THE FINANCING EFFECT: WILL A TAX TRANSPARENT FORM FOR CLOSELY HELD BUSINESSES IN AUSTRALIA ASSIST WITH FINANCING?

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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). The central proposition of the ICAA proposal is that the introduction of a tax transparent company will be beneficial to closely held businesses in Australia. An issue facing closely held businesses can be in terms of financing, and this article will consider whether the introduction of a tax transparent company is likely to assist closely held businesses with this. This analysis will consider the model outlined in the ICAA proposal, as well as a number of foreign transparent company forms, particularly: 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 about the interaction of a tax transparent company with financing, particularly in terms of eligibility requirements, assessment for unpaid allocations, comparison to corporate tax treatment and active members. It will be argued that as currently structured the ICAA proposal is unlikely to substantially assist closely held businesses address their financing problems and that a partial loss transparent company would be preferable model in this regard.

I 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). The contention of the ICAA proposal is that a tax transparent company will assist closely held businesses. While there have been some criticisms of the claims of decreased compliance cost in the ICAA proposal it is argued that another area of concern for this sector is financing.

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1 Australia, Australia’s Future Tax System – Consultation Paper, (Henry, K Chairman), (2008).
2 Institute of Chartered Accountants in Australia and Deloitte, Entity flow-through (EFT) submission, (2008).
4 Institute of Chartered Accountants in Australia and Deloitte, Entity flow-through (EFT) submission, (2008), 9 and 12.
The raising of finance (in terms of equity and debt) can be a challenge for closely held businesses, which can be attributable to both internal and external factors. In what respect does tax transparency — that is, disregarding the legal form and allocating income and/or losses directly to members — assist or hinder closely held businesses in meeting their financing requirements. It is argued that it is important for the issue to be considered in the Australian context, as some transparent companies have been attributed to tax arbitrages unique to their jurisdictions.

This article will consider how transparent companies potentially affect closely held businesses’ financing, by considering not only the ICAA proposal, but also a number of foreign tax transparent companies, being: 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). The consideration of foreign jurisdictions may highlight beneficial and adverse effects of tax transparency which at first consideration may not be obvious. Such an analysis will demonstrate that in the jurisdictions studied, compared to an entity or integrated system, consistent advantages of tax transparency are the treatment of tax preferences, losses and the imposition of a single layer of tax on capital gains. These tax advantages could assist closely held businesses in addressing their financing issues. However, it will be argued that tax transparency does not necessarily result in an overall lower tax burden. This depends upon several factors including the relationship between the tax rates applying to corporations, capital gains and individuals. Also eligibility requirements and the assessment of unpaid allocations can be adverse. Another issue implicated in this analysis, is the appropriate tax status of transparent company members as either ‘employees’ or as ‘self-employed’.

Through this analysis it will be argued that it is questionable what benefits in terms of financing will accrue to closely held businesses through the ICAA proposal. Instead it will be argued that a preferable approach to assist Australian closely held businesses in terms of financing 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 issues closely held businesses in Australia can face in terms of financing. The article will then consider the overseas experience as well as reflecting upon the ICAA proposal in terms of financing. The potential reasons why transparency may aid or hinder financing will be considered. The final section of the article will outline the conclusions as to whether the ICAA proposal will assist closely held businesses in terms of financing.

II WHAT IS A TAX TRANSPARENT COMPANY?

The combined attributes present in the tax transparent company considered are a corporation’s separate legal entity status and limited liability, with a general

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6 For example an internal characteristic of closely held businesses obtaining finance is that members may want to retain ‘control’. An external factor could be that banks are hesitant to lend to a business without an established track record.

7 Or legal personality.
partnership’s flow-through taxation treatment. It is these three core characteristics that define the nature of a tax transparent company (or transparent company).³

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.⁴ 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 tax returns by the business form or the selection of depreciation methods.

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 liability⁵ and is a separate legal entity from its constituent members.

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³ Tax transparent treatment is argued to be an attribute of general partnerships, particularly in the Australian context.
⁴ 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.
⁵ Referred to as aggregate approach, transparency or flow-through taxation.
⁶ 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 percent discount: Income Tax Assessment Act 1997 (Cth) (ITAA 1997), Div 115.
⁷ The extent of limited liability protection does vary amongst transparent companies.
Figure 1: The continuum of the taxation of business forms

![Diagram of the continuum of the taxation of business forms]

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; and the United States: Blueprints for Basic Tax Reform in 1977, and in 1992 and the American Law Institute Federal Income Tax Project – Taxation of Private Business Enterprises in 1999. In Australia, reference to tax transparent companies has been quite pervasive: in the 1975 Asprey Report, the 1981 Campbell Committee’s enquiry into the Australian

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13 Figure modified from Sijbren Cnossen, ‘Alternative Forms of Corporation Tax’ (1984) 1 Australian Tax Forum 253, 255.
17 Australia, Asprey Report, Taxation Review Committee Full Report, (1975), [16.79 to 16.96]. The Asprey Committee did not regard the scheme as being primarily directed to assisting small companies [16.85] or available to the subsidiaries of large or foreign companies [6.89].
18 Australia, Campbell Report, Committee of Inquiry into the Australian Financial System — Final Report, (1981), 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
financial system, and the Government’s 1985 Draft White Paper.\(^{19}\) It should also be noted that in 1998 the Ralph Committee referred to the tax transparent treatment of corporations.\(^{20}\) More recently the Australian government announced that the ICAA proposal for a tax transparent company will be considered in the Henry Review.\(^{21}\)

The ICAA proposal advocates for the introduction of tax transparent company, particularly for micro enterprises.\(^{22}\) The proposal, if implemented, would see transparency through application of the general partnership tax provisions to corporations and unit trust which elect to be part of the regime.\(^{23}\) A reason underlying the ICAA proposal is that 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.\(^{24}\) Whether the ICAA proposal would reduce compliance costs is questionable, as evidence from foreign jurisdictions would tend to indicate that tax transparent companies increase compliance costs.\(^{25}\) Part of potential complexity is the compliance with integrity measures, such as loss restriction rules, to ensure that a transparent regime is not abused.\(^{26}\) Nevertheless, the ICAA proposal contends that a tax transparent company would be a preferable mechanism to tax closely held businesses in Australia.

A reason underlying such a proposal is that economists have advocated for tax transparency (an aggregate approach) as an ideal model,\(^{27}\) as it can improve tax neutrality, reducing the impact of tax on consumption choices.\(^{28}\) In justify their separate tax treatment. It was not convinced that operation of an enterprise under limited liability should result in an additional tax burden.


\(^{22}\) Institute of Chartered Accountants in Australia and Deloitte, above n 2, [3.7.10].

\(^{23}\) The ICAA proposal applies to unit trusts as well as corporations. Institute of Chartered Accountants in Australia and Deloitte, above n 2, 6.

\(^{24}\) The ICAA proposal argues that Division 7A would not need to apply nor fringe benefits tax for benefits to employee-members: Institute of Chartered Accountants in Australia and Deloitte, above n 2, 9 and 12. Other complex provision that need not necessarily apply to a transparent company could include share value shifting (*ITAA 1997* (Cth), Div 723 to 727), tracing capital gain discounts (*ITAA 1997* (Cth), s 115-40), and tracing rules for capital assets acquired prior to 20 September 1985 (*ITAA 1997* (Cth), CGT event K6). Furthermore, a tax transparent company could provide an alternative form of tax consolidations which can be problematic for small businesses.

\(^{25}\) Freudenberg, above n 3.

\(^{26}\) For a discussion about the integrity measures that can apply to tax transparent companies see: Brett Freudenberg, ‘Losing My Losses: Are the Loss Restriction Rules Applying to Australia’s Tax Transparent Companies Adequate?’ (2008) 23(2) *Australian Tax Forum* 125.

\(^{27}\) Another term that can be used to describe an aggregate approach is ‘fiscally transparent’. Jeffrey Kwall, *The Federal Income Taxation of Corporations, Partnerships, Limited Partnerships, Limited Liability Companies, and their Owners* (3rd ed 2005), 10. John Head, Company Tax Systems: From Theory to Practice. In *Company Tax Systems*, edited by J Head and R Krever (1997), 22: ‘In the traditional public finance literature, full integration of the corporate income tax with the personal income tax has long been viewed as the relevant ‘blueprint’ or ideal’. Cnossen, above n 11, 262: “For tax purposes there should be no difference between corporate profits and other capital income, such as interest and rents, or labour income, such as wages and salaries that is solely subject to the individual income tax”.

\(^{28}\) Australia, above n 15, 16.
comparison, the ‘entity’ approach can cause a number of distortions, including the favouring of the retention of profits. This is because the distribution of profits to members results in additional tax being assessed to the member, and therefore it can be perceived as preferable to shelter income in the business form. Such retention of profits within the business form may have several adverse consequences. Another potential distortion of an entity approach is that it can discriminate against equity funding compared to debt because interest on debt for the business form is tax deductible compared to profit distributions to members.

In comparison, tax transparency is stated to improve or enhance the tax neutrality and equity of a tax system, compared to an entity approach. The Organisation for Economic Co-operation and Development (OECD) in its 1991 report espoused a preference for transparency:

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

The adoption of tax transparent treatment can achieve greater horizontal and vertical equity and this is because there is an alignment in the taxation of business profits with the notion of the capacity to pay tax. Furthermore, tax transparency can achieve greater equivalent tax treatment on debt and equity. Also it has been argued that, in addition to their economic benefits, tax transparent companies are advantageous for closely held businesses.

Historically, however, it has been argued the implementation of such an economic ideal is problematic for business forms with limited liability and separate legal entity status. The asserted difficulties relate to the potential of risk to revenue, allocation and administrative issues, complexity and the pressure to distribute money. 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.

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


Yin and Shakow, above n 14, 70. Oats, above n 28, 39: “This presupposes profitability as an acceptable measure of ability to pay tax”.


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.
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.\textsuperscript{37}

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.\textsuperscript{38} However, the LAQC is not a fully transparent company, but instead is a ‘partial loss transparent company’, with only the losses are automatically allocated to members, with income initially taxed to the business form.\textsuperscript{39} It is these foreign transparent companies that will be studied to evaluate the claims within the ICAA proposal of a tax transparent company being a benefit for Australian closely held businesses in terms of financing.

\section{FINANCING AND CLOSELY HELD BUSINESSES}

One of the problems confronting closely held businesses can be in terms of financing, whether this be from internal or external sources. To an extent the financing problem can be self-inflicted. While the problems discussed could have equal application to widely held business, it is argued that inherently they can be more evident for closely held businesses, particularly with small operations. Research demonstrates that very few small corporations attract any equity other than from active members.\textsuperscript{40} Consequently, equity finance from active members can be an essential source of financing, especially in the early years of operation.\textsuperscript{41} Some research has indicated that equity (including retained profits) is a less important source of finance for small businesses when compared to that of widely held corporations.\textsuperscript{42} However, this research must be qualified, as much of the long-term debt for closely held business is in the form of member loans,\textsuperscript{43} with member guarantees and personal assets used as security not being recorded on the balance sheet.

