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Published

2009

Journal Title

Australian Tax Review

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A Model Idea: Is the ICAA proposal for a tax transparent company the ideal model for Australia?

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Abstract

Currently one of the potential reforms being 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 ICAA proposal argues that tax transparency applying to closely held corporations and unit trusts would provide an enhanced tax system for micro-enterprises in Australia.

While there are arguments that tax transparency does provide for an enhanced method for taxing business forms and their members, there are various concerns about the consequences of following this economic ideal. This article will evaluate the model outlined in the ICAA proposal, and raise concerns about what will be achieved if a transparent company was introduced in Australia. A number of alternative models to achieve a tax transparent company in Australia will be considered, including the ICAA proposal. Through this analysis it will be argued that a partial loss transparent company is the preferred model to achieve transparency given the existing tax regime in Australia.

1.1. Introduction

Recently the Australian government announced that the proposal for a tax transparent company by the Institute of Chartered Accountants in Australia and Deloitte (the ICAA proposal) would be considered in a Tax Review to be chaired by Ken Henry (the Henry Review).¹ The ICAA proposal is based on the attractive proposition that a tax transparent company will provide an improved tax regime for closely held businesses, in particular alleviating them from such provisions as Division 7A. Within this article, it will be considered whether Australia should strive for the economic ideal of a tax transparent company. In doing this, the historical relationship between transparent companies and closely held businesses will be critiqued.

It will be argued that Australia may have little to gain from introducing such a tax transparent company. However, due to both domestic and international factors the government may find itself being subject to increasing pressure to broaden its recognition of transparent forms. Consequently, with this broader policy implication in mind, the analysis will consider a number of alternative models in which the introduction of a tax transparent company could be facilitated. It will be argued that the preferable model, if needed, would be the introduction 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 model of transparency advocated within the ICAA proposal will be outlined. The article will then consider the association between closely held businesses and transparent companies, before critiquing the various models through which a transparent company could be implemented in Australia. The final section of the article will outline the conclusions as to whether a tax transparent company is a model idea for Australia.

¹ Australia, "Australia's Future Tax System – Consultation Paper", (Henry, K Chairman) (2008), 10 December, Barton: Attorney-General's Department.

1.2. What is a tax transparent company?

The taxation of business forms can be conceptualised in terms of a continuum, from an 'entity approach' to an 'aggregate approach', with an 'integrated approach' lying between these two points.² While an entity approach can be conceived in relatively simplistic terms, economists have advocated that an aggregate (tax transparent) approach is preferable with income and/or losses directly allocated to members.³ Such a tax transparent approach is stated to improve tax neutrality, and thus reduce the tax system's potential to distort investment decisions.⁴ Also it has been argued that, in addition to their economic benefits, tax transparent companies are advantageous for closely held businesses.⁵

² An 'integrated approach' describes when tax relief is provided to distributions from an entity. This could include an imputation, dividend deduction, split rate and distribution exemption system.

³ Another term that can be used to describe an aggregate approach is 'fiscally transparent'. Kwall, JL. *The Federal Income Taxation of Corporations, Partnerships, Limited Partnerships, Limited Liability Companies, and their Owners*. 3rd ed. (Foundation Press, 2005) p 10, and Maine JA, "Linking Limited Liability and Entity Taxation: A Critique of the ALI Reporters' Study on the Taxation of Private Business Enterprises" (2001) 62 *University of Pittsburgh Law Review* 223 at 240. Head JG, "Company Tax Systems: From Theory to Practice" in Head J and Kreyer R (eds), *Company Tax Systems* (Australian Tax Research Foundation, 1997) p 22: "In the traditional public finance literature, full integration of the corporate income tax with the personal income tax has long been viewed as the relevant 'blueprint' or ideal". Crossen S, "Alternative Forms of Corporation Tax" (1984) 1 *Australian Tax Forum* 253 at 262: "For tax purposes there should be no difference between corporate profits and other capital income, such as interest and rents, or labour income, such as wages and salaries that is solely subject to the individual income tax". Bird RM, "Corporate–personal tax integration" in *Tax Coordination in the European Community* (Kluwer Law and Taxation Publishers, 1987) p 242. Crawford C and Freedman J, "Small Business Taxation" in *Report prepared for the Commission on Reforming the Tax System for the 21st Century* Chaired by Sir James Mirrless (The Institute of Fiscal Studies, 2008) at Section III.

⁴ Australia, "Taxation Review Committee Full Report", (Asprey, KW Chairman) (1975), 31 January, Canberra: AGPS at 16.

⁵ For LLCs see: Hicks A, Drury R and Smallcombe J, "Alternative Company Structures for the Small Business". in *ACCA Research Report No 42* (Certified Accountants Educational Trust, 1995) p 53. For LLPs see: House of Commons – Select Committee, *Trade and Industry – Fourth Report: Draft Limited Liability Partnership Bill*, (HC, 1999) 59 at [65]: heard evidence that LLPs might be attractive to small general partnerships and corporations. Morse G, "Limited Liability Partnerships and Partnership Law Reform in the United Kingdom" in McCahery J, Raaijmakers T and Vermeulen E (Eds) *The Governance of Close Corporations and Partnerships: US and European Perspectives* (Oxford University Press, 2004) Birds J, "A New Form of Business Association for the Twenty-First Century" (2000) 21(2) *The Company Lawyer* 39. Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Final Report*. (London, 2001) at [2.7]. However, Freedman questions the validity of this statement given that this Group had not investigated the LLP itself, or studied its characteristics, since this was outside its terms of reference. Other commentators have been less than certain, specifying that LLPs 'at least on the face of it' are ideally suited to closely held businesses: Lower M, "What's on offer? A consideration of the legal forms available for use by small – and medium – sized enterprises in

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 liability⁶ and is a separate legal entity from its constituent members.⁷ It is these three core characteristics, separate legal entity status⁸ and limited liability with flow-through taxation,⁹ that define the nature of a tax transparent company (or transparent company).¹⁰

the United Kingdom” (2003) 24(6) *The Company Lawyer* 166 at 168. For the benefit of LAQCS for closely held businesses see: Polson Higgs & Co and Rickman B, *Qualifying Companies*. Paper read at Professional Development Course Paper No S 703, June (Institute of Chartered Accountants, 2003); and Holmes K, “The Taxation of Closely-Held Companies: Concepts, Legislation and Problems in New Zealand” (1992) 9 *Australian Tax Forum* 321.

