Fact or fiction? A sustainable tax transparent form for closely held businesses in Australia

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Fact or fiction? A sustainable tax transparent form for closely held businesses in Australia

By Dr Brett Freudenberg*

Abstract

Currently a comprehensive review is being undertaken of the Australian tax system (the Henry Review).1 One of the potential reforms to be considered by the Henry Review is a proposal by the Institute of Chartered Accountants Australia and Deloitte for the introduction of a tax transparent company (the ICAA proposal).2 The ICAA proposal argues that tax transparency applying to closely held corporations and unit trusts will reduce their compliance burden and facilitate an enhanced tax system for micro-enterprises. If the claims made in the ICAA proposal are accurate, it could be contended that a tax transparent company provides a more sustainable tax system for closely held businesses in Australia.

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While there are arguments that tax transparency does provide for an enhanced method for taxing business forms and their members, there are various concerns about the consequences of following this economic ideal. This article will evaluate the model outlined in the ICAA proposal, and consider whether complexity would be eased through the introduction of tax transparent company. This will be ascertained by considering empirical data about the compliance cost burden of foreign transparent company forms. This analysis will consider the following transparent companies: 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).

Through this analysis, a number of areas of concern will be raised in terms of eligibility requirements, the extent of aggregation and loss restriction rules. It will be argued that a sustainable tax system based on transparency for closely held businesses needs careful consideration to ensure that it is fact and not fiction.

1.1 Introduction

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 a Tax Review to be chaired by Ken Henry (the Henry Review).4

A reason underlying the ICAA proposal is the contention that a tax transparent company will reduce complexity.5 However, such a position is juxtaposed to the historical concern of transparency applying to a company form.6 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.

Complexities can be seen as diminishing the theoretical advantages of tax transparency.7 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 foreign indicates that transparent companies may, indeed, have higher tax compliance costs than other

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4 Above n 1.
5 Above n 2, at 9 and 12.
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 having lower tax compliance costs than new form transparent companies. In ascertaining the relationship between tax transparent companies and complexity the foreign tax transparent companies that will be considered are: 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).

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.

Through this analysis it will be argued that it is questionable what benefits in terms of complexity will accrue to closely held businesses through the ICAA proposal. Instead it will be argued that a preferable approach to implementing a fully tax transparent company in Australia is for the introduction of a partial loss transparent company.

The next section of this article will outline the definition of tax transparent companies and how they may be classified. Then the ICAA proposal will be outlined, as well as the importance of complexity for closely held businesses in Australia. The article will then consider the available empirical evidence of the compliance cost of the foreign transparent companies studied. The potential reasons why transparency may result in greater complexity will be considered. The final section of the article will outline the conclusions as to whether the ICAA proposal does present a sustainable business form in terms of complexity.

1.2 What is a tax transparent company?

In this article 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 status and limited liability, with a general partnership’s flow-through taxation treatment. It is these three core characteristics that define the nature of a tax transparent company (or 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. 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. 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.

In relation to the continuum conceptualised in Figure 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 liability and is a separate legal entity from its constituent members.

8 Or legal personality.
9 Tax transparent treatment is argued to be an attribute of general partnerships, particularly in the Australian context.
10 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.
11 Other terms used to describe this is the aggregate approach, transparency or flow-through taxation.
12 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.
13 The extent of limited liability protection does vary amongst transparent companies.
Consideration of transparent companies is not new, and reference to them can be found internationally in the various jurisdictions. For example: Canada: Carter Commission in 1966;\textsuperscript{15} Germany in 1971;\textsuperscript{16} the United States: Blueprints for Basic Tax Reform in 1977, and in 1992\textsuperscript{17} and the American Law Institute Federal Income Tax Project – Taxation of Private Business Enterprises in 1999;\textsuperscript{18} New Zealand: the Valabh

\textsuperscript{14} Figure modified from Cnossen, S. (1984). Alternative Forms of Corporation Tax. \textit{Australian Tax Forum} 1:253, at 255.

\textsuperscript{15} Canada. (1966). Royal Commission on Taxation (known as the Carter Commission), Ottawa.

\textsuperscript{16} Above n 8, at 92.


Committee in 1990,\textsuperscript{19} and the Tax Review in 2001;\textsuperscript{20} in France in 1992;\textsuperscript{21} the United Kingdom in the Bolton Report in 1971\textsuperscript{22} and in Department of Trade and Industry Report in 1997;\textsuperscript{23} Singapore in 2003\textsuperscript{24} and Japan in 2006.\textsuperscript{25}

In Australia, reference to tax transparent companies has been quite pervasive: in the 1975 Asprey Report,\textsuperscript{26} the 1981 Campbell Committee's\textsuperscript{27} enquiry into the Australian financial system, and the Government's 1985 Draft White Paper.\textsuperscript{28} It should also be noted that in 1998 the Ralph Committee referred to the tax transparent treatment of

\begin{itemize}
  \item 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.
  \item 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 36: French law has provided that certain *Société a 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.
  \item 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".
  \item 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).
  \item Australia. (1981). Committee of Inquiry into the Australian Financial System — Final Report, (Campbell, J.K. Chairman), Canberra: AGPS, at 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.
\end{itemize}
corporations.29 More recently the Australian government announced that the ICAA proposal for a tax transparent company will be considered in the Henry Review.30

Economists have advocated for tax transparency (an aggregate approach) as an ideal model,31 as it can improve tax neutrality, reducing the impact of tax on consumption choices.32 Also it has been argued that, in addition to their economic benefits, tax transparent companies are advantageous for closely held businesses.33

