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Author

Freudenberg, Brett

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ENTITY TAXATION: THE INCONSISTENCY BETWEEN STATED POLICY AND ACTUAL APPLICATION

BRETT FREUDENBERG

Brett Freudenberg is a Lecturer in the Griffith Business School, Griffith University.

I BACKGROUND TO THE PROPOSALS

In 1998 when the government announced its proposal for a new tax system in its White Paper, *Not a New Tax, A New Tax System* (ANTS),¹ it perceived there were a lot of inadequacies with the Australian tax system. The emphasis the government put on selling its reforms can be seen in the title of its paper, which tried to reassure Australians of the government's overall aims.

One of the proposals contained in the White Paper was for the introduction of a new consistent entity regime for the taxing of income and distributions, known as entity taxation.² The justifications put forward by the government for this recommendation was to provide simplicity, clarity and fairness, while also addressing techniques highlighted by the High Wealth Individual Taskforce (HWIT).³

This paper will examine the concerns that led to the government's proposals, and what these proposals entailed. The paper will then critique the government's initial justifications for its proposals by analysing the submissions lodged in response to the government's Exposure Draft Bill. The paper will then determine whether there was any consistency between the government's stated policy objectives and the actual application of the proposals. This analysis is important in explaining the government's lack of success in implementing these reforms, as the government needs to appreciate that there needs to be consistency between its stated objectives and the actual legislation. Otherwise any proposed reforms can be easily discredited and shown to be lacking by comparing the reforms against their stated objectives.

¹ Australia, The Howard Government's Plan for a New Tax System, *Tax Reform: Not a New Tax, a New Tax System* (1998) Canberra, AGPS.

² Ibid.

³ Ibid 114.

A The Popularity of Discretionary Trusts

Discretionary trusts⁴ have been increasingly adopted in Australia as an alternative business structure,⁵ with 39 per cent of trusts in the property industry, 29 per cent in finance, insurance, real estate and business service industry, and 6 per cent in the retail trade and primary production industry, respectively.⁶

Prior to the government's announcement of possible reforms in August 1998 there had been a 28 per cent increase in the number of trust taxpayers over a five-year period.⁷ In the same period there was a 20 per cent increase in company taxpayers, and partnerships decreased by nearly 5.5 per cent.⁸

Additionally, of the trusts registered as taxpayers, 72 per cent identified themselves as discretionary trusts.⁹

Since the government's initial reform announcements in August 1998, there has been a sharp decrease in the number of new trust taxpayers being registered, with only a 0.5 per cent increase in 1998–99,¹⁰ and actually a 0.01 per cent decrease in 1999–2000.¹¹ Company taxpayers grew by 2.2 per cent in 1998–99,¹² and then decreased by 3 per cent in the 1999–2000 year.¹³ Partnerships decreased by 4 per cent in 1998–99,¹⁴ and then decreased by a further 2 per cent in 1999–2000.¹⁵

⁴ Discretionary trust refers to a trust where the allocation or division of the beneficial interest in the trust property and income is left to the discretion of the trustee. The trustee has the power to decide how to apportion both the income and capital of the trust amongst the beneficiaries from a defined class in the trust instrument. There is no guarantee that a particular beneficiary will get anything. The entities involved in a discretionary trust include the trustee, the settlor and the beneficiaries (objects), with the beneficiaries being classified as either income or corpus depending upon their potential entitlement.

⁵ Cooper and Lybrand and the Property Council of Australia, *The Taxation of Trusts: Dispelling the Myth* (1997). <http://www.propertyoz.com.au/data/national/advoc/subs/971119tt.pdf>.

⁶ Australian Taxation Office, *Taxation Statistics 1998–99: A Summary of Taxation and Superannuation Statistics* (2001) Canberra, AGPS. [ATO 2001]

⁷ *Ibid* 89. According to statistics from the Australian Taxation Office, there has been a 28 per cent increase in the number of trust taxpayers between the 1994 financial year to the 1998 financial year.

⁸ *Ibid*.

⁹ The Board of Taxation, *Taxation of Discretionary Trusts: A Report to the Treasurer and the Minister for Revenue and Assistant Treasurer* (2002) AGPS, Canberra, 25. Reference is to lodged tax returns for the 1998–99 year.

¹⁰ Above n 6, ATO 2001.

¹¹ Australian Taxation Office, *Taxation Statistics 1999–2000: A Summary of Taxation, Superannuation and Industry Benchmark Statistics 1999–2000 and 2000–01*, (2002) Canberra, AGPS. There have been no figures released since the announcement of the withdrawal of the reforms in February 2001; it will be interesting to see if the negative growth continues, or whether there will be a turn around. It remains to be seen how the Treasurer's announcement in February 2001 will affect the future growth of trusts, as the figures are not yet available for the 2001 year. [ATO 2002]

¹² Above n 6, ATO 2001, 89.

¹³ Above n 11, ATO 2002.

The popularity of discretionary trusts can be traced to a number of factors, including: the cost of establishing a trust structure is less than a company; they can be an effective means of protecting business assets, while ensuring that the assets can be retained within a family group.¹⁶ In contrast to these commercial and family considerations, many have regarded trusts, especially discretionary trusts, suspiciously. This is because discretionary trusts are considered vehicles for facilitating large-scale tax minimisation.¹⁷ This concern, in part, can be traced to the fact that little is known about the precise use of trusts, as there are no general disclosure laws applying to them.¹⁸

Tax minimisation can occur as effective control can remain with the person who transferred the income and assets to a discretionary trust, while that person still enjoys the tax benefits of splitting income with beneficiaries who are family members.¹⁹

1 *Distributions of Tax-Preferred Amounts*

Another tax minimisation strategy available to discretionary trusts includes the ability of tax-preferred amounts to flow through to discretionary beneficiaries.²⁰ Tax-preferred amounts describe amounts that are not included in the trust estate's calculation of net income pursuant to the *Income Tax Assessment Act 1936* (ITAA36) s 95. These tax-preferred amounts may arise due to a number of reasons, including asset revaluations, capital gains concessions,²¹ accelerated depreciation for plant and equipment purchased prior to 21 September 1999,²² and the small business 15-year exemption amount.²³ A detailed list of tax-preferred amounts is contained in Table 1.1 below. Companies and fixed trusts do not enjoy the ability to distribute these amounts without adverse tax consequences to the same extent.

¹⁴ Above n 6, ATO 2001.

¹⁵ Above n 11, ATO 2002.

¹⁶ Taxation Institute of Australia, (1998) 'Taxation of Trusts and Other Entities' 1:5 *The Tax Specialist* 281, 281.

¹⁷ Australian Council of Social Services, *Review of Business Taxation: ACOSS Response to First Discussion Paper*, Information Paper 990204 (1999) at <http://www.acoss.org.au/media/1999/ip990204.pdf>.

¹⁸ Senate Official Hansard, *Parliamentary Debates*, Monday 23 March 1998, Canberra, AGPS, 1020, (Senator Murray).

¹⁹ Australia, *A Strong Foundation* (Ralph Report No 1), (1998) Canberra, AGPS, 12.

²⁰ *Ibid.*

²¹ Such as the CGT asset being acquired prior to 20 September 1985: Sub-section 104-10(5) ITAA97.

²² Division 42 ITAA97.

²³ Section 152-105 ITAA97.

Table 1.1 Tax-preferred amounts

<p>Tax-preferred amounts may arise because of:</p> <ul style="list-style-type: none">■ Asset revaluations;■ Capital gains concessions (such as the CGT asset being acquired prior to 20 September 1985);²⁴■ Division 43 capital works;²⁵■ Accelerated depreciation for plant and equipment purchased prior to 21 September 1999;²⁶■ Small business 15-year exemption amount;²⁷■ Small business further 50 per cent reduction amount;²⁸■ Depreciation concessions for small businesses electing to be part of the simplified tax system;²⁹■ Environmental expenditure deductions;³⁰■ Water care deductions;³¹■ Amounts sheltered because of carried forward losses;³²■ Amounts sheltered because of indexation of CGT assets' cost bases;³³ and■ Capital gains discount amounts.³⁴

²⁴ Section 104-10(5) ITAA97.

²⁵ Division 43 ITAA97.

²⁶ Division 42 ITAA97.

²⁷ Section 152-105 ITAA97.

²⁸ Section 152-205 ITAA97.

²⁹ Division 328 ITAA97.

³⁰ Section 43-20 ITAA97.

³¹ Sub-division 388-A ITAA97.

³² Division 36 ITAA97.

³³ Division 114 ITAA97. Note indexation is now frozen from September 1999.

³⁴ Division 115 ITAA97.

II THE REFORM PROPOSALS

A A New Tax System

In recognition of perceived inadequacies in the tax system, the government set out on an ambitious tax reform agenda to revolutionise the Australian taxation system in 1998 with its ANTS White Paper.³⁵ Included in the White Paper was the proposal to reform the taxation of trusts, to be known as entity taxation.³⁶

With this proposed system, the government hoped it would provide simplicity, clarity and fairness, while also addressing techniques highlighted by HWIT.³⁷ The inadequacies the government observed included the fact that exactly the same investment achieved very different tax treatment depending upon the collective business structure adopted.³⁸ The government considered that this meant wealthier individuals, having access to legal and accounting advice, could target particular investments and structures.³⁹ By doing this, wealthier individuals could take advantage of the differences in tax treatment, and minimise the amount of their tax.⁴⁰ The government concluded that this meant that the rest of the community subsidised the wealthier investor.⁴¹ If this conclusion were correct, then the principle of vertical equity⁴² would be violated.

The entities to be covered by this proposed single regime were companies, fixed trusts and discretionary trusts. The government considered that these entities should be

³⁵ Above n 1. Some aspects of this reform agenda included, together with the introduction of a goods and services tax, the simplified imputation system (involving the full franking of all dividends distributed by entities), the refund of excess imputation credits for individuals, moving towards a 30 per cent company tax rate, and extending capital gains tax rollover relief for small businesses.