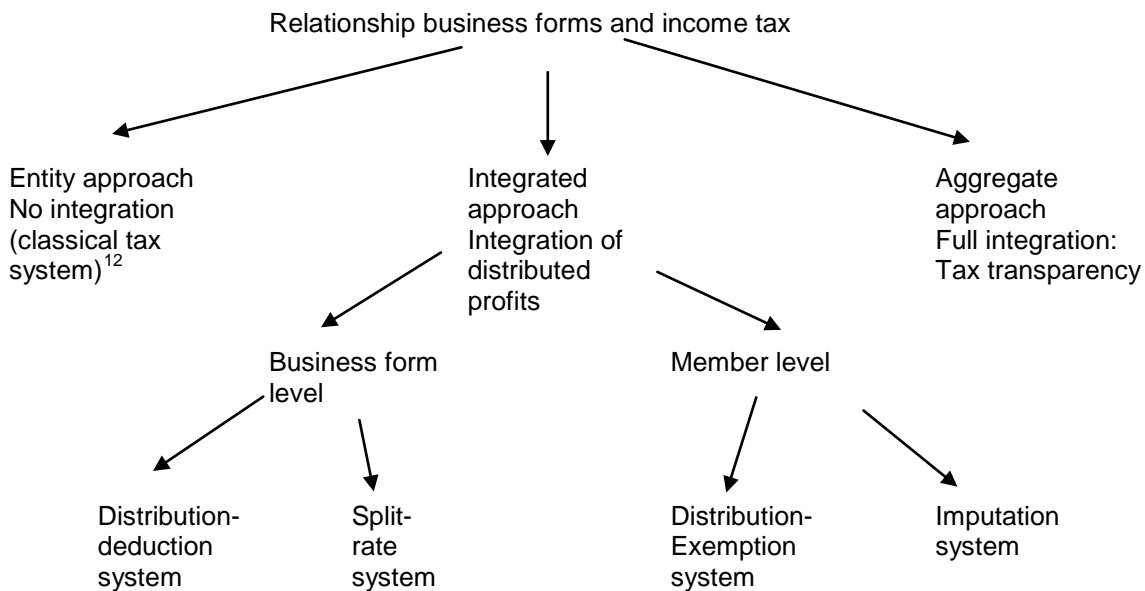
⁶ The extent of limited liability protection does vary amongst transparent companies.

⁷ Of course, it is quite possible to have corporate characteristics without limited liability, as in the case of unlimited companies and to have separate legal personality without the other characteristics of a company, as in the case of Scottish and of United States general partnerships.

⁸ Or legal personality.

⁹ Tax transparent treatment is argued to be an attribute of general partnerships, particularly in the Australian context.

¹⁰ 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. Other terms used to describe this is the aggregate approach, transparency or flow-through taxation. The transparent company’s losses, when deductions exceed assessable income, are similarly directly allocated to members. Normally, in this respect, a conduit principle applies to these allocations, so that receipts and expenditure items of the business form retain their identity for members. Note even though transparency applies, at times there can be recognition of the business form for tax purposes (referred to as entity acknowledgement), such as the lodgement of information returns by the business form. 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.

Figure 1: The continuum of the taxation of business forms¹¹

Consideration of transparent companies is not new, and reference to them can be found internationally¹³ and in Australia.¹⁴ Historically, however, it has been argued the

¹¹ Figure modified from Clossen, n 3 at 255.

¹² Such an entity approach was described in the early 1970s as the 'classical system' by Van den Tempel: Van den Tempel, AJ "Corporation Tax and Individual Income Tax in the European Communities" (EEC Brussels: 1970), at p 7. It should be noted, however, that, contrary to what the terminology suggests, the imputation system is of older date in Europe.

¹³ Canada, *Report of the Royal Commission on Taxation*, (Carter Commission) vol. 4, (Queen's Printer, 1967) Chapter 19. US Department of Treasury, *Blueprints for Basic Tax Reform (Treasury 1)* (US Treasury Department, 1991); Treasury, *Report of the Department of the Treasury on Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once* (US Treasury Department, 1992). There is also an early Treasury document back in 1946/1948 that discussed transparency: Postwar Taxation by Growes. Yin GK and Shakow DJ "Taxation of Private Business Enterprises" in *Federal Income Tax Project*. (The American Law Institute, 1999). Consultative Committee on the Taxation of Income from Capital, *Taxation of Distributions from Companies*, (Auckland, November 1990), and Consultative Committee on the Taxation of Income from Capital, *Taxation of Distributions from Companies: Final Report*, (Auckland, July 1991); McLeod, R, Patterson, D, Jones, S, Chatterjee, S, and Sieper, E. (2001). *Tax Review 2001 - Final Paper*. Wellington. Hicks, Drury and Smallcombe, n 5, at p 36.

¹⁴ Australia (Asprey Report), n 4, at [16.79 to 16.96]. The Asprey Committee did not regard the scheme as being primarily directed to assisting small companies (paragraph 16.85) or available to the subsidiaries of large or foreign companies (paragraph 16.89). Australia, "Committee of Inquiry into the Australian Financial System — Final Report", (Campbell, J.K. Chairman), (1981) Canberra: AGPS at 223. The Campbell Inquiry recommended full integration in the interests of equity and neutrality, stating that the fact that companies and their shareholders were separate did not justify their separate tax treatment. It was not convinced that operation of an enterprise under limited liability should result in an additional tax burden. Australian Treasury, "Draft White Paper on the Reform of the Australian Tax System" (1985), Canberra: AGPS. Australia, "A strong

implementation of such an economic ideal is problematic for business forms with limited liability and separate legal entity status.¹⁵ The asserted difficulties relate to the potential risk to revenue, allocation and administrative issues, complexity and the pressure to distribute money.¹⁶ 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.¹⁷

Nevertheless, 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 limited liability companies (LLCs), the United Kingdom's limited liability partnerships (LLPs) and New Zealand's Loss Attribution Qualifying Companies (LAQCs) and its new limited partnership regime.¹⁸

foundation" (Ralph Report No 1), (1998) Canberra: AGPS at [277] of Overview; Australia (Henry Review), n 1, at p 155.

¹⁵ 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. While Australia has adopted a variety of approaches for taxing corporations, it has never provided a complete aggregate approach. Australia's first corporate tax, established in 1915, combined a dividend deduction or split-rate mechanism with a shareholder tax rebate (an integrated approach). This was replaced from 1940 to 1987 with a classical system of corporation taxation (an entity approach). Then, in 1987, Australia returned to an integrated approach, adopting an imputation system for the taxation of corporations: Harris PA, *Corporate/Shareholder Income Taxation and Allocating Taxing Rights Between Countries: A Comparison of Imputation Systems*. Amsterdam (IBFD Publications BV 1996) p 87 and 94.