32 Above n 27, at 16.
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.\(^{34}\) The asserted difficulties relate to the potential risk to revenue, allocation and administrative issues, complexity and the pressure to distribute money. 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.\(^{35}\)

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 the United States’ S Corporations and LLCs, the United Kingdom’s LLPs and New Zealand’s LAQCs and its new limited partnership regime. Other tax transparent companies introduced around the world include Singapore’s LLP,\(^{36}\) Northern Ireland’s LLP,\(^{37}\) and Japan’s LLP and LLC.\(^{38}\) Other jurisdictions have introduced entities with some of these attributes, but these entities currently lack the separate legal entity status.\(^{40}\)

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.\(^{41}\) However, the LAQC is not a fully transparent company, but instead is a ‘partial loss transparent company’, with only the losses automatically allocated to members, with income initially taxed

\(^{34}\) 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.

\(^{35}\) In contrast, 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. Another term used to describe this treatment is ‘opaque’. Harris, PA. (1996). Corporate/Shareholder Income Taxation and Allocating Taxing Rights Between Countries: A Comparison of Imputation Systems. Amsterdam: IBFD Publications BV, at 43 and 51. It should be pointed out that the adoption of an entity approach has the potential to breach tax neutrality, as it can cause a preference for retention of profits and debt funding by the business form.

\(^{36}\) Introduced in April 2005 by the Limited Liability Partnership Act (Chapter 163A).

\(^{37}\) Which is similar to the United Kingdom’s LLP, and took effect from 13 September 2004.

\(^{38}\) Commencing 1 April 2005.

\(^{39}\) 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.

\(^{40}\) 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.

to the business form.\(^{42}\) It is these foreign transparent companies that will be studied to evaluate the claims within the ICAA proposal of reduced complexity.

Furthermore, 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 understanding of these paradigmatic classifications, Table 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 1: Classifications of tax transparent companies**

<table>
<thead>
<tr>
<th>Classification</th>
<th>Description</th>
<th>Example</th>
</tr>
</thead>
</table>
| 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      |

### 1.3 ICAA proposal

The ICAA proposal advocates for the introduction of tax transparent company, particularly for micro enterprises.\(^{43}\) The proposal, if implemented, would see transparency achieved through the application of the general partnership tax provisions to corporations and unit trust which elect to be part of the regime.\(^{44}\) As

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\(^{42}\) Similar to the fully transparent company, the partial loss transparent company also provides for limited liability and the notion of a separate legal entity.

\(^{43}\) Above n 2, at paragraph 3.7.10.

\(^{44}\) The ICAA proposal applies to unit trusts as well as corporations. Above n 2, at 6. With a membership restriction of five.
currently drafted the ICCA proposal is for a fully tax transparent company (as defined), and would be best classified as a ‘special tax rule company’ with S Corporations and LAQCs. Indeed, in the ICAA proposal there are numerous references to the United States’ experience with S Corporations and LLCs.

A reason underlying the ICAA proposal is that the application of tax transparency could remove the need for the application of complex tax integrity measures imposed to address the disguised distribution of profits from private corporations, and thereby reduce compliance costs. The ICAA proposal argues that Division 7A would not need to apply nor fringe benefits tax for benefits to employee-members. Other complex provision that need not necessarily apply to a transparent company could include share value shifting, tracing capital gain discounts, and tracing rules for capital assets acquired prior to 20 September 1985. Furthermore, a tax transparent company could provide an alternative form of tax consolidations which can be problematic for small businesses.

If this reasoning is correct, then such a tax transparent company could provide a more sustainable method of taxing closely held businesses in Australia. This is because research has highlighted that when closely held businesses operations are small they have the least capacity to cope with the burden of regulations. This can lead to the compliance cost for small businesses being regressive. 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.

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45 Although this is classification is not precise, as the ICAA proposal envisages that the existing Australian general partnership tax rules would apply to the transparent company rather than introducing a special set of transparent tax rules.

46 Above n 2, at 9 and 12.

47 ITAA 1997 (Cth), Division 723 to 727.

48 ITAA 1997 (Cth), s 115-40.

49 ITAA 1997 (Cth), CGT event K6.

50 Above n 2, at 10.


53 Chittenden, F, Kauser, S, and Poutziouris, P. (2000). Regulatory Burdens of Small Business: A Literature Review: University of Manchester, at 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 lax 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.
Also compliance costs are not just purely financial, as non-financial costs can include stress and lost time.\textsuperscript{54} 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.\textsuperscript{55}

The regressive nature of compliance cost was demonstrated in the study 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.

\begin{table}[h]
\centering
\begin{tabular}{|l|c|c|c|}
\hline
Type of Business & Small (<A$100,000) & Medium (100,000 to A$9,999,999) & Large (> A$10 million) \\
\hline
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 \\
\hline
\end{tabular}
\caption{AUS: Average compliance cost}
\end{table}


The Australian example is indicative of the international experience, with compliance costs being regressive.\textsuperscript{56} 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 3 demonstrates that for firms with less than 20 employees the

\begin{itemize}
\item Board of Taxation. (2007). \textit{Scoping study of small business tax compliance costs: A report to the Treasurer}, Attorney-General’s Department, Canberra, December, at 7: Finding 6. Other costs can include psychological, temporal, opportunity and transitional.
\end{itemize}

\textbf{Table 3: US: Cost of regulation per employee}

<table>
<thead>
<tr>
<th></th>
<th>All firms</th>
<th>&lt; 20 employees</th>
<th>20 -499 employees</th>
<th>&gt; 500 employees</th>
</tr>
</thead>
<tbody>
<tr>
<td>Environmental</td>
<td>US$1213</td>
<td>US$3328</td>
<td>US$1173</td>
<td>US$717</td>
</tr>
<tr>
<td>Total</td>
<td>US$2798</td>
<td>US$5322</td>
<td>US$2604</td>
<td>US$2313</td>
</tr>
</tbody>
</table>


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 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.