An inhibitor to attracting additional equity investment is that existing members may want to retain control and can resist attracting additional members

\begin{footnotesize}
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\item Other tax transparent companies introduced around the world include Singapore’s LLP, Northern Ireland’s LLP and Japan’s LLP and LLC. Other jurisdictions have introduced entities with some of these attributes, but these entities currently lack the separate legal entity status. 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.
\item Similar to the fully transparent company, the partial loss transparent company also provides for limited liability and the notion of a separate legal entity.
\item In the years of operation the business may not have the ‘track record’ to satisfy creditors, nor have tangible assets which can stand as security for the loans.
\item Johns et al., n 42, 110: Note the study refers to ‘director loans’ however this appears to be a mistake in the correct nature of the loans given the prior discussion in the document.
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because of concerns with the dilution of control.\textsuperscript{44} This can apply when operations are small or large, as there can be a ‘high value’ placed on freedom and the opportunity to control.\textsuperscript{45} For some closely held businesses there may be little desire for business growth.\textsuperscript{46} In Australia, it is estimated that 70 percent of small and medium enterprises are ‘traditional’, following a low growth path, with few if any growth aspirations, and exist principally to provide their members with a source of employment.\textsuperscript{47} However, for those businesses wanting to expand, this financing problem means that they may not possess sufficient capital or retained earnings to carry their development opportunities to fruition.\textsuperscript{48}

In respect of sourcing outside loans there can be a number of intrinsic problems.\textsuperscript{49} Regardless of size, external financiers may be reluctant to finance closely held businesses, particularly if there is no tangible property to secure the finance and/or a viable business track record.\textsuperscript{50} Another factor is that such outside loans are often regarded as risky, so financial institutions may charge a ‘funding premium’ (often in the form of higher interest rates), particularly if operations are small. This means closely held businesses can face higher borrowing costs than larger businesses. Also, this can mean that such businesses do not qualify for normal business loans.\textsuperscript{51} Additionally, outside loans will generally require interest to be paid regularly, whereas a business that raises capital through equity will not be required to make regular distributions, except in unusual circumstances. Regular payments to an external financier require a matching of cash flows to obligations and this can present difficulties for closely held businesses which may have lumpy cash flows or may be unsophisticated in carrying out the precise provisioning required. This can lead to defaults on outside loans, even though the business is expanding.

These circumstances can lead to small closely held business relying more heavily on overdraft facilities, which may result in a higher level of cost due to

\textsuperscript{44} Johns et al., n 42, 29. Judith Freedman, ‘Small Business and the Corporate Form: Burden or Privilege’ (1994) 57 The Modern Law Review 555, 581: “Small business research has shown clearly that one of the major barriers to growth of small firms is the desire for independence and the unwillingness to part with control, particularly by the alienation of equity in a company”.


\textsuperscript{46} Johns et al., n 42, 29.


\textsuperscript{48} Stephen Barkocy and Daniel Sandler, Government Venture Capital Incentives: A multi-jurisdiction comparative analysis, Research Study No 46 (2007), 20. John Howard (Prime Minister), More Time for Business: 24 March 1997: “Many small businesses are constrained in their development and growth by a lack of access to appropriate sources of finance. If small businesses are to innovate, take up new technology and export, they need an accessible financial market that offers a wide range of financial products”.

\textsuperscript{49} Barkocy and Sandler, above n 48, 20.

\textsuperscript{50} It has been said that the finance gap is for ‘new and start-up’ businesses rather than small businesses: Teresa Graham, Graham Review of the Small Firms Loan Guarantee: Recommendations (2004).

\textsuperscript{51} Neil Mann, “The Tax Office and the Challenges for Small to Medium Enterprises”, In Taxing Small Business: Developing Good Tax Policies (2003) 183, 127: “Banks in lending to SMEs often incorporate a substantial risk margin. This can increase SME variable rates by up to 5 percentage-lending points”.

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charges. Furthermore, to support outside loans, members may be required to give personal guarantees for such debt, or to offer personal assets as security. Such personal guarantees would prejudice on the limited liability protection that may be provided by the business form, as the guarantee makes the member liable for principal and interest payments on default.

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

The relationship with financing and closely held businesses 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 during 2000–2001, representing 97 percent of all private sector businesses and employing almost 3.6 million people (49 percent of all private sector employment).

Small businesses account for around 30 percent of Australia’s gross domestic product. For this reason, this sector has been described as ‘the engine room of the Australian economy’.


53 Johns et al., n 42, 113. Which, given that they are not recorded in the balance sheet can sometimes give the misleading impression that the bank is providing more funds to start the business than the member.

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

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

56 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: Scott Holmes and Brian Gibson, Definition of Small Business (2001), 8; Cynthia Coleman and Chris Evans, Tax Compliance Issues for Small Business in Australia. Taxing Small Business: Developing Good Tax Policies (2003) 147, 149; Small Business Deregulation Task Force, Time for Business (1996), 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’: Harris, above n 29, 47. While it is acknowledged that ‘closely held’ and ‘small business’ are not per se interchangeable, the vast majority of closely held businesses will nonetheless be small to medium enterprises. However, there can be a number of closely held businesses that are large. Judith Freedman and J Ward, ‘Taxation of Small and Medium-Sized Enterprises’ (2000) May European Taxation: 158, 159.

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


60 John Howard (Prime Minister), More Time for Business: 24 March 1997.
Accordingly, whether a tax transparent company might assist closely held businesses with their financing needs to be carefully analysed. Within this article financing will be considered by analysing the eligibility for transparency and the overall tax burden, in terms of unpaid allocations, losses and tax preferences, capital gains, corporate tax treatment, active members and debt versus equity funding.

IV ELIGIBILITY FOR TRANSPARENCY

For a jurisdiction to allow for a tax transparent company there can be eligibility requirements. The ICAA proposal suggests that its flow-through regime be restricted to corporations and unit trusts that are private with five or fewer members. 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. Indeed, do eligibility requirements have to be so restrictive? For the foreign transparent companies studied, LLCs and LLPs have minimal eligibility requirements for transparency, whereas for S Corporations and LAQC they have strict requirements. This facet is of major importance because eligibility requirements can restrain the ability to raise equity due to, for example, requirements concerning classes of membership interest; membership numbers; members’ status; and business activities.

The requirement for a transparent company to have only one class of membership interest can restrict the ability to raise equity. This is because new equity members may require preferred membership interests or, alternatively, interests with specific rights attached to them to invest equity so as to expand operations.

Another way the ability to raise equity finance can be constrained is via restrictions on the quantum of members allowed. As an illustration of this point, an S Corporation is now restricted to comprising 100 members. While this is a substantial increase from the original ten allowed, it does nevertheless place an arbitrary cap on the number of members. Similar to the ICAA proposal, for LAQC the raising of equity is restricted to five members, although this can be

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61 A ‘private’ entity based on a definition similar to that found in ITAA 1936 (Ch), s 103A.
62 Institute of Chartered Accountants in Australia and Deloitte, above n 2, [3.7.10].
63 Institute of Chartered Accountants in Australia and Deloitte, above n 2, [3.7.10].
64 Furthermore eligibility requirements could have a relationship with regulatory complexity. See: Freudenberg, above n 3.
65 The requirement for one class of membership interest applies to S Corporations and LAQC.
67 Originally, back in 1958, only ten members were allowed; subsequent amendments raised the number to 15 (1976), then 25 (1981), then one year later to 35 (1982), then 75 (1997) and finally 100 (2005). Amended by section 232 of American Jobs Creation Act 2004 (US), amending IRC 1986 (US), s 1361(b)(1)(A)). This limitation applies to the number of members at any one time during the taxable year.
68 However, the potential membership of an S Corporation may exceed 100, due to the treatment of family members within six generations as one member: IRC 1986 (US), s 1361(c)(1)(B) [applying from 1 January 2005]. A family is defined to include members with a common ancestor, lineal descendants and spouse (including former spouse) at the time of the election six or less generations from the youngest generation of members part of the family, part from the operation of the section. Prior to 1 January 2005, most joint owners were counted separately: Treasury Regulation, s 1.1371-1(d)(1), although a husband and wife [and their estates] could be treated as one member: IRC 1986 (US), s 1361(c)(1).
circumvented by investors forming a general partnership of a number of LAQCs,\(^{68}\) and treating blood relatives as ‘one’ member.\(^{69}\) However, the concurrent use of business forms and the treatment of family members, inevitably increases complexity and calls into question the need for a cap in the first place.

An additional restriction on the raising of equity is that only certain types of entities can be members and this thereby inevitably excludes certain persons or entities. For example, an S Corporation may raise equity from resident individuals\(^{70}\) – except in restricted circumstances.\(^{71}\) Theoretically, this restriction means, in effect, that a C Corporation could not become a member of an S Corporation. In contrast to S Corporations, New Zealand’s LAQC may have non-resident members, although adverse tax implications may effectively deter this.\(^{72}\)

For S Corporations it is understood that non-residents were excluded due to the potential risk to revenue as allocated income to a non-resident member may have escaped taxation in the United States. This is because if a non-resident S Corporation member was not actively involved in the business, then as a non-resident only fixed income (interest and dividends) sourced in the United States would be taxed - with other income not subject to tax.\(^{73}\) It was for similar concerns that the residency requirement for LAQCs (compared to members) in New Zealand was one of the eligibility requirements.\(^{74}\) However, others have

\(^{68}\) Committee of Experts on Tax Compliance, *Tax Compliance: Report to the Treasurer and the Minister of Revenue: Chapter 6 – Tax Mitigation, Avoidance and Evasion*. (1998), [6.107]. The structure of a general partnership of LAQCs has been widely used in the forestry industry since shortly after enactment of the LAQC regime. In the United States the use of general partnerships in this fashion to increase membership of S Corporations was originally ruled against: Revenue Ruling 77-220, 1977-1 C.B. 263.

\(^{69}\) There are a number of special rules that allow more than five members, including the treatment of blood relations, nominees, corporate members and trustee members. Inland Revenue (NZ), Qualifying Companies: A guide to qualifying corporation tax law. (March 2001), 13 [cited 6 January 2008]. Available from http://www.ird.govt.nz/forms-guides/keyword/businessincometax/companies/ir435-guide-qualifying-companies.html.

\(^{70}\) IRC 1986 (US), s 1361 (b)(1)(C).

\(^{71}\) Only in restricted circumstances can a member be a corporation, or general partnership or trust. For example an S Corporation could not be a member of an affiliated group as defined in IRC 1986 (US), s 1361(b)(2)(A). S corporations can now hold 100 percent of membership interest in a subsidiary, and can elect to treat the subsidiary as a Qualified Subchapter S Corporation (QSSS): IRC 1986 (US), s 1361(b)(3)(B).

\(^{72}\) The benefit for a non-resident member investing into an LAQC may be limited; since the effective tax rate applying to distributions to them could be higher compared to if their investment was structured through a different business form. For members of an LAQC, who are New Zealand non-residents, imputation credits must still be attached to dividends paid to non-resident members, and are therefore wasted because non-resident members cannot normally claim a credit for them against their New Zealand tax liability, or for most members’ jurisdictions, against their home country tax liability. See: Brett Freudenberg, ‘Is the New Zealand Qualifying Company regime achieving its original objectives?’ (2005) 11(2) NZJTLP 185, 207. While not restricting equity investment, the restriction on an LAQC not having greater than $10,000 non-dividend income source from outside New Zealand could limit the LAQC’s operations and limiting the ability to attract equity investors.

\(^{73}\) A foreign member is allowed a credit for the tax withheld. If the income is not connected with trade in the United States then the withholding tax rate is generally 30 percent unless a Double Tax Agreement applies a lower rate: IRC 1986 (US), s 1146(a). George Mundstock, *A Unified Approach to Subchapter K & S*, (2006), 229.