¹⁶ It has been argued that the Australian government's approach to tax neutrality amongst business forms centres on whether the business form provides some form of limitation of liability. See: Freudenberg B, "Are transparent companies the way of the future for Australia?" (2006) 35(3) *AT Rev* 200 at 214-216.

¹⁷ In contrast, an 'entity' approach is taken when a jurisdiction recognises a business form as a separate taxpayer from its constituent members, imposing tax on the legal entity. Another term used to describe this treatment is 'opaque'. Harris, n 15, at p 43 and 51. Ting A, "Policy and Membership Requirements for Consolidation: A Comparison between Australia, New Zealand and the US" (2005) 3 *British Tax Review* 335 at 311. It should be pointed out that the adoption of an entity approach has the potential to breach tax neutrality, as it can cause a preference for retention of profits and debt funding by the business form.

¹⁸ Other tax transparent companies introduced around the world include Singapore's LLP [Introduced in April 2005 by the *Limited Liability Partnership Act* (Chapter 163A)], Northern Ireland's LLP [which took effect from 13 September 2004] and Japan's LLP [Known as *Godo Kaisha* 'GK' commencing 1 May 2006. Note it is not clear whether such an entity for Japanese tax purposes has been granted tax transparent treatment] 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.

While the S Corporation and LLC, as well as the United Kingdom's LLP, are fully tax transparent companies,¹⁹ the LAQC is not a fully transparent company, but instead is a 'partial loss transparent company', with only the losses automatically allocated to members, with income initially taxed to the business form.²⁰

It is possible that the tax transparent companies studied can be classified into two distinct paradigms. The first classification pertains to whether the tax transparent company was produced by introducing a special set of tax rules to an existing business form, the corporation, referred to as 'special tax rule company'. The second classification specifically relates to when the transparent company represents the creation of an entirely new business form that is subjected to existing tax rules, referred to as a 'new form transparent company'. To enhance understanding of these paradigmatic classifications, Table 1 details the categorisation of the transparent companies studied, and how they relate to the transparent companies referred to.²¹

Table 1: Classifications of tax transparent companies

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

Until this point in time Australia has given only restricted recognition to tax transparent companies, with the implementation of venture capital incorporated limited partnerships

¹⁹ Freudenberg, n 16.

²⁰ Freudenberg B, "The Troubled Teen Years: Is the repeal of New Zealand's LAQC regime required?" (2008) 14(1) *New Zealand Journal of Taxation Law and Policy* 67. Similar to the fully transparent company, the partial loss transparent company also provides for limited liability and the notion of a separate legal entity.

²¹ The S Corporation and the LAQC fall within the 'special tax rule companies' classification, since both of these entities are essentially corporations for which the respective governments have introduced a special tax transparent regime for particular closely held corporations. In contrast, LLCs and LLPs are categorised within the second classification, 'new form transparent companies', since both of these entities required the introduction of new legislation for their formation and governance, with transparency provided by the application of existing general partnership tax rules.

(venture capital ILPs)²² and amendments to controlled foreign hybrid companies (CFC hybrids).²³ However, there have been calls for the broader availability of a transparent company in Australia, most recently being the ICAA proposal.²⁴

1.3. ICAA proposal

The ICAA proposal advocates for the introduction of tax transparent company, particularly for micro enterprises.²⁵ The proposal, if implemented, would see transparency achieved through the application of the general partnership tax provisions to corporations and unit trust that elect to be part of the regime.²⁶ As currently drafted the ICAA proposal is for a fully tax transparent company (as defined), and would be best classified as a 'special tax rule company'.²⁷

²² ITAA 1997 (Cth), Sub-Div 118-F. The new venture capital regime was introduced on 1 July 2002 by two pieces of legislation, being: *Venture Capital Act 2002* (Cth) and *Taxation Laws Amendment (Venture Capital) Act 2002* (Cth). Australia has two other venture capital programs being (a) PDF program introduced in 1992; and (b) the Foreign Superannuation Fund program introduced in 1999.

²³ ITAA 1997 (Cth), Div 830. Commencing 1 July 2003, the CFC hybrid amendments were introduced to address the asymmetrical tax treatment applying to Australian residents investing in certain foreign transparent companies.

²⁴ Institute of Chartered Accountants in Australia and Deloitte, *Entity flow-through (EFT) submission* (Institute of Chartered Accountants, 2008). Other groups who have lobbied for transparency include: Australian Institute of Mining and Metallurgy, *Pre-Budget Submission 2007-08*, Carlton, November 2006 at 6-7, [cited 11 March 2005]. Available at www.ausimm.com.au. Coonan H (Minister for Revenue and the Assistant Treasurer), *Taxation Reform and the Exploration Industry – Laying the Foundations for Future Success*. Paper read at Speech to the APPEA Tax and Finance Conference (2003), at Barossa Valley. House of Representatives: Standing Committee on Industry and Resources, *Exploring: Australia's Future* (Canberra: The Parliament of the Commonwealth of Australia, 2003) at [3.62]. Hooke MH, *The case for a Flow Through Share Scheme for minerals exploration* (Minerals Council of Australia, 2006). Szekely L, "Limited liability for the sole trader" (2007) *Intax* October at 23. Johns BL, Dunlop, WC and Sheehan WJ, *Small Business in Australia: Problems and Prospects*. (George Allen & Unwin, 1983) p 163. Hayes G, "Real Tax Problems Need Real Solutions" (2003) *Australian Financial Review*, 14 October at 50. Stewart M, "Towards flow through taxation of limited partnerships: It's time to repeal Division 5A" (2003) 32 *AT Rev* 171 at 194. Brooks N, "Taxation of closely-held corporations: the partnership option and the lower rate of tax" (1986) 3(4) *Australian Tax Forum*:381.

²⁵ Institute of Chartered Accountants in Australia and Deloitte, n 24, at [3.7.10].

²⁶ The ICAA proposal applies to unit trusts as well as corporations. Institute of Chartered Accountants in Australia and Deloitte, n 24, at p 6. With a membership restriction of five.

²⁷ Although this classification is not precise, as the ICAA proposal envisages that the existing Australian general partnership tax rules would apply to the transparent company rather than introducing a special set of transparent tax rules.