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. 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. 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.

Figure 2: AUS: Average small business compliance cost

![Bar chart showing average compliance cost per $000 of turnover after tax deduction for different business forms: Sole Proprietor, General Partnerships, Trusts, Superannuation Funds, Corporations.]


60 Above n 55, at 8: Finding 11.
61 Above n 55, at 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).
62 Above n 55, at 105 – 108.
The imposition of compliance costs on closely held businesses\textsuperscript{63} is important because, 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 businesses\textsuperscript{64} 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).\textsuperscript{65} Small businesses account for around 30 per cent of Australia’s gross domestic product.\textsuperscript{66} For this reason, this sector has been described as ‘the engine room of the Australian economy.’\textsuperscript{67}

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’.\textsuperscript{68} 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.\textsuperscript{69} It has been stated:

\footnotesize
\begin{itemize}
\item \textsuperscript{63} For the purposes of this article, the qualitative characteristics inherent for a ‘closely held business’ is that membership interest is not widely dispersed, and that it is not publicly traded: Holmes, S, and Gibson, B. (2001). Definition of Small Business: The University of Newcastle, at 8; Coleman, C, and Evans, C. (2003). Tax Compliance Issues for Small Business in Australia. \textit{Taxing Small Business: Developing Good Tax Policies}, Australian Tax Research Foundation: Sydney (Conference Series 23):147, at 149; Above n 52, at 13. Normally, a closely held business is one that is independently owned and operated, with most, if not all, capital contributed by members and managers. Furthermore, members are likely to participate in the management of the business (member-management). 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’: Above n 36, at 47. While it is acknowledged that ‘closely held’ and ‘small business’ are not \textit{per se} interchangeable, the vast majority of closely held businesses will nonetheless be small to medium enterprises. However, there can be a number of closely held businesses that are large. Freedman, J, and Ward, J. (2000). Taxation of Small and Medium–Sized Enterprises. \textit{European Taxation} May: 158, at 159.
\item \textsuperscript{64} Defined to be businesses that employ less than 20 people.
\item \textsuperscript{65} Australian Bureau of Statistics. (2002). Small Business in Australia 2001, Canberra: AGPS.
\item \textsuperscript{67} Howard, J (Prime Minister). (1997). More Time for Business: 24 March 1997, Canberra: AGPS.
\end{itemize}
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.70

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.71 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.

Accordingly, the argument that a tax transparent company might achieve compliance cost savings needs to be carefully analysed, particularly as historically this was not the considered opinion. Is there evidence overseas to support this contention?

1.4 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. This issue takes on greater significance if it is acknowledged that tax compliance costs are ultimately regressive for small businesses.72

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 LLC.73 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 LAQC.74 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


74 Above n 20. The Committee went on to say that their observation was supported by advice received from ‘private sector practitioners in the United States.’
their relative complexity. Unfortunately, there is no available data-set in respect of the United Kingdom’s LLP, which is probably attributable to its recent introduction there.\footnote{The LLP regime commenced 6 April 2001.} However, there are some important characteristics of the tax treatment of LLPs as general partnerships, which it is argued is important for Australia. It is for this reason that the LLP is included in this analysis.

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.\footnote{DeLuca, D, Greenland, A, Guyton, J, Hennessy, S, and Kindlon, A. (2005). \textit{Measuring the Tax Compliance Burden of Small Business}. Paper read at Internal Revenue Services’ Research Conference, 7-8 June, at Washington DC.} Portions of the data from this survey of 5,875 businesses are replicated in Table 4. 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.

\textbf{Table 4: US: Tax compliance costs}

<table>
<thead>
<tr>
<th>Average income tax compliance burden for 2002.</th>
<th>General Partnership</th>
<th>LLC</th>
<th>S Corporation</th>
<th>C Corporation</th>
</tr>
</thead>
<tbody>
<tr>
<td>All firms</td>
<td>$1,516</td>
<td>$2,611</td>
<td>$2,282</td>
<td>$2,231</td>
</tr>
<tr>
<td>Firms with less than 100 employees.</td>
<td>$1,469</td>
<td>$2,711</td>
<td>$2,259</td>
<td>$2,139</td>
</tr>
</tbody>
</table>


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.\footnote{In this study ‘small’ is measured by a firm having less than 100 employees.}

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.\footnote{Above n 74, at 634.} However, despite this, S Corporations indicated higher tax compliance cost
than C Corporations irrespective of the fact that they share a similar 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.\(^79\) In comparison, the tax rules applying to S Corporations were ranked nearly one whole percentage point lower as the 12th most complex issue.\(^80\) 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.\(^81\) Part of the findings of Ingraham and Karlinsky is reproduced in Table 5.