\(^{74}\) In the New Zealand circumstances the residency requirement was to ensure that the foreign dividend withholding payment regime was not deliberated: Freudenberg, above n 72, 195.
pointed out that rather than excluding non-resident members, this could be addressed by applying withholding tax rules.\textsuperscript{75} For example, because the taxation of the United States’ LLC and its members occurs pursuant to a different sub-chapter, this means that LLC members are regarded as engaged in the business activity conducted by the LLC, and accordingly they are automatically subject to withholding tax on allocations to them.\textsuperscript{76} Others have argued that non-residents should also be excluded due to the potential complexity involved, including calculating the appropriate level of tax due to ascertaining world-wide income and administrative problems in applying a withholding tax.\textsuperscript{77}

Nevertheless, it is argued while allowing non-resident members does potentially impose a risk to revenue, provided there are adequate withholding measures for allocations to them, they should not be excluded. Indeed, by excluding non-residents from being eligible members, there is the potential to breach the non-discrimination article in Double Tax Agreements that Australia has entered into with other countries.\textsuperscript{78} Another concern with non-resident members is that there may be an erosion of the tax revenue due to lower rates of withholding tax applying to their allocations pursuant to Double Tax Agreements.\textsuperscript{79} However, determination of this depends upon how the allocation to members are characterised. If allocations are treated as ‘dividend’ payments, then lower withholding tax rates can apply.\textsuperscript{80} However, if instead members are treated as carrying on the underlying business of the transparent company, then the appropriate article would be the ‘business profits’ which does not generally benefit from the lower withholding tax rates.\textsuperscript{81}

The raising of equity is a highly significant issue and the capacity of a business form to facilitate it has been identified as an important feature. It is understood the formation of capital is one of the reasons behind the popularity of LLCs.\textsuperscript{82} The ‘formation of capital’ was one of the original reasons behind the introduction of the corporation one hundred and fifty years ago and it continues to be an important characteristic.\textsuperscript{83}


\textsuperscript{76} Mundstock, above n 73, 229.

\textsuperscript{77} Yin and Shakow, above n 14, 106.

\textsuperscript{78} For a discussion about the reasoning why the exclusion of non-residents for S Corporations does not breach the non-discrimination article see: John Taylor, ‘An Old Tax Is A Simple Tax: A Back To The Future Suggestion For The Simplification Of Australian Corporate-Shareholder Taxation’ (2006) 2(1) \textit{Journal of the Australasian Tax Teachers Association} 30, 54. However, it is highlighted that this reasoning is not accepted by all: American Bar Association, Section of Taxation, Committee on S Corporations and Partnerships, above n 73. American Bar Association, Section of Taxation, Committee on S Corporations and Partnerships, ‘Report on the Comparison of S Corporations and Partnerships: Part II’ (1991) 44(3) \textit{The Tax Lawyer} 813. For a discussion about the potential application of the non-discrimination clause to an imputation system see: Richard J Vann, ‘International Implications of Imputation, Australian’ (1985) 2(4) \textit{Australian Tax Forum} 452.

\textsuperscript{79} Taylor, above n 78, 55.

\textsuperscript{80} Taylor, above n 78, 54-55.

\textsuperscript{81} Jesper Barenfeld, \textit{Taxation of Cross-Border Partnerships: Double Tax Relief in Hybrid and Reverse Hybrid Situations}, (2005), 105.

\textsuperscript{82} For example the LLC Agreement can allow greater flexibility in profit sharing arrangements.

Overly restrictive eligibility for transparency has the deleterious consequence of reducing the capacity of the business to raise equity. It is argued that such a limitation in the ICAA proposal is artificial and will be lead to practices to circumvent the limitation anyway or alternatively to unduly exclude entities from being eligible. It is argued that the proposed eligibility requirements below provide sufficient flexibility to allow for the raising of equity while at the same time not compromising the integrity of the tax system.

The United States’ circumstances provide an interesting comparison, as it has two transparent companies with vastly different eligibility requirements. McNulty, in the early 1990s, identified the enactment of LLC legislation across the United States as illustrating the need to liberalise S Corporations eligibility requirements. Indeed, since this time, there has been liberalisation of the S Corporation’s eligibility requirements in 1996 and 2004. However, there is still a push for further relaxation with the proposed amendments of 2005 and 2006. It is argued that a major justification for this relaxation for S Corporations in the United States is that it is hard to justify the different eligibility requirements for transparency between S Corporations and LLCs when they have similar underlying legal characteristics.

In this context, it is argued that the 2006 proposals did not go far enough in their liberalisation objective, and that both transparent company forms in the United States should be subject to the one standardised regime. This inconsistency is further highlighted by the fact that the Check-the-Box regulations allow certain foreign corporations to Check-the-Box and elect for transparency under Sub-Chapter K, whereas corporations formed within the United States are not entitled to do this. Many of these foreign corporations, such as an Australian private company, can have similar governance regimes and legal characteristics as an S Corporation. When viewed in this context, this inconsistency between domestic and foreign corporations is difficult to justify. Also, it should be noted that it is possible for a C Corporation to hold the membership interests in an LLC, whereas it cannot readily do so for an S Corporation.

It is argued that for tax transparency to be implemented, only three core eligibility requirements are required: non-public trading of membership interests;

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85 These are in addition to the reforms that occurred in 1981 and 1982. The 1982 reforms saw removal of the 80 percent foreign income restriction *IRC 1986* (US), s 1372(e); and specification that differences in transfer and voting rights did not create a second class of membership interest: *IRC 1986* (US), s 1361(c)(4). In 1996, certain trust were allowed to hold membership interests and S Corporations were able to hold 100 percent of subsidiary corporations: *IRC 1986* (US), s 1361(b)(3)(B), known as QSSS.
86 The 2004 amendments included allowing some bank trading activity, the creation of employee stock ownership plans, and providing for the increase in membership number to 100: *IRC 1986* (US), s 1361(b)(1)(A), with the aggregation of family members in this count: *IRC 1986* (US), s 1361(c)(1)(B).
87 The proposed 2005 amendments are in *S Corporation Reform of 2005 Bill* (US), which was before the House Committee on Ways and Means.
88 In the circumstances that the C Corporation holds all the membership interests in the LLC, then the LLC would be a disregarded entity, meaning all of the LLC’s activity is treated as the C Corporations; this saves doing annual tax consolidations, and can allow for tax free re-organisations when another corporation is acquired. The new corporation can acquire the LLC’s assets in exchange for shares in the holding corporation.
election for transparent status; and cross-jurisdiction status. An optional fourth requirement could be further specified, that being the condition pertaining to one class of membership interest. These core requirements are in addition to any loss restriction rules that apply in relation to members utilising allocated losses. Each of these core eligibility requirements is now discussed.

Similar to the ICAA proposal, the first core eligibility requirement argued for is the non-public trading of membership interests. In considering this issue, it is informative to consider the listing of membership interests on an exchange, such as through an initial public offer (IPO). When an entity lists, the number of members can be very large. However, both S Corporations and LLCs are prevented from making IPOs if they wish to retain transparency. This is because S Corporations would find it difficult to ensure that the strict eligibility requirements are satisfied — such as having only resident members and not exceeding 100 members.

The exclusion of publicly traded partnerships from being able to Check-the-Box for transparency prevents an LLC undertaking an IPO. Indeed, for an LLC and its members to rely on safe harbour provisions made pursuant to regulations it is prudent that the number of LLC members is restricted to 100. Accordingly, there is some consistency between S Corporations and LLCs within the United States, with membership limited to 100 for tax transparency. However, these are enumerated under different Sub-Chapters of the IRC 1986 (US).

In the United Kingdom, the laws pertaining to the LLP do not have an upper limit on the number of its members. This does not mean, however, that an

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89 It is argued that a number of the eligibility requirements for S Corporations and LAQCs do not in themselves justify exclusion from tax transparency; instead, other ‘general’ mechanisms in the tax system should be able to adequately deal with the underlying concerns that the eligibility restrictions represent. For example, the prohibition of non-resident members could be adequately covered through the implementation of withholding tax rules on income allocations. Indeed, this is the mechanism used for LAQCs, LLCs and LLPs. Eligibility requirements that purport to exclude certain trading activities or asset holdings should be subject to an overall consistent tax system, and if adequate loss restriction rules are utilised then any trading activities should be allowed.

90 Such an IPO can provide for a larger pool of equity funds and liquid market for transfer of membership interests.

91 IRC 1986 (US), s 7704.

92 IRC 1986 (US), s 7704. An example of a ‘publicly traded partnership’ under section 7704 is one which has partnership interest that are either (a) traded on established securities markets, (b) readily traded on a secondary market. Regulations provide safe harbours for a partnership to avoid being classified as publicly traded (Treasury Regulation, s 1.7704): (a) all interests issued in a transaction/s are not registered under the Securities Act of 1933, and (b) there are not greater than 100 members during the year. A partnership deriving greater than 90 percent of income from passive income will be excluded from being publicly traded: IRC 1986 (US), s 7704(c) & (d).

93 Of course it is possible for this cap to be circumvented with transparency being retained. For example, family members within six generations are counted as one for S Corporations. For an LLC, it would be possible to argue that there is no secondary market for its membership interest even though the membership exceeds 100.

94 The absence of an explicit upper limit compares favourably to the previous limit of 20 members which was imposed on general partnerships and limited partnerships. Louise Pinfold (ed), Tolley’s Tax Planning 2005-06. Vol. 1 (2005), 1346. Another potential restriction for LLPs raising equity is that a ‘person’ may be an LLP member, meaning individuals, corporations, other LLPs, or some other form of corporate entity can be LLP members: Interpretation Act 1978 (UK), ‘Person’ includes an incorporated body of persons. However, the Registrar does not accept an unincorporated body such as a trust or general partnership being an LLP member, and requiring
LLP is able to offer its membership interests (or other securities) to the public, either directly or indirectly, as this can be an offence — unless certain procedures are compiled with.\textsuperscript{95} There are some current examples of LLPs being utilised for widely held operations, particularly as property investment vehicles, as well as for very large professional firms of solicitors and accountants.\textsuperscript{96} Corresponding to the ICAA proposal, in New Zealand the LAQC’s eligibility restriction of five members would likely prevent an IPO of membership interest in any meaningful way.

Across the jurisdictions studied, the restriction applying to membership ranges from five to 100, and to unlimited. Even with the potentially large number of members in the United Kingdom, there is a concern in all of the jurisdictions studied about when transparency is extended to publicly listed business forms. However, it should be recognised that these restrictions do not prevent a transparent company from listing their bonds on an exchange, thereby raising debt finance.\textsuperscript{97} Part of the rationale behind these restrictions could include the administrative difficulties inherent with transparent treatment in widely-held circumstances.\textsuperscript{98} This includes problems in relation to the collection of tax from a large number of members instead of just one entity; or the consequences pertaining to later amendments to taxable income for a year. However, given advances in technology these difficulties have diminished. For example, in each of the jurisdictions full and partial transparent forms have been used for collected investment vehicles.\textsuperscript{99}

Even without quantum restrictions, tax transparency itself could be a natural inhibitor to very large memberships. This is because it is uncertain whether a large number of members would agree to transparency, particularly if they are being assessed on unpaid profit allocations. It is understood that for publicly listed trusts in Australia, which have partial income transparency, this is dealt with by having quarterly distributions to members.\textsuperscript{100} It is argued that allowing members to choose whether to have tax transparency or not may be a preferable inhibitor, rather than picking an arbitrary number, which may be circumvented in any event.

\textsuperscript{95} For example a public corporation can offer membership interests publicly provided it has, amongst other things, a minimum membership capital of at least £50,000. Under reforms in the Companies Bill 2006 (UK), it will no longer be a criminal offence, with instead penalties and the corporation required to registerer as a public corporation or be struck off.