³⁶ *Ibid*, Australia, Chapter Three, *Appendix A: The Time Line of Reforms*. Details the chronology of events that occurred from the government's initial announcement of this reform measure to date.

³⁷ *Ibid* 114.

³⁸ *Ibid* 107. Such as companies, trusts and life insurers.

³⁹ *Ibid* 108.

⁴⁰ *Ibid*.

⁴¹ *Ibid*.

⁴² Vertical equity is achieved when taxpayers are taxed according to their ability to pay: R Vann, 'Australia's Policy on Entity Taxation' (2001) 4:3 *The Tax Specialist* 120, 120. This is reflected in the adoption of progressive marginal tax rates for individuals in Australia. The tax rates for Australian resident taxpayers are currently: 0–6000 nil; 6001–20000 17%;

20 001–50 000 30%, 50 001–60 000 42%, and 60 001 plus 47%. It is proposed that these tax rates be altered from 1 July 2003 to: 0–6000 nil, 6001–21 600 17%, 21 601–52 000 30%, 52 001–62 500 42% and 62 501 plus 47% in Treasury, *Budget Measures 2003–2004*, (Budget Paper No 2), (2003) AGPS, Canberra, 31. However, the use of progressive marginal tax rates in Australia may be superficial. This is because tax avoidance by high-income taxpayers reduces the effectiveness of marginal tax rates: G Cooper, (ed) *Tax Avoidance and the Rule of Law* (1999) IBFD Publications BV, Amsterdam, 64. An analysis of tax incidence over the years tends to show that wealthier individuals simply do not end up paying the expected high marginal rates: G Cooper, (ed) (1999) *Tax Avoidance and the Rule of Law* (1999) IBFD Publications BV, Amsterdam, 257.

subjected to consistent treatment, as they all offered investors the prospect of limited liability.⁴³

The government expressed that pursuant to the current taxation methodology, beneficiaries of discretionary trusts were enjoying the best of both worlds. This was because the government considered that these beneficiaries could benefit from limited liability, as well as the flow through of tax-preferred amounts.⁴⁴

A similar flow through of tax-preferred amounts could not occur for companies. This is because such distributions from a company would be in the form of an unfranked dividend,⁴⁵ which the shareholder would be fully assessed on.

Neither could fixed trusts enjoy the flow through of tax-preferred amounts, as fixed beneficiaries would generally be taxed on a delayed basis.⁴⁶ This is referring to the application of CGT event E4,⁴⁷ under which a fixed beneficiary's cost base would be reduced to the extent of the tax-preferred distribution, resulting in a larger capital gain on the disposal of the fixed interest.⁴⁸ This statement by the government fails to acknowledge that there are some exceptions that allow for tax-preferred amounts to actually flow through to fixed beneficiaries. These exceptions include amounts deducted for capital works,⁴⁹ excluded exempt income⁵⁰ and the small business 15-year exempt amount.⁵¹

The government identified sole traders and partnerships⁵² as being able to access tax-preferred amounts also. Though for sole traders and partnerships, the government considered that this was not adverse, since these entity types directly bore the liability for losses in their businesses.⁵³

⁴³ Above n 1, 113. There is some doubt as to whether this assumption of limited liability is in fact correct, a flaw that could directly undermine the government's justification for unified treatment. This is because courts have held that beneficiaries, at least those who have full capacity, can be personally liable to indemnify the trustee for those liabilities which are properly incurred and which relate to administration of the trust for the benefit of the particular beneficiary sought to be made liable: see *JW Broomhead (Vic) Pty Ltd v JW Broomhead Pty Ltd* (1985) VR 891. This issue is beyond the scope of this paper.

⁴⁴ Above n 1.

⁴⁵ 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: ITAA36 s 47A.

⁴⁶ Above n 1, 109.

⁴⁷ Section 104-70 ITAA97.

⁴⁸ Section 104-70 ITAA97.

⁴⁹ Up until 1 July 2001. Section 104-70 ITAA97.

⁵⁰ Sub-section 104-71 ITAA97.

⁵¹ Sub-section 104-71 ITAA97.

⁵² Except for limited partnerships: which are already taxed as companies under Division 5A ITAA36.

⁵³ Above n 1, 109.

The central thrust of the government's proposed regime was that taxable income derived by the affected entities should be subject to the same tax rate at the entity level. For a trust it meant that the taxable income of the trust estate would be taxed in the hands of the trustee.

The government's proposal also envisaged that tax-preferred amounts⁵⁴ would, if distributed, be subject to tax at the entity level, in that tax-preferred amounts retained by an entity would not be taxed as income but would if distributed.⁵⁵ This new tax on distributions of tax-preferred amounts was to be known as deferred company tax.⁵⁶ While the recipient of such a distribution would be assessable on it, the recipient would have the benefit of imputation credits.⁵⁷

The government stated that these proposals would, when combined with the refund of excess imputation credits, mean little effective change to the income tax liabilities for most existing beneficiaries of private trusts.⁵⁸ This was based on the government's belief that income would still be able to be split amongst beneficiaries, and therefore assessed at their individual rates.⁵⁹

It is submitted that this statement is itself an example of the inconsistency between the government's stated policy intention and the actual application of the proposals. This is because the proposed measures would involve a fundamental change in the tax liabilities for beneficiaries. In particular, distributions of tax-preferred amounts under the measures would now be assessable. This is in stark contrast to their current accepted treatment. Indeed, under the proposed measures, the government changed what was meant by assessable income for a beneficiary of a discretionary trust. Furthermore, given the complexity of the proposals, it is not clear how the goals of simplicity and clarity were going to be achieved.

After announcing its platform of potential reforms in ANTS in August 1998, the government referred them for further consideration to the Review of Business Taxation Committee.⁶⁰ This committee became known as the Ralph Committee, after its chairman, Mr John T Ralph AO. The Ralph Committee's brief was to review the proposals, take public submissions and formulate recommendations for the government.⁶¹

⁵⁴ Income that does not fall as part of taxable income. Refer to the *Glossary of Terms* for a precise definition of this in relation to discretionary trusts.

⁵⁵ J Glover, 'Taxing Trusts: Entity v Conduit – An Assessment' (1999) 2:4 *The Tax Specialist* 194, at 196.

⁵⁶ *Ibid.*

⁵⁷ Above n 1, 113.

⁵⁸ *Ibid.*

⁵⁹ Above n 55, 196.

⁶⁰ Commencing 27 October 1998.

⁶¹ Above n 19, Overview Chapter.

B Ralph Committee's Recommendation

After releasing a number of reports and taking extensive submissions from the public, the Ralph Committee gave the government its fourth report, *A Tax System Redesigned*,⁶² in July 1999. This report contained recommendations, as well as draft legislation in respect to reforming the taxation of trusts. The Ralph Committee concluded that the best way of addressing tax avoidance and promoting fairness was to put in place a consistent and comprehensive approach to business taxation.⁶³

This comprehensive business taxation system would govern fixed trusts, non-fixed trusts, life insurers, cooperatives, companies and limited partnerships, and would be known as the 'unified entity taxation system',⁶⁴ a system similar to that originally proposed by the government.

However, the Ralph Committee didn't recommend adopting the deferred company tax, as originally proposed by the government.⁶⁵ Additionally, the Ralph Committee noted that the diametrically opposed proposition to the unified entity regime, which would allow tax-preferred amounts to flow through companies, was not feasible from a revenue viewpoint.⁶⁶

The Ralph Committee agreed with the government's proposed profits first rule applying to distributions from entities to members.⁶⁷ This rule effectively meant entities would be treated as distributing all retained profits before distributing contributed capital. The Ralph Committee envisaged that the advantage of this rule would be that entities could not defer tax on retained profits, or stream contributed capital and profit in accordance with members' tax profiles.⁶⁸ An additional benefit of this would be that specific anti-avoidance provisions dealing with dividend streaming,⁶⁹ and capital streaming⁷⁰ could be repealed, leading to more simplicity.

⁶² Australia, *A Tax System Redesigned* (Ralph Report No 4) (1999) Canberra, AGPS.

⁶³ *Ibid*, para 34.

⁶⁴ *Ibid*, Overview Chapter, para 276.

⁶⁵ *Ibid*, para 281. This was because the Ralph Committee accepted submissions that such a tax would impact adversely on the after tax profits of Australian companies, leading to negative perceptions by investors and consequently affecting the ability of companies to raise capital. This perceived adverse impact was due to companies having greater income tax expense because of the imposition of the deferred company tax. This was because amounts not previously subject to tax would be taxable for the company, thereby resulting in lower after tax profit. Previously, such distributions of tax-preferred amounts by a company would be in the form of an unfranked dividend, representing that no company tax had been paid on the amount.

⁶⁶ *Ibid*, para 277 of Overview.

⁶⁷ *Ibid*, para 294 of Overview.

⁶⁸ *Ibid*, para 294 of Overview.

⁶⁹ Sections 160AQCBA and 177EA of ITAA36.

⁷⁰ Sections 45, 45A, 45B and 45C of ITAA36.

C Government's Response

A further inconsistency between the government's stated policy justification and its actions can be illustrated by the difference between its stated and actual response to the Ralph Committee's recommendations.

1 Stated Justifications

The Treasurer released to the public the Committee's fourth report, *A Tax System Redesigned*, on 21 September 1999, together with a press release indicating, among other things, the government's acceptance of the proposed unified entity taxation regime.⁷¹ Though in recognition of the demand on businesses at the time associated with Year 2000 compliance issues and the introduction of the GST, the commencement date of the proposed regime was to be deferred until 1 July 2001.

