appear to be any reason why this should not be extended to active business participants.

In terms of the issue of streaming, this becomes a concern only when differential treatment exists between receipts and outgoings. Given this, streaming rules may be superfluous in the presence of an adequate membership cost basis rule that takes into account a member’s economic risk.²⁰³ Rules that try to restrict streaming may add undue complexity to the tax system, compared to the revenue at risk, which in any case is more of a timing issue. Furthermore, an added benefit of streaming is that it could assist closely held businesses in addressing their financing problems by reducing members’ overall tax liability.

²⁰⁰ Especially relevant for the CFC hybrids as they apply to LLCs that under the United States tax rules can include such outside loans in the membership cost basis.

²⁰¹ This later liability may allow for adjustments to be made for prior years.

²⁰² For example, the non-transparency given to venture capital corporations.

²⁰³ While streaming may enable the timelier utilisation of losses, these will be restricted to the membership cost basis.

While the CFC hybrid loss restriction rule applies to revenue and capital losses, the calculation of the capital loss can be complicated due to the fractional nature of member's interest in CGT assets. It is argued in Chapter Seven that a preferable approach could be to have some entity acknowledgement, with the entity having its own cost basis and capital proceeds, then allocating this net capital gain to members. This would be a similar approach to what occurs for trusts in Australia. The complexity of the fractional approach for CGT assets held through a general partnership form is illustrated by sub-division 830-D, which provides for setting tax costs for the CFC hybrids.

Consequently, it is considered that the Australian loss restriction rules for the CFC hybrids, with minor changes, are adequate to ensure that the allocation of losses to members themselves should not distort investment decisions.²⁰⁴ Due to this, it is argued that the loss restriction rules applying to the CFC hybrids, with suggested modifications, would be adequate to allow for the broad availability of tax transparency in Australia. This would have the ultimate effect of providing for tax transparency beyond Australians investing into certain foreign transparent companies or for venture capital investment.²⁰⁵ The presence of an adequate loss restriction rule should alleviate concerns about the risk to tax revenue due to tax transparent companies.

²⁰⁴ It should be acknowledged that the implication of the venture capital tax provisions overall are to encourage greater venture capital investment. That is, to distort investment.

²⁰⁵ Indeed, the Australian government must have considered the loss restriction rules to be adequate as an integrity measure to protect the Australian revenue from residents investing in foreign transparent companies. However, it is acknowledged that the rule does not apply to all foreign transparent companies - just to those specified in the legislation or included via regulation. Thus, this 'vetting' mechanism adds another layer of protection.

6.6 Conclusion

This chapter has considered whether the loss restriction rules applying to venture capital ILPs and CFC hybrids are adequate compared to those of the foreign jurisdictions studied. This analysis is an extremely significant one, as historically in Australia there has been a concern about the effect transparent companies could have on the integrity of the tax system. It was argued that it is impossible to achieve total tax neutrality, as different business forms have characteristics which necessitate different tax treatment or restrictions. If governments do not acknowledge this fundamental fact, then this may have adverse economic and public consequences. In Chapter Five it was argued that, due to the Australian government's approach to tax neutrality between business forms, an adequate loss restriction rule was imperative to maintain the integrity of the tax system.

To determine the overall adequacy of the rules applying to Australia's transparent companies, the loss restriction rules applicable to the venture capital ILPs and the CFC hybrids were compared and contrasted to those that apply in the United States, the United Kingdom and New Zealand. This analysis provided the conclusion that Australia's rules appear very conservative and comparable to the selected jurisdictions. Indeed, the CFC hybrids appear the most complete, applying to both revenue and capital losses. Through this analysis several recommendations were made to improve the application of the rules in terms of membership cost basis, risk rule, passivity and streaming. It was argued that the CFC hybrid loss restrictions rules would be adequate to allow for the broad introduction of tax transparency in Australia beyond its current limited application.

If there is to be a broadly available transparent company, the question then arises about what type of transparent company would be preferable. This consideration will be the foundation of the analysis of complexity, financing and governance that follows in Chapters Seven to Nine.

Chapter Seven: The complexity of transparent companies

7.1 Introduction

This chapter highlights the compliance cost issues with transparent companies and suggests how they may be mitigated. Historically, one purported disadvantage of a tax transparent company is the complexity that it may involve.¹ This generally can be attributed to the divergence between legal ownership of assets and earnings (with the transparent company) on the one hand and the tax consequences (with members) on the other. The analysis in Chapter Six already drew attention to some of the complexities that the loss restriction rules may impose.

Specifically, complexities can be seen as diminishing the theoretical advantages of tax transparency.² However, this raises the significant question of whether the empirical evidence demonstrates that disregarding the legal form for tax purposes does increase compliance costs. While modest, the available data indicates that transparent companies may, indeed, have higher tax compliance costs than other business forms where the tax treatment is more aligned with legal ownership of assets. The available data also suggests a difference between the two classifications of transparency, with special tax rule companies have lower tax compliance costs than new form transparent companies.

¹ New Zealand. (1991). *The Taxation of Distributions from Companies: Final Report*. Auckland, at p 14; and Oats, LM. (2000). *The Evolution of Federal Company and Shareholder Taxation in Australia: 1915 -- 1995*, Department of Accounting and Finance, University of Western Australia, at p 38.

² Oats, n 1, at p 38. Bevin, P. (1985). *How Should Business Be Taxed? An examination of defects in business taxation and suggestions for reform*. Wellington: Victoria University Press, at p 102.

To explore why transparent companies may potentially increase tax compliance cost, tax transparency is analysed in terms of eligibility requirements, the extent of aggregation, loss restriction rules and cross-jurisdictional issues. It is argued that eligibility requirements can impose compliance costs to enter a transparency regime and can impose additional costs with respect to ongoing monitoring. Given the experience with new form transparent companies, the necessity for extensive eligibility requirements will be questioned.

Furthermore, it will be argued that tax compliance cost could increase due to the extent of aggregation adopted, particularly regarding membership interest and asset holdings. A more complete aggregate approach for tax purposes may impose undue complexities — particularly if membership interests are disregarded, with members treated as holding direct fractional interests in the business assets. In this context, it will be argued that ‘entity acknowledgement’ for membership interest and associated asset holdings may decrease tax compliance costs and, in this respect, may not necessarily be inconsistent with the overall goals of tax transparency.

7.2 Studies on tax transparency and compliance cost

Tax compliance costs are an important consideration for any jurisdiction that is considering the implementation of a transparent company. In essence, it is a truism that costs detract from the theoretical advantages of improved tax neutrality via tax transparency.³ This issue takes on greater significance if it is acknowledged that tax compliance costs are ultimately regressive for small businesses.⁴

³ Refer to the discussion in Chapter Two outlining the theoretical advantages of tax transparency applying to business forms.

⁴ Evans, C, Ritchie, K, Tran-Nam, B, and Walpole, M. (1997). A Report into Taxpayer Costs of Compliance. Canberra: AGPS. Coleman, C, and Evans, C. (2003). Tax Compliance Issues for Small Business in Australia. Taxing Small Business: Developing Good Tax Policies, Australian

In relation to the transparent companies in the United States, Bratton and McCahery observed (without any data) that the S Corporation form appeared 'more complex' than the limited liability company (LLC).⁵ Indeed, S Corporations were rejected as a model by the New Zealand Valabh Committee because they were considered too complex, with the committee formulating its own transparent company, the Loss Attributing Qualifying Company (LAQC).⁶ Does the available empirical evidence support these assertions and are there any differences between the classifications of transparency identified?

Several tax compliance cost studies have identified transparent companies separately from other business forms, and these are informative in determining their relative complexity. Unfortunately, there is no available data-set in respect of the United Kingdom's limited liability partnership (LLP), which is probably attributable to its recent introduction there.

A 2002 United States' study found that LLCs on average had the highest mean total money burden of income tax compliance cost when compared to S Corporations, C Corporations and general partnerships.⁷ Portions of the data from this survey of 5,875 businesses are replicated in Table 7-0-1. Unfortunately the study does not detail precisely how compliance cost was measured, or whether it included members' compliance issues, although the compliance cost study by Evans et al. appears to be informative.

Tax Research Foundation: Sydney (Conference Series 23):147. Ritchie, K. (2002). *New Zealand Small Business Tax Compliance Costs – Some Empirical Evidence*. Wellington: Inland Revenue.

⁵ Bratton, WW, and McCahery, JA. (1997). An Inquiry into the Efficiency of the Limited Liability Company: Of Theory of the Firm and Regulatory Competition. *Washington and Lee University Law Review* 54:629, at p 634.

⁶ Consultative Committee on the Taxation of Income from Capital. (1991). *Taxation of Distributions from Companies: Final Report*, Auckland. The Committee went on to say that their observation was supported by advice received from 'private sector practitioners in the United States'.

⁷ DeLuca, D, Greenland, A, Guyton, J, Hennessy, S, and Kindlon, A. (2005). *Measuring the Tax Compliance Burden of Small Business*. Paper read at Internal Revenue Services' Research Conference, 7-8 June, at Washington DC.

Table 7-0-1: US: Tax compliance costs

Average income tax compliance burden for 2002.	General Partnership	LLC	S Corporation	C Corporation
All firms	\$1,516	\$2,611	\$2,282	\$2,231
Firms with less than 100 employees.	\$1,469	\$2,711	\$2,259	\$2,139

Source: DeLuca, D, Greenland, A, Guyton, J, Hennessy, S, and Kindlon, A. (2005). *Measuring the Tax Compliance Burden of Small Business*. Paper read at Internal Revenue Services' Research Conference, 7-8 June, at Washington DC, Table 5, at p 83.

Note it is not clear what is the measure of tax compliance cost. It may be the average compliance cost per \$100,000 of turnover.

The average monetary burden for income tax compliance for all LLCs was \$2,611; in comparison with \$1,516 for general partnerships; \$2,231 for C Corporations; and \$2,282 for S Corporations. In terms of firms with less than 100 employees, the distribution was greater, with LLCs recording a level at \$2,711; general partnerships at \$1,469; C Corporations: \$2,139; and S Corporations: \$2,259. This would imply that the tax compliance cost for LLCs are more regressive for smaller firms compared to the other business forms studied.⁸

In all circumstances the income tax compliance cost for the C Corporation was lower than for the transparent companies, with S Corporations imposing less tax compliance cost than LLCs. Such evidence would refute Bratton and McCahery's earlier observations about the relative complexity of S Corporations compared to LLCs.⁹ However, despite this, S Corporations indicated higher tax compliance cost than C Corporations irrespective of the fact that they share a similar

⁸ In this study 'small' is measured by a firm having less than 100 employees.

⁹ Bratton and McCahery, n 5, at p 634.

underlying governance framework. Therefore, the difference between S Corporations and C Corporations is apparently due to the different tax rules applying to corporations under different Sub-Chapters of the *IRC 1986* (US). Also it appears that compliance costs for S Corporations are more regressive for smaller firms than C Corporations.

These findings are supported, in part, by the research of Ingraham and Karlinsky who found in a survey of United States 'small business tax practitioners' that the tax applying to partnerships was ranked as the most complex. It is through these partnership tax rules that the LLCs achieve their tax transparency.¹⁰ In comparison, the tax rules applying to S Corporations were ranked nearly one whole percentage point lower as the 12th most complex issue.¹¹ Unfortunately the study did not have a ranking in terms of C Corporations' own taxation, although there was reference to the alternative minimum tax for corporations.¹² Part of the findings of Ingraham and Karlinsky is reproduced in Table 7-0-2.

¹⁰ In the United States the partnership tax rules are found in *IRC 1986* (US), Sub-Chapter K. Unfortunately, the study did not identify LLCs separately to general partnerships.

¹¹ Ingraham, LR and Karlinsky, S. (2005). Tax Professionals' Perceptions of Small-Business Tax Law Complexity, *Tax Notes*, April 4:79. Practitioners had to rank various tax items in terms of complexity on a scale with 1 (not complex) to 5 (extremely complex). The findings are also reproduced in: McKerchar, M, Ingraham, LR, and Karlinsky, S. (2005). Tax Complexity and Small Business: A Comparison of the Perceptions of Tax Agents in the United States and Australia, *Journal of Australian Taxation* 9:289.

¹² There are two alternative minimum tax systems applying in the United States, one for individuals and the other for corporations.

Table 7-0-2: US: Perceptions of complexity

Complexity ranking	Small business tax item	Average complexity score (scale 1 to 5)
1	Partnerships	3.4167
2	Estate and Gift Tax Valuation	3.1910
3	Tax Deferred Exchanges	3.1058
4	Frequency of Tax Law Changes	3.1023
5	Retirement Plans	2.9772
6	AMT – Individuals	2.9333
7	Accumulated Earnings Tax	2.8539
8	AMT – Corporate	2.7159
9	Inventory	2.7079
10	Passive Activity Losses	2.6897
11	Constructive Ownership	2.5814
12	S Corporation Tax Rules	2.5281

Source: Ingraham, LR and Karlinsky, S. (2005). Tax Professionals' Perceptions of Small-Business Tax Law Complexity, Tax Notes, April 4:79.

While it is impossible to draw definitive conclusions, this data would support the proposition that special tax rule companies may impose less tax compliance cost than new form transparent companies. Of course, even if the data is accurate, the differences may, indeed, be due to factors unique or idiosyncratic to the United States and may not be replicable in other jurisdictions. For example, the greater tax compliance cost for LLCs may be because they are a relatively new business form and their costs may decrease with time as familiarity increases. Also, the compliance cost differential may be due to the increased flexibility available with LLCs, particularly with distributions, which can lead to greater tax planning requiring professional advice, and therefore greater cost.¹³

¹³ For example, losses allocated through an LLC have to satisfy the 'substantial economic effect' rule, whereas S Corporation members with one class of membership interest do not.

The differences between the United States' transparent companies and C Corporations would tend to indicate that the tax transparency does involve greater tax compliance costs than an entity tax system. That is, as the general tenor of the chapter has indicated, disregarding the legal form for tax purposes does increase tax compliance costs.

Figure 7-0-1: US: Income tax compliance costs

Source: DeLuca, D, Greenland, A, Guyton, J, Hennessy, S, and Kindlon, A. (2005). *Measuring the Tax Compliance Burden of Small Business*. Paper read at Internal Revenue Services' Research Conference, 7-8 June, at Washington DC, Table 5, at p 83.

Figure 7-0-1 reinforces the extent of the differences between the business forms in the United States. This data also demonstrates that general partnerships had the lowest overall tax compliance costs (\$1,516) of all business forms, particularly when compared to LLCs (\$2,611).¹⁴ This is interesting as general partnerships and LLCs are both assessed pursuant to the Sub-Chapter K of the *IRC 1986* (US), and therefore this difference of 72 per cent may be attributed to how the LLC's legal characteristics (particularly limited liability) interact with tax

¹⁴ Note sole proprietors were not included in the survey. It is not clear whether this data also includes time spent on the members' tax compliance, as technically it is the members of both S Corporations and LLCs who are assessed on the income or losses of the business.

transparency.¹⁵ Recall the Ingraham and Karlinsky study found that partnership tax was ranked as the most complex issue by small business tax practitioners.

However, the difference in tax compliance cost could be attributed to the fact that LLCs are adopted in more sophisticated and, consequently, more complicated business scenarios compared to general partnerships. Also, the formalities that are required with the formation of LLCs may mean that advisors will inform their clients of the potential tax planning opportunities through such mechanisms as 'special allocations', with complex tax rules then being applicable.¹⁶ In contrast, a general partnership may be formed without any formal documentation, and therefore members may be unaware of, and may not explore, the available tax planning opportunities. Furthermore, members of a general partnership may not be as vigilant with their tax compliance obligations because of the informal nature of this business form.

While the data-set is not sufficient enough to draw comprehensive and universal conclusions on this issue pertaining to business compliance costs, some trends can be tentatively formulated. In particular, in the United States there is some evidence that the application of tax transparency to business forms with separate entity status and limited liability for members is likely to increase tax compliance costs, in comparison to a business form without limited liability. This is a significant factor to be considered when formulating a tax transparent framework. Furthermore, tax transparent companies could increase the regressive nature of tax compliance cost for small businesses.

In New Zealand, Ritchie conducted a small study on compliance costs which included five 'small' and nine 'medium' business taxpayers surveyed over twelve

¹⁵ In comparison, members of a general partnership do not have liability protection. Note in the United States some general partnerships provide for a separate legal entity with the adoption of the *Revised Uniform Partnership Act* in 1994.

¹⁶ Refer to the analysis in Chapter Six. A counter argument is that the improved governance regime tailored to the business by the engagement of a professional at formation is advantageous.

months about their estimated compliance costs. Some of the specific businesses studied utilised LAQCs.¹⁷ While it is acknowledged that the findings of this study cannot be generalised and that the breadth of the survey was limited, the study may be a pertinent indicator concerning how the LAQC regime affects compliance costs.

In terms of the 'small' businesses studied, Table 7-0-3 demonstrates that participant 3, who utilised the LAQC form, had the greatest overall compliance hours (320 hours) compared with the other participants, with participant 5 being the closest (152 hours). However, all other small participants were sole proprietors — that is, a business form with clearly less regulatory burden. The LAQC participant also operated as a tax agent and, due to his profession, may have estimated higher compliance costs, or may been more thorough with his regulatory compliance. One of the other participants (participant 4) was a chartered accountant who operated as a sole proprietor. It is argued that, given the industry similarities of the businesses conducted, participants 3 and 4 are the best comparison in this survey. However, Ritchie does warn to read data for participant 3 (LAQC) with caution, as the time spent on some activities appeared to have been 'overstated'.¹⁸

For the small business operators over the year, the total time on all compliance costs for participant 4 was 44 hours, whereas for participant 3 (the LAQC), the time spent was 320 hours. Accordingly, the LAQC business form claimed

¹⁷ The study also covered two large businesses, but neither of these identified as being LAQCs, so their results are not relevant to this dissertation. Ritchie, n 4.

¹⁸ Ritchie, n 4, at p 21. It should be noted that participant 5, a sole proprietor, had the highest total time of tax compliance costs of 61.45 hours, approximately double that of participant 3. Participant 5's additional tax compliance costs related to time spent on sales (an additional 18.30 hours); purchases (an additional 7.07 hours); bank and cash records (an additional 2.89 hours); paying bills (an additional 2 hours); GST returns (an additional 1.69 hours); income tax (additional 8.66 hours); and other tax issues (additional 8.66 hours). However, participant 5 had lower tax compliance costs in relation to dealing with Inland Revenue (Te Tari Takke) (New Zealand Revenue) and vehicle logbooks. Ritchie does note that participant 5 keep meticulous double entry accounting records of every transaction as it occurred on a daily basis and this 'eye for detail' may be the cause of the increase burden.

approximately seven times greater time spent on all compliance costs than the sole proprietor. Clearly a difference of this magnitude would be of concern, if it were based on broader and more reliable data. It is interesting to note that, in relation to total time on just 'tax' compliance costs, there was little difference. Participant 3 had 33.75 hours, and participant 4 had 31.13 hours.¹⁹ From this, it would appear that the additional compliance costs reported by the LAQC may have stemmed not from taxation issues, but from other regulatory burdens on an LAQC, such as those involved with complying with the New Zealand *Companies Act 1993* (NZ). Such additional burdens of a corporate structure have been repeatedly stated as a disadvantage of this entity form for closely held businesses.²⁰ Unfortunately, the United States study did not isolate tax and non-tax compliance costs, and hence no preliminary comparisons can be made with respect to this issue.

¹⁹ Ritchie observes that participant 3's total time is considerably greater, and that it might be overstated: Ritchie, n 4, at p 36.

²⁰ It appears that a significant proportion of this total compliance cost difference between participants 3 and 4 related to: business management (an additional 149.58 hours by participant 3); bank and cash records (an additional 77.48 hours by participant 3); sales (an additional 24.79 hours by participant 3); contact with Inland Revenue (an additional 11 hours by participant 3); and GST returns (an additional 4.66 hours by participant 3).

Table 7-0-3: NZ: Compliance cost – small business

Participant	Business form	Business description	Turnover	Sum of 4 Quarters	
				Total hours (incl. tax)	Tax hours only
1	Sole Proprietor	Part-time repairing electronics	\$10,000	57.14	17.34
2	Sole Proprietor	Professional Photographer	\$40,000	52.40	16.52
3	LAQC	Tax agent	\$48,000	320.07	33.75
4	Sole Proprietor	Chartered Accountant	\$70,000	44.07	31.13
5	Sole Proprietor	Adviser computer package	\$80,500	152.04	61.45
Total				625.72	160.19
Source: Ritchie, K. (2002). <i>New Zealand Small Business Tax Compliance Costs – Some Empirical Evidence</i> . Wellington: Inland Revenue, at p 37 Table 4.29.					

Table 7-0-4 details the 'medium' business surveyed by Ritchie, with two of the participants utilising LAQCs (participants 11 and 12).²¹ Five of the other participants used the corporate model, and one used a general partnership (participant 9). It is argued that, due to turnover size and industry, the most informative comparison is between the LAQC participants and participant 13, (particularly between 12 and 13, as both are in the same industry category). While the study is limited it yields important insights.

Participants 13 and 11 (LAQC) had similar total compliance hours (998.89 hours and 1021.21 hours, respectively) whereas participant 12 (LAQC) had lower total hours (478.25 hours). However, when isolating tax compliance hours, both LAQCs had higher hours (145.30 and 143.18 hours) compared with participant 13 (100.21 hours). These results tend to indicate that LAQC status does add extra or additional tax compliance costs when compared to the imputation system that applies to New Zealand corporations.²² Figure 7-0-2 illustrates the extent of the differences between the participants operating medium businesses in the Ritchie study.

²¹ Another participant had previously elected for LAQC status, but then subsequently revoked the status and had normal corporation tax treatment for the period of the survey.

²² Participant 6 also had high total tax hours (139 hours) even though it had a lower turnover. This high tax compliance time could be due to the fact that participant 6 was a recent New Zealand subsidiary of Australian corporation with a number of transfer pricing issues that it was trying to determine.

Table 7-0-4: NZ: Compliance costs – medium business

Participant	Business type	Business description	Turnover	Sum of Quarters	4
				Total hours (incl. tax)	Tax hours only
6	Corporation	Australian subsidiary – business services	\$300,000	261.85	139.38
7	Corporation	Apparel industry	\$300,000	239.95	25.01
8	Corporation	Engineer	\$500,000	223.60	54.27
9	General Partnership	Personal services	\$800,000	120.60	10.57
10	Corporation	Engineering	\$863,294	163.42	29.54
11	LAQC	Health Care	\$1,500,000	1021.21	145.30
12	LAQC	Agriculture	\$2,500,000	478.25	143.18
13	Corporation	Agriculture	\$3,000,000	998.89	100.21
Total				3507.77	647.45
Source: Ritchie, K. (2002). <i>New Zealand Small Business Tax Compliance Costs – Some Empirical Evidence</i> . Wellington: Inland Revenue, at p 40 to 59 Tables 4.33, 4.60 and 4.61; and Ritchie, K. (2001). <i>A Year in the Life of the Tax Compliance Costs of Some Small New Zealand Businesses</i> . Paper read at 13th Annual Australasian Tax Teachers Association Conference, February 2001, at Sydney at p 17.					

Figure 7-0-2: NZ: Compliance costs – medium businesses

Source: Ritchie, K. (2002). *New Zealand Small Business Tax Compliance Costs – Some Empirical Evidence*. Wellington: Inland Revenue, at pp 40 to 59 Tables 4.33, 4.60 and 4.61.

While participant 9's turnover is lower than that of the other participants, it utilised a general partnership form and recorded the lowest total compliance and total tax hours. This may reflect that a general partnership structure has lower compliance costs than the alternative corporate model. The observation that corporations entail greater tax compliance costs in New Zealand is supported by a study undertaken by Colmar Brunton. The Colmar Brunton study detailed tax compliance cost by entity type and, significantly, placed corporations highest – as demonstrated in Table 7-0-5. This finding is also consistent with the United States study by DeLuca et al. and the Australian studies cited in Chapter Two. Unfortunately, the Colmar Brunton analysis does not distinguish between corporations electing for LAQC status and those not.²³ It is argued, that this does

²³ Other New Zealand compliance cost studies have highlighted the problems of tax: Massey, C, and Quin, P. (2001). *Final Report to the Ministerial Panel on Business Compliance Cost: Review of Responses from Business*: New Zealand Centre for SME Research: Massey University found that the taxation was the major concern for business compliance costs; unfortunately the study did not precisely identify what these were. Ministerial Panel on Business Compliance Cost. (2001). *Finding the Balance: Maximising Compliance at Minimum Cost*. Wellington: Ministry of Economic Development of New Zealand, at pp 120-121: "The major tenor of business response

not necessarily mean that transparent companies with governance rules based on a general partnership will have a lower tax compliance cost burden when compared to a corporate model. For example, the United States' study found that LLCs have greater tax compliance cost than S Corporations.²⁴

Table 7-0-5: NZ: Tax compliance cost – small and medium

Entity type	GST	Income Tax	PAYE	FBT	Total costs (internal external)
Corporation	\$2,296	\$2,591	\$696	\$100	\$5,677
Individual	\$818	\$1579	\$121	\$3	\$2,521
Partnership	\$1,873	\$2,079	\$459	\$9	\$4,416
Trust	\$1,027	\$1,951	\$197	\$24	\$3,202

Source: Colmar Brunton. (2005). measuring the tax compliance costs of small and medium-sized business - a benchmark survey: Final Report. New Zealand, at p 100, Table 9.6.

Generally, the results of these studies support the view that transparent companies may increase tax compliance costs. The reasoning behind this is as follows: when the legal form is disregarded for tax purposes this increases the tax compliance costs because of the incongruence (or mismatch) between the legal characteristics (ownership) and tax. There are difficulties treating all of the available studies as conclusive, so the matter requires further research and cannot be seen as concluded.

The foregoing analysis, then, raises the obvious question that if transparent companies do increase tax compliance cost why have they been so extensively adopted? The data in Chapter Three demonstrated the popularity of transparent companies in both the United States and New Zealand, and an increasing number of LLPs in the United Kingdom. It is argued that any additional tax compliance cost could be offset or counter-balanced by other advantages —

that the tax legislation is just too complex for the majority of small business to understand and therefore to comply with".

²⁴ DeLuca, Greenland, Guyton, Hennessy and Kindlon, n 7, at p 83.

particularly tax savings.²⁵ In particular, these tax savings could more than offset the additional compliance cost burden of transparent companies, making them a viable business form. Other potential advantages that could offset the additional tax compliance cost could relate to improved governance, tax flexibility, equity financing options and ease of divestment. Nevertheless, it is important to consider the attributes that could contribute to this increased tax compliance cost, and whether it is possible to mitigate them.

7.3 Characteristics of transparency and compliance cost

For the reasons specified below, it is argued that tax transparency may impose additional tax compliance cost due to several legal and institutional factors, including the eligibility requirements for transparency, the extent of aggregation, the loss restriction rules, and the cross-jurisdictional issues. Each of these characteristics is discussed below, in order to identify each one's association with, or imposition of, compliance costs.

7.3.1 Eligibility requirements

For some transparent companies, transparency does not apply automatically as there are eligibility requirements that need ongoing adherence. It is these eligibility requirements that may impose additional complexities when entering the tax transparency regime; as well as ongoing monitoring costs. These eligibility requirements may mean that professional advice is needed to ensure they are met, not only when new members are introduced or major transactions entered into, but also to avoid inadvertent breaches.

²⁵ The overall tax liability of the transparent companies studied is discussed in detail in Chapter Eight.

In Chapter Three it was specified that, new form transparent companies, such as the LLCs²⁶ and LLPs,²⁷ have the most relaxed eligibility requirements. In comparison, the eligibility requirements for special tax rule companies, S Corporations²⁸ and LAQCs,²⁹ are stringent. These stringent eligibility requirements could reflect the United States and New Zealand governments' concern about the wide ability of special tax rule companies. Furthermore, in New Zealand they may act as a quasi-loss restriction rule, given the absence of a comprehensive loss restriction rule in that jurisdiction. However, it should be acknowledged that some eligibility requirements were adopted to remove the need for complex tax integrity rules.

These requirements mean that constant monitoring of member numbers for both S Corporations and LAQCs is required to ensure that the relative membership caps are not exceeded. This monitoring can increase tax compliance costs and could be of particular importance when new equity is sought, or when a member dies or becomes bankrupt and is subject to insolvency administration.³⁰ The importance of monitoring is illustrated by the ease with which the requirements

²⁶ Treasury Regulation, section 301.7701. For federal taxation purposes from 1997, an LLC can simply 'Check-the-Box' for tax transparency provided it is not a state corporation (which by its nature it is not), a publicly traded entity, or certain foreign business forms.

²⁷ In the United Kingdom, tax transparency is mandatory for an LLP if it has two or more members associated for carrying on a lawful business with a view to profit: *LLP Act 2000* (UK), sections 2 and 10; *Income and Corporation Taxes Act 1988* (UK), section 118ZA.

²⁸ *IRC 1986* (US), section 1361. As described in Chapter Three, for S Corporation status to be obtained: a) the corporation itself and its members must be United States residents, b) there must be only one class of membership interest, c) membership must not exceed 100, and d) there must be a valid election for S Corporation status. Additionally, certain trading activities and asset holdings are prohibited.

²⁹ *Income Tax Act 2007* (ITA 2007) (NZ), sections HA 1 to HA 9. There are essentially ten eligibility requirements which need to be satisfied at all times of the year for a corporation to be treated as a Qualifying Company (QC). These requirements relate to residency, the number of members, members' election, members' liability, directors' election, corporate members' status, trustee members' status, not being a unit trust, not losing LAQC status, and not earning excessive foreign income. In addition to the ten eligibility requirements for a QC, for a corporation to become an LAQC, there must be only one class of share, a further member and director election, no avoidance arrangement, and at all times the corporation must be a QC: *ITA 2007* (NZ), sections HA 5 and HA 10.

³⁰ That is, under the member's will the membership interest could be left to a number of persons, which could result in exceeding the membership cap. Also, when members go insolvent, their membership interest passes to a third party's control and resultant dispositions may breach the membership cap.

can be inadvertently breached: one example is the restriction on non-residents for S Corporations, which could be breached if an existing member marries a non-resident in an American state that provides for communal property.³¹ In terms of LAQCs, the limit of five members could be inadvertently breached if a trustee member distributes to a new beneficiary, even though there are only five direct members of the LAQC.³² However, these inadvertent breaches may be adequately dealt with by the presence of provisions in the members' agreement to make such transfers or distributions ineffective, although this is likely to require professional advice for such drafting.³³

However, some of the restrictions cannot be dealt with through drafting. For example, the restriction on the quantum of foreign income means that LAQCs are required to constantly monitor foreign income. Indeed, currency fluctuations could cause the LAQC to breach the restriction of \$10,000 worth of foreign non-dividend income, even though the volume of sales remains constant.³⁴ It needs to be pointed out that the \$10,000 figure has not been changed since the LAQC's introduction in 1992, and therefore at a minimum should be increased. However, the necessity of this restriction is questionable.³⁵

One requirement that has been identified as imposing additional compliance costs is the need for only one class of membership interest for both S

³¹ The relevant states being: Louisiana, Texas, New Mexico, Arizona, California, Washington, Idaho, Nevada, Wisconsin, and (if elected by the spouses) Alaska.

³² *ITA07* (NZ), section HA 7(2). Where a trustee holds shares in a LAQC on trust for beneficiaries, then the number of deemed members at any time in respect of the trustee shareholder is the greater of the number of beneficiaries who: (a) have received dividends from the QC through the trust since the 1991/02 income year; or (b) elected that the corporation become a QC on behalf of the trust. The trustee itself is not counted as a member for the purposes of this test, with the focus on the beneficiaries

³³ A properly drafted corporate constitution could adequately address this by requiring other member consent before the transfer could be finalised.

³⁴ *ITA07* (NZ), section HA 9.

³⁵ Freudenberg, B. (2005). Is the New Zealand Qualifying Company regime achieving its original objectives? *New Zealand Journal of Taxation Law and Policy* 11(2):185, at p 212.

Corporations and LAQCs.³⁶ The reason this can increase compliance costs is that ascertaining whether there is one class of membership interest requires all of the governing provisions of the S Corporation and LAQCs to be carefully considered. For example, this could involve reviewing the corporate charter, articles of incorporation, bylaws/constitution, applicable state law,³⁷ members' agreements and binding agreements relating to distribution and liquidation proceeds.³⁸ Also, it is important to consider whether 'debt' could be regarded as a second class of membership interest.³⁹

However, it is argued somewhat paradoxically, that the requirement for one class of membership interest may in some ways ease tax compliance costs. This is because, on a purely mathematical basis, allocations of income and/or losses to members are made on a per day basis for each membership interest held. Another reason is that one class restricts the potential for preferential streaming of income and/or losses and thus removes the need for certain tax integrity measures. As discussed in Chapter Six, in the United States S Corporation members do not have to address complex rules requiring that allocations have 'substantial economic effect', whereas LLC members do.⁴⁰ These rules are described as 'among the most complex' in all of the United States tax law,⁴¹ and are accompanied by 'voluminous' regulations.⁴² While the ability to make 'special allocations' has been stated as one of the most important tax benefits of an

³⁶ Note from 1982 that S Corporations restrictions on the transfer rights do not create a second class of membership interest: Revenue Ruling 85-161, 1985-2 C.B. 191.

³⁷ Not relevant for New Zealand.

³⁸ Treasury Regulation, section 1.1361—1(1)(2).

³⁹ Due to difficulties in distinguishing between debt and equity investments, there are safe harbour rules in the United States providing for 'straight' debt: *IRC 1986* (US), section 1361 (c)(5). In order to be within the safe harbour provisions, the debt must meet the following criteria: (1) there must be a written unconditional promise to pay on demand, or on a specified date, a sum certain in money; (2) the interest rate and payment dates must not be contingent on profits, the borrower's discretion or similar factors; (3) the debt must not be convertible into membership interest; and (4) the creditor must be an individual (other than a non-resident alien), an estate, or a trust that is otherwise permitted to hold shares of an S corporation.

⁴⁰ *IRC 1986* (US), section 704.

⁴¹ Stark, K, and Zolt, EM. (2000). United States Partnership Taxation: Current Structure and Proposals for Reform. *Bulletin* July:326, at p 332.

⁴² Treasury Regulation, section 1.704-1(b)(2)(i).

LLC,⁴³ it appears that doing so entails increased tax compliance costs in order to satisfy the integrity rules.⁴⁴ It may be that these ongoing implications could have contributed to the results that were outlined in the DeLuca et al. tax compliance study.

Furthermore, it appears that the one class of membership interest means that integrity measures for 'revenue assets'⁴⁵ do not apply to S Corporations.⁴⁶ Thus, the requirement for one class of membership interest may increase tax compliance costs, but this has the corresponding advantage that the complex tax integrity measures do not apply. It is arguable that, when considered holistically, one class of membership interest may be advantageous, although this may restrain the ability to attract additional equity members. This later consequence is considered in the analysis in Chapter Eight, which considers the financing implications of the transparent companies studied.

Another more subtle and less discernible benefit pertaining to the eligibility requirements for special tax rule companies is that it may mean that a professionally drafted members' agreement is required to ensure that only one class of membership interest is maintained.⁴⁷ This members' agreement may encourage more detailed and comprehensive professional advice at the formation stage, with more tailored terms for the business activities. These tailored terms could have ongoing advantages by providing an enhanced governance regime. However, these findings are only tentative and are provided to implicate avenues for further academic investigation. Further empirical evidence is thus required to support these speculative conclusions.

⁴³ Friedman, HM. (2004). The Silent LLC Revolution - The Social Cost of Academic Neglect. *Creighton Law Review* 38(1), at p 23.

⁴⁴ There is also concern about how, through anti-abuse regulations, the Internal Revenue Services (US) (the United States IRS) has asserted broad authority to re-characterise transactions in order to limit the use of the Sub-Chapter K for tax avoidance purposes. Treasury Regulation, section 1.701-2. Stark and Zolt, n 41, at pp 327-328.

⁴⁵ A revenue asset is one held on a revenue account of the enterprise: for example trading stock or inventory.

⁴⁶ This revenue asset rule is explained in greater detail latter in the chapter.

⁴⁷ This was previously discussed to ensure that adverse transfers or admissions did not occur.

However, the question needs to be raised as to whether all these eligibility restrictions are required? The S Corporation's eligibility requirements have been relaxed since their introduction in 1958. In particular, requirements addressing the number of members and the treatment of family members have been altered.⁴⁸ The basis for the relaxation of the eligibility requirements was stated to be for improved simplification and tax neutrality.⁴⁹ Other factors that could have influenced the relaxation of eligibility requirements include the introduction of LLCs; reforms to limited partnerships; and the temporary tax relief provided to capital gains and C Corporation dividends.⁵⁰ However, it should be pointed out that the residual eligibility requirements are still criticised as 'burdensome'.⁵¹ In contrast to this position, the LAQCs requirements have not been substantially relaxed since their introduction in 1992. This is in spite of the fact that the Valabh Committee had envisaged that this would occur.⁵²

It will be argued in Chapter Eight that the experience with new form transparent companies demonstrates that the eligibility for transparency can and should be relaxed provided there are adequate loss restriction rules. To proceed otherwise could impose additional tax compliance cost in terms of monitoring or of unjustly excluding certain investors or activities from transparent treatment.

⁴⁸ From 1 January 2005 all members of a family can be treated as one member: *IRC 1986* (US), section 1361(c)(1)(B). A family is defined to include members with a common ancestor, lineal descendants and spouse (including former spouse) at the time of the election six or less generations from the youngest generation of members part of the family, part from the operation of the section. This includes an adopted child: *IRC 1986* (US), section 152(b)(2).

⁴⁹ Eustice, JS. (1983-1984). Subchapter S Corporations and Partnerships: A search for the pass through paradigm (some preliminary proposals). *Tax Law Review* 39:345, at p 346.

⁵⁰ It appears that the 2004 reforms were in part to offer more incentives to S Corporations because of the reduced tax advantage offered by S Corporations compared to C Corporations given the temporary tax relief for the taxation of dividends: Landau, Z. (2005). Recent Reform and Simplifications for S Corporations. *The CPA Journal* [cited 6 January 2008]. Available from <http://www.nysscpa.org/cpajournal/2005/1105/essentials/p46.htm>; referring to Speakers at the congressional session.

⁵¹ Henning, JJ. (2004). Partnership law review: the joint consultation papers and the Limited Liability Partnership Act in brief historical and comparative perspective. *The Company Lawyer* 25 (6):163, at p 14.

⁵² Consultative Committee on the Taxation of Income from Capital, n 6, at p 8. In New Zealand the Valabh Committee originally identified that once the regime has been in operation for some time, it may be 'desirable' to consider liberalising the qualifying criterion.

The analysis will now focus on the second factor that potentially contributes to tax compliance costs: the 'extent of aggregation'.

7.3.2 Extent of aggregation

While an entity tax system applying to corporations may be seen as 'theoretically inferior', a practical advantage is that it can be simpler than tax transparency or an integrated approach. For example, an entity system does not require yearly allocations to members, multiple capital gains calculations, or the recording of tax paid at the entity level and the allocation of this to members. However, the simplicity of an entity system may be to the potential detriment of tax neutrality and equity.

In response to concerns about the application of the entity tax system to C Corporations, proposals in the United States illustrate the tension between the theoretical ideal and complexity. Acknowledgement of this tension resulted in legislation that sought to facilitate a 'compromise' between simplicity, on the one hand, and tax neutrality on the other.⁵³ The original proposals envisaged tracing through the tax paid at the corporate level to members, with members receiving an increase in their membership interest cost basis for any taxed profits retained within a C Corporation. Such an increased membership cost basis would mean, on future disposals, members would have a lower capital gain. This mechanism was intended to decrease the extent of economic double taxation that the entity tax system applying to C Corporations may impose. While there was theoretical

⁵³ The original reforms were announced on 28 January 2003 by George W. Bush in his State of Union Address, where he announced (amongst other things) to improve tax neutrality: (a) end most taxes on dividends, and (b) provide tax relief to individuals for already taxed earnings retained at the corporate level. These proposals did not relate to members of real estate investment trusts, money market funds nor preferred membership interest.

merit to these proposals, they were criticised as ‘highly complex’.⁵⁴ Instead, a simpler 15 per cent rate was introduced for qualifying dividends and realised capital gains. This concessional treatment decreased the extent of double taxation, although it lacked the precision of the original proposal. It is argued that it is important to acknowledge the tension that is always extant in tax regimes between economic ideals, practical application, and the cost that can result from the application of a theoretical model.

As an example of this tension, tax transparency in its purest form involves the full aggregation of income, losses and asset holdings to members. This calculation is achieved for tax purposes with complete disregard to the business form. In terms of the transparent companies studied, even though transparency applies, in certain circumstances the legal status of the business form is recognised for tax purposes (referred to as entity acknowledgment). An excellent example of ‘entity acknowledgement’ is the requirement for the business form to lodge information returns with the relevant tax office detailing the year’s activities and member allocations; and the obligation of the business to inform the members of their allocation.⁵⁵ Other examples of entity acknowledgement can relate to the tax elections about depreciation and accounting methods to be used by the business.⁵⁶

It would appear that entity acknowledgement may be preferable in times when governments wish to decrease tax compliance costs and improve certainty. It should also be pointed out that entity acknowledgement is not necessarily inconsistent with the overall aims of tax transparency and may be a beneficial

⁵⁴ Boyd, JH, Crumbley, DL, Davis, JS, Dilley, SC, Hoffman Jnr, WH, Maloney, DM, McGill, GA, Persellin, MB, Raabe, WA, Randall, BC, Sanders, DL, Seago, WE, Smith, JE, and Willis, E. (2005). *Corporations, Partnerships, Estates and Trusts*. Edited by W. Hoffman Jnr, W. Raabe, J. Smith and D. Maloney. 2005 ed. Mason: Thomson South-Western, at p 4-11.

⁵⁵ However, the LAQC has to inform only of allocated losses, and not of allocated income, as members are assessed only on income distributions via dividends. Refer to Chapter Three description of the tax methodology applying to LAQCs.

⁵⁶ For example, entity acknowledgement is adopted for LLCs in respect of accounting methods and depreciation methods, which are made by the LLC and not by the members: *IRC 1986* (US), section 703(b).

compromise. This conclusion is supported by statements accompanying the introduction of the new limited partnership regime in New Zealand,⁵⁷ and by jurisdictions adopting an ‘integrated approach’ rather than an aggregated approach.⁵⁸

The extent of entity acknowledgment among the transparent companies studied varies. The special tax rule companies, S Corporations⁵⁹ and LAQCs have greater entity acknowledgement, whereas the United Kingdom’s LLPs have more of a complete aggregate approach. The United States’ LLC lies between the special tax rule companies and the LLP.

The complexities in pursuing the economic ideal of tax transparency with full aggregation can involve the monitoring of membership cost basis and the treatment of capital and/or revenue assets. Each of these will now be discussed considering the transparent companies studied and how full aggregation could influence tax compliance costs. This analysis will also reflect upon the potential tax impost between the alternatives.

7.3.2.1 Monitoring membership cost basis

Recognising the membership interest of a transparent company and measuring its cost basis (membership cost basis) for tax purposes illustrates the operation of entity acknowledgement. In contrast, if a full aggregate approach were used, there would be no need to consider the membership interest separately for tax purposes, as members are the ‘tax’ owners of the business assets. In the United

⁵⁷ Cullen, M (Minister of Finance), and Dunne, P (Minister of Revenue). (2006). General and limited partnerships — proposed tax changes: A government discussion document. Wellington, at p 44: Identifying that an entity acknowledgement should clarify and reduce complexity of tax rules applying to general partnerships with the entry and exit of members.

⁵⁸ For example, an imputation system for corporate distribution to members.

⁵⁹ For example, when an S Corporation has prior C Corporation trading activities, then the S Corporation itself can be liable for tax. In these circumstances there may be tax on built-in capital or income gains and prior passive income: *IRC 1986* (US), section 1374(a), (c).

States there is recognition of the membership interest as a separate tax asset itself. Indeed, for the United States' transparent companies studied the membership cost basis is central to members' tax treatment.⁶⁰ The membership cost basis influences the amount of losses that can be utilised, as well as the tax treatment of distributions to members and the disposal of their membership interest.⁶¹ This recognition can both increase and reduce complexity, depending upon the circumstances, which will be explored below.

An initial complexity is with measuring this membership cost basis. For example, the cost basis is not reflected anywhere on the information schedules provided to members each year by either S Corporations or LLCs. Instead, each member is required to maintain their own personal record of adjustments to their membership cost basis.⁶² While the annual information schedule provided to members does reconcile a member's capital account, this is rarely the same amount as the membership cost basis.⁶³ It is argued that simplification could be achieved if there was alignment of these amounts.

For Trade LLPs in the United Kingdom, even though the membership interest does not exist as a separate tax asset,⁶⁴ the application of the notion of 'contributed capital' for the loss restriction rules effectively mean that a membership cost basis has to be established and monitored. Furthermore, it is possible for an LLP to fail to be eligible for transparency; if this happens, the membership interest will then be recognised as a separate tax asset which will

⁶⁰ Known in the United States as the 'outside cost basis'.

⁶¹ Refer to the discussion in Chapter Five on how the membership cost basis influences the utilisation of allocated losses by members of S Corporations and LLCs.

⁶² Adjustments would occur when there is capital contribution by the member (either cash, property or future services); an allocation of the transparent company's income or loss; or distribution of cash or property from the transparent company.

⁶³ Stark and Zolt, n 41, at p 330. For example, "a member's initial capital account is the sum of the amount of any money contributed to the LLC by the member plus the fair market value, not the cost basis, of any property contributed".

⁶⁴ This is even though the LLP Act envisages that a member of an LLP has a 'share', and 'interests', in the LLP: see for example *LLP Act 2000* (UK), section 7(a)(d).

involve a historical reconstruction.⁶⁵ It is argued that the United Kingdom model of transparency may have been better served if the existence of the membership interest had been recognised for tax purposes.

New Zealand has entity acknowledgment and this recognises the membership interest in an LAQC as a separate tax asset. This recognition of the membership interest as a separate tax asset provides a clear delineation between the LAQC member and the LAQC owning the assets. However, due to the absence of a capital gains tax (CGT) in New Zealand and a loss restriction rule based on membership cost basis, there is no compelling requirement to monitor LAQC's membership cost basis, thereby decreasing compliance cost.⁶⁶

7.3.2.2 Asset holdings

A related issue to membership interests is the tax treatment of assets held by the transparent company, with this influencing member contributions and/or distributions, as well as disposals of assets by the transparent company to third parties. With 'entity acknowledgement' there would be a tax disposal on transfers (whether contributions or distributions) between members and the transparent company. In contrast, if a full aggregate approach were utilised, then transfers between members and the transparent company would not result in a complete

⁶⁵ Due to this potential recognition it is prudent for LLP members to monitor their membership cost basis as a separate tax asset because if the LLP does go into liquidation, or otherwise ceases to be eligible for tax transparent treatment, then each membership cost base will need to be determined. This cost base will be determined by historical capital contributions made as if the LLP had never been tax transparent, rather than the market value of the membership interest at the time when transparency ceases: CG28008 – Limited Liability Partnerships: Liquidation. This would require detailed records to be maintained throughout the existence of the LLP, or it would require those records to be constructed later. Also, at cessation of tax transparency, previous chargeable gains rolled over as a result of the acquisition of a fractional interest in an LLP asset would crystallise for the member: *Taxation of Chargeable Gains Act 1992* (UK), section 156A.