\textsuperscript{96} In the Cabvision case there was a plan for an LLP to raise capital to finance a project in the vicinity of £22.5 million by the issue of membership interests: \textit{Cabvision Limited v Feetum, Marsden and Smith} [2005] EWCA Civ 1601 (20 December 2005), [15]. The United Kingdom Government has been concerned about LLPs being used in this way and has brought in a number of counter provisions.


\textsuperscript{99} For example in the United States there is partial transparent treatment given for publicly traded oil and energy trusts.

\textsuperscript{100} Michael Brown, \textit{Collective Unconscious: It’s time to examine collective investment vehicles.} Paper read at Business Tax Reform – Meet the Critics, Sydney (28-29 September 2006).
An argument against tax transparency applying when membership is widely held is that the theoretical reason for transparency may be weaker as there is a greater distribution of membership, with a separation between management and members. In widely-held circumstances, members are more akin to passive investors, who are unlikely to be involved in the management of the business.\(^{101}\) Therefore, in widely-held circumstances, an entity or an integrated tax system may be preferable.\(^{102}\)

In view of the above analysis, it is argued that no quantum on membership numbers is required to allow for transparency and instead, at most, the restriction should exclude membership interest in the transparent company being publicly traded. However, there may be some merit, indeed, in allowing transparency to both publicly and non-publicly traded entities.\(^{103}\) An advantage of having no quantum restriction on membership, is that membership interests may be issued to employees to reward employees for their effort and loyalty. Such employee membership interests can be critical in the start-up phase when cash is a limited resource.

The second core eligibility requirement that is argued for is an election for transparent status to be applicable. This is preferable given that members are assessed on the business’s allocated income even though it is unpaid. This tax liability for the business income could be seen as an exception to the normal legal notion that members are not liable for the debts of the transparent company.\(^{104}\) Such a consent mechanism also alerts members to their obligations and may, in a logistical context, assist the tax authority in the collection from them. It is argued that this election mechanism is more appropriate to deal with unpaid allocations compared to the ‘one class’ of membership interest.\(^{105}\)

The ICAA proposal does highlight the potential problems that can arise in respect of members having to pay tax on their unpaid allocations. It nevertheless concludes that this is better dealt with internally by the business’ operating agreement rather than to be externally mandated in tax rules.\(^{106}\) The ICAA proposal suggests that the election for flow-through requires a unanimous member election.\(^{107}\)

There are several election mechanisms extant in the jurisdictions studied. In terms of S Corporations, this includes the initial unanimous member election. However, an incoming member must accept an existing S Corporation election, unless the incoming member acquires greater than 50 percent of membership interest.\(^{108}\) Alternatively, in the context of election mechanisms for LLCs, members’ consent to tax transparency depends upon the LLC’s Operating

\(^{101}\) Although non-active members may be adequately dealt with the differentiation between passive and active losses.

\(^{102}\) Harris, above n 29, 44.

\(^{103}\) Of course, a large consideration would be the administrative feasibility of transparency applying to a publically traded entity.

\(^{104}\) It is argued that if not for tax transparency, it would be the transparent company as a separate legal entity that would have the resulting tax liability to the relevant Tax Office.

\(^{105}\) It has been argued that the eligibility requirement for having ‘one class’ of membership interest is potentially a way to address the problem of unpaid allocations in terms of fairness: Taylor, above n 76, 49.

\(^{106}\) Institute of Chartered Accountants in Australia and Deloitte, above n 2, [3.8.5].

\(^{107}\) Institute of Chartered Accountants in Australia and Deloitte, above n 2, [3.9.3].

\(^{108}\) IRC 1986 (US), s 1362(d)(1)(B).
Agreement to determine how tax elections are to be made. Pursuant to the \textit{Revised ULLC Act 2006} this is likely just to be a majority decision.\textsuperscript{109} For an eligible LLP there is no election mechanism, as tax transparency applies automatically in the United Kingdom when it is eligible. The election for LAQC status in New Zealand can either be unanimous or a majority election.\textsuperscript{110} Manager elections have similar percentages as to member elections.

Given the above analysis of the various mechanisms, it is argued that for tax transparency to apply it is sufficient that a majority election, as opposed to unanimous, by the members (and managers if separate to members) be made. Any oppression of minority members that might result because of unfunded tax liabilities would be better dealt with under regimes provided by the relevant governance regimes, rather than adding tax rules that duplicate or vary those existing governance regimes.

The third core eligibility requirement argued for is the consideration of cross-jurisdictional treatment.\textsuperscript{111} To enhance cross-jurisdictional treatment and to limit the potential tax arbitrages of a foreign business form, it is argued that transparency should be extended to non-resident business forms only if they are treated as a transparent entity in their jurisdiction of residence, so that the business form is transparent in both jurisdictions. Such a rationale underpins the recent Australian CFC hybrid amendments.\textsuperscript{112} This requirement could assist in reducing asymmetrical treatment of transparent companies, as well as reducing the potential for tax arbitrages.\textsuperscript{113} Additionally, such symmetry could reduce the potential complexities that may arise with cross border transactions.\textsuperscript{114} The ICAA proposal does not canvass the issue of foreign entities electing for transparency, which may be due from its focus on micro businesses and the assumption that they would be domestic firms.

It has so far been argued that the eligibility requirements for tax transparency should be non-listing of membership interest; the requirement of majority member/manager election; and the condition that foreign entities be required to have symmetrical treatment in their resident jurisdiction. In addition to these three core eligibility requirements, it may be preferable to provide an optional rule that if the transparent company has one class of membership interest, then certain tax integrity measures will not apply. This is predicated on the

\textsuperscript{109} \textit{Revised ULLC Act}, s 407(b)(2). In the absence of a contrary LLC Agreement, the default rule provides members of a member-managed LLC with equal rights in decisions.

\textsuperscript{110} \textit{ITA 2007 (NZ)}, s HA 29. Such a majority election would be automatically revoked when a minority member becomes a majority member, or alternatively when a minority member obtains a majority of shares. To determine whether a majority election can be made the member’s effective interest in a corporation is measured by the percentage of decision-making rights carried by the shares (and options) in a corporation in relation to dividends (or other corporation distributions) plus corporation constitution, variation of the corporation’s capital and director appointments or elections: \textit{ITA 2007 (NZ)}, s HA 43.

\textsuperscript{111} There appears to be no reason why a non-resident entity should not be eligible to elect for transparency. Any concerns with the diversion of income offshore could be addressed with the requirement to lodge an information return detailing activities, which is done for all transparent entities except a single member LLC.

\textsuperscript{112} \textit{ITAA 1997 (Cth)}, Div 830.

\textsuperscript{113} Philip Postlewaite, ‘Treasury creates a monster. Australia, beware the hybrid entity!’ (2006) 16 \textit{Revenue Law Journal} 156. However, this may sufficiently be dealt with by Double Tax Agreements, particularly if they have transparent company provision.

\textsuperscript{114} Brett Freudenberg, above n 3.
argument that a transparent company with only one class of membership interest may have the effect of decreasing the overall complexity, because integrity measures addressing potential streaming of income and/or losses will not be applicable. For example, a benefit of providing for one class of membership is that it can provide a simpler basis to determine the allocation of profit and/or losses members.

The ICAA proposal does not include a requirement for one class of membership interest; instead it outlines that profit and losses should be distributed based on a proportional entitlement to profit, similar to the CFC hybrid amendments. The ICAA proposal also advocates largely that rollover rules that apply to general partnership revenue assets should be extended to the flow-through entity.

It is argued that it is preferable to provide a safe harbour for a transparent company with only one class of membership interest. If a transparent company has more than one class of membership, then, and only then, additional rules should apply addressing streaming issues. In this way, members could elect the degree of complexity to apply. Of course, one class of membership interest would in turn (conversely) decrease the flexibility of distributions and may increase the overall tax burden.

As an illustration of the above contention, in the early phase of a firm’s development a simple capital structure of one class of membership interest may be perfectly adequate. However, for subsequent raising of equity, different classes of membership interest may be necessary. This flexibility thereby allows the organisation both institutionally and structurally to expand. Further, the proposed eligibility restrictions allow for sophistication of membership interest, though they also may nevertheless impose additional integrity measures. In this way, the business can choose the level of tax complexity that may potentially result from raising additional equity.

Of course, the requirement for one class of membership need not be explicit, because if one class did exist then *quid pro quo* integrity measures aimed at streaming should not apply. If such streaming rules do exist, by having one class of membership as an explicit exclusion highlights the additional complexity.

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116 Also revenue asset rules for disposal of membership interest need not apply when one class of membership interest exists. Freudenberg, above n 24.

117 For example, with S Corporations and LAQCs, allocations to members are determined by considering the number of days that members have held their interest and the percentage of their membership interest: James S Eustice, ‘Subchapter S Corporations and Partnerships: A search for the pass through paradigm (some preliminary proposals)’ (1983-1984) 39 Tax Law Review:345, 362.

118 Institute of Chartered Accountants in Australia and Deloitte, above n 2, [3.10.6].


120 This option may be preferable for capital intensive industries, as they might want to stream tax preferences to certain members.

121 Note it has been questioned whether streaming rules are necessary at all. If streaming rules were excluded from a tax system, then it is likely that complexity of the tax system would be decreased by one class of membership. Freudenberg, above n 24.
that having greater than one class would involve. In terms of the Australian CFC hybrid amendments, streaming is dealt with by members’ allocations for tax purposes based on an overall percentage.\textsuperscript{122} Additionally it is argued that these eligibility requirements may alleviate some of complexity issues that can arise with tax transparent companies.\textsuperscript{123}

V OVERALL TAX BURDEN

If tax transparency can decrease or defer the income tax burden then this could help alleviate closely held businesses’ financing problem. A lower tax burden would allow members to reinvest profits into the business, thereby reducing the necessity to seek and obtain external debt financing or alternatively equity investment.\textsuperscript{124} Also, if tax transparency does improve the neutrality between debt and equity financing, then this could assist closely held businesses, which have historically been more reliant on equity funding than on external debt for financing.\textsuperscript{125} It is argued that if tax transparency does not operate in this way, it is questionable as to the extent to which tax transparency would assist closely held businesses.\textsuperscript{126}

It has been previously demonstrated the role a jurisdiction’s tax system performed in the context of the introduction of the transparent companies studied.\textsuperscript{127} For S Corporations and LAQCs it was shown that the objective was to improve tax neutrality between general partnerships and closely held corporations. It was also suggested that transparency applying to S Corporations and LAQCs could be perceived as a ‘carve out’ from the normal corporate tax treatment. For the introduction of LLCs and LLPs, breaches of tax neutrality tended to motivate taxpayers to lobby for the introduction of a new business form — one that was subject to tax transparency provided to general partnerships.

Similar to Australia, in considering the foreign experience the utilisation of transparent companies does not guarantee an overall lower tax liability, because there are inevitably qualifications and exceptions. Indeed, in some circumstances, transparent treatment can increase members’ tax burden. Nevertheless, there is significant potential for tax savings with transparent companies — particularly with access to losses, tax preferences and capital gains.\textsuperscript{128} The significance of these implications is analysed below. In addition to this analysis, consideration is

\textsuperscript{122} ITAA 1997 (Cth), s 830-30.
\textsuperscript{123} Restrictive eligibility requirements may adversely impact on compliance costs; the complexity of a transparent regime could be mitigated as well as allowing for the greater potential to raise equity finance by adopting the above criteria for transparency eligibility. It is asserted that these conditions should be the core requirements for eligibility for transparency; other concerns could be adequately dealt with by general tax provisions, such as withholding tax applying to allocations to non-resident members. See: Freudenberg, above n 3.
\textsuperscript{124} An incentive for members to contribute equity to a transparent company is that generally this would allow them greater utilisation of allocated losses. See: Freudenberg, above n 24. Also for some transparent companies a greater membership cost basis means that distributions to them from the transparent company are tax free.
\textsuperscript{125} Johns et al., n 42, 110. Also, tax transparency can improve the tax neutrality between debt and equity funding: Bevin, above n 29, 96, and Bird, above n 28, 235.
\textsuperscript{126} Of course there could be other salient reasons, such as flexibility of governance rules and liability protection.
\textsuperscript{127} Freudenberg, above n 36.
\textsuperscript{128} This may be enhanced by streaming and the splitting of income.
accorded to assessment of unpaid allocations, as well as to the status of active members.