The government stated that its justification for supporting the reforms was because the reforms would provide a more consistent taxation treatment of business entities and their members, while being fairer, simpler and having greater integrity.⁷²

2 Government's Actions

However, over time it appeared that the government's belief in a more consistent taxation treatment of business entities wavered. This is because over a year later, on 11 October 2000, when the government released its own Exposure Draft Bill for entity taxation, the measures only applied to non-fixed trusts.⁷³ The term 'unifying' was a stark omission from the title of the government's Exposure Draft Bill.

Some identified the omission of 'unified' in the Exposure Draft Bill's title as an indication of a departure from the ideals espoused by the Ralph Committee.⁷⁴ Instead of providing uniform rules for a number of entities, entity taxation now appeared to be specific anti-avoidance provisions addressing concerns about the taxation of non-fixed trusts only.

The Press Release accompanying the Exposure Draft Bill noted that the exclusion of companies, fixed trusts, limited partnerships and cooperatives⁷⁵ meant that there would be no requirement for the introduction of a collective investment vehicle regime.⁷⁶ What this referred to was the fact that since the excluded entities would continue to be taxed under their current methodology, there would be no requirement for a 'carve out' to occur for collective investment vehicles.

⁷¹ Treasury, 'The New Business Tax System' (Treasurer Press Release No 58, 1999).

⁷² Ibid, Attachment K.

⁷³ Treasury, 'Taxing Trusts Like Companies and Simplified Imputation Rules: Exposure Draft Legislation' (Treasurer Press Release No 95, 2000).

⁷⁴ P Drum, *The New Business Tax System: Entity Tax Exposure Draft – Comments of CPA Australia*, (2000), at http://www.cpaaustralia.com.au/01_information_centre/1_0_0_0_home.asp, at 3.

⁷⁵ They would retain their current taxation treatment.

⁷⁶ Above n 73.

Apart from this comment, no other precise explanation was provided for the exclusion of these entities from the provisions. However, the government did consider that the Exposure Draft Bill would achieve greater consistency in the taxation of entities, while minimising compliance and restructuring costs.⁷⁷

This conclusion was doubted by many submissions, since these submissions questioned how consistency between entities could be achieved by the introduction of additional legislative requirements for just one entity type. Some commentators stated that the Treasurer's claim that the purpose was to create 'equal treatment' for all business entities was clearly false, as partnerships and many types of trusts were not touched.⁷⁸

It is submitted that the Exposure Draft Bill is a clear illustration of inconsistency between the government's stated policy objectives and the actual operation of the proposed legislation. This is particularly the case in relation to the government's claim that the measures would 'achieve greater consistency in the taxation of entities'. How can this be the case when the Exposure Draft Bill introduced complicated rules applying to only one type of entity? Furthermore, and more importantly, it is submitted that this lack of consistency between the government's stated justification and its actual Exposure Draft Bill meant that the government could have undermined its own reform measures. This inconsistency made it easy for the Exposure Draft Bill to be criticised by reference to the government's own stated policy objectives, leaving little room for the government to defend its proposals.

The provisions of the government's entity taxation will be reviewed below, focussing in particular on whether they would have addressed distributions of tax-preferred amounts by discretionary trusts. Following this, a detailed critique of the Exposure Draft Bill will be undertaken—in particular the profits first rule—in order to examine whether there was any consistency between the government's stated justifications and the envisaged operation of the Exposure Draft Bill. The submissions received by the government in response to the release of its Exposure Draft Bill will be used as the basis of this critique.

⁷⁷ Ibid.

⁷⁸ I Spry, 'Taxation: Why the Attack on Family Trusts?', (2000) at http://www.newsweekly.com.au/articles/2000nov4_tax.html

III ENTITY TAXATION: AN OVERVIEW

Apart from the entities to which it applied, the government's Exposure Draft Bill drew heavily on the Ralph Committee's own draft legislation⁷⁹ that accompanied its report *A New Tax System Redesigned*. The government's Exposure Draft Bill also included the notions of a profits first rule,⁸⁰ a slice rule,⁸¹ non-commercial loans,⁸² contributed capital,⁸³ and a wide definition of distributions.⁸⁴ Set out below is a brief summary of how the proposed entity taxation system as detailed in the government's Exposure Draft Bill was to operate. The proposed entity taxation system is then considered as to whether it would have taxed distributions of tax-preferred amounts by discretionary trusts.

1 *Non-Fixed Trusts*

As the legislation only applied to non-fixed trusts, the pivotal concept in the Exposure Draft Bill was the meaning of non-fixed trusts. To this end the Exposure Draft Bill adopted the definition of 'non-fixed trust' and 'fixed trust' from the trust loss measures in Schedule 2F of ITAA36.⁸⁵

The precise scope of this definition is yet to be subject to judicial review, and some commentators claim that trusts which are traditionally considered to be fixed trusts would in fact be regarded as non-fixed trusts according to this strict definition.⁸⁶

For the purposes of this paper it is assumed that discretionary trusts as defined would clearly fall within the definition of a non-fixed trust, and therefore would have been subject to the proposed regime.⁸⁷

⁷⁹ Titled: A New Tax System (Income Tax Assessment) Bill 1999 (Cth).

⁸⁰ Sub-division 154-A in A New Tax System (Income Tax Assessment) Bill 1999 (Cth), and then Sub-division 157-B in Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth).

⁸¹ Sub-division 154-D in A New Tax System (Income Tax Assessment) Bill 1999 (Cth), and then Sub-division 157-E in Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth).

⁸² Section 154-40 in A New Tax System (Income Tax Assessment) Bill 1999 (Cth), and then section 157-115 in Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth).

⁸³ Sub-division 153-B in A New Tax System (Income Tax Assessment) Bill 1999 (Cth), and then Sub-division 157-C in Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth).

⁸⁴ Sub-division 960-C in A New Tax System (Income Tax Assessment) Bill 1999 (Cth), and then Section 960-126 in Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth).

⁸⁵ Sub-section 272-5(1) Schedule 2F ITAA36.

⁸⁶ Especially if the trust deed allows some discretion to the trustee as to whether to distribute or not. For a more precise discussion of these issues refer to: K Rooke, 'Fixed and Non fixed Trusts' (2001) 4:4 *The Tax Specialists*, 211.

⁸⁷ By the Exposure Draft Bill adopting this definition, it provided some consistency in the assessment acts, a consistency that too many times is lacking. For example a number of provisions dealing with small business adopt different measures to establish whether a small business exists. In Division 152 ITAA97 \$5 million net CGT assets is used, while for access to the simplified tax system the measure is annual turnover of less than \$1 million is used (that is, Division 328 ITAA97). However, the definition of non-fixed trust could mean a broader application of the measures than intended. Also because of the

2 Trustee Paying Income Tax

In contrast to Division 6,⁸⁸ under the proposed entity regime a discretionary trust would be liable to pay tax on its taxable income.⁸⁹ The calculation of taxable income for the trust would be similar to the calculation of net income under s 95.⁹⁰ Accordingly, such a calculation of taxable income would not itself incorporate any increment in value of an appreciating asset held by a trust recognised by an asset revaluation, nor other tax preferred amounts.

Under the proposals, a trust paying tax on its taxable income would generate franking credits. These credits would then be able to be passed on to beneficiaries by the allocation of franking credits to most distributions.⁹¹ However, pursuant to the 45-day holding rule, it appeared that franking credits would only be able available to beneficiaries of discretionary trusts that had made a family trust election.⁹²

uncertainty about the definition, it could create uncertainty as to whether a trust is a non-fixed trust or not—a fundamental differentiation, since the application of the Bill centred on this.

⁸⁸ ITAA36.

⁸⁹ Section 153-5 and s 9-1 Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth). This is in contrast to the practice under Division 6 where income of the trust estate is generally assessed to a presently entitled beneficiary.

⁹⁰ ITAA36.

⁹¹ Section 153-5, Divisions 160 and 161 of Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth).

⁹² Sub-section 160APHL(10) ITAA36. Pursuant to the 45-day holding rule, discretionary trusts and their beneficiaries are deemed to have a delta of negative one in respect of shares acquired from 1 January 1999: sub-section 160APHL(10) ITAA36. 'Delta' is a financial calculation that measures the relative change in the price of shares and the price of a related hedging arrangement, such as an option or other derivative. A derivative with a positive delta indicates that its price is expected to rise and fall relative to the underlying security. Whereas a negative delta indicates the movement of the derivative will be in the opposite direction to the movement of the underlying security. R Deutsch, M L Friezer, I G Fullerton, M M Gibson, P J Hanley, and T Snape, *Australian Tax Handbook* (2003), 1013.

Having a delta of negative one is important in determining whether the 45-day holding rule has been satisfied to enable the utilisation of franking rebates attached to franked dividends: Section 160APHL ITAA36. This is because days with materially diminished risk, ascertained as days where a taxpayer's net position of deltas in respect of shares held is less than 30 per cent, are excluded in the 45-day count: Section 160APHO ITAA36. With a delta of negative one, discretionary trusts and their beneficiaries are deemed to have no risk in holding shares, therefore limiting their ability to utilise franking credits. Exception for trusts that have made a Family Trust election: Section 160APHL ITAA36.

However by a trust making a family trust election, the trust and its beneficiaries are deemed to hold shares at risk, and therefore satisfy the 45-day holding rule. Though a trust making such an election is effectively limited to making distributions to only the statutory family as defined: Section 272-90 Schedule 2F ITAA36, as distributions outside this group are subjected to tax at 48.5 per cent. Known as Family Trust Distribution Tax: Division 271 of Schedule 2F ITAA36.

Accordingly, the assertion by the government that franking credits could pass to beneficiaries may be of limited application. This would mean that a discretionary beneficiary would not get a credit of the tax paid at the trust level, unless a family trust election was made.