A reason underlying the ICAA proposal is that the application of tax transparency could remove the need for the application of complex tax integrity measures imposed to address the disguised distribution of profits from private corporations, and thereby reduce compliance costs. The ICAA proposal argues that Division 7A would not need to apply nor fringe benefits tax for benefits to employee-members.²⁸ Other complex provision that need not necessarily apply to a transparent company could include share value shifting,²⁹ tracing capital gain discounts,³⁰ and tracing rules for capital assets acquired prior to 20 September 1985.³¹ Furthermore, a tax transparent company could provide an alternative form of tax consolidations that can be problematic for small businesses.³²

However, is the model of transparency advocated within the ICAA proposal the preferable way for a transparent company to be implemented in Australia. Indeed is tax transparency necessary at all? It is advocated that these are important considerations given the importance of closely held businesses, because, if it is accepted that most small and medium enterprises are closely held,³³ 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 businesses³⁴ during 2000–2001, representing 97 per cent of all private sector businesses and employing

²⁸ Institute of Chartered Accountants in Australia and Deloitte, n 24, at p 9 and 12.

²⁹ *ITAA 1997* (Cth), Div 723 to 727.

³⁰ *ITAA 1997* (Cth), s 115-40.

³¹ *ITAA 1997* (Cth), CGT event K6.

³² Institute of Chartered Accountants in Australia and Deloitte, n 24, at p 10.

³³ For the purposes of this article, the qualitative characteristics inherent for a 'closely held business' is that membership interest is not widely dispersed, and that it is not publicly traded: Holmes S and Gibson B, *Definition of Small Business* (The University of Newcastle, 2001) p 8; Coleman C and Evans C, "Tax Compliance Issues for Small Business in Australia" in *Taxing Small Business: Developing Good Tax Policies* (Australian Tax Research Foundation, 2003) (Conference Series 23):147 at 149; Small Business Deregulation Task Force, *Time for Business*, (AGPS, 1996) p 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, n 15, at p 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. Freedman J and Ward J, "Taxation of Small and Medium-Sized Enterprises" (2000) *European Taxation* May:158 at 159.

³⁴ Defined to be businesses that employ less than 20 people.

almost 3.6 million people (49 per cent of all private sector employment).³⁵ Small businesses account for around 30 per cent of Australia's gross domestic product.³⁶ For this reason, this sector has been described as 'the engine room of the Australian economy'.³⁷

Apart from their contribution to a country's current GDP, small closely held businesses are seen as important for future economic performance, being described as the 'seed bed for a country's future economic growth'.³⁸ For example in the United States, small businesses have 13 times more patents per employee than large corporations, and employ 39 per cent of the high tech workforce.³⁹

Closely held businesses can have a range of advantages for the economy, as they can be flexible, perform important sub-contractor functions and be a source of new ideas and innovation.⁴⁰ It is argued, that due to their current and future influence on a country's economy, it is important to consider the issues confronting this sector. Accordingly, the argument that a tax transparent company may be a better way to tax closely held businesses deserves careful analysis.

1.4. A model idea?

For the Australian government regulatory burden, in terms of both governance and tax rules, is a major concern with small businesses that generally are closely held.⁴¹ For the

³⁵ Australian Bureau of Statistics, *Small Business in Australia 2001* (AGPS, 2002).

³⁶ Australian Bureau of Statistics, n 34. Warren N (ED), "Foreword. Taxing Small Business: Developing Good Tax Policies" (Australian Tax Research Foundation, 2003) (Conference Series 23), at 11; and Coleman and Evans, n 33, at p 147.

³⁷ Howard, J (Prime Minister), *More Time for Business*, 24 March 1997, (AGPS).

³⁸ Barkoczy S and Sandler D, *Government Venture Capital Incentives: A multi-jurisdiction comparative analysis*, Research Study No 46 (Australian Tax Research Foundation, 2007) p 19.

³⁹ Karlinsky S, "How Does U.S. Income Tax Law Define a Small Business? Let Me Count the Ways" in *Taxing Small Business: Developing Good Tax Policies* (Australian Tax Research Foundation, 2003) (Conference Series 23) p 45 referring to the Office of Advocacy, Small Business Administration.

⁴⁰ Holmes and Gibson, n 33, at p 1, and Hendy P, "Threats to Small and Medium Enterprises from Tax and other Regulations" in *Taxing Small Business: Developing Good Tax Policies* (Australian Tax Research Foundation, 2003) (Conference Series 23) p 116-117.

⁴¹ See generally: Burton M, "The Australian small business tax concessions - public choice, public interest or public folly?" (2006) 21(1) *Australian Tax Forum* 71.

Australian government to adopt a tax transparent company it would need to be satisfied that transparency does reduce the regulatory burden for small businesses.⁴² However, it is argued that this is not necessarily the case.

It is not certain whether there would be any substantial benefits for closely held businesses if Australia strived for the economic ideal of a tax transparent company, particularly if tax transparency was introduced as an 'alternative' way of taxing business forms in addition to the established methods in Australia.⁴³ If it were not part of an overall comprehensive reform package, such an additional alternative would merely add to an already complex system. This is reinforced by the acknowledgement that complexity can also be influenced by the frequency of changes made to tax laws.⁴⁴ Indeed, such an optional additional approach may encourage taxpayers to choose a business form due to tax arbitrages.⁴⁵

Unfortunately, it is such an 'additional' methodology advocated in the ICAA proposal, although the ICAA proposal does provide for a conversion mechanism for established businesses to move into the transparent regime.⁴⁶ Furthermore, the demand or desire for such transparency may be insufficient to see it adopted by a large number of taxpayers. This is due, in part, to the fact that the breaches of tax neutrality in Australia may not be as significant as in other jurisdictions because of the full imputation system for corporations and the use of discretionary trusts for businesses.⁴⁷ To explain more

⁴² The concern for regulatory burden can be illustrated by: Tanner L (Minister for Finance and Deregulation), "Government on track to reduce business reporting burden" (2009) Media Release 23/09, 21 April.

⁴³ For example, the full imputation system applying to corporations and limited partnerships, partial income transparency applying to discretionary and unit trusts, and full aggregation for general partnership, venture capital ILPs, CFC hybrids and sole traders.

⁴⁴ Australian Chamber of Commerce and Industry, "Business Tax Reform: A Process that is Never Complete" in *ACCI Review* No 102. (Barton, 2003) p 2: "Small, medium and large sized businesses all found that the complexity of the tax system and the frequency of changes made was the greatest problem facing their businesses while the level of taxation came a close second".

⁴⁵ It is for a similar reason that a United States' style of Check-the-Box, allowing businesses to choose which tax methodology will apply to them is not advocated. A similar conclusion has recently been articulated in the United Kingdom. Crawford and Freedman, n 3.