A Assessment for unpaid allocations

A potential adverse implication of tax transparency is the assessment of members for allocated income, in spite of the fact that there has been no distribution from the transparent company to them. This applies to members of S Corporations, LLCs and LLPs.\textsuperscript{129} Furthermore, with such an unpaid allocation, a member’s tax rate could be higher than that applying to corporations and, hence, the allocation could result in a higher overall tax burden.

This is an important consideration given the trend worldwide to lower the tax on capital, including corporate rates.\textsuperscript{130} While there is also a trend of lowering personal rates, these are still normally higher than the corporate rates.\textsuperscript{131} This is important, as the corporate form can be used to ‘shelter income’ at a lower rate. In those jurisdictions studied, the United States’ Federal top personal marginal tax rate is equivalent to the top corporate tax rate of 35 percent.\textsuperscript{132} In the United Kingdom the top personal tax rate can be either 40 or 32.5 percent depending upon the type of income, with the corporate rate recently reduced from 30 percent to 28 percent.\textsuperscript{133} In New Zealand, the corporate rate is 30 percent from 1 April 2008 (reduced from 33 percent), whereas the top personal marginal tax rate is currently 39 percent.\textsuperscript{134}

Similarly a negative factor with a tax transparent company in Australia is the relationship between the corporation and the individual tax rates in Australia. The tax benefits of transparency in Australia are eroded by the full imputation system applying to corporations and by the lower corporate tax rate of 30 percent, compared to the top individual marginal tax rate of 45 percent plus 1.5 percent Medicare levy. This means the allocation of income to members of an Australian transparent company could be subject to a greater rate of tax compared to profits accumulated in a corporation. With current income tax brackets for individuals, once tax income exceeds $120,000 on average the sheltering of income within a corporate structure can be preferable.

\textsuperscript{129} Note the decision of \textit{Knott v Commissioner United States} Tax Court, 1991. 62 T.C.M. 287 confirmed that the income of an S Corporation need not be distributed in order to be included in the taxable income of the member.


\textsuperscript{132} IRC 1986 (US), s 199. While currently in the United States there is some alignment between the corporate tax rate and the maximum individual tax rate, prior to the 1986 tax reforms the corporate rate was lower than the individual rate; with the 1986 tax reforms this was reversed until 1993. From 1993 to 2003 the corporate tax rate was lower than the individual rate, and equalled it from 2003. Note from 2005 a corporation may be entitled to reduce tax rate, as all businesses can get a 3 percent of the qualified amount, up to 9 percent for a domestic activity deduction.

\textsuperscript{133} Starting in the 2008 year. Note there are proposals to increase the rate of income tax to 45 percent for those taxpayers with income greater than £150,000 (from 6 April 2011).

\textsuperscript{134} In New Zealand, when LAQCs were first introduced there as an alignment between the individual and corporate tax rate at 33 percent.
This may mean that the adoption of such a fully tax transparent company could increase the overall tax burden and thereby reduce the incentive for the utilisation of a transparent system. After all it was the lack of perceived benefits that undermined the utilisation of the Simplified Tax System in Australia.\(^{135}\)

In contrast, the profits of New Zealand’s LAQC are not automatically allocated to members; this is because it is a partial loss transparent company rather than a fully transparent company. This means an LAQC’s income is initially assessed at the entity level at 30 percent.\(^{136}\) Only when a member receives a franked dividend from an LAQC will the member include the dividend in their assessable income,\(^{137}\) together with the imputation credit.\(^{138}\) The LAQC member is then able to offset their tax liability with the imputation credit.\(^{139}\) This mechanism allows for the accumulation of taxable income in the business form at a lower rate of tax.

Another implication is that the direct allocation of profits to members means that the capital growth in the business may be taxed as ‘income’ to members on a regular basis, rather than on the disposal of the membership interest.\(^{140}\) To the extent that income is allocated to members, they would not be able to access the concessional treatment that can apply to capital gains in the various jurisdictions. From an economic perspective, this can be considered appropriate, as members’ annual assessment more accurately reflects their increase in wealth due to the business operations. This contrasts with the position of deferral of profits available when the business form is subjected to an entity or integrated tax treatment, with members not assessed on growth until the consequent sale of their membership interest, which then could be concessionally taxed as a capital gain.\(^{141}\)

However, despite the foregoing analysis, tax transparency does not result in a full assessment of economic wealth. Appreciating capital assets that are held by the transparent company are not assessed to members until the gain is realised through the disposal of the underlying asset. In this circumstance, members of a transparent company would receive the benefit of deferral, as well as the concessional CGT treatment.

\(^{136}\) An imputation system applies to the LAQC and other New Zealand corporations. For New Zealand tax purposes the definition of ‘company’ also includes a ‘unit trust’, so unit trusts are subject to an imputation system also: \textit{ITA 2007 (NZ)}, s YA 1. Sole proprietors, general partnerships and trusts (apart from unit trusts) are taxed on a flow-through basis. This means that the payment of corporate tax is recorded in the LAQC’s imputation credit account: \textit{ITA 2007 (NZ)}, s OB 4.
\(^{137}\) The imputation credits are then attached to the dividends paid out: \textit{ITA 2007 (NZ)}, s OB 30. The LAQC must impute any dividend payment to the fullest extent possible, known as a franked dividend: \textit{ITA 2007 (NZ)}, s HA 15. This is similar to what previously operated in Australia before the implementation of the new franking rules from 2002.
\(^{138}\) \textit{ITA 2007 (NZ)}, ss HA 14 and HA 15.
\(^{139}\) \textit{ITA 2007 (NZ)}, ss HA 14 and HA 15. Note in New Zealand the correct term is ‘fully imputed dividend’, but to ensure consistency within this dissertation the term ‘fully franked’ has been used. For an individual on the top marginal rate (39 percent) an effective additional nine percent tax rate would apply to the receipt of a fully franked dividend.
\(^{140}\) Each year the profits of the transparent company are directly assessed to members as either income or capital.
\(^{141}\) Of course income derived by the business form would be subject to tax, which could be below or above the member’s tax rate.
Also, the assessment of members on allocated income could put pressure on a transparent company to distribute money to enable members to fund their respective tax obligations, which then (in turn) could generate cash flow problems and organisational instability. However, if members are active in the management of the transparent company, then they can in this capacity determine the timing and quantum of distributions. For example, a distribution to a member could be purely to fund the member’s tax liability amount and not (to fund) the full allocation. A related issue is how ‘unpaid allocations’ could affect the ability of members to use allocated losses.

B Access to losses and tax preferences

With all the transparent companies studied, a discernible advantage over corporations subject to an entity or integrated tax system is that losses are allocated directly to members. For corporations in the jurisdictions studied, losses are ‘trapped’ at the entity level, to be carried forward to offset future income earned by the corporation. With transparency the allocation of losses directly to members can enable members to offset these losses against other assessable income. This has the overall effect of reducing members’ aggregate tax burden. Of course this is subject to the proviso that the relevant loss restriction rules are satisfied.

The value of losses can deteriorate with the time value of money and hence the timelier utilisation of losses will be beneficial for members. Additionally, losses at the member level may shelter income which would otherwise be taxed at a higher rate rather than that applying at the corporate level. The ICAA proposal advocates the allocation of losses directly to members, but subjected to a loss restriction rule based on the venture capital incorporated limited partnership rules.

A related issue to losses is the ability of members to access tax preferences when transparency applies. Tax preferences describe amounts or receipts that are not included in a taxpayer’s (including a business form) taxable income. When an entity or integrated approach applies, normally the distributions to members of profits that have been sheltered from tax, in effect, are ‘clawed back’, thereby resulting in members being fully assessed on the previously untaxed profit. In contrast, tax transparency can allow for tax preferences to flow through to members, thereby resulting in an overall lower tax burden. In the United States

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142 Joint Committee on Taxation, Present Law and Background Relating to Selected Business Tax Issues. (2006), 10.
143 Freudenberg, above n 24.
144 For example in the United States if C Corporations have net operating losses not absorbed by their taxable income in the two preceding years, the losses may be carried forward for up to twenty years to be applied against assessable income: IRC 1986 (US), s 172. In the United Kingdom any losses realised by a corporation are trapped at the entity level and cannot be allocated to members.
145 Freudenberg, above n 24.
146 Institute of Chartered Accountants in Australia and Deloitte, above n 2, [3.15.6].
147 These tax preferences may arise due to various taxation rules. For example, tax preferences in Australia could arise due to research and development concessions, exempt income, asset revaluations, capital gains concession (such as the CGT asset being acquired prior to 20 September 1985 in Australia), capital works, accelerated depreciation for plant and equipment, small business concessions, environmental expenditure deductions, water care deductions, or amounts sheltered because of carried forward losses.
context, an advantage that LLCs have over S Corporations is the ability to direct these tax preferences, through special allocations, to certain members.\textsuperscript{148} However, such streaming is not unrestrained, with special allocations likely to be restricted to a member’s capital account.\textsuperscript{149}

Even in the case of the partial loss transparent company studied — the LAQC — the treatment of unfranked dividends paid out to members enable members to access tax preferences.\textsuperscript{150} In effect, unfranked dividends represent profits of the corporation that have not been subject to tax at the entity level. For an LAQC member, the receipt of an unfranked dividend is regarded as exempt income and not assessable.\textsuperscript{151} The major tax preference in New Zealand is the absence of a comprehensive CGT. In comparison, when a New Zealand corporation distributes profit realised through the sale of a capital asset, this would normally be as an unfranked dividend which is fully assessable to the member.\textsuperscript{152} The ICAA proposal would allow tax preferences to flow-through to members, as opposed to the claw-back that generally occurs for corporations and their members in Australia.\textsuperscript{153}

\section*{C Capital gains}

A potential benefit of transparency is that it can more clearly avoid the perceived double layer of taxation that can occur in respect of appreciated assets when an entity approach is adopted. Vann has demonstrated that this ‘double taxation’ of capital gains is incorrect provided that the value of the membership interest is based on retained profits.\textsuperscript{154} However, it should be appreciated that such a valuation will not always be the case. If an appreciated asset\textsuperscript{155} is sold by a corporation, subject to an entity tax system, then the corporation is likely to be subject to tax on that sale. If the profit from this sale is then distributed, members

\textsuperscript{148} This means that amounts could be allocated to LLC members who can better utilise the tax preferences.

\textsuperscript{149} Treasury Regulation, s 1704-1(b)(2)(ii)(b).(d). For such special allocations to be effective the LLC’s Operating Agreement must provide for it and the allocations must have ‘substantial economic effect’: IRC 1986 (US), s 704. Also there is a restriction on special allocations of deductions attributable to LLC’s non-recourse outside loans: Treasury Regulation, s 1.752-1(a)(2): Indebtedness secured by partnership property for which no partner bears personal risk. Treasury Regulation, s 1.704—2(b)(1).