⁶⁶ However, as demonstrated in Chapter Six New Zealand's failure to have a loss restriction rule formulated on a membership cost basis may be compromising its tax revenue. For the jurisdictions studied, New Zealand is unique in this regard, and it is argued that a jurisdiction with CGT would require either the monitoring of the membership cost basis, or their fractional interest in the transparent company's assets.

disposal, as there would be some, but not complete, retention of a fractional interest in the asset by the transferring member.

It is argued that entity acknowledgement for asset holdings impose less tax compliance cost because there is greater consistency between their legal treatment and their associated tax treatment. However, such a framework could create greater tax imposts on the transfer of assets. Contrast this situation to an aggregate approach where asset holdings may result in greater complexity with less, although not necessarily no, tax impost.

It is important to appreciate, then, that the presence or the absence of entity acknowledgement may influence the level of tax imposed on transfers of assets between members and the transparent company. If the tax implications of member contributions are too high then this may inhibit those contributions and impede investment — thereby stifling organisational growth. This is a pertinent consideration if equity is regarded as an important source of finance.⁶⁷ Thus, it may be preferable for the tax burden on contributions for membership interest to be deferred until disposal, thus increasing the available pool of financial resources.

The following analysis seeks to substantiate these claims.

7.3.2.3 Asset transfers between members and transparent company

In the United States entity acknowledgment for S Corporations, compared to that for a LLC member, can result in greater tax burden for S Corporation members contributing appreciated property and/or future services for membership

⁶⁷ Refer to the discussion in Chapter Two that highlighted that members of closely held businesses are an important source of financing (equity and debt).

interest.⁶⁸ For a member contributing appreciated property to an S Corporation, there is a disposal of the property by the member for tax purposes, with a resulting CGT liability for that member.⁶⁹ However, this tax liability can be deferred in restricted circumstances, if the member and other contemporaneous contributors have 'control' of the S Corporation.⁷⁰

In comparison, the contribution of appreciated property to an LLC by a member does not result in a disposal for tax purposes, irrespective of control issues, as the LLC inherits the cost basis of the property.⁷¹ This is somewhat a similar outcome to when the 'control' deferral mechanism available for an S Corporation member.

⁶⁸ The contribution of cash should have similar results between transparent companies. The contribution of 'future services' for a membership interest will have different treatments between the two United State transparent company forms. This is because entity acknowledgement is taken with S Corporations, whereas an aggregate approach is taken for LLCs. An S Corporation member will be assessable for the receipt of property (the property being the membership interest in the S Corporation), as consideration for services: *IRC 1986* (US), section 83. Unlike the CGT on contributed appreciated property by a member, an S Corporation member may not defer this tax liability, as service is not 'property': *IRC 1986* (US), section 351(a). On 20 May 2005 the United States IRS proposed new regulations that would treat the receipt of an LLC membership interest for services as a taxable event regardless of whether the member had received a current interest in the LLC capital. The proposed regulations, however, allow the LLC to elect to treat the fair market value of the interest as being the value of the member's interest in the LLC capital. Thus, if the service member has not received a current membership interest in the LLC capital and the election is made, the member will not recognise income.

⁶⁹ *IRC 1986* (US), section 1363(d).

⁷⁰ *IRC 1986* (US), section 351(a). 'Control' exists if the transferring members own 80 per cent or more of the membership interest in the S Corporation: *IRC 1986* (US), section 368(c). With this deferral, the membership cost basis will be reduced to the contributed property's cost basis and the S Corporation inherits the lower cost basis in respect of the property: *IRC 1986* (US), section 358A(1). This deferral does not apply to future contributions of property or contributions of services.

⁷¹ *IRC 1986* (US), sections 723 and 721. Though this does not extend to transactions between the member and the LLC, when the member is not acting in the capacity of a member: *IRC 1986* (US), section 707(a). Stark and Zolt, n 41, at p 330. However, the non-recognition provisions of section 721 do not apply either: (a) where appreciated membership interests are contributed to an investment LLC [defined as one with more than 80 per cent of assets marketable securities, interest in mutual funds and real estate: *IRC 1986* (US), section 721(b)]; (b) or the transaction is essentially a taxable exchange of properties; or (c) the transaction is a disguised sale of properties [that is, within a two-year period of LLC transfer, the LLC transfers money or consideration back to the member: *IRC 1986* (US), section 707]; (d) or the membership interest is received in exchange for services rendered to the LLC by the member. A similar result occurs when a non-resident member contributes appreciated property to an LLC, unless it is United States real property: Treasury Regulation, section 1.897-1(c).

In this way, the contributing LLC member's CGT is 'deferred' until the property is sold by the LLC.⁷² However, there may be additional complexities in relation to the LLC treatment, because the identity of the contributing member needs to be maintained as the pre-contribution gain will be required later to be assessed to them.⁷³ Also, there are potential adverse consequences if the contributed LLC asset is distributed to another member.⁷⁴

The LLC treatment requires two calculations to be undertaken: the measure of the capital gain at contribution and the measure of the capital gain since contribution. It is argued that the deferral mechanism adopted for the S Corporation is preferable as it results in a decrease of the cost basis of membership interest and the property at the time of contribution.⁷⁵

In terms of when an S Corporation distributes appreciated property to a member, then the entity acknowledgment means that the S Corporation must recognise a gain as though it sold the property at its fair market value.⁷⁶ This calculated gain is then allocated to all S Corporation members. In addition to the allocated gain, the S Corporation member receiving the appreciated property will have tax consequences for the receipt of a distribution.⁷⁷ It should be noted that (in

⁷² *IRC 1986* (US), section 704(c).

⁷³ There will be a mandatory allocation of pre-contribution gain or loss to the original contributing member: *IRC 1986* (US), section 704(c).

⁷⁴ Note there is an exception if contributed appreciated property is distributed to another member within seven years of contribution: *IRC 1986* (US), section 704(c)(1)(B); or if the LLC distributes any property to the original contributor of appreciated property within seven years: *IRC 1986* (US), section 737.

⁷⁵ There are slightly different consequences for S Corporations and LLCs if the contributed property is encumbered with a liability. If the contributed property is encumbered with a liability (encumbered property), and the S Corporation assumes this liability, a realised gain is recognised by the member to the extent that the assumed liability exceeds the tax basis of the contributed property: *IRC 1986* (US), section 357(c). For a member of a LLC contributing encumbered property, the member is considered relieved of the liability which constitutes a deemed cash distribution from the LLC to the member. Due to the limited liability afforded to LLC members, this debt is likely to be considered relieved.

⁷⁶ *IRC 1986* (US), section 1363(d). Such a gain would be allocated and assessable to all members in proportion of their membership interests: *IRC 1986* (US), sections 311 and 1366. Such an allocation would increase the member's membership cost basis.

⁷⁷ For the S Corporation member receiving the distributed property, this would decrease their membership cost basis, and if their membership cost basis was exhausted, the excess would

contrast) more of an aggregate approach applies when a LLC distributes property to a member, as neither the LLC nor the member recognises a gain or loss at that time.⁷⁸ Instead, the member receiving the property inherits the LLC's 'inside cost basis' for the property and the membership cost basis is reduced.⁷⁹ There is no gain recognised by the LLC member, regardless of whether the value of the distributed property exceeds their membership cost basis,⁸⁰ as any gain by the LLC member is not assessed until the property received is later disposed of.⁸¹ This means that the entity acknowledgement for the S Corporation results in greater tax cost for distributions of property to members. However, it is argued that the imposition of tax on S Corporations arises at the more appropriate point of time where the asset ceases being used for the business.⁸²

The United Kingdom's LLP has a more complete aggregate approach for asset holdings, with each LLP member treated as having direct fractional interests in the LLP's assets.⁸³ However, the strict legal treatment of capital gains for LLPs generally is unclear, because there is no legislative codification of practice. Rather, the processes are governed by a Statement of Practice by the HM Revenue and Customs (United Kingdom Revenue).⁸⁴ The treatment of members

likely to be a capital gain. If an S Corporation repurchased a membership interest in exchange for appreciated property, then the member could also be taxed on the gain realised on the sale of his or her membership interest: *IRC 1986* (US), section 302.

⁷⁸ *IRC 1986* (US), section 731(b) and (c).

⁷⁹ *IRC 1986* (US), sections 732(a)(1), 733(2), 7701(a). It should be recalled that the inside cost basis is the LLC's cost basis in the property. The inherited inside cost basis cannot exceed the amount of the membership cost basis of the membership interest immediately before the distribution: *IRC 1986* (US), section 732(a)(2).

⁸⁰ *IRC 1986* (US), section 731(a)(1).

⁸¹ *IRC 1986* (US), section 732(b).

⁸² The treatment of distributions of assets by the LLC is similar to the General Utilities Doctrine that applied to corporations and their members prior to the 1986 tax reforms in the United States. In contrast, full aggregation is adopted if an S Corporation distributes depreciated property (defined to mean that it has decreased in value since being held by the entity) with no loss being recognised by the S Corporation, giving a similar result the LLC scenario. This appears to be an integrity measure to decrease the ability to create losses between the S Corporation and its members.

⁸³ *Taxation of Chargeable Gains Act 1992* (UK), section 59A and Inland Revenue (UK). (1975). *Statement of Practice D12* (revised October 2002). [cited 20 September 2006]. Available from <http://www.hmrc.gov.uk>.

⁸⁴ Inland Revenue (UK). (1975). *Statement of Practice D12* (revised October 2002). [cited 20 September 2006]. Available from <http://www.hmrc.gov.uk>.

having direct fractional interests is similar to members of a general partnership in Australia.

This complete aggregate approach means that the admission of a new member to an LLP⁸⁵ who contributes an appreciated asset generates a disposal by the new member of some of his or her fractional interests in the contributed asset to the other LLP members.⁸⁶ The contributing member could have tax consequences for this fractional disposal if the contribution is undertaken in connection with a payment, or with prior revaluation of existing assets or if the contribution is not at arm's length.⁸⁷

Also, it should be noted that existing members would be disposing of some of their fractional interests in existing LLP assets to the incoming member. The precise calculation of this chargeable gain would depend on each individual LLP members' share of proceeds,⁸⁸ and the cost basis of their fractional interests

⁸⁵ *Income Tax (Trading and Other Income) Act 2005* (UK), section 852(2)(a): On the introduction of a member, the member is deemed to have his or her own trade commencing on their introduction.

⁸⁶ Inland Revenue (UK). (1975). *Statement of Practice D12* (revised October 2002). [cited 20 September 2006]. Available from <http://www.hmrc.gov.uk>. Walton, K, and Flint, A. (2005). *Tolley's Capital Gains Tax*. London: LexisNexis Butterworths, at p 585. Where fractional share in a LLP asset is built up in stages (that is, acquired at different times), such acquisitions are pooled for CGT purposes. For fungible assets (such as goodwill generated by the LLP, membership interest in corporations and securities) pooling does not apply to fungible assets acquired after 5 April 1998: CG27640 – Partnerships: The 1998 Changes: Fungible assets. CG27643 – Partnerships: The 1998 Changes: Fungible assets: Separate assets.

⁸⁷ In certain circumstances, the United Kingdom Revenue allows for members to defer their tax consequences for changes in their fractional shares by allowing the sale proceeds to equal the relevant fraction of the current balance sheet value: CG27185 – Partnerships: Statement of Practice D12: Consideration: balance sheet value. CG27187 – Partnerships: Statement of Practice D12: BSV consideration: assets not revalued. When deferral applies, members carry forward either a smaller or a greater fractional interest in the underlying LLP asset: Walton, K, and Flint, A. (2005). *Tolley's Capital Gains Tax*. London: LexisNexis Butterworths, at p 581.

⁸⁸ If any actual consideration passes between the members, such payments are treated as consideration additional to any consideration based on the current Balance Sheet value: CG27186 – Partnerships: Statement of Practice D12: Consideration: actual. *Taxation of Chargeable Gains Act 1992* (UK), section 17(1)(b).

disposed of.⁸⁹ It is argued that such tax consequences could inhibit the introduction of new members.⁹⁰

In the reverse scenario, when the LLP distributes an asset to a member, then the receiving member will not be regarded as disposing of its fractional share in the asset,⁹¹ with the non-receiving members being treated as having disposed of their fractional interests in the asset. The asset is treated as having been disposed of at its current market value, with the gain being allocated to the members not receiving the asset.⁹² The member receiving the asset is not assessed on the allocated gain, although the CGT cost of the asset, reduced by the member's allocated gain, is carried forward at the market value of the asset at the date of distribution. Similar principles would apply when a depreciated asset disposal results in a loss being allocated to members.⁹³

⁸⁹ CG27121 – Partnerships: Statement of Practice D12: Actual Consideration. This will mean for the incoming member that their acquisition cost will need to be determined. In calculating the acquisition cost or the disposal proceeds, you look at: (a) the value placed on the asset(s) in the partnership Balance Sheet at the date(s) of acquisition or disposal; (b) or, if actual consideration was given, the amount in money or money's worth given for the disposal or acquisition. *Taxation of Chargeable Gains Act 1992* (UK), section 38 (1)(a); and CG27184 – Partnerships: Statement of Practice D12: Calculating the cost or proceeds. The tax consequences would be mitigated through accessing CGT taper relief by the members. Also it is possible that the incoming member could roll over their chargeable gain. *Taxation of Chargeable Gains Act 1992* (UK), section 162.

⁹⁰ Also, the United Kingdom's aggregate approach may inhibit a LLP from issuing interests to employees. If there is a payment by the employee for the issue or a prior revaluation, then this causes existing members to have immediate tax consequences for the issue: CG27214 – Partnerships: Statement of Practice D12: New partners: negligible value claims. *Taxation of Chargeable Gains Act 1992* (UK), section 24(2); CG27240 – Partnerships: Statement of Practice D12: Revaluing Assets. In comparison, United Kingdom corporations may issue membership interest to directors and employees with the concessional tax treatment.

⁹¹ Inland Revenue (UK). (1975). *Statement of Practice D12* (revised October 2002). [cited 20 September 2006]. Available from <http://www.hmrc.gov.uk>.

⁹² *Taxation of Chargeable Gains Act 1992* (UK), section 59A and Inland Revenue (UK). (1975). *Statement of Practice D12* (revised October 2002), at paragraph 2 [cited 20 September 2006]. Available from <http://www.hmrc.gov.uk>. The gain is then allocated in the ratio of the members' fractional share in the asset surplus at the time of disposal. If this disposal results in a chargeable gain to the member, the member might qualify for CGT taper relief: *Taxation of Chargeable Gains Act 1992* (UK), section 2A and Schedule A1 from 6 April 1998.

⁹³ Inland Revenue (UK). (1975). *Statement of Practice D12* (revised October 2002). [cited 20 September 2006]. Available from <http://www.hmrc.gov.uk>. In calculating the gains or losses the proceeds of disposal will be allocated between the members in the ratio of their proportion in asset surpluses at the time of disposal. Where this is not specifically laid down the allocation will follow the actual destination of the surplus as shown in the LLP accounts; regard will also be paid to any agreement outside the accounts.

The approach applying to the United Kingdom's LLP demonstrates that an aggregate approach can result in tax being imposed on the transfer of assets between the transparent company and members. The complexity which inheres in this tax treatment of asset holdings manifests in the fact that every member has fractional interests in each of the LLP assets, with possibly different acquisition dates and cost basis. This compliance maze is compounded when disposals of fractional interests occur through changes in membership, or changes in the profit and asset sharing ratios.

Furthermore, this complexity can increase with greater asset holdings and/or membership. While the United Kingdom Revenue submits that its Practice Statement saves on valuation costs and makes for simpler computation,⁹⁴ it is argued that this conclusion is questionable, especially when there are large numbers of members and/or capital assets. To reduce this complexity, LLP businesses implement a number of mechanisms, such as holding capital assets separately in non-partnership entities.⁹⁵ It is argued that such techniques are cumbersome, and in themselves impose additional costs and unnecessary complexity.

The lack of empirical data from the United Kingdom on tax compliance cost is unfortunate as it could provide a substantive basis for the argument that a complete aggregate approach may increase tax compliance cost unnecessarily. However, a recent study by KPMG in the United Kingdom noted that the administrative burden of compiling information for a general partnership tax return was three per cent (which the LLP would use), which was ranked slightly

⁹⁴ CG27217 – Partnerships: Statement of Practice D12: Part-disposals.

⁹⁵ It is understood that large professional firms do not hold many CGT assets directly apart from goodwill. Instead other CGT assets held in a separate entity. It is understood in relation to goodwill, professional firms argue that members do not own a stake in this goodwill with it remaining with the firm on members exiting the firm. Such an argument means that there is no 'fractional' disposal of goodwill on the entry and exit of members from large professional firms. That is, members do not pay for goodwill on entry to the large professional firms, nor did they get anything when they exit.

higher than a corporate tax return (two per cent).⁹⁶ When this was broken down to firm size, the administrative burden between general partnerships and corporations was similar except for the large category, which saw that general partnership burdens were substantially greater than those of corporations.⁹⁷ This may support the claim that the LLP's aggregate treatment for asset holdings increases complexity, especially as organisational size increases. However, with the absence of any stronger data, no precise conclusions can be made.

The LAQC has the greatest entity acknowledgement of the transparent companies studied. This is likely to be attributed to the fact that it is not a fully transparent company, with only automatic allocation of losses.⁹⁸ The contribution of property by a member would result in a disposal of the asset to the LAQC, although because New Zealand has no CGT the member would not be liable for tax on the contribution. Similarly, the distribution of a capital asset to a member would be a disposal by the LAQC, again with no tax imposed. For the receiving member the distribution would be treated as such and, to the extent that there are available franking credits in the LAQC, it would be taxable. To the extent that the distribution was unfranked it would be an exempt distribution.⁹⁹

7.3.2.4 Disposal of asset to third parties by transparent company

The extent of entity acknowledgment can also influence the tax impost and compliance cost for disposals of assets by the transparent company to third parties. When an asset is transferred by a transparent company to a third party, entity acknowledgement would result in the capital gain being calculated at the transparent company level, and then allocated among members. In the

⁹⁶ KPMG LLP. (2006). *Administrative Burdens: HMRC Measurement Project*. London, at p 30.

⁹⁷ KPMG LLP. (2006). *Administrative Burdens: HMRC Measurement Project*. London, at p 33.

⁹⁸ It should be recalled that the LAQC is regarded as a partial loss transparent company.

⁹⁹ Refer to Chapter Three for a complete explanation of the distribution rules applying to LAQCs and their members.

Australian context, this is similar to what occurs for the disposal of CGT assets by trustees.¹⁰⁰

Applying an aggregate approach to disposals by the transparent company to a third party would have the consequence that each member respectively disposed of their fractional interests in the underlying asset. Hence, there would be no capital gain calculation at the transparent company level, with each member having their own discrete capital gain calculation.

Entity acknowledgment is adopted for both S Corporations and LLCs when an appreciated asset is sold by the transparent company to a third party. The transparent company is treated as an entity in respect of the assets held and has its own cost basis for the relevant assets.¹⁰¹ This means the capital gains calculation is determined at the transparent company level and is then allocated to the members.

In terms of an LLP, on the disposal of a capital asset, the capital gain is not included in the LLP's annual taxable income; instead each member calculates their own capital gain depending on their fractional interest in the underlying LLP asset. This can result in a number of different calculations depending upon when the member entered the LLP and/or the asset was acquired.

In further terms of an LAQC, the disposal of the asset by the LAQC to a third party is treated for tax purposes as a disposal by the LAQC, but is not likely to be subject to tax due to the absence of a comprehensive CGT in New Zealand.¹⁰² Due to the LAQC being a partial loss transparent company, there would be no

¹⁰⁰ *ITAA 1936* (Cth), section 95.

¹⁰¹ Known as the 'inside cost basis'.

¹⁰² While New Zealand does not have a comprehensive capital gains tax, it does have section DB 26 *ITA 2007* (NZ), which assesses amounts from profit-making undertakings: *CIR v Thomas Borthwick & Sons (Australasia) Ltd* (1992) 14 NZTC 9, 101 (CA).

immediate tax consequences for members until there was a distribution from the LAQC.¹⁰³

7.3.2.5 Exit of members

The dynamics of entity acknowledgment can affect how subsequent sales of membership interests are treated for tax purposes. On the exit of a member when a full aggregate approach applies, tax would be determined by the underlying assets held by the transparent company. This is because the sale would result in the member disposing of all of his or her fractional interests in the underlying assets, some of which may be revenue or capital in nature. In comparison, with entity acknowledgment there would be the disposal of a tax asset, the membership interest, which could be capital in nature. This distinction has important ramifications for complexity issues and the level of tax imposed. To illustrate how important these ramifications are, all the jurisdictions provide concessional treatment of capital gains when compared to revenue receipts: these concessions create a preference for members to realise capital receipts rather than revenue.

If members of an S Corporation or LLC¹⁰⁴ sell or exchange their membership interest in a taxable transaction, they will normally realise either a capital gain or loss.¹⁰⁵ If a capital gain subsequently is realised, then the exiting member may

¹⁰³ Refer to the discussion in Chapter Eight that identifies that a capital gain could be distributed tax free by an LAQC to a members as an unfranked dividend.

¹⁰⁴ The LLC member's gain or loss is the difference between the amount realised and the outside cost basis of the membership interest: *IRC 1986* (US), section 1001(a); Treasury Regulation, section 1.741(a). Normally, there would be no change in the inside cost basis of assets held by the LLC merely because of change in membership: *IRC 1986* (US), section 743(a).

¹⁰⁵ McNulty, JK. (1992). *Federal Income Taxation of S Corporations*. New York: The Foundation Press Inc, at p 118: "The excess of amount realised over the adjusted basis will be gain: an excess of basis (adjusted for pass-through items) over amount realised will be loss. The nature of the gain or loss will depend on the relationship of the membership interest, the result usually being capital gain or loss".

be eligible for the concessional CGT rate of 15 per cent.¹⁰⁶ However, for members of the United States' LLCs, some of their receipts for sale of membership interest can be re-characterised as revenue in nature if the LLC holds certain 'revenue assets'.¹⁰⁷ This means an LLC member would report his or her share of unrealised gain in any unrealised receivable or inventory items held by the LLC as ordinary income at disposal time. The member could not then utilise the concessional CGT rate for this deemed revenue amount, and therefore would have a greater tax liability. Accordingly, for LLC members the entity acknowledgement is not as complete as for S Corporation members.

The 'revenue asset' rule has been described as a cure 'worse than the disease'.¹⁰⁸ These integrity measures have been seen as necessary due to Sub-Chapter K's flexibility in structuring economic arrangements which may facilitate artificial outcomes.¹⁰⁹ There is an historical concern with the flexibility of Sub-Chapter K which does not apply to S Corporations due to having one class of membership interest. It is argued that if this analysis is correct, then the rationale for not applying the revenue asset rules to S Corporation members is questionable. This is because there is still the potential for S Corporation members to re-characterise receipts as capital rather than revenue, even though this is limited.¹¹⁰ Irrespective, it is argued that the premise of revenue asset rule may be flawed, because it may result in economic double taxation on unrealised

¹⁰⁶ *IRC 1986* (US), section 1202(a). Note for the purposes of the 'alternative minimum tax' calculation the entire amount is included: *IRC 1986* (US), section 57(a)(7). An additional advantage to the sale of S corporation membership interest is the availability of ordinary loss treatment under *IRC 1986* (US), section 1244 if the membership interest is 'small business stock'. In these circumstances, members can exclude 50 per cent of any gain on sale: *IRC 1986* (US), section 1202 but normal tax rates apply.

¹⁰⁷ *IRC 1986* (US), section 751. These revenue assets are commonly referred to as 'hot assets', and include unrealised receivables and appreciated inventory. The primary purpose of this rule is to prevent a member from converting ordinary income into capital gain through the sale of a membership interest.

¹⁰⁸ Cunningham, LE, and Cunningham, NB. (1996). *The Logic of Sub-chapter K: A Conceptual Guide to the Taxation of Partnerships*.

¹⁰⁹ A similar concern seems to be behind the 'anti-abuse' rules that apply only to Sub-Chapter K of *IRC 1986* (US).

¹¹⁰ Indeed due to possible rollovers, an S Corporation member could contribute a revenue asset in exchange for membership interest, and then sell the membership recognising a capital and not a revenue gain.

revenue gains, where the remaining LLC members are assessed on these revenue gains later when they are realised on disposal.¹¹¹

The aggregate approach applying to the United Kingdom's LLP means that the member is attributed their fractional interest in the disposal of revenue assets as well as capital assets held by the LLP on the disposal of a membership interest.¹¹² Instead of one calculation on the disposal of the membership interest, there are a number of calculations which can be either capital or revenue in nature. In terms of capital receipts the member may be entitled to concessional treatment through CGT trapper relief or rollover.¹¹³ This treatment is similar to that applying to the United States' LLC; except that the double taxation should not occur as the remaining LLP members will have a greater fractional interest in the revenue asset, and therefore a lower resulting gain.

The transfer of a membership interest in an LAQC would be normally regarded as capital in nature, and therefore not assessable due to the absence of CGT in New Zealand. LAQCs are similar to S Corporations, insofar as members are not subject to a revenue asset adjustment, so there could be an incentive for members to re-characterise amounts. Note in terms of New Zealand's new limited partnerships more of an aggregate approach is used as there are rules requiring exiting members, in certain circumstances, to recognise revenue gains and losses.¹¹⁴

¹¹¹ However, in certain circumstances it may be possible for an LLC purchaser to have a set up cost for revenue asset: *IRC 1986* (US), section 754

¹¹² *Taxation of Chargeable Gains Act 1992* (UK), section 59 and 59A. Inland Revenue (UK). (1975). *Statement of Practice D12* (revised October 2002). [cited 20 September 2006]. Available from <http://www.hmrc.gov.uk>.

¹¹³ *Taxation of Chargeable Gains Act 1992* (UK), section 59A and Schedule A1. Additionally, members can avail themselves of a general 'rollover' relief available to nearly all businesses where a qualifying business asset is sold and the proceeds are reinvested in a new qualifying business asset. Freedman, J, and Ward, J. (2000). Taxation of Small and Medium-Sized Enterprises. *European Taxation* May:158, at pp 163-164. Qualifying assets include land and buildings, goodwill and certain fixed plant and machinery.

¹¹⁴ *ITA 2007* (NZ), new section HD inserted by *Taxation (Limited Partnerships) Act 2008* (NZ). This is subject to a minimum threshold rule that disposal proceeds exceed the interest in partnership property by more than \$50,000. When the threshold is met, then exiting partners will

In terms of asset holding and membership interest, it is argued that entity acknowledgement for tax purposes may decrease the tax compliance cost that could result if the legal relationship is completely disregarded for tax — that is a full aggregate approach. Tax calculations first at the entity level with subsequent allocations to members, can provide for one global calculation, rather than for a number of discrete individual ones.

However, it is acknowledged that such an entity acknowledgement could increase the tax imposed on contributions and, therefore, could justify the adoption of a deferral mechanism. Such a deferral mechanism could involve members' capital gain not crystallising until later disposal of the contributed asset by the transparent company. Alternatively, the cost base for the membership interest in the transparent company could be the original cost basis of the contributed property. In this circumstance following the legal form for membership interest and asset holdings could reduce complexity. It is argued in this respect that the revenue assets rules are probably not necessary, as the remaining members will be liable for tax on the later disposal of revenue assets.¹¹⁵ Alternatively, if the revenue asset rules are to part of a transparent system, then this could be a rule excluded when the transparent company has only one class of membership interest.

Furthermore, entity acknowledgement recognising the membership interest as a separate tax asset would be more consistent with loss restrictions based on the member's financial exposure amount, reflected in their membership cost basis.

be assessable on trading stock (subject to a further threshold of the partnership's annual turnover is greater than \$3 million), depreciable tangible property (subject to a further threshold that the historical cost is greater than \$200,000), and financial arrangements (unless the partnership is not in the business of deriving income from such arrangements). The incoming member will have a cost base equivalent to the exiting members disposal value.

¹¹⁵ Note the tax system would need a rule to provide for adjustment if a revenue asset stops being held on revenue account.

In terms of the ICAA proposal for a transparent company in Australia, more of an ‘aggregate’ approach is advocated. This results from a greater reliance on the existing tax treatment for general partnerships,¹¹⁶ with members of the proposed flow-through entity having direct fractional interest in the CGT assets held.¹¹⁷ This means that changes in membership can potentially trigger partial disposals.¹¹⁸ It is submitted that this full aggregate approach could impose greater complexity for Australian businesses, particularly if there are large asset holdings.

7.3.3 Loss restriction rules

It is argued that an inherent complication of transparent companies is that there is a need for loss restriction rules to underpin the integrity of the tax system and to ensure that the tax system does not distort investments. However, the question is which loss restrictions are necessary without imposing unnecessary costs.¹¹⁹

While it is argued that New Zealand’s loss restriction rules impose the least tax compliance costs, it is also argued that its rules are insufficient and compromise the tax revenue base. At the other end of the spectrum, the United States system suffers from having too many rules that duplicate and overlap each other. This problem is attributed to the fact that different rules have been implemented over time when concerns about specific abuses were raised. The United States’ tax system would benefit from reforms to consolidate the existing loss restriction

¹¹⁶ Institute of Chartered Accountants in Australia and Deloitte. (2008). Entity flow-through (EFT) submission. Sydney: Institute of Chartered Accountants, at paragraph 3.18.1.

¹¹⁷ Institute of Chartered Accountants in Australia and Deloitte, n 116, at paragraph 3.18.2.

¹¹⁸ Also in terms of revenue assets held, such as depreciating assets, trading stock and work in progress, changes in membership can cause disposal. However, there is the potential for rollover relief to disregard these disposals in certain circumstances: depreciating assets [*ITAA 1997* (Cth), section 40-340(3)]; trading stock [*ITAA 1997* (Cth), section 70-100(6)].

¹¹⁹ In this respect, reference should be made to Chapter Six’s analysis about the various loss restriction rules and the complexity that they entail.

rules into an overarching rule limiting losses to a member's financial exposure amount.¹²⁰ However, there may be a reluctance to do this, due to the perception that any replacement rule may have gaps or may provide tax arbitrages that do not currently exist.

In the United Kingdom, loss restriction rules impose concepts which are inconsistent with the aggregate approach for asset holdings and the failure to recognise membership interests as separate 'tax' assets. This is because the losses which may be claimed for a Trade LLP are limited to a member's contributed capital, even though for other purposes the membership interest is not recognised. Due to this inconsistency, the relevant rules have been described as 'complex'.¹²¹

It is important in drafting the loss restriction rules for a jurisdiction to be mindful to ensure that the measures are adequate without imposing undue compliance cost burdens. It is considered that the rules currently formulated for the CFC hybrid (with suggested amendments) would provide an adequate rule without undue complexity. It was queried in Chapter Six what was the basis of the claim within the ICAA proposal that the loss restriction rules applying to venture capital ILPs were less complicated.

7.3.4 Cross-jurisdictional issues

When the legal form is disregarded for tax purposes, complications can arise if the transparent company conducts business activities in a number of jurisdictions or if it has foreign members. The complexities arise because a foreign jurisdiction may have a tax system that assesses business forms in a manner aligned with

¹²⁰ However, in addition to such a rule, there would be the passivity test which is utilised in the United States.

¹²¹ Stewart, M. (2003). Towards flow through taxation of limited partnerships: It's time to repeal Division 5A. *Australian Tax Review* 32:171.

their legal characteristics. In these circumstances, a transparent company could be taxed as an entity separate from its members, particularly as a 'corporation'. Such a consequence could result in asymmetrical treatment, known in the literature as 'hybrid taxation'.¹²² This asymmetrical treatment can increase complexity and the potential for economic double taxation, as two countries are assessing different entities.¹²³ Also, hybrid taxation can provide for tax arbitrages and tax planning opportunities for taxpayers to exploit.¹²⁴

This asymmetric treatment has been identified as a problem with the United Kingdom's LLP, as other jurisdictions are likely to tax it as a corporation.¹²⁵ This has seen some firms adopt United States LLP laws instead, sometimes utilising two United States LLPs, with one holding and operating the United Kingdom business.¹²⁶

Another issue for international dealings and complexity is how Double Tax Agreements (DTA) apply to the transparent company and its members. A transparent company may not be a 'person' covered by a DTA, and it can be hard to determine if it is a resident of a country, to access treaty benefits. This

¹²² Note in Larking, B, ed. (2005). *IBFD International Tax Glossary*. 5th ed. Amsterdam: IBFD defines a 'hybrid entity' as an "entity that is characterized as transparent for tax purposes (e.g. as a partnership) in one jurisdiction and non-transparent (e.g. as a corporation) in another jurisdiction".

¹²³ This is because one country is assessing members, and the other the business entity. Additionally foreign jurisdictions have concerns about the availability of information when an entity owned by one member is a disregarded entity: in such circumstances there is no filing requirement with the United States IRS, which can make it hard for foreign jurisdictions to ascertain whether the correct income is being declared.

¹²⁴ Such asymmetric treatment can provide tax planning advantages, including the circumvention of Controlled Foreign Company (CFC) rules, and facilitate greater utilisation of foreign tax credits and losses. For a description of the difficulties that can arise due to asymmetrical treatment possible because of Check-the-Box, see: Postlewaite, PF. (2006). Treasury creates a monster. Australia, beware the hybrid entity! *Revenue Law Journal* 16:156, and Taxpayer Alert TA 2007/3: Income Tax: Foreign tax credit enhanced return bond investment.

¹²⁵ For example Shearman and Sterling have stated that a United Kingdom LLP would have been its 'first choice', but it would have lead to obstacles in other European countries because of asymmetrical treatment, where those other countries would have treated the LLP as a corporation for tax purposes. For example, French members could be subject to double tax on their share of the United Kingdom LLP profit. Laverriere, K. (2003). Tax treatment hinders limited liability partnerships. *International Tax Review* 14(5):8.

¹²⁶ Laverriere, n 125.

realisation has seen recent amendments introduced to several DTAs, providing for a ‘fiscally transparent persons’ provision.¹²⁷ For example, the United States–United Kingdom provision provides that income derived through a person who is a fiscally transparent entity under the laws of either the United States or the United Kingdom will be treated as the income of a resident of a contracting state if the taxation laws of either country treat it as such. This allows treaty benefits to be available to the resident of either the United States or the United Kingdom, and not to the fiscally transparent entity.¹²⁸

Currently there is no such provision in the United States–Canadian DTA, and the Canadian Revenue Agency’s position is that tax transparent LLCs will not be entitled to the benefits of the United States–Canada tax convention. This is because the LLC does not qualify as a resident of the United States for purposes of the convention, even when the LLC members are United States residents.¹²⁹ Moreover, there are unresolved issues about how portfolio holdings through a transparent company should be treated to enable access to lower withholding tax.¹³⁰

While asymmetric treatment could arise with a number of entities, it is argued that this is more likely to occur with a transparent company, where the tax system does not follow the legal form. For example, the Organisation for Economic

¹²⁷ For example: (a) Article 1(8) of the United States–United Kingdom DTA, which was signed on 24 July 2001, with an amending protocol being signed a year later on 19 July 2002. The treaty came into force on 31 March 2003; (b) Article 6(e) of the 2004 United States–Netherlands Protocol, amending the 1992 United States–Netherlands Income Tax Treaty to include a new Article 24(4); (c) Article 4(6) of the 2003 United States–Japan Income Tax Treaty; (d) 2005 United States–Mexico Competent Authority Mutual Agreement implement a provision into the 1992 Protocol to the United States–Mexico Income Tax Treaty. See: Connors, PJ, and Femia, RV. (2006). Application of U.S. Treaties to Hybrid Entities. *Tax Management International Journal* 35 (3):147, at p 148.

¹²⁸ United States–United Kingdom DTA, Article 1(8).

¹²⁹ Snider, K, and Spiro, D. (2005). Tax Planning for U.S. Limited Liability Companies Investing in Canada. *Tax Notes International* July:151, at p 151. Note this is in contrast to favourable position given to S Corporations, or LLC electing for C Corporation status and then S Corporation status.

¹³⁰ This issue relates to the fact that at the transparent company level the portfolio holding may be 10 per cent, but if the portfolio is traced to individual members it may fall below the required threshold.

Co-operation and Development (OECD) raised a number of issues that arise with inter-jurisdictional treatment of partnerships.¹³¹

While the OECD Partnership Report purports to provide some guidance for hybrid treatment, it is questionable how meaningful this analysis and advice is, given that its discussion is on ‘partnerships’ in a more traditional sense with no reference being alluded to contemporary transparent companies with ‘company’ characteristics — the subject of this dissertation.¹³² In this context, it is unclear whether that the transparent companies studied would in fact be ‘partnerships’ *per se* for the OECD purposes.¹³³

Accordingly, the cross-jurisdictional treatment of transparent companies is far from resolved, and such uncertainty would increase compliance costs. It is important for a jurisdiction to consider this issue. Precisely for this reason, attention in Chapter Eight focuses on why symmetrical treatment should be one criterion for transparency eligibility.

¹³¹ Organisation for Economic Co-operation and Development, ed. (1999). *The Application of the OECD Model Tax Convention to Partnerships, Issues in International Taxation No 6*. Paris: OECD.

¹³² Connors, PJ, and Femia, RV. (2006). Application of U.S. Treaties to Hybrid Entities. *Tax Management International Journal* 35 (3):147, at p 150: “The OECD Partnership Report takes the position that the source country should extend treaty benefits to any beneficial owner of a fiscally transparent entity if the residence country taxes the owner currently on the same income for which the owner claims the benefits” ... “The owner in such a case would be entitled to treaty benefits as if it had earned the income directly. The OECD Partnership Report also takes the position that the source country should not extend treaty benefits to any beneficial owner of what it considers to be a fiscally transparent entity unless the residence country taxes the owner currently on the same income to which the owner claims the benefits”. See discussion in OECD Partnership Report at paragraphs 35 and 56. This position is set out in the OECD Commentary to Article 1, paragraph 3, and the OECD Commentary to Article 4, paragraph 8.2.

¹³³ Collison, D. and Tiley, J. (2005). *Tiley and Collision UK Tax Guide 2005-06*. London: LexisNexis Butterworths, at p 315: “A problem with this approach is that the OECD Model does not make a distinction between companies and partnerships based on how the body is taxed; thus, as it stands, it would be difficult to fit categorization into the OECD Model. The Commentary assumes that companies are legal entities and that, in most countries, partnerships are not, which may be true generally, but is now subject to numerous exceptions ‘Company’ is defined in the OECD Model (Art. 3(l)(b)): the term ‘company’ means any body corporate or any entity that is treated as a body corporate for tax purposes”.

7.4 Conclusion

The small number of studies available, suggest that transparent companies may have higher tax compliance costs than both the entity treatment afforded to corporations, and the aggregate approach of general partnerships. Furthermore, transparent companies may aggravate the regressive nature of compliance costs when operations are small. Accordingly, when the tax system disregards the legal form and taxes members directly, there appears to be a concomitant increase in tax compliance cost. As was shown, this increase in tax compliance cost could be attributed to a variety of factors, including eligibility requirements, extent of aggregation, complying with loss restriction rules, and cross-jurisdictional issues.

The data implicates the significant point that there are differential levels of tax compliance cost between the two identified classifications, being special tax rule companies and new form transparent companies. It is possible that the increased tax compliance cost for new form transparent companies may be attributed to tax planning strategies adopted through these forms via less restrictive eligibility requirements for transparency.

It was argued that some entity acknowledgement for membership interest and asset holdings may be preferable compared to a full aggregate approach, and that this need not be inconsistent with tax transparency. For example, a business with entity acknowledgement could assist in decreasing the complexity by requiring only one capital gain calculation which is then allocated to members.

It appears that the prescriptive eligibility requirements for special tax rule companies — particularly the one class of membership interest — may assist in reducing ongoing tax compliance cost, particularly if complex tax integrity measures do not apply.

If this relationship with tax transparency and compliance cost is correct, then the compliance with tax legislation for transparency could diminish any benefits of improved tax neutrality. Accordingly, when disregarding the legal form for tax purposes jurisdictions need to be mindful of the complexity that may be involved when pursuing the economic ideal.

Even with increased tax compliance cost, transparent companies may *in toto* still be advantageous for closely held businesses if they assist in addressing the finance burden which may offset any increase in compliance cost. To demonstrate how this is possible, the overall tax effect of transparency in each of the jurisdictions is now analysed in Chapter Eight.

Chapter Eight: Transparent companies and financing

8.1 Introduction

The raising of finance (in terms of equity and debt) can be a challenge for closely held businesses, which can be attributable to both internal and external factors.¹ In what respect does tax transparency — that is, disregarding the legal form and allocating income and/or losses directly to members — assist or hinder closely held businesses in meeting their financing requirements. Any jurisdiction contemplating the introduction of a transparent company should consider this issue, as some transparent companies have been attributed to tax arbitrages unique to their jurisdictions.

This chapter will consider how transparent companies potentially affect closely held businesses' financing, by considering the ability to raise equity finance and the overall tax burden. It will be demonstrated that eligibility requirements for transparency — particularly for special tax rule companies — can restrict the ability to raise equity finance, thereby potentially frustrating growth. Given the minimal eligibility requirements for new form transparent companies, are such restrictive requirements necessary in the first place? These contentions will result in a proposal for a universal set of eligibility requirements for tax transparency that should not unduly hinder the raising of equity.

The overall tax burden of transparency for businesses will be examined through the consideration of the assessment of members for unpaid allocations; the access to losses and tax preferences; the capital gains treatment; the

¹ Refer to Chapter Two's analysis for a thorough discussion of these financing issues. For example an internal characteristic of closely held businesses obtaining finance is that members may want to retain 'control'. An external factor could be that banks are hesitant to lend to a business without an established track record.

relationship between corporate and transparent company tax treatment; active member status; and debt versus equity funding.

Such an analysis will demonstrate that in the jurisdictions studied, compared to an entity or integrated system, consistent advantages of tax transparency are the treatment of tax preferences, losses and the imposition of a single layer of tax on capital gains. These tax advantages could assist closely held businesses in addressing their financing issues. However, it will be argued that tax transparency does not necessarily result in an overall lower tax burden. This depends upon several factors including the relationship between the tax rates applying to corporations, capital gains and individuals.

Another issue implicated in this analysis, is the appropriate tax status of transparent company members as either 'employees' or as 'self-employed'. This distinction is important because it can influence the application of various employment related taxes. An active member of a special tax rule company is likely to be treated as an 'employee', whereas for a new form transparent company a member is likely to be treated as 'self-employed'. It will be argued that the status of members for all transparent companies should be consistent, and a universal approach is advocated.

8.2 Eligibility for transparency

In Chapter Three, limited liability companies (LLCs) and limited liability partnerships (LLPs) were seen to have minimal eligibility requirements for transparency, whereas for S Corporations and Loss Attributing Qualifying Companies (LAQCs) they are strict. This facet is of major importance because eligibility requirements can restrain the ability to raise equity due for example to requirements concerning classes of membership interest; membership numbers; members' status; and business activities. In this respect, Chapter Seven drew

attention to the central relationship that these eligibility requirements could have with regulatory complexity. They are now reviewed in terms of financing.

The requirement for a transparent company to have only one class of membership interest can restrict the ability to raise equity.² This is because new equity members may require preferred membership interests or, alternatively, interests with specific rights attached to them to invest equity so as to expand operations.

Another way the ability to raise equity finance can be constrained is via restrictions on the quantum of members allowed. As an illustration of this point, an S Corporation is now restricted to comprising 100 members. While this is a substantial increase from the original ten allowed,³ it does nevertheless place an arbitrary cap on the number of members.⁴ For LAQCs, the raising of equity is restricted to five members, although this can be circumvented by investors forming a general partnership of a number of LAQCs,⁵ and treating blood

² The requirement for one class of membership interest applies to S Corporations and LAQCs. *IRC 1986* (US), section 1361(b)(1)(D). *ITA 2007* (NZ), sections HA 1 to HA 10.

³ Originally, back in 1958, only ten members were allowed; subsequent amendments raised the number to 15 (1976), then 25 (1981), then one year later to 35 (1982), then 75 (1997) and finally 100 (2005). Amended by section 232 of *American Jobs Creation Act 2004* (US), amending *IRC 1986* (US), section 1361(b)(1)(A)). This limitation applies to the number of members at any one time during the taxable year.

⁴ However, the potential membership of an S Corporation may exceed 100, due to the treatment of family members within six generations as one member: *IRC 1986* (US), section 1361(c)(1)(B) [applying from 1 January 2005]. A family is defined to include members with a common ancestor, lineal descendants and spouse (including former spouse) at the time of the election six or less generations from the youngest generation of members part of the family, part from the operation of the section. Prior to 1 January 2005, most joint owners were counted separately: Treasury Regulation, section 1.1371-1(d)(1), although a husband and wife [and their estates] could be treated as one member: *IRC 1986* (US), section 1361(c)(1).

⁵ Committee of Experts on Tax Compliance. (1998) *Tax Compliance: Report to the Treasurer and the Minister of Revenue*: Chapter 6 – Tax Mitigation, Avoidance and Evasion, Wellington, at paragraph 6.107. The structure of a general partnership of LAQCs has been widely used in the forestry industry since shortly after enactment of the LAQC regime. In the United States the use of general partnerships in this fashion to increase membership of S Corporations was originally ruled against: Revenue Ruling 77-220, 1977-1 C.B. 263. But see P.L.R. 88-23027 (Mar. 8, 1988) (permitting each partner at a law firm (of fewer than 35 partners) to incorporate as an S Corporation and to form a partnership with the S Corporations as partners).

relatives as 'one' member.⁶ However, the concurrent use of business forms and the treatment of family members, inevitably increases complexity and calls into question the need for a cap in the first place.

An additional restriction on the raising of equity is that only certain types of entities can be members and this thereby inevitably excludes certain persons or entities. For example, an S Corporation may raise equity from resident individuals⁷ — except in restricted circumstances.⁸ Theoretically, this restriction means, in effect, that a C Corporation could not become a member of an S Corporation. In contrast to S Corporations, New Zealand's LAQC may have non-resident members, although adverse tax implications may effectively deter this.⁹

The raising of equity is a highly significant issue and the capacity of a business form to facilitate it has been identified as an important feature. It is understood the formation of capital is one of the reasons behind the popularity of LLCs.¹⁰ The 'formation of capital' was one of the original reasons behind the introduction

⁶ There are a number of special rules that allow more than five members, including the treatment of blood relations, nominees, corporate members and trustee members. Inland Revenue (NZ). (2001). *Qualifying Companies: A guide to qualifying corporation tax law*. Inland Revenue, March 2001, at p 13 [cited 6 January 2008]. Available from <http://www.ird.govt.nz/forms-guides/keyword/businessincometax/companies/ir435-guide-qualifying-companies.html>.