3 *Distributions to Members*

The next determination would be whether there had been in fact a distribution to a member,⁹³ either of money, property or credits.⁹⁴ The term 'distribution' extended beyond its normal meaning and included excessive remuneration and eligible termination payments made to beneficiaries. Also the term encompassed loans to beneficiaries on non-commercial terms⁹⁵ or a forgiven commercial loan.

4 *Determining Source of Distribution: Profits First Rule*

An integral part of the proposed entity taxation regime was the profits first rule. This rule, amongst other things, sought to make most distributions (including distributions of tax-preferred amounts) by discretionary trusts taxable. The way the profits first rule achieved this was to provide that any distribution from a discretionary trust would be made from available profits first, rather than capital.⁹⁶ If there were available profits,⁹⁷ then the distribution would be assessable income for the recipient.⁹⁸ Pursuant to entity taxation, 'available profits' were calculated by deducting from the net market value of the assets held by the non-fixed trust the accounting provisions, contributed capital and prior taxed amounts.⁹⁹ This calculation occurred just prior to distribution being made by a non-fixed trust. Accordingly, key components of 'available profits' are the concepts of 'net market value',¹⁰⁰ 'accounting provisions',¹⁰¹ 'contributed capital',¹⁰² and 'prior taxed amounts'.¹⁰³

⁹³ Beneficiary.

⁹⁴ Section 156-20, Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth).

⁹⁵ Not in respect of employment of the beneficiary. These were similar to Division 7A ITAA36 that applies to non-commercial loans from private companies to shareholders, though there were some inconsistencies, such as the date of which the appropriate interest rate was determined.

⁹⁶ An asset revaluation reserve distribution would generally be regarded for trust law purposes as from capital (corpus).

⁹⁷ Section 995-1 defines this if Division 157 provides that it is from profits: Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth).

⁹⁸ Section 154-5 Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth).

⁹⁹ Section 157-85 Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth).

¹⁰⁰ Pursuant to entity taxation this was defined as the difference between the market value of the non-fixed trust's assets and the amount of the trust's liabilities at a point in time: Section 157-85(1) Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth).

¹⁰¹ The accounting provisions that were able to be deducted were limited to provisions for depreciation, annual leave, long service leave, and the amortisation of intellectual property and trademarks: Sub-section 157-85(1) Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth).

¹⁰² Pursuant to entity taxation the concept of contributed capital was espoused to be comparable to the share capital of a company: Explanatory Memorandum [EM] accompanying the Exposure Draft New Business Tax System (Entity Taxation) Bill 2000, para 6.2. It was basically the contributions made to a non-fixed trust to create or to increase the value of membership interest in the trust, including amounts settled: EM para 6.7.

¹⁰³ These are amounts that have been taxed under sections 97, 98, 99 and 99A ITAA36: Section 154-55 Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth). Or when ultimate

Consequently, if a discretionary trust having available profits at that time distributed a tax-preferred amount, then the beneficiary would indeed be assessed, unless the distribution fell within one of the exceptions.

The exceptions to the profits first rule included: if the distribution was of a prior taxed amount;¹⁰⁴ or in relation to a member's interest being terminated or reduced (known as the slice rule);¹⁰⁵ or from a CGT advantaged asset.¹⁰⁶ It is unlikely these exceptions would have encompassed distributions of tax-preferred amounts except for CGT advantaged assets.

If a trust did not have available profits at the time of the distribution, then the distribution would be treated as from contributed capital,¹⁰⁷ up to the balance of the trust's contributed capital account. For a beneficiary receiving a distribution from contributed capital, the taxation consequences would be dealt with under the CGT provisions.¹⁰⁸

The Explanatory Memorandum (EM) accompanying the exposure draft noted that for discretionary beneficiaries a distribution of contributed capital would remain tax-free.¹⁰⁹ Although for this to be the case, two new conditions had to be satisfied if the beneficiary's membership interests had a zero cost base. It is submitted that this would have been the case for most beneficiaries of discretionary trusts. This is because discretionary beneficiaries would not generally have paid or given any property for

beneficiary tax has been paid: Division 6D ITAA36. Though this was not possible if applied to a beneficiary's benefit by crediting the beneficiary's loan account.

¹⁰⁴ Section 157-40 Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth). These are amounts that have been taxed under sections 97, 98, 99 and 99A ITAA36, or when ultimate beneficiary tax has been paid.

¹⁰⁵ Section 157-45 Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth). Pursuant to entity taxation, this was the second broad exception to the profits first rule. It arose when there was a distribution to a taxpayer as part of a process that results directly in either a fixed membership interest ceasing to exist, or proportional rights attaching to a fixed membership interest being reduced. Additionally, the slice rule could apply to a distribution to a taxpayer with a non-fixed trust membership interest if the distribution was made as part of a process for the interest ceasing to exist because of the termination of the trust. In the circumstances that the slice rule operated, the member's share of contributed capital needed to be calculated: EM, para 4.44. If the member's share of contributed capital was equal or greater than the distribution, then the distribution was regarded as being entirely from contributed capital. If the member's share in contributed capital were less than the distribution, then the deference would be treated as from taxed or untaxed profits: EM, para 4.44.

¹⁰⁶ Section 157-55 Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth). CGT advantaged assets encompassed realisations of CGT assets acquired prior to 20 September 1985, discount capital gains (on assets held on trust as at 23 December 1999), frozen indexation components (though indexation is frozen from September 1999), the small business 15-year exemption and the small business 50 per cent active asset reduction.

¹⁰⁷ Section 157-20 Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth).

¹⁰⁸ Section 154-10 Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth).

¹⁰⁹ Explanatory Memorandum accompanying the Exposure Draft New Business Tax System (Entity Taxation) Bill 2000, para 5.15.

being a discretionary beneficiary.¹¹⁰ Additionally, even if the market value substitution rule applied,¹¹¹ the market value of a discretionary beneficiary's interest, whether a normal or a default beneficiary, would be nil or minimal.¹¹²

Accordingly, the two additional conditions would have been pertinent to ensure that discretionary beneficiaries were not taxed on distributions of capital. While not in the Exposure Draft Bill, the EM outlined these two additional conditions:

- (a) that the member receiving the distribution of contributed capital is part of the same family group as the family trust; and
- (b) only individuals or members of the family group have contributed capital to the family trust.¹¹³

It is unlikely that many discretionary trusts could have satisfied these two additional requirements, thereby negating the government's assertion that returns of contributed capital would remain tax-free. This appears to be another illustration of the inconsistency between the government's statements and the actual operation of the Exposure Draft Bill.

5 The Solution to Tax-Preferred Distributions?

It is not disputed that the proposed entity tax system would have achieved the government's goal of addressing concerns of the Tax Office and Treasury regarding the use of discretionary trusts to make tax-free distributions of tax-preferred amounts. This is because if the profits first rule under entity taxation had been introduced, then distributions of tax-preferred amounts by discretionary trusts would have been likely to be assessable for the receiving beneficiary.¹¹⁴ This is because unrealised gains of assets held by a trust would have increased the available profits of the trust, and therefore led to the conclusion that the distribution to the beneficiary was assessable. The only apparent exception is the distribution of a CGT advantaged asset provided certain time frames were met.

Why then did the government back-down from this apparent solution to the distribution of tax-preferred amounts by discretionary trusts? Particularly if the reforms, as originally postulated in 1998, introducing entity taxation provided simplicity, clarity and fairness.¹¹⁵ It is submitted that the reason for this backdown was the lack of consistency between the government's stated justifications and the actual operation of

¹¹⁰ Sub-section 110-25(2) ITAA97.

¹¹¹ Section 112-20 ITAA97. This potentially applies as the beneficiary gave nothing for being included as an object of the discretionary trust.

¹¹² *Chief Commissioner of Stamp Duties (NSW) v Buckle* 98 ATC 4103, 4104. It was acknowledged in *Leedale (Inspector of Taxes) v Lewis* (1982) 3 All ER 803, per Lord Fraser of Tullybelton at 814, that actuarial or market value of interests would be impossible in the case of discretionary interests.

¹¹³ EM, para 5.115.

¹¹⁴ This is on the presumption that the trust would have had 'available profits'.

¹¹⁵ Above n 114.

the Exposure Draft Bill. The submissions received by the government will be analysed to ascertain whether this was the case or not.

IV THE SUBMISSIONS: OUT TO GET TRUSTS¹¹⁶

Although the new entity tax regime professes to treat trusts and companies in the same way, the reality is that they share the same tax rate and not much else. A simplified tax regime may have been John Ralph's aim, but once it has gone through the political process, the result is that companies and trusts will continue to have rules specific to their structures.¹¹⁷

In the three-week period for submissions,¹¹⁸ the government received written submissions from over forty entities dealing with the non-fixed trust regime and the proposed dividend imputation system.¹¹⁹ It is submitted that such a three-week period was far too limited considering the complex nature of the proposed reforms.

Statements in the submissions varied from specifying that entity taxation should not be introduced at all,¹²⁰ to those highlighting that only technical amendments need occur.¹²¹

The submissions that contained statements about the profits first rule, referred to a number of issues. In particular, they addressed the key components of the profits first rule—being 'non-commercial loans from beneficiaries', the calculation of 'available profits', 'contributed capital' and 'prior taxed amounts'. It is these concerns, among others, that will be analysed to evaluate the profits first rule, as to whether it achieved its stated justifications of providing simplicity, clarity and fairness.¹²²

A Non-Commercial Loans From Beneficiaries

¹¹⁶ Comment made by tax lawyer Tony Riordan in respect of the Tax Office's position for the introduction of the trust loss measures in M Laurence, 'Family Trusts Under the Hammer' (1996) *Business Review Weekly* (26 February 1996) 42, 43. It is submitted that the entity tax regime demonstrated the same attitude.

¹¹⁷ R Bowerman, 'Tax Planning 4: Investing Through a Company' *Personal Investor* (February 2000).

¹¹⁸ Above n 73.

¹¹⁹ The Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth) not only contained the measures for non-fixed trusts, but also the proposed new simplified imputation system.