⁴⁶ Institute of Chartered Accountants in Australia and Deloitte, n 24, at [4.3]. Of course, such conversions may have adverse stamp duty consequences.

⁴⁷ Freudenberg, n 16 at 219-220. However, it could be argued that the use of discretionary trusts for tax planning strategies actually breaches tax neutrality. Of course, the imputation system for corporations or the partial transparency applying to trust does not achieve total tax neutrality – for example losses remain trapped within these business forms.

fully, in Australia there is not the 'catalyst for change' for wide scale adoption of tax transparent companies. While the United Kingdom and New Zealand both introduced transparent companies when they had an integrated tax system applying to corporations and their members, there are characteristics unique to those jurisdictions that largely are not replicable in Australia.

It is argued that a peculiarity in the United Kingdom is the application of the National Insurance Contribution (NIC) scheme and the instrumental role that professional firms played in lobbying for the introduction of LLPs.⁴⁸ In the United Kingdom, tax transparency for LLPs has meant that a more favourable rate of NIC is applied to professionals as self-employed persons, compared to corporations and their employee-members.⁴⁹ The application of the NIC could be significant, given that members of a professional firm are likely to be active in their business. This discrete tax saving for professionals encouraged them to lobby for the LLP to have transparent treatment.⁵⁰ In Australia there is also differing tax treatment applying to self-employed persons compared to employee-members. Generally, the status of being an employee for an active member can be beneficial as it may increase access to concessionally taxed fringe benefits and preferable superannuation treatment.⁵¹ However, wages⁵² paid to an active member could be subject to payroll taxes levied by the various Australian states

⁴⁸ The NIC is a hypothecated tax to pay most of the cost of retirement pensions, unemployment benefits and sickness benefits. The different application of NIC between the two entities results from NIC rates depending upon whether an employment or self-employment relationship exists. See: Kay JA and King MA, *The British Tax System*. 5 ed. (Oxford University Press, 1990) p 22-23. For a detailed discussion about the reasons behind the introduction of the LLP see: Freudenberg, n 16 at p 210-213.

⁴⁹ The overall rates of NIC that are applicable to a corporation are greater than those applicable to an LLP self-employed situation. In terms of a corporation which employs its members, an overall NIC rate of up to 23.8 per cent could indeed be payable, with some by the corporation as employer, and the remainder then being paid by the employee-member. In contrast, when the LLP form is utilised, an LLP member would be regarded as self-employed rather than as an employee, and thus subject to a lower NIC rate. The maximum NIC rate applicable to those who are self-employed is approximately nine per cent.

⁵⁰ Also the conversion for established professional firms from general partnerships to corporations could be costly due to the application of capital gains tax (CGT), which does not occur with conversions to an LLP.

⁵¹ However, this is subject to many qualifications and legislative changes. For example commencing 1 July 2007, a self-employed person can now claim a 100 per cent deduction on contributions made to a qualifying superannuation fund. *ITAA 1997 (Cth)*, s 290-170.

⁵² Including fringe benefits and superannuation.

and territories, whereas the allocation of profits would not be.⁵³ Overall, then, the status as an ‘employee’ for active members can be beneficial and the Australian government considers some practices to achieve this status as abusive.⁵⁴ Currently, it is not possible for a sole proprietor or a member of a general or limited partnership to obtain employee status,⁵⁵ while it is possible for an active member of a corporation or a beneficiary of trust to do so. The ICAA proposal argues that the introduction of a transparent company could have the effect of reducing the additional compliance cost due to the non-application of fringe benefits tax (FBT) to benefits provided to employee-members, as they should not be regarded as an ‘employee’.⁵⁶

Peculiarities of the New Zealand tax model relate to the access to tax losses and tax preferences. It has been observed that New Zealand does not have any substantive loss restriction rules based on members’ contributed equity to the LAQC.⁵⁷ This means that tax transparency in New Zealand can provide, to an extent, the unfettered access to losses for LAQC members.⁵⁸ The other peculiarity in New Zealand is its large tax preference of the non-taxation of capital gains,⁵⁹ with LAQC members being able to access this tax preference.⁶⁰ For tax transparency to broadly apply in Australia it has been argued that the Australian government would require the application of a loss restriction rule to a transparent company.⁶¹ Furthermore, since 1985 Australia has included most capital gains in taxpayers’ assessable income, thereby having the effect

⁵³ However, this payroll tax can be mitigated through the manipulation of the wage level paid to active members.

⁵⁴ For example, the Australian government introduced Personal Services Business provisions, which restrict the extent that the benefits can be obtained: *ITAA 1997* (Cth), Divi 84 to 87. Also caps have been introduced on the extent of salary packaging allowed for employees of tax-exempt employers.

⁵⁵ However, it appears that it is possible for ‘salaried partners’ who are not equity members of a general partnership to obtain ‘employee’ status.

⁵⁶ Institute of Chartered Accountants in Australia and Deloitte, n 24, at p 12.

⁵⁷ Freudenberg B, “Losing My Losses: Are the Loss Restriction Rules Applying to Australia’s Tax Transparent Companies Adequate?” (2008) 23(2) *Australian Tax Forum* 125 and Freudenberg, n 20.

⁵⁸ Freudenberg, n 20 at 75.

⁵⁹ While New Zealand does not have a comprehensive capital gains tax it does have s DB 26 *ITA 2007* (NZ), which assesses amounts from profit-making undertakings. For a discussion about some of the tax preferences available in Australia see: Freudenberg B and McDermott, “The Forgotten CGT events: Are asset revaluations reserve distributions by trustees of discretionary trusts capital gains?” (2005) 34(2) *AT Rev* 67 at 67.

⁶⁰ *ITA 2007* (NZ), s HA 16 and CW 15. Freudenberg, n 20 at 69.

⁶¹ This is reflected with the introduction of venture capital ILPs and the CFC hybrid amendments. See: Freudenberg, n 16. Freudenberg, n 57.

of reducing the extent of this tax preference. Due to the combination of these factors, the peculiarities in the New Zealand model are generally not replicable in Australia, although there is some concessional treatment of capital gains.⁶²

The reduced benefit of a tax transparent company in Australia may be aggravated if there is a relationship between the extent of breaches of tax neutrality and the extent of utilisation of transparent company forms, especially in the early years when uncertainty costs concerning them could be the greatest. For example, Bankman has argued that transparent companies do have attendant uncertainty costs, particularly when they are introduced, and even more so if they are 'new form' transparent companies.⁶³ This uncertainty can relate to various issues: the recognition of their limited liability; an unfamiliar governance regime; and the 'blending' of general partnership and corporations law.⁶⁴ There can also be conversion expenses for established businesses into the new form. These costs may be aggravated by increased tax compliance costs that may result with tax transparency applying to a business form with limited liability and separate legal entity status.⁶⁵ To be successfully introduced into a jurisdiction, a transparent company needs to provide its members with benefits that outweigh these potential costs.