\textsuperscript{150} Note that any dividends received from a subsidiary corporation by an LAQC are assessable to the LAQC, as there is no exemption in relation to wholly owned subsidiaries. However, the LAQC would be entitled to claim any imputation credits attached to the dividends paid from a subsidiary, which may effectively eliminate any tax payable: Inland Revenue (NZ), above n 67, 41. This rule is considered necessary to prevent an LAQC receiving a dividend from a non-QC subsidiary on a tax-free basis, and then passing this out to individual shareholders with no further tax imposed.

\textsuperscript{151} ITA 2007 (NZ), ss HA 16 and CW 15.

\textsuperscript{152} This would be assessed at their appropriate income tax rate without any imputation credit to offset the resulting tax liability.

\textsuperscript{153} A noted exception to this is some of the provisions in ITAA 1997 (Cth), Div 152. For unit trusts electing to be within the scheme, CGT event E4 would not apply to distributions of non-assessable amounts: ITAA 1997 (Cth), s 104-70.

\textsuperscript{154} Richard J Vann, ‘Australia's Policy on Entity Taxation’ (2001) 16 Australian Tax Forum 33, 38: “The example shows that in the simple case presented there is no double tax on retainments to the owner under the CGT to the extent that value is based on retainments (putting aside the problem of matching the dividends and the capital loss for the purchaser). Thus the double taxation of retainments is a myth”.

\textsuperscript{155} Appreciated asset is property that has increased in value.
are also likely to be assessed on the receipt of a dividend, although there could be some dividend relief. This dividend receipt would be income in nature even despite the fact that the underlying profit relates to the disposal of a capital asset. The dividend receipt as income restricts the ability of the member to access the concessional treatment that may be afforded to capital receipts. If instead a dividend is not declared and the member sells their membership interest, this sale is likely to be at an increased value, due to the appreciated property or profit held by the corporation. In this circumstance the member is also assessed on the capital growth, although the member is able to access CGT concessions.\textsuperscript{156} In comparison, tax transparency can allocate the capital gain directly to the members, thereby resulting in clearly one layer of tax, as well as allowing members to access concessional CGT treatment.

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{157} with members of the proposed flow-through entity having direct fractional interest in the CGT assets held.\textsuperscript{158} Such treatment could inhibit the attraction of new equity as changes in membership can potentially trigger partial disposals.\textsuperscript{159} This is similar to the United Kingdom’s LLP,\textsuperscript{160} although such treatment of capital gains has been described as a major advantage of the LLP, compared to the position when membership interests in a corporation are sold.

D \textit{Comparison to corporate tax treatment}

While the comparison between corporate entity tax treatment and transparency is a multi-faceted issue, there is indeed the potential for tax transparency to decrease the overall tax burden. This will depend upon a number of factors, including whether the corporation is subject to an entity or integrated tax system, the relationship between tax rates, and the treatment of capital receipts and employment taxes.

As previously discussed, Australian corporations and their members are subjected to an imputation system. This means that income can be sheltered at the corporate level and once distributed can either be in the form of franked or unfranked dividends. While both dividend types are assessable to the member, franked dividends have attached franking credits which allow the member to decrease their tax payable.

Due to the United States’ entity tax system, S Corporations and LLCs offer some tax savings to closely held businesses compared to the tax treatment

\textsuperscript{156} Note however the incoming new member will have a greater cost basis due to the greater amount paid recognising the appreciated value of the asset held, thus diminishing the extent of this double economic taxation.

\textsuperscript{157} Institute of Chartered Accountants in Australia and Deloitte, above n 2, [3.18.1].

\textsuperscript{158} Institute of Chartered Accountants in Australia and Deloitte, above n 2, [3.18.2].

\textsuperscript{159} 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)]}.

\textsuperscript{160} One implication of LLP’s tax transparent treatment is that members hold fractional interests in the LLP’s assets, even though the LLP is a separate legal entity to the members: \textit{LLP Act 2000 (UK), s 1; Taxation of Chargeable Gains Act 1992 (UK), s 59A}. 
for C Corporations.\textsuperscript{161} While the extent of this saving has decreased since 1986, with the individual tax rate now equivalent to the top corporate tax rate of 35 percent, and capital gains and dividends being concessionally tax, there are still potential tax savings.\textsuperscript{162}

There are a number of characteristics of the United Kingdom tax system that reduce the advantages of LLPs compared to the taxation of corporations. In the United Kingdom, corporations are assessed to a corporation’s tax on profits under a separate act.\textsuperscript{163} A corporation’s assessed profits include both income and chargeable capital gains, with indexation available for capital gains.\textsuperscript{164}

In the United Kingdom the overall tax burden in effect is lower in a corporate scenario when there is accumulation and then disposal of membership interest. This contrasts with the situation where there are yearly distributions which produce a higher tax burden, even with the notional dividend credit system that applies.\textsuperscript{165} This accumulation advantage of the corporation is enhanced by the fact that, prior to disposal of membership interest, tax liability was lower, thereby providing a timing advantage. This can mean disregarding the imposition of

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\textsuperscript{161} C Corporation members are not assessed on corporate profits until profits are distributed via dividends to them. When dividends are paid an entity tax system applies, with the member assessable on the dividend with no credit for tax paid at the corporate level. In terms of an individual member, normally marginal tax rates would apply up to 35 percent on the receipt of such dividends. However, there is temporary tax relief for the receipt of dividends by a member: a 15 percent rate applies until 2010: \textit{IRC 1986 (US), s 1(h)(11)} introduced by the \textit{Jobs and Growth Tax Relief Reconciliation Act (US) 2003} (passed May 2003). This reduces the top capital gains tax and dividend tax rate to 15 percent (or 5 percent for low income families and 0 percent for the 2008 year only) for the period 1 January 2003 to 31 December 2008. This has now been extended to 2010 through the \textit{Tax Increase Prevention and Reconciliation Act 2005 (US)}.

\textsuperscript{162} However, it should be appreciated that the extent of ‘double taxation’ for C Corporations and their members can be mitigated through a number of mechanisms. For example the payment of the following deductible amounts by C Corporations to members could also achieve a single layer of taxation: wages, royalties, rent and interest on loans. Also the C Corporation could make contributions to a pension fund established for the member. Alternatively, C Corporations could retain profits and members could realise their increase in wealth as a capital gain through the sale of their membership interest, which facilitates deferral and potential concessional tax treatment. If this transfer of membership interest occurs through inheritance at death then tax can be avoided altogether, as the heir is entitled to a step up in the membership cost basis to the fair market value.

\textsuperscript{163} \textit{Income and Corporation Taxes Act 1988 (UK), s 6(1):} A corporation which is resident in the United Kingdom is chargeable to corporate tax in respect of all its profits wherever arising. United Kingdom resident corporations are, however, not liable in respect of dividends received from other United Kingdom resident corporations.\textsuperscript{166}

\textsuperscript{164} \textit{Income and Corporation Taxes Act 1988 (UK), s 6(4).} For the 2008 year the first £300,000 profit of a corporation is assessed at 21 percent; for profits in excess of £1.5 million, the rate is 28 percent. \textit{Finance Act 2002 (UK), s 30.} Prior to 2008 the corporate tax rate was 30 percent. Before 6 April 1999, corporations making distributions had to pay advanced corporation tax as part of the United Kingdom’s imputation system. The rate between these two figures is 30 percent less an amount to ease the transition to the highest rate, using a fraction. From 2002 to 2006 there was a special rate that applied to small corporations, but this has been abolished: Freedman, above n 44, 325.

\textsuperscript{165} The United Kingdom now has a notional dividend tax credit system, this being a form of integration for corporate distributions. This requires a corporation to pay an additional tax (known as the non-corporate distribution rate) when a corporation has an underlying rate of tax less than 19 percent and it makes a distribution to a person not a corporation. \textit{Income and Corporation Taxes Act 1988 (UK), s 13AB inserted by Finance Act 2004 (UK), s 28, Schedule 3, paragraph 2.} Applies from 31 March 2004. If a corporation member disposes of their membership interest, this could result in a chargeable gain to the member. However, CGT taper relief could reduce the burden of this.
employment taxes, the tax payable through an LLP can be greater compared to corporation.

In New Zealand, the relationship between LAQCs and other corporations is more closely aligned, due to the LAQC being a partial loss transparent company and a full imputation system applying to corporations. Indeed there is largely tax equivalence between LAQCs and corporations in New Zealand, unless there are tax losses or tax preferences. There is no overall tax burden difference between the LAQC and a corporation when there are no tax preferences with all earnings assessable and where these after-tax profits are distributed to members.

E Active members

Prior research has illustrated that members of closely held businesses are likely to be active in the business. In the jurisdictions studied, there are issues pertaining to the tax treatment of active members and, in particular, whether they should be treated as self-employed or as an employee. Such status can influence the overall level of tax payable. Sometimes it can be tax favourable and other times not.

In the Australian context, the ICAA proposal suggests that active members would be treated as self-employed rather than as employees, thus removing the application of fringe benefits tax to benefits provide to active members. The ICAA proposal suggests that the treatment of active members as self-employed will reduce compliance costs due to the non-application of fringe benefits tax (FBT) to benefits provided to them. However this fails to appreciate that some fringe benefits are concessionally taxed and have been used by active members through their business structures to reduce their tax impost. Indeed the Australian government has introduced provisions to restrict this ability due to concerns of abuse.

How have the foreign jurisdictions studied addressed active members? For an active member, the S Corporation can be advantageous when compared with that of a member of an LLC in the United States. In the United Kingdom, the LLP can be particularly advantageous for active members when compared to corporations. Equally, New Zealand’s LAQC can be advantageous compared with general partnerships. Given the variations, this raises the issue of should be the appropriate treatment for an active member of a transparent company.

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166 Harris, above n 29, 47.
167 Institute of Chartered Accountants in Australia and Deloitte, above n 2, [3.21.1]. However, the ICAA proposal highlights that this status may not be recognised by various state governments in the application of payroll tax and workers compensation. Accordingly, when there are different levels of governments, it is preferable that a consistent approach is utilised.
168 For example, the personal services income provisions disregard the business form for tax purposes and allocate the income and or losses directly to the member performing the personal services. The operation of these provisions restrict taxpayer’s ability to shelter personal services income in an entity taxed at a lower rate, to split income among a number of taxpayers, and the ability to access concessional fringe benefits and superannuation provided to employee-members. ITAA 1997 (Cth), s 86-15.
169 The potential savings offered by the two transparent companies in the United States is not equivalent. There are numerous differences in their precise treatment, including tax implications for contributions or distributions of assets between members and the transparent company, the ability to stream allocations and the application of employment taxes.
For the United States’ transparent companies, when members are active in the business, income allocations, member wages and fringe benefits can be treated differently. In terms of the tax treatment of an S Corporation, it is possible for the member to be regarded as an employee, even if the member owns 100 percent of the membership interests in the S Corporation. This situation denotes ‘entity acknowledgement’ for the S Corporation and its active members, because the S Corporation is acknowledged as a separate legal entity to the member, thereby enabling it to be the employer of the member. In view of this, wages that are paid to an active member for work should meet standards of reasonable compensation and this would then be an allowable deduction for the S Corporation. For the member, such wages would be assessable income. However, in addition to income taxes, in the United States wages paid would be subject to employment and social security taxes (employment taxes), which amount up to an additional 15.3 percent.\footnote{Such as employment taxes, federal social-security taxes (FICA), Medicare taxes, interest and penalties. \textit{IRC} 1986 (US), ss 1401 and 3101 impose self-employment tax on an individual’s net earnings from self-employment. In 2005, the self-employment tax and combined social security tax rate was 12.4 percent on earnings up to $90,000, and 2.9 percent on all earnings above that for hospital insurance. Specified types of income can be excluded, such as rentals from real estate, dividends, interest, capital gains and losses from timber, certain non-inventory mineral income and retirement payments: see \textit{Joint Committee on Taxation, Additional Options to Improve Tax Compliance} (2006), 29.}