¹²⁰ National Tax and Accountants Association [NTAA], *Submission in Response to Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth)*, (2000) at <http://www.treasury.gov.au/contentitem.asp?pageId=&ContentID=456>.

¹²¹ Pitcher Partners [PP], *Submission in Response to Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth)*, (2000) at <http://www.treasury.gov.au/contentitem.asp?pageId=&ContentID=456>.

¹²² Above n 1.

One of the major criticisms about entity taxation was the legislative deeming as contributed capital of non-commercial loans from beneficiaries to non-fixed trusts (loans-in). The consequence of such a legislative deeming was that the repayment of the loan by the trust would be regarded as a distribution, and therefore subject to the profits first rule.

This legislative deeming, which was a new concept for taxation measures, appeared to be necessitated to maintain the integrity of the profits first rule. This is because under the entity tax regime, debt financing by a beneficiary would have had better tax outcomes than equity financing. In the absence of the legislative deeming, if a beneficiary loaned money to a discretionary trust, then the beneficiary would only be assessable on the interest component and not the repayments of principal by the discretionary trust. Whereas, because of the profits first rule, if a beneficiary contributed equity to a discretionary trust, then the repayment of that equity would be subject to the profits first rule. This could mean that the entire payment of equity may have been regarded as from profits, and therefore assessable for the beneficiary. Normally the repayment of equity would not be regarded as ordinary income, though it may have CGT consequences.

However, this legislative deeming appeared to have harsh consequences, especially for small businesses, and was difficult to rationalise as necessary to address tax-planning practices of high wealth individuals. There was to be a deemed contribution of capital when a member or associate made a non-commercial loan to a non-fixed trust, and the loan was not fully repaid within 12 months of the end of the loan year.¹²³ Depending upon the precise date of the loan made by the beneficiary to the trust, this could have given nearly two years for the repayment of the loan, before being deemed to be contributed capital.¹²⁴

In submissions, statements were made that it was unclear, in regard to the supposed policy intention, why the mere repayment of a loan to a member should be treated as a distribution.¹²⁵

Parties also stated in submissions that non-commercial loans from beneficiaries were a vital tool to aid small businesses in continuing operations or just staying afloat,¹²⁶ and that they were an extremely common source of working capital funding for businesses.¹²⁷ It was submitted that in most cases non-commercial loans were a

¹²³ Section 157-115 Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth).

¹²⁴ For example if a loan was made by a beneficiary to a trust on 1 July 2001, the trust would not need to repay the loan until 30 June 2003, before it would be deemed to be contributed capital.

¹²⁵ Arthur Andersen [AA], *Submission in Response to Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth)*, (2000). At: <http://www.treasury.gov.au/contentitem.asp?pageId=&ContentID=456>.

¹²⁶ Australian Chamber of Commerce and Industry [ACCI], *Submission in Response to Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth)*, (2000). At: <http://www.treasury.gov.au/contentitem.asp?pageId=&ContentID=456>.

¹²⁷ Above n 121, PP.

legitimate dealing between family members, and were provided interest-free to the trust to ensure the on-going operation of the business.¹²⁸

Indeed these observations are correct prior to the proposed entity taxation regime. However, if the entity taxation regime were introduced, these loans would have been tainted as possibly trying to avoid the profits first rule. The reality was that the profits first rule would make debt financing a problem. Accordingly, the government's proposal of entity taxation would have created more uncertainty, and compliance costs, contrary to its stated aims.

It was observed that this flexible financing had been carried on by small and medium trusts for years, and it provided a flexible and economical way for these businesses to finance their survival and growth.¹²⁹ The treatment of these loans as contributed capital contradicted the substance of the transaction and the taxing of the repayment of these loans would have constituted double taxation.

It was submitted that double taxation occurred because members would have first paid tax on earnings before lending the funds to the non-fixed trust, and then the second taxation would have occurred on the repayment of these loans.¹³⁰ It is questionable whether the government had considered such consequences and whether such a result is justified. It appears that the profits first rule would have led to more problems than it proposed to solve.

Another observation made was that for many small farm businesses, the business property is owned by a discretionary trust for asset protection and family succession purposes, while the individual family members in partnership carried on the actual business. A consequence of such an operating structure was that a bank would generally only lend money to the partnership if the trust guaranteed the loan, as the trust holds the valuable business reality.¹³¹

If the partnership defaulted under the loan and the bank called on the guarantee, the payment by the trust to the bank would have been treated as an unfranked assessable distribution to the individuals.¹³² What could be observed in these circumstances is that the reason the partnership defaulted on the loan was because it was unable to afford the repayment of the loan, and now in addition to this the partners will have a

¹²⁸ Above n 126, ACCI. See also: Institute of Chartered Accountants in Australia [ICCA], *Submission in Response to Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth)*, (2000). At: <http://www.treasury.gov.au/contentitem.asp?pageId=&ContentID=456>.

¹²⁹ Above n 121 PP. See also: Pricewaterhousecoopers [PWC], (*Submission in Response to Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth)*, 2000), at <http://www.treasury.gov.au/contentitem.asp?pageId=&ContentID=456>; and National Institute of Accountants [NIA], *Submission in Response to Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth)*, (2000), at <http://www.treasury.gov.au/contentitem.asp?pageId=&ContentID=456>.

¹³⁰ Above n 121, PP.

¹³¹ Above n 120, NTAA.

¹³² Section 156-175 Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth).

significant debt to the tax office on the deemed distribution.¹³³ It is highly questionable whether such a result is fair.

In other submissions it was queried whether the repayment of an affected loan would actually reduce the loan balance of the ‘creditor’ in the balance sheet of the trust.¹³⁴ This was because if the trustee of the trust understood that it was making a payment of principal reducing the non-commercial loan, the recipient would receive an assessable distribution to the extent that the trust had available profits. In such circumstances, the recipient may not accept that the payment was a reduction of the principal, but rather akin to interest.¹³⁵ Accordingly, in addition to the added complexity to the taxation laws, entity taxation could have made commercial dealings more perplexing.

Additionally, this treatment of non-commercial loans would immediately distort horizontal equity between companies and non-fixed trusts in relation to member-to-entity loans.¹³⁶ This inconsistency is diametrically opposed to the original intention of the government when it initially proposed entity taxation under ANTS.¹³⁷ The government had envisaged that more consistency would be achieved for the taxation of a number of entities. These proposals as espoused in the Exposure Draft Bill singled out non-fixed trusts for the implementation of harsh rules—harsh rules that appeared to be aimed more at eradicating non-fixed trusts, than at establishing a more consistent taxation regime.

¹³³ Above n 121, PP.

¹³⁴ Cowell Clarke Lawyers [CCL], *Submission in Response to Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth)*, (2000). At: <http://www.treasury.gov.au/contentitem.asp?pageId=&ContentID=456>.

¹³⁵ Ibid.

¹³⁶ Above n 125, AA.

¹³⁷ Above n 1.

B 'Available Profits': Taxes Unrealised Gains

A number of the entities lodging submissions felt that the calculation of 'available profits' was unacceptable, as it would result in the taxing of unrealised gains.¹³⁸ This concern was because in calculating available profits it was neither the book value nor the tax value of assets, as was proposed under the tax value method, which was taken into account. Instead the asset's market value was utilised. Such a calculation brought to account any unrealised increases in the value of assets held by the trust.

Additionally, the value of many assets could fluctuate regularly,¹³⁹ resulting in unrealised gains being astronomical. In such circumstances members receiving repayments of loans or distributions of capital could pay significant tax.¹⁴⁰ If the market value then decreased significantly, essentially tax could have been paid on non-existent profits. Such a result was thought to be inequitable,¹⁴¹ especially if there was a subsequent realisation of a loss on the asset.¹⁴² This was particularly harsh when one considers that such losses would be trapped at the trust level, and not distributable to beneficiaries.

It was also highlighted that Australia's taxation system has always been based on the taxation of realised gains, so the introduction of the profits first rule just for non-fixed trusts was seen as inequitable.¹⁴³ This submission is not totally correct in relation to trading stock.¹⁴⁴ However, this submission is particularly accurate when compared to the proposed tax value method, which has now been subsequently abandoned.¹⁴⁵ This is because the tax value method based the calculation of taxable income on changes in the tax value of assets, and not their market value. Pursuant to the proposed tax value method the net income of a taxpayer would have been calculated as:¹⁴⁶

¹³⁸ Above n 120, NTAA. See also CPA Australia, *Submission in Response to Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth)*, (2000). At: <http://www.treasury.gov.au/contentitem.asp?pageId=&ContentID=456>. See also above n 120 NTAA.

¹³⁹ Above n 120, NTAA. See also: Master Builders Australia [MBA], *Submission in Response to Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth)*, (2000). At: <http://www.treasury.gov.au/contentitem.asp?pageId=&ContentID=456>.

¹⁴⁰ Above n 120, NTAA. See also above n 139, MBA; and above n 138, CPA.

¹⁴¹ Above n 120, NTAA. See also above n 139, MBA; and above n 11, ATO 2002.

¹⁴² William Buck (Vic) Pty Ltd, *Submission in Response to Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth)*, (2000). At: <http://www.treasury.gov.au/contentitem.asp?pageId=&ContentID=456>.

¹⁴³ Above n 120, NTAA.

¹⁴⁴ This is because a taxpayer at the end of the income year can elect the value of trading stock to be based on its market selling value: Sub-section 70-45(1)(a) ITAA97.

¹⁴⁵ Treasury, 'Government Decides Against the Tax Value Method', (Treasurer Press Release No 48, 2002).