One such benefit could be an improved governance regime provided by the transparent company form, particularly 'new form transparent companies'. However, governance benefits may of course be difficult to quantify precisely. For example, they could be accumulative or, alternatively, they may never need to be utilised. It is argued, then, that potential tax savings make a more immediate, tangible and discernible benefit. For

⁶² For example the 50 per cent discount provided to capital gains for CGT assets held greater than 12 months: *ITAA 1997* (Cth), Div 115.

⁶³ With the introduction of new form transparent companies, an issue that has emerged and which requires consideration is that, as a 'new' business form, there can be (consequent) unfamiliarity with their governing laws. Additionally, the determination of their governance rules could require the 'blending' of existing principles originating from partnership and corporation law. This 'blending' may serve to create further uncertainty as to how courts will interpret and resolve governance issues. Bankman J, "The Structure of Silicon Valley Start-Ups" (1994) 41 *University of California Los Angeles Law Review* 1737; Freedman J, "Limited Liability: Large Company Theory and Small Firms" (2000) 63(3) *The Modern Law Review* 317 at 324. Morse, n 5, at p 329.

⁶⁴ While historically there was some relationship between corporations and partnership law, over the years the rules governing both forms have diverged.

⁶⁵ DeLuca D, Greenland A, Guyton J, Hennessy S and Kindlon A, *Measuring the Tax Compliance Burden of Small Business*. Paper read at Internal Revenue Services' Research Conference, 7-8 June 2005, at Washington DC.

example, the access to losses through a transparent company could offset a member's overall tax liability. Such discrete savings could encourage the utilisation of a transparent company form.⁶⁶ Furthermore, transparency in some circumstances decrease the overall tax burden for the business and its members, compared to the treatment of corporations.⁶⁷

It is argued that tax savings may play an important part in the willingness of businesses to adopt a transparent company form, as an offset to any perceived costs (including uncertainty and tax compliance costs). Of course such an acknowledgement is at odds with the idea that tax transparency enhances tax neutrality.

In terms of closely held businesses benefiting from the introduction of a tax transparent company, there are a number of concerns in the foreign jurisdictions studied. For example, empirical data from overseas suggests that tax transparency can result in greater tax compliance costs compared to transparency applying to businesses without company characteristics⁶⁸ and integrated approaches applying to corporations.⁶⁹ Reasons for this increased compliance cost may be related to eligibility requirements, the extent of aggregation, loss restrictions and cross-jurisdiction treatment; although, it appears that special tax rule companies may impose less compliance costs than those for new form transparent companies.⁷⁰

Analysis of foreign jurisdictions demonstrates that tax transparent companies will not necessarily assist closely held businesses in addressing their financial challenges. This includes concerns about strict eligibility requirements and the adverse effect this may

⁶⁶ The savings that losses present is that they decrease the overall financing cost of the business operations and alleviate pressure on debt funding.

⁶⁷ For example, consideration of the foreign jurisdictions studied demonstrates that the utilisation of transparent companies does not guarantee an overall lower tax liability, because there are inevitably qualifications and exceptions. Indeed, in some circumstances, transparent treatment can increase members' tax burden. Nevertheless, there is significant potential for tax savings with transparent companies – particularly with access to losses, tax preferences and capital gains.

⁶⁸ That is, general partnerships and sole proprietors.

⁶⁹ The studies include: DeLuca, Greenland, Guyton, Hennessy and Kindlon, n 65; and Ritchie K, *New Zealand Small Business Tax Compliance Costs – Some Empirical Evidence* (Inland Revenue, 2002).

⁷⁰ This potential relationship of complexity and tax transparent companies is the subject of a forthcoming article by the author titled in 'Fact or Fiction? A sustainable tax transparent form for closely held businesses in Australia' in the *Australian Tax Forum*.

have on raising equity. Also the relationship between corporate, capital and individual tax rates is critical in determining the overall tax benefit.⁷¹ However, tax transparency can be seen to be advantageous in terms of access to tax losses, tax preferences and capital gains.

While, historically, there has been reference to the relationship between tax transparency and closely held businesses, it is argued that tax transparent companies are not necessarily a benefit for closely held businesses. Instead, it can be considered that closely held businesses are beneficial for the implementation of a tax transparent regime. That is, tax transparency is more feasible and operational for governments when membership is closely held. If this is the way the relationship operates, then it brings into question the validity of the notion that tax transparency is a benefit for closely held businesses.

It is due to these reasons that there is serious doubt as to whether the broad introduction of a tax transparent company is a model idea for closely held businesses in Australia. Despite these reservations about what can be achieved by the broad introduction of a transparent company in Australia, if prior conclusions about the persuasiveness of international influences then a transparent company in Australia may be inevitable.⁷² This focus is reinforced by the recent ICAA proposal that advocates a transparent company. However, there are a number of alternative models of how this could be achieved; each of which will now be considered.⁷³

1.5 Models of transparency

It has been previously argued that the Australian loss restriction rules for CFC hybrids (with amendments) are adequate to allow for the broad availability of a tax transparent

⁷¹ This potential for tax transparent companies to address the financing requirements of closely held businesses is the subject of a forthcoming article by the author.

⁷² Freudenberg, n 16.

⁷³ In addition to the potential consequences identified, if a transparent company was to be implemented transitional issues would need to be address. For example, whether existing forms could move into the transparent regime. Also issues of the application of goods and services tax and State government treatment would need to be considered.

company.⁷⁴ However, there are a number of possible alternative models for the introduction of a tax transparent company in Australia. Firstly, venture capital ILPs or CFC hybrids could be made available to all investors. Secondly, Australia could introduce its own ‘new form transparent company’, or thirdly a ‘special tax rule company’ could be devised. The fourth option, and the preferred alternative, is the introduction of a partial loss transparent company. Below is a detailed analysis of these alternatives, highlighting the advantages and disadvantages, culminating in the preferred approach.