⁷ *IRC 1986* (US), section 1361 (b)(1)(C).

⁸ Only in restricted circumstances can a member be a corporation, or general partnership or trust. For example an S Corporation could not be a member of an affiliated group as defined in *IRC 1986* (US), section 1361(b)(2)(A). S corporations can now hold 100 per cent of membership interest in a subsidiary, and can elect to treat the subsidiary as a Qualified Subchapter S Corporation (QSSS): *IRC 1986* (US), section 1361(b)(3)(B).

⁹ The benefit for a non-resident member investing into an LAQC may be limited; since the effective tax rate applying to distributions to them could be higher compared to if their investment was structured through a different business form. For members of an LAQC, who are New Zealand non-residents, imputation credits must still be attached to dividends paid to non-resident members, and are therefore wasted because non-resident members cannot normally claim a credit for them against their New Zealand tax liability, or for most members' jurisdictions, against their home country tax liability. See: Freudenberg, B. (2005). Is the New Zealand Qualifying Company regime achieving its original objectives? *New Zealand Journal of Taxation Law and Policy* 11 (2):185, at p 207. While not restricting equity investment, the restriction on an LAQC not having greater than \$10,000 non-dividend income source from outside New Zealand could limit the LAQC's operations and limiting the ability to attract equity investors.

¹⁰ For example the LLC Agreement can allow greater flexibility in profit sharing arrangements.

of the corporation one hundred and fifty years ago and it continues to be an important characteristic.¹¹

Later in this chapter it will be argued that the transparent eligibility restrictions should be based on three core requirements which would enhance the ability of transparent companies to raise equity. Additionally such a relaxation may alleviate some of the complexity issues alluded to in Chapter Seven.

8.3 Overall tax burden

If tax transparency can decrease or defer the income tax burden then this could help alleviate closely held businesses' financing problem. A lower tax burden would allow members to reinvest profits into the business, thereby reducing the necessity to seek and obtain external debt financing or alternatively equity investment.¹² Also, if tax transparency does improve the neutrality between debt and equity financing, then this could assist closely held businesses, which have historically been more reliant on equity funding than on external debt for financing.¹³ It is argued that if tax transparency does not operate in this way, it is questionable as to the extent to which tax transparency would assist closely held businesses.¹⁴

The analysis in Chapter Four demonstrated the role a jurisdiction's tax system performed in the context of the introduction of the transparent companies

¹¹ Elias, S. (1987). *Contemporary Issues in Company Law*, edited by J Farrar, New Zealand: CCH.

¹² An incentive for members to contribute equity to a transparent company is that generally this would allow them greater utilisation of allocated losses. Refer to the discussion in Chapter Six about the loss restriction rules. Also for some transparent companies a greater membership cost basis means that distributions to them from the transparent company are tax free.

¹³ Refer to the discussion in Chapter Two about the findings of Johns, BL, Dunlop, WC, and Sheehan, WJ. (1983). *Small Business in Australia: Problems and Prospects*. Sydney: George Allen & Unwin, at p 110.

¹⁴ Of course there could be other salient reasons, such as flexibility of governance rules and liability protection.

studied. For S Corporations and LAQCs it was shown that the objective was to improve tax neutrality between general partnerships and closely held corporations. It was also suggested that transparency applying to S Corporations and LAQCs could be perceived as a 'carve out' from the normal corporate tax treatment. For the introduction of LLCs and LLPs, breaches of tax neutrality tended to motivate taxpayers to lobby for the introduction of a new business form — one that was subject to tax transparency provided to general partnerships.

In this context, the Appendix to this dissertation details several important examples that illustrate the tax imposts levied for the various transparent companies and how these compare to corporations. The rationale for selecting the corporation is that it represents the most popular alternative business form with limited liability protection and separate legal entity status in the jurisdictions studied.¹⁵

The most pertinent of these examples are discussed below. These examples illustrate that the utilisation of transparent companies does not guarantee an overall lower tax liability, because there are inevitably qualifications and exceptions. Indeed, in some circumstances, transparent treatment can increase members' tax burden. Nevertheless, there is significant potential for tax savings with transparent companies¹⁶ — particularly with access to losses, tax preferences and capital gains. The significance of these implications is therefore analysed below. In addition to this analysis, consideration is accorded to assessment of unpaid allocations, as well as to the status of active members and to debt versus equity funding.

¹⁵ Refer to the data in Chapter Three that details the extent of the use of corporations in the jurisdictions studied.

¹⁶ This may be enhanced by streaming and the splitting of income.

8.3.1 Assessment for unpaid allocations

A potential adverse implication of tax transparency is the assessment of members for allocated income, in spite of the fact that there has been no distribution from the transparent company to them. This applies to members of S Corporations, LLCs and LLPs.¹⁷ Furthermore, with such an unpaid allocation, a member's tax rate could be higher than that applying to corporations and, hence, the allocation could result in a higher overall tax burden.

This is an important consideration given the trend world wide to lower the tax on capital, including corporate rates.¹⁸ While there is also a trend of lowering personal rates, these are still normally higher than the corporate rates.¹⁹ This is important, as the corporate form can be used to 'shelter income' at a lower rate. In those jurisdictions studied, the United States' Federal top personal marginal tax rate is equivalent to the top corporate tax rate of 35 per cent.²⁰ In the United Kingdom the top personal tax rate can be either 40 or 32.5 per cent depending upon the type of income, with the corporate rate recently reduced from 30 per cent to 28 per cent.²¹ In New Zealand, the corporate rate is 30 per cent from 1

¹⁷ Note the decision of *Knott v Commissioner United States Tax Court*, 1991. 62 T.C.M. 287 confirmed that the income of an S Corporation need not be distributed in order to be included in the taxable income of the member.

¹⁸ Ganghof, S, and Eccleston, R. (2004). Globalisation and the Dilemmas of Income Taxation in Australia. *Australian Journal of Political Science* 39 (3):519.

¹⁹ Hallerberg, M, and Basinger, S. (1998). Internationalization and Changes in Tax Policy in OECD Countries: The Importance of Domestic Veto Players. *Comparative Political Studies* 31 (3):321, at p 321.

²⁰ *IRC 1986* (US), section 199. While currently in the United States there is some alignment between the corporate tax rate and the maximum individual tax rate, prior to the 1986 tax reforms the corporate rate was lower than the individual rate; with the 1986 tax reforms this was reversed until 1993. From 1993 to 2003 the corporate tax rate was lower than the individual rate, and equalled it from 2003. Note from 2005 a corporation may be entitled to reduce tax rate, as all businesses can get a 3 per cent of the qualified amount, up to 9 per cent for a domestic activity deduction.

²¹ Starting in the 2008 year. Note there are proposals to increase the rate of income tax to 45 per cent for those taxpayers with income greater than £150,000 (from 6 April 2011).

April 2008 (reduced from 33 per cent), whereas the top personal marginal tax rate is currently 39 per cent.²²

Illustrating the interaction between corporate and personal tax rates, Example 8-0-3 and Example 8-0-4 demonstrate that in the United States where there is no distribution of profit, there is some equivalence between C Corporation treatment and transparency.²³ For the United Kingdom, Example 8-0-11 and Example 8-0-13 demonstrate that the tax burden can be higher when tax transparency applies, compared to a corporation that simply accumulates profits.²⁴

In contrast, the profits of New Zealand's LAQC are not automatically allocated to members; this is because it is a partial loss transparent company rather than a fully transparent company. This means an LAQC's income is initially assessed at the entity level at 30 per cent.²⁵ Only when a member receives a franked dividend from an LAQC will the member include the dividend in their assessable income,²⁶ together with the imputation credit.²⁷ The LAQC member is then able to offset their tax liability with the imputation credit.²⁸ Example 8-0-23 demonstrates that if there is annual distribution of profits in New Zealand there

²² In New Zealand, when LAQCs were first introduced there as an alignment between the individual and corporate tax rate at 33 per cent.

²³ However, on disposal there is a variance given the different CGT treatment.

²⁴ Once there is a distribution of profit with either the entity or integrated tax treatment for corporations, this results in a higher overall tax burden. For the United States, see: Example 8-0-1; and for the United Kingdom, see: Example 8-0-10 (excluding the application of the NIC).

²⁵ An imputation system applies to the LAQC and other New Zealand corporations. For New Zealand tax purposes the definition of 'company' also includes a 'unit trust', so unit trusts are subject to an imputation system also: *ITA 2007 (NZ)*, section YA 1. Sole proprietors, general partnerships and trusts (apart from unit trusts) are taxed on a flow-through basis. This means that the payment of corporate tax is recorded in the LAQC's imputation credit account: *ITA 2007 (NZ)*, section OB 4.

²⁶ The imputation credits are then attached to the dividends paid out: *ITA 2007 (NZ)*, section OB 30. The LAQC must impute any dividend payment to the fullest extent possible, known as a franked dividend: *ITA 2007 (NZ)*, section HA 15. This is similar to what previously operated in Australia before the implementation of the new franking rules from 2002.

²⁷ *ITA 2007 (NZ)*, sections HA 14 and HA 15.

²⁸ *ITA 2007 (NZ)*, sections HA 14 and HA 15. Note in New Zealand the correct term is 'fully imputed dividend', but to ensure consistency within this dissertation the term 'fully franked' has been used. For an individual on the top marginal rate (39 per cent) an effective additional nine per cent tax rate would apply to the receipt of a fully franked dividend.

will be a higher tax burden, compared to Example 8-0-24, which involves the scenario of simple accumulation of taxable income by a corporation and/or LAQC.

For S Corporations, LLCs and LLPs the direct allocation of profits to members means that the capital growth in the business may be taxed as 'income' to members on a regular basis, rather than on the disposal of the membership interest.²⁹ To the extent that income is allocated to members, they would not be able to access the concessional treatment that can apply to capital gains in the various jurisdictions. From an economic perspective, this can be considered appropriate, as members' annual assessment more accurately reflects their increase in wealth due to the business operations. This contrasts with the position of deferral of profits available when the business form is subjected to an entity or integrated tax treatment, with members not assessed on growth until the consequent sale of their membership interest, which then could be concessionally taxed as a capital gain.³⁰ In the United States³¹ and the United Kingdom, Example 8-0-3 and Example 8-0-13 highlight that the growth is not assessed to the member of a corporation until the disposal of the membership interest in the tenth year, which is then assessed at a lower rate.³²

²⁹ Each year the profits of the transparent company are directly assessed to members as either income or capital.

³⁰ Of course income derived by the business form would be subject to tax, which could be below or above the member's tax rate.

³¹ C Corporation members are not assessed on corporate profits until profits are distributed via dividends to them. When dividends are paid an entity tax system applies, with the member assessable on the dividend with no credit for tax paid at the corporate level. In terms of an individual member, normally marginal tax rates would apply up to 35 per cent on the receipt of such dividends. However, there is temporary tax relief for the receipt of dividends by a member: a 15 per cent rate applies until 2010: *IRC 1986* (US), section 1(h)(11) introduced by the *Jobs and Growth Tax Relief Reconciliation Act* (US) 2003 (passed May 2003). This reduces the top capital gains tax and dividend tax rate to 15 per cent (or 5 per cent for low income families and 0 per cent for the 2008 year only) for the period 1 January 2003 to 31 December 2008. This has now been extended to 2010 through the *Tax Increase Prevention and Reconciliation Act 2005* (US). However, there are some exceptions to the entity tax system, such as corporate shareholders are entitled to a dividends-received deduction ensuring that most of a dividend received by another corporation will be free of tax: *IRC 1986* (US), section 243.

³² For example, when a disposal does occur, the resulting capital gain is currently taxed at the concessional rate of 15 per cent, compared to the top marginal tax rate of 35 per cent: *IRC 1986* (US), section 302.

However, despite the foregoing analysis, tax transparency does not result in a full assessment of economic wealth. Appreciating capital assets that are held by the transparent company are not assessed to members until the gain is realised through the disposal of the underlying asset. In this circumstance, members of a transparent company would receive the benefit of deferral, as well as the concessional CGT treatment. As an illustration, Example 8-0-6 demonstrates precisely how capital growth in an appreciating asset is not assessed to an S Corporation member until disposal has taken place.

Also, the assessment of members on allocated income could put pressure on a transparent company to distribute money to enable members to fund their respective tax obligations, which then (in turn) could generate cash flow problems and organisational instability.³³ However, if members are active in the management of the transparent company, then they can in this capacity determine the timing and quantum of distributions. For example, a distribution to a member could be purely to fund the member's tax liability amount and not (to fund) the full allocation. A related issue is how 'unpaid allocations' could affect the ability of members to use allocated losses — which was canvassed in Chapter Six.

8.3.2 Access to losses and tax preferences

With all the transparent companies studied, a discernible advantage over corporations subject to an entity or integrated tax system is that losses are allocated directly to members. For corporations in the jurisdictions studied, losses are 'trapped' at the entity level, to be carried forward to offset future income

³³ Joint Committee on Taxation. (2006). Present Law and Background Relating to Selected Business Tax Issues. Washington DC: Senate Committee on Finance, at p 10.

earned by the corporation.³⁴ With transparency the allocation of losses directly to members can enable members to offset these losses against other assessable income. This has the overall affect of reducing members' aggregate tax burden. Chapter Six provided an example to illustrate the tax savings that the transparent model could present to members when losses are directly allocated to them.³⁵ Of course this is subject to the proviso that the relevant loss restriction rules are satisfied.³⁶

The value of losses can deteriorate with the time value of money and hence the timelier utilisation of losses will be beneficial for members. Additionally, losses at the member level may shelter income which would otherwise be taxed at a higher rate rather than that applying at the corporate level.

A related issue to losses is the ability of members to access tax preferences when transparency applies. Tax preferences describe amounts or receipts that are not included in a taxpayer's (including a business form) taxable income.³⁷ When an entity or integrated approach applies, normally the distributions to members of profits that have been sheltered from tax, in effect, are 'clawed back', thereby resulting in members being fully assessed on the previously untaxed profit. Example 8-0-7, Example 8-0-15 and Example 8-0-26 demonstrate how this claw back occurs when exempt income is distributed by a corporation in

³⁴ For example in the United States if C Corporations have net operating losses not absorbed by their taxable income in the two preceding years, the losses may be carried forward for up to twenty years to be applied against assessable income: *IRC 1986* (US), section 172. In the United Kingdom any losses realised by a corporation are trapped at the entity level and cannot be allocated to members. Antczak, G, and Walton, K. (2005). *Tolley's Corporation Tax*. London: LexisNexis Butterworths, at p 199.

³⁵ In some circumstances it could be preferable for losses to be retained at the entity level for future use if members are not likely to ever satisfy the loss restriction rules for the utilisation of the allocated losses.

³⁶ Refer to the analysis in Chapter Six about the various jurisdictions' loss restriction rules.

³⁷ These tax preferences may arise due to various taxation rules. For example, tax preferences in Australia could arise due to research and development concessions, exempt income, asset revaluations, capital gains concession (such as the CGT asset being acquired prior to 20 September 1985 in Australia), capital works, accelerated depreciation for plant and equipment, small business concessions, environmental expenditure deductions, water care deductions, or amounts sheltered because of carried forward losses.

the United States, the United Kingdom and New Zealand. In contrast, tax transparency can allow for tax preferences to flow through to members, thereby resulting in an overall lower tax burden: see Example 8-0-8, Example 8-0-16 and Example 8-0-27. In the United States context, an advantage that LLCs have over S Corporations is the ability to direct these tax preferences, through special allocations, to certain members.³⁸ However, such streaming is not unrestrained, with special allocations likely to be restricted to a member's capital account.³⁹

Even in the case of the partial loss transparent company studied — the LAQC — the treatment of unfranked dividends paid out to members enable members to access tax preferences.⁴⁰ In effect, unfranked dividends represent profits of the corporation that have not been subject to tax at the entity level. For an LAQC member, the receipt of an unfranked dividend is regarded as exempt income and not assessable.⁴¹ The major tax preference in New Zealand is the absence of a comprehensive CGT. In comparison, when a New Zealand corporation distributes profit realised through the sale of a capital asset, this would normally be as an unfranked dividend which is fully assessable to the member.⁴² Example 8-0-26 and Example 8-0-27 illustrate the differences between New Zealand corporations⁴³ and LAQCs in the distribution of tax preferences. This contrasts

³⁸ This means that amounts could be allocated to LLC members who can better utilise the tax preferences.

³⁹ Treasury Regulation, section 1704-1(b)(2)(ii)(b),(d). As discussed in Chapter Six, for such special allocations to be effective the LLC's Operating Agreement must provide for it and the allocations must have 'substantial economic effect': *IRC 1986* (US), section 704. Also there is a restriction on special allocations of deductions attributable to LLC's non-recourse outside loans: Treasury Regulation, section 1.752-1(a)(2): Indebtedness secured by partnership property for which no partner bears personal risk. Treasury Regulation, section 1.704—2(b)(1).

⁴⁰ Note that any dividends received from a subsidiary corporation by an LAQC are assessable to the LAQC, as there is no exemption in relation to wholly owned subsidiaries. However, the LAQC would be entitled to claim any imputation credits attached to the dividends paid from a subsidiary, which may effectively eliminate any tax payable: Inland Revenue (NZ), n 6, at p 41. This rule is considered necessary to prevent an LAQC receiving a dividend from a non-QC subsidiary on a tax-free basis, and then passing this out to individual shareholders with no further tax imposed.

⁴¹ *ITA 2007* (NZ), sections HA 16 and CW 15.

⁴² This would be assessed at their appropriate income tax rate without any imputation credit to offset the resulting tax liability.

⁴³ Note there are special rules for 'close companies' which are when five or fewer members have great than 50 per cent interest in the corporation. The member-employees of the close company are subject to special rules in relation to PAYE, pensions, fringe benefits, dividends and

with the New Zealand position in which a corporation or LAQC derives profits that are fully assessable: see Example 8-0-22 and Example 8-0-23.

8.3.3 Capital gains

A potential benefit of transparency is that it can more clearly avoid the perceived double layer of taxation that can occur in respect of appreciated assets when an entity approach is adopted. In this respect, Chapter Two outlined Vann's demonstration that this 'double taxation' of capital gains is incorrect provided that the value of the membership interest is based on retained profits.⁴⁴ However, it should be appreciated that such a valuation will not always be the case. If an appreciated asset⁴⁵ is sold by a corporation, subject to an entity tax system, then the corporation is likely to be subject to tax on that sale. If the profit from this sale is then distributed, members are also likely to be assessed on the receipt of a dividend, although there could be some dividend relief. This dividend receipt would be income in nature even despite the fact that the underlying profit relates to the disposal of a capital asset. The dividend receipt as income restricts the ability of the member to access the concessional treatment that may be afforded to capital receipts. If instead a dividend is not declared and the member sells their membership interest, this sale is likely to be at an increased value, due to the appreciated property or profit held by the corporation. In this circumstance the member is also assessed on the capital growth, although the member is able

remuneration. Included as dividends are certain loans to the principals, excessive remuneration, sales and acquisitions of property at over- and undervalue, certain bonus issues and buybacks, interest on certain debt instruments and expenditures on behalf of the member.

⁴⁴ Vann, R.J.(2001). Australia's Policy on Entity Taxation. *Australian Tax Forum* 16:33, at p 38: "The example shows that in the simple case presented there is no double tax on retentions to the owner under the CGT to the extent that value is based on retentions (putting aside the problem of matching the dividends and the capital loss for the purchaser). Thus the double taxation of retentions is a myth".

⁴⁵ Appreciated asset is property that has increased in value.

to access CGT concessions.⁴⁶ In comparison, tax transparency can allocate the capital gain directly to the members, thereby resulting in clearly one layer of tax, as well as allowing members to access concessional CGT treatment.

Illustrating most significantly the differential tax treatment that can arise because of capital gains are the examples of the United Kingdom's LLP over the conventional corporate entity. In the simple circumstances described in Example 8-0-20 and Example 8-0-21, the LLP has a lower tax burden compared to the corporation situation, because in the corporate circumstance there is the potential for tax to be levied at both the corporate and member level. The LLP taxes the capital gain only at the member level due to their direct fractional interest in the underlying capital assets.⁴⁷ Such treatment of capital gains has been described as a major advantage of the LLP, compared to the position when membership interests in a corporation are sold.

8.3.4 Comparison to corporate tax treatment

While the comparison between corporate entity tax treatment and transparency is a multi-faceted issue, there is indeed the potential for tax transparency to decrease the overall tax burden. This will depend a number of factors, including whether the corporation is subject to an entity or integrated tax system, the relationship between tax rates, and the treatment of capital receipts and employment taxes.

Due to the United States' entity tax system, S Corporations and LLCs offer some tax savings to closely held businesses compared to the tax treatment for C

⁴⁶ Note however the incoming new member will have a greater cost basis due to the greater amount paid recognising the appreciated value of the asset held, thus diminishing the extent of this double economic taxation.

⁴⁷ One implication of LLP's tax transparent treatment is that members hold fractional interests in the LLP's assets, even though the LLP is a separate legal entity to the members: *LLP Act 2000* (UK), section 1; *Taxation of Chargeable Gains Act 1992* (UK), section 59A.

Corporations. While the extent of this saving has decreased since 1986, with the individual tax rate now equivalent to the top corporate tax rate of 35 per cent, and capital gains and dividends being concessionally tax, there are still potential tax savings.⁴⁸ Example 8-0-1 to Example 8-0-4 illustrate the tax benefits that transparency may provide in the United States.

In relation to the level of members' income tax payable, members of S Corporations and LLCs are in a beneficial situation compared to a member of a C Corporation, irrespective of whether there is a distribution or an accumulation scenario. Example 8-0-2 and Example 8-0-4 demonstrate the total income tax paid, with transparency lower than that for C Corporations and their members.

Table 8-0-1 demonstrates the savings potentially available with the one layer of tax as a percentage compared to an entity tax treatment. In 1988 the savings for one layer was the greatest at 187 per cent. However, this has now decreased to 128 per cent. It should be recalled that it was in the year 1988 that the Internal Revenue Services (US) (United States IRS) ruled that the Wyoming LLC would be taxed as a general partnership and not as a corporation. Given the potential tax savings achievable at this time through this one layer of tax, the enthusiasm for the lobbying for the introduction of the LLC form in the various American states is quite understandable.⁴⁹

⁴⁸ However, it should be appreciated that the extent of 'double taxation' for C Corporations and their members can be mitigated through a number of mechanisms. For example the payment of the following deductible amounts by C Corporations to members could also achieve a single layer of taxation: wages, royalties, rent and interest on loans. Also the C Corporation could make contributions to a pension fund established for the member. Alternatively, C Corporations could retain profits and members could realise their increase in wealth as a capital gain through the sale of their membership interest, which facilitates deferral and potential concessional tax treatment. If this transfer of membership interest occurs through inheritance at death then tax can be avoided altogether, as the heir is entitled to a step up in the membership cost basis to the fair market value.

⁴⁹ Refer to the discussion in Chapter Four which detailed the speed of enactment of LLC legislation through the various American states in the late 1980s and early 1990s.

Figure 8-0-1: US: Entity and transparency comparison

Source: Internal Revenue Service (US). (1981 – 2005) Tax Statistics of tax rates. Available at: <http://www.irs.gov/taxstats/index.html>

Chapter Seven discussed the study by DeLuca et al. which found that for the 2002 income tax year, the percentage increase in compliance cost for LLCs (when compared with C Corporations) was 17 per cent for all firms and 26.7 per cent for firms with less than 100 employees.⁵⁰ In terms of LLCs with less than 100 employees, this figure indicates that they have, on average, a 27 per cent greater income tax compliance cost than C Corporations with similar numbers of employees. However, compared to entity tax treatment, the tax savings achievable with transparency for the 2002 income tax year was broadly 56 per cent.⁵¹ These compliance costs and tax savings are detailed in Table 8-0-1.

⁵⁰ DeLuca, D, Greenland, A, Guyton, J, Hennessy, S, and Kindlon, A. (2005). *Measuring the Tax Compliance Burden of Small Business*. Paper read at Internal Revenue Services' Research Conference, 7-8 June, at Washington DC, Table 5, at p 83.

⁵¹ In the 2002 year, the highest individual marginal rate was 38.6 per cent, and the C Corporation rate was 35 per cent, giving the total tax paid on distributed profits of 60.09 per cent. 56 per cent equals 38.6 divided by 60.09. With the temporary tax relief provided to dividend payments, the tax

Consequently, it is argued that the potential tax saving offered by LLCs compared to C Corporations could offset the greater income tax compliance cost generated by transparency. Adopting Scholes and Wolfson's terminology referred to in Chapter Two, this could ensure that the trade off between 'tax costs' and 'transaction costs' made LLCs beneficial compared to C Corporations. This could explain the continued growth of LLCs as demonstrated in the data in Chapter Three despite the potential increased compliance cost. Of course, it is questionable whether this is an efficient outcome.

Table 8-0-1: US: Compliance cost: LLCs & C Corporation

Average income tax compliance burden	LLC	C Corporation	Percentage burden increase LLC to C Corporation	2002 tax transparent saving compared to classical system
All firms	\$2,611	\$2,231	17%	56%
Firms with less than 100 employees	\$2,711	\$2,139	26.7%	56%

Adapted from: DeLuca, D, Greenland, A, Guyton, J, Hennessy, S, and Kindlon, A. (2005). *Measuring the Tax Compliance Burden of Small Business*. Paper read at Internal Revenue Services' Research Conference, 7-8 June, at Washington DC, Table 5, at p 83.

There are a number of characteristics of the United Kingdom tax system that reduce the advantages of LLPs compared to the taxation of corporations. In the United Kingdom, corporations are assessed to a corporation's tax on profits under a separate act.⁵² A corporation's assessed profits include both income and

savings represented by transparency have reduced to 27 per cent for the 2006 year: \$447.50 divided by \$350.

⁵² *Income and Corporation Taxes Act 1988* (UK), section 6(1): A corporation which is resident in the United Kingdom is chargeable to corporate tax in respect of all its profits wherever arising. United Kingdom resident corporations are, however, not liable in respect of dividends received from other United Kingdom resident corporations.

chargeable capital gains, with indexation available for capital gains.⁵³ For the 2008 year the first £300,000 profit of a corporation is assessed at 21 per cent; for profits in excess of £1.5 million, the rate is 28 per cent.⁵⁴ From 2002 to 2006 there was a special rate that applied to small corporations, but this has been abolished.⁵⁵

It should be noted that United Kingdom now has a notional dividend tax credit system, this being a form of integration for corporate distributions.⁵⁶ To explain: for a member receiving a dividend from a corporation, the member would be assessed on it as savings income,⁵⁷ and the member would gross-up the receipt by one-ninth of the dividend amount, and then claim a non-refundable tax credit equivalent to the gross-up amount.⁵⁸ This system of dividend relief replaces the previous partial imputation system that operated in the United Kingdom from 1973 to 1997.⁵⁹ If a corporation member disposes of their membership interest,

⁵³ *Income and Corporation Taxes Act 1988* (UK), section 6(4).

⁵⁴ *Finance Act 2002* (UK), section 30. Prior to 2008 the corporate tax rate was 30 per cent. Before 6 April 1999, corporations making distributions had to pay advanced corporation tax as part of the United Kingdom's imputation system. The rate between these two figures is 30 per cent less an amount to ease the transition to the highest rate, using a fraction.

⁵⁵ For a period there was a lower rate applying to very small corporations, which was initially ten per cent and then reduced to nil per cent (commencing 1 April 2002), before being totally abolished starting 6 April 2006. *Income and Corporation Taxes Act 1988* (UK), sections 13 and 13AA. Freedman, J. (2000). Limited Liability: Large Company Theory and Small Firms. *The Modern Law Review* 63 (3):317, at p 325.

⁵⁶ This requires a corporation to pay an additional tax (known as the non-corporate distribution rate) when a corporation has an underlying rate of tax less than 19 per cent and it makes a distribution to a person not a corporation. *Income and Corporation Taxes Act 1988* (UK), section 13AB inserted by *Finance Act 2004* (UK), section 28, Schedule 3, paragraph 2. Applies from 31 March 2004.

⁵⁷ *Income and Corporation Taxes Act 1988* (UK), section 20 - under Schedule F.

⁵⁸ Collison, D, and Tiley, J. (2005). *Simon's Tiley and Collision UK Tax Guide 2005-06*. London: LexisNexis Butterworths, at p 1008.

⁵⁹ Kay, JA, and King, MA. (1990). *The British Tax System*. 5 ed. Oxford: Oxford University Press, at p 166; and Collison and Tiley, n 58, at p 1008. The United Kingdom had an imputation system from 1973 to 1997. The rate of imputation was set equal to the basic rate of income tax. It was only a 'partial imputation' system since only a part of the corporation tax paid by the corporation was imputed to the member. In order to ensure that the tax used as a credit by the member represented tax paid by the corporation, the corporation when paying the dividend (or any other qualifying distribution) had to pay advance corporation tax (ACT) to the HM Revenue and Customs (United Kingdom Revenue). Liability to pay ACT arose whether or not the corporation was liable to pay corporation tax, for example through lack of profits. The ACT was set against the corporation's liability to corporation tax.

this could result in a chargeable gain to the member. However, CGT taper relief could reduce the burden of this.⁶⁰

Example 8-0-10 to Example 8-0-21 detail the tax implications when profits are either distributed or accumulated by corporations and LLPs in the United Kingdom. These examples illustrate that there is no guarantee that the LLP will produce a lower overall tax burden.

As previously highlighted, Example 8-0-10 and Example 8-0-13 demonstrate that the overall tax burden in effect is lower in a corporate scenario when there is accumulation and then disposal of membership interest. This contrasts with the situation where there are yearly distributions which produce a higher tax burden. This accumulation advantage of the corporation is enhanced by the fact that, prior to disposal of membership interest, tax liability was lower, thereby providing a timing advantage. However, the overall tax burden for accumulation would have been greater without the CGT taper relief. Furthermore, disregarding the imposition of employment taxes, Example 8-0-11 illustrates that the tax payable through an LLP can be greater compared to corporation: Example 8-0-13.

In New Zealand, the relationship between LAQCs and other corporations is more closely aligned, due to the LAQC being a partial loss transparent company and a full imputation system applying to corporations. Indeed there is largely tax equivalence between LAQCs and corporations in New Zealand, unless there are tax losses or tax preferences. Example 8-0-22 and Example 8-0-23 demonstrate that there is no overall tax burden difference between the LAQC and a corporation when there are no tax preferences with all earnings assessable and where these after-tax profits are distributed to members.

⁶⁰ One such CGT taper relief includes the business CGT taper relief applying to periods of ownership from 6 April 2000. To qualify for small business CGT taper relief, either (a) the individual is an employee of the corporation; or (b) the corporation is unlisted or the corporation is listed and the member is able to exercise five per cent or greater of the votes.

8.3.5 Active members

Chapter Two outlined prior research which illustrated that members of closely held businesses are likely to be active in the business. In the jurisdictions studied, there are issues pertaining to the tax treatment of active members and, in particular, whether they should be treated as self-employed or as an employee. Such status can influence the overall level of tax payable. For an active member, the S Corporation can be advantageous when compared with that of a member of an LLC in the United States.⁶¹ In the United Kingdom, the LLP can be particularly advantageous for active members when compared to corporations. Equally, New Zealand's LAQC can be advantageous compared with general partnerships. Given the variations, this raises the issue of should be the appropriate treatment for an active member of a transparent company.

For the United States' transparent companies, when members are active in the business, income allocations, member wages and fringe benefits can be treated differently. In terms of the tax treatment of an S Corporation, it is possible for the member to be regarded as an employee, even if the member owns 100 per cent of the membership interests in the S Corporation. This situation denotes 'entity acknowledgement' for the S Corporation and its active members, because the S Corporation is acknowledged as a separate legal entity to the member, thereby enabling it to be the employer of the member. In view of this, wages that are paid to an active member for work should meet standards of reasonable compensation⁶² and this would then be an allowable deduction for the S Corporation. For the member, such wages would be assessable income.

⁶¹ The potential savings offered by the two transparent companies in the United States is not equivalent. There are numerous differences in their precise treatment, including tax implications for contributions or distributions of assets between members and the transparent company, the ability to stream allocations and the application of employment taxes.

⁶² AICPA Tax Division's S Corporation Taxation Technical Resource Panel. (2004). Renewed Focus on S Corp. Officer Compensation, *Tax Advisor*, May, at p 280. Small Business Administration. (2003). *Forms of Business Ownership 2003* [cited 15 December 2003]. Available from http://www.sba.gov/starting_business/legal/forms.html, at p 4. What is reasonable could take into account geographical region and occupation.

However, in addition to income taxes, in the United States wages paid would be subject to employment and social security taxes (employment taxes), which amount up to an additional 15.3 per cent.⁶³

In comparison to 'wages' paid to an active member, business 'income' that is allocated to S Corporation members while assessable to them, it is, however, not subject to employment taxes.⁶⁴ The imposition of employment taxes on wages paid to members may encourage the payment of lower wages to active members, with the balance being taken out through higher allocations of income to members.⁶⁵ This arrangement would not be effective if the S Corporation member's wages were not reasonable. However, what precisely is 'reasonable' is a malleable and difficult concept to quantify at times,⁶⁶ and enforcement by the United States' IRS can be difficult due to factual determinations made on a case-by-case basis.⁶⁷

Unlike S Corporations, an LLC member usually does not qualify as an employee of the LLC for tax purposes. Instead more of an aggregate approach is utilised, with an LLC member treated as self-employed.⁶⁸ That is, the LLC is not

⁶³ Such as employment taxes, federal social-security taxes (FICA), medicare taxes, interest and penalties. *IRC 1986* (US), sections 1401 and 3101 impose self-employment tax on an individual's net earnings from self-employment. In 2005, the self-employment tax and combined social security tax rate was 12.4 per cent on earnings up to \$90,000, and 2.9 per cent on all earnings above that for hospital insurance. Specified types of income can be excluded, such as rentals from real estate, dividends, interest, capital gains and losses from timber, certain non-inventory mineral income and retirement payments: see Joint Committee on Taxation, n 33, at p 29.

⁶⁴ Revenue Ruling 59-221, 1959-1 C.B. 225.

⁶⁵ If there were lower wage expenses, then this would increase the transparent company's income, which the S Corporation would allocate to members for the taxable year. Also the elimination of the cap on hospital insurance could also encourage lower wages. Joint Committee on Taxation, n 33, at p 32. The cap on hospital insurance component was eliminated by the *Revenue Reconciliation Act of 1993* (US); this means that paying hospital insurance tax on higher wages does not increase the individual's Medicare benefits. Note that self-employed persons can now deduct health insurance where previously they could not.

⁶⁶ Joint Committee on Taxation, n 33, at p 34: The addition of the independent investor test used in the Seventh Circuit (partially recognised by others) has altered the prediction of multi-factor test used by judges in determining reasonable compensation.

⁶⁷ Joint Committee on Taxation, n 33, at p 30.

⁶⁸ Boyd, JH, Crumbley, DL, Davis, JS, Dilley, SC, Hoffman Jnr, WH, Maloney, DM, McGill, GA, Persellin, MB, Raabe, WA, Randall, BC, Sanders, DL, Seago, WE, Smith, JE, and Willis, E.

recognised as a separate taxpayer from its active member and, consequently, a member cannot then be employed by him or herself. This has the resultant consequence that the entire allocation of income to an LLC member (including guarantee amounts)⁶⁹ is likely to be regarded as self-employment income, and is consequently subject to employment taxes.⁷⁰ Thus, in effect, this means that the entire LLC allocation could be subject to employment taxes in addition to income taxes. Contrast this situation with that pertaining to an S Corporation where, for the active member, only the reasonable wages paid to him or her are subject to employment taxes.

Some commentators argue that allocations to LLC members as a 'limited partner'⁷¹ should not be subject to employment taxes.⁷² This has resulted in planning strategies, including the imposition of an additional LLC between the active member and the LLC conducting the business. The efficacy of these

(2005). *Corporations, Partnerships, Estates and Trusts*. Edited by W. Hoffman Jnr, W. Raabe, J. Smith and D. Maloney. 2005 ed. Mason: Thomson South-Western, at p 10-40.

⁶⁹ A guarantee payment is a payment for services performed by the members or for the use of the member's capital, usually expressed as a fixed dollar amount. Guarantee amounts would be assessable income to the member, and an allowable deduction for the LLC: *IRC 1986* (US), section 707(c).

⁷⁰ *IRC 1986* (US), section 1402(a): provides that self-employment income includes the distributive share (whether or not distributed) of income or loss from any trade or business carried on by a partnership of which the individual is a member.

⁷¹ Limited partners are excluded from employment tax: *IRC 1986* (US), section 1402(a)(13). Proposed Regulation, section 1.1402(a)-2(h)(2) provides that an individual is treated as a limited partner unless: (a) has personal liability; (b) has authority to contract on behalf of the partnership; or (c) participates for greater than 500 hours in the business for the year. Note if not a limited partner because of greater than 500 hours involvement, it is still possible to be a limited partner if other identical membership interest are held by limited partners: Proposed Regulations, section 1.1402(a)-(2)(h)(4).

⁷² *IRC 1986* (US), section 1402(a)(13). Friedman, HM. (2004). The Silent LLC Revolution - The Social Cost of Academic Neglect. *Creighton Law Review* 38(1), at p 27: In 1997, the United States IRS proposed a controversial set of regulations that would have helped LLC investors determine more clearly their self-employment tax liability. Definition of Limited Partner for Self-Employment Tax Purposes, Treasury Regulation, 1702 (13 Jan 1997). The proposal was so controversial that Congress at one point imposed a one-year moratorium on their adoption. *Taxpayer Relief Act of 1997*, section 935, 111 Stat. 788, 882. Those regulations have never been adopted in final form, so it is somewhat uncertain the extent of their liability for self-employment tax. The proposed regulations remain the only definitive guide to applying the *IRC 1986* (US): Koski, TR. (2005). Self-Employment Tax and Limited Liability Companies: When are LLC Earnings Subject to Self-Employment Tax? *Taxes - The Tax Magazine* September: 33, at p 34. It appears though that the United States IRS has been increasing will to rely on the proposed regulations.

strategies is by no means certain as they have not been subjected to judicial scrutiny.⁷³ The conservative view is that LLC allocations are subject to employment taxes, whereas a more aggressive position argues they are not. A 'middle ground' has been propounded whereby only active LLC members' allocations should be subject to employment taxes.

It is important to note that the imposition of employment taxes may reverse the initial benefit in the United States of the transparent treatment over a C Corporation. This is highlighted in Example 8-0-1 and Example 8-0-2. Of course, the C Corporation could have employees to conduct the business, thereby incurring employment tax as well, which would reduce the differential.

The United States Government is aware of the discrepancies in relation to the application of employment taxes between S Corporations and LLCs.⁷⁴ Research concludes that S Corporations might be a 'multi-billion employment tax shelter'⁷⁵ that is worth an estimated \$39 billion in lost tax revenue for the 2001 year.⁷⁶ Hence, there are current proposals on the political agenda designed to treat members as self-employed if the S Corporation conducts a 'service business'. For such service businesses, all allocations from an S Corporation would be subject to employment taxes like LLC members, although these are yet to be implemented.⁷⁷

⁷³ Koski, n 72, at pp 37-38. One argument that appears to be used is that the regulations refer to 'partner' and not a 'member', which an LLC member is, and so the regulations should therefore not apply.

⁷⁴ It was reported that a prior Vice Presidential candidate John Edwards (running partner with Al Gore) appreciated the difference between allocations and wages, prompting him to use an S Corporation rather than an entity subject to Sub-Chapter K for the conduct of his law business to minimise self employment taxes. [cited 8 March 2007]. Available from: <http://www.traderstatus.com/IRSauidits.htm>.

⁷⁵ Treasury Inspector General for Tax Administration. (2005). *Actions are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations*, Reference No. 2005-30,080, at p 2.

⁷⁶ Internal Revenue Services (US). (2006). IRS Updates Tax Gap Estimates, IR 2006-28, February 14.

⁷⁷ Joint Committee on Taxation, n 33, at p 31. For this purpose, a service partnership is a partnership (including an LLC or other entity that is treated as a partnership for Federal income tax purposes), substantially all of whose activities involve the performance of services in the fields

Due to the application of employment taxes, members of an S Corporation may have a lower overall tax burden compared to members of an equivalent LLC. The potential saving offered by S Corporations to compared LLCs is illustrated in Figure 8-0-2, which demonstrates that while both S Corporations and LLCs are treated as transparent for income tax purposes, the application of employment taxes to LLC allocations could increase the overall tax burden. Indeed, the application of employment taxes means that from 2003, with the temporary tax relief measures for C Corporation distributions and capital gains, the level of taxation on LLC and their members may be greater than on their C Corporation equivalents. This could explain the reported practice of LLCs electing for C Corporation treatment and then S Corporation status. In this manner a business can take advantage of the LLC's governance rules and the overall lower employment tax implications for an S Corporation.

If the treatment of active member LLCs has the consequence that their tax benefits are now not greater than C Corporations, future utilisation of LLCs may provide some empirical evidence that the LLC does, in actual fact, provide benefits beyond their tax treatment. However, this finding is by no means conclusive as there are other tax benefits obtainable through Sub-Chapter K, compared to Sub-Chapter C governed entities, including access to tax losses and the deferral of tax on the transfer of assets between members and the LLC.

Additionally, it is important to note that the difference in employment tax treatment may provide the justification or rationale behind the continued use of S Corporations in the United States. The data in Chapter Three demonstrates that even with the increased utilisation of LLCs, the number of S Corporations have steadily increased at an average rate of six per cent since 1994.

of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.

Figure 8-0-2: US: Employment tax savings – S Corporations & LLCs

Source: Internal Revenue Service (US). (1981 – 2005) Tax Statistics of tax rates. Available at: <http://www.irs.gov/taxstats/index.html>

A related issue here is the provision of ‘benefits’ to active members. Unlike with income allocations, there is greater consistency of fringe benefits provided by S Corporations and LLCs to members, and therefore greater tax neutrality. In terms of fringe benefits an aggregate approach is used, because an active member of an S Corporation with more than two per cent of the membership interest (greater than two per cent members) is essentially treated as self-employed and not as an employee.⁷⁸ Like LLC members, greater than two per cent members of S Corporations are not eligible to receive tax favoured fringe benefits from their transparent company employer.⁷⁹ Instead, the provisions of such benefits would be treated as distributions by the transparent company and taxed as such.⁸⁰

⁷⁸ IRC 1986 (US), section 1372. Section 1372 invokes section 318 allocation rules for application of the more than 2 per cent rule.

⁷⁹ McNulty, JK. (1992). *Federal Income Taxation of S Corporations*. New York: The Foundation Press Inc, at p 62. Such favourable fringe benefits would include excludable health and accident plans or policies: IRC 1986 (US), sections 105, 106, group-term life insurance and employer-provided meals and lodging: IRC 1986 (US), section 132. However, there are still some fringe

It is unclear, in this respect, precisely why there is this discrepancy between employment taxes, on the one hand, and fringe benefits for United States' transparent companies on the other hand.⁸¹ The discrepancy or miss-match appears to be a consequence of legislative oversight, rather than deliberate policy formation. The application of employment and fringe benefits taxes illustrates the tension between a full aggregate approach and an alternative approach comprising transparency with some 'entity acknowledgement'.

It is argued that the inconsistent application of employment taxes between S Corporations and LLCs is not desirable. A simple way that this could be rectified is by treating all greater than two per cent members of S Corporations as self-employed. Allocations to these members would then be subject to employment taxes like LLCs and this would in turn enhance tax neutrality. Also, as this approach employs a distinction already used for fringe benefits, then this should consequently reduce compliance costs. Alternatively, if a member is regarded as 'active' (pursuant to the passive loss rules) then he or she should be regarded as self-employed irrespective of which transparent company is utilised. This test would then eliminate passive investors from being regarded as self-employed, which, by the nature of their investment they are not.⁸²

benefits that can be provided by the S Corporation to an active member, and there have been some alterations to allow self employees to deduct certain expenses, such as private health insurance.

⁸⁰ *IRC 1986* (US), section 1402(a). Actual distributions would not be assessed to the extent of the membership cost basis. Any excess would normally be assessed as a capital gain.

⁸¹ Note increasingly the difference between self-employed and employees has been decreasing, as now self-employed can deduct 100 per cent of their health insurance, and some fringe benefits are available to them.

⁸² The proposed reforms before the Senate Committee do not recommend either of these alternatives. Instead they recommend an approach that will raise additional tax revenue by addressing 'professional' firms only. It is argued that this proposal is better understood in terms of being politically acceptable, rather than trying to improve tax neutrality. Joint Committee on Taxation, n 33, at pp 31 and 34.

The application of employment taxes in the United Kingdom can influence the level of tax imposed on a corporation, compared to that of an LLP. In terms of non-active members, the United Kingdom corporate form could be quite instrumentally advantageous or beneficial compared to the LLP. Example 8-0-10, Example 8-0-11 and Example 8-0-13 illustrate that a corporation with either a distribution policy or an accumulation policy tends to produce an overall tax advantage, compared to the position that pertains to an LLP.⁸³ This is because LLP members are treated as self-employed and, in addition to the imposition of income tax, they are also subject to a National Insurance Contribution (NIC) liability which, in turn, increases their overall tax burden.⁸⁴ However, given that closely held businesses can be characterised by active members, the corporation's initial advantage will be reduced when corporate members are actively engaged in the underlying business activities. This is because when an active member is present in the corporation, the latter entity should be paying reasonable wages, with a resultant NIC obligation imposed for both employer and employee. The overall rates of NIC that are applicable to a corporation are greater than those applicable to an LLP self-employed situation.

In terms of a corporation which employs its members, an overall NIC rate of up to 23.8 per cent could indeed be payable, with some by the corporation as

⁸³ This observation is made in Crawford, C, and Freedman, J. (2008). *Small Business Taxation*. In *Prepared for the Report of a Commission on Reforming the Tax System for the 21st Century*, Chaired by Sir James Mirrless: The Institute of Fiscal Studies, at p 2.

⁸⁴ The NIC is a hypothecated tax to pay most of the cost of retirement pensions, unemployment benefits and sickness benefits. It should be acknowledged that in the circumstance that the member was not engaged as an employee by the corporation, it is likely that a non-member would have to be employed with a resulting NIC obligation anyway. Also, a self-employed person will qualify to be relieved by pension contributions (subject to annual limits), whereas dividend income cannot be relieved in this way: Thompson, N. (2006). Look before you LLP. *Accountancy Magazine* January:110, at p 110. Normally, an LLP member is not to be regarded for any purpose as employed by the LLP unless the member would be regarded as employed by a general partnership in like circumstances. *LLP Act 2000* (UK), section 4(4). If treated as employee, then the LLP member would be within the scope of the *Income Tax (Earnings and Pensions) Act 2003* (UK) and with the NIC consequences of employer/employee relationship. *PDC Copyright (South) v George* (Sp C 141), [1997] SSCD 326.

employer, and the remainder then being paid by the employee-member.⁸⁵ Of course, reasonable remuneration and the NIC will be deductible for the corporation.⁸⁶ The impact of NIC in a closely held corporation can be mitigated if an employee-member takes payments out of the corporation by way of dividend instead of remuneration,⁸⁷ as dividends are not subject to NIC and carry the benefit of a tax credit.