¹⁴⁶ Section 5-55 *Draft Legislation Tax Value Method Prototype #3*, 5 December 2001, at http://www.taxboard.gov.au/content/tvm_index.asp.

$$[Receipts - Payments] + [(Closing\ tax\ values\ of\ assets - Opening\ tax\ values\ of\ assets)] - [(Closing\ tax\ value\ of\ liabilities) - (Opening\ tax\ value\ of\ liabilities)]$$

It was contended that an entity which was a going concern would never have been able to access contributed capital.¹⁴⁷ CPA Australia considered this enormously harsh and unacceptable, especially when compared to the rules that apply to companies who are able to perform share buy-backs.¹⁴⁸ This highlights yet another inconsistency that would have been introduced into the tax system if the proposed entity taxation system were implemented.

PKF Australia Ltd submitted that for going concerns this would mean that a distribution of corpus of the trust would be treated as a distribution of profits even when there were no realised profits in the trust. This would be of particular relevance for discretionary trusts that are required to make corpus distributions to beneficiaries under the terms of the trust instrument.¹⁴⁹ This statement is valid, and displays how it was difficult to rationalise the government's stated intention of entity taxation being the 'taxation of distributions on the basis of their economic substance'.¹⁵⁰

It is submitted that this proposition by the government is misleading, since the profits first rule regards most distributions, regardless of their substance, to be from profits. Additionally, the profits first rule had far greater implications than the proposed tax value method,¹⁵¹ as the tax value method did not try to tax unrealised gains. Also the profits first rule would lead to inconsistencies between the treatment of a distribution at trust law compared to taxation law. For at trust law a distribution may have been from corpus, though under the profits first rule it could be regarded as from profits.

It was also highlighted that any form of distribution out of a pre-CGT asset revaluation must be treated as a taxable distribution, even though a distribution out of the realised pre-CGT reserves would be exempt.¹⁵² Such inconsistencies are again hard to comprehend given the government's stated objectives.

The calculation of available profits would mean the taxation of income would be accelerated, as the beneficiary would be assessable on an amount that the trust itself

¹⁴⁷ Above n 138, CPA.

¹⁴⁸ Ibid.

¹⁴⁹ PKF Australia Limited, *Submission in Response to Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth)*, (2000). At: <http://www.treasury.gov.au/contentitem.asp?pageId=&ContentID=456>.

¹⁵⁰ Sub-section 157-10(1) Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth).

¹⁵¹ Above n 62.

¹⁵² Above n 128, ICCA.

would not be taxable on.¹⁵³ This is referring to the fact that even under the entity taxation regime, the trust in calculating its 'net income' would not have included unrealised gains.

Consequently, the inclusion of unrealised gains in available profits ignores the fact that such profits are not available to a non-fixed trust until the asset is actually realised.¹⁵⁴

Another complication highlighted by KPMG was that when the income was unrealised and untaxed in the hands of the non-fixed trust, no imputation credits would be available for a distribution sourced to those profits.¹⁵⁵ Accordingly, the receiving member would not have the benefit of imputation credits to decrease their tax payable on receipt of the distribution.

Also, it was submitted that a consequence of the profits first rule could be that it forces the realisation of assets to be able to pay the tax liability.¹⁵⁶ This realisation may not be the best economic opportunity. The National Institute of Accountants submitted that these situations could occur when the trust deed requires the trustee to distribute out of corpus.¹⁵⁷ This is highlighting that a corpus beneficiary, under the profits first rule, would be assessed on a corpus distribution, which may be in-specie. Consequently, for the beneficiary to be able to pay the income tax assessed on the distribution, the beneficiary may have to sell the corpus asset it had received.

Additionally, the profits first rule introduced the concept of 'anticipated profits' in the circumstances that available profits and contributed capital were exhausted.¹⁵⁸ The effect of the concept of 'anticipated profits' was that profits that may never materialise would be taxed.¹⁵⁹ Again this result is hard to justify when the government's stated objective of the profits first rule was to tax distributions on their economic effect, rather than their legal form.¹⁶⁰

¹⁵³ KPMG, *Submission in Response to Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth)*, (2000). At: <http://www.treasury.gov.au/contentitem.asp?pageId=&ContentID=456>.

See also: S Page, *Submission in response to Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth)*, (2000). At: <http://www.treasury.gov.au/contentitem.asp?pageId=&ContentID=456>.

See also: AICD, *Submission in Response to Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth)*, (2000). At <http://www.treasury.gov.au/contentitem.asp?pageId=&ContentID=456>.

¹⁵⁴ Above n 153, KPMG.

¹⁵⁵ Ibid.

¹⁵⁶ Above n 129, NIA.

¹⁵⁷ Ibid.

¹⁵⁸ Section 157-20 Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth).

¹⁵⁹ Above n 121, PP.

¹⁶⁰ Sub-section 157-10(1) Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth).

C Tax-Free into Taxable

In addition to this acceleration, potentially tax-free distributions would be turned into taxable distribution,¹⁶¹ which was seen as unacceptable.¹⁶² The reason why this was unacceptable was due to the inconsistency of treatment. An exception to the profits first rule was the distribution of certain capital gains if distributed within 12 months.¹⁶³ However, until these capital gains were actually realised by the trust they would be taken into account to ascertain 'available profits'. Consequently, in an unrealised form, these gains increased the possibility that a distribution would be assessable for a receiving beneficiary.

The profits first rule would have achieved this because 'available profits' would have included, amongst other things, the market value of assets acquired prior to 20 September 1985.

Pitcher Partners stated in their submission that this result would mean the concessional treatment that was promised to entities in respect of pre-CGT assets might be rendered a nullity by the actual operation of the profits first rule.¹⁶⁴ In particular, the available profits for a trust would be overstated in circumstances where the pre-CGT assets constituted a large part of the net market value of assets of the entity.¹⁶⁵

The Taxation Institute of Australia stated that this result was unfair. This is because it meant artificial profits, which on realisation would not be assessed, would have been treated as distributed and thus be assessable before a capital distribution could be made.¹⁶⁶

D Double Taxation

Some regarded the profits first rule as a defacto wealth tax,¹⁶⁷ and highlighted that on the eventual sale of the trust's assets, that the trust would be liable for tax on the realisation. This would mean there would be double taxation.¹⁶⁸

¹⁶¹ National Farmers' Federation [NFF], *Submission in Response to Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth)*, (2000). At: <http://www.treasury.gov.au/contentitem.asp?pageId=&ContentID=456>.

¹⁶² Ibid.

¹⁶³ Section 157-225 Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth). See also above n 161 NFF.

¹⁶⁴ Above n 121, PP.

¹⁶⁵ Ibid.

¹⁶⁶ Taxation Institute of Australia [TIA], *Submission in Response to Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth)* (2000), at <http://www.treasury.gov.au/contentitem.asp?pageId=&ContentID=456>.

¹⁶⁷ Above n 161, NFF. See also: Mike Stephens and Associates [MSA], *Submission in Response to Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth)* (2000). at <http://www.treasury.gov.au/contentitem.asp?pageId=&ContentID=456>.

¹⁶⁸ Above n 167, MSA; above n 138, CPA; above n 153, KPMG; above n 121, PP.

The way in which double taxation could occur was illustrated by the following example contained in the National Farmers' Federation's submission:

When a distribution was made out of actual capital from the trust to a member, it may nevertheless be deemed to come out of unrealised gains and be taxable in the hands of the member. Upon the actual sale of the asset by the trust, the trust would be taxed on the capital gain even though the unrealised gain had already been taxed in the member's hands.¹⁶⁹

This double taxation would occur because available profits include unrealised gains, and then the actual distribution of proceeds from the realisation of the gain would be assessable to the beneficiary, albeit franked.¹⁷⁰

The Australian Chamber of Commerce and Industry stated that this double taxation would reduce the incentive to invest.¹⁷¹ Such a submission could be valid, as recently there have been calls to allow for the flow through of tax-preferred amounts for mining companies to encourage investment in the mining sector.¹⁷² It is submitted that the profits first rule's operation would have been harsher than the classical system in relation to dividends that existed for companies prior to the introduction of the Australian imputation system in 1987.

E Reliance on Accounting Records

The concession for non-fixed trusts being able to rely on accounting records to ascertain available profits was questionable. This was because accounting records will almost never disclose any internally generated goodwill, and rarely show the current market value of land, buildings or share portfolios.¹⁷³

It was highlighted that the calculation of 'available profits' would be required for every deemed distribution, as well as normal distributions.¹⁷⁴ Furthermore, these costly valuations would still be required when a distribution was not entirely out of available profits.¹⁷⁵

¹⁶⁹ Above n 161, NFF.

¹⁷⁰ Above n 139, MBA; above n 167, MSA; above n 161, NFF.

¹⁷¹ Above n 126, ACCI.

¹⁷² N Wilson, 'West Digs in to go with Tax Flow', *The Australian*, 21 March 2003, 38.

¹⁷³ Above n 134, CCL.

¹⁷⁴ J Morgan [JM], *Submission in Response to Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth)*, (2000). At: <http://www.treasury.gov.au/contentitem.asp?pageId=&ContentID=456>.

¹⁷⁵ Above n 120, NTAA.

A consequence of this is that a trustee could be required to determine available profits a number of times during a year if multiple distributions were made,¹⁷⁶ thus increasing compliance costs as valuations could be required.