**Table 5: US: Perceptions of complexity**

<table>
<thead>
<tr>
<th>Complexity ranking</th>
<th>Small business tax item</th>
<th>Average complexity score (scale 1 to 5)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Partnerships</td>
<td>3.4167</td>
</tr>
<tr>
<td>2</td>
<td>Estate and Gift Tax Valuation</td>
<td>3.1910</td>
</tr>
<tr>
<td>3</td>
<td>Tax Deferred Exchanges</td>
<td>3.1058</td>
</tr>
<tr>
<td>4</td>
<td>Frequency of Tax Law Changes</td>
<td>3.1023</td>
</tr>
<tr>
<td>5</td>
<td>Retirement Plans</td>
<td>2.9772</td>
</tr>
<tr>
<td>6</td>
<td>AMT – Individuals</td>
<td>2.9333</td>
</tr>
<tr>
<td>7</td>
<td>Accumulated Earnings Tax</td>
<td>2.8539</td>
</tr>
<tr>
<td>8</td>
<td>AMT – Corporate</td>
<td>2.7159</td>
</tr>
<tr>
<td>9</td>
<td>Inventory</td>
<td>2.7079</td>
</tr>
<tr>
<td>10</td>
<td>Passive Activity Losses</td>
<td>2.6897</td>
</tr>
<tr>
<td>11</td>
<td>Constructive Ownership</td>
<td>2.5814</td>
</tr>
<tr>
<td>12</td>
<td>S Corporation Tax Rules</td>
<td>2.5281</td>
</tr>
</tbody>
</table>


\(^79\) 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.


\(^81\) There are two alternative minimum tax systems applying in the United States, one for individuals and the other for corporations.
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.82

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, disregarding the legal form for tax purposes does increase tax compliance costs.

**Figure 3: US: Income tax compliance costs**

![Graph showing average income tax compliance burden for 2002 for different business types]


Figure 3 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

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82 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. Refer to the analysis in Freudenberg, B. (2008). *Losing my Losses: Are the loss restriction rules applying to Australia’s tax transparent companies adequate?* Australian Tax Forum 23(2):125, at 147.
compared to LLCs ($2,611). 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 transparency. 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. 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 months about their estimated compliance costs. Some of the specific businesses studied utilised LAQCs. 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 6 demonstrates that participant 3, who utilised the LAQC form, had the greatest overall compliance hours (320

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83 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.

84 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.

85 Refer to the analysis in Above n 83. A counter argument is that the improved governance regime tailored to the business by the engagement of a professional at formation is advantageous.

86 The study also covered two large businesses, but neither of these identified as being LAQCs, so their results are not relevant to this article. Ritchie, K. (2002). *New Zealand Small Business Tax Compliance Costs – Some Empirical Evidence*. Wellington: Inland Revenue.
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’.87

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 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.88 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.89 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.

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87 Above n 87, at 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.

88 Ritchie observes that participant 3’s total time is considerably greater, and that it might be overstated: Above n 87, at 36.

89 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).
FAcT OR FIcTION? A SUSTAINAbLE TAX TRANSpAReNT FORM

Table 6: NZ: Compliance cost – small business

<table>
<thead>
<tr>
<th>Participant</th>
<th>Business form</th>
<th>Business description</th>
<th>Turnover</th>
<th>Sum of 4 Quarters</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total hours (incl. tax)</td>
<td>Tax hours only</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>Sole Proprietor</td>
<td>Part-time repairing electronics</td>
<td>$10,000</td>
<td>57.14</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>17.34</td>
</tr>
<tr>
<td>2</td>
<td>Sole Proprietor</td>
<td>Professional Photographer</td>
<td>$40,000</td>
<td>52.40</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>16.52</td>
</tr>
<tr>
<td>3</td>
<td>LAQC</td>
<td>Tax agent</td>
<td>$48,000</td>
<td>320.07</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>33.75</td>
</tr>
<tr>
<td>4</td>
<td>Sole Proprietor</td>
<td>Chartered Accountant</td>
<td>$70,000</td>
<td>44.07</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>31.13</td>
</tr>
<tr>
<td>5</td>
<td>Sole Proprietor</td>
<td>Adviser computer package</td>
<td>$80,500</td>
<td>152.04</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>61.45</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td></td>
<td>625.72</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>160.19</td>
</tr>
</tbody>
</table>


Table 7 details the ‘medium’ business surveyed by Ritchie, with two of the participants utilising LAQCs (participants 11 and 12).\(^{90}\) 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.\(^{91}\) Figure 4 illustrates the extent of the differences between the participants operating medium businesses in the Ritchie study.

\(^{90}\) 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.

\(^{91}\) 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.
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 8.

Table 7: NZ: Compliance costs – medium business

<table>
<thead>
<tr>
<th>Participant</th>
<th>Business type</th>
<th>Business description</th>
<th>Turnover</th>
<th>Total hours (incl. tax)</th>
<th>Tax hours only</th>
</tr>
</thead>
<tbody>
<tr>
<td>6</td>
<td>Corporation</td>
<td>Australian subsidiary</td>
<td>$300,000</td>
<td>261.85</td>
<td>139.38</td>
</tr>
<tr>
<td>7</td>
<td>Corporation</td>
<td>Apparel industry</td>
<td>$300,000</td>
<td>239.95</td>
<td>25.01</td>
</tr>
<tr>
<td>8</td>
<td>Corporation</td>
<td>Engineer</td>
<td>$500,000</td>
<td>223.60</td>
<td>54.27</td>
</tr>
<tr>
<td>9</td>
<td>General Partnership</td>
<td>Personal services</td>
<td>$800,000</td>
<td>120.60</td>
<td>10.57</td>
</tr>
<tr>
<td>10</td>
<td>Corporation</td>
<td>Engineering</td>
<td>$863,294</td>
<td>163.42</td>
<td>29.54</td>
</tr>
<tr>
<td>11</td>
<td>LAQC</td>
<td>Health Care</td>
<td>$1,500,000</td>
<td>1021.21</td>
<td>145.30</td>
</tr>
<tr>
<td>12</td>
<td>LAQC</td>
<td>Agriculture</td>
<td>$2,500,000</td>
<td>478.25</td>
<td>143.18</td>
</tr>
<tr>
<td>13</td>
<td>Corporation</td>
<td>Agriculture</td>
<td>$3,000,000</td>
<td>998.89</td>
<td>100.21</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td></td>
<td>3507.77</td>
<td>647.45</td>
</tr>
</tbody>
</table>