1.5.1 Broadening Australia’s existing forms

Currently there is restricted availability of venture capital ILPs and CFC hybrids in Australia. For example, tax transparency is only available to venture capital ILPs for certain types of investments in venture capital corporations.⁷⁵ If these requirements are not satisfied then tax transparency will not apply.⁷⁶

Similarly, tax transparency is not available for Australian investors who formed an LLC or LLP in the United States or United Kingdom respectively and then used that business form for Australian operations. Where there are extensive Australian business operations with Australian members, the LLC⁷⁷ or LLP⁷⁸ is likely to be regarded as an

⁷⁴ Freudenberg B, n 57.

⁷⁵ Instead an integrated tax approach would apply—the consequence being that the ILP is taxed similarly to a corporation.

⁷⁶ *ITAA 1936* (Cth), Div 5A.

⁷⁷ For the LLC, the Australian Tax Office is of the opinion that the LLC is a ‘company’, and as such it is not necessarily excluded from conducting business in Australia while remaining non-resident. This is because even if the LLC, for example, was formed overseas it could be regarded as an Australian tax resident if it carries on business in Australia and has its central management and control in Australia, or its voting power is controlled by members who are residents of Australia: *ITAA 1936* (Cth), s 6(1) definition of ‘resident’ for a company. This is confirmed in Australian Taxation Office. (2006). ATO Interpretive Decision: ATO ID 2006/18: Income Tax: Foreign hybrid rules: treatment of foreign hybrid company as partnership. Canberra. The Explanatory Memorandum indicates that in certain circumstances an LLC could have Australian sourced income and still come within the CFC hybrid rules: Explanatory Memorandum accompanying Taxation Laws Amendment Bill (No 7) 2003 (Cth), at [9.30]. However, to remain a non-resident the management and control must not be within Australia and voting control must exist outside Australia. These requirements largely exclude the possibility of Australian business operations utilising the LLC or LLP to gain tax transparency in Australia.

⁷⁸ For tax transparency to apply to a CFC hybrid, one of the requirements is that the foreign business form must not be an Australian tax resident. Due to ‘residency’ tests this can restrict Australians trying to utilise foreign transparent companies for Australian business operations. For

Australian resident and therefore would be excluded from the transparency applying pursuant to the CFC hybrid amendments.⁷⁹

Accordingly, legislative reform is necessary to broaden their availability. One possibility for reform is for Australian state governments to make ILPs available to all investors and not just venture capital investors qualifying for registration with the Venture Capital Registration Board.⁸⁰ Additionally, the Federal government would need to extend tax transparency to all ILPs operations and not just venture capital investment.⁸¹ The broad availability of an ILP form is what the New Zealand government recently implemented with its new limited partnership.⁸²

However, the broad availability of ILPs may not be the preferred approach: the governance regime of ILPs may be problematic for use by closely held businesses. For

a non-resident transparent company that is regarded as a 'limited partnership', then it appears there can be no Australian operations. This would exclude Australian investors using the United Kingdom's LLP for any Australian business operations at all. However, this conclusion is not without question, as an LLP may come within the Australian meaning of 'company', which has a different residency test. Indeed, an ATO ID that indicates that LLP is a company due to corporate characteristics: Australian Taxation Office. (2006). ATO Interpretive Decision: ATO ID 2006/332: Foreign Hybrid Limited Partnership: UK Limited liability partnership: referring to the fact that an LLP is a body corporate, and not 'an association of persons ... in receipt of income jointly'. For foreign transparent companies that are considered as a 'partnership' there is no current definition of Australian 'residency' for general partnerships, though there is one for a 'corporate limited partnership'. A 'corporate limited partnership' is an Australian resident when it is (a) formed in Australia, or (b) carries on business in Australia; or (c) has central management and control in Australia: *ITAA 1936* (Cth), s 94T. Due to the broadness of the second limb of this test, any business operation in Australia by a limited partnership could make it resident. This conclusion is supported by the Explanatory Memorandum accompanying Taxation Laws Amendment Bill (No 7) 2003 (Cth), at [9.27], which states that the non-resident status means that a limited partnership cannot carry on business in Australia during the year. Technically it is not clear if this definition would apply to a CFC hybrid as they are excluded from being a 'corporate limited partnership' (circular definitions).

⁷⁹ *ITAA 1997* (Cth), s 830-15(c). Of course 'residency' of a corporation could be influenced by residency of the Board of Directors.

⁸⁰ Known previously as the Pooled Development Fund Board up to 21 June 2007.

⁸¹ With the application of the loss restriction rule.

⁸² This was finalised by the *Limited Partnerships Act 2008* (assented to 13 March 2008), commencing 1 April 2008. Cullen M (Minister of Finance) and Dunne P (Minister of Revenue), *General and limited partnerships — proposed tax changes: A government discussion document*. (Wellington, 2006) p 6. New Zealand's approach is particularly understandable given that it is hard to categorise venture capital as a precise 'industry', as it really consists of private investors who could invest in a wide range of industries (both traditional and upcoming industries). This characteristic of venture capital is why it is also known as 'private equity', to distinguish it from businesses raising public funds through stock market listings.

instance, the ILP does not allow for single membership,⁸³ a characteristic of many Australian businesses. Also, the ILP may be unsuitable for active members, as even with safe harbour provisions their involvement in the business may prejudice their limited liability protection as a limited member.⁸⁴ Furthermore, the restricted governance framework of the ILPs regarding their default rules may act as an impediment for the development of extensive networking benefits. For these reasons it is argued that a transparent company based on the ILP is not the preferable option.⁸⁵

Alternatively, the CFC hybrid rules could be amended to ensure that tax transparency applies to all LLCs and LLPs formed overseas, even if they are considered Australian tax residents.⁸⁶ Arguably, such an alternative could have some positive outcomes. For example, investors would have a wider choice of potential business forms, which may in turn offer more appropriate governance rules. Some academics have argued that allowing such jurisdictional choice could have 'profound benefits for the evolution of business law'.⁸⁷ There could also be networking benefits insofar as there is an established body of law overseas addressing the business form's governance.

Nevertheless, it is argued that this alternative has negative implications for closely held businesses. Firstly, the wider choice may lead to an 'array' of business forms, and this

⁸³ An ILP requires at least two members, one general and one limited: *Partnership Act 1892* (NSW), s 53C; *Partnership Act 1958* (Vic), s 96; *Partnership Act 1891* (Qld), s 84; *Partnership Act 1963* (ACT), s 66; *Partnership Act 1891* (SA), s 51C; and *Partnership Act 1997* (NT), s 64.