In contrast, when the LLP form is utilised, an LLP member would be regarded as self-employed rather than as an employee, and thus subject to a lower NIC rate. The maximum NIC rate applicable to those who are self-employed is approximately nine per cent.⁸⁸ Accordingly, an LLP member would be subject to an overall NIC rate of nine per cent on allocated income, compared with up to 23.8 per cent for an employee-member of a corporation. Due to this disparity the LLP can be an attractive alternative to a corporation when the members are actively engaged in the business.⁸⁹ The impact of NIC was identified as part of

⁸⁵ For the 2007 year employees are assessed as Class One (primary contributions) once they have earnings over the threshold of £97 per week, between this figure and £645 a rate of 11 per cent applies. Employees' income over £645 per week is not subject to NIC. Employers are also liable to Class One (known as secondary contributions), and payroll in excess of £97 each week, being subject to 12.8 per cent with no cap. The application of the NIC on employers is more akin to a payroll tax. NIC can also apply to fringe benefits provided to employees (known as Class 1A).

⁸⁶ Freedman, J, and Ward, J. (2000). *Taxation of Small and Medium-Sized Enterprises*. *European Taxation* May:158, at p 166: "... if it is unreasonable in amount, it may be partially disallowed under the 'wholly and exclusively' rule". Crawford and Freedman, n 83, at p 2: Alternatively, profits could be retained in the corporation and then realised as capital gain on sale or liquidation.

⁸⁷ However, this would not be unrestricted as the employee-member would be entitled to a reasonable remuneration, although what is 'reasonable' is arguable.

⁸⁸ Inland Revenue (UK). (2000). *Limited Liability Partnerships*, *Inland Revenue Tax Bulletin – Issue 50*. [cited 20 September 2006]. Available from: <http://www.hmrc.gov.uk/bulletins/tb50.htm#2>; confirms members of LLP will be liable for Class 2, 3 and 4 NIC as appropriate. For self-employed persons they are initially subject to Class 2 NIC which is a flat £2.10 per week – although they can be exempted if their yearly profit is below £4,465 per year (2007 year). In addition to Class 2 NIC, self-employed persons can be subject to Class 4 NIC, which is 8 per cent on profits from £5,035 to £33,450, and then 9 per cent of profits in excess of £33,450. NIC would apply to a non employee-member of an LLP as there is no requirement that the member carries on the business: *McDougall v Smith* 7 TC 134.

⁸⁹ Crawford and Freedman, n 83: "Another benefit of self-employment status is that tax deductions may be more accessible due to a less stringent deductibility test compared to employees. Employee's test is 'incurred wholly, exclusively and necessarily in the performance of the duties of employment': *Income Tax (Earnings and Pensions) Act* 2003 (UK), section 336. Self-employed test is 'incurred wholly and exclusively for the purpose of trade: *Income Tax (Trading and Other Income) Act* 2005 (UK), section 34.

the reason professional firms lobbied for the introduction of LLPs with general partnership tax treatment. This was despite the fact that the firms could have utilised a corporate form to obtain liability protection.⁹⁰ The greater tax impost arising for a corporation with an active member compared to the same situation with an LLP is illustrated in Example 8-0-17 and Example 8-0-11.

In contrast to the United States position with employment taxes, a self-employment status can be advantageous in the United Kingdom in terms of the application of the NIC.⁹¹ Given the high participation rates of members in closely held businesses, this tax advantage of an LLP over a corporation could be substantial. Of course, there are strategies used by the corporate form to limit NIC application — particularly in terms of determining what level of ‘reasonable’ wages accrue to active members.⁹²

While New Zealand does not have an employment tax or payroll tax, the status of employment is important for fringe benefits tax purposes. Due to entity acknowledgement, an active member of a LAQC is treated as an employee and thus is able to access the concessional treatment of fringe benefits. If fringe benefits are provided to LAQC employee-members, the expenditure incurred in providing these benefits should be fully deductible for the LAQC.⁹³ It should be

⁹⁰ Refer to the discussion in Chapter Four about the drivers influencing the introduction of LLPs in the United Kingdom.

⁹¹ An employee-member of a corporation would result in an overall NIC rate of approximately 23.8 per cent NIC being payable. For the employee-members being liable for NIC on their wages (up to 11 per cent for wages up to 615 pounds per week) and then the corporation as their employer liable to 12.8 per cent on their wages. This is compared to employee-member of an LLP being regarded as self-employed, subject to at most 9 per cent (plus \$2.10 per week). Whittaker, J, and J Machell. (2001). *Limited Liability Partnerships: The new law*. Bristol: Jordans, at p 204. *Social Security Contributions and Benefits Act 1992* (UK), section 15. The clause is silent in respect of the other classes of National Insurance contributions, but the Revenue have confirmed that members of an LLP will also be liable to Class 2 National Insurance contributions and/or, where applicable, Class 4 National Insurance contributions: see Tax Bulletin Issue 50.

⁹² Crawford and Freedman, n 83: Argues that the rate of NIC should be aligned between self-employed and employees. These methods for reducing the impact of NIC are similar to what was previously outlined for S Corporations.

⁹³ This is subject to the stipulation that they meet the normal deductibility criteria.

noted that the LAQC could be liable for FBT⁹⁴ and this benefit would be non-assessable to the employee-member.⁹⁵ Although, this treatment is consistent with other corporations in New Zealand, it is at odds with the benefits provided to members of a general partnership.⁹⁶ This is because general partnerships are not separate legal entities to their members, and therefore a member cannot be an employee of a partnership in which the member has an equity investment.⁹⁷ The consequence of this is that a benefit provided to a member of a general partnership is non-deductible — in terms of the general partnership and assessable to the member. This difference between LAQCs and general partnerships appears to result from an entity acknowledgement for LAQCs, rather than from the adoption of a full aggregate approach.⁹⁸

Unlike the S Corporation, the LAQC does not use a two per cent membership test to provide greater tax neutrality between transparent companies and general partnerships. It is argued that the status of active members is an important consideration for the implementation of a transparent company. A universal proposal is outlined later in this chapter.

8.3.6 Debt versus equity funding

Chapter Two outlined the contention that tax transparency can eliminate the tax preference for debt rather than equity funding, thereby providing greater tax

⁹⁴ Normally when a fringe benefit is provided by a corporation, then the corporation pays 64 per cent tax on specific benefits provided to employees. These benefits include the use of cars, low interest loans, contributions to insurance and superannuation. Inland Revenue (NZ), n 6, at p 41.

⁹⁵ Inland Revenue (NZ), n 6, at p 41.

⁹⁶ As well as benefits that sole proprietors might provide to the member.

⁹⁷ Case S75 85 ATC 544: holding that a partner salary was not deductible.

⁹⁸ Also, because members of a general partnership cannot be employees of the general partnership, so there can be no deduction normally for the salaries paid to them, seen as drawings: Case F123 (1984) 6 NZTC 60, 157; and Case L28 (1989) 11 NZTC 1,172. The exceptions to this are (a) when member's salary is made under a written contract of service; and (b) when tax deduction allowed for pension is of a reasonable amount. Renting of property from general partnership member is deductible provided reasonable. Interest on capital contributions is not deductible, but on proper member-to-general partnership loans is deductible .

neutrality between these two sources of financing. In comparison, an entity approach to business taxation can result in a preference for debt funding. It is worthwhile considering whether tax neutrality between debt and equity funding has been achieved with the transparent companies studied, particularly as closely held businesses can be characterised by a reliance on equity funding.

Example 8-0-1 and Example 8-0-9 illustrate the different levels of tax burden between debt and equity funding for a C Corporation. These examples demonstrate how the tax system pursuant to Sub-Chapter C in the United States can result in a preference for debt rather than for equity funding by members. As can be seen, this is because the overall tax burden is lower with debt compared to equity.⁹⁹ If not for the temporary relief provided to dividends, the difference between the two sources of finance would be greater. Example 8-0-2 demonstrates that transparent treatment does achieve the same level of tax between equity and debt funding in each circumstance, thereby reducing the arbitrage between these sources of finance.

Example 8-0-10 and Example 8-0-12 illustrate that with the current tax system for corporations in the United Kingdom there can be a preference for debt rather than for equity funding by members, as the overall tax burden is lower with debt compared to equity. Further, Example 8-0-11 demonstrates that the transparent treatment of the LLP does tend to reduce — although not eliminate — the arbitrage between debt and equity funding. It is suggested that this remaining difference is due to the differential tax rates that are applicable to different types of income for individuals in the United Kingdom. Accordingly, there could still be advantages in members' debt funding an LLP.

Example 8-0-22 and Example 8-0-25 illustrate how, with the current New Zealand tax system, the overall tax burden can be equivalent between debt and

⁹⁹ This inconsistency continues to exist even with the temporary tax relief provided to C Corporation dividends.

equity funding. This equivalence is due to New Zealand's full imputation which is a system of tax integration.

The examples illustrate that tax transparency in the jurisdictions studied can improve tax neutrality between debt and equity funding.¹⁰⁰ This is important as the contributions by members may be more accurately categorised as equity compared to debt. Additionally, improved tax neutrality may tend to reduce the desire to use debt in situations when servicing the debt could be problematic, and this has the consequence of not penalising businesses that rely on equity funding. However, due to risk exposure of equity amounts, members may prefer to fund operations through loans so they rank with other creditors.

Attention now turns to advocating for universal transparency eligibility and treatment of members in the specific context of employment taxes.

8.4 Overall themes

This chapter has established that a major impediment to the raising of equity can be eligibility requirements for transparency. Accordingly, it is argued that due consideration needs to be given to the form that these eligibility requirements should take. As a corollary to this contention, the section further stresses the need for a consistent treatment for active members for employment taxes.

8.4.1 *Transparency eligibility*

Overly restrictive eligibility for transparency has the deleterious consequence of reducing the capacity of the business to raise equity. It is argued that the

¹⁰⁰ Note the examples are on the basis of resident members. The application of withholding tax for non-resident members may provide differences between debt and equity funding.

proposed eligibility requirements below provide sufficient flexibility to allow for the raising of equity while at the same time not compromising the integrity of the tax system.

The United States' circumstances provide an interesting comparison, as it has two transparent companies with vastly different eligibility requirements. McNulty, in the early 1990s, identified the enactment of LLC legislation across the United States as illustrating the need to liberalise S Corporations eligibility requirements.¹⁰¹ Indeed, since this time, there has been liberalisation of the S Corporation's eligibility requirements in 1996¹⁰² and 2004.¹⁰³ However, there is still a push for further relaxation with the proposed amendments of 2005 and 2006.¹⁰⁴ It is argued that a major justification for this relaxation for S Corporations in the United States is that it is hard to justify the different eligibility requirements

¹⁰¹ McNulty, n 79, at p 204.

¹⁰² These are in addition to the reforms that occurred in 1981 and 1982. The 1982 reforms saw removal of the 80 per cent foreign income restriction *IRC 1986* (US), section 1372(e); and specification that differences in transfer and voting rights did not create a second class of membership interest: *IRC 1986* (US), section 1361(c)(4). In 1996, certain trust were allowed to hold membership interests and S Corporations were able to hold 100 per cent of subsidiary corporations: *IRC 1986* (US), section 1361(b)(3)(B), known as QSSS.

¹⁰³ The 2004 amendments included allowing some bank trading activity, the creation of employee stock ownership plans, and providing for the increase in membership number to 100: *IRC 1986* (US), section 1361(b)(1)(A), with the aggregation of family members in this count: *IRC 1986* (US), section 1361(c)(1)(B).

¹⁰⁴ The proposed 2005 amendments are in *S Corporation Reform of 2005 Bill* (US), which was before the House Committee on Ways and Means. If implemented, these proposed 2005 amendments would further enhance an S Corporation's flexibility, as they would allow trusts constituting an individual's retirement account [Proposed *IRC 1986* (US), section 1361(c)(2)(A)(vi)], and non-residents to become members of an S Corporation: *S Corporation Reform of 2005 Bill* (US), section 9. To ensure tax is collected from allocations to non-resident members, the proposed 2005 amendments would subject such allocations to a withholding tax similar to that non-resident members of general partnerships are: *IRC 1986* (US), section 1446. The proposed 2005 amendments also extended the type of membership interests by allowing qualified preferred stock (membership interest) [Defined in *IRC 1986* (US), section 1504] not to be treated as a second class of membership interest or the person as a member. *S Corporation Reform of 2005 Bill* (US), proposed section 1361(f)(3). These proposed amendments are similar to what was proposed by the American Law Institute in its 'Taxation of Pass-Through Entities' Reporters Study. The proposed 2005 amendments provide that preferred membership interest will be treated as a debt, with distributions deductible to the S Corporation and assessable to the holder. Additionally, the proposed reforms wanted to expand the safe harbour provisions to include debt convertible into membership interest, provided such terms could be made to an unrelated person: Defined in *IRC 1986* (US), section 465(b)(3)(C). *S Corporation Reform of 2005 Bill* (US), proposed section 1361(c)(5)(ii) and (iii).

for transparency between S Corporations and LLCs when they have similar underlying legal characteristics.

In this context, it is argued that the 2006 proposals did not go far enough in their liberalisation objective, and that both transparent company forms in the United States should be subject to the one standardised regime. This inconsistency is further highlighted by the fact that the Check-the-Box regulations allow certain foreign corporations to Check-the-Box and elect for transparency under Sub-Chapter K, whereas corporations formed within the United States are not entitled to do this. Many of these foreign corporations, such as an Australian private company, can have similar governance regimes and legal characteristics as an S Corporation. When viewed in this context, this inconsistency between domestic and foreign corporations is difficult to justify. Also, it should be noted that it is possible for a C Corporation to hold the membership interests in an LLC, whereas it cannot readily do so for an S Corporation.¹⁰⁵

It is argued that a number of the eligibility requirements for special tax rule companies do not in themselves justify exclusion from tax transparency; instead, other 'general' mechanisms in the tax system should be able to adequately deal with the underlying concerns that the eligibility restrictions represent. For example, the prohibition of non-resident members could be adequately covered through the implementation of withholding tax rules on income allocations. Indeed, this is the mechanism used for LAQCs, LLCs and LLPs and with the ICAA proposal.¹⁰⁶

¹⁰⁵ In the circumstances that the C Corporation holds all the membership interests in the LLC, then the LLC would be a disregarded entity, meaning all of the LLC's activity is treated as the C Corporations; this saves doing annual tax consolidations, and can allow for tax free re-organisations when another corporation is acquired. The new corporation can acquire the LLC's assets in exchange for shares in the holding corporation.

¹⁰⁶ Institute of Chartered Accountants in Australia and Deloitte. (2008). Entity flow-through (EFT) submission. Sydney: Institute of Chartered Accountants, at paragraph 3.24.

For S Corporations it is understood that non-residents were excluded due to the potential risk to revenue as allocated income to a non-resident member may have escaped taxation in the United States. This is because if a non-resident S Corporation member was not actively involved in the business, then as a non-resident only fixed income (interest and dividends) sourced in the United States would be taxed - with other income not subject to tax.¹⁰⁷ It was for similar concerns that the residency requirement for LAQCs (compared to members) in New Zealand was one of the eligibility requirements.¹⁰⁸ However, others have pointed out that rather than excluding non-resident members, this could be addressed by applying withholding tax rules.¹⁰⁹

For example, because the taxation of the United States' LLC and its members occurs pursuant to a different sub-chapter, this means that LLC members are regarded as engaged in the business activity conducted by the LLC, and accordingly they are automatically subject to withholding tax on allocations to them.¹¹⁰ Others have argued that non-residents should also be excluded due to the potential complexity involved, including calculating the appropriate level of tax due to ascertaining world-wide income and administrative problems in applying a withholding tax.¹¹¹

Nevertheless, it is argued that while allowing non-resident members does potentially impose a risk to revenue, provided there are adequate withholding

¹⁰⁷ A foreign member is allowed a credit for the tax withheld. If the income is not connected with trade in the United States then the withholding tax rate is generally 30 percent unless a Double Tax Agreement applies a lower rate: *IRC 1986* (US), section 1146(a). Mundstock, G. (2006). *A Unified Approach to Subchapter K & S*. St Paul: Thomson/West, at p 229.

¹⁰⁸ In the New Zealand circumstances the residency requirement was to ensure that the foreign dividend withholding payment regime was not deliberated: Freudenberg, B. (2005). Is the New Zealand Qualifying Company regime achieving its original objectives? *New Zealand Journal of Taxation Law and Policy* 11(2):185, at p 195.

¹⁰⁹ American Bar Association, Section of Taxation, Committee on S Corporations and Partnerships. (1991). Report on the Comparison of S Corporations and Partnerships: Part I. *The Tax Lawyer* 44(2):483.

¹¹⁰ Mundstock, n 107, at p 229.

¹¹¹ Yin, GK., and Shakow, DJ. (1999). Taxation of Private Business Enterprises. In *Federal Income Tax Project*. Philadelphia: The American Law Institute, at p 106.

measures for allocations to them, they should not be excluded. Indeed, by excluding non-residents from being eligible members, there is the potential to breach the non-discrimination article in Double Tax Agreements that Australia has entered into with other countries.¹¹² Another concern with non-resident members is that there may be an erosion of the tax revenue due to lower rates of withholding tax applying to their allocations pursuant to Double Tax Agreements.¹¹³ However, determination of this depends upon how the allocations to members are characterised. If allocations are treated as 'dividend' payments, then lower withholding tax rates can apply.¹¹⁴ However, if instead members are treated as carrying on the underlying business of the transparent company, then the appropriate article would be the 'business profits', which does not generally benefit from the lower withholding tax rates.¹¹⁵

Eligibility requirements that purport to exclude certain trading activities or asset holdings should be subject to an overall consistent tax system, and if adequate loss restriction rules are utilised then any trading activities should be allowed.

When considering foreign income passing through a transparent company to a non-resident member without any domestic tax being imposed, questions may be raised as to whether the jurisdiction has a taxing right over such income in the first place. In this context, it is not precisely clear why corporations in the United

¹¹² For a discussion about the reasoning why the exclusion of non-residents for S Corporations does not breach the non-discrimination article see: Taylor, C.J. (2006). An Old Tax Is A Simple Tax: A Back To The Future Suggestion For The Simplification Of Australian Corporate-Shareholder Taxation. *Journal of the Australasian Tax Teachers Association* 2(1):30, at p 54. However, it is highlighted that this reasoning is not accepted by all: American Bar Association, Section of Taxation, Committee on S Corporations and Partnerships, n 109. American Bar Association, Section of Taxation, Committee on S Corporations and Partnerships. (1991). Report on the Comparison of S Corporations and Partnerships: Part II. *The Tax Lawyer* 44(3):813. For a discussion about the potential application of the non-discrimination clause to an imputation system see: Vann, R.J. (1985). International Implications of Imputation, *Australian Tax Forum* 2(4): 452.

¹¹³ Taylor, n 112, at p 55.

¹¹⁴ Taylor, n 112, at pp 54-55.

¹¹⁵ Barenfeld, J. (2005). Taxation of Cross-Border Partnerships: Double Tax Relief in Hybrid and Reverse Hybrid Situations. Doctor of Laws, Jonkoping International Business School, Jonkoping, at p 105.

States are excluded from being members of an S Corporation since this framework could provide a form of tax consolidation for corporate groups — although, it is conceded, at different membership thresholds.¹¹⁶

It is argued that for tax transparency to be implemented, only three core eligibility requirements are required: non-public trading of membership interests; election for transparent status; and cross-jurisdiction status. An optional fourth requirement could be further specified, that being the condition pertaining to one class of membership interest. These core requirements are in addition to any loss restriction rules that apply in relation to members utilising allocated losses. Each of these core eligibility requirements is now discussed.

The first core eligibility requirement argued for is the non-public trading of membership interests. In considering this issue, it is informative to consider the listing of membership interests on an exchange, such as through an initial public offer (IPO).¹¹⁷ When an entity lists, the number of members can be very large. However, both S Corporations and LLCs are prevented from making IPOs if they wish to retain transparency. This is because S Corporations would find it difficult to ensure that the strict eligibility requirements are satisfied — such as having only resident members and not exceeding 100 members.

The exclusion of publicly traded partnerships from being able to Check-the-Box for transparency prevents an LLC undertaking an IPO.¹¹⁸ Indeed, for a LLC and its members to rely on safe harbour provisions made pursuant to regulations it is prudent that the number of LLC members is restricted to 100.¹¹⁹ Accordingly,

¹¹⁶ For corporate consolidation in the United States, membership must be at least 80 per cent. In comparison, for S Corporation status there must initially be unanimous member agreement.

¹¹⁷ Such an IPO can provide for a larger pool of equity funds and liquid market for transfer of membership interests.

¹¹⁸ *IRC 1986* (US), section 7704.

¹¹⁹ *IRC 1986* (US), section 7704. An example of a 'publicly traded partnership' under section 7704 is one which has partnership interest that are either (a) traded on established securities markets, (b) readily traded on a secondary market. Regulations provide safe harbours for a partnership to avoid being classified as publicly traded (Treasury Regulation, section 1.7704): (a) all interests

there is some consistency between S Corporations and LLCs within the United States, with membership limited to 100 for tax transparency. However, these are enumerated under different Sub-Chapters of the *IRC 1986* (US).¹²⁰

In the United Kingdom, the laws pertaining to the LLP do not have an upper limit on the number of its members.¹²¹ This does not mean, however, that an LLP is able to offer its membership interests (or other securities) to the public, either directly or indirectly, as this can be an offence – unless certain procedures are compiled with.¹²² There are some current examples of LLPs being utilised for widely held operations, particularly as property investment vehicles, as well as for very large professional firms of solicitors and accountants.¹²³ In New Zealand, the LAQC's eligibility restriction of five members would likely prevent an IPO of membership interest in any meaningful way.

issued in a transaction/s are not registered under the Securities Act of 1933, and (b) there are not greater than 100 members during the year. A partnership deriving greater than 90 per cent of income from passive income will be excluded from being publicly traded: *IRC 1986* (US), section 7704(c) & (d).

¹²⁰ Of course it is possible for this cap to be circumvented with transparency being retained. For example, family members within six generations are counted as one for S Corporations. For an LLC, it would be possible to argue that there is no secondary market for its membership interest even though the membership exceeds 100.

¹²¹ The absence of an explicit upper limit compares favourably to the previous limit of 20 members which was imposed on general partnerships and limited partnerships. Pinfold, L, ed. (2005). *Tolley's Tax Planning 2005-06*. Vol. 1. London: LexisNexis Butterworths, at p 1346. Another potential restriction for LLPs raising equity is that a 'person' may be an LLP member, meaning individuals, corporations, other LLPs, or some other form of corporate entity can be LLP members: *Interpretation Act 1978* (UK), 'Person' includes an incorporated body of persons. However, the Registrar does not accept an unincorporated body such as a trust or general partnership being an LLP member, and requiring members to have their own legal personality: Whittaker, J, Machell, J, and Ives, C. (2004). *The Law of Limited Liability Partnerships* (2nd ed.). Bristol: Jordan Publishing Limited, at p 14.

¹²² For example a public corporation can offer membership interests publicly provided it has, amongst other things, a minimum membership capital of at least £50,000. Under reforms in the *Companies Bill 2006* (UK), it will no longer be a criminal offence, with instead penalties and the corporation required to register as a public corporation or be struck off.

¹²³ In the *Cabvision* case there was a plan for an LLP to raise capital to finance a project in the vicinity of £22.5 million by the issue of membership interests: *Cabvision Limited v Feetum, Marsden and Smith* [2005] EWCA Civ 1601 (20 December 2005), at paragraph 15. The United Kingdom Government has been concerned about LLPs being used in this way and has brought in a number of counter provisions.

Across the jurisdictions studied, the restriction applying to membership ranges from five to 100, and to unlimited. Even with the potentially large number of members in the United Kingdom, there is a concern in all of the jurisdictions studied about when transparency is extended to publicly listed business forms. However, it should be recognised that these restrictions do not prevent a transparent company from listing their bonds on an exchange, thereby raising debt finance.¹²⁴ Part of the rationale behind these restrictions could include the administrative difficulties inherent with transparent treatment in widely-held circumstances.¹²⁵ This includes problems in relation to the collection of tax from a large number of members instead of just one entity; or the consequences pertaining to later amendments to taxable income for a year. However, given advances in technology these difficulties have diminished. For example, in each of the jurisdictions full and partial transparent forms have been used for collected investment vehicles.¹²⁶

Even without quantum restrictions, tax transparency itself could be a natural inhibitor to very large memberships. This is because it is uncertain whether a large number of members would agree to transparency, particularly if they are being assessed on unpaid profit allocations. It is understood that for publicly listed trusts in Australia, which have partial income transparency, this is dealt with by having quarterly distributions to members.¹²⁷ It is argued that allowing members to choose whether to have tax transparency or not may be a preferable inhibitor, rather than picking an arbitrary number, which may be circumvented in any event.

¹²⁴ *IRC 1986* (US), section 7704 is not triggered if a business has only publicly traded debt. Booth, RA. (1997). The Limited Liability Company and the Search for a Bright Line Between Corporations and Partnerships. *Wake Forest Law Review* 32:79, at p 81.

¹²⁵ McLure, CE. (1979). *Must Corporate Income Be Taxed Twice?* A report of a conference sponsored by the Fund for Public Policy Research and the Brookings Institution. Washington DC: The Brookings Institution.

¹²⁶ For example in the United States there is partial transparent treatment given for publicly traded oil and energy trusts.

¹²⁷ Brown, M. (2006). Collective Unconscious: It's time to examine collective investment vehicles. Paper read at Business Tax Reform – Meet the Critics, 28-29 September, at Sydney.

An argument against tax transparency applying when membership is widely held is that the theoretical reason for transparency may be weaker as there is a greater distribution of membership, with a separation between management and members. In widely-held circumstances, members are more akin to passive investors, who are unlikely to be involved in the management of the business.¹²⁸ Therefore, in widely-held circumstances, an entity or an integrated tax system may be preferable.¹²⁹

In view of the above analysis, it is argued that no quantum on membership numbers is required to allow for transparency and instead, at most, the restriction should exclude membership interest in the transparent company being publicly traded. However, there may be some merit, indeed, in allowing transparency to both publicly and non-publicly traded entities.¹³⁰ An advantage of having no quantum restriction on membership, is that membership interests may be issued to employees to reward employees for their effort and loyalty. Such employee membership interests can be critical in the start-up phase when cash is a limited resource.

The transparent entity proposal by the Institute of Chartered Accountants in Australia and Deloitte (the ICAA proposal) suggested that its flow-through regime be restricted to entities that are private¹³¹ with five or fewer members.¹³² However, this low quantum of members is based on the proposal only extending to 'micro-SME groups',¹³³ to reduce the potential impact on tax revenue. It is argued that such a limitation is artificial and will lead to practices to circumvent

¹²⁸ Although non-active members may be adequately dealt with the differentiation between passive and active losses.

¹²⁹ Harris, PA. (1996). *Corporate/Shareholder Income Taxation and Allocating Taxing Rights Between Countries: A Comparison of Imputation Systems*. Amsterdam: IBFD Publications BV, at p 44.

¹³⁰ Of course, a large consideration would be the administrative feasibility of transparency applying to a publically traded entity.

¹³¹ A 'private' entity based on a definition similar to that found in *ITAA 1936* (Cth), section 103A.

¹³² Institute of Chartered Accountants in Australia and Deloitte, n 106, at paragraph 3.7.10.

¹³³ Institute of Chartered Accountants in Australia and Deloitte, n 122, at paragraph 3.7.10.

the limitation anyway or alternatively to unduly exclude entities from being eligible.

The second core eligibility requirement that is argued for is an election for transparent status to be applicable. This is preferable given that members are assessed on the business's allocated income even though it is unpaid. This tax liability for the business income could be seen as an exception to the normal legal notion that members are not liable for the debts of the transparent company.¹³⁴ Such a consent mechanism also alerts members to their obligations and may, in a logistical context, assist the tax authority in the collection from them. It is argued that this election mechanism is more appropriate to deal with unpaid allocations, compared to the 'one class' of membership interest.¹³⁵

To elaborate further, there are several election mechanisms extant in the jurisdictions studied. In terms of S Corporations, this includes the initial unanimous member election. However, an incoming member must accept an existing S Corporation election, unless the incoming member acquires greater than 50 per cent of membership interest.¹³⁶ Alternatively, in the context of election mechanisms for LLCs, members' consent to tax transparency depends upon the LLC's Operating Agreement to determine how tax elections are to be made. Pursuant to the *Revised ULLC Act 2006* this is likely just to be a majority decision.¹³⁷ For an eligible LLP there is no election mechanism, as tax transparency applies automatically in the United Kingdom when it is eligible. The

¹³⁴ It is argued that if not for tax transparency, it would be the transparent company as a separate legal entity that would have the resulting tax liability to the relevant Tax Office.

¹³⁵ It has been argued that the eligibility requirement for having 'one class' of membership interest is potentially a way to address the problem of unpaid allocations in terms of fairness: Taylor, n 112, at p 49.

¹³⁶ *IRC 1986* (US), section 1362(d)(1)(B).

¹³⁷ *Revised ULLC Act*, section 407(b)(2). In the absence of a contrary LLC Agreement, the default rule provides members of a member-managed LLC with equal rights in decisions.

election for LAQC status in New Zealand can be either unanimous or a majority election.¹³⁸ Manager elections have similar percentages as to member elections.

Given the above analysis of the various mechanisms, it is argued that for tax transparency to apply it is sufficient that a majority election by the members (and managers if separate to members) be made. Any oppression of minority members that might result because of unfunded tax liabilities would be better dealt with under regimes provided by the relevant governance regimes, rather than adding tax rules that duplicate or vary those existing governance regimes.

The ICAA proposal does highlight the potential problems that can arise in respect of members having to pay tax on their unpaid allocations. It nevertheless concludes that this is better dealt with internally by the business' operating agreement rather than to be externally mandated in tax rules.¹³⁹ The ICAA proposal suggests that the election for flow-through requires a unanimous member election.¹⁴⁰

The third core eligibility requirement argued for is the consideration of cross-jurisdictional treatment.¹⁴¹ To enhance cross-jurisdictional treatment and to limit the potential tax arbitrages of a foreign business form, it is argued that transparency should be extended to non-resident business forms only if they are treated as a transparent entity in their jurisdiction of residence, so that the business form is transparent in both jurisdictions. Such a rationale underpins the

¹³⁸ *ITA 2007 (NZ)*, section HA 29. Such a majority election would be automatically revoked when a majority member becomes a minority member, or alternatively when a minority member obtains a majority of shares. To determine whether a majority election can be made the member's effective interest in a corporation is measured by the percentage of decision-making rights carried by the shares (and options) in a corporation in relation to dividends (or other corporation distributions) plus corporation constitution, variation of the corporation's capital and director appointments or elections: *ITA 2007 (NZ)*, section HA 43.

¹³⁹ Institute of Chartered Accountants in Australia and Deloitte, n 106, at paragraph 3.8.5.

¹⁴⁰ Institute of Chartered Accountants in Australia and Deloitte, n 106, at paragraph 3.9.3.

¹⁴¹ There appears to be no reason why a non-resident entity should not be eligible to elect for transparency. Any concerns with the diversion of income offshore could be addressed with the requirement to lodge an information return detailing activities, which is done for all transparent entities except a single member LLC.

Australian CFC hybrid amendments discussed in Chapter Three. This requirement could assist in reducing asymmetrical treatment of transparent companies, as well as reducing the potential for tax arbitrages previously discussed.¹⁴² The ICAA proposal does not canvass the issue of foreign entities electing for transparency, which may be due from its focus on micro businesses and the assumption that they would be domestic firms.

It has so far been argued that the eligibility requirements for tax transparency should be non-listing of membership interest; the requirement of majority member/manager election; and the condition that foreign entities be required to have symmetrical treatment in their resident jurisdiction.

In addition to these three core eligibility requirements, it may be preferable to provide an optional rule that if the transparent company has one class of membership interest, then certain tax integrity measures will not apply. This is predicated on the argument that a transparent company with only one class of membership interest may have the effect of decreasing the overall complexity,¹⁴³ because integrity measures addressing potential streaming of income and/or losses will not be applicable. For example, a benefit of providing for one class of membership is that it can provide a simpler basis to determine the allocation of profit and/or losses members.¹⁴⁴ Furthermore, in Chapter Seven it was suggested that revenue asset rules for disposal of membership interest need not apply when one class of membership interest exists.

¹⁴² Postlewaite, PF. (2006). Treasury creates a monster. Australia, beware the hybrid entity! *Revenue Law Journal* 16:156. However, this may sufficiently be dealt with by Double Tax Agreements, particularly if they have transparent company provision.

¹⁴³ The findings of DeLuca et al. partly support this assertion. Refer to Chapter Seven's discussion of DeLuca, Greenland, Guyton, Hennessy and Kindlon, n 50.

¹⁴⁴ For example, with S Corporations and LAQCs, allocations to members are determined by considering the number of days that members have held their interest and the percentage of their membership interest: Eustice, JS. (1983-1984). Subchapter S Corporations and Partnerships: A search for the pass through paradigm (some preliminary proposals). *Tax Law Review* 39:345, at p 362.

Accordingly, it is argued that it is preferable to provide a safe harbour for a transparent company with only one class of membership interest. If a transparent company has more than one class of membership, then, and only then, additional rules should apply addressing streaming issues. In this way, members could elect the degree of complexity to apply.¹⁴⁵ Of course, one class of membership interest would in turn (conversely) decrease the flexibility of distributions and may increase the overall tax burden.

As an illustration of the above contention, in the early phase of a firm's development a simple capital structure of one class of membership interest may be perfectly adequate. However, for subsequent raising of equity, different classes of membership interest may be necessary. This flexibility thereby allows the organisation both institutionally and structurally to expand. Further, the proposed eligibility restrictions allow for sophistication of membership interest, though they also may nevertheless impose additional integrity measures. In this way, the business can choose the level of tax complexity that may potentially result from raising additional equity.

Of course, the requirement for one class of membership need not be explicit, because if one class did exist then *quid pro quo* integrity measures aimed at streaming should not apply.¹⁴⁶ If such streaming rules do exist, by having one class of membership as an explicit exclusion highlights the additional complexity that having greater than one class would involve. In terms of the Australian CFC hybrid amendments, streaming is dealt with by members' allocations for tax purposes based on an overall percentage.¹⁴⁷ The ICAA proposal does not include a requirement for one class of membership interest; instead it outlines that profit and losses should be distributed based on a proportional entitlement to

¹⁴⁵ This option may be preferable for capital intensive industries, as they might want to stream tax preferences to certain members.

¹⁴⁶ Note Chapter Six questioned whether streaming rules are necessary at all. If streaming rules were excluded from a tax system, then it is likely that complexity of the tax system would be decreased by one class of membership.

¹⁴⁷ Refer to the analysis of the Australian loss restriction rules in Chapter Six.

profit, similar to the CFC hybrid amendments.¹⁴⁸ The ICAA proposal also advocates largely that rollover rules that apply to general partnership revenue assets should be extended to the flow-through entity.¹⁴⁹

In Chapter Seven it was argued that restrictive eligibility requirements may adversely impact on compliance costs; the complexity of a transparent regime could be mitigated as well as allowing for the greater potential to raise equity finance by adopting the above criteria for transparency eligibility. It is asserted that these conditions should be the core requirements for eligibility for transparency; other concerns could be adequately dealt with by general tax provisions, such as withholding tax applying to allocations to non-resident members.

8.4.2 Employment taxes

In all the jurisdictions studied it was highlighted there are inconsistencies in the tax treatment of members as either self-employed persons or employees. This appeared to be influenced by the extent of 'entity acknowledgement' with the transparent system. Status as either self-employed or employee could be beneficial or detrimental depending upon the jurisdiction and the applicable tax treatment. It is beyond the scope of this dissertation to consider whether it is appropriate to tax self-employed persons differently to employees. However, it is contended that, in terms of transparent companies, there needs to be a consistent approach in terms of the categorisation of members (particularly when active in the business).

In the context of this discussion, it would be more theoretically consistent if active members of a transparent company are treated as self-employed. This is

¹⁴⁸ Institute of Chartered Accountants in Australia and Deloitte, n 106, at paragraph 3.10.6.

¹⁴⁹ Institute of Chartered Accountants in Australia and Deloitte, n 106, at paragraph 3.18.4 (depreciating assets), 3.18.6 (trading stock) and 3.18.9 (work-in-progress).

because tax transparency essentially is predicated on disregarding the legal form for taxation purposes and treating the economical activities of the underlying business as being those of the constituent members.¹⁵⁰ Such an approach reflects an ‘aggregate approach’ rather than ‘entity acknowledgment’. It is argued that active members should be regarded as self-employed. Indeed there is merit for all members (regardless of the extent of their involvement) to be considered self-employed. For special tax rule companies, the adoption of this approach would provide greater tax neutrality with general partnerships, which was a stated goal of their introduction.¹⁵¹

For a jurisdiction contemplating the introduction of a transparent company, the status of active members is an important issue, as the application of employment taxes may breach tax neutrality and may influence the utilisation of the transparent company. For example, in the context of the regulatory framework of the United States, the favoured employment tax position of active members of an S Corporation, compared to that of LLCs, may explain the continued and growing utilisation of S Corporations in the United States.¹⁵² In the United Kingdom, the application of NIC is a characteristic that can clearly provide an advantage for LLP active members compared to the corporate form.

In the Australian context, the ICAA proposal suggests that active members would be treated as self-employed rather than as employees, thus removing the application of fringe benefits tax to benefits provide to active members.¹⁵³ However, the ICAA proposal highlights that this status may not be recognised by various state governments in the application of payroll tax and workers

¹⁵⁰ Refer to the discussion in Chapter Two.

¹⁵¹ Refer to the analysis in Chapter Four about the drivers behind the introduction of the transparent companies studied.

¹⁵² Refer to the data presented in Chapter Three.

¹⁵³ Institute of Chartered Accountants in Australia and Deloitte, n 106, at paragraph 3.21.1.

compensation.¹⁵⁴ Accordingly, when there are different levels of governments, it is preferable that a consistent approach is utilised.

8.5 Conclusion

This chapter has demonstrated that transparency does not necessarily assist closely held businesses in addressing their financing problems. If the eligibility requirements for transparency are too strict, this may reduce the ability of the business to raise equity from alternative sources. Additionally, while there may be tax savings achieved through transparency, this is not always the case when compared to corporations. This will depend upon many factors, such as the corporate tax rate, the individual tax rate and the treatment of capital receipts. However, access to tax losses, tax preferences and the one layer of taxation on capital gains can be advantageous. It was demonstrated that transparency could assist in reducing the tax preference of debt compared to equity funding. An important consideration to determine the taxation burden included the treatment of members as either employees or self-employed.

This led to a recommendation for eligibility for transparency depending upon three factors: membership interest in the business form not being publicly traded, a member/manager election and jurisdictional symmetric treatment; but with the possibility of one class of membership interest. Also, it was argued that active members of a transparent company should be regarded as self-employed rather than as employees.

Chapter Nine will consider the actual governance framework that underpins the legal form being disregarded for tax purposes and will consider whether the underlying governance is important for the suitability of transparent companies for closely held businesses.

¹⁵⁴ Institute of Chartered Accountants in Australia and Deloitte, n 106, at paragraph 3.21.3.

Chapter Nine: Governing transparent companies

9.1 Introduction

While from an economic perspective, it may be preferable for tax purposes to disregard the actual legal form of a business and allocate income and/or losses directly to members, it is suggested that the underlying governance regime of the business form remains an important consideration. In order to enhance the understanding of the legal forms that are being disregarded for tax purposes, this chapter considers the internal governance regimes of the transparent companies studied and their suitability for closely held businesses. Drawing upon the characteristics of closely held businesses outlined in Chapter Two, this analysis considers the following issues: mandatory rules in terms of single membership and insolvent trading; the default governance rules; the concept of member-management; and transferability of membership interest.

This analysis will consider whether there are any differences between the two classifications of transparent companies identified in Chapter Three. Additionally, consideration is accorded to an investigation regarding whether a relationship is extant between the role of closely held businesses and the introduction of the transparent companies, as was identified in Chapter Four.

It will be argued that the suitability of ‘special tax rule companies’ — S Corporations and Loss Attributing Qualifying Companies (LAQCs) — is significantly influenced by the governance regime imposed by the relevant corporation law, which can be problematic for closely held businesses. It will be suggested that a more holistic and contextual approach to corporate regulation would have been preferable when S Corporations and LAQCs were originally introduced.

It is further argued that, in terms of the governance regimes for 'new form transparent companies', the appropriateness of limited liability partnerships (LLPs) for closely held businesses is somewhat challenging due to the lack of any substantial default rules, the assumed member-management and the requirement for at least two members. While the governance rules for limited liability companies (LLCs) are more appropriate for closely held businesses, serious concerns will be expressed with recent amendments which could be adverse for closely held businesses.

9.2 Classification of transparent companies

In Chapter Three it was argued that the transparent companies studied could be classified two ways. Within the first classification tax transparency was achieved by introducing special tax rules for certain corporations — referred to as 'special tax rule companies' — which included S Corporations and LAQCs. Accordingly, for special tax rule companies their underlying governance rules are based on the corporation legislation in the respective jurisdictions.

The regulatory framework for the United States' S Corporations is governed by the various corporation acts in each American state. There are many variations among the state corporation acts, although in an endeavour to provide some consistency there is the *Revised Model Business Corporation Act 1994* (the *Model Corporation Act*) on which states can base their legislation.¹

¹ The Model is merely a form of legislation suggested by the American Bar Association and adopted by the Committee on Corporate Laws of the Section of Business Law with support of the American Bar Foundation. States are free to adopt it in total, in part, or not at all. An alternative model which is adopted by some states is the *Delaware Business Corporation Act*. The most popular states for corporate formation are New York (12.5 per cent), Florida (11.8 per cent), California (9.2 per cent), Texas (5.5 per cent) and Delaware (4.1 per cent). This is a percentage of the estimate of the total number of domestic corporations of good standing in 2005, Sourced from the 2000 - 2006 Annual Reports of the Jurisdictions of the International Association of Corporation Administrators; and Various Internal Revenue Service (US). (2002-2003). The next top five states are Illinois (4.8 per cent), Ohio (3.9 per cent), Michigan (3.4 per cent), New Jersey (3.5 per cent) and New Jersey (3.5 per cent).

Furthermore, the *Model Statutory Close Corporation Supplement* (the *Close Supplement*) can provide provisions which are perceived as advantageous for closely held businesses,² although this is not always the case.³ However much of the flexibility of the *Close Supplement* is now obtainable pursuant to the *Model Corporation Act* through a members' agreement.⁴ Given the similarities between the various legislative frameworks, a members' agreement pursuant to the *Model Corporation Act* will be the focus of the analysis in this chapter.

The regulatory framework of New Zealand's LAQC is governed by the *Companies Act 1993* (NZ).⁵ Similarly to S Corporations, the legislation's application to an LAQC can be altered by a members' agreement and/or constitution, and it is this combination that will form part of the analysis in this chapter.

The second classification of transparent company conceptualised the creation of an entirely new business form that achieved tax transparency via the application of the existing general partnership tax rules. This second classification has been

² Created in 1982, the *Model Corporation Act* has the *Model Statutory Close Corporation Supplement* (the *Close Supplement*), which was at that time more liberal in some respects. If adopted, the *Close Supplement* allows members to govern the corporation directly, without the necessity of appointing a Board of Directors: *Close Supplement*, section 20(b). The *Close Supplement* also restricts the right to transfer of membership interest, although the Articles of Association may provide otherwise: *Close Supplement*, sections 11 and 12. The *Close Supplement* also details rules for compulsory purchase of membership interest if one member dies, provided the Articles of Association adopt them. It also provides for a member to seek the courts assistance in certain circumstances: *Close Supplement*, sections 40 to 43.

³ Naude, S.J. (1982). The need for a new legal form for small business. *Modern Business Law* 4:5, at p 9: "One of the chief criticisms levelled at the existing integrated close corporation statutes is that they are so cumbersome that lawyers are afraid to use them". This is conceded by the draftsmen of the Supplement: "To a large extent, the statutory framework for close corporations will inevitably be somewhat complex because the provisions must be drafted around the existing corporate statutes and case law".

⁴ *Model Corporation Act*, section 7.32. Karjala argues that Close Supplement essentially has no positive virtues over a flexibly written general corporation law. Karjala states that these close "statutes do nothing more for parties who know what they want and who hire a competent lawyer to effect their desires in appropriate legal instruments": Karjala, D.S. (1989). An Analysis of Close Corporation Legislation in the United States. *Arizona State Law Journal* 21:663, at pp 11 and 12.

⁵ The *Companies Act 1993* (NZ) replaces the *Companies Act 1955* (NZ), and was effective from 1 July 1994.

described as ‘new form transparent companies’ and includes LLCs and LLPs. Accordingly, the governance rules for LLCs and LLPs depend upon the unique legislation introduced for their formation.

LLCs are governed by the various LLC Acts which are extant in each American state. There has been an attempt to provide consistency between the states with a recommended uniform act, which recently has been revised by the *Revised Uniform Limited Liability Company Act 2006 (Revised ULLC Act)* replacing the previous *Uniform LLC Act 1996*.⁶ This dissertation will refer to the *Revised ULLC Act* as a consolidation of the LLC’s governance provisions. Of course, it needs to be acknowledged that existing LLCs may have different governing rules, with attributes of the *Revised ULLC Act* only being adopted prospectively. In addition to the legislation, an LLC Operating Agreement (LLC Agreement) can be instrumental in governing the internal affairs of the LLC,⁷ and so will form part of the analysis.

The *Limited Liability Partnerships Act 2000* (UK) (the *LLP Act 2000* (UK)) provides for the establishment and the governance of the United Kingdom’s LLP.⁸ In addition, regulations add modified sections of the *Companies Act 1985*

⁶ The *Revised ULLC Act* replaces the prior uniform act of 1996, the *Uniform Limited Liability Company Act 1996 (ULLC Act)*. On 13 July 2006 the National Conference of Commissioner on Uniform State Laws approved the *Revised ULLC Act*. It is now being submitted to the states for approval. There are two models: the Prototype LLC Act drafted by the American Bar Association and one by National Conference of Commissioner on Uniform State Laws. States are free to adopt it in total, in part, or not at all. As at 2000, only nine of the American states had adopted the Uniform Limited Liability Company Act: Callison, JW. (2000-01). Venture Capital and Corporate Governance: Evolving the Limited Liability Company to Finance the Entrepreneurial Business. *Journal of Corporation Law* Fall (26):97, at p 102. However, it should be acknowledged that state acts are ‘widely dissimilar from one another’: Rutledge, TE. (2005). The Alphabet Soup of Unincorporated Business Law: What is Happening With LLCs, LPs, LLPs, GPs, LLLPs, & BTs and Dealing with RUPA, ReRULPA, (Re) ULLCA, UnETA, MITA, & META. Paper read at Choice of Entity - 2005: Selecting Legal Form and Structure for Closely Held Businesses and Ventures, 10 February, at ALI-ABA, at p 5. Although Ribstein would argue that they evolving into the same: Ribstein, LE, and Kobayashi, BH. (1996). An Economic Analysis of Uniform State Laws. *Journal of Legal Studies* 25 (1):131. Nevertheless, most state LLC acts are similar in four respects, (a) limited liability for members, (b) events of dissolution, (c) restrictions on transferability of a member’s interest; and (d) participation of members in management.