The finding by Colmar Brunton is also consistent with the United States study by DeLuca et al. and the Australian studies. Unfortunately, the Colmar Brunton analysis does not distinguish between corporations electing for LAQC status and those not.92 It is argued, that this does 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.93

92 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 120-121: “The major tenor of business response that the tax legislation is just too complex for the majority of small business to understand and therefore to comply with”.

93 Above n 77, Table 5, at 83.
Table 8: NZ: Tax compliance cost – small and medium

<table>
<thead>
<tr>
<th>Entity type</th>
<th>GST</th>
<th>Income Tax</th>
<th>PAYE</th>
<th>FBT</th>
<th>Total costs (internal external)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporation</td>
<td>$2,296</td>
<td>$2,591</td>
<td>$696</td>
<td>$100</td>
<td>$5,677</td>
</tr>
<tr>
<td>Individual</td>
<td>$818</td>
<td>$1579</td>
<td>$121</td>
<td>$3</td>
<td>$2,521</td>
</tr>
<tr>
<td>Partnership</td>
<td>$1,873</td>
<td>$2,079</td>
<td>$459</td>
<td>$9</td>
<td>$4,416</td>
</tr>
<tr>
<td>Trust</td>
<td>$1,027</td>
<td>$1,951</td>
<td>$197</td>
<td>$24</td>
<td>$3,202</td>
</tr>
</tbody>
</table>


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 demonstrates the popularity of transparent companies in both the United States and New Zealand, and an increasing number of LLPs in the United Kingdom.94 It is argued that any additional tax compliance cost could be offset or counter-balanced by other advantages – particularly tax savings.95 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, given that the overseas evidence is incongruent with the contention of the ICAA proposal it is important to consider the attributes that could contribute to this increased tax compliance cost, and whether it is possible to mitigate them.

1.5 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

94 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. See: Above n 83.

95 A consistent advantage of tax transparency is the treatment of tax preferences, losses and the imposition of a single layer of tax on capital gains.
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.

1.5.1 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.

The transparent entity within the ICAA proposal suggests that its flow-through regime be restricted to entities that are private with five or fewer members (whether they are resident or not). However, this low quantum of members is based on the proposal only extending to ‘micro-SME groups’ to reduce the potential impact on tax revenue. While the notion of non-listing is a valid eligibility requirement, it is argued that the quantum limitation is artificial and will be lead to practices to circumvent the limitation anyway or, alternatively, unduly exclude entities from being eligible. Furthermore, a quantum restriction means that membership numbers require continual monitoring.

New form transparent companies, such as the LLCs and LLPs, have the most relaxed eligibility requirements. In comparison, the eligibility requirements for special tax rule companies, S Corporations and LAQCs are stringent. These

97 A 'private' entity based on a definition similar to that found in ITAA 1936 (Cth), s 103A.
98 Above n 2, at paragraph 3.7.10 and 3.24.
99 Above n 2, at paragraph 3.7.10.
100 Treasury Regulation, s 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.
101 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), ss 2 and 10; Income and Corporation Taxes Act 1988 (UK), s 118ZA.
102 IRC 1986 (US), s 1361. 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.
103 Income Tax Act 2007 (ITA 2007) (NZ), ss 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
stringent eligibility requirements could reflect the United States and New Zealand
governments’ concern about the wide ability of special tax rule companies and the
potential risk to tax revenue that they may entail. 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. The importance of
monitoring is illustrated by the ease with which the requirements 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. 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. 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.

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

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104 Above n 42.
105 For example, it is understood that the one class of membership interest was introduce to ease the
calculation of income and loss allocation, but also inhibit the ability for preferential streaming to
occur. Also the majority elections were imposed to provide some safeguard for minority memers
as they could be assessed on income not actually allocated to them.
106 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.
107 The relevant states being: Louisiana, Texas, New Mexico, Arizona, California, Washington,
Idaho, Nevada, Wisconsin, and (if elected by the spouses) Alaska.
108 ITA07 (NZ), s 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.
109 A properly drafted corporate constitution could adequately address this by requiring other
member consent before the transfer could be finalised.
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.\footnote{ITA07 (NZ), s HA 9. 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: 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 212.}

One requirement that has been identified as imposing additional compliance costs is the need for only one class of membership interest for both S Corporations and LAQCs.\footnote{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.} 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,\footnote{Not relevant for New Zealand.} members' agreements and binding agreements relating to distribution and liquidation proceeds.\footnote{Treasury Regulation, s 1.1361—1(1)(2).} Also, it is important to consider whether 'debt' could be regarded as a second class of membership interest.\footnote{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), s 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.}

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. 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.\footnote{IRC 1986 (US), s 704. See: Above n 83.} These rules are described as ‘among the most complex’ in all of the United States tax law,\footnote{Stark, K, and Zolt, EM. (2000). United States Partnership Taxation: Current Structure and Proposals for Reform. Bulletin July:326, at 332.} and are accompanied by ‘voluminous’ regulations.\footnote{Treasury Regulation, s 1.704-1(b)(2)(i).} While the ability to make 'special allocations' has been stated as one of the most important tax benefits of an LLC,\footnote{Friedman, HM. (2004). The Silent LLC Revolution - The Social Cost of Academic Neglect. Creighton Law Review 38(1), at 23.}
it appears that doing so entails increased tax compliance costs in order to satisfy the
integrity rules.\textsuperscript{119} It may be that these ongoing implications could have contributed to
the results that were outlined in the DeLuca et al. tax compliance study. Indeed, the
chequered past of the tax treatment of LLCs may highlight that a more considered
approach to its implementation could have been preferable.\textsuperscript{120}

Furthermore, it appears that the one class of membership interest means that
integrity measures for ‘revenue assets’\textsuperscript{121} do not apply to S Corporations.\textsuperscript{122} 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.