Additionally, concern was expressed about the legislative exception that allowed accounting records to be sufficient evidence for the distribution being regarded as being out of available profits. This exception operated when the accounting records indicated that book profits were greater than the distribution amount.¹⁷⁷ The National Institute of Accountants questioned whether this legislative exception would override the trustee's obligations to members, which could still require valuations to determine the available profits.¹⁷⁸

In other submissions problems were outlined in ascertaining the market value of assets, especially when the assets had not been realised on the open market.¹⁷⁹ Intellectual property assets such as trademarks, patents, copyright and designs were provided as an example. In an unrealised form the 'market value' of such property can span a very large range. Due to this variability of value, Cowell Clark Lawyers expressed concern about the non-fixed trust rules giving rise to a plethora of tax cases based on valuations.¹⁸⁰

This imprecision about market value is a valid concern, and is especially confounding when the beneficiary's taxation treatment depends upon it. The implications for relying on incorrect valuations would lead to beneficiaries either incorrectly including or excluding amounts from their assessable income. Questions of culpability in such circumstances would be complicated. The complication of valuations is illustrated by the Tax Office's review of valuations relied upon for the utilisation of the margin scheme under the GST legislation.¹⁸¹ The ramifications of any changes of such valuations are expected to be complicated and adverse for the parties involved in the transactions.¹⁸²

Additionally, CPA Australia submitted that it was inequitable that prepayments were to be included in assets and therefore the calculation of 'available profits' when they are not legally recoverable debts.¹⁸³ The reason that a prepaid expense could be included in available profits is that pursuant to accounting standards prepayments are assets, representing a future benefit.¹⁸⁴ Their inclusion does appear unnecessarily harsh, since

¹⁷⁶ Above n 138, CPA.

¹⁷⁷ Sub-section 157-85(2) Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 (Cth).

¹⁷⁸ Above n 129, NIA.

¹⁷⁹ Above n 134, CCL.

¹⁸⁰ Ibid.

¹⁸¹ Division 75 of *A New Tax System (Goods and Services Tax) Act 1999* (Cth).

¹⁸² M Newnham, 'Tax Office Plays Scrooge', *The Age*, 23 December 2002, 3.

¹⁸³ Above n 138, CPA.

¹⁸⁴ Australian Accounting Research Foundation and Australian Accounting Standards Board. (1995). *Statement of Accounting Concepts SAC 4 – Definition and Recognition Criteria of the Elements of Financial Statements*, Melbourne, at paragraph 14.

prepayments only represent book assets, with no particular tangible assets underlying them.

F Similar Rules do not Apply to Companies or Fixed Trusts

Pricewaterhousecoopers stated that the fact that the profits first rule would not apply to companies or to fixed trusts, made the stated reason for taxing trusts at odds with the entity tax regime.¹⁸⁵

Other entities in their submissions highlighted that the treatment of unrealised capital gains would not apply to companies and fixed trusts.¹⁸⁶ Nor would the non-commercial loans and guarantees from beneficiaries¹⁸⁷ apply to companies and fixed trusts.¹⁸⁸

It was stated in submissions that the entity tax regime would impose special rules on non-fixed trusts, dramatically increasing complexity and creating new distortions to Australia's taxation system.¹⁸⁹ The result of this would be to severely disadvantage many small businesses that use a non-fixed trust entity structure.¹⁹⁰

The inconsistencies between non-fixed trusts and companies was illustrated by noting that although non-fixed trusts will be taxed at the same rate as companies, the process for calculating the trust's and member's tax position, would be quite different from the treatment of companies and their shareholders. Consequently, the National Institute of Accountants concluded that the original aim of reducing inconsistency and complexity would not be achieved by the proposed measures.¹⁹¹

This inconsistency was also observed by KPMG in the government's suggestion that the mandatory application of the profits first rule to non-fixed trusts merely replicated the rules applying to corporate entities. KPMG validly submitted that the profits first rule went a lot further than the anti-avoidance provisions in ss 45 to 45C of ITAA36.¹⁹²

Additionally, companies would still be able to distribute capital to shareholders in circumstances where the distribution is, in effect, not in substitution of a dividend. Such ability would not apply if the profits first rule applied to companies.¹⁹³ In comparison non-fixed trusts would have no opportunity to return capital to their members, other than where no profits existed or on the extinguishment of the

¹⁸⁵ Above n 129, PWC.

¹⁸⁶ Above n 139, MBA; above n 126, ACCI.

¹⁸⁷ Above n 126, ACCI.

¹⁸⁸ This is set to change with the new debt/equity rules to commence from 1 July 2004.

¹⁸⁹ Above n 129, NIA.

¹⁹⁰ Ibid.

¹⁹¹ Ibid.

¹⁹² Above n 153, KPMG; above n 161, NFF.

¹⁹³ Above n 161, NFF.

membership interest.¹⁹⁴ It is submitted that may be it was this 'extinguishment' of discretionary trusts that was in fact the underlying aim of the entity tax regime, and not the consistent taxation treatment between different entity types.

G Move Away from High-Level Principles

CPA Australia made an insightful point in its submission as it felt the Exposure Draft Bill was devoid of the high level principles espoused in the *Review of Business Taxation Report*.¹⁹⁵ CPA Australia stated that the high-level attributes of the original unified entity regime had been lost in the process and the Exposure Draft Bill proposed a separate, complex regime for non-fixed trusts. The Exposure Draft Bill had failed to provide the horizontal equity originally sought.¹⁹⁶

An important component of creating horizontal equity in the tax system is that the entity structure through which a business is operated, or an investment is made, should not produce different taxation consequences when all other things are equal. The National Institute of Accountants thought it was clear that the Exposure Draft Bill did not create horizontal equity, and in fact worked against it.¹⁹⁷ This is a valid observation because, if the entity tax regime had been introduced, it would have added complexity and a special class of rules just for non-fixed trusts.

V THE WITHDRAWAL AND THE LESSONS LEARNT

It is submitted that the submissions received by the government in response to the Exposure Draft Bill highlighted on numerous occasions the inconsistencies between the government's stated justifications about entity taxation and its actual operation. Accordingly, there was grave doubt as to the substance behind the government's justification for the proposed amendments providing simplicity, clarity and fairness. It may be that this inconsistency led to the government withdrawing the entity taxation proposal, as the government found it especially difficult to defend the proposals in light of its inconsistencies.

After considering the submissions, the government announced on 27 February 2001 that it no longer intended to proceed with entity taxation in its current form.¹⁹⁸ Instead the government referred the issue to the newly created Board of Taxation (the 'Board') for further consideration.¹⁹⁹

¹⁹⁴ Ibid.

¹⁹⁵ Above n 74.

¹⁹⁶ Ibid.

¹⁹⁷ Above n 129, NIA.

¹⁹⁸ Treasury, 'Entity Taxation' (Treasurer Press Release No 8, 2001).

¹⁹⁹ Ibid.

Newspapers reported that the government gave no reason for the change of heart, and that it was believed that entity taxation proved too complicated to implement, attracted too much opposition from the investment industry, and made too little difference to revenue.²⁰⁰

Statements made by the Treasurer on the withdrawal of the Exposure Draft Bill support the comments concerning complications and opposition from the investment industry.²⁰¹ However, the cost to revenue did not appear to be minimal. In the federal budget in May 2001, the Treasury noted that the loss of revenue due to the withdrawal of the proposed entity taxation system was estimated to be \$1.1 billion over four years.²⁰² While consistent with this, the Treasurer's initial estimate in February 2001²⁰³ appears to play down the loss of revenue. This is because it only disclosed the 2002 financial year loss of \$110 million alone, and did not disclose the impact for future financial years.

Indeed the Treasurer's press release detailed that a great number of the submissions received raised technical problems, particularly in relation to distinguishing the source of different distributions, and valuation and compliance issues, which meant that the draft legislation was not workable.²⁰⁴

It is interesting that the Treasurer stated that the Exposure Draft Bill was 'unworkable'. This raises concerns about the initial considerations put into its drafting by the legislative division of the Tax Office. There appears to have been an apparent breakdown of adequate consideration for the practical operation of the proposed entity tax system. This is notable when it is considered that the responsibility for the design of tax laws and regulations has, with effect from 1 July 2002, been transferred from the Tax Office back to the Treasury. The reasons stated for this transfer of staff and responsibility were to bring the accountability for tax policies and legislative design more directly under Ministerial control.²⁰⁵

It is worthwhile to contemplate what influence the draft entity tax bill experience had on the government's decision. The decision to transfer staff and responsibility to the Treasury was based on a report by the Board. The Board's report to the government made no direct mention of the entity taxation experience, but it did state:

The perception is that the ATO's dual responsibility for instructing on the drafting of tax legislation and for administering that legislation results in legislation that is overly biased towards meeting the compliance and

²⁰⁰ A Kohler, A 'Down for the Count', *Australian Financial Review*, 21 October 2000, 3.

²⁰¹ Above n 198.

²⁰² Treasury, *Budget Measures 2001-2002*, (Budget Paper No 2, 2001), Table 1: Revenue Measures since the 2000-01 MYEFO.

²⁰³ Above n 198. In the Treasurer's announcement of the withdrawal of entity taxation, \$110 million was stated as the cost of lost tax revenue for the 2001-02 financial year.

²⁰⁴ Above n 198.

²⁰⁵ Treasury, 'Reforms to Community Consultation Processes and Agency Accountabilities in Tax Design', (Treasurer Press Release No 22, 2002).

administrative objectives of the ATO. This is seen as producing *unnecessary complexity and compliance cost burdens* to taxpayers.²⁰⁶ [Emphasis added]

This is not the first time the Tax Office has come under criticism for its drafting, as it was felt that in relation to the trust loss measures the Tax Office had its own agenda and the legislation it drafted did not reflect the Treasurer's initial announcement of the measures.²⁰⁷ The Treasurer's conclusion that the entity taxation system was unworkable appears to be correct. This was highlighted by the numerous technical problems outlined in the submissions. These technical problems included:

- (a) how market value was to be determined for assets that had not been previously realised;
- (b) what 'assets' were to be included;
- (c) how contributed capital could be allocated to sub-accounts for discretionary trusts, and
- (d) why unrealised gains on CGT assets acquired prior to 20 September 1985 should be taken into account in determining 'available profits', when if they are realised they could be distributed tax-free to beneficiaries.