⁷ *Revised ULLC Act*, section 110 (previously *ULLC Act*, section 103).

⁸ Commencing 6 April 2001.

or 2006 (UK),⁹ the *Insolvency Act 1986* (UK), the *Company Directors Disqualification Act 1986* (UK) and the *Financial Services and Markets Act 2000* (UK). This addition of 'modified sections' of other acts has been one of the criticisms levelled against LLPs, as the *LLP Act 2000* (UK) does not contain a discrete set of governing rules for this particular entity. Instead the navigation through various provisions in several statutes is required to determine the basic governance rules of the LLP.¹⁰ The implication of this is that there are in excess of 478 sections that apply to govern the LLP, rather than just the 19 that appear in the *LLP Act 2000* (UK) itself.¹¹ In view of this, it has been suggested that firms may find it necessary 'to seek legal advice on fairly straight forward points lest they should misinterpret the legislation', leading to increased cost.¹² Of course, closely held businesses, especially if operations are small, are often reluctant to secure legal advice because of its associated cost, which then leads to the (undesirable) possibility of non-compliance.

Additionally, the internal governance of an LLP can be influenced by an optional LLP Operating Agreement (LLP Agreement) which is entered into by members; and is included in the analysis.

⁹ *Companies Act 1985* (UK) is to be superseded in parts by the *Companies Act 2006* (UK), which is planned to occur in full by October 2009.

¹⁰ Shohet, P, and Jenner, A. (2005). Get you teeth into LLPs. *Accountancy Magazine* May: 73, at p 74. A format that has seen other legislation fail: House of Commons – Select Committee. (1999). *Trade and Industry – Fourth Report: Draft Limited Liability Partnership Bill*, HC 59, at paragraph 78: referring to a submission by Professor Morse that suggested that a similar drafting technique used for Insolvent Partnership Regulation had 'failed dismally'.

¹¹ In ascertaining the LLPs governing rules, an initial comment is that the brevity of the *LLP Act 2000* (UK), with its 19 sections and a Schedule, is illusionary, as the regulations made under sections 14 to 17 add an array of statutory provisions. The author calculates that the number of sections applying would more correctly be estimated in excess of 478 sections, compared with 19 that appear in the LLP Act. Being: 184 sections from *Companies Act 1985* (UK), 261 sections from the *Insolvency Act 1986* (UK), and 33 sections from the *Company Directors Disqualification Act 1986* (UK). These do not take into account the provisions of the *Financial Services and Markets Act 2000* (UK) that apply to LLPs, or the sections of the new *Companies Bill 2006* (UK).

¹² House of Commons – Select Committee, n 10, at paragraph 78: referring to ACCA submission.

9.3 Unfamiliarity and blending

Morse observed that following the early 1900s the creation of new business forms remained substantially free from parliamentary activity,¹³ although the actual regulatory and tax regime(s) applicable to these traditional business forms has altered.¹⁴ After this period of inactivity, there has recently been a considerable movement internationally towards providing alternative business forms, including the new form transparent companies studied.

With the introduction of new form transparent companies, an issue that has emerged and which requires consideration is that, as a 'new' business form, there can be (consequent) unfamiliarity with their governing laws. Additionally, the determination of their governance rules could require the 'blending' of existing principles originating from partnership and corporation law. This 'blending' may serve to create further uncertainty as to how courts will interpret and resolve governance issues.¹⁵

¹³ Morse, G. (2004). Limited Liability Partnerships and Partnership Law Reform in the United Kingdom. In *The Governance of Close Corporations and Partnerships: US and European Perspectives*, edited by J. McCahery, T. Raaijmakers and E. Vermeulen. Oxford: Oxford University Press, at p 318. The United Kingdom offered businesses effectively four generic business forms: the sole trader, the general partnership, the limited partnership and the corporation. The introduction of Limited Partnerships was the last by the 1907 *Limited Partnership Act* (UK).

¹⁴ For example, Australia's regulatory laws governing corporations have been altered a number of times, with extensive reforms in the 1990s, which saw the introduction of such legislation as *First Corporate Law Simplification Act 1995* (Cth).

¹⁵ Bankman, J. (1994). The Structure of Silicon Valley Start-Ups, *University of California Los Angeles Law Review* 41:1737. Freedman, J. (2000). Limited Liability: Large Company Theory and Small Firms. *The Modern Law Review* 63 (3):317, at p 324. Morse, n 13, at p 329. For example, to date there have been only a few cases that have considered LLPs, although none have undertaken a thorough investigation into the nature of an LLP itself: *Cabvision Limited v Feetum, Marsden and Smith* [2005] EWCA Civ 1601 (20 December 2005), per Lord Justice Jonathan Parker; *Marchands Associates LLPs and Ors v The Thompson Partnership LLP* [2004] EWCA Civ 878 (28 June 2004), per Lord Justice Lloyd, at paragraph 1: "No point turns on the fact that it is an LLP rather than a company".; *Keydon Estates Limited v Eversheds LLP* [2005] EWHC 972 (Ch) (20 May 2005); *Tower Taxi Technology LLP and Ors v Stephen Richard Marsden and Simon Alan Smith*, Court of Appeal – Civil Division, 14 October 2005.

While ‘unfamiliarity’ with the governing law applying to new form transparent companies may be argued as ‘theoretically suspect’,¹⁶ in the early years of the regime it is suggested that some uncertainty may be manifest until case law develops and clarifies the situation. However, this concern about unfamiliarity could be mitigated by the enacting legislation utilising governance provisions from existing business forms,¹⁷ thereby providing some indication about the potential interpretation of the new governing law. This use of prior law could, to a certain extent, utilise the networking benefits of established prior case law precedents. However, this may in turn produce potential ‘blending’ problems insofar as prior law is applied to a business form with different characteristics. Such blending problems have been identified in respect of the LLPs whereby partnership type provisions may be interpreted differently by a court given the LLP’s overall corporate characteristics.¹⁸

In the context of special tax rule companies their governance is based on the more established principles of corporation law. However, this does not then imply that corporation law is immune from uncertainty or blending. For example, there may be uncertainty in closely held circumstances insofar as courts may be more willing to pierce the corporate veil.¹⁹ Further, if the governance of a corporation is

¹⁶ Ribstein, LE. (2005). The Important Role of Non-Organization Law. In *Illinois Law and Economics Working Paper Series: Working Paper No. LE05-014*. Champaign: University of Illinois College of Law, at p 16.

¹⁷ Such as general partnerships.

¹⁸ Freedman, J. (2004). Limited Liability Partnerships in the United Kingdom: Do They Have a Role for Small Firms? In *The Governance of Close Corporations and Partnerships: US and European Perspectives*, edited by J. McCahery, T. Raaijmakers and E. Vermeulen. Oxford: Oxford University Press, at p 298. To illustrate this, if the general partnership default provisions are relied upon by an LLP and its members, courts may not interpret them in the same way as they do for a general partnership. This is because the LLP default provisions have to be read subject to the rest of the LLP legislation ‘as the context requires’, and this context is largely corporate and not general partnership based: *LLP Regulations 2001* (UK), regulations 3(2)(c), 4(1)(i) and 5(2)(g). Morse provides an illustration of the potential uncertainty, as courts may have to relate the general partnership concept of ‘expulsion exercised in good faith’ with the corporate concept of ‘unfairly prejudice’.

¹⁹ In the United States: Thompson, R. (1991). Piercing the Corporate Veil, An Empirical Study, *Cornell Law Review* 76:1036, at p 1075. In terms of Australia: Ramsay, I, and Noakes, D. (2001). Piercing the Corporate Veil in Australia, *Company and Securities Law Journal* 19:250: courts are more prepared to pierce the corporate veil of proprietary corporation than of a public corporation,

altered by a members' agreement adopting partnership concepts, then this will cause 'blending' due to the interaction between the members' agreement and the underlying corporation law. Therefore, it is argued that the problem of 'blending' is not isolated to new form transparent companies. Indeed, it may be preferable to have the blending of principles originating from the legislation that created the business form, rather than originating from separate and distinct members' agreements. If blending occurs within the legislation, then future networking benefits may be established when case law develops around a standard set of 'blended' legislated principles.²⁰ However, it should be acknowledged that the market could provide template members' agreements, thereby providing partial standardisation, and the consequent potential for improved networking benefits.²¹

Nevertheless, concerns about unfamiliarity and blending have not prevented the growth of LLCs and LLPs — particularly LLCs.²² The growth experienced with LLCs and LLPs may be due to advantages obtainable through them that offset any initial uncertainty, such as access to superior governance regime or tax savings. In this respect, it will be argued in Chapter Ten that these advantages may be important in facilitating the utilisation of transparent companies in the early years of their introduction.

It is important for a jurisdiction considering the introduction of a tax transparent company to reflect on the potential for uncertainty and complexity that can be produced in terms of the regulatory governance regime. With this in mind, the chapter will now analyse whether the governance regimes of the transparent companies studied provide features which assist and, indeed, facilitate closely

and courts pierce more frequently when sought against one or more individual shareholders rather than a parent corporation.

²⁰ It should be recalled that 'networking benefits' refers to the idea that legislating for laws to govern business forms can reduce transactions costs. Refer to the discussion in Chapter Two.

²¹ This needs to be balanced with the research discussed later by Dugan et al. which would query whether this occurs in any meaningful way: Dugan, R, McKenzie, P, and Patterson, D. (2000). *Closely Held Companies: Legal and Tax Issues*. Auckland: CCH New Zealand Limited, at pp 119, and 274-275.

²² Refer to the data presented in Chapter Three. However, unfamiliarity may have restricted the growth that would otherwise have occurred.

held businesses through a consideration of some of the mandatory and default rules.

9.4 Mandatory rules

Mandatory rules can have the greatest impact on a business form's complexity as they cannot be contractually avoided or subverted, and include disclosure, duties and unfair preferences.²³ While it is beyond the scope of this dissertation to consider all the mandatory rules applying to the transparent companies studied, given the focus on closely held business, the concept of minimum membership will occupy the central focus of this section. Furthermore, since tax transparent companies provide liability protection for members, the relevant insolvent trading rules will be reviewed to ascertain the measures that have been introduced to ensure that the liability protection is not abused by members.

9.4.1 Insolvent trading

When a business form provides members with liability protection it is perceived as being necessary to ensure that the business is not utilised as a vehicle or as a mechanism to defraud creditors. To this end, rules have been introduced to ensure that capital is maintained²⁴ and that insolvent trading is avoided.

A significant issue previously identified concerned the appropriate treatment of unpaid allocations to members of a transparent company. This issue was whether such unpaid allocations represented further equity contributions or debt

²³ Refer to the discussion in Chapter Two about the impact of mandatory rules for closely held businesses.

²⁴ For example, dividends are to be only paid out of profits: *Corporations Act* (Cth), section 254T.

owing to the members (member loans).²⁵ This distinction is of central importance because, if considered as a further equity contribution, an unpaid allocation can then be subject to capital protection rules that (in turn) restrict the ability for the amount to be subsequently withdrawn without obstruction.²⁶ The distinction is also of importance as it has potential to impact on the comparative ranking of creditors. For example, if an unpaid allocation is considered equity, then the member will have only a residual claim after secured and unsecured creditors have been satisfied. In comparison, if it is regarded as an unsecured member loan, then it can rank equally with other unsecured creditors. Determining the status of unpaid allocations is critical for closely held businesses, insofar as members may not demand the full payment of income allocations, in an endeavour to assist with the financing of the transparent company's operations.²⁷ Also, in terms of being able to utilise allocated losses, there could be a desire for members to have unpaid allocations treated as equity contributions to increase the membership cost basis.²⁸

If it is determined that an unpaid allocation is a member loan then the governing constitution of the transparent company would need to recognise and appropriately deal with the loan as a debt in its accounting books. Furthermore, managers of the transparent company would need to ensure that this debt was properly provisioned; otherwise general director duties and the associated obligations to avoid insolvent trading could be infringed by the incurring of this (or future) debts.²⁹

²⁵ Refer to the discussion in Chapter Six about the potential influence of unpaid allocations on members' ability to utilise allocated losses.

²⁶ For example in Australia the share buy-back and reduction in capital rules: *Corporations Act* (Cth), Part 2J.1.

²⁷ Refer to Chapters Two and Eight for a discussion about the financing problems that closely held businesses can face.

²⁸ Refer to the discussion of the loss utilisation rules in Chapter Six.

²⁹ Alternatively, members may prefer that the right to receive the allocation is stapled to the obligation to be paid the unpaid allocation of the transparent company's profit. Failure to do this may cause systematic insolvency of the members.

In terms of insolvent trading, the protection of creditors is provided for with both of the United States' tax transparent companies by having mandatory rules that no distribution may be made if (after it) the S Corporation or LLC would not be able to pay its debts as they become due in the usual course of business,³⁰ or its total assets would be less than the sum of its total liabilities and the satisfaction of members' preferential rights upon dissolution.³¹ In terms of S Corporations, if a distribution is made in breach of this and an action is commenced within two years,³² a director who votes or assents to such an excess distribution will be personally liable to the corporation.³³ Additionally, there is a restricted right of recovery from members and other directors.³⁴ In comparison, a member of a 'member-managed LLC' or a manager of a 'manager-managed LLC' who consents to such an improper distribution is personally liable for the excess violation amount.³⁵ Accordingly, such provisions can prejudice a member's limited liability protection via the transparent company and could affect the ability to make a distribution to a member to satisfy a prior unpaid allocation.

In the United Kingdom, members of an LLP have potential liability exposure through actions for misfeasance,³⁶ fraudulent trading,³⁷ wrongful trading,³⁸ and

³⁰ *Model Corporation Act*, section 6.40(c)(1). *Revised ULLC Act* section 405 and 406.

³¹ *Model Corporation Act*, section 6.40(c)(2). *Revised ULLC Act* section 405 and 406. The Board of Directors may base their decision for a distribution on financial statements prepared either on the basis of accounting principles and practices that are reasonable or on fair value: *Model Corporation Act*, section 6.40(d). This essentially provides a defence to directors: Dugan, R. (1994). *Company Law: A transactional approach*. Wellington: Butterworths, at p 103.

³² *Model Corporation Act*, section 8.33 III.

³³ *Model Corporation Act*, section 8.33 I.

³⁴ *Model Corporation Act*, section 8.33 II: A director is entitled to contribution or recoupment from other directors also liable and from members who knowingly received the distribution.

³⁵ *Revised ULLC Act*, section 406. An action must be commenced within two years of the improper distribution. The Delaware code provides for a similar rule with a three-year time limit: Del Code, section 18-607.

³⁶ *Insolvency Act 1986* (UK), section 212. The provision provides that if a person has taken part in the management of a LLP and has misapplied, retained or become accountable for money or property of the LLP, or been guilty of misfeasance or breach of any fiduciary duty or other duty in relation to the LLP, then pursuant to sub-section (3) the court may on application of the receiver/liquidator/creditor compel the offender to repay, restore or account with interest.

³⁷ *Insolvency Act 1986* (UK), section 213. The provision provides that if in the course of winding-up it appears that an LLP's business was carried on with intent to defraud the LLP's creditors or other creditors, then pursuant to sub-section (2) the court may on application by the liquidator make a person make contributions.

adjustment of withdrawals.³⁹ Furthermore, the liability protection offered by the LLP to members is not certain.⁴⁰ The adjustment of withdrawals — unlike other obligations — does not apply to corporations, thereby leading some commentators to state that ‘LLP members face a more severe clawback than company [corporation] directors’. The adjustment of withdrawals rule was considered a necessary imposition as LLPs can distribute their profits ‘without let or hindrance’.⁴¹ The adjustment of withdrawal can result in a court ordering a past or present LLP member to make a contribution to the LLP’s assets if in the prior two years⁴² they withdrew LLP property or had any other withdrawal.⁴³ In this context, the term ‘withdrawal’ is defined widely and extends beyond a profit distribution and includes salary, principal and interest payments to a member.⁴⁴ It was argued in Chapter Six this can mean that payments of allocations recognised as debt to members could be subject to this withholding adjustment even though they would not increase a member’s ability to utilise allocated losses.⁴⁵ Also, concerns have been expressed about the lack of defences for

³⁸ *Insolvency Act 1986* (UK), section 214. The ‘wrongful trading’ liability provides that if an LLP has become insolvent, and before commencement of winding-up the members knew or ought to have concluded that there was no reasonable prospect to avoid insolvency, then the court can order that members personally pay some contribution towards paying off the LLP’s debts to its creditors. It is a defence to wrongful trading if the members took every step with a view to minimising the potential loss to the LLP’s creditors: *Insolvency Act 1986* (UK), section 214(3). The wrongful trading provisions include both a subjective and an objective judgement when considering directors’ duties: *Insolvency Act 1986* (UK), section 214(4).

³⁹ *Insolvency Act 1986* (UK), section 214A: Members may have to contribute on a winding up if they withdrew property from the LLP over the two years preceding winding up at a time when they knew or had reasonable grounds for believing that the LLP was or would thereby become unable to pay its debts. However, others have argued that creditor’s protection may be weakened by LLP members pleading ignorance of the LLP’s financial circumstances and consequently could not be said to have reasonable grounds for believing the LLP’s insolvency. House of Commons – Select Committee, n 10, at paragraphs 48 to 51. Finch, V and Freedman, J. (2002). The Limited Liability Partnership: Pick and Mix or Mix-up? *Journal of Business Law* (September):475, at p 509.

⁴⁰ Refer to the outline in Chapter Three of the problems and uncertainty that surrounds LLP’s liability shield offered to members.

⁴¹ House of Commons – Select Committee, n 10, at paragraph 48: referring evidence provided by the Department of Trade and Industry.

⁴² More precisely, within two years of the start of the winding up.

⁴³ *Insolvency Act 1986* (UK), section 214A.

⁴⁴ Regulations pursuant to *Insolvency Act 1986* (UK), section 214A.

⁴⁵ Refer to the arguments in Chapter Six that this means such amounts should be included in a membership cost basis to determine the utilisation of allocated losses.

withholding adjustment to LLPs that are available under other insolvent trading provisions.⁴⁶

As a corporation, New Zealand's LAQC is subject to a solvency test pursuant to the *Companies Act 1993* (NZ).⁴⁷ An LAQC passes this solvency test if it is able to pay its debts as they become due in the normal course of business and when the value of its assets is greater than the value of its liabilities — including contingent ones.⁴⁸ If this is breached, then in certain circumstances a member who received the distribution may have to reimburse it.⁴⁹ Directors also may be potentially liable to repay to the LAQC so much of the distribution that cannot be recovered from the member.⁵⁰ Additionally, actions are available on the liquidation of an LAQC — such as preference payments of debt.⁵¹

Accordingly, such insolvent trading and capital protection rules can increase the complexity of a transparent company. To further complicate matters, these rules increase members' risk exposure to the extent that they inhibit the distributions to satisfy unpaid allocations for which members have been liable to be taxed on in earlier years. The above analysis then implicates the importance of members being aware of how unpaid allocations are ranked in terms of other creditors and the restrictions that may curtail their payment.

⁴⁶ For example, the defence in wrongful trading of 'limiting the potential loss to creditors' does not appear in withdrawal adjustments: *Insolvency Act 1986* (UK), section 214(3). This concern is exacerbated as there is no need to prove lack of good faith in carrying on business with a withdrawal action, with such a defence available against undervalued transactions proceedings: *Insolvency Act 1986* (UK), section 238(4). *Re MC. Bacon Ltd* [1990] B.C.C. 78; *Phillips v. Brewin Dolphin Bell Lawrie Ltd* [2001] 1 W.L.R. 143 (Lords), [1999] 2 All E.R. 844 (CA); *Re Barton Manufacturing Co Ltd* [1998] B.C.C. 827; *Re Lewis of Leicester Ltd* [1995] B.C.C. 514]. Finch and Freedman, n 39, at p 503.

⁴⁷ *Companies Act 1993* (NZ), sections 4 and 52.

⁴⁸ *Companies Act 1993* (NZ), section 4.

⁴⁹ *Companies Act 1993* (NZ), section 56(1).

⁵⁰ *Companies Act 1993* (NZ), section 56(2).

⁵¹ *Companies Act 1993* (NZ), section 292(2): Liquidator is able to avoid a transaction by a corporation if at the time of the transaction the corporation was unable to pay its debts due and it was within two years before the commencement of the liquidation. Furthermore, a Liquidator is entitled to recover from a party where the party received property at an undervalue from the corporation and the corporation was unable to pay its debts and the party received the property within one year prior to the commencement of liquidation: *Companies Act 1993* (NZ), section 297(1).

9.4.2 Minimum membership

A mandatory rule of importance for closely held businesses is the requisite minimum number of members, because the vast majority of businesses can be owned by one member.⁵² For S Corporations, LLCs and LAQCs, it is possible to have single membership.⁵³ However, whether the governing rules are adjusted or drafted to adequately cater for single membership is debateable. The important question is whether the governance rules cater for single membership in a meaningful manner or whether the availability of single membership is an 'add-on' that has been imposed on a governance framework drafted really for multiple members with provisions dealing with agency issues between members and/or managers. To illustrate this conundrum, while an LAQC can have a single member, the *Companies Act 1993* (NZ) does not provide any separate rules for closely held corporations and still requires a Board of Directors.⁵⁴ In relation to LLCs, Ribstein questions whether a single member is appropriate, due to the default rules obviously being drafted for multiple members rather than one. Ribstein expresses concerns about interpretation problems that could arise from such a 'mismatch'⁵⁵ which have not been addressed by the *Revised ULLC Act*.

⁵² For example the vast majority of corporations in the United States are owned by one or a few members: Friedman, HM. (2004). The Silent LLC Revolution - The Social Cost of Academic Neglect. *Creighton Law Review* 38(1), at p 20.

⁵³ S Corporation: *Model Business Corporation Act*, Chapter 7. LAQC: *Companies Act 1993* (NZ), sections 10 and 150. The act does allow for a single member-director corporation with no company secretary required; Directors required to be a natural person: *Companies Act 1993* (NZ), section 151(3). LLC: Massachusetts changed its laws in 2003 to allow for a single member LLC, being the last American state to do so.

⁵⁴ Farrar, JH. (2001). *Corporate Governance in Australia and New Zealand*. South Melbourne: Oxford University Press. Dugan, McKenzie and Patterson, n 21, at p 268. *Companies Act 1993* (NZ), sections 10 and 150.

⁵⁵ Ribstein, LE, and Sargent MA, eds. (1996). Check-the-Box and Beyond: The Future of Limited Liability Entities. *The Business Lawyer* 52, at p 638. This is because LLCs are built on a contractual model, which implies an agreement amongst members. In such circumstances, there is a danger that LLC default rules will be applied, for example, to give rights to non-owner associates such as managerial employees. To address this, Ribstein wonders whether a new non-corporate statutory form, the limited liability sole proprietorship would be a better alternative.

While single-member transparent companies in the United States and New Zealand may not be perfect, they are preferable to the United Kingdom's LLP. This is because the LLP does not allow for single membership at all – requiring at least two members.⁵⁶ It is argued that the requirement for two members is inconsistent with the overall corporate nature of LLPs and, instead, reflects the contractual nature of the relationship between members of a general partnership. Even though the LLP's name – limited liability 'partnership' – connotes the impression that its governance is partnership based, it is argued that the LLP is essentially 'corporate' in nature.⁵⁷ This is because a large volume of the corporation's law is included through regulations. Indeed, others have questioned whether the label 'partnership' is appropriate at all in describing the LLP.⁵⁸ Such an observation is reinforced by the fact that it is expressly stated in the first section of the *LLP Act* that the law relating to partnerships does not apply to an LLP except so far as the *LLP Act 2000* (UK) (or any other Act) provides.⁵⁹

Given that a corporation in the United Kingdom is allowed a single member with some flexibility in its internal arrangements, it seems inconsistent that two members are required for an LLP.⁶⁰ This inconsistency is further compounded by amendments introduced to remove the need for a secretary for a small

⁵⁶ *LLP Act 2000* (UK), section 2: must have two or more persons associated for carrying on a lawful business with a view to profit. *LLP Act 2000* (UK), section 8(2): and must have at least two designated members. However, the legislation expressly envisages that the LLP can continue to carry on business although it has only one member: *Companies Act 1985* (UK), section 24 – however this will lead to liability exposure for members. There is some relief for LLP membership falling to one member provided it is rectified within six months

⁵⁷ This corporate context is illustrated by the fact that there is no expressed duty between the LLP members, compared to general partnerships. This conclusion is supported by the Australian Taxation Office: Australian Taxation Office. (2006). ATO Interpretive Decision: ATO ID 2006/332 – Foreign Hybrid Limited Partnership: UK limited liability partnership: which concludes because of the LLP's corporate nature it would be classified as a 'company' for Australian taxation purposes.

⁵⁸ Avery Jones, JF, De Broe, L, Ellis, MJ, Miyatake, T, Roberts, SI, Goldberg, SH, Killius, J, Maisto, G, Giuliani, F, Vann, RJ, Ward, DA, and Wiman, B. (2002). Characterization of Other States' Partnerships for Income Tax. *Bulletin – Tax Treaty Monitor* July:288, at p 305, and Freedman, n 18, at p 295. Morse, G. (2006). *Partnership Law*. 6th ed. Oxford: Oxford University Press.

⁵⁹ *LLP Act 2000* (UK), section 1(5).

⁶⁰ *Companies Act 1985* (UK), section 352A. *Companies (Single Member Private Limited Companies) Regulations*, (1992) SI 1992/1699.

corporation in the United Kingdom.⁶¹ The requirement for two members supports assertions that LLPs are not designed for closely held businesses,⁶² especially as a large proportion of United Kingdom businesses have one member.⁶³ It is argued that this requirement for two members may frustrate closely held businesses in the United Kingdom and could thereby compel the utilisation of non-active members to fulfil the requisite condition.⁶⁴ However, enticing a person to become a non-active member of an LLP could be difficult due to the extensive obligations placed on members.⁶⁵

Consequently, it is argued that the transparent companies of S Corporations, LLCs and LAQCs are preferable to the LLP in terms of allowing one member.

9.5 Default rules

The default rules of the transparent companies studied are considered in terms of the provision of a standard constitution, member-management and transferability of membership interests.

9.5.1 Default standard constitution

In Chapter Two the contention was that an important feature of the governing rules for a closely held business form is the provision of a standard set or

⁶¹ *Companies Act 2006* (UK).

⁶² Freedman, J. (2001). Limited Liability Partnerships in the United Kingdom – Do They Have a Role For Small Business? *Journal of Corporation Law* 26(4):897, at p 902.

⁶³ Over 70 per cent of corporations have only one or two members. Some 90 per cent have fewer than five members: Department of Trade and Industry. (2000). *Modern Company Law for a Competitive Economy, Developing the Framework*, A Consultative Document from the Company Law Review Steering Committee, March, at p 221.

⁶⁴ Other terms that could be used to describe non-active members are 'silent members' or 'nominee members'. It should be recalled that this is what occurred in the famous decision of *Salomon v Salomon & Co.* [1897] AC. 22 (H.L.), where six nominee members were utilised to ensure the minimum membership of seven at the time was satisfied.

⁶⁵ The obligations for a non-active LLP member are explored later in this chapter.

framework of rules that provide a default governance framework⁶⁶ — particularly to develop and facilitate ‘networking benefits’.⁶⁷ It was shown that case law considering this standard set of rules evidenced an improved understanding about precisely how these provisions will be applied in the future.⁶⁸ Chapter Two further acknowledged that the heterogeneous nature of closely held businesses would have the potential consequence that default rules would require some customisation. However, it was argued that the absence of extensive default rules would produce worse outcomes insofar as it would involve higher costs.

In terms of S Corporations there is several default rules provided for in the *Model Corporation Act*, although overall these can be perceived as more appropriate for widely held, rather than closely held, businesses.⁶⁹ While these default rules can be altered through a members’ agreement, this then weakens any potential networking benefits insofar as there can be variations among the different corporation members’ agreements.⁷⁰

⁶⁶ Easterbrook and Fischel have argued that in the absence of transaction costs the supply of clear and simple default rules will be regarded as value enhancing: Easterbrook, FH, and DR Fischel. (1991). *The Economic Structure of Corporate Law*. Cambridge: Harvard University Press. Compared with Ribstein, LE. (1992). Efficiency, Regulation and Competition: A comment on Easterbrook & Fischel's *Economic Structure of Corporate Law*. *Northwestern University Law Review* 87 (1):254. Freedman, n 62, at p 902.

⁶⁷ Networking benefits refers to the idea that legislating for laws to govern businesses forms can reduce transaction costs: Callison, n 6, at p 117. Hansmann, H, and Kraakman, R. (2004). The Essential Role of Organisational Law. In *The Governance of Close Corporations and Partnerships: US and European Perspectives*, edited by J. McCahery, T. Raaijmakers and E. Vermeulen. Oxford: Oxford University Press.

⁶⁸ Of course, it could be possible to argue that judicial interpretations at times create uncertainty rather than certainty. Ribstein, LE. (1995). Statutory Forms for Closely Held Firms: Theories and Evidence from LLCs. *Washington University Law Quarterly* 73 (2):369, at p 376. This information can increase the clarity of contract terms by reducing errors of ambiguity, inconsistency and incompleteness. However, interpretive benefits may be limited in some situations.

⁶⁹ Rules include one vote for each outstanding membership interest on each matter voted at the member's meeting: *Model Corporation Act*, section 7.21. This applies unless the Articles of Association provide otherwise. Directors are elected by a plurality of votes of members: *Model Corporation Act*, section 7.28. Regular meetings of Board of Directors can be held without notice: *Model Corporation Act*, section 8.22. And no approval of members is required to sell or lease assets in the regular course of business: *Model Corporation Act*, section 12.01.

⁷⁰ Note in terms of the *Close Supplement* in the United States it does not apply automatically and requires contracting for its application. Additionally, it does not provide a complete regime, instead just providing the potential for a members’ agreement and restriction of transfers of membership interests.

The corporate legislation governing New Zealand's LAQC is similar to the United States legislation, in that it provides default rules that are more suited for a widely held membership. It was a conscious decision for those drafting the New Zealand Corporations Law not to provide automatic rules for closely held corporations. This was justified on the basis that it would have been impossible to cater for all variations.⁷¹ The body responsible for the drafting of the Corporations Law thought that the market would develop suitable standard form constitutions for the various business types.⁷² While the heterogeneous nature of closely held businesses is correct, research into corporation's constitutions in New Zealand raises concerns as to whether the development of standard form constitutions in practice has occurred in a meaningful way. The minor review by Dugan et al. of corporation constitutions concluded that the constitutions were 'replete with redundant material, errors and ambiguities and revealed no serious attempt to adopt the rules of the Act to the circumstances'.⁷³ This could reflect that closely held business cannot afford, or perceive it to be too expensive, to pay for properly tailored rules at the formation stage. These authors' empirical research potentially highlights the important role that government can play in enacting a standard set of default rules for closely held businesses and thus provide the underlying 'infrastructure' to assist business operations.

⁷¹ The Law Commission found that separate regulation for closely held businesses was 'unnecessary' and 'based on arbitrary definitions'. The Commission recognised that closely held corporations are extremely diverse, and that tailor-made constitutions may be necessary in any event: New Zealand Law Commission. (1989). *Report No 9: Company Law Reform and Restatement*, Wellington: NZLC, paragraphs 240, 241 and 237.

⁷² New Zealand Law Commission, n 71, at paragraph 257.

⁷³ Dugan, McKenzie and Patterson, n 21, at pp 119 and 274-275: the majority of provisions in the typical standard form constitution, which usually make up 90 to 95 per cent of the document, consist of quoted or restated sections of the 1993 Act, particularly section 131-145; 45-47; 58-61; 76-78; 84-85; 150-155; and First Schedule rules for meetings. It appears that this finding is similar to a survey in the United Kingdom where only 8 per cent reported that the articles were tailored to their own requirements and most of these also had a written shareholders' agreement: Freedman, J. (1997). *The Quest for an Ideal Form for Small Businesses – A Misconceived Enterprise?* In *Developments in European Company Law: Volume 2/1997: The Quest for an Ideal Legal Form for Small Business*, edited by B. A. K. Rider and M. Andenas. London: Kluwer Law International Ltd, at p 27.

There are several LLC default rules which appear to be more appropriate when the business is member-managed. These default rules include the provision that distributions are to be in equal shares among members⁷⁴ when the LLC is member-managed,⁷⁵ then management will be collective⁷⁶ — with equal rights,⁷⁷ majority votes to resolve differences⁷⁸ (although unanimous member consent is required for activities outside ordinary course of business)⁷⁹ and amendment to LLC Agreement.⁸⁰

Even though the governance regimes applicable to LLCs were only recently introduced in the early 1990s, it is important to observe that there has already been extensive reform.⁸¹ Ribstein argues this reform to LLC statutes suggest the influence of jurisdictional competition,⁸² and the evolution toward more efficient provisions.⁸³ However, these changes may have more to do with Check-the-Box making tax transparency easier to obtain. This is because up until 1996, in drafting LLC legislation state governments, were likely to have considered the Kintner Regulation's corporate characteristics to ensure only two of the four were present to allow tax transparency to apply.⁸⁴ In this respect, Federow argues that the Kintner Regulation's influence compromised the drafting of the original LLC legislation.⁸⁵ This was reflected in Friedman's observation that after 1997

⁷⁴ *Revised ULLC Act*, section 404. Note the Act is silent in respect of 'allocations' as this is a tax term and its exclusion was intentional: Reporters Notes to the *Revised ULLC Act* for the February 2006 Draft Committee Meeting, National Conference of Commissioners on Uniform State Laws.

⁷⁵ *Revised ULLC Act*, section 407(a).

⁷⁶ *Revised ULLC Act*, section 407(b)(1).

⁷⁷ *Revised ULLC Act*, section 407(b)(2).

⁷⁸ *Revised ULLC Act*, section 407(b)(3).

⁷⁹ *Revised ULLC Act*, section 407(b)(4).

⁸⁰ *Revised ULLC Act*, section 407(b)(5).

⁸¹ As seen in Chapter Four, while Wyoming was the first American state to introduce the LLC, it was not until after the 1988 tax ruling that other American states introduced similar LLC legislation (excluding Florida which introduced its LLC legislation prior to the ruling).

⁸² Ribstein, n 68, at p 412.

⁸³ Ribstein, n 68, at p 384.

⁸⁴ In fact, the influence of the Kintner Regulations is explicit in many of the LLC acts. Some acts provided that they should be applied to 'permit a limited liability company to qualify for taxation as an entity that is not an association taxable as a corporation under the *IRC* (US) of 1986': Ribstein, n 68, at p 384: 15 PA. CONS. STAT. 8915 (Supp. 1994). The four corporate characteristics were continuity of life, free transferability of interests centralised management and limited liability.

⁸⁵ Ribstein and Sargent, n 55, at p 612: per Federow.

virtually all American states with Kintner compliant statutes subsequently transformed them into statutes that permitted greater flexibility in the LLC structure.⁸⁶

However, concerns have since been expressed regarding the appropriateness for closely held businesses of changes to LLC's governance. Commentators have argued that since the introduction of the Check-the-Box requirement, American state legislators have been convinced to move the LLC closer to the corporate mode by eliminating all dissociation rights for default provisions.⁸⁷ This is perceived to have had the ultimate consequence that LLCs may potentially be more 'perilous' for informal businesses.⁸⁸ Some of these changes are considered in more detail later in this chapter. The importance of this is re-enforced by the data in Chapter Three that demonstrates the number of general partnerships in the United States is declining, with taxpayers maybe opting for the LLC instead.

In the absence of an LLP Agreement in the United Kingdom, the LLP's internal operations are governed by the default rules in the regulations.⁸⁹ These default rules reflect some fundamental aspects of general partnership law, including the following elements: the equal sharing of capital and profits;⁹⁰ the requirement that every member may take part in management;⁹¹ the requirement that matters are to be dealt with by majority vote;⁹² and the requirement that specific duties imposed on directors/members to account for competing activities and for misapplication of LLP property.⁹³

⁸⁶ Friedman, n 52, at p 20: States that originally had bullet-proof acts included Colorado, Michigan, Nebraska, Nevada, Michigan, Virginia and Wyoming.

⁸⁷ Hamill, SP. (2005). The Story of LLCs: Combining the Best Features of a Flawed Business Tax Structure. In *Business Tax Stories: An In-depth look at ten leading developments in Corporate and Partnership taxation*. Foundation Press, at p 314.

⁸⁸ Hamill, n 87, at p 314.

⁸⁹ *LLP Act 2000* (UK), section 5(1).

⁹⁰ *LLP Regulations 2001* (UK), regulation 7(1).

⁹¹ *LLP Act 2000* (UK), section 15(c) and *LLP Regulations 2001* (UK), regulation 7(8).

⁹² *LLP Act 2000* (UK), section 15(c) and *LLP Regulations 2001* (UK), regulation 7(6). Except for changes in the nature of the LLP business requires unanimous member consent.

⁹³ *LLP Act 2000* (UK), section 15(c) and *LLP Regulations 2001* (UK), regulation 7(9) and (10). Other default rules are: if a member, without consent of LLP, competes with LLP business, the

However, the LLP default rules have been criticised as 'rudimentary',⁹⁴ 'sketchy'⁹⁵ and unlikely to be adequate to deal with all the issues arising for a closely held business. Identified inadequacies include the absence of the power to expel a member and the power to amend on a majority vote,⁹⁶ as well as a failure to deal with corporate and insolvency laws that are applicable to LLPs.⁹⁷ For example, the LLP Agreement will need to consider compulsory and voluntary winding-up procedures, which involve calling of members and creditors meetings.⁹⁸ Freedman argues that the absence of comprehensive internal governance rules is a negative factor that tends to diminish any networking benefits.⁹⁹ The absence of a standard constitution may, in this respect, explain

member must account for and pay over to the LLP all profits made in that competing business [regulation 7(9)]; and every member must account to the LLP for any benefit derived without consent of LLP from transaction concerning the LLP or use of LLP property, name or business connection: regulation 7(10). Further default rules include: no automatic entitlement for remuneration: regulation 7(4), members must render true account and full information of things affecting the LLP to any members: regulation 7(8), no person to be introduced as a member without unanimous member consent: regulation 7(5), availability of books and records for inspection by members: regulation 7(7), and indemnification of members for payments and liabilities properly incurred: regulation 7(2).

⁹⁴ Finch and Freedman, n 39, at p 499.

⁹⁵ Pinfold, L, ed. (2005). *Tolley's Tax Planning 2005-06*. Vol. 1. London: LexisNexis Butterworths, at p 1361.

⁹⁶ Finch and Freedman, n 39, at p 499. There is no power to expel a member; all that could be done would be to buy the member out or dissolve the LLP. It is also essential that it must contain the power to be amended on a majority vote.

⁹⁷ Linsell, R. (2000). Limited Liability Partnerships: Yes or No? *Solicitors Journal*, Nov, 994, at p 994.

⁹⁸ This is because the full corporate insolvency regime applies to winding-up of the LLP: Linsell, n 97, at p 997. Other things that would be expected in an LLP Agreement include: internal procedures to change the LLP's registered office, designated members appointment and responsibilities; the declaring of conflict of interests; duty of good faith between members (if desired); measures excluding unfair prejudice actions; expulsion of members; restrictive covenants procedures for later variations of the LLP Agreement and payments for exiting members. The LLP Agreement needs to deal with meeting notices, quorums, chairing, voting methods and majorities required for certain decisions; also intellectual property rights, member's capital contributions, terms and conditions for assignment of interest, rules for voluntary and compulsory removal of members, entitlements and obligations of outgoing members, ensuring new members bind themselves to the LLP Agreement and procedures for variations of the LLP Agreement, procedure for approval of annual accounts, limitations on member's authority, duties and obligations of members. Exiting members would need to consider part year profits and unrealised gains on LLP assets.

⁹⁹ Freedman, n 18, at p 298.

why an LLP is more expensive to set up than a United Kingdom corporation, which is provided with a standard-form constitution.¹⁰⁰

Also, it should be noted that the LLP's minimal default rules may lead to 'gaps' in governance arrangements, particularly where neither the default rules nor the LLP Agreement deals with a situation. Such gaps could produce expensive and lengthy periods of litigation, which would increase uncertainty and complexity for LLPs who rely on the minimal default provisions.¹⁰¹ It is argued that given the extensive mandatory obligations placed on the LLP and its members, it would have been preferable to have a pre-existing comprehensive default governance framework.

It is interesting to contrast the LLP with current reforms for private corporations in the United Kingdom, which have continued to make available a standard form constitution.¹⁰² Accordingly, the United Kingdom government appears to acknowledge the benefit of a comprehensive set of default rules for corporations, whereas it does not do so for LLPs. Given the extent of application of corporation law to LLPs, this discrepancy is a curious one. The absence of comprehensive default rules may be due to the fact that LLPs were originally intended for professionals, who could be considered more sophisticated in providing for their own internal governance regime.¹⁰³ However, since the availability of LLPs was extended beyond professionals, it is questionable whether the underlying governance framework was adequately adjusted for this.

¹⁰⁰ An LLP is more expensive to set up than a corporation: as at 20 October 2006 the basic cost charge from Jordans for setting up an LLP (including draft LLP Agreement) is £213.87 (including VAT), whereas for a corporation the basic cost is approximately £139 (including VAT). The cost for LLPs appears to have reduced since 2002 when the cost of setting up a company through Jordans can be as little as £145 and the cost of a Jordans LLP is £488.75. Finch and Freedman, n 39, at p 499.

¹⁰¹ Finch and Freedman, n 39, at p 490.

¹⁰² *Companies Act 2006* (UK), previously known as the *Company Law Reform Bill 2006* (UK). This Bill completed the Commons Committee stage on 20 July 2006, and received Royal assent on 8 November 2006. The *Companies Act 2006* (UK) is to be introduced in stages which are estimated to be complete in October 2009.

¹⁰³ Refer to the analysis in Chapter Four of the reasons behind the LLPs introduction.

9.5.2 Member-management

Chapter Two outlined and analysed research demonstrating that member-management is a common characteristic of closely held businesses,¹⁰⁴ and therefore it is important for default rules to accommodate this.

The involvement of members in management does not of itself impact directly on liability protection directly in the transparent companies studied. However, members' activities — such as in the capacity of a manager — may potentially expose them to liability. For example, if an S Corporation is member-managed, then members' duties as directors must be discharged in good faith and in a manner that is in the best interest of the S Corporation.¹⁰⁵ Further, it should be noted that United States corporations law imposes a fiduciary duty on a controlling member.¹⁰⁶ In terms of LLCs, the major default rule (and to an extent mandatory as it cannot be eliminated if manifestly unreasonable to do so)¹⁰⁷ are the duties of loyalty,¹⁰⁸ care¹⁰⁹ and the obligations of good faith and fair

¹⁰⁴ Hicks, A, R Drury, and J Smallcombe. (1995). *Alternative Company Structures for the Small Business*. In *ACCA Research Report No 42*. London: Certified Accountants Educational Trust, at p 15.

¹⁰⁵ *Model Corporation Act*, section 8.30(b). This is known as the 'Business Judgement Rule'. The standard conduct required, is that this duty will be discharged with the care that a person in a like position would reasonably believe appropriate under similar circumstances: *Model Corporation Act*, section 8.30(a). There are procedures to be followed if the director has a conflict of interest: *Model Corporation Act*, sections 8.60 to 8.62. The burden is on the other party challenging the director's duties: *Aronson v Lewis*, 473 A.2d, 812 (Del. 1984). Courts tend not to intervene with Directors' decisions.

¹⁰⁶ Farrar, n 54.

¹⁰⁷ *Revised ULLC Act*, sections 110(c)(4) and (d)(1). Identify specific activities that do not violate the duty of loyalty [*Revised ULLC Act*, section 110(c)(4) and (d)(2)] and/or provide for their later ratification: *Revised ULLC Act*, section 110(c)(4) and (e).

¹⁰⁸ The duty of loyalty of a member in a member-managed LLC includes the duty to account [*Revised ULLC Act*, section 409(b)(1)], to refrain from dealing adversely to the LLC [*Revised ULLC Act*, section 409(b)(2)] and to refrain from competing with the LLC: *Revised ULLC Act*, section 409(b)(3).

¹⁰⁹ *Revised ULLC Act*, section 110(c)(4): and any other fiduciary duty (previously section 409 *ULLC Act*). The duty of care involves the member of a member-managed LLC to act with reasonable care and in what the member believes is the best interest of the LLC: *Revised ULLC Act*, section 409(c).

dealing.¹¹⁰ In the circumstances that the LLC is manager-managed, then these duties (loyalty, care and good faith and fair dealing) apply to the manager(s) and not to the members.¹¹¹

The corporate governance structures used for S Corporations and LAQCs means that the default application is for a Board of Directors to manage the business.¹¹² This requires such formalities as mandatory annual member meetings;¹¹³ special member meetings;¹¹⁴ meeting notice rules;¹¹⁵ and required officers.¹¹⁶ Commentators have argued that this automatic separation between management and members means this corporate model is more appropriate for widely held businesses,¹¹⁷ which are characterised by this separation.

However, this position for S Corporations and LAQCs can be altered through drafting to make the management structure more appropriate for closely held businesses.¹¹⁸ For S Corporations,¹¹⁹ provided the corporation is not listed,¹²⁰

¹¹⁰ *Revised ULLC Act*, section 110(c)(5) per section 409(d).

¹¹¹ *Revised ULLC Act*, section 409(g).

¹¹² For example the mandatory rules for running of the corporation include that all corporate powers are to be exercised by the Board of Directors [*Model Business Corporation Act*, section 8.01(b)], which is normally mandatory for a corporation to have: *Model Business Corporation Act*, section 8.01(a). *Companies Act 1993* (NZ), section 128(2): The business and affairs of the corporation, subject to the constitution, must be managed by the Board of Directors.

¹¹³ *Model Business Corporation Act*, section 7.01.

¹¹⁴ For example in the United States on call by Board of Directors or by ten per cent of members: *Model Business Corporation Act*, section 7.02.

¹¹⁵ For example in the United States: *Model Business Corporation Act*, section 7.05.

¹¹⁶ For example in the United States: *Model Business Corporation Act*, section 8.40.