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.\textsuperscript{123} 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.

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.\textsuperscript{124} The
basis for the relaxation of the eligibility requirements was stated to be for improved
simplification and tax neutrality.\textsuperscript{125} 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

\textsuperscript{119} 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, s 1.701-2.
Above n 117, 327-328.

\textsuperscript{120} Above n 97.

\textsuperscript{121} A revenue asset is one held on a revenue account of the enterprise: for example trading stock or
inventory.

\textsuperscript{122} This revenue asset rule is explained in greater detail latter in the article.

\textsuperscript{123} This was previously discussed to ensure that adverse transfers or admissions did not occur.

\textsuperscript{124} From 1 January 2005 all members of a family can be treated as one member: IRC 1986 (US),
s 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), s 152(b)(2).

Corporation dividends. However, it should be pointed out that the residual eligibility requirements are still criticised as 'burdensome'. 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.

It is argued 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. Restrictive eligibility requirements could also inhibit the ability of transparent companies in raising equity, due to restrictions on membership numbers or member attributes. To proceed otherwise could impose additional tax compliance cost in terms of monitoring or of unjustly excluding certain investors or activities from transparent treatment. In addition to the eligibility requirements previously referred to the ICAA proposal includes the requirement of a unanimous member election. This is, in part, due to potential problems that can arise in respect of members having to pay tax on their unpaid allocations. While the eligibility requirements within the ICAA proposal themselves are not too onerous, there is concern with the capping to five members.

It is 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.

The analysis will now focus on the second factor that potentially contributes to tax compliance costs: the 'extent of aggregation'.

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126 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.


128 Above n 75, at 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.

129 Above n 2, at paragraph 3.9.3.

130 Above n 2, at paragraph 3.8.5. The ICAA proposal outlines that any conflict over unpaid allocations is better dealt with internally by the business’ operating agreement rather than to be externally mandated in tax rules.

131 A detailed discussion outlining the arguments for these eligibility requirements is the subject of an article currently under review, titled: The financing effect: Will a tax transparent form for closely held businesses in Australia assist with financing?
1.5.2 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. 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 merit to these proposals, they were criticised as ‘highly complex’. 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. Other

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132 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.


134 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. See: Above n 111.
examples of entity acknowledgement can relate to the tax elections about depreciation and accounting methods to be used by the business.\textsuperscript{135}

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 compromise. This conclusion is supported by statements accompanying the introduction of the new limited partnership regime in New Zealand,\textsuperscript{136} and by jurisdictions adopting an ‘integrated approach’ rather than an aggregated approach.\textsuperscript{137}

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,\textsuperscript{138} with members of the proposed flow-through entity having direct fractional interest in the CGT assets held.\textsuperscript{139} This means that changes in membership can potentially trigger partial disposals.\textsuperscript{140} It is submitted that this full aggregate approach could impose greater complexity for Australian businesses, particularly if there are large asset holdings, whether they be capital or revenue assets.

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, it is argued that 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 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 can be demonstrated by the application of loss restriction rules, where an LLC’s outside loan can increase the membership cost basis despite the LLC member having no

\textsuperscript{135} 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: \textit{IRC 1986 (US)}, s 703(b).

\textsuperscript{136} 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 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.

\textsuperscript{137} For example, an imputation system for corporate distribution to members.

\textsuperscript{138} Above n 2, at paragraph 3.18.1.

\textsuperscript{139} Above n 2, at paragraph 3.18.2.

\textsuperscript{140} 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 \textit{[ITAA 1997 (Cth), s 40-340(3)]}; trading stock \textit{[ITAA 1997 (Cth), s 70-100(6)]}. 
personal liability for the loan.\textsuperscript{141} 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.\textsuperscript{142}

The extent of entity acknowledgment among the transparent companies studied varies. The special tax rule companies, S Corporations\textsuperscript{143} 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.

\textbf{1.5.2.1 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 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.\textsuperscript{144} 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. This recognition can both increase and reduce complexity, depending upon the circumstances, which will be explored below.

\textsuperscript{141} While this inclusion was then reversed out by the ‘at risk’ rule, this overlay is not preferable. Above n 83.


\textsuperscript{143} For example, when an S Corporations 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), s 1374(a), (c).

\textsuperscript{144} Known in the United States as the ‘outside cost basis’.
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.\textsuperscript{145} 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.\textsuperscript{146} 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,\textsuperscript{147} 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 involve a historical reconstruction.\textsuperscript{148} 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.\textsuperscript{149}

\textsuperscript{145} 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.

\textsuperscript{146} Above n 117, 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”.

\textsuperscript{147} 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), s 7(a)(d).

\textsuperscript{148} 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), s 156A.

\textsuperscript{149} However, 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. See: Above n 42.
1.5.2.2 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 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 should be recalled that the ICAA proposal advocates for direct fractional holdings in assets by members of its transparent entity.