Others expressed there were more political reasons in the Treasurer's announcement, as stated by Senator Cook who suggested that the decision was made:

in order to get him past the election, in order to get him past the vociferous complaints of the coalition partner, the National Party, and obviously in order to get him past the vociferous complaints of the many frontbenchers of the government who are beneficiaries from family trusts. ... There is a conflict within the government in not honouring its commitment on ANTS.²⁰⁸

For the time being it appears that the comprehensive tax reform of discretionary trusts has been defeated. This is because the Board concluded that there were no compelling arguments to closely align the tax treatment of discretionary trusts and companies.²⁰⁹ Remember that this was the purported underlying premise of entity taxation. Indeed, the Board recommended that the government should retain the current flow-through treatment of distributions of non-assessable (tax-preferred) amounts by discretionary trusts.²¹⁰ This was because the Board considered that any attempt to remove these tax advantages for classes of trusts delineated either by size, type or complexity, carried the risk of being arbitrary and unfair.²¹¹ It is not clear from the Board's report what the arbitrary and unfair risks were.

²⁰⁶ The Board of Taxation, *Consultation with the Community on the Development of Taxation Legislation: A Report to the Treasurer and the Minister for Revenue and Assistant Treasurer*, (2002) 19.

²⁰⁷ Senate Economics Legislation Committee, Taxation Laws Amendment (Trust Loss and Other Deductions) Bill 1997, Family Trust Distribution Tax (Primary Liability) Bill 1997, Family Tax Distribution Tax (Secondary Liability) Bill, Medicare Levy Consequential Amendment (Trust Loss) Bill 1997, Canberra, AGPS, per Mr Leibler at 86.

²⁰⁸ Senate Official Hansard, 'Parliamentary Debates: Tuesday, 6 March 2001', per Senator Cook at 22589.

²⁰⁹ Above n 9, 1.

²¹⁰ Ibid.

²¹¹ Ibid 14.

However, the Board did recommended changes to s 109UB ITAA36 to improve its effectiveness and remove unfairness.²¹² In particular, the Board identified how asset revaluation reserve distributions could be used to circumvent the operation of Division 7A.²¹³

The government, on releasing the Board's report, announced it would legislate to rectify faults in s 109UB in Division 7A, as identified by the Board in respect of asset revaluation reserve distributions, which has now been done pursuant to Schedule 8 of *Tax Laws Amendment (2004 Measures No 1) Act 2004* (Cth).²¹⁴

It is notable that the government was silent in respect of the Board's recommendation to retain flow-through.²¹⁵ Though, through conversations with the Treasury, it is understood by the author that the government will follow this recommendation for now.²¹⁶

The government found that the profits first rule under entity taxation was quite unacceptable to a persuasive part of its constituency.²¹⁷ In fact, complexities with the profits first rule would have made compliance with the rule extremely difficult. Such complexities need to be acknowledged, as when tax laws are complex and taxpayers cannot understand them (let alone their professional advisors) then taxpayers are unaware of their obligations. This can mean taxpayers inadvertently do not comply with the tax laws,²¹⁸ a position that is not in the best interests of the tax system.

²¹² Ibid 1. The unfairness referred to is that the deemed loan under section 109UB ITAA36, unlike a real loan made by a private company, cannot be: (a) repaid by year end; or (b) be structured within the minimum terms to avoid the application of Division 7A.

²¹³ Ibid, 16. The Board also observed that a trustee performing an asset revaluation reserve distribution could circumvent the operation of s 109UB even when a discretionary trust had an unpaid distribution to a private company. The Board saw that this circumvention could occur by an asset revaluation being performed, the trustee then making a tax-free distribution of corpus to a beneficiary—known as an asset revaluation reserve distribution—and the beneficiary then lending the corpus distribution back to the trust. This process meant that the trustee was indebted to the beneficiary, rather than the beneficiary being indebted to the trustee. Accordingly, the subsequent act of the trustee repaying the loan to the beneficiary would not come within the ambit of s 109UB, nor be assessable to the beneficiary.

²¹⁴ On 19 February 2004, some 14 months after the Board's initial recommendations, the proposed amendments were introduced into the House of Representatives—contained in Sch 8 of Tax Laws Amendment (2004 Measures No 1) Bill 2004 (Cth). The Bill was passed by the Senate in June 2004, received Royal Assent on 29 June 2004 and Sch 8 commenced on the date of Royal Assent.

²¹⁵ Treasury, 'Taxation of Discretionary Trusts' (Treasurer Press Release No 81, 2002).

²¹⁶ In response to another recommendation the Australian Taxation Office has released a Taxation Ruling detailing that interest is not deductible for trusts borrowing money to fund an asset revaluation reserve distribution: Commissioner of Taxation, Australian Taxation Office, *Taxation Ruling TR 2003/9: Income tax: Deductibility of Interest Expenses Incurred by Trustees on Borrowed Funds Used to Pay Distributions to Beneficiaries*.

²¹⁷ K Schurgott, Structuring for 2002, (2001) 35:11 *Taxation in Australia* 597, 600.

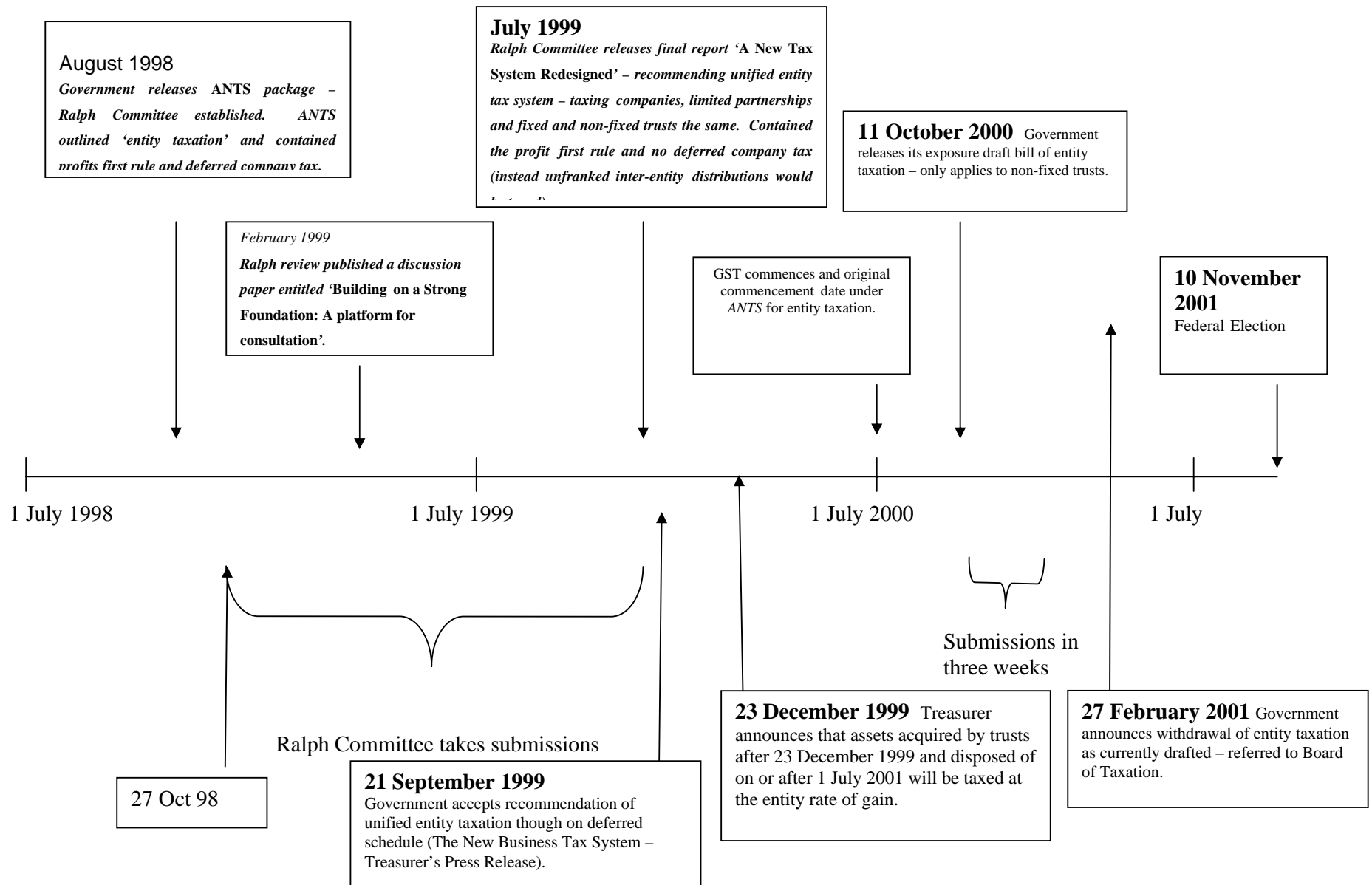
²¹⁸ Above n 120, NTAA.

The government must acknowledge and take into account the lessons it learnt from the failed attempt to introduce entity taxation. These lessons include, but are not limited to: the government should not introduce draft reforms that are ‘unworkable’, which have ‘technical problems’ and are ‘complex’.²¹⁹ Additionally, and perhaps more importantly, there needs to be consistency between the government’s stated policy for proposed reforms, and the way that those proposals in fact operate. If there is no consistency between these two factors, then the government provides opportunity for valid criticisms to be made of reform proposals using the government’s own stated policy objectives. The government’s stated policy goals for entity taxation was for simplicity, clarity and fairness. Unfortunately, as events unfolded it became clear that there was little or no substance behind this rhetoric. It is submitted that it was the lack of consistency between stated policy and actual legislation that was the main cause for the demise of entity taxation proposals.

For the Australian taxation system to progress, the government needs to acknowledge and ensure that there is indeed substance behind its policy justifications for reform and the provisions it implements. It is with this consistency that the overall Australian tax system will be improved.

²¹⁹ These are just the problems that the Treasurer referred to in withdrawing entity taxation. Above n 198.

Appendix A: Time Line of Reforms



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