¹¹⁷ Hicks, A. (1997). Legislating for the Needs of the Small Business. In *Developments in European Company Law: Volume 2/1997: The Quest for an Ideal Legal Form for Small Business*, edited by B. A. K. Rider and M. Andenas. London: Kluwer Law International Ltd, at pp 53-54. Friedman, n 52, at p 11. Ribstein and Sargent, n 55, at p 631: per Schedler.

¹¹⁸ The internal governing rules of a United States' corporation is known as its 'by-laws' which can alter the application of the non-mandatory default rules: *Model Corporation Act*, section 3.02.

¹¹⁹ Both the *Model Corporation Act* and the *Close Supplement* provide for substantial organisational flexibility to adopt rules of private ordering that differ from the typical mandatory default rules within the corporation act. Provisions similar to this have been adopted in some form in 21 states of the America. *Close Supplement*, section 20(b). In this circumstance all corporation powers are exercised by or under the authority of, and the business by, the members: section 21(g). And unless the Articles of Association require otherwise, acting requiring direct or both Director and member approval is authorised by members, or if majority, then majority of members: section 21(c)(1).

¹²⁰ *Model Corporation Act*, section 7.32(d).

the *Model Corporation Act* achieves this through a unanimous member agreement,¹²¹ which can eliminate or restrict the Board of Directors;¹²² regulate the authorisation of distributions;¹²³ specify the division of voting power between members and directors;¹²⁴ and transfer to one or more members (or others) power to exercise the business and affairs of the corporation.¹²⁵ Additionally, the agreement (provided it is not against public policy) can otherwise govern the existence of the corporation, powers, management, relationship between members and/or directors.¹²⁶

The flexibility of such an agreement is acknowledged by the *Model Corporation Act* insofar as it indicates that such an agreement may treat 'the corporation as a [general] partnership or result in failure to observe corporate formalities'.¹²⁷ However, the act specifies that such treatment internally as a general partnership does not mean that a member has personal liability.¹²⁸ While such drafting is of assistance to make the United States' corporate form more appropriate for closely held businesses, the presence of a members' agreement could present 'blending' problems, as previously argued. This is because general partnership law may be referred to by courts in solving corporate disputes when partnership-type principles have been utilised. Furthermore, if there is great variation among members' agreements then this could diminish the potential to develop any meaningful 'networking' benefits.

However, by eliminating the Board of Directors, member-management of an S Corporation can be achieved, and a number of corporation rules perceived

¹²¹ *Model Corporation Act*, section 7.32. If such a member agreement is entered into its existence must be clearly stated on certificates for membership interests: *Model Corporation Act*, section 7.32(d). Such a member agreement is normally valid only for 10 years unless it provides otherwise: *Model Corporation Act*, section 7.32(b)(3).

¹²² *Model Corporation Act*, section 7.32(a)(1).

¹²³ *Model Corporation Act*, section 7.32(a)(2) – but subject to the capital protection rule.

¹²⁴ *Model Corporation Act*, section 7.32(a)(4).

¹²⁵ *Model Corporation Act*, section 7.32(a)(6).

¹²⁶ *Model Corporation Act*, section 7.32(a)(8).

¹²⁷ *Model Corporation Act*, section 7.32(f).

¹²⁸ *Model Corporation Act*, section 7.32(f).

unsuitable for closely held businesses can be removed.¹²⁹ The effect of a members' agreement in improving the governance of a corporation can be overlooked by commentators who champion the LLC as providing a more suitable governance framework in the United States.¹³⁰

In terms of the governance of LAQCs, there is potential to alter the operation of the *Companies Act 1993* (NZ) through the LAQC's constitution and/or members' agreement.¹³¹ Unlike the United States' position, neither of these documents can provide for the complete removal of the Board of Directors, although management could be given to someone else.¹³² This means that an LAQC must

¹²⁹ For example rules which are perceived as unsuitable for closely held corporations include the annual election of managers, the requirement that decisions be made in formal meetings, that there be an annual meeting of members (with certain notice periods), a detailed list of members be available, the requirement that various records (including resolution of directors) be kept and be available for inspection by members, how the Articles of Incorporation are to be amended, the mandatory annual member meetings, special member meetings on call by Board of Directors or by ten per cent of members, meeting notice rules and required officers: *Model Business Corporation Act*, sections 7.01 to 16. In relation to these rules the *Close Supplement* only specifically removes the requirement for the annual meeting of members unless one or more members request it [*Close Supplement*, section 23(b)], and requirement to adopt by-laws [*Close Supplement*, section 22: provided provisions of the by-laws are covered in Articles of Association or members' agreement].

¹³⁰ For example see Ribstein, n 16, at p 15. When the author explains the non-tax reasons for adopting an LLC over the corporation, Ribstein does not explicitly consider the implications of a shareholder agreement improving a corporation's flexibility.

¹³¹ *Companies Act 1993* (NZ), section 30. The members' agreement can alter only a few specified provisions and cannot eliminate the Board of Directors. *Companies Act 1993* (NZ), section 107: requiring the unanimous assent of all entitled persons. *Companies Act 1993* (NZ), section 107 does not list section 10 (Board of Directors). A members' agreement only applies to matters listed in section 107(1), (2) and (3) – which includes dealing with dividends of greater value to some members, discounting shares, redeeming shares, financial assistance to acquire shares, remuneration for directions, share capital and dispensing with limited formalities required for self-interested transactions by director. Note a section 107 agreement is subject to a solvency test: *Companies Act 1993* (NZ), section 108.

¹³² *Companies Act 1993* (NZ), section 128(3): clearly indicates that the constitution management can be given to someone beside the Board of Directors; but it does not specially provide for the Boards removal. Dugan, McKenzie and Patterson, n 21, at paragraph 219: "More than 20 significant statutory provisions expressly anticipate variation and negation by the constitution. Only a few provisions are specifically stated to be immune from variation by the constitution; the vast majority of provisions are silent in relation to their mutability": Dugan, McKenzie and Patterson, n 21, at p 123: "the prevailing view is that the constitution can only negate or alter those statutory provisions which are expressly subject to the constitution. While there is some uncertainty about which provisions can be altered by the constitution, it appears that the requirement for a Board of Directors cannot be removed. However, a constitution has no effect to the extent it contravenes or is inconsistent with the *Companies Act 1993* (NZ), section 31(1)". A

have a Board of Directors, even if there is only one active member, and the Board does not play any management role. This can result in a sole member having two distinct roles; one as a member and the other as a manager (director),¹³³ resulting in the sending of notices to oneself, reporting to oneself and certifying one's actions.¹³⁴ Such consequences can undermine the goal of aiming to provide a business form appropriate for single membership.

While the LLC can allow for member-management, the default position under the *Revised ULLC Act* is for manager-management.¹³⁵ Therefore, in view of this, appropriate legislative drafting is required to alter this default position to allow for member-management. In this respect, the default position of the LLC being that of manager-managed is re-enforced insofar as a member is not automatically an agent of the LLC:¹³⁶ therefore, is the default position entirely appropriate for closely held businesses?

It appears that every member of the United Kingdom's LLP is assumed to be a manager, as every member of an LLP is an agent of the LLP.¹³⁷ Indeed the default rule is that every LLP member can take part in management.¹³⁸

special resolution of members is required to adopt or alter a constitution: *Companies Act 1993* (NZ), section 32(1) and (2).

¹³³ However, there is no need to have a company secretary. Farrar, n 54. Fitzsimons, P. (1999). *New Zealand Company Law*. In *Company Law in East Asia*, edited by R. Tomasic. Aldershot: Ashgate, at p 605.

¹³⁴ Dugan, McKenzie and Patterson, n 21, at p 141. The failure to comply with these obligations can result in criminal and civil liability: *Waller v Paul* (1997) 8 NZCLC 261, at p 351.

¹³⁵ *Revised ULLC Act*, section 407(a).

¹³⁶ *Revised ULLC Act*, section 301(a).

¹³⁷ *LLP Act 2000* (UK), section 6(1). However, this agency can be limited: *LLP Act 2000* (UK), section 6(2): sets out circumstances in which the LLP will not be bound by the acts of a member. It provides that, although every member of an LLP is the agent of the LLP, an LLP is not bound by anything done by a member in dealing with a third party if (a) the member has no authority to act for the LLP by doing that thing, and (b) the third party either knows that the member has no authority, or does not know or believe him to be a member of the LLP. Whittaker, J. and Machell, J. (2001). *Limited Liability Partnerships: The new law*. Bristol: Jordans, at p 46: This provision is similar to the second part of *Partnership Act 1890* (UK), section 5: "... unless the partner so acting has no authority to act for the firm in the particular matter, and the person with whom he is dealing either knows that he has no authority, or does not know or believe him to be a partner".

¹³⁸ *LLP Act 2000* (UK), section 15(c) and *LLP Regulations 2001* (UK), regulation 7(3). However, a member-manager is not automatically entitled to remuneration for this. *LLP Act 2000* (UK), section 15(c) and *LLP Regulations 2001* (UK), regulation 7(4).

Even though the LLP has a corporate character, the LLP does not automatically provide for a separate or discrete Board of Directors.¹³⁹ While an LLP does not have directors it does, nevertheless, provide for 'designated members'.¹⁴⁰ However, designated members have additional responsibilities beyond those normally reserved for a director: for example, the disclosure and notification requirements to the Registrar, such as the notification of auditor appointment.¹⁴¹ Designated members could be better perceived as fulfilling the role of a corporation's secretary.¹⁴² However, this is not in itself entirely accurate. The default rule is that every member is a designated member;¹⁴³ and at least two of the LLP members must be nominated as designated members.¹⁴⁴ Given that designated members do have a greater liability exposure for breaches of their duties, the lack of clarity for their role is cause for significant concern.¹⁴⁵

Consequently, in view of the above considerations, the LLP legislation is drafted on the assumption of member-management by all members, with a minimum of two members. While the LLP does not expressly require that every member take part in the management, a characteristic that saw Gower's 1981 proposal for a new business form fail in the United Kingdom, this is the overall effect of the LLP legislation.¹⁴⁶ This is because with the *LLP Act 2000* (UK)'s inclusion of other

¹³⁹ Or the equivalent thereof. This is unlike the special tax rule companies studied, which have corporate governance rules.

¹⁴⁰ *LLP Act 2000* (UK), section 8.

¹⁴¹ *Companies Act 1985* (UK), section 391A. Other duties include (a) notice of changes of members and the registered office, (b) signing and delivery of the Annual reports to the Registrar, (c) the appoint auditors and (d) circulate auditors' representations: *Companies Act 1985* (UK), sections 233, 242, 244, 363 and 385.

¹⁴² House of Commons – Select Committee, n 10, at paragraph 71.

¹⁴³ *LLP Act 2000* (UK), section 8(2).

¹⁴⁴ *LLP Act 2000* (UK), section 8(2).

¹⁴⁵ Commentators argue that there needs to be more of a 'distinguishing thread' running through the functions of designated members: Whittaker, J, Machell, J, and Ives, C. (2004). *The Law of Limited Liability Partnerships* (2nd ed.). Bristol: Jordan Publishing Limited, at p 121.

¹⁴⁶ Department of Trade and Industry. (1981). *A New Form of Incorporation for Small Firms* Cmnd 8171 (London, HMSO, 1981). It annexed a proposal advanced by Professor Gower for a separate, simplified regime for incorporated firms with limited liability. Freedman, J. (1994). Small Business and the Corporate Form: Burden or Privilege. *The Modern Law Review* 57 (July):555, at p 575: The Gower model would have been limited to entities with no more than 10 members, with

acts, the references to 'directors' in the *Companies Act 2006 and 1985* (UK) and *Insolvency Act 1986* (UK) are replaced with the term LLP 'members', and not 'designated members'.¹⁴⁷

It is argued that by not making members' assumed participation in LLP management explicit it could, in effect, 'trap' investors. This is especially the case if members of a closely held business have not obtained comprehensive advice, or who do not completely understand the internal corporate structure — a characteristic that may frequently arise for closely held businesses.¹⁴⁸ Furthermore, the requirement for at least two designated members to be extant appears somewhat inconsistent with current reforms aimed at removing the necessity of a secretary for a private corporation.

In short, the default position of LLPs is for member-management, whereas for special tax rule companies and LLCs the default position is for manager-management. However, both of these positions may be altered through members' agreements. In terms of closely held businesses it is argued that the preferable default position is to provide for member-management.

Of course, it should be pointed out that not all closely held businesses will have active members — particularly if operations expand, and new equity is required. In such circumstances having management separate from members (manager-management) can be beneficial and can account for the potential agency costs. In this respect, for both S Corporations and LAQCs there is clearly the possibility to have a Board of Directors. Furthermore, the LLC is able to adopt separate

each member being entitled to take part in the management of the business and any provision precluding this being void. The problems identified with Gower's proposals included restrictions on limited liability, the mandatory member-management, and that there was no real desire among business owners for change: Roe, MJ. (1996). Chaos and Evolution in Law and Economics. *Harvard Law Review* 109:641.

¹⁴⁷ *LLP Regulations 2001* (UK), regulation 4(1)(g).

¹⁴⁸ Investors may not appreciate the difference in the obligations imposed by becoming a member of an LLP compared to being a shareholder in a corporation. In this regard, the LLP obligations are more akin with those of a general partnership.

managers from members if required, with consequent different duties.¹⁴⁹ This latter ability to adopt a separate and discrete management structure appears to address Callison's prior concerns about the use of LLCs for venture capital operations.¹⁵⁰ This flexibility allows the LLC to be more partnership-like or more corporate-like, depending on the needs of the members.¹⁵¹ It could be that more corporate-like features are warranted when the LLC is manager-managed, as members may be passive in the LLC's operations.

Such a clear and discrete delineation between managers and non-active members does not appear possible for the LLP even though there is no upper limit on membership. This is because there are several duties imposed on members regardless of their involvement in management.¹⁵² Unlike for a corporation, there is no distinction built into the LLP between the roles of members and managers (directors).¹⁵³ This may mean that non-active members would require certain safeguards or guarantees to be included in an LLP Agreement to mitigate the agency costs that may result by the member relying on

¹⁴⁹ If the LLC is to be manager-managed, then the default rules provided is that the majority of members appoint the manager(s) [*Revised ULLC Act*, section 407(c)(5)], that activities are exclusively decided by managers [*Revised ULLC Act*, section 407(c)(1)], with each manager with equal rights [*Revised ULLC Act*, section 407(c)(2)], and majority votes to resolve manager's differences: *Revised ULLC Act*, section 407(c)(3). However, the default rules provide that the consent of all members is required for such things as the conduct of activities outside ordinary business, mergers and amend the LLC Agreement: *Revised ULLC Act*, section 407(c)(4). There is nothing to stop the LLC Agreement to include a Board of Directors, which is what has occurred with the LLC Agreement for AOL Holdings LLC. See: Amended and Restated Limited Liability Company Agreement of AOL Holdings LLC, section 4.01 Board of Managers. [cited 15 December 2006]. Available from: <http://contracts.onecle.com/google/aol.llc.2006.shtml>.

¹⁵⁰ An identified problem with the use of LLC for venture capital operations is that when a LLC is manager-managed there is no corporation-like Board of Directors: Callison, n 6, at p 111. This means there is no separation of operational management functions (for example, the initiation and implementation of proposals) from control functions (for example, the ratification of significant proposals, monitoring management performance and management rewards). This may mean an increase in agency costs as there are no inbuilt active and ongoing monitoring costs.

¹⁵¹ Friedman, n 52, at p 18.

¹⁵² The initial source of members' potential liability is if they fail to comply with their statutory responsibilities, which are generally collective. For example, members are collectively responsible for appointing auditors and preparing accounts: *Companies Act 1985* (UK), section 384(1). Designated members have additional responsibilities for the disclosure and notification requirements to the Registrar, such as the notification of auditor appointment: *Companies Act 1985* (UK), section 391A. For a comprehensive listing of members' duties refer to Whittaker, Machell and Ives, n 145, at pp 142 to 147.

¹⁵³ Whittaker and Machell, n 137, at p 1.

other members or managers to ensure strict compliance. However, these safe guards would manifest themselves only in the form of private contracts between members, and would not absolve non-active members from their statutory obligations.¹⁵⁴

The position of non-active members in an LLP can be contrasted to that in a corporation, where such members have fewer responsibilities for the corporation's operation. This is because these latter obligations are borne by the directors [managers]. The responsibilities placed on all LLP members, regardless of their involvement, may limit the ability or capacity of the LLP to attract non-active members to invest equity. This has led to criticisms describing LLPs as 'cumbersome',¹⁵⁵ being a potential barrier to their growth.¹⁵⁶ Concerns about these mandatory members' duties were raised with the House of Commons Select Committee in the drafting process of the LLP legislation. The objections were to the effect that directors' duties would be better served if they fell on the LLP's designated members rather than on all members.¹⁵⁷ However, the Committee thought that all LLP members should be responsible given the benefits of the LLP's unregulated internal management.¹⁵⁸ The Committee relied on general partnership principles in formulating this conclusion.¹⁵⁹ However, given the corporate nature of LLPs, this reasoning is questionable and may have resulted in the imposition of unnecessary rules. The Committee concluded that if investors found the members' duties too arduous they could form either a

¹⁵⁴ Also, for an LLP to avoid being subject to the restrictions placed on collective investment schemes in attracting new members, LLP members together must have day-to-day control over the management of the LLP property: *Financial Services and Markets Act 2000* (UK), section 235(2).

¹⁵⁵ Percy, S. (2006). Partners: an endangered species? *Accountancy Magazine* July:40, at p 41. Also undischarged bankrupts are normally excluded from being LLP members, compared to United Kingdom corporations who can raise equity from such a person. *Company Directors Disqualification Act 1986* (UK), section 11. This is because of the LLP members' duties. An undischarged bankrupt would need the leave of the courts to be an LLP member.

¹⁵⁶ Freedman, n 18, at p 296.

¹⁵⁷ House of Commons – Select Committee, n 10, at paragraph 72: referring to submissions received by APP, Grant Thornton, ICSA, ICAEW and PWC.

¹⁵⁸ House of Commons – Select Committee, n 10, at paragraph 73.

¹⁵⁹ House of Commons – Select Committee, n 10, at paragraph 73.

corporation or be an employee: it is argued that this conclusion has potentially stunted the future utilisation of LLPs in the United Kingdom.¹⁶⁰ Nevertheless, it should be acknowledged that there are current examples of LLPs being utilised for widely held operations, particularly as a property investment vehicle, apparently because of LLP's flexibility, although it could be more due to tax transparency.¹⁶¹

9.5.3 Transferability of membership interest

A stated reason for the success of corporations is, in part, due to membership interests being transferable.¹⁶² This is because transferability of membership interest can assist in the raising of equity and liquidity. However, it should be recalled that for transparent companies the tax implications on membership interest may impose transaction costs that could hinder the transferability of membership interests.¹⁶³ For example, is the membership interest is treated as its own discrete tax asset (entity acknowledgment) or does its transfer produce the resultant disposal of fractional interests in the underlying assets (aggregate approach).¹⁶⁴ Also eligibility requirements for transparency can circumscribe the ability to raise equity — particularly for S Corporations and LAQCs.¹⁶⁵ Additionally, the notion of membership interest can be important in determining the ability to utilise allocated losses.¹⁶⁶

¹⁶⁰ House of Commons – Select Committee, n 10, at paragraph 73.

¹⁶¹ Whittaker, Machell and Ives, n 145, at p 290. In the *Cabvision* case there was a plan for the LLP to raise capital to finance a project in the vicinity of £22.5 million by the issue of membership interests: *Cabvision Limited v Feetum, Marsden and Smith* [2005] EWCA Civ 1601 (20 December 2005), at paragraph 15.

¹⁶² Elias, S. (1987). *Contemporary Issues in Company Law* (J Farrar ed.) CCH, New Zealand. The other important corporate characteristics are the characteristics of limited liability and continuity.

¹⁶³ Refer to the discussion in Chapter Seven about the potential tax consequences when there are changes to the membership.

¹⁶⁴ Refer to Chapter Seven.

¹⁶⁵ Refer to Chapter Eight.

¹⁶⁶ Refer to Chapter Six.

It should be acknowledged that the members of closely held businesses may prefer restrictions to be put in place on the issuing and/or transferring of membership interests. Restrictions may be preferable due to the high degree of trust (or non trust) between members, the members' reduced diversification opportunities¹⁶⁷ and the desire to retain control.¹⁶⁸ Indeed, the transfer of membership interests and the exercise of voting rights can be matters that figure prominently in litigation relating to members' agreements.¹⁶⁹ Depending upon members' objectives, these restrictions may aid or hinder the raising of equity.¹⁷⁰

Each of the transparent companies studied provide for a separate membership interest which is potentially transferable. The default position for S Corporations, LAQCs and LLCs is that membership interests are freely transferable, whereas for LLPs, transfers require membership consent.¹⁷¹ This means that the rules

¹⁶⁷ This is referring to the fact that members may have invested all of their capital (human and/or financial) into the business operations, and do not have remaining resources to diversify their risk. Due to this there can be greater imperative to have control.

¹⁶⁸ The notion of control was an important characteristic desired by closely held businesses: Hicks, A, Drury, R, and Smallcombe, J. (1995). *Alternative Company Structures for the Small Business*. In *ACCA Research Report No 42*. London: Certified Accountants Educational Trust.

¹⁶⁹ Dugan, McKenzie and Patterson, n 21, at p 189 referring to *Hallam v Ryan* (1990) 5 NZCLC 66, at 123; *Mercury Energy Ltd v Utilicorp NZ Ltd* (1996) 7 NZCLC 261, at p 230 and *Macalister v Ishizuka* (1998) 9 NZCLC 261, at p 663.

¹⁷⁰ For example the existence of unanimous members' agreement for the transfer or issuing of membership interest clearly restricts the obtaining of new equity. However, existing equity holders may not have become members without the existence of such restrictions.

¹⁷¹ For S Corporations, the default position of the *Model Corporation Act* is for the free transferability of membership interest, although restrictions can be imposed: *Model Corporation Act*, section 6.27(a). Possible restrictions include that members to do a first offer to the corporation [*Model Corporation Act*, section 6.27(d)(1)], obligate the corporation to purchase [*Model Corporation Act*, section 6.27(d)(2)], require reasonable approval [*Model Corporation Act*, section 6.27(d)(3)] or prohibit transfers to designated person(s) [*Model Corporation Act*, section 6.27(d)(4)]. In contrast, if adopted, the *Close Supplement* automatically defaults for restriction rules, although the Articles of Association may provide otherwise: *Close Supplement*, sections 11 and 12. The default rule of the *Revised LLC Act* is for the right of members to transfer membership interest [*Revised ULLC Act*, section 502(a)], with transferee's retaining the right of the member [*Revised ULLC Act*, section 502(g)]. However, a transfer is ineffective if it is in violation of a restriction in the Operating Agreement [*Revised ULLC Act*, section 502 (f)]. The default rules also provides grounds for a member to be dissociated from a LLC, including pursuant to the LLC Agreement [*Revised ULLC Act*, section 602(b)(2),(3)], because of death or dissolution of the member [*Revised ULLC Act*, section 602(4)(C),(6)] or wilful or persistent breach of duties of loyalty, care and fiduciary duties [*Revised ULLC Act*, section 602(5)(B) and 409]. The default rules for the United Kingdom's LLP provides that consent of all members is required for a person to be introduced or assigned a membership interest [*LLP Act 2000* (UK), section 15(c)]

applying to S Corporations, LAQCs and LLCs could require rules to be drafted to restrict transfers. Indeed such restrictions could be preferable to ensure that S Corporations and LAQCs remain eligible for tax transparency given their strict eligibility requirements.¹⁷²

Prior to the 1997's Check-the-Box regulations LLCs may have provided for restrictions on transferability of membership interest to ensure general partnership tax treatment was available pursuant to the Kintner Regulations. This is because one of the four corporate features considered in determining whether an entity would be taxed as a corporation or not, was the transferability of membership interest.¹⁷³ With the advent of Check-the-Box, such restrictions are no longer essential for tax transparency to apply, with the default rule of the *Revised LLC Act* for members to be able to transfer membership interest.¹⁷⁴

9.6 Appropriateness of governance rules

In Chapter Four it was demonstrated that to varying degrees there was consideration of closely held businesses with the introduction of the transparent companies studied. For instance, in terms of S Corporations and LAQCs the consideration of the closely held businesses manifested itself in the eligibility requirements restricting membership numbers and the associated desire to improve tax neutrality. Furthermore, for LLCs and LLPs, large closely held businesses were instrumental in lobbying for the introduction and implementation

and *LLP Regulations 2001* (UK), regulation 7(5)], and reasonable notice to other members (not LLP) is required for a member to cease being a member [*LLP Act 2000* (UK), section 4(3)].

¹⁷² For example, a membership interest restriction that could be warranted for S Corporations is to prohibit transfer of membership interests to non-residents. For an LAQC such restrictions would be to ensure that the limitation of five members is not exceeded.

¹⁷³ The four corporate characteristics were continuity of life, free transferability of interests; centralised management; and limited liability. This is illustrated by the previous *ULLC Act*, section 404's default rule for unanimous member consent for admission of new members.

¹⁷⁴ *Revised ULLC Act*, section 502(a). Note the *Revised ULLC Act* uses the term 'transferable interest' to describe membership interests. Transferees retain the rights of the member: *Revised ULLC Act*, section 502(g). However, a transfer is ineffective if it is in violation of a restriction in the Operating Agreement: *Revised ULLC Act*, section 502 (f).

of the new business forms – this even involved assistance in drafting the initial legislation.

It is argued that while there was an explicit focus on closely held businesses in terms of the implementation of ‘special tax rule companies’ – S Corporations and LAQCs – this was, in effect, only partially reflected in policy. In particular, rather than tailoring the underlying governance rules for closely held businesses, the restriction on membership numbers may be better understood as a measure to ensure that the availability of tax transparency was constrained, thereby limiting the potential risk to tax revenue. For special tax rule companies their suitability for closely held businesses is influenced by the governance regime imposed by the relevant corporation law; however this was not specifically addressed at the time when these transparent companies were introduced.

It is further contended that the default operation of corporation law in both the United States and New Zealand is more appropriate for widely held businesses. The main reason for this is that these rules are characterised by a discrete separation between management and members. Nevertheless, despite this, both jurisdictions provide for alteration of the default rules through the specific drafting of constitutional documents or members’ agreements. However, this drafting can impose additional costs, which closely held business can be sensitive about, especially at the commencement stage of their operations.

Furthermore, it should be noted that this individual drafting could result in the loss of networking benefits – particularly if there are significant variations among agreements (due to case law developments concerning individual agreements, as opposed to centralised legislative provisions). In comparison to the New Zealand model, the United States’ corporation law has some advantages for closely held businesses, particularly with the possibility of the complete removal of the Board of Directors. This is because even in spite of the presence of a members’ agreement, the New Zealand model retains a number of rules which

appear to serve little purpose in a closely held business scenario, particularly those addressing agency cost when there is a separation between management and members.¹⁷⁵

Concern in relation to the suitability of the LAQC can be re-enforced by the lobbying in New Zealand for the introduction of a new business form based on the United States' LLC model.¹⁷⁶ This may indicate a preference for a new transparent business form, rather than a special tax rule company.

However, despite these concerns the popularity of the corporate form cannot be denied. As illustrated by the data presented in Chapter Three, excluding sole proprietorships, corporations represent 69 per cent of businesses in the United States, 99 per cent in the United Kingdom¹⁷⁷ and 52 per cent in New Zealand.

In view of this, it is argued that the introduction of special tax rule companies would have been improved if closely held businesses had been considered beyond the applicable tax rules, and had included the governance issues. While such holistic reform is possible in New Zealand with a unitary government, this

¹⁷⁵ Dugan et al. argue that for a single member New Zealand corporation there is a 'mass of information' generating only a 'small part of which' is of any use to third parties, the corporation or member: Dugan, McKenzie and Patterson, n 21, at p 221. Dugan et al. argue that there are five features of the *Companies Act 1993* (NZ) that make it unsuitable for closely held businesses. "Firstly the record-keeping and financial reporting as they just duplicate what is required for income tax purposes, and because they are dated, not audited and not compiled in accordance with GAAP are of little interest to either creditors or managers. Secondly there are a number of notices that must be lodged with the Registrar for events and transactions that provide little if any useful information to third parties. Thirdly, the distinction between a Board and members becomes unnecessarily complex. Fourthly there are a number of directors' duties which serve no purpose when membership and management the same. Fifthly, the criminalisation of non-compliance with Director's duties": Dugan, McKenzie and Patterson, n 21, at pp 695-696.

¹⁷⁶ David Goddard (Special Advisor to the Ministry of Economic Development). Institute of Chartered Accountants of New Zealand. (2004) Submission to the Ministry of Economic Development: Limited Partnerships in New Zealand: A Proposal to Reform Special Partnerships, Part II *Partnership Act 1908*. [cited 13 January 2006]. Available from: <http://www.nzica.com/StaticContent/AGS/GRASPIssues.cfm>, at p 7. Dugan, McKenzie and Patterson, n 21, at p 731. However, such proposals do not refer to the tax treatment of such an entity.

¹⁷⁷ However, in terms of VAT registration private corporations represent only 58 per cent of business forms (including sole proprietors) in the United Kingdom.

would involve a co-ordinated approach in the United States as the individual American states, not the Federal government, control the corporation power.

Unfortunately a similar narrow approach is reflected in the flow-through entity proposal by the Institute of Chartered Accountants in Australia and Deloitte (the ICAA proposal).¹⁷⁸ The ICAA proposal does not consider in any detail the suitability of the underlying governance framework of corporations and unit trusts to which the flow-through would apply; it considers only the tax rules. Similar to the special tax rule companies, it appears the restriction of membership numbers in the ICAA proposal is to reassure revenue concerns.

The intended use of new form transparent companies — LLCs and LLPs — by closely held businesses was not as explicit as for special tax rule companies. However, this use can nevertheless be inferred from the drafting of the governance rules for these two entities and the original role that large closely held businesses played in their actual introduction. To illustrate this point, the original LLC legislation was predicated on general partnership principles, and the LLP legislation — once it was extended beyond professional firms — saw the inclusion of some general partnership default rules.

In this respect, it is argued that the governance framework of the United Kingdom's LLP is problematic for closely held businesses. This difficulty may be attributed to the fact that LLPs were initially designed for professional firms with a sophisticated membership. Hence, Finch and Freedman's contention that 'as currently drafted' the LLP is not appropriate for a closely held business is eminently understandable.¹⁷⁹ Also, the proclaimed flexibility of LLPs¹⁸⁰ needs to

¹⁷⁸ Institute of Chartered Accountants in Australia and Deloitte. (2008). Entity flow-through (EFT) submission. Sydney: Institute of Chartered Accountants, at paragraph 3.6.2.

¹⁷⁹ Finch and Freedman, n 39. Freedman, J. (2001). Limited Liability Partnerships in the United Kingdom - Do They Have a Role For Small Business? *Journal of Corporation Law* 26(4):897, at p 902.

¹⁸⁰ See for example: Department of Trade and Industry (UK). (2000). *Limited Liability Partnerships: Regulatory Default Provisions Governing Relationship Between Members*. London,

be considered against the United Kingdom private corporation which is relieved from a number of requirements imposed on public corporations.¹⁸¹ These concessions mean that private corporations have increased flexibility in how they organise themselves; this flexibility could account for their popularity in the United Kingdom. LLPs do nevertheless provide some concessions to the corporate form, such as non-application of restrictions on loans by corporation to directors;¹⁸² flexibility of internal governance (subject to imposed legislation);¹⁸³ meetings and resolutions;¹⁸⁴ and no restrictions to share capital.¹⁸⁵ Despite these concessions, the reforms introduced for United Kingdom corporations may suggest that the private corporation provides a superior governance regime for a closely held business desirous of limited liability.¹⁸⁶

at p 2: This reflects the desire for freedom of members to arrange the internal affairs of the LLP in a 'flexible manner'.

¹⁸¹ For example, it is possible for a private corporation to dispense with annual general meetings [*Companies Act 1985* (UK), section 366A]; the requirement to table annual accounts and directors' reports at a general meeting [*Companies Act 1985* (UK), section 252(1)]; appointment of auditors annually at a general meeting [*Companies Act 1985* (UK), section 386]; and the requirement that directors not have the authority to allot corporation membership over a period in excess of five years: *Companies Act 1985* (UK), section 378(3) and 369(4). Other things that allow private corporations more flexibility include that: capital can be used for the acquisition of its own membership interests: *Companies Act 1985* (UK), section 172; Articles can provide for no right of pre-emption on allotment of membership interests: *Companies Act 1985* (UK), section 91; and dividends payments by private corporation need not comply with net asset rule, provided it has more accumulated realised profits than accumulated realised losses: *Companies Act 1985* (UK), section 263(3). Grier, N. (1998). *UK Company Law*. Chichester: John Wiley & Sons, at pp 45-47.

¹⁸² Hodgson, R, and Zabrosky, A. (2002). LLPs in Great Britain. *Consulting to Management* 13(2), 50, at p 51.

¹⁸³ *Companies Act 1985* (UK), sections 282 - 347 and 366 - 383. Freedman, n 18, at p 296.

¹⁸⁴ *Companies Act 1985* (UK), sections 366 to 383.

¹⁸⁵ *Companies Act 1985* (UK), sections 58 to 220. For example allotment of shares and reduction of capital. However, there are distribution rules that must be satisfied.

¹⁸⁶ These reforms are in response to criticisms that the *Companies Act 1985* (UK) is not accessible to those managing and advising closely held businesses because its structure tends to be based on large public corporations with detailed adaptations for other corporations. Faber, A. (2002). Legal Structures for Small Businesses. In *The Reform of United Kingdom Company Law*, edited by J. de Lacy. London: Cavendish Publishing Limited, at p 89. The reforms include that there will be separate model articles of association for private corporations, containing the minimum key rules on the internal workings of the corporation, abolishing the requirement for private corporations to have a secretary, introduce a statutory statement of directors' general duties, abolish the need for private corporations to hold an annual general meeting, make it easier for corporations to take decision by written resolution, resolutions may be carried with a simple or 75 per cent majority of eligible votes, greater use of electronic communications with members, abolishing circumstances in which corporations can provide assistance for the acquisition or purchase of their own membership interests, and easier capital reductions;

The LLC has several indicia or characteristics which can be beneficial for, and facilitative of, closely held businesses — including extensive default rules that appear to have been drafted to take into account issues that are likely to arise. While Karjala and others argue that in the United States the LLC ‘provides nothing (besides uncertainty) not already available under partnership and corporation statutes’;¹⁸⁷ this nevertheless fails to acknowledge that the LLCs to a large part automatically provide more appropriate governance rules for closely held businesses, whereas corporations require extensive drafting to achieve this. In critiquing New Zealand’s corporate law, Goddard argues that closely held businesses would have been better served from ‘starting at [general] partnership law’ rather than corporation’s law.¹⁸⁸ It was such a starting point of partnership

improved ability to appoint authorised signatories; and authorisation of directors’ conflict of interest.

¹⁸⁷ Karjala, DS. (1995). Planning Problems in the Limited Liability Company *Washington University Law Quarterly* 73:455. Indeed, critics of LLCs argue that there are now too many choices to be made between different types of entity and that the result could be confusion, a case of ‘hyperlexis’: Freedman, n 15, at p 324: “Walter D Schwidetzky ascribes the term ‘hyperlexis’, meaning ‘pathological condition caused by an over-active law making gland’ to Bayless Manning”. Whereas Weidner considers that the myriad of business forms in the United States, many of which accomplish, or can be made to accomplish, the same thing, present no coherent rationale: Weidner, DJ. (2004). Pitfalls in Partnership Law Reform: Some US Experience. In *The Governance of Close Corporations and Partnerships: US and European Perspectives*, edited by J. McCahery, T. Raaijmakers and E. Vermeulen. Oxford: Oxford University Press, at p 368. Vestal concluded that the 1990’s reforms in the United States were of “great change and little accomplishment”: Vestal, AW. (2004). Drawing Near the Fastness?: The Failed US Experiment in Unincorporated Business Entity Reform. In *The Governance of Close Corporations and Partnerships: US and European Perspectives*, edited by J. McCahery, T. Raaijmakers and E. Vermeulen. Oxford: Oxford University Press, at p 357. Other commentators argue that it is possible to obtain most of the informalities offered by an LLC in a closely held corporation through properly drafted close corporation agreements: Friedman, n 52, at p 28.

¹⁸⁸ Goddard, D. (1998). Company Law Reform - Lessons from the New Zealand Experience. *Company and Securities Law Journal* 16:236 at p 251. Dugan et al. argues that an LLC based on the Wyoming LLC statute could provide the best alternative: Dugan, McKenzie and Patterson, n 21, at pp 700 - 701. The frustration with the New Zealand corporate provisions has led Dugan et al. to explore the possibility of New Zealanders forming an LLC in the United States, and then using that business form to trade in New Zealand. However, they did not state whether they thought the United States *Model Corporations Act* to be any good or not. Similarly, Goddard supports the introduction of an LLC in New Zealand because of the complexities in corporation law, arguing that an LLC would have been introduced — although it does not specify whether flow-through should apply and nor does it refer to LAQCs: Goddard, n 188, at pp 248-249. Other commentators agree that the general partnership model is preferable for closely held businesses: Ribstein and Sargent, n 55, at p 631: per Schedler; and Hicks, n 117, at pp 53-54.

law that saw the formation of the LLC, as their origins can be traced to the *Limitada*.¹⁸⁹

Karjala argued in 1989 that there was no empirical evidence supporting the proposition that members of closely held corporations wanted a general partnership form.¹⁹⁰ However, the increase in popularity of LLCs could support the proposition for governance rules based on partnership law.¹⁹¹ Further, Cohen argues that the growth of LLCs might provide empirical proof of the triviality of much of corporate law, as firms can contract around most mandatory rules.¹⁹²

However, Chapter Three illustrated the continued popularity of the S Corporation in the United States, despite the introduction of the LLC. This means that even with the observed inadequacies of the corporate form for closely held businesses, the corporation continues to be embraced. An explanation for the continued use of S Corporations is the number of businesses established prior to the broad acceptance of the LLCs. Also, the transaction costs could impede

¹⁸⁹ It would appear that the LLC origins are from the Panamanian '*Limitada*': Goforth, CR. (1995). The Rise of the Limited Liability Company: Evidence of a Race Between the States, But Heading Where? *Syracuse Law Review* 45:1193, at p 1201; Johnson, R. (1983). Comment, The Limited Liability Company Act *Fla St. U. L. Rev.* 11:387, at p 387. The Floridian committee reports discussing LLCs specifically noted that LLCs were similar to a form of business organisation prevalent in Central and South America's and might therefore be particularly attractive to international investors. However, this origin of the LLC is not universally accepted as Wood states that the LLC origins is German GmbH or the French SARL: Hicks, Drury and Smallcombe, n 168, at p 52: referring to Wood 1993. Alternatively, Carney considers the LLC's origin stems from the English joint stock company: Carney, WJ. (1995). Limited Liability Companies: Origins and Antecedents. *University of Colorado Law Review* 66 (4):855.

¹⁹⁰ Karjala, n 4, at p 12.

¹⁹¹ Bulloch. (1985). Heightened Fiduciary Duties in Closely Held Corporations: Donahue Revisited, *Pacific Law Journal* 16:935, at p 954.

¹⁹² Cohen, DL. (1998). Theories of the Corporation and the Limited Liability Company: How Should Courts and Legislatures Articulate Rules for Piercing the Veil, Fiduciary Responsibility and Securities Regulation for the Limited Liability Company? *Oklahoma Law Review* 51 (3):427, at pp 471-472. The author was building upon: Black, BS. (1990). Is Corporate Law Trivial? A Political and Economic Analysis, *Northwestern University Law Review* 84(8):542, at pp 544 and 559. Previously, Black had argued that the unavoidable corporation laws are merely 'market mimicking' (that is, what a free market would have provided anyway) or otherwise most rules are for the most part avoidable though at varying costs. Cohen suggests that LLCs are 'market mimicking' since nearly all LLC laws can be waived and the remaining laws as are the ones that the market would want anyway.

change from an S Corporation form to an LLC.¹⁹³ However, the impact of transactional costs would explain the data only as they relate to established businesses. It does not explain the continued growth in S Corporation numbers.

A further explanation could be that some advisors are more comfortable with S Corporations and the rules that govern them, in both governance and tax law.¹⁹⁴ Accordingly, such advisors may continue to recommend the S Corporation to their clients, particularly if they consider that the LLC brings a level of complexity or uncertainty not justified by the level of their client's business activities.¹⁹⁵ This could be a valid concern given the compliance cost data presented in Chapter Seven. Furthermore, there could be some continuing concern about the developing law for LLCs and the uncertainty this may entail, although this should diminish over time.¹⁹⁶ Also clients who are requesting the S Corporation model may be unaware of alternative business forms available. Another reason could be that state government treatment may make the S Corporation advantageous to the LLC, for example filing fees, state taxation treatment and restriction on business operations.¹⁹⁷ Alternatively, if public listing is desired in the future, S Corporations could be perceived as better facilitating this through lower tax transaction costs.¹⁹⁸

¹⁹³ These transaction costs could include both taxation and advisor fees, as well as organisational changes.

¹⁹⁴ Such actions may be illustrations of uncertainty may influence economic behaviour: See generally: Fontana, G, and Gerrard, B. (2004). A Post Keynesian theory of decision making under uncertainty. *Journal of Economic Psychology* 25:619.

¹⁹⁵ Commentators thought that lawyers would be more comfortable with S Corporations, as they know their applicable tax and non-tax rules. Whereas LLCs are 'a little scary': Ribstein and Sargent, n 55, at p 629: per Galler. Other commentators thought that clients seem to comprehend Subchapter S more easily compared to LLCs: Ribstein and Sargent, n 55, at p 630: per Lemke.

¹⁹⁶ Ribstein and Sargent, n 55, at p 629: per Galler.

¹⁹⁷ Friedman, n 52.

¹⁹⁸ A benefit an S Corporation has over a LLC, is that an S Corporation can qualify to engage in Subchapter C tax-free reorganisations and divisions: McNulty, JK. (1992). *Federal Income Taxation of S Corporations*. New York: The Foundation Press Inc, at p 146.

Nevertheless, it is argued that the governance principles underlying the LLC as a business form are worthy of further consideration, to ascertain whether they do indeed provide an improved governance framework for closely held businesses.

9.7 Conclusion

The notion of tax transparency is to disregard the legal form for tax purposes and to allocate income and/or losses to members. However, in determining the appropriateness of transparent companies to closely held businesses it is important to consider the characteristics of this 'legal form' being disregarded for tax purposes.

While special tax rule companies, S Corporations and LAQCs, were introduced for closely held businesses, their implementation did not extend to adjustments in the underlying corporate governance regime. This means that the suitability of these transparent companies for closely held businesses can be problematic, requiring drafting to accommodate characteristics exhibited by closely held businesses, particularly member-management. This has led to incomplete policy implementation by the governments of the respective jurisdictions.

In contrast, the introduction of the new transparent business forms, LLCs and LLPs, was accompanied by the implementation of new governance regimes through the lobbying of large closely held businesses. The United Kingdom's LLP appears to be plagued by a policy switch during its implementation which has resulted in a cumbersome regime. It is questionable how suited the LLP governance is for closely held businesses, particularly unsophisticated ones. The LLC appears to provide the best governance rules that automatically apply to closely held businesses; however, given their heterogeneous nature, some

tailoring is still required. Also, recent reforms to LLC appear to be taking on more widely rather than closely held characteristics.¹⁹⁹

The analysis in this chapter demonstrates that there is more to tax transparent companies than their tax treatment, as there is a divergence in their governance frameworks. It is argued that any jurisdiction introducing a tax transparent company should have a holistic approach that considers whether the governance regime caters for characteristics exemplified by closely held businesses.

Chapter Ten will present the final conclusions for this dissertation, initially summarising the key findings from each chapter, and then providing some recommendations about whether Australia should pursue the economic ideal of a tax transparent company.

¹⁹⁹ However, the LLC's improved governance regime for closely held businesses may be diminished when other regulatory rules are considered, particularly tax compliance costs: See Chapter Seven.

Chapter Ten: Lifting the veil on tax transparency

Economists are relatively good at identifying departures from a theoretically ideal or neutral tax base, but as a result they tend to advocate radical or comprehensive reform. The economist tends to be concerned with broad issues of general principle, rather than with the intricate details of the operation of tax systems. Lawyers and accountants, the other major group contributing to tax reform debates, devote more attention to the details and less to the broad principles ... Development of a sound reform strategy requires a merging of these two approaches.¹

10.1 Introduction

The impact of tax transparent companies in the United States, the United Kingdom and New Zealand has been critically analysed in this dissertation to ascertain what has been the experience in striving for the economic ideal. Initially a summary of the key conclusions from each of the preceding chapters will be provided, with a view to developing key recommendations as to whether Australia should strive for the economic ideal of a tax transparent company. A related key issue is whether tax transparency provides any substantive benefits to closely held businesses, or whether the reverse is true, that closely held membership more easily facilitates the introduction of a tax transparent company.

It will be argued that Australia may have little to gain from introducing such a tax transparent company. However, due to both domestic and international factors the government may find itself being subject to increasing pressure to broaden its recognition. Consequently, with this broader policy implication in mind, the analysis will consider a number of alternative mechanisms in which the introduction of a tax transparent company could be facilitated. It will be argued that the preferable approach, if needed, would be to introduce a partial loss transparent company. The dissertation will then develop implications for further research opportunities and policy development.

¹ Bevin, P. (1985). *How Should Business Be Taxed? An examination of defects in business taxation and suggestions for reform*. Wellington: Victoria University Press, at p 67.

10.2 Chapter summary

To exemplify what the experiences with tax transparent companies has been the findings and conclusions of each chapter will be summarised. This will lead to the final over-arching analysis for this dissertation.

10.2.1 Chapter One

It was highlighted in Chapter One that the taxation of business forms can be conceptualised in terms of a continuum, from an 'entity approach' to an 'aggregate approach', with an 'integrated approach' lying between these two points.² While an entity approach can be conceived in relatively simplistic terms, economists have advocated that an aggregate (tax transparent) approach is preferable with income and/or losses directly allocated to members. Such a tax transparent approach is stated to improve tax neutrality, and thus reduce the tax system's potential to distort investment decisions.

Historically, due to concerns about the practicality and the integrity of the tax system, implementation of such an economic ideal has been regarded as problematic for business forms with limited liability and separate legal status. However, examples were provided of how some jurisdictions have recently moved towards this economic ideal by introducing tax transparent companies. The introduction of these transparent companies have received mixed reactions, with some academics praising them — particularly for closely held businesses — while others question what has really been achieved.

² An 'integrated approach' describes when tax relief is provided to distributions from an entity. This could include an imputation, dividend deduction, split rate and distribution exemption system.