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.\(^{150}\) 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.

1.5.2.3 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 interest.\(^{151}\)

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\(^{151}\) 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), s 83. Unlike the CGT on contributed appreciated property by a member, an S Corporation member may not
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.\textsuperscript{152} However, this tax liability can be deferred in restricted circumstances, if the member and other contemporaneous contributors have ‘control’ of the S Corporation.\textsuperscript{153}

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.\textsuperscript{154} This is somewhat a similar outcome to when the ‘control’ deferral mechanism available for an S Corporation member.

In this way, the contributing LLC member’s CGT is ‘deferred’ until the property is sold by the LLC.\textsuperscript{155} 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.\textsuperscript{156} Also, there are potential adverse consequences if the contributed LLC asset is distributed to another member.\textsuperscript{157}

defer this tax liability, as service is not ‘property’: \textit{IRC 1986 (US)}, s 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.

\textsuperscript{152} \textit{IRC 1986 (US)}, s 1363(d).
\textsuperscript{153} \textit{IRC 1986 (US)}, s 351(a). ‘Control’ exists if the transferring members own 80 per cent or more of the membership interest in the S Corporation: \textit{IRC 1986 (US)}, s 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: \textit{IRC 1986 (US)}, s 358A(1). This deferral does not apply to future contributions of property or contributions of services.
\textsuperscript{154} \textit{IRC 1986 (US)}, ss 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: \textit{IRC 1986 (US)}, s 707(a). Above n 117, 330. However, the non-recognition provisions of s 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: \textit{IRC 1986 (US)}, s 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: \textit{IRC 1986 (US)}, s 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, s 1.897-1(c).
\textsuperscript{155} \textit{IRC 1986 (US)}, s 704(c).
\textsuperscript{156} There will be a mandatory allocation of pre-contribution gain or loss to the original contributing member: \textit{IRC 1986 (US)}, s 704(c).
\textsuperscript{157} Note there is an exception if contributed appreciated property is distributed to another member within seven years of contribution: \textit{IRC 1986 (US)}, s 704(c)(1)(B); or if the LLC distributes any property to the original contributor of appreciated property within seven years: \textit{IRC 1986 (US)}, s 737.
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.158

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.159 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.160 It should be noted that (in 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.161 Instead, the member receiving the property inherits the LLC’s ‘inside cost basis’ for the property and the membership cost basis is reduced.162 There is no gain recognised by the LLC member, regardless of whether the value of the distributed property exceeds their membership cost basis,163 as any gain by the LLC member is not assessed until the property received is later disposed of.164 This means that the entity acknowledgement for the S Corporation results in greater tax cost for distributions of property to members.

158 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), s 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.

159 IRC 1986 (US), s 1363(d). Such a gain would be allocated and assessable to all members in proportion of their membership interests: IRC 1986 (US), ss 311 and 1366. Such an allocation would increase the member’s membership cost basis.

160 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 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), s 302.

161 IRC 1986 (US), s 731(b) and (c).

162 IRC 1986 (US), ss 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), s 732(a)(2).

163 IRC 1986 (US), s 731(a)(1).

164 IRC 1986 (US), s 732(b).
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.\textsuperscript{165}

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.\textsuperscript{166} 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).\textsuperscript{167} The treatment of members 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 LLP\textsuperscript{168} 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.\textsuperscript{169} 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.\textsuperscript{170}

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’

\begin{footnotesize}
\begin{enumerate}
\item 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.\textsuperscript{165}
\item Income Tax (Trading and Other Income) Act 2005 (UK), s 852(2)(a): On the introduction of a member, the member is deemed to have his or her own trade commencing on their introduction.
\item 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). \textit{Tolley’s Capital Gains Tax}. London: LexisNexis Butterworths, at 581.
\end{enumerate}
\end{footnotesize}
share of proceeds,\textsuperscript{171} and the cost basis of their fractional interests disposed of.\textsuperscript{172} It is argued that such tax consequences could inhibit the introduction of new members.\textsuperscript{173}

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,\textsuperscript{174} 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.\textsuperscript{175} 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.\textsuperscript{176}

\textsuperscript{171} 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. \textit{Taxation of Chargeable Gains Act 1992} (UK), s 17(1)(b).

\textsuperscript{172} 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. \textit{Taxation of Chargeable Gains Act 1992} (UK), s 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. \textit{Taxation of Chargeable Gains Act 1992} (UK), s 162.

\textsuperscript{173} 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. \textit{Taxation of Chargeable Gains Act 1992} (UK), s 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.


\textsuperscript{176} Inland Revenue (UK). (1975). \textit{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,\(^\text{177}\) 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.\(^\text{178}\) 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 higher than a corporate tax return (two per cent).\(^\text{179}\) 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.\(^\text{180}\) 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.\(^\text{181}\) 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.

\(^{177}\) CG27217 – Partnerships: Statement of Practice D12: Part-disposals.

\(^{178}\) 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 this 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.


\(^{180}\) Above n 180, at 33.

\(^{181}\) It should be recalled that the LAQC is regarded as a partial loss transparent company.
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.