In comparison to ‘wages’ paid to an active member, business ‘income’ that is allocated to S Corporation members while assessable to them, it is, however, not subject to employment taxes.\footnote{Revenue Ruling 59-221, 1959-1 C.B. 225.} The imposition of employment taxes on wages paid to members may encourage the payment of lower wages to active members, with the balance being taken out through higher allocations of income to members.\footnote{If there were lower wage expenses, then this would increase the transparent company’s income, which the S Corporation would allocate to members for the taxable year. Also the elimination of the cap on hospital insurance could also encourage lower wages. \textit{Joint Committee on Taxation, Taxation above n 168, 32. The cap on hospital insurance component was eliminated by the \textit{Revenue Reconciliation Act} of 1993 (US); this means that paying hospital insurance tax on higher wages does not increase the individual’s Medicare benefits. Note that self-employed persons can now deduct health insurance where previously they could not. This arrangement would not be effective if the S Corporation member’s wages were not reasonable. However, what precisely is ‘reasonable’ is a malleable and difficult concept to quantify at times, and enforcement by the United States’ IRS can be difficult due to factual determinations made on a case-by-case basis.}

Unlike S Corporations, an LLC member usually does not qualify as an employee of the LLC for tax purposes. Instead more of an aggregate approach is utilised, with an LLC member treated as self-employed.\footnote{James Boyd, D Larry Crumbley, Jon Davis, Steven Dilley, William Hoffman Jnr, David Maloney, Gary McGill, Mark Persellin, William Raabe, Boyd Randall, Debra Sanders, W Eugene Seago, James Smith and Eugene Willis, \textit{Corporations, Partnerships, Estates and Trusts}. Edited by W. Hoffman Jnr, W. Raabe, J. Smith and D. Maloney (2005), 10-40.} That is, the LLC is not recognised as a separate taxpayer from its active member and, consequently, a member cannot then be employed by him or herself. This has the resultant consequence that the entire allocation of income to an LLC member (including guarantee amounts)\footnote{A guarantee payment is a payment for services performed by the members or for the use of the member’s capital, usually expressed as a fixed dollar amount. Guarantee amounts would be} is likely to be regarded as self-employment income, and is
consequently subject to employment taxes.\textsuperscript{175} Thus, in effect, this means that the entire LLC allocation could be subject to employment taxes in addition to income taxes. Contrast this situation with that pertaining to an S Corporation where, for the active member, only the reasonable wages paid to him or her are subject to employment taxes.\textsuperscript{176}

The United States Government is aware of the discrepancies in relation to the application of employment taxes between S Corporations and LLCs.\textsuperscript{177} Research concludes that S Corporations might be a ‘multi-billion employment tax shelter’\textsuperscript{178} that is worth an estimated $39 billion in lost tax revenue for the 2001 year.\textsuperscript{179} Hence, there are current proposals on the political agenda designed to treat members as self-employed if the S Corporation conducts a ‘service business’. For such service businesses, all allocations from an S Corporation would be subject to employment taxes like LLC members, although these are yet to be implemented.\textsuperscript{180}

A related issue here is the provision of ‘benefits’ to active members. Unlike with income allocations, there is greater consistency of fringe benefits provided by S Corporations and LLCs to members, and therefore greater tax neutrality. In terms of fringe benefits an aggregate approach is used, because an active member of an S Corporation with more than two percent of the membership interest (greater than two percent members) is essentially treated as self-employed and not as an employee.\textsuperscript{181} Like LLC members, greater than two percent members of S Corporations are not eligible to receive tax favoured fringe benefits from their transparent company employer.\textsuperscript{182} Instead, the provisions of

\textsuperscript{175} IRC 1986 (US), s 1402(a): provides that self-employment income includes the distributive share (whether or not distributed) of income or loss from any trade or business carried on by a partnership of which the individual is a member.

\textsuperscript{176} Some commentators argue that allocations to LLC members as a ‘limited partner’ should not be subject to employment taxes. This has resulted in planning strategies, including the imposition of an additional LLC between the active member and the LLC conducting the business. The efficacy of these strategies is by no means certain as they have not been subjected to judicial scrutiny. IRC 1986 (US), s 1402(a)(13). Howard Friedman, ‘The Silent LLC Revolution - The Social Cost of Academic Neglect’ (2004) 38(1) Creighton Law Review, 27.

\textsuperscript{177} It was reported that a prior Vice Presidential candidate John Edwards (running partner with Al Gore) appreciated the difference between allocations and wages, prompting him to use an S Corporation rather than an entity subject to Sub-Chapter K for the conduct of his law business to minimise self employment taxes. [cited 8 March 2007]. Available from: http://www.traderstatus.com/IRSaudits.htm.


\textsuperscript{179} Internal Revenue Services (US), IRS Updates Tax Gap Estimates, IR 2006-28, (February 14 2006).

\textsuperscript{180} Joint Committee on Taxation, above n 168, 31. For this purpose, a service partnership is a partnership (including an LLC or other entity that is treated as a partnership for Federal income tax purposes), substantially all of whose activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.

\textsuperscript{181} IRC 1986 (US), s 1372. Section 1372 invokes section 318 allocation rules for application of the more than 2 percent rule.

\textsuperscript{182} McNulty, above n 84, 62. Such favourable fringe benefits would include excludable health and accident plans or policies: IRC 1986 (US), ss 105, 106, group-term life insurance and employer-provided meals and lodging: IRC 1986 (US), s 132. However, there are still some fringe benefits
such benefits would be treated as distributions by the transparent company and taxed as such. 183

It is unclear, in this respect, precisely why there is this discrepancy between employment taxes, on the one hand, and fringe benefits for United States’ transparent companies on the other hand. 184 The discrepancy or miss-match appears to be a consequence of legislative oversight, rather than deliberate policy formation. The application of employment and fringe benefits taxes illustrates the tension between a full aggregate approach and an alternative approach comprising transparency with some ‘entity acknowledgement’. 185

In contrast to the United States position with employment taxes, a self-employment status can be advantageous in the United Kingdom for LLPs compared to corporations in terms of the application of the National Insurance Contribution (NIC). 186 When the LLP form is utilised, an LLP member would be regarded as self-employed rather than as an employee, and thus subject to a lower NIC rate. The maximum NIC rate applicable to those who are self-employed is approximately nine percent. 187 An LLP member would be subject to an overall

tax that can be provided by the S Corporation to an active member, and there have been some alterations to allow self employees to deduct certain expenses, such as private health insurance. 183 IRC 1986 (US), s 1402(a). Actual distributions would not be assessed to the extent of the membership cost basis. Any excess would normally be assessed as a capital gain. 184 Note increasingly the difference between self-employed and employees has been decreasing, as now self-employed can deduct 100 percent of their health insurance, and some fringe benefits are available to them. 185 It is argued that the inconsistent application of employment taxes between S Corporations and LLCs is not desirable. A simple way that this could be rectified is by treating all greater than two percent members of S Corporations as self-employed. Allocations to these members would then be subject to employment taxes like LLCs and this would in turn enhance tax neutrality. Also, as this approach employs a distinction already used for fringe benefits, then this should consequently reduce compliance costs. Alternatively, if a member is regarded as ‘active’ (pursuant to the passive loss rules) then he or she should be regarded as self-employed irrespective of which transparent company is utilised. This test would then eliminate passive investors from being regarded as self-employed, which, by the nature of their investment they are not. The proposed reforms before the Senate Committee do not recommend either of these alternatives. Instead they recommend an approach that will raise additional tax revenue by addressing ‘professional’ firms only. It is argued that this proposal is better understood in terms of being politically acceptable, rather than trying to improve tax neutrality. Joint Committee on Taxation, above n 170, 31 and 34. 186 The NIC is a tax to pay most of the cost of retirement pensions, unemployment benefits and sickness benefits. It should be acknowledged that in the circumstance that the member was not engaged as an employee by the corporation, it is likely that a non-member would have to be employed with a resulting NIC obligation anyway. Also, a self-employed person will qualify to be relieved by pension contributions (subject to annual limits), whereas dividend income cannot be relieved in this way. Normally, an LLP member is not to be regarded for any purpose as employed by the LLP unless the member would be regarded as employed by a general partnership in like circumstances. LLP Act 2000 (UK), s 4(4). If treated as employee, then the LLP member would be within the scope of the Income Tax (Earnings and Pensions) Act 2003 (UK) and with the NIC consequences of employer/employee relationship. PDC Copyright (South) v George (Sp C 141), [1997] SScD 326. 187 Inland Revenue (UK), Limited Liability Partnerships, Inland Revenue Tax Bulletin – Issue 50 (2000) [cited 20 September 2006]. Available from: http://www.hmrc.gov.uk/bulletins/tb50.htm#2: confirms members of LLP will be liable for Class 2, 3 and 4 NIC as appropriate. For self-employed persons they are initially subject to Class 2 NIC which is a flat £2.10 per week – although they can be exempted if their yearly profit is below £4,465 per year (2007 year). In addition to Class 2 NIC, self-employed persons can be subject to Class 4 NIC, which is 8 percent on profits from £5,035 to £33,450, and then 9 percent of profits in excess of £33,450. NIC would
NIC rate of nine percent on allocated income, compared with up to 23.8 percent for an employee-member of a corporation. Due to this disparity the LLP can be an attractive alternative to a corporation when the members are actively engaged in the business. The impact of NIC was identified as part of the reason professional firms lobbied for the introduction of LLPs with general partnership tax treatment. This was despite the fact that the firms could have utilised a corporate form to obtain liability protection.

While New Zealand does not have an employment tax or payroll tax, the status of employment is important for fringe benefits tax purposes. Due to entity acknowledgement, an active member of a LAQC is treated as an employee and thus is able to access the concessional treatment of fringe benefits. If fringe benefits are provided to LAQC employee-members, the expenditure incurred in providing these benefits should be fully deductible for the LAQC. It should be noted that the LAQC could be liable for FBT and this benefit would be non-assessable to the employee-member. Although, this treatment is consistent with other corporations in New Zealand, it is at odds with the benefits provided to members of a general partnership. This is because general partnerships are not separate legal entities to their members, and therefore a member cannot be an employee of a partnership in which the member has an equity investment. The consequence of this is that a benefit provided to a member of a general partnership is non-deductible — in terms of the general partnership and assessable to the member. This difference between LAQCs and general partnerships appears to result from an entity acknowledgement for LAQCs, rather than from the adoption of a full aggregate approach. Unlike the S Corporation, the LAQC does not use a two percent membership test to provide greater tax neutrality between transparent companies and general partnerships.

apply to a non employee-member of an LLP as there is no requirement that the member carries on the business: *McDougall v Smith* 7 TC 134.


189 For a discussion about the drivers influencing the introduction of LLPs in the United Kingdom refer to: Freudenberg, above n 38.

190 This is subject to the stipulation that they meet the normal deductibility criteria.

191 Normally when a fringe benefit is provided by a corporation, then the corporation pays 64 percent tax on specific benefits provided to employees. These benefits include the use of cars, low interest loans, contributions to insurance and superannuation. *Inland Revenue (NZ)*, above n 69, 41.