Until this point in time Australia has given only restricted recognition to tax transparent companies, with the implementation of venture capital incorporated limited partnerships (venture capital ILPs) and amendments to controlled foreign hybrid companies (CFC hybrids). Despite this, there have been calls for the broader availability of a transparent company in Australia, most recently from the Institute of Chartered Accountants in Australia and Deloitte (the ICAA proposal).³ Given the touted benefits of tax transparency, including the potential benefits to closely held businesses, it was argued that a more detailed and critical understanding of these transparent companies is needed. The dissertation proposed to analyse tax transparent companies in the United States of America (United States), the United Kingdom and New Zealand using a comparative legal framework. Theoretical and doctrinal research would be used to critically evaluate the research questions espoused.

10.2.2 Chapter Two

The underlying theoretical rational of tax neutrality and its relationship with tax transparent companies was detailed in Chapter Two. This analysis highlighted that in the absence of tax neutrality, the productive capacity of an economy may be impeded due to the distortion of investment decisions. With a view to illustrating the potential for investors to be influenced by changes in the tax system, prior studies were discussed, including Holub's research.⁴ Furthermore, it was argued that governments were placing greater emphasis on the goal of tax neutrality in operating their tax systems.

³ Institute of Chartered Accountants in Australia and Deloitte. (2008). Entity flow-through (EFT) submission. Sydney: Institute of Chartered Accountants.

⁴ Holub's thesis considered the reaction of taxpayers when the tax method applying to public unit trusts in Australia was altered so that they were taxed as corporations: Holub, M. (2001). Taxes and the Choice of Organisational Form in Australia. PhD, Department of Accounting and Finance, University of Western Australia.

Tax neutrality was then discussed in terms of business forms, and the key question was raised regarding how a business form's legal characteristics could influence the way a government resolved to tax it and its members. Specifically, in Chapter Two it was highlighted that breaches of tax neutrality can occur when an entity approach is used to tax a business form.⁵

In comparison, tax transparent treatment is argued as improving tax neutrality, with the Organisation for Economic Co-operation and Development (OECD) expressing how transparency would achieve greater neutrality and equity.⁶ Part of the analysis in this chapter addressed the importance of tax neutrality for cross-boarder transactions — particularly in the context of globalisation of trade and capital movements.

To appreciate the hesitation to implement tax transparency, some potential difficulties were canvassed, including administrative difficulties, unfunded tax liabilities for members and the potential risk to revenue for governments.

Empirical research that discussed the characteristics of closely held businesses and their economic significance was then considered. The inherent characteristics of a closely held business were that: the membership was not widely dispersed — particularly not publicly traded — it was independently owned and operated, with most capital contributed by members and managers. It was also outlined that members are likely to be active in the management of the business. While it was acknowledged that 'closely held' and 'small business' are not interchangeable *per se*, the vast majority of closely held businesses will, nonetheless, be small to medium enterprises.⁷ Despite this, however, it was pointed out that there can be a number of closely held businesses that are

⁵ For example, an entity approach can result in a preference for retention of profits and differences between debt and equity funding.

⁶ OECD.(1991). *Taxing Profits in a Global Economy: Domestic and International Issues*, at p 23

⁷ Freedman, J, and Ward, J. (2000). Taxation of Small and Medium-Sized Enterprises. *European Taxation* May:158, at p 159.

indeed large.⁸ To a substantial extent this dissertation focused on small and medium closely held businesses, although at times the implications for larger closely held businesses were raised.

An analysis of the literature concluded that challenges faced by closely held businesses included complexity, financing and governance. This analysis provided the basis for a critical examination of whether tax transparent companies were advantageous for closely held businesses.

10.2.3Chapter Three

Within Chapter Three a definitional basis of what is meant by a ‘tax transparent company’ was provided, which was predicated on three attributes: separate legal entity status; limited liability; and tax transparent treatment. It was demonstrated how the foreign business forms studied exemplified this, particularly S Corporations and limited liability companies (LLCs) from the United States, and limited liability partnerships (LLPs) from the United Kingdom. The Loss Attributing Qualifying Company (LAQCs) from New Zealand, also studied, was not a fully transparent company, and instead was a partial loss one — with only losses automatically allocated to members.

It was concluded that the transparent companies studied could be classified as ‘special tax rule companies’ which achieved tax transparency by applying special tax rules to corporations satisfying certain eligibility requirements; or alternately, ‘new form transparent companies’, representing the introduction of a new business form with transparency applying via the general partnerships tax rules.

⁸ Also, corporate groups with subsidiary companies could themselves be regarded as closely held.

It was then demonstrated that Australia's restricted recognition of tax transparent companies to date — venture capital ILPs and CFC hybrids — have the characteristics of tax transparent companies. Empirical data demonstrated that in the United States and New Zealand transparent companies had become a popular business form. In the United States, the transparent companies studied accounted for a majority of business forms (excluding sole traders), whereas in New Zealand the LAQC accounted for approximately 12 per cent of business forms. The United Kingdom's LLP had the lowest utilisation, although it was acknowledged that the LLP had been introduced only recently there.

10.2.4 *Chapter Four*

In order to address the first guiding research question, the discussion in Chapter Four considered whether the introduction of the foreign transparent companies studied was motivated by the desire to achieve greater tax neutrality or whether ulterior motives were more explanative. Furthermore, this analysis considered the role of closely held businesses in their introduction.

It was argued that a relationship was extant between the identified classifications of transparent companies, tax neutrality and closely held businesses. For 'special tax rule companies', the key motivating factor for both the United States and the New Zealand governments in introducing S Corporations and LAQCs was to improve tax neutrality for closely held businesses. That is, there was a desire that the tax system would have less influence on whether a business opted for an incorporated or unincorporated form. The relationship with closely held businesses was particularly evident through the membership restriction rules that were imposed in order to be eligible for tax transparency. However, a cynical explanation could be that, despite government sentiments, these transparent companies were a 'carve out' for closely held businesses from the normal tax treatment of corporations, providing them with concessional tax treatment.

For the two 'new form transparent companies' studied (LLCs and LLPs) the role of tax neutrality was not as explicit when they were introduced; rather breaches of it acted as a 'catalyst for change'. For both LLCs and LLPs it was concluded that there was a market drive for the introduction of an entire new business form subject to existing tax transparent rules for general partnerships. It was important that this new business form provided members with liability protection. These factors resulted in interest groups lobbying for their introduction and, led to competition among jurisdictions. Furthermore, large closely held businesses were instrumental in lobbying for, and even drafting original legislation for the enactment of the new form transparent companies.

10.2.5 *Chapter Five*

Given the underlying reasons identified with the foreign transparent companies studied, the focus within Chapter Five was to consider whether similar factors are extant in Australia. Through this analysis it was concluded that the key motivating institutional, legal and public policy influences observed overseas are not as prevalent in Australia. For special tax rule companies, one impediment is the Australian government's approach to tax neutrality, which is initially oriented to whether or not the business form provides limited liability to members rather than if the business form is closely held. This approach is diametrically opposed to that of the United States and the New Zealand governments with their introduction of S Corporations and LAQCs. The Australian government's position, in part, related to concerns about maintaining the integrity of the tax system. However, it was argued that if adequate loss restriction rules were implemented with a tax transparent company, then the Australian government's concern about the potential risk to revenue could be alleviated.

For new form transparent companies, Australia's full imputation system for corporate distributions and the use of discretionary trust for business operations reduce the extent of breaches of tax neutrality, particularly if compared to an entity approach.⁹ Also, peculiarities with the United Kingdom's and New Zealand's integrated tax systems for corporations do not exist in Australia. It was concluded that this meant there may not be the 'catalyst for change' to motivate interest groups to lobbying for reform. However, it was acknowledged that tax transparency could be beneficial in Australia due to the non-application of certain tax integrity measures, such as Division 7A. It was demonstrated that breaches of tax neutrality played a part in the introduction of Australia's restricted recognition of transparent companies to date. For example, the application of tax transparency to venture capital ILPs improved tax neutrality between debt and equity financing, whereas for CFC hybrids it improved import-export neutrality.

Discussion in the chapter further identified that there is currently no major drive for the introduction of a new form transparent company — by either businesses or professionals — although the recent ICAA proposal has seen the consideration of a flow-through entity become part of a broader tax review. Given the current range of available business forms, the factors of improved governance and limited liability were seen as to be not as significant in Australia. However, it was identified that international factors were instrumental in Australia's recognition of tax transparency for venture capital ILPs and CFC hybrids. It was concluded that international influences could be the most instrumental factor for the future introduction of transparent companies in Australia.

⁹ Although the use of these entities for tax planning strategies could be perceived as breaching tax neutrality.

10.2.6 Chapter Six

The analysis in Chapter Six focused on how the jurisdictions studied have ensured that tax transparency for a business form with limited liability for members has not jeopardised their tax systems, particularly the utilisation of losses. It was identified that in the absence of adequate loss restriction rules, unfettered access to losses by limited members could result in the tax system distorting investment decisions which contradicts the proposition that transparency achieves greater tax neutrality.

To ascertain what measures had been adopted in the foreign jurisdictions studied, an analysis was then conducted of the loss restriction rules applicable to tax transparent companies in the United States, the United Kingdom and New Zealand. These foreign rules were compared and contrasted with rules introduced in Australia for venture capital ILPs and CFC hybrids to ascertain their adequacy. It was argued that the foreign jurisdictions in whole or in part had adopted four loss restriction rules based on membership cost basis, risk, passivity and streaming.

The first restriction involved the notion that members are able to utilise allocated losses to the extent of their equity investment in the transparent company (membership cost basis). The second restriction considered the level of a member's risk exposure in terms of their equity investment in the transparent company or, alternately, in terms of being exposed to movements in value of their membership interest. The third restriction was associated with passivity, considering the extent of a member's involvement in the transparent company's business. The final restriction related to the capacity of transparent companies to stream losses to some members in preference to others.

It was concluded that the loss restriction rules applying to Australia's CFC hybrids were more thorough than those applying to venture capital ILPs and compared favourably to the foreign jurisdictions studied. However, amendments and clarifications are required, including the inclusion of members' subordinated debt, the exclusion of non-recourse loans to fund the acquisition of membership interests and the extension of the restriction rules to all members. It was argued in Chapter Six that the Australian loss restriction rules (with amendments) would be adequate to allow for the broad availability of a tax transparent company in Australia.

10.2.7 *Chapter Seven*

The dissertation then addressed the subsidiary research questions in relation to the implications for closely held businesses of the availability of a transparent company form. The analysis in Chapter Seven reflected upon whether disregarding the legal form for tax purposes would lead to increased tax complexity due to the divergence between legal ownership of assets and earnings (with the transparent company), with the tax consequences (with members). The available empirical evidence suggested that tax transparent companies might result in higher tax compliance costs compared to other business forms. Furthermore, it appeared that new form transparent companies imposed greater compliance costs than special tax rule companies. Also transparent companies could aggravate the regressive nature of compliance cost for small businesses.

This potential to increase compliance costs was then examined in terms of eligibility requirements, the extent of aggregation, loss restriction rules and cross-jurisdictional issues. The chapter concluded by questioning the need for imposing extensive eligibility requirements. Furthermore, it was argued that some 'entity acknowledgement' for tax purposes, in terms of asset holdings and membership

interest, might be a beneficial compromise in decreasing tax compliance costs, while still achieving the overall aims of tax transparency. This was because full aggregation, with members having direct fractional interests in underlying assets, could result in increased complexity. Additionally, it was argued that a jurisdiction needs to be mindful in drafting loss restriction rules to ensure that they achieve their goals without being too onerous.

10.2.8 *Chapter Eight*

Given the prior literature highlighting the finance problems faced by closely held businesses, the focus in Chapter Eight was to consider how tax transparency might assist closely held businesses, in terms of their ability to raise equity and their overall tax burden.

It was concluded that the eligibility requirements for special tax rule companies to gain tax transparency could inhibit their ability to raise equity and thereby stifle their development. Given the minimal eligibility requirements for new form transparent companies it was argued that tax transparency could be available when the following conditions existed: membership interests were not publicly traded; a majority election was made by members and managers; and, if the business form is resident of a foreign country, then tax transparency also applied there. It was argued that there may be some benefit in providing that a transparent company with one class of membership interest did not have to comply with anti-streaming rules, to decrease possible compliance cost.

It was concluded that, in comparison to the tax treatment of corporations and their members, transparency did not always result in an overall lower tax burden in the foreign jurisdictions. Also the problem of member assessment for unpaid

allocations was discussed.¹⁰ However, tax transparency was beneficial compared to the situation for corporations and their members subject to an entity or integrated approach in terms of access to losses, tax preferences and capital gains.

This analysis demonstrated that an important influence on the level of tax burden was the characterisation of active members as either employees or self-employed persons which, depending upon the jurisdiction, could have a negative or positive impact. It was argued, that given the underlying goal of tax transparency, the more appropriate treatment was to treat active members as self-employed rather than as employees. The analysis also identified that tax transparency did improve tax neutrality between debt and equity funding, which is beneficial for closely held businesses as they can be characterised by a reliance on equity funding.

10.2.9 Chapter Nine

While economically it may be preferable for tax purposes to disregard the legal form and allocate income and/or losses directly to members, the governance regime of such a form can be important to facilitate investment. To gain a better appreciation of what legal forms were being disregarded for tax purposes, the underlying governance regimes of the foreign transparent companies studied were analysed in Chapter Nine. This analysis considered the mandatory rules in regards to capital protection and single membership, the default governance rules, member-management and transferability of membership interests.

It was argued that the suitability of special tax rule companies is largely influenced by the governance regime imposed by the relevant corporation law.

¹⁰ However, this did not apply to the LAQC, as it is a partial loss transparent company with income initially assessed at the entity level.

This can be problematic both in the United States and in New Zealand, as the default governance regime for corporations appears to be more appropriate for widely held rather than for closely held businesses. While the use of membership agreements or operating agreements alleviates the impact of the default governance regime in both the United States and New Zealand, this can increase costs and decrease networking benefits. It was argued that the relevant governments should have had greater consideration to the underlying governance rules in addition to the tax rules when introducing their special tax rule companies.

In terms of the governance regime for the new form transparent companies, LLPs appears a problematic choice of business form for closely held businesses due to the lack of any substantial default rules, the assumed member-management and the requirement for at least two members. This could be traced back in part to the reasons identified in Chapter Four, which indicated that the LLP was originally intended for professional firms. LLCs appeared to have more appropriate governance rules for closely held businesses, although concerns were expressed with recent moves to adopt more default characteristics appropriate to widely held membership.

It was argued that it was preferable for any jurisdiction introducing a tax transparent company to have a holistic approach and not focus only on tax characteristics, and to consider whether the governance regime provided for characteristics exemplified by closely held businesses.

10.3 To strive or not to strive?

For the Australian government regulatory burden, in terms of both governance and tax rules, is a major concern with small businesses which generally are closely held.¹¹ For the Australian government to adopt a tax transparent company it would need to be satisfied that transparency does reduce the regulatory burden for small businesses. However, given the prior analysis in this dissertation it is argued that this is not necessarily the case.

From the factors outlined in prior chapters, it is not certain whether there would be any substantial benefits for closely held businesses if Australia strived for the economic ideal of a tax transparent company, particularly if tax transparency was introduced as an 'alternative' way of taxing business forms in addition to the established methods in Australia.¹² If it were not part of an overall comprehensive reform package, such an additional alternative would merely add to an already complex system. Indeed, such an optional additional approach may encourage taxpayers to choose a business form due to tax arbitrages. Unfortunately, it is such an 'additional' methodology advocated in the ICAA proposal. Furthermore, the demand or desire for such transparency may be insufficient to see it adopted by a large number of taxpayers. This is due, in part, to the fact that the breaches of tax neutrality in Australia may not be as significant as in other jurisdictions because of the full imputation system for corporations and the use of discretionary trusts for businesses.¹³ To explain more fully, in Australia there is not the 'catalyst for change' for wide scale adoption of tax transparent companies. While the United Kingdom and New Zealand both

¹¹ See generally: Burton, M. (2006). The Australian small business tax concessions - public choice, public interest or public folly? *Australian Tax Forum* 21 (1):71.

¹² For example, the full imputation system applying to corporations and limited partnerships, partial income transparency applying to discretionary and unit trusts, and full aggregation for general partnership, venture capital ILPs, CFC hybrids and sole traders.

¹³ However, it could be argued that the use of discretionary trusts for tax planning strategies actually breaches tax neutrality.

introduced transparent companies when they had an integrated tax system applying to corporations, it was highlighted in Chapter Five that the application of the National Insurance Contributions (NIC) and the absence of a comprehensive capital gains tax were characteristics unique to those jurisdictions which largely are not replicable in Australia. In view of this, it is argued that the extent of breaches of tax neutrality may have a relationship with the extent of utilisation of transparent company forms, especially in the early years when uncertainty costs concerning them could be the greatest.

It has been previously argued that transparent companies do have attendant uncertainty costs, particularly when they are introduced, and even more so if they are 'new form' transparent companies.¹⁴ This uncertainty can relate to various issues: the recognition of their limited liability; an unfamiliar governance regime; and the 'blending' of general partnership and corporations law. There can also be conversion expenses for established businesses into the new form. These costs may be aggravated by increased tax compliance costs that may result with tax transparency applying to a business form with limited liability and separate legal entity status.¹⁵ To be successfully introduced into a jurisdiction, a transparent company needs to provide its members with benefits that outweigh these potential costs.

In Chapter Nine it was argued that one such benefit could be an improved governance regime. However, governance benefits may of course be difficult to quantify precisely. For example, they could be accumulative or, alternatively, they may never need to be utilised. It is argued, then, that potential tax savings make a more immediate, tangible and discernible benefit. For example, Chapter Six demonstrated that access to losses through a transparent company could offset a member's overall tax liability. Such discrete savings could encourage the

¹⁴ Refer to the discussion in Chapter Nine.

¹⁵ Refer to the studies discussed in Chapter Seven.

utilisation of a transparent company form.¹⁶ Furthermore, Chapter Eight provided examples of how transparency can decrease the overall tax burden for the business and its members, compared to the treatment of corporations.¹⁷

It is argued that tax savings may play an important part in the willingness of businesses to adopt a transparent company form, as an offset to any perceived costs (including uncertainty and tax compliance costs). Of course such an acknowledgement is at odds with the idea that tax transparency enhances tax neutrality.

In terms of closely held businesses benefiting from the introduction of a tax transparent company, the analysis in Chapters Seven to Nine highlighted a number of concerns in the jurisdictions studied. While, historically, there has been reference to the relationship between tax transparency and closely held businesses, it is argued that tax transparent companies are not necessarily a benefit for closely held businesses. Instead, it can be considered that closely held businesses are beneficial for the implementation of a tax transparent regime. That is, transparency is more feasible and operational for governments when membership is closely held. If this is the way the relationship operates, then it brings into question the validity of the notion that transparency is a benefit for closely held businesses.

For example, Chapter Seven identified empirical data which suggested that tax transparency can result in greater tax compliance costs compared to transparency applying to businesses without company characteristics¹⁸ and integrated approaches applying to corporations. Reasons for this increased compliance cost were raised in terms of eligibility requirements, the extent of

¹⁶ The savings that losses present, especially as they could be in early years of operation is that decrease the overall financing cost of the business operations and alleviate pressure on debt funding.

¹⁷ However, the extent of these potential savings did vary and had certain qualifications.

¹⁸ That is, general partnerships and sole proprietors.

aggregation, loss restrictions and cross-jurisdiction treatment; although, it did appear that special tax rule companies may impose less compliance costs than those for new form transparent companies.

The discussion in Chapter Eight demonstrated that tax transparent companies will not necessarily assist closely held businesses in addressing their financial challenges. This included concerns about strict eligibility requirements and the adverse effect this may have on raising equity. Also it was demonstrated that the relationship between corporate, capital and individual tax rates was critical in determining the overall tax benefit. However, tax transparency was seen to be advantageous in terms of access to tax losses, tax preferences and capital gains.

Despite these reservations about what can be achieved by the broad introduction of a transparent company in Australia, if Chapter Five's conclusions about the persuasiveness of international influences then a transparent company in Australia may be inevitable. This focus is reinforced by the recent ICAA proposal which advocated for a transparent company. However, there are a number of alternatives of how this could be achieved; each of which will now be considered.¹⁹

10.4 Transparent company alternatives

In Chapter Six it was concluded that the Australian loss restriction rules for CFC hybrids (with amendments) are adequate to allow for the broad availability of a tax transparent company. However, there are a number of possible alternative ways a tax transparent company could be implemented in Australia. Firstly, venture capital ILPs or CFC hybrids could be made available to all investors.

¹⁹ In addition to the potential consequences identified, if a transparent company was to be implemented transitional issues would need to be addresses. For example, whether existing forms could move into the transparent regime. Also issues of goods and services tax and State government treatment would need to be considered.

Secondly, Australia could introduce its own 'new form transparent company', or thirdly a 'special tax rule company' could be devised. The forth option, and the preferred alternative, is the introduction of a partial loss transparent company. Below is a detailed analysis of these alternatives, highlighting the advantages and disadvantages, cumulating in the preferred approach.

10.4.1 *Broadening Australia's existing forms*

Currently there is restricted availability of venture capital ILPs and CFC hybrids in Australia. For example, tax transparency is only available to venture capital ILPs for certain types of investments in venture capital corporations.²⁰ If these requirements are not satisfied then tax transparency will not apply.²¹

Similarly, tax transparency is not available for Australian investors who formed an LLC or LLP in the United States or United Kingdom respectively and then used that business form for Australian operations. Where there are extensive Australian business operations with Australian members, the LLC²² or LLP²³ is

²⁰ Instead an integrated tax approach would apply — the consequence being that the ILP is taxed similarly to a corporation. Refer to the prior discussion in Chapter Three about the eligibility requirements.

²¹ *ITAA 1936* (Cth), Division 5A.

²² For the LLC, the Australian Tax Office is of the opinion that the LLC is a 'company', and as such it is not necessarily excluded from conducting business in Australia while remaining non-resident. This is because even if the LLC, for example, was formed overseas it could be regarded as an Australian tax resident if it carries on business in Australia and has its central management and control in Australia, or its voting power is controlled by members who are residents of Australia: *ITAA 1936* (Cth), section 6(1) definition of 'resident' for a company. This is confirmed in Australian Taxation Office. (2006). ATO Interpretive Decision: ATO ID 2006/18: Income Tax: Foreign hybrid rules: treatment of foreign hybrid company as partnership. Canberra. The Explanatory Memorandum indicates that in certain circumstances an LLC could have Australian sourced income and still come within the CFC hybrid rules: Explanatory Memorandum accompanying Taxation Laws Amendment Bill (No 7) 2003 (Cth), at paragraph 9.30. However, to remain a non-resident the management and control must not be within Australia and voting control must exist outside Australia. These requirements largely exclude the possibility of Australian business operations utilising the LLC or LLP to gain tax transparency in Australia.

²³ For tax transparency to apply to a CFC hybrid, one of the requirements is that the foreign business form must not be an Australian tax resident. Due to 'residency' tests this can restrict Australians trying to utilise foreign transparent companies for Australian business operations. For a non-resident transparent company that is regarded as a 'limited partnership', then it appears

likely be regarded as an Australian resident and therefore would be excluded from the transparency applying pursuant to the CFC hybrid amendments.²⁴

Accordingly, legislative reform is necessary to broaden their availability. One possibility for reform is for Australian state governments to make ILPs available to all investors and not just venture capital investors qualifying for registration with the Venture Capital Registration Board.²⁵ Additionally, the Federal government would need to extend tax transparency to all ILPs operations and not just venture capital investment.²⁶ The broad availability of an ILP form is what the New Zealand government recently implemented with its new limited partnership.²⁷

However, the broad availability of ILPs may not be the preferred approach: the governance regime of ILPs may be problematic for use by closely held

there can be no Australian operations. This would exclude Australian investors using the United Kingdom's LLP for any Australian business operations at all. However, this conclusion is not without question, as an LLP may come within the Australian meaning of 'company', which has a different residency test. Note ATO ID that indicates that LLP is a company due to corporate characteristics: Australian Taxation Office. (2006). ATO Interpretive Decision: ATO ID 2006/332: Foreign Hybrid Limited Partnership: UK Limited liability partnership: referring to the fact that an LLP is a body corporate, and not 'an association of persons ... in receipt of income jointly'. For foreign transparent companies that are considered as a 'partnership' there is no current definition of Australian 'residency' for general partnerships, though there is one for a 'corporate limited partnership'. A 'corporate limited partnership' is an Australian resident when it is (a) formed in Australia, or (b) carries on business in Australia; or (c) has central management and control in Australia: *ITAA 1936* (Cth), section 94T. Due to the broadness of the second limb of this test, any business operation in Australia by a limited partnership could make it resident. This conclusion is supported by the Explanatory Memorandum accompanying Taxation Laws Amendment Bill (No 7) 2003 (Cth), at paragraph 9.27, which states that the non-resident status means that a limited partnership cannot carry on business in Australia during the year. Technically it is not clear if this definition would apply to a CFC hybrid as they are excluded from being a 'corporate limited partnership' (circular definitions).

²⁴ *ITAA 1997* (Cth), section 830-15(c).

²⁵ Known previously as the Pooled Development Fund Board up to 21 June 2007.

²⁶ With the application of the loss restriction rule.

²⁷ This was finalised by the *Limited Partnerships Act 2008* (assented to 13 March 2008), commencing 1 April 2008. Cullen, M (Minister of Finance), and Dunne, P (Minister of Revenue). (2006). General and limited partnerships — proposed tax changes: A government discussion document. Wellington, at p 6. New Zealand's approach is particularly understandable given that it is hard to categorise venture capital as a precise 'industry', as it really consists of private investors who could invest in a wide range of industries (both traditional and upcoming industries). This characteristic of venture capital is why it is also known as 'private equity', to distinguish it from businesses raising public funds through stock market listings.

businesses. For instance, the ILP does not allow for single membership,²⁸ a characteristic of many Australian businesses. Also, the ILP may be unsuitable for active members, as even with safe harbour provisions their involvement in the business may prejudice their limited liability protection as a limited member.²⁹ Furthermore, the restricted governance framework of the ILPs regarding their default rules may act as an impediment for the development of extensive networking benefits. For these reasons it is argued that a transparent company based on the ILP is not the preferable option.³⁰

Alternatively, the CFC hybrid rules could be amended to ensure that tax transparency applies to all LLCs and LLPs formed overseas, even if they are considered Australian tax residents.³¹ Arguably, such an alternative could have some positive outcomes. For example, investors would have a wider choice of potential business forms, which may in turn offer more appropriate governance rules. Some academics have argued that allowing such jurisdictional choice could have 'profound benefits for the evolution of business law'.³² There could

²⁸ An ILP requires at least two members, one general and one limited: *Partnership Act 1892* (NSW), section 53C; *Partnership Act 1958* (Vic), section 96; *Partnership Act 1891* (Qld), section 84; *Partnership Act 1963* (ACT), section 66; *Partnership Act 1891* (SA), section 51C; and *Partnership Act 1997* (NT), section 64.

²⁹ *Partnership Act 1892* (NSW), sections 66A and 67A; *Partnership Act 1958* (Vic), sections 97 and 98; *Partnership Act 1891* (Qld), sections 86 and 87; *Partnership Act 1963* (ACT), sections 67 and 68; *Partnership Act 1891* (SA), sections 64A and 65A; and *Partnership Act 1997* (NT), sections 65 and 66. Of course, an active member could be a general member, but then they would have liability exposure. The safe harbour provisions in terms of limited liability appear to be based on the Delaware limited partnership model, even though the *Uniform Limited Partnership Act (2001)* in the United States has removed altogether the exclusion of limited members from participating in management.

³⁰ However, there is merit in making ILPs available beyond venture capital investment, as it appears artificial to restrict their utilisation to just venture capital investment. This is particularly given the fluid nature of what exactly is venture capital investment, see: Barkoczy, S, and Sandler, D. (2007). *Government Venture Capital Incentives: A multi-jurisdiction comparative analysis*, Research Study No 46. Sydney: Australian Tax Research Foundation.

³¹ Note currently the special tax rule companies studied, S Corporations and LAQCs, are not entities covered by the CFC hybrid amendments. As discussed in Chapter Three, S Corporations and LAQCs do not come within the term 'foreign hybrid company', since neither the United States or the New Zealand tax system treat them for tax purposes 'as a partnership': *ITAA 1997* (Cth), section 830-15(2)(b).

³² McCahery, JA. (2004). Introduction: Governance in Partnership and Close Corporation Law in Europe and the United States. In *The Governance of Close Corporations and Partnerships: US*

also be networking benefits insofar as there is an established body of law overseas addressing the business form's governance.

Nevertheless, it is argued that this alternative has negative implications for closely held businesses. Firstly, the wider choice may lead to an 'array' of business forms, and this could easily lead to 'inconvenience' and complexity.³³ This position could be exacerbated by Australian professionals' (lawyers, accountants and financiers) unfamiliarity with the foreign law, leading to greater uncertainty costs. For example a financier may require greater returns on credit or greater security to offset the potential uncertainty.

Furthermore, when dealing with a foreign form there may be continuing tax and other regulatory obligations in the foreign jurisdiction where the business form was initially established – even if that business form only trades in Australia.³⁴ Compliance with a foreign jurisdiction's law could thus be costly, as foreign advisers may have to be appointed to supplement the Australian advisers. This uncertainty and complexity is of concern – particularly for closely held business – as compliance costs can be regressive if their operations are small.

Moreover, this uncertainty may inhibit the ability to raise equity, as members may be reluctant to invest in a business governed by foreign law. Further, the potential for networking benefits may be restricted if the transparent company was only recently established overseas. This is compounded if the foreign case law is not followed in Australia or if Australian regulatory rules are overlaid. In view of this, it is argued that the interaction between foreign and domestic law

and *European Perspectives*, edited by J. McCahery, T. Raaijmakers and E. Vermeulen. Oxford: Oxford University Press, at pp 186-187.

³³ McCahery, JA, and Vermeulen, EPM. (2004). The Evolution of Closely Held Business Forms in Europe. In *The Governance of Close Corporations and Partnerships: US and European Perspectives*, edited by J. McCahery, T. Raaijmakers and E. Vermeulen. Oxford: Oxford University Press, at p 220.

³⁴ Such as annual filing requirements.

may outweigh any perceived benefits.³⁵ In this context, Chapter Nine raised some associated issues about the overall suitability of the governance laws, especially for LLPs, for closely held businesses. For these reasons it is argued that extending Australia's existing transparent companies is not the preferable approach to facilitate the broad availability of tax transparent company in Australia.

10.4.2 *Australia's own new form transparent company*

Another alternative for the broad introduction of a transparent company in Australia is for the various State governments or the Federal government to enact their own new form transparent company based on a governance regime similar to that of either LLCs or LLPs. Which tier of government would enact the relevant regulatory legislation would depend in part upon whether the Federal government's constitutional powers extended to enacting for LLCs or LLPs as 'corporations'. Currently the Federal government, through agreement with the states, has power to legislate for corporate formation and governance, but has no power over formation of partnerships and trusts.³⁶ It was for these constitutional reasons that the states, rather than the Federal government, enacted the governing legislation for venture capital ILPs. Given the combination of partnership and corporate characteristics of these new form transparent companies, the states are likely to have the relevant constitutional powers.

³⁵ McCahery, JA, and Vermeulen, EPM. (2003). Business Organization Law and Venture Capital. In *Venture Capital Contracting and the Valuation of High-technology Firms*, edited by J. McCahery and L. Renneboog. Oxford: Oxford University Press, at p 174. In Chapter Four it was noted that Jersey failed to attract foreign businesses to utilise its LLP due to high switching costs. It is such inter-jurisdictional transaction costs that hinder Ribstein's premise of jurisdictional competition leading to an evolution of businesses forms: Ribstein, LE. (2004). The Evolving Partnership. In *The Governance of Close Corporations and Partnerships: US and European Perspectives*, edited by J. McCahery, T. Raaijmakers and E. Vermeulen. Oxford: Oxford University Press.

³⁶ All Australian states passed legislation referring their powers to the Commonwealth. New South Wales was the first State to do this with the *Corporations (Commonwealth Powers) Act 2001* (NSW). The referral legislation contains a sunset provision, terminating five years after the commencement of the new corporations' legislation unless the States agree to extend it.

However, as detailed in Chapter Five, their income tax treatment would rest with the Federal government through the income tax assessment acts.

This alternative, Australia's own new form transparent company, could provide members with a business form with liability protection which, nevertheless, would have distribution rules to protect creditors. The governance of such a new form could be designed to provide a superior framework for closely held businesses. As established in Chapter Nine, the governance rules should provide for the following characteristics of closely held businesses: single or multi-membership, member-management, transferability of membership interest and a default set of standard rules that could be altered through a membership agreement.

The creation of Australia's own new form transparent company may provide greater clarity about its governance, compared with the prior alternative of utilising foreign forms. With a default set of standard rules, networking benefits could be provided as relevant case law develops, although an initial degree of uncertainty may result until familiarity grew and a body of case law was established.

Part of this uncertainty could relate to the 'blending' of general partnership and corporate law in terms of the governance. However, as previously argued in Chapter Nine, this has already occurred to a certain extent with closely held corporations, and it may be preferable to have the blending of principles originating from the legislation creating the business form, rather than from a situation where members' agreements and the governing law are blended.

An important attribute to improve certainty would be the confirmation that tax transparency applied to this business form with company attributes. This would require the Federal government to alter the current tax law to ensure this.³⁷ It should be recalled that the uncertainty surrounding the tax treatment of LLCs in

³⁷ Otherwise such a business form would be taxed as a corporation or a limited partnership.

the United States saw only two states enact LLC legislation prior to the 1988 tax ruling specifying its tax treatment. The improved certainty provided by the 1988 tax ruling, led to the remaining 48 states and the District of Columbia enacting LLC legislation within six years.³⁸

While there are a number of models that could be utilised for the development of this new form transparent company, of the two studied for this dissertation, it was concluded in Chapter Nine that the LLC governance regime is the preferable model for closely held businesses.³⁹ This model is most definitely the preferred paradigm, given that the United Kingdom's LLP governance has a number of characteristics that are problematic for closely held businesses.⁴⁰ Of course it would be beneficial to consider business forms in other jurisdictions beyond the analysis in this dissertation.

While there are potential benefits of introducing a new form transparent company, if the conclusions in Chapter Seven are correct, then tax transparency applying to a new form transparent company could result in greater tax compliance cost, which could be regressive for small businesses. It is for this reason that the introduction of a special tax rule company deserves greater attention.

³⁸ As outlined in Chapter Three, between 1977 and the 1988 tax ruling that provided some certainty about the LLC's tax treatment, only two American states had introduced LLC legislation and less than 100 businesses filed as LLCs in Wyoming. After the 1988 tax ruling, LLC legislation was rapidly introduced by all American states within six years. Five years after the 1988 tax ruling, LLCs represented just 0.32 per cent of business forms lodging tax returns (excluding sole proprietorships). The certainty for LLC's tax treatment with the introduction of Check-the-Box in 1998 was further improved. In 1998 LLCs represented 7.10 per cent of all business forms lodging tax returns. By 2003 this had increased to 14.14 per cent.

³⁹ This is a sentiment shared by other commentators: McCahery and Vermeulen, n 33, at p 195.

⁴⁰ For example the LLP has no standard set of comprehensive default rules, requires at least two members, and has members' duties regardless of their involvement in the business. Refer to Chapter Nine.

10.4.3 *A special tax rule company*

Another alternative to make tax transparent companies broadly available in Australia is the introduction of a special tax rule company with full transparency. This model could be similar to S Corporations insofar as members and managers would elect for tax transparency, rather than the corporate imputation system. To reinforce this argument, the ICAA proposal put forward a model similar to S Corporations, extending unit trusts as well.⁴¹ In terms of S Corporations there are a number of eligibility requirements for tax transparency, including one class of membership interest; residency of the business form and/or members; and trading activities. In Chapter Eight it was argued that provided an adequate loss restriction rule applies then the eligibility restrictions need not be so severe.⁴²

Also, if a special tax rule company was introduced, reliance on existing corporations law may reduce the potential uncertainty cost.⁴³ This may mean that the introduction of a special tax rule company is easier to facilitate in Australia due to lower costs. However, the benefits of such a model for closely held businesses would depend upon, in part, the appropriateness of the underlying corporation law.

The pursuit of this alternative in Australia would have a number of advantages. Firstly, it would allow taxpayers to have networking benefits in terms of utilising an established business form, the corporation, with its existing body of case law and understanding in terms of governance. This alternative would address, in

⁴¹ Institute of Chartered Accountants in Australia and Deloitte, n 3.

⁴² In Chapter Eight it was argued that the complexity of a tax transparency regime could be mitigated by adopting the following eligibility criteria: that the membership interests are not publicly traded; that a majority election exists by members (and managers); and that, if the business form is resident in another jurisdiction, then tax transparency applies there. Additionally, there could be the option to exclude certain tax integrity measures if one class of membership interest exists.

⁴³ Cost in terms of uncertainty and tax compliance.

part, concerns that new transparent company forms create increasing uncertainty.⁴⁴

Furthermore, it would be possible to have single membership⁴⁵ with member-management not prejudicing liability protection for members.⁴⁶ Related to this is the fact that membership interest could be freely transferable or restrictions imposed if desired. If the argued eligibility requirements in Chapter Eight were adopted then the on-going monitoring cost should be mitigated, although the loss restriction rules would need to be satisfied. Such a vehicle would allow potential listing on a stock exchange if desired in the future. Upon listing the underlying business form would not change, but the applicable tax rules would alter from tax transparency to the corporate imputation system. In terms of finance, while a special tax rule company would facilitate the raising of equity, the tax benefits of transparency compared to imputation may be minimal.

However, in addition to the flow-through of tax losses and preferences, there would be benefits in certain avoidance provisions not applying, such as Division 7A⁴⁷ and the personal services income provisions.⁴⁸ Other complex provision that need not necessarily apply to a transparent company could include share value shifting,⁴⁹ tracing capital gain discounts,⁵⁰ and tracing rules for capital

⁴⁴ Freedman, J. (2004). Limited Liability Partnerships in the United Kingdom: Do They Have a Role for Small Firms? In *The Governance of Close Corporations and Partnerships: US and European Perspectives*, edited by J. McCahery, T. Raaijmakers and E. Vermeulen. Oxford: Oxford University Press, at p 512.

⁴⁵ *Corporations Act 2001* (Cth), section 114.

⁴⁶ Although such activity may expose an active corporate member to liability in other capacities, such as a director or an employee.

⁴⁷ *ITAA 1936* (Cth). Division 7A was, introduced (effective from 4 December 1997) to address the practice by private corporations of effectively distributing profits to members, or associates of members, via non-assessable payments, loans or forgiven debts. When Div 7A applies to a payment, loan or forgiven debt, under s 109D of the *ITAA 1936*, an amount is deemed to be a dividend paid by the private corporation to a member, and is then assessable income for the member.

⁴⁸ *ITAA 1997* (Cth), Division 84 to 87. The operation of these provisions restrict taxpayer's ability to shelter personal services income in an entity taxed at a lower rate, to split income among a number of taxpayers, and the ability to access concessional fringe benefits and superannuation provided to employee-members. *ITAA 1997* (Cth), section 86-15.

⁴⁹ *ITAA 1997* (Cth), Division 723 to 727.

assets acquired prior to 20 September 1985.⁵¹ Furthermore, a tax transparent company could provide an alternative path of tax consolidations, which is often problematic for small businesses.⁵² While ‘tax benefits’ of themselves should not be a driving motivation of a transparent company, such a consequence reflects Chapter Four’s cynical observation that special tax rule companies could be seen as a ‘carve out’ for closely held businesses from the normal tax rules applying to corporations.

Another tax concession potentially available is that fringe benefits tax (FBT) would not apply to benefits provided to member-managers, thus decreasing compliance cost particularly if there are no other employees. This concession is on the proviso that active members are treated as self-employed, as argued for in Chapter Eight. However, certain fringe benefits are concessionally taxed, so this treatment could increase the tax impost for active members of a transparent company compared to active members of a corporation.

A problem with this alternative is the suitability of the Australian corporation for utilisation by closely held businesses, although this has not stopped many businesses utilising this form. Even with the improvements of the Corporations Act simplification program, there are still criticisms that a corporation’s internal governance rules are too onerous for closely held businesses.⁵³ It is argued that it would be preferable, in the process of introducing a special tax rule company to take the opportunity to critically evaluate whether the current governance rules provided by the Corporation’s Law are appropriate for closely held businesses. It may be that new governance rules starting from a general partnership model be created. Indeed it may be worthwhile reconsidering the benefits of the *Closed*

⁵⁰ ITAA 1997 (Cth), section 115-40.

⁵¹ ITAA 1997 (Cth), CGT event K6.

⁵² Institute of Chartered Accountants in Australia and Deloitte, n 3, at p 10.

⁵³ Farrar, JH. (2001). *Corporate Governance in Australia and New Zealand*. South Melbourne: Oxford University Press, Whincop, MJ. (1997) Trivial Pursuit: A Theoretical Perspective on Simplification Initiatives 7 AJCL 250 and Hill, J. (1989). Close Corporations in Australia: The Close Corporations Bill 1988. *Canadian Business Law Journal* 15:43, at p 49.

Corporations Act which was 'lost' in the constitutional challenges of the early 1990s.⁵⁴ Another relevant point to note here is that there could be a greater role of membership agreements in making the corporations law more appropriate. It should be recalled that in Chapter Nine it was argued that the jurisdictions studied would have benefited from such a holistic approach when introducing their special tax rule companies.

The ICAA proposal argues for such a special tax rule company; while the author sees some merit in this proposal, throughout this dissertation a number of concerns have been raised about it, including the applicable loss restriction rule (Chapter Six); lack of entity acknowledgement (Chapter Seven); eligibility requirements (Chapter Eight); and failure to consider underlying governance rules (Chapter Nine). Given this critique, it is argued that these concerns need addressing if the proposal was to be implemented.

However, it should be acknowledged that tax transparency could impose greater tax compliance cost than an entity or integrated approach, as demonstrated by the data discussed in Chapter Seven. Greater compliance cost could result from the extent of aggregation, loss restriction rules and the eligibility requirements. The ICAA proposal largely overlays general partnership tax principles for its flow-through entity. It is argued that this is not preferable, as the superimposing of partnership tax rules could be awkward when applied to a business form with separate legal entity status and limited liability for members. Instead, uncertainty could be mitigated by having particular tax rules drafted for a transparent company.

For example, it is argued that unnecessary tax compliance costs arise for the United States' LLCs because they are taxed pursuant to Sub-Chapter K of the *Internal Revenue Code 1986* (US), which was drafted for general partnerships characterised by no liability protection for members. The differences between

⁵⁴ Refer to the discussion in Chapter Five about the proposed *Close Corporations Act 1989* (Cth).

business forms mean that the provisions of Sub-Chapter K do not adequately deal with the potential legal nuisances. This awkwardness in terms of the tax regime and a company structure was demonstrated in Chapter Six, where an LLC's outside loan increased the membership cost basis despite the LLC member having no personal liability for the loan.⁵⁵ It is argued that if tax transparency is to be applicable to an entity that has limited liability and separate legal entity status, it is preferable to have provisions drafted specifically for it.

It is for a similar reason that a United States' style of Check-the-Box, allowing businesses to choose which tax methodology will apply to them is not advocated. It is argued that such a wide discretion is fraught with difficulties as the particular legal characteristics of business forms may require particular tax rules, otherwise unforeseen tax arbitrages may arise. A similar conclusion has recently been articulated in the United Kingdom.⁵⁶

A negative factor with a special tax rule company is the relationship between the corporation and the individual tax rates in Australia. Chapter Five highlighted that the tax benefits of transparency in Australia are eroded by the full imputation system applying to corporations and by the lower corporate tax rate of 30 per cent, compared to the top individual marginal tax rate of 45 per cent plus 1.5 per cent Medicare levy. This means the allocation of income to members of an Australian transparent company could be subject to a greater rate of tax compared to profits accumulated in a corporation.

This may mean that the adoption of such a fully tax transparent company could increase the overall tax burden and thereby reduce the incentive for the

⁵⁵ While this inclusion was then reversed out by the 'at risk' rule, this overlay is not preferable.

⁵⁶ Crawford, C, and Freedman, J. (2008). Small Business Taxation. In *Prepared for the Report of a Commission on Reforming the Tax System for the 21st Century*, Chaired by Sir James Mirrless: The Institute of Fiscal Studies: suggest that for the United Kingdom an optional transparent system would just result in taxpayers seeking tax arbitrages.

utilisation of a transparent system. After all it was the lack of perceived benefits that undermined the utilisation of the Simplified Tax System in Australia.⁵⁷

It is for all these reasons that a partial loss transparent company is advocated rather than a fully tax transparent company.

10.4.4 *A partial loss transparent company*

The interaction between corporate and individual tax rates is of particular importance given the financing problem that can confront closely held businesses and their reliance on funding from members. For this reason, it may be preferable to have a partial loss transparent company, similar to New Zealand's LAQC. In this way, when the Australian tax transparent company has income, profits would be initially assessed at the entity level at 30 per cent, with franking credits being generated on the income tax paid.

A benefit of this system is that if there are concerns with protecting the tax base when there are non-resident members of a transparent company – then the suggested alternative addresses this to an extent as tax is initially collected at the entity level.⁵⁸

Such a system would allow income to be accumulated at the entity level and to be available for further reinvestment into the business. However, accumulated profits would have to be allocated to members so to increase their membership cost basis, which would influence their ability to utilise any losses allocated by the partial loss transparent company.⁵⁹ Such a mechanism would be consistent

⁵⁷ Burton, n 11.

⁵⁸ Refer to the prior discussion in Chapter Eight about the eligibility requirements and the potential concerns with allocations to non-resident members.

⁵⁹ It is argued that retained profits should allow the greater utilisation of losses as these profits are at risk should the transparent company become insolvent.

with the policy recommended by Pizzacalla to improve the capital of small and medium enterprises.⁶⁰

It is argued that such a partial loss transparent company would provide greater incentive for Australian investors to adopt transparency. Later distributions to members would either be franked or unfranked. 'Distributions' would include profit distributions, loans to taxpayers and the transfer of assets from the transparent company to the member. The inclusion of member loans would negate the need for Division 7A to apply to transparent companies. If a franked distribution was received, it would be assessable to members, with members offsetting their tax liability with franking credits.⁶¹ If a distribution were unfranked, it would be exempt income for the receiving members, thus allowing tax preferences to flow through to members. Such treatment would be advantageous, compared to that of members of a corporation, as most tax preferences are 'clawed back' on distribution.⁶² Also such distributions would decrease a membership cost basis.

However, a rule may be needed to prevent dividends being paid out of asset revaluation reserves when the underlying asset would, if disposed of, be subject to CGT. Otherwise the ability to pay dividends from asset revaluation reserves could be an artificial way to create tax preferences, and thereby exempt 'unfranked' dividends.⁶³

An additional benefit of this option relates to when foreign income is earned by the partial loss transparent company as there can be complexities in determining

⁶⁰ Pizzacalla, M. (2008). Global SME tax policy conundrum. *Australian Tax Forum* 23(1):40, at p 85.