1.5.2.4 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 acknowledgment would result in the capital gain being calculated at the transparent company level, and then allocated among members. In the Australian context, this is similar to what occurs for the disposal of CGT assets by trustees.182

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.183 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.184 Due to the LAQC being a partial loss transparent company, there would be no immediate tax consequences for members until there was a distribution from the LAQC.185

182 ITAA 1936 (Cth), s 95.
183 Known as the ‘inside cost basis’.
184 While New Zealand does not have a comprehensive capital gains tax, it does have s 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).
185 A capital gain could be distributed tax free by an LAQC to a members as an unfranked dividend.
1.5.2.5 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 LLC\(^{186}\) sell or exchange their membership interest in a taxable transaction, they will normally realise either a capital gain or loss.\(^{187}\) If a capital gain subsequently is realised, then the exiting member may be eligible for the concessional CGT rate of 15 per cent.\(^{188}\) 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’.\(^{189}\) 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.

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186 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), s 1001(a); Treasury Regulation, s 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), s 743(a).

187 McNulty, JK. (1992). Federal Income Taxation of S Corporations. New York: The Foundation Press Inc, at 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”.

188 IRC 1986 (US), s 1202(a). Note for the purposes of the ‘alternative minimum tax’ calculation the entire amount is included: IRC 1986 (US), s 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), s 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), s 1202 but normal tax rates apply.

189 IRC 1986 (US), s 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.
The ‘revenue asset’ rule has been described as a cure ‘worse than the disease.’ These integrity measures have been seen as necessary due to Sub-Chapter K’s flexibility in structuring economic arrangements which may facilitate artificial outcomes. 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. Irrespective, it is argued that the premise of revenue asset rule may be flawed, because it may result in economic double taxation on unrealised revenue gains, where the remaining LLC members are assessed on these revenue gains later when they are realised on disposal.

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. 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. 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.\textsuperscript{196}

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.\textsuperscript{197} 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. It is
for these reasons that the complete aggregate approach advocated within the ICAA
proposal is not considered preferable in terms of easing the compliance cost for
closely held businesses.

\subsection*{1.5.3 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.\textsuperscript{198}

\textsuperscript{196} ITA 2007 (NZ), new s 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 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.

\textsuperscript{197} Note the tax system would need a rule to provide for adjustment if a revenue asset stops being
held on revenue account.

\textsuperscript{198} In this respect, reference should be made to the analysis about the various loss restriction rules
and the complexity that they entail: Above n 83.
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 rules into an overarching rule limiting losses to a member’s financial exposure amount. 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’.200

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 is queried what the basis of the claim within the ICAA proposal that the loss restriction rules applying to venture capital ILPs are less complicated.201 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, and are more complete as they apply to both capital and revenue losses.

Furthermore, the need for a loss restriction rule further reinforces the preference for greater entity acknowledgement as the membership cost basis will need to be monitored anyway. Indeed there is an inherent inconsistency if members are treated as having direct fractional interests in the underlying assets, and then having to monitor their membership cost basis in terms of loss restriction rules.

1.5.4 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 their legal

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199 However, in addition to such a rule, there would be the passivity test which is utilised in the United States.
201 Above n 2, at paragraph 3.15.6.
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’. This asymmetrical treatment can increase complexity and the potential for economic double taxation, as two countries are assessing different entities. Also, hybrid taxation can provide for tax arbitrages and tax planning opportunities for taxpayers to exploit.

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. 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.

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 only. However, it is argued that it is important to consider the potential cross-jurisdictional issues that may arise.

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 realisation has seen recent amendments introduced to several DTAs, providing for a ‘fiscally transparent persons’ provision. For example, the United States–United Kingdom provision provides that

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202 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”.

203 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.

204 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.

205 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.

206 Above n 206.

207 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
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.\footnote{United States–United Kingdom DTA, Article 1(8).}

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.\footnote{Snider, K, and Spiro, D. (2005). Tax Planning for U.S. Limited Liability Companies Investing in Canada. \textit{Tax Notes International} July:151, at 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.} Moreover, there are unresolved issues about how portfolio holdings through a transparent company should be treated to enable access to lower withholding tax.\footnote{This issues 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.}

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 following the legal form. For example, the Organisation for Economic Co-operation and Development (OECD) raised a number of issues that arise with inter-jurisdictional treatment of partnerships.\footnote{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.}

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.
FACT OR FICTION? A SUSTAINABLE TAX TRANSPARENT FORM 421

– the subject of this article. In this context, it is unclear whether that the transparent companies studied would in fact be ‘partnerships’ per se for the OECD purposes.

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, it is argued that symmetrical treatment should be one criterion for transparency eligibility.

1.6 Conclusion

Through the analysis within it is questionable to what extent would a transparent company as formulated in the ICAA proposal for decrease compliance cost for Australian closely held businesses. 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.

212 Above n 208, 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.

213 Collison, D. and Tiley, J. (2005). Tiley and Collision UK Tax Guide 2005-06. London: LexisNexis Butterworths, at 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.”
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 pursing the economic ideal.

While the suggestion that a fully transparent company will reduce complexity for closely held businesses in Australia is attractive, given the experience overseas this may not be what eventuates. While the author sees some merit in the ICAA proposal, there are a number of concerns with it, including the lack of entity acknowledgement and how this will affect complexity.\(^\text{214}\) Currently, as drafted a transparent company under the ICAA proposal is more likely to be fiction in creating a more sustainable business form for Australia closely held businesses.

If a transparent company is going to be introduced in Australia there needs to be greater consideration of the potential implications, including complexity, the tax treatment of other business forms and governance. It may be the circumstances that given Australia’s existing business forms and imputation system for corporations that a partial loss transparent company, rather than a fully transparent company, may be preferable. It is such an alternative that the author argues for in other research.\(^\text{215}\)

\(^{214}\) Other concerns include the applicable loss restriction rule; eligibility requirements; and failure to consider underlying governance rules.