192 Inland Revenue (NZ), above n 69, 41.

193 As well as benefits that sole proprietors might provide to the member.

194 *Case S75 85 ATC 544*: holding that a partner salary was not deductible.

195 Also, because members of a general partnership cannot be employees of the general partnership, so there can be no deduction normally for the salaries paid to them, seen as drawings: *Case F123* (1984) 6 NZTC 60, 157; and *Case L28* (1989) 11 NZTC 1,172. The exceptions to this are (a) when member’s salary is made under a written contract of service; and (b) when tax deduction allowed for pension is of a reasonable amount. Renting of property from general partnership member is deductible provided reasonable. Interest on capital contributions is not deductible, but on proper member-to-general partnership loans is deductible.
Therefore, in all the jurisdictions studied there are inconsistencies in the tax treatment of active members as either self-employed persons or employees. This appeared to be influenced by the extent of ‘entity acknowledgement’ with the transparent system. Status as either self-employed or employee could be beneficial or detrimental depending upon the jurisdiction and the applicable tax treatment. It is beyond the scope of this article to consider whether it is appropriate to tax self-employed persons differently to employees. However, it is contended that, in terms of transparent companies, there needs to be a consistent approach in terms of the categorisation of members (particularly when active in the business).

In the context of this discussion, it would be more theoretically consistent if active members of a transparent company are treated as self-employed. This is because tax transparency essentially is predicated on disregarding the legal form for taxation purposes and treating the economical activities of the underlying business as being those of the constituent members. Such an approach reflects an ‘aggregate approach’ rather than ‘entity acknowledgment’. It is argued that active members should be regarded as self-employed. Indeed there is merit for all members (regardless of the extent of their involvement) to be considered self-employed. However, this then means that for a tax transparent company in Australia, active members would not be able to access concessationally taxed fringe benefits.

For the reasons outlined in this article, it is argued that the introduction of a fully tax transparent company in Australia is unlikely to assist closely held businesses to address their financing issues. This is due to restrictions of membership numbers, assessment for unpaid allocations, the differential between the corporate and individual tax rate and the treatment of fringe benefits to active members. However, there are benefits in terms of capital gains, allocation of losses and access to tax preferences. It is due to these reasons, that if a transparency regime is going to assist Australian closely held businesses in terms of finance – that a partial loss transparent company is advocated.

VI PARTIAL LOSS TRANSPARENT COMPANY

The interaction between corporate and individual tax rates in Australia is of particular importance given the financing problem that can confront closely held businesses and their reliance on funding from members. For this reason, it may be preferable to have a partial loss transparent company, similar to New Zealand’s LAQC. In this way, when the Australian tax transparent company has income, profits would be initially assessed at the entity level at 30 percent, with franking credits being generated on the income tax paid. It is argued that such a partial loss transparent company may be a necessary compromise to striving for the economic ideal when taking into account complexity and financing.

196 Head, above n 25, 22.
197 In the New Zealand context it remains to be seen whether LAQCs remain as a popular taxing method due to the recent introduction of tax transparency applying to LLPs there. However, this the choice between the LAQC and LLPs in New Zealand may be influenced by the underlying governance rules which differ between the two forms.
Such a system would allow income to be accumulated at the entity level and to be available for further reinvestment into the business. However, accumulated profits would have to be allocated to members so to increase their membership cost basis, which would influence their ability to utilise any losses allocated by the partial loss transparent company.\textsuperscript{198} Such a mechanism would be consistent with the policy recommended by Pizzacalla to improve the capital of small and medium enterprises.\textsuperscript{199}

It is argued that such a partial loss transparent company would provide greater incentive for Australian investors to adopt transparency. Later distributions to members would either be franked or unfranked. ‘Distributions’ would include profit distributions, loans to taxpayers and the transfer of assets from the transparent company to the member.\textsuperscript{200} If a franked distribution was received, it would be assessable to members, with members offsetting their tax liability with franking credits.\textsuperscript{201} If a distribution were unfranked, it would be exempt income for the receiving members, thus allowing tax preferences to flow through to members. Such treatment would be advantageous, compared to that of members of a corporation, as most tax preferences are ‘clawed back’ on distribution.\textsuperscript{202} Also such distributions would decrease a membership cost basis.\textsuperscript{203}

When the Australian partial loss transparent company had losses these would be automatically allocated to members in accordance with their membership interest, and subject to a loss restriction rule based on the CFC hybrid rules (with amendments).\textsuperscript{204}

\textsuperscript{198} It is argued that retained profits should allow the greater utilisation of losses as these profits are at risk should the transparent company become insolvent.


\textsuperscript{200} The inclusion of member loans would negate the need for Division 7A to apply to transparent companies.

\textsuperscript{201} Such distributions would decrease the membership cost basis.

\textsuperscript{202} A possible exception to this is when the distribution is made as part of a liquidator’s distribution: then there may be a flow-through of pre-CGT profits: ITAA 1936 (Cth), s 47A.

\textsuperscript{203} However, there may be need to introduce a rule to prevent dividends being paid out of asset revaluation reserves when the underlying asset would, if disposed of, be subject to CGT. Otherwise the ability to pay dividends from asset revaluation reserves could be an artificial way to create tax preferences, and thereby exempt ‘unfranked’ dividends. For a discussion about asset revaluation reserve distributions see: Brett Freudenberg, ‘The end of asset revaluation reserve distributions? An analysis of the Government’s latest attack on discretionary trusts performing asset revaluation reserve distributions’ 33(2) Australian Tax Review 150.

\textsuperscript{204} Freudenberg, above n 24. To reduce the tax arbitrage between the partial loss transparent company and members, allocated tax losses could be converted to a ‘loss tax credit’ calculated at the corporate tax rate. Such an allocated loss tax credit could be used by members to offset their tax payable, or be refunded if exceeding the member’s tax liability. For example, a $1000 worth of losses would be converted to a loss tax credit of $300 and allocated to members to use as an offset. This mechanism would be mean that allocated losses would shelter income at the member level at the same rate as that applying to corporations, rather than the individual marginal tax rates of up to 45 percent. It is such an idea advocated by the Australian mining industry for a flow through share. Association of Mining and Exploration Companies, Australasian Institute of Mining and Metallurgy, Australian Securities Exchange, Australian Shareholders Association, The Chamber of Mines and Energy of Western Australia, Minerals Council of Australia, Queensland Resources Council and South Australian Chamber of Minerals and Energy, “Joint Industry Submission: To the Minister for Resources and Energy, The Hon. Martin Ferguson AM MP, - A proposal to introduce ‘flow through shares’ (FTS) in Australia.” (5 November 2008), 12 – 15. Indeed, instead of introducing two discrete transparent regimes, one for closely held businesses and the other for
It is argued that a partial loss transparent company achieves a result similar to the Danish dual tax company system, which allows re-invested unincorporated business income to be taxed at the corporate rate, with only distributions taxed at the individual marginal tax rates. The tax advantage of allowing for a partial loss transparent company could be important in influencing the overall utilisation rates of such a transparent form.

However, unlike the LAQC it is argued, active members should be regarded as self-employed. This would mean that the receipt of benefits would be regarded as a distribution by the transparent company to the member and taxed accordingly. Note this would mean that such members could not access concessional FBT treatment. It is argued that a partial loss transparent company may have other benefits in terms of complexity and revenue collection.

Another way that this proposal could assist closely held businesses with their financing is that while a conduit principle would not be directly evident, the treatment of unfranked dividends as exempt income would allow tax preferences to flow through to members. While such a partial loss transparent company would not be able to access the 50 percent discount on capital gains provided to individuals, the corporate tax rate of 30 percent is comparable to the 50 percent of the highest marginal tax rate applying to individuals (plus Medicare levy).

Of course disadvantages with this option need to be acknowledged. For example, there could be increased complexity due to measuring the membership

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205 Also known as the dual tax system.


207 A similar consequence would follow in respect of superannuation contributions made on behalf of an active member.

208 Another benefit of the partial loss transparent company is that it has greater entity acknowledgement and thus if arguments about the adverse nature of full aggregation in respect of compliance costs are correct, then this should decrease compliance cost. This would mean that the membership interest is treated as a separate tax asset rather than members having direct fractional interests in the underlying assets. Furthermore, a partial loss transparent company could assist in the collection of tax, as the tax paid initially by the business form acts as a form of withholding tax. Such transparency could also assist with problems about the interaction between the capital protection rules and unpaid allocations, as members are not assessed on retained profits. Also this option has the benefit that special tax rules would be drafted to provide for this partial loss transparent company rather than having an overlay of general partnership tax rules. Also, given the New Zealand experience it could be possible for existing corporations to transfer into the regime on the payment of corporate tax on any retained profit not covered by franking credits. Such a payment of tax would be necessary, as after entering into the regime the distribution of unfranked dividends would be exempt income for members.

209 That is, capital profits realised at the entity level would not retain their capital nature on distribution to members.

210 For example, the amount of capital gain sheltered from tax due to indexation method would be non-assessable as exempt income on distribution to member if an unfranked dividend.

211 Assuming an individual is on the highest marginal tax rate, then the effective tax rate on a discounted capital gain is 23.25 percent.
cost basis (including altering it for retained profits within the entity).\textsuperscript{212} Furthermore, in New Zealand the possible repeal of the LAQC regime has been raised a number of times.\textsuperscript{213} However, it is argued that this is due to inadequate loss restriction rules applying to LAQCs.\textsuperscript{214} Given the loss restriction rules argued for this should not be the circumstance in Australia.\textsuperscript{215}

VII CONCLUSION

Through the analysis within this article it is questionable to what extent a transparent company as formulated in the ICAA proposal will assist Australian closely held businesses in addressing their financing problems. This article has demonstrated that transparency does not necessarily assist closely held businesses in addressing their financing problems. If the eligibility requirements for transparency are too strict, this may reduce the ability of the business to raise equity from alternative sources. Additionally, while there may be tax savings achieved through transparency, this is not always the case when compared to corporations. This will depend upon many factors, such as the corporate tax rate, the individual tax rate and the treatment of capital receipts. However, access to tax losses, tax preferences and the one layer of taxation on capital gains can be advantageous. It was demonstrated that transparency could assist in reducing the tax preference of debt compared to equity funding. An important consideration to determine the taxation burden included the treatment of members as either employees or self-employed.

This led to a recommendation for eligibility for transparency depending upon three factors: membership interest in the business form not being publicly traded, a member/manager election and jurisdictional symmetric treatment; but with the possibility of one class of membership interest. Also, it was argued that active members of a transparent company should be regarded as self-employed rather than as employees.

While the suggestion that a fully transparent company will be beneficial for closely held businesses in Australia is attractive, given the existing Australian tax system and the experience overseas this may not be the case in terms of addressing the finance problem. 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, is the preferable option.

\textsuperscript{212} Such a proposal in the United States was considered too complex, and instead a basic 15 percent concessional rate was introduced.

\textsuperscript{213} For the most recent consideration see: Michael Cullen (Minister of Finance) and Peter Dunne (Minister of Revenue), General and limited partnerships — proposed tax changes: A government discussion document (2006).

\textsuperscript{214} Brett Freudenberg, “The Troubled Teen Years: Is the repeal of New Zealand’s LAQC regime required?” (2008) 14(1) NZJTLP 67.

\textsuperscript{215} Also, to improve the uptake of such a transparent entity, serious consideration should be given of applying capital gains and stamp duty relief for existing business forms to convert to this model, particularly discretionary trusts. There could be a transition period of five years to allow for this conversion.