⁶¹ Such distributions would decrease the membership cost basis.

⁶² A possible exception to this is when the distribution is made as part of a liquidator's distribution: then there may be a flow-through of pre-CGT profits: *ITAA 1936* (Cth), section 47A.

⁶³ For a discussion about asset revaluation reserve distributions see: Freudenberg, B. (2004). The end of asset revaluation reserve distributions? An analysis of the Government's latest attack on discretionary trusts performing asset revaluation reserve distributions. *Australian Tax Review* 33(2):150.

an Australian resident's entitlement to a foreign tax credit when full aggregate tax treatment applies.⁶⁴ With a partial loss transparent company, the entity will either be entitled to a foreign tax credit when the foreign income has been subject to foreign tax, or otherwise it will be exempt income.⁶⁵ In these circumstances, where there is no or little Australian tax paid on the foreign income by the partial loss transparent company, this could be paid out effectively as an unfranked dividend to members, and received tax free. Such an mechanism would support arguments that entity acknowledgement can be beneficial in decreasing compliance cost.

When the Australian partial loss transparent company had losses these would be automatically allocated to members in accordance with their membership interest, and subject to a loss restriction rule based on Chapter Six's recommendations. Indeed, if there was only one class of membership interest, then the calculation of the allocation of profit or loss could be done by considering the number of days that membership interest is held and the percentage of that membership interest to the total issued.

To reduce the tax arbitrage between the partial loss transparent company and members, allocated tax losses could be converted to a 'loss tax credit' calculated at the corporate tax rate. Such an allocated loss tax credit could be used by members to offset their tax payable, or be refunded if exceeding the member's tax liability. For example, \$1000 worth of losses would be converted to a loss tax credit of \$300 and allocated to members to use as an offset. This mechanism would mean that allocated losses would shelter income at the member level at the same rate as that applying to corporations, rather than at the individual

⁶⁴ For example, see Taxation Ruling TR 2009/D1: Income tax: entitlement to foreign income tax offsets under section 770-10 of the Income Tax Assessment Act 1997 where income is derived from investing in fiscally transparent entities.

⁶⁵ Exemption could be possible pursuant to *ITAA 1936* (Cth), section 23AH or 23AJ. This is on the presumption that the partial loss transparent company is regarded as a 'company' for tax purposes.

marginal tax rates of up to 45 per cent. It was this type of idea advocated by the Australian mining industry for a flow through share.⁶⁶

Indeed, instead of introducing two discrete transparent regimes, one for closely held businesses and the other for the mining industry, a partial loss transparent company could be a universal transparency regime in Australia.

It is argued that a partial loss transparent company achieves a result similar to the Danish dual tax company system,⁶⁷ which allows re-invested unincorporated business income to be taxed at the corporate rate, with only distributions taxed at the individual marginal tax rates.⁶⁸ The tax advantage of allowing for a partial loss transparent company could be important in influencing the overall utilisation rates of such a transparent form.

⁶⁶ Association of Mining and Exploration Companies, Australasian Institute of Mining and Metallurgy, Australian Securities Exchange, Australian Shareholders Association, The Chamber of Minerals and Energy of Western Australia, Minerals Council of Australia, Queensland Resources Council and South Australian Chamber of Minerals and Energy. (2008). *Joint Industry Submission: To the Minister for Resources and Energy, The Hon. Martin Ferguson AM MP, - A proposal to introduce 'flow through shares' (FTS) in Australia*. 5 November, at pp 12-15.

⁶⁷ Also known as the dual tax system.

⁶⁸ Sorensen, PB. (1998). Recent Innovations in Nordic Tax Policy: From the Global Income Tax to the Dual Income Tax. In *Tax Policy in the Nordic Countries*, edited by P. Sorensen. London: MacMillan Press Ltd. Ganghof, S. (2000). Adjusting National Tax Policy to Economic Internationalization: Strategies and Outcomes. In *Welfare and Work in the Open Economy*, edited by F. W. Scharpf and V. A. Schmidt. Oxford: Oxford University Press, at p 619. However, recent research argues that such a dual system can lead to distortions in investment decisions: Kari, S and Karikallio, H. (2007). Tax treatment of dividends and capital gains and the dividend decision under dual income tax. *International Tax Public Finance*, 14, pp 427-456. To address this Norway adopted a residents' shareholder income tax with a rate of return allowance (the RRA) in 2006: Crawford and Freedman, n 56: "the RRA exempts all shareholder income (including both dividends and realised capital gains, which are treated identically) below an imputed normal rate of return on the share basis (the RRA) at the personal level, as this income has already been subject to corporation tax (at a rate corresponding to the capital income tax rate) and should therefore should not be further taxed. The share basis in any given year is defined as the sum of the original share cost plus all unutilised RRAs from previous years: this is equivalent to carrying forward retained profits (postponed capital gains tax liabilities) with a normal return to ensure that only capital gains in excess of the normal return are subject to taxation at the higher labour income rate". A problem with this that there are still distortions between debt and equity funding.

As previously argued, active members should be regarded as self-employed. This would mean that the receipt of benefits would be regarded as a distribution by the transparent company to the member and taxed accordingly.⁶⁹

Another benefit of the partial loss transparent company is that it has greater entity acknowledgement and thus if prior arguments about the adverse nature of full aggregation in respect of compliance costs are correct, then this should decrease compliance cost. This would mean that the membership interest is treated as a separate tax asset – rather than members having direct fractional interests in the underlying assets.

Furthermore, a partial loss transparent company could assist in the collection of tax, as the tax paid initially by the business form acts as a form of withholding tax. Such transparency could also assist with problems about the interaction between the capital protection rules and unpaid allocations, as members are not assessed on retained profits.⁷⁰

While a conduit principle would not be directly evident,⁷¹ the treatment of unfranked dividends as exempt income would allow tax preferences to flow through to members.⁷² While such a partial loss transparent company would not be able to access the 50 per cent discount on capital gains provided to individuals, the corporate tax rate of 30 per cent is comparable to the 50 per cent of the highest marginal tax rate applying to individuals (plus Medicare levy).⁷³

⁶⁹ A similar consequence would follow in respect of superannuation contributions made on behalf of an active member.

⁷⁰ Refer to the discussion in Chapter Nine.

⁷¹ That is, capital profits realised at the entity level would not retain their capital nature on distribution to members.

⁷² For example, the amount of capital gain sheltered from tax due to indexation method would be non-assessable as exempt income on distribution to member if an unfranked dividend.

⁷³ Assuming an individual is on the highest marginal tax rate, then the effective tax rate on a discounted capital gain is 23.25 per cent.

Also this option has the benefit that special tax rules would be drafted to provide for this partial loss transparent company rather than having an overlay of general partnership tax rules.⁷⁴ Of course disadvantages with this option need to be acknowledged. For example, there could be increased complexity due to measuring the membership cost basis (including altering it for retained profits within the entity).⁷⁵ Furthermore, in New Zealand the possible repeal of the LAQC regime has been raised a number of times. However, it is argued that this is due to inadequate loss restriction rules applying to LAQCs.⁷⁶ Given the loss restriction rules argued for in Chapter Six, this should not be the circumstance in Australia.

10.5 Implications for future research

Within its stated scope, this dissertation provided a critical analysis of the tax transparent companies studied. Throughout this dissertation further avenues of potential research and policy development have been identified. Firstly, future research could extend and further develop that already undertaken in this dissertation by considering transparent companies in jurisdictions beyond the four studied. These other alternatives may enlighten benefits or trends not observed through this dissertation. Future research could build upon the findings of this thesis to consider in more detail the potential international implications that could arise from the introduction of tax transparent companies, including the potential for treaty shopping and tax arbitrage.⁷⁷

⁷⁴ Refer to prior argument in Chapter Six that the overlay of general partnership tax rules for a transparent company can be awkward due to the tax rules generally being drafted for a business form without separate legal entity status and limited liability.

⁷⁵ Recall such a proposal in the United States was considered too complex, and instead a basic 15 per cent concessional rate was introduced.

⁷⁶ See: Freudenberg, B. (2008). The Troubled Teen Years": Is the repeal of New Zealand's LAQC regime required? *New Zealand Journal of Taxation Law and Policy* 14(1):67.

⁷⁷ For example, see: Postlewaite, PF. (2006). Treasury creates a monster. Australia, beware the hybrid entity! *Revenue Law Journal* 16:156.

Secondly, it would be valuable if research were conducted to ascertain whether the Corporate Law Simplification Program has delivered meaningful improvements in terms of governance of Australian closely held businesses, and whether legislative and public policy reforms are required to enhance it. Such research should focus on the perceptions and the experience of both professional advisers and business operators. This could include extending Dugan et al.'s research regarding whether tailored members' agreements or constitutions occur in any meaningful way for closely held businesses.⁷⁸

Moreover, research in Australia adopting a framework similar to Hicks et al. would be informative to gain a greater understanding about closely held businesses' characteristics and what attributes in a business form they themselves want.⁷⁹ This could encompass whether closely held businesses would benefit from a new business form with a governance regime similar to that of the LLC.

In all the jurisdictions studied, it would be beneficial if there were comprehensive compliance cost studies considering tax transparency, integration and entity tax approaches. Such a study should consider if there is a relationship with these different taxing methodologies and a business form's characteristics, particularly limited liability and separate legal entity status. Such studies should distinguish between governance and tax compliance costs, as well as identifying industry and size. From such a study, more informed conclusions could be drawn about the precise factors that influence compliance cost and its relationship with tax transparency.

⁷⁸ Dugan, R, McKenzie, P, and Patterson, D. (2000). *Closely Held Companies: Legal and Tax Issues*. Auckland: CCH New Zealand Limited.

⁷⁹ Hicks, A, Drury, R, and Smallcombe, J. (1995). *Alternative Company Structures for the Small Business*. In *ACCA Research Report No 42*. London: Certified Accountants Educational Trust.

10.6 Conclusion

In 2003 Stewart suggested that an LLP should be introduced in Australia,⁸⁰ and Fletcher indicated that ILPs should be available to be utilised outside the venture capital industry.⁸¹ More recently, the ICAA proposal for a flow-through entity gained government attention.⁸²

While it is questioned within this dissertation about what would be achieved by enacting a transparent company for closely held businesses, it supports the view that serious consideration should be given to the future of tax transparent companies in Australia. This dissertation assists in this, by illuminating the factors behind the introduction of the transparent companies studied, and the relationship to the goal of improved tax neutrality and closely held businesses. This dissertation has also considered how governments could ensure that transparent companies do not distort investment decisions due to the allocation of losses to limited members. Furthermore, there has been a holistic appraisal of how transparent companies may assist closely held businesses in terms of complexity, financing and governance.

The findings of this dissertation are an important step in determining what Australia's response should be to the growing global trend for transparent companies. The Australian Government needs to ensure that the consequences

⁸⁰ Stewart, M. (2003). Towards flow through taxation of limited partnerships: It's time to repeal Division 5A. *Australian Tax Review* 32:171, at p 194: "Both the VCLP and foreign hybrid reforms appear to be reactive to special interest group lobbying. They provided limited solutions for those interest groups while adding complexity to the tax law. It is unsupportable from a policy perspective for Australian resident limited partnerships with direct holdings in businesses and investments, and for foreign investors with Australian investments, to be denied flow-through tax treatment for the limited partnership structure, while foreign hybrids and the investors in certain venture capital investments are entitled to such treatment".

⁸¹ Fletcher, K. (2004). Incorporated Limited Partnerships: Venture capital's contribution to legal development. *Australian Journal of Corporate Law* 71:157, at p 172: although Fletcher does not specify whether flow-through taxation should apply.

⁸² Emerson, C. (Innovation, Industry, Science and Research Minister). (2008). Media Release: Simplifying Small Business Taxation Under Consideration by Rudd Government. Canberra: Australian Government.

are fully considered before any further reforms are introduced. It needs to be acknowledged that Australia as a sovereign state still has choices to make, though these choices will inevitably be influenced by international trends.⁸³ McLure observed that ‘foreign practice should not necessarily be emulated; after all, the same policy issues may have to be resolved differently in every country, in part because of differences in legal and economic environments’.⁸⁴ It is because of these reasons that a partial loss transparent company is regarded as the preferable option for Australia.

Tax transparent companies represent for economists the theoretical ideal of taxing business forms. However, in striving for this economic ideal to achieve greater tax neutrality, it is important for a jurisdiction to consider the practical applications of such reforms. It needs to be recognised that reform is an ‘intellectual, a legal, and a political one’.⁸⁵ For example, lawyers and accountants can identify difficulties in how tax transparent companies can be implemented, although foreign practice indicates that is possible. Given the possible benefits that tax transparent companies may represent, it is important that there is greater economic and legal collaboration.

While this dissertation’s focus is on the tax implications, the analysis has identified that if tax transparent companies are to be introduced, it is critical that tax and governance issues are considered together, rather than just focusing on one or the other. Although tax transparency is about disregarding the legal form for taxation purposes, the governance rules of that legal form is an important consideration.

⁸³ Benge, M, and Robinson, T. (1986). *How to Integrate Company and Shareholder Taxation*. Wellington: Victoria University Press, at p 53.

⁸⁴ McLure, CE. (1979). *Must Corporate Income Be Taxed Twice? A report of a conference sponsored by the Fund for Public Policy Research and the Brookings Institution*. Washington DC: The Brookings Institution, at p 50.

⁸⁵ Weidner, DJ. (2004). Pitfalls in Partnership Law Reform: Some US Experience. In *The Governance of Close Corporations and Partnerships: US and European Perspectives*, edited by J. McCahery, T. Raaijmakers and E. Vermeulen. Oxford: Oxford University Press, at p 370.

A concern expressed about some of the transparent companies studied was that their introduction was 'not particularly well informed by an understanding of the position in those other jurisdictions'.⁸⁶ This dissertation contributes to a greater understanding and appreciation by 'lifting the veil' on several aspects: what exactly tax transparent companies are in the foreign jurisdictions studied, why they were introduced, their potential to assist closely held businesses, and their potential application in Australia. It is with such an informed perspective that the potential consequences of striving for tax neutrality can be understood and this understanding may, in turn, inform improved policy development. While it is admirable for a jurisdiction to strive for greater tax neutrality, in striving for a goal it is critical to look to the future to ascertain exactly what will be achieved.

⁸⁶ Freedman, n 44, at p 303.

Appendix: Australian venture capital investment

Tax Transparent Companies: Striving for tax neutrality?

Appendix: Example tax calculations in the jurisdictions studied

Detailed below are a number of simple scenarios to illustrate the tax impost between the tax treatment of corporations and the transparent companies studied. These examples are used for the analysis in Chapter Eight.

United States

Example 8-0-1: US: Distribution of all after-tax profits – C Corporation

<p>Assumptions:</p> <ul style="list-style-type: none"> • Equity investment of \$1,000; • Annual earnings of \$100 taxable income each year over ten years; • Entity each year will distribute all after-tax profits; • The highest tax rates will apply to both the entity and the member; and • After 10 years the member disposes of their membership interest (and there is no internally generated goodwill or other non-reported asset). Nor has there been any assets purchased by the entity. 	
<p>Year 1</p> <p>\$100 business taxable income</p> <p>(\$35) corporate tax</p> <p>\$65 after-tax profit.</p> <p>\$65 Dividend payment to member</p> <p>(\$9.75) Individual tax payable at 15% (temporary tax relief)</p> <p>\$55.25 After tax amount.</p>	<p>Year 2 to Year 10</p> <p>Refer to Year 1.</p>
<p>Total tax for Year 1 is \$44.75. Over 10 years this will amount to \$447.50. When the member disposes of the membership interest there should be nil capital gain as no growth in business as all profits have been paid out.</p>	
<p>If temporary dividend tax relief did not apply, then the individual would pay \$22.75 on dividend distribution (at 35%), meaning a total tax of \$57.75 paid each year. Over 10 years this would amount to \$577.50. Again on disposal of the membership interest there should be no capital gain as all profits distributed.</p>	

Example 8-0-2: US: Distribution of all after-tax profits –transparency

Same assumptions as Example 8-0-1; except that tax transparent treatment applies (either Sub-Chapter K or S)	
<p>Year 1</p> <p>\$100 business taxable income</p> <p>(\$nil) no tax at entity level</p> <p>Entire profit allocated to member</p> <p>\$100</p> <p>(\$35) Individual tax payable</p> <p>\$65 after tax amount.</p> <p>The business entity would make distributions of \$100 each year which the member would not pay tax on, as their outside cost basis would have been increased by the allocated income, which would then be reduced (but not exhausted by) the distribution amount.</p>	<p>Year 2 to Year 10</p> <p>Refer to Year 1.</p>
<p>Total tax for Year 1 is \$35. Over 10 years this will amount to \$350. When member disposes of the membership interest there should be nil capital gain as no growth in business. The total amount of tax is not affected by the temporary tax relief measures.</p>	
<p>For the LLC, employment tax can also be payable by the member on the allocated amount, up to an additional 15.3%, amounting to \$153 over the 10 years. This brings the total income tax and employment tax to \$503 for the 10-year period for the LLC member, compared to S Corporations of \$350.</p>	

Example 8-0-3: US: Accumulation of all after-tax profits – C Corporation

Assumptions same as Example 8-0-1, except:

- Entity will NOT distribute annually after-tax profits for 10 years; instead they will be accumulated within the entity
- Member then sells membership interest at the end of the 10th year.

<p>Year 1</p> <p>\$100</p> <p>(\$35) corporate tax</p> <p>\$65 after-tax profit.</p> <p>No dividend payment to member, therefore member is not liable to tax.</p>	<p>Year 2 to Year 9</p> <p>Refer to Year 1.</p>	<p>Year 10</p> <p>\$100</p> <p>(\$35)</p> <p>\$65 after tax profit</p> <p>No dividend payment but member disposes of membership interest.</p> <p>\$1,650 (Sale price representing accumulated after tax profits and initial investment)</p> <p>\$1,000 outside cost basis</p> <p>\$650 Capital gain</p> <p>(97.50) Member assessed on gain at 15% CGT rate</p> <p>\$447.50 After-tax gain for member</p>
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Total corporate tax paid over 10-year period is \$350, with the member paying \$97.50 CGT in year 10. Giving the total tax payable (both corporation and member) of \$447.50 for the 10 years.

Example 8-0-4: US: Accumulation of all after-tax profits – transparency

Assume same facts as Example 8-0-1, except member will not be paid any distributions from the entity, and will sell their membership interest at the end of the 10th year.

Profits will be allocated each year but so the transparent company can accumulate there will be no distributions to the member. Unpaid distribution to member would be regarded as a loan by the member to the entity or further contributions. If further contributions, then membership interest cost basis¹ would be initial \$1000 plus \$1000 (representing \$100 each year for 10 years). Sale price is likely to be \$2,000 (representing the initial capital contribution plus the accumulated profit) – so no capital gain on disposal of membership interest.

Total tax payable is \$350 over the 10-year period, being \$35 each year by the member.

For the LLC, employment tax can also be payable by the member on the allocated amount, up to an additional 15.3%, amounting to \$153 over the 10 years. This brings the total income tax and employment tax to \$503 for the 10-year period for the LLC member, compared to S Corporations of \$350.

¹ Known in the United states as members 'outside cost' basis.

Example 8-0-5: US: C Corporation with appreciating asset & no distribution

Assumptions:

- Equity investment of \$1,000 which the corporation uses to purchase an appreciating asset;
- Annual earnings of \$100 taxable income each year over ten years;
- Entity each year will distribute all after-tax profits;
- The highest tax rates will apply to both the entity and the member; and
- Corporation disposes of appreciating asset in the tenth year for \$3000, the gain is not distributed;
- The member disposes of their membership interest after the distributions in the tenth year and is eligible for CGT concession treatment

Year 1	Year 2 to Year 9	Year 10
<p>\$100 business taxable income</p> <p>(\$35) corporate tax</p> <p>\$65 after-tax profit.</p> <p>\$65 Dividend payment to member</p> <p>(\$9.75) Individual tax payable at 15% (temporary tax relief)</p> <p>\$55.25 After tax amount.</p>	<p>Refer to Year 1.</p>	<p>\$100 + \$2,000 The \$2,000 representing the capital gain</p> <p>(\$735) Tax</p> <p>\$1365 After tax profit</p> <p>No dividend payment but member disposes of membership interest.</p> <p>\$650 Capital gain (\$1,365 - \$1,000)</p> <p>(54.75) Member assessed on gain at 15% CGT rate</p> <p>\$1,310.25 After-tax gain for member</p>

Total corporate tax paid over 10-year period is \$1,050, with the member paying \$54.75 CGT in year 10. Giving the total tax payable (both corporation and member) of \$1104.75 for the 10 years.

Example 8-0-6: US: Transparency and holding an appreciating asset

Assumptions:

- Equity investment of \$1,000 which the Transparent Company uses to purchase an appreciating asset;
- Annual earnings of \$100 taxable income each year over ten years;
- Entity each year will distribute all after-tax profits;
- The highest tax rates will apply to the members; and
- Transparent Company disposes of appreciating asset in the tenth year for \$3000 and the after tax gain is allocated to the members.

Year 1	Year 2 to Year 10	Year 10
\$100 business taxable income (\$nil) no tax at entity level	10 Refer to Year 1.	\$100 \$2000 Capital gain.
Entire profit allocated to member \$100 (\$35) Individual tax payable \$65 after tax amount.		\$2,100 Entire profit allocated to members.
The business entity would make distributions of \$100 each year which the member would not pay tax on, as their outside cost basis would have been increased by the allocated income, which would then be reduced (but not exhausted by) the distribution amount.		(\$300) (\$35) Members assessed on gain at 15% and income at 35% rate
		\$1,765 After-tax profit for members.

Total tax for Year 1 is \$35. Over 10 years this will amount to \$350. The sale of the appreciated asset would result in a capital gain which would retain its character as it is allocated to the member. This means that the member is able to utilise the concessional CGT rate of 15% in terms of the gain (\$2,000 * 15%). So the total tax paid is \$650.

Example 8-0-7: US: C Corporation distributing earned exempt income

Assumptions:

- Equity investment of \$1,000;
- Annual earnings of \$100 exempt income each year over ten years;
- Entity each year will distribute all after-tax profits;
- The highest tax rates will apply to both the entity and the member; and
- After 10 years the member disposes of their membership interest (and there is no internally generated goodwill or other non-reported asset). Nor has there been any increase assets purchased by the entity.

Year 1

\$100 business exempt income

(\$0) corporate tax

\$100 after-tax profit.

\$100 Dividend payment to member

(\$15) Individual tax payable at 15%
(temporary tax relief)

\$85 After tax amount.

Year 2 to Year 10

Refer to Year 1.

Total tax for Year 1 is \$15. Over 10 years this will amount to \$150. When the member disposes of the membership interest there should be nil capital gain as no growth in business as all profits have been paid out.

If temporary dividend tax relief did not apply, then the individual would pay \$35 on dividend distribution (at 35%), meaning a total tax of \$35 paid each year. Over 10 years this would amount to \$350. Again on disposal of the membership interest there should be no capital gain as all profits distributed.

Example 8-0-8: US: Transparency and exempt income

Assumptions:

- Equity investment of \$1,000;
- Annual earnings of \$100 exempt income each year over ten years;
- Entity each year will distribute all after-tax profits;
- The highest tax rates will apply to both the entity and the member; and
- After 10 years the member disposes of their membership interest (and there is no internally generated goodwill or other non-reported asset). Nor has there been any increase assets purchased by the entity.

Year 1

\$100 business taxable income

(\$nil) no tax at entity level

Entire profit allocated to member

\$100

(\$0) Individual tax payable – exempt income retains its character

\$100 after tax amount.

The business entity would make distributions of \$100 each year which the member would not pay tax on, as their outside cost basis would have been increased by the allocated income, which would then be reduced (but not exhausted by) the distribution amount.

Year 2 to Year 10

Refer to Year 1.

Total tax for Year 1 is \$nil. Over 10 years this will amount to \$nil. When member disposes of the membership interest there should be nil capital gain as no growth in business. The total amount of tax is not affected by the temporary tax relief measures.

Example 8-0-9: US: Debt funding**Assumptions:**

- Debt funding by member of \$1,000;
- Annual earnings of \$100 taxable income each year over ten years;
- Interest costs each year \$100 on debt;
- Entity each year will distribute all after-tax profits;
- The highest tax rates will apply to both the entity and the member; and
- After 10 years the member disposes of their membership interest (and there is no internally generated goodwill or other non-reported asset). Nor has there been any increase assets purchased by the entity.

Year 1

\$100 business assessable income
 (\$100) interest expense
 (\$nil) business taxable income
 (\$nil) corporate tax
 \$nil after-tax profit.

\$nil Dividend payment to member
 \$100 Interest payment to member
 (\$35) Individual tax payable
 \$65 After tax amount.

Year 2 to Year 10

Refer to Year 1.

Total tax for Year 1 is \$35. Over 10 years this will amount to \$350. When the member disposes of the membership interest there should be nil capital gain as no growth in business as all profits have been paid out.

United Kingdom

Example 8-0-10: UK: Distribution of all after-tax profits – corporation

Assumptions:

- Equity investment of £1,000;
- Annual earnings of £100 taxable income each year over ten years;
- Entity each year will distribute all after-tax profits;
- The highest tax rates will apply to both the entity and the member; and
- After ten years the member disposes of their membership interest (and there is no internally generated goodwill or other non-reported asset) nor has there been any increase in the assets purchased by the entity. Business CGT taper relief will be utilised when applicable.

Year 1

£100	Business taxable income.
(£28)	Corporate tax.
£72	After-tax profit.
£72	Dividend payment to member.
£8	(1/9 th gross-up).
£80.00	Total income.
(£18.00)	Individual tax payable at 32.5% (on savings income) of 88 = 26 less 8 tax credit.
£54.00	After tax amount.

Year 2 to Year 10

Refer to Year 1.

Total tax for Year 1 is £46. Over ten years this will amount to £460. When the member disposes of the membership interest there should be nil capital gain as no growth in business as all profits have been paid out.

The payment of dividends by the corporation to the member would not be subject to NIC.

Example 8-0-11: UK: Distribution of all after-tax profits – LLP

Assumptions:

- Equity investment of £1,000;
- Annual earnings of £100 taxable income each year over ten years;
- Entity each year will distribute all after-tax profits;
- The highest tax rates will apply to both the entity and the member; and
- After ten years the member disposes of their membership interest (and there is no internally generated goodwill or other non-reported asset) nor has there been any increase in the assets purchased by the entity. Business CGT taper relief will be utilised when applicable.

Year 1

£100 Business taxable income.
(£nil) No tax at entity level.

£100 Entire profit allocated to
members.
(£40) Individual tax payable on non-
savings income.
£60 After tax amount.

The business entity would
make distributions of £100
each year which the member
would not pay tax on.

Year 2 to Year 10

Refer to Year 1.

Total tax for Year 1 is £40. Over ten years this will amount to £400. When the LLP disposes of the CGT asset the members are treated as disposing of it, there should be nil capital gain as no growth in business.

NIC would also be payable on the allocated amount up to an additional nine per cent (plus the weekly flat fee) amounting to approximately £9 each year and a total of £90 over the ten years. Bringing the total income tax and NIC to £490 for the ten year period.

Example 8-0-12: UK: Debt funding – corporation

Assumptions:

- Member debt investment of £1,000;
- Annual earnings of £100 assessable income each year over ten years;
- Annual interest payment on debt is £100;
- Entity each year will distribute all after-tax profits;
- The highest tax rates will apply to both the entity and the member; and
- After ten years the member disposes of their membership interest (and there is no internally generated goodwill or other non-reported asset) nor has there been any increase in the assets purchased by the entity. Business CGT taper relief will be utilised when applicable.

Year 1		Year 2 to Year 10
£100	Business assessable income.	Refer to Year 1.
(£100)	Interest payment	
£nil	Corporate tax.	
£nil	After-tax profit.	
£100	Interest payment to member	
£nil	Dividend payment to member.	
£100	Total income.	
(£32.5)	Individual tax payable at 32.5% (on savings income).	
£67.50	After tax amount.	
Total tax for Year 1 is £32.50. Over ten years this will amount to £325. When the member disposes of the membership interest there should be nil capital gain as no growth in business as all profits have been paid out.		
The payment of interest by the corporation to the member would not be subject to NIC.		

Example 8-0-13: UK: Accumulation of all after-tax profits –corporation

Same assumptions as Example 8-0-10 except:

- Entity will not distribute annually after-tax profits for ten years; instead they will be accumulated within the entity
- Member then sells membership interest at the end of the tenth year.

Year 1	Year 2 to	Year 10
£100	Year 9	£100
(£28) Corporate tax.	Refer to	(£28) Corporate tax.
£72 After-tax profit.	Year 1.	£72 After-tax profit.
No dividend payment to member, therefore member is not liable to tax.		No dividend payment but member disposes of membership interest.
		£1,720 Sale price representing accumulated profits and initial investment.
		£1,000 Cost basis of membership interest.
		£720 Capital gain.
		(72) Member assessed on gain at 10% CGT rate. ²
		£648 After-tax gain for member.

Total corporate tax paid over ten year period is £280, with the member paying £72 CGT in year ten; the total tax payable (by both corporation and member) of £352 for the ten years.

The capital gain made by the member would not be subject to NIC.

² The member could be eligible for CGT tapering relief which would decrease the effective CGT rate from 40 per cent to 10 per cent.

Example 8-0-14: UK: Accumulation of all after-tax profits – LLP

Same assumptions as Example 8-0-11, except members will not be paid any distributions from the entity and the LLP disposes of CGT asset at the end of the tenth year.

Profits will be allocated each year but so the LLP can accumulate there will be no distributions to the members. Unpaid distribution to members would be regarded as a loan by the members to the entity or further contributions (the LLP Agreement must unconditionally provide for this). If regarded as further contributions, then members' total contributed capital will be their initial £1000 plus £1000 (representing £100 each year for 10 years). Sale of any underlying capital asset purchase with the contributed capital is likely to be for £2,000 (representing the initial capital contribution plus the accumulated profit) – so the members have no capital gain on disposal of the underlying asset.

Total tax payable is £400 over the ten year period, being £40 each year by the members.

NIC is also payable on the allocated amount up to nine per cent amounting to £9 each year and a total of £90 over the ten years. The total income tax and NIC to £490 for the ten year period.

Example 8-0-15: UK: Corporation distributing earned exempt income

Assumptions:		
<ul style="list-style-type: none">• Equity investment of £1,000;• Annual earnings of £100 exempt income each year over ten years;• Entity each year will distribute all after-tax profits;• The highest tax rates will apply to both the entity and the member; and• After ten years the member disposes of their membership interest (and there is no internally generated goodwill or other non-reported asset); nor has there been any increase in the assets purchased by the entity.		
Year 1		Year 2 to Year 10
£100	Business taxable income.	Refer to Year 1.
(£19)	Non-corporate distribution rate would apply. ³	
£81	After-tax profit.	
£81	Dividend payment to member.	
£9	(1/9 th gross-up).	
£90.00	Total income.	
(£20.25)	Individual tax payable at 32.5% (on savings income) of 90 = 29.25 less 9 tax credit.	
£69.75	After tax amount.	
Total tax for Year 1 is £39.25. Over ten years this will amount to £392.50. When the member disposes of the membership interest there should be nil capital gain as no growth in business; all profits have been paid out.		
The payment of dividends by the corporation to the member would not be subject to NIC.		

³ From 31 March 2004 a special rate (known as the non-corporate distribution rate) applies when a corporation has an underlying rate of tax less than 19 per cent and it makes a distribution to a person not a corporation *Income and Corporation Taxes Act 1988* (UK), section 13AB inserted by *Finance Act 2004* (UK), section 28, Schedule 3, paragraph 2.

Example 8-0-16: UK: Transparency earning exempt income

Assumptions:

- Equity investment of £1,000;
- Annual earnings of £100 exempt income each year over ten years;
- Entity each year will distribute all after-tax profits;
- The highest tax rates will apply to both the entity and the member; and
- After ten years the member disposes of their membership interest (and there is no internally generated goodwill or other non-reported asset), nor has there been any increase in the assets purchased by the entity. Business CGT taper relief will be utilised when applicable.

Year 1

£100 Business taxable income.
(£nil) No tax at entity level.

£100 Entire profit allocated to
(£nil) members.
 No individual tax as exempt
 income retains character.

£100 After tax amount.

 The business entity would
 make distributions of £100
 each year which the member
 would not pay tax on.

Year 2 to Year 10

Refer to Year 1.

Total tax for Year 1 is £nil. Over ten years this will amount to £nil. When the LLP disposes of the CGT asset the members are treated as disposing of it there should be nil capital gain as no growth in business.

Example 8-0-17: UK: Employment of member by corporation

Assumptions:

- Equity investment of £1,000;
- Annual earnings of £100 each year over ten years;
- Member is employed by corporation and wages amount to £50 each year;
- Entity each year will distribute all after-tax profits;
- The highest tax rates will apply to both the entity and the member; and
- After ten years the member disposes of the membership interest (and there is no internally generated goodwill or other non-reported asset).

Year 1		Year 2 to Year 10
£100	Earnings.	Refer to Year 1.
(£50)	Less wages.	
(£6.40)	Employer NIC liability. ⁴	
£43.60	Taxable Income.	
(£12.21)	Corporate tax.	
£31.39	After-tax profit.	
£31.39	Dividend payment to member.	
£3.49	(1/9 th gross-up).	
£50	Wages income.	
£84.88	Total taxable income.	
(£27.85)	Individual tax payable at 32.5% (on savings income) of 34.88 = 11.34 less 3.49 = £7.85 tax, and wages tax at 40% (£50 * 40% = £20).	
(£5.5)	NIC employee at 11% (capped to earnings to £675).	
£48.04	After tax amount.	

Total income tax for Year 1 is £40.06 with NIC of £11.90 giving total tax of £51.96. Over ten years this will amount to £519.60. When the member disposes of the membership interest there should be nil capital gain as there is no growth in business: all profits have been paid out.

The payment of dividends by the corporation to the member would not be subject to NIC.

⁴ *Income Tax (Earnings and Pensions) Act 2003* (UK), section 481.

Example 8-0-18: UK: Employment of non-member by corporation

Assumptions:

- Equity investment of £1,000;
- Annual earnings of £100 each year over ten years;
- A non-member is employed by corporation and wages amount to £50 each year;
- Entity each year will distribute all after-tax profits;
- The highest tax rates will apply to both the entity and the member; and
- After ten years the member disposes of their membership interest (and there is no internally generated goodwill or other non-reported asset).

Year 1

£100	Earnings.
(£50)	Less wages.
(6.40)	Employer NIC liability.
£43.60	Taxable Income.
(£12.21)	Corporate tax.
£31.39	After-tax profit.
£31.39	Dividend payment to member.
£3.49	1/9 th gross-up.
£34.89	Total taxable income.
(£7.85)	Individual tax payable at 32.5% (on savings income) of 34.88 = 11.34 less 3.49 = £7.85 tax.
£27.03	After tax amount.

Year 2 to Year 10

Refer to Year 1.

Total income tax for Year 1 is £20.06 and then NIC of £6.40 (no NIC payable by member as not employee) giving total tax of £26.46. Over ten years this will amount to £264.60. When the member disposes of the membership interest there should be nil capital gain as there was no growth in business: all profits have been paid out.

The payment of dividends by the corporation to the member would not be subject to NIC.

Example 8-0-19: UK: Employment of non-member – LLP

Assumptions:

- Equity investment of £1,000;
- Annual earnings of £100 each year over ten years;
- A non-member is employed by the LLP and wages amount to £50 each year;
- Entity each year will distribute all after-tax profits;
- The highest tax rates will apply to both the entity and members; and
- After ten years the members disposes of their membership interest (and there is no internally generated goodwill or other non-reported asset).

Year 1		Year 2 to Year 10
£100	Earnings.	Refer to Year 1.
(£50)	Less wages.	
(6.40)	Employer NIC liability.	
£43.60	Taxable Income.	
(£0)	No tax at entity level allocated to members.	
£43.60	Allocated amount to members.	
£43.60	Total taxable income.	
(£17.44)	Individual tax payable at 40% (on non-savings income).	
(£3.92)	NIC payable at 9% on self-employment income.	
£22.24	After tax amount.	

Total income tax for Year 1 is £17.44 and then NIC of £10.32 giving total tax of £27.76. Over ten years this will amount to £277.60. When the LLP disposes of capital asset there should be nil capital gain: no growth in business as all profits have been paid out.

Example 8-0-20: UK: Corporation holding appreciating asset

Assumptions:

- Equity investment of £1,000 which the corporation uses to purchase an appreciating asset;
- Annual earnings of £100 taxable income each year over ten years;
- Entity each year will distribute all after-tax profits;
- The highest tax rates will apply to both the entity and the member; and
- Corporation disposes of appreciating asset in the tenth year for £3000, the gain is not distributed;⁵
- The member disposes of their membership interest after the distributions in the tenth year and is eligible for CGT business taper relief.

Year 1		Year 2 to Year 9		Year 10	
£100	Taxable income.	Refer to		£100	
(£28)	Corporate tax.	Year 1.		£2000	Capital gain
£72	After-tax profit.			(£1,512	Corporate tax
					After tax profit.
£72	Dividend payment to member.				No dividend payment but member disposes of membership interest.
£8	1/9 th gross-up.				
£78	Total income.			£3,003.85	Sale price representing accumulated after tax profits and initial investment.
(£17.35)	Individual tax payable at 32.5% (on savings income) of 78 = 25.35 less 8 tax credit.			£1,000	Outside cost basis.
				£2,004	Capital gain.
				(200.40)	Member assessed on gain at 10% CGT rate. ⁶
£54.65	After tax amount.				After-tax gain for member.
				£2,803.45	

Total corporate tax paid over ten year period is £1,079.85, with the member paying £200.40 CGT in year ten, giving the total tax payable (both corporation and member) of £1,280.25 for the ten years. If the CGT business taper relief did not apply, then the overall tax burden would have been £1,881.45.

The capital gain made by the member would not be subject to NIC.

⁵ Note the corporation would be able to index the cost basis to decrease the chargeable gain.

⁶ CGT taper relief could reduce the impact of this.

Example 8-0-21: UK: LLP holding appreciating asset

Assumptions:

- Equity investment of £1,000 which the LLP uses to purchase an appreciating asset;
- Annual earnings of £100 taxable income each year over ten years;
- Entity each year will distribute all after-tax profits;
- The highest tax rates will apply to the members; and
- LLP disposes of appreciating asset in the tenth for £3000, the after tax gain is allocated to the members.⁷

Year 1	Year 2	Year 10
£100 Taxable income.	to Year	£100
(£nil) No tax at entity level.	9	£2000 Capital gain.
Entire profit allocated to members.	Refer to	Entire profit allocated to members.
£100	Year 1.	£2,100
(£40) Individual tax payable on non-savings income.		(240) Members assessed on gain at 10% (£200) and income at 40% rate (£40).
£60 After tax amount.		£1,860 After-tax gain for members.
The business entity would make distributions of £100 each year which the members would not pay tax on.		

Total tax for Year 1 is £40. Over ten years this will amount to £400. When LLP disposes of the appreciated asset there is an additional £200 CGT payable. Total income and CGT tax over ten years is £600. If not for the CGT taper relief the overall tax burden would have been £1,200.

If NIC would also be payable on the allocated amount then up to an additional 9% (plus the weekly flat fee) would be payable, amounting to £9 each year (Yr 1 to 10), a total of £90 over the ten years: This brings the total income tax and NIC to £690 for the ten years.

⁷ Individuals are no longer able to index the cost base in calculating a chargeable gain.

New Zealand**Example 8-0-22: NZ: Distribution of all after-tax profits – corporation****Assumptions:**

- Equity investment of \$1,000;
- Annual earnings of \$100 taxable income each year over ten years;
- Entity each year will distribute all after-tax profits;
- The highest tax rates will apply to both the entity and the member; and
- After ten years the member disposes of their membership interest (and there is no internally generated goodwill or other non-reported asset), nor has there been any increase in the assets purchased by the entity.

Year 1

\$100	Business taxable income.
(\$30)	Corporate tax.
\$70	After-tax profit.
\$70	Dividend payment to member.
\$30	Imputation credits attached
\$100	Total income for member.
(\$39))	Individual tax payable at 39%
((30))	Less imputation credit
\$9	Tax payable by member
\$61	After tax amount

Year 2 to Year 10

Refer to Year 1.

Total tax for Year 1 is \$39. Over ten years this will amount to \$390. When the member disposes of the membership interest, there should be nil capital gain as no growth in business as all profits have been paid out.

Example 8-0-23: NZ: Distribution of all after-tax profits – LAQC**Assumptions:**

- Equity investment of \$1,000;
- Annual earnings of \$100 taxable income each year over ten years;
- Entity each year will distribute all after-tax profits;
- The highest tax rates will apply to both the entity and the member; and
- After ten years the member disposes of their membership interest (and there is no internally generated goodwill or other non-reported asset), nor has there been any increase in the assets purchased by the entity.

Year 1

\$100	Business taxable income.
(\$30)	Corporate tax.
\$70	After-tax profit.
\$70	Dividend payment to member.
\$30	Imputation credits attached
\$100	Total income for member.
(\$39))	Individual tax payable at 39%
((30))	Less imputation credit
\$9	Tax payable by member
\$61	After tax amount

Year 2 to Year 10

Refer to Year 1.

Total tax for Year 1 is \$39. Over ten years this will amount to \$390. When the member disposes of the membership interest there should be nil capital gain: there was no growth in business as all profits have been paid out.

Example 8-0-24: NZ: Corporation and LAQC – accumulation

Assumptions:

- Equity investment of \$1,000;
- Annual earnings of \$100 taxable income each year over ten years;
- Entity each year will not distribute any profits;
- The highest tax rates will apply to both the entity and the member; and
- After ten years the member disposes of their membership interest (and there is no internally generated goodwill or other non-reported asset), nor has there been any increase in the assets purchased by the entity.

Year 1	Year 2 to Year 9	Year 10
\$100 Business taxable income.	Refer to Year 1.	\$100
(\$30) Corporate tax.		(\$30) Corporate tax
\$70 After-tax profit.		\$70 After tax profit.
No Dividend payment to member.		No dividend payment but member disposes of membership interest.
		\$1,700 Sale price representing accumulated after tax profits and initial investment.
		\$1,000 Outside cost basis.
		(\$700) Capital gain.
		(nil) No tax as a capital gain
		\$1,700

Total tax for Year 1 is \$30. Over ten years this will amount to \$300. When the member disposes of the membership interest there should be a capital gain; however in New Zealand there is no CGT.

Example 8-0-25: NZ: Debt funding corporation

Assumptions:

- Debt investment by member of \$1,000;
- Annual earnings of \$100 taxable income each year over ten years;
- Interest expense of \$100 each year on debt
- Entity each year will distribute all after-tax profits;
- The highest tax rates will apply to both the entity and the member; and
- After ten years the member disposes of their membership interest (and there is no internally generated goodwill or other non-reported asset) nor has there been any increase in the assets purchased by the entity.

Year 1

\$100	Business assessable income.
(\$100)	Interest expense
(\$nil)	Corporate tax.
\$nil	After-tax profit.
\$nil	Dividend payment to member.
\$100	Interest payment
\$nil	Imputation credits attached
(\$39))	Individual tax payable at 39%
\$61	After tax amount

Year 2 to Year 10

Refer to Year 1.

Total tax for Year 1 is \$39. Over ten years this will amount to \$390. When the member disposes of the membership interest there should be nil capital gain: there was no growth in business as all profits have been paid out.

Example 8-0-26: NZ: Corporation holding appreciating asset

Assumptions:

- Equity investment of \$1,000 which the corporation uses to purchase an appreciating asset;
- Annual earnings of \$100 taxable income each year over ten years;
- Entity each year will distribute all after-tax profits;
- The highest tax rates will apply to both the entity and the member; and
- Corporation disposes of appreciating asset in the tenth year for \$3000; the gain is distributed.

Year 1	Year 2 to Year 9	Year 10
\$100 Taxable income.		\$100
(\$30) Corporate tax.		\$NIL Capital gain of \$2,000 is non assessable
\$70 After-tax profit.	Refer to Year 1.	(\$30) Corporate tax
		\$2,070 After tax profit.
\$70 Dividend income		Dividend paid
30 Imputation		
\$100 Total income		\$2,070 Dividend income
(\$39) Individual tax		30 Imputation credit
((30)) Less imputation credit		\$2,100 Total assessable income
\$9 Tax payable		(\$819) Individual tax
		((30)) Less imputation credit
		\$789 Tax payable.

Total tax for Year is \$39. Over the ten years this will amount to \$390. When corporation disposes of the appreciated asset there is no tax payable on the capital gain as New Zealand does not have a CGT. However, the unfranked dividend would be assessable income for the member, with the total tax payable over the ten years \$1,179.

If the corporation member had sold their membership interest of the non assessable corporate gain being distributed via a dividend, then this sale of membership interest would be a non assessable capital gain to the member, thereby decreasing the overall tax burden to the same level as the LAQC. However, to achieve this, member must dispose of their membership interest and thereby lose control of the business.

Example 8-0-27: NZ: LAQC holding appreciating asset

Assumptions:

- Equity investment of \$1,000 which the corporation uses to purchase an appreciating asset;
- Annual earnings of \$100 taxable income each year over ten years;
- Entity each year will distribute all after-tax profits;
- The highest tax rates will apply to both the entity and the member; and
- Corporation disposes of appreciating asset in the tenth year for \$3000; the gain is distributed.

Year 1		Year 2 to Year 9	Year 10
\$100	Taxable income.		£100
(\$30)	Corporate tax.		\$NIL
\$70	After-tax profit.	Refer to Year 1.	Capital gain of \$2,000 is non-assessable.
	Dividend paid.		(\$30) Corporate tax
			\$2,070 After tax profit.
\$70	Dividend income		Dividend paid
30	Imputation		\$70 Dividend income ⁸
\$100	Total income		2000 Exempt dividend amount
(\$39)	Individual tax		30 Imputation credit
((30))	Less imputation credit		\$100 Total assessable income
\$9	Tax payable		(\$39) Individual tax
			((30)) Less imputation credit
			\$9 Tax payable.

Total tax for Year is \$39. Over the ten years this will amount to \$390. When corporation disposes of the appreciated asset there is no tax payable on the capital gain as New Zealand does not have a CGT. However, when this non-taxed income is distributed by the LAQC as an exempt dividend, allowing it to remain tax free. Total tax payable over the ten years \$390.

⁸ In this case, the calculation of the extent to which the dividends can be imputed is calculated as the lesser of: (i) maximum imputation credits: $(30 \div 70) \times \$\text{dividend amount}$; or (ii) imputation credits deemed to be attached(a) $(\text{imputation credit account balance} \times \text{tax instalment paid by corporation}) \div \text{dividend amount}$. The amount of the imputation credit dividend by 0.30. The second step is to determine the proportion of exempt dividends. This can be computed by subtracting the taxable dividend from the total dividend (that is, the dividend plus imputation credit). The debit to the ICA arises on the date the dividend is paid.

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