⁸⁴ *Partnership Act 1892* (NSW), ss 66A and 67A; *Partnership Act 1958* (Vic), ss 97 and 98; *Partnership Act 1891* (Qld), ss 86 and 87; *Partnership Act 1963* (ACT), ss 67 and 68; *Partnership Act 1891* (SA), ss 64A and 65A; and *Partnership Act 1997* (NT), ss 65 and 66. Of course, an active member could be a general member, but then they would have liability exposure. The safe harbour provisions in terms of limited liability appear to be based on the Delaware limited partnership model, even though the *Uniform Limited Partnership Act (2001)* in the United States has removed altogether the exclusion of limited members from participating in management.

⁸⁵ However, there is merit in making ILPs available beyond venture capital investment, as it appears artificial to restrict their utilisation to just venture capital investment. This is particularly given the fluid nature of what exactly is venture capital investment, see: Barkoczy and Sandler, n 38.

⁸⁶ Note currently the special tax rule companies studied, S Corporations and LAQCs, are not entities covered by the CFC hybrid amendments. S Corporations and LAQCs do not come within the term 'foreign hybrid company', since neither the United States or the New Zealand tax system treat them for tax purposes 'as a partnership': *ITAA 1997* (Cth), s 830-15(2)(b).

⁸⁷ McCahery JA, "Introduction: Governance in Partnership and Close Corporation Law in Europe and the United States" in McCahery J, Raaijmakers T and Vermeulen E (eds) *The Governance of Close Corporations and Partnerships: US and European Perspectives* (Oxford University Press, 2004) p 186-187.

could easily lead to 'inconvenience' and complexity.⁸⁸ This position could be exacerbated by Australian professionals' (lawyers, accountants and financiers) unfamiliarity with the foreign law, leading to greater uncertainty costs. For example a financier may require greater returns on credit or greater security to offset the potential uncertainty.⁸⁹

Furthermore, when dealing with a foreign form there may be continuing tax and other regulatory obligations in the foreign jurisdiction where the business form was initially established – even if that business form only trades in Australia.⁹⁰ Compliance with a foreign jurisdiction's law could thus be costly, as foreign advisers may have to be appointed to supplement the Australian advisers. This uncertainty and complexity is of concern – particularly for closely held business – as compliance costs can be regressive if their operations are small.⁹¹

Moreover, this uncertainty may inhibit the ability to raise equity, as members may be reluctant to invest in a business governed by foreign law. Further, the potential for networking benefits may be restricted if the transparent company was only recently established overseas. This is compounded if the foreign case law is not followed in Australia or if Australian regulatory rules are overlaid. In view of this, it is argued that the interaction between foreign and domestic law may outweigh any perceived benefits.⁹² In this context, there could be some associated issues about the overall suitability of the governance laws, especially for LLPs, for closely held businesses.⁹³ For

⁸⁸ McCahery JA and Vermeulen EPM, "The Evolution of Closely Held Business Forms in Europe" in McCahery J, Raaijmakers T and Vermeulen E (eds) *The Governance of Close Corporations and Partnerships: US and European Perspectives* (Oxford University Press, 2004) p 220.

⁸⁹ Of course, it may be that the potential benefits outweigh these additional costs.

⁹⁰ Such as annual filing requirements.

⁹¹ Evans C, Ritchie K, Tran-Nam B and Walpole M, *A Report into Taxpayer Costs of Compliance*. (AGPS, 1997).

⁹² McCahery JA and Vermeulen EPM, "Business Organization Law and Venture Capital" in edited by McCahery J and Renneboog, L (eds) *Venture Capital Contracting and the Valuation of High-technology Firms* (Oxford University Press, 2003) p 174. Jersey has failed to attract foreign businesses to utilise its LLP due to high switching costs. It is such inter-jurisdictional transaction costs that hinder Ribstein's premise of jurisdictional competition leading to an evolution of businesses forms: Ribstein LE, "The Evolving Partnership" in McCahery J, Raaijmakers T and Vermeulen E (eds) *The Governance of Close Corporations and Partnerships: US and European Perspectives* (Oxford University Press, 2004).

⁹³ In this respect, it is argued that the governance framework of the United Kingdom's LLP is problematic for closely held businesses. This difficulty may be attributed to the fact that LLPs were initially designed for professional firms with a sophisticated membership. For example, the LLP default rules have been criticised as 'rudimentary' and the LLP legislation is drafted on the assumption of member-management by all members, with a minimum of two members.

these reasons it is argued that extending Australia's existing transparent companies is not the preferable approach to facilitate the broad availability of tax transparent company in Australia.

1.5.2 Australia's own 'new form transparent company'

Another alternative model for the broad introduction of a transparent company in Australia is for the various State governments or the Federal government to enact their own new form transparent company based on a governance regime similar to that of either LLCs or LLPs. Which tier of government would enact the relevant regulatory legislation would depend in part upon whether the Federal government's constitutional powers extended to enacting for LLCs or LLPs as 'corporations'. Currently the Federal government, through agreement with the states, has power to legislate for corporate formation and governance, but has no power over formation of partnerships and trusts.⁹⁴ It was for these constitutional reasons that the states, rather than the Federal government, enacted the governing legislation for venture capital ILPs. Given the combination of partnership and corporate characteristics of these new form transparent companies, the states are likely to have the relevant constitutional powers. However, their income tax treatment would rest with the Federal government through the income tax assessment acts.

This alternative, Australia's own new form transparent company, could provide members with a business form with liability protection which, nevertheless, would have distribution rules to protect creditors. The governance of such a new form could be designed to provide a superior framework for closely held businesses. It is argued that the governance rules should provide for the following characteristics of closely held businesses: single or multi-membership, member-management, transferability of

⁹⁴ All Australian states passed legislation referring their powers to the Commonwealth. New South Wales was the first State to do this with the *Corporations (Commonwealth Powers) Act 2001* (NSW). The referral legislation contains a sunset provision, terminating five years after the commencement of the new corporations' legislation unless the States agree to extend it.

membership interest and a default set of standard rules that could be altered through a membership agreement.⁹⁵

The creation of Australia's own new form transparent company may provide greater clarity about its governance, compared with the prior alternative of utilising foreign forms. With a default set of standard rules, networking benefits could be provided as relevant case law develops, although an initial degree of uncertainty may result until familiarly grew and a body of case law was established.

Part of this uncertainty could relate to the 'blending' of general partnership and corporate law in terms of the governance. However, this has already occurred to a certain extent with closely held corporations, and it may be preferable to have the blending of principles originating from the legislation creating the business form, rather than from a situation where members' agreements and the governing law are blended.⁹⁶

An important attribute to improve certainty would be the confirmation that tax transparency applied to this business form with company attributes. This would require the Federal government to alter the current tax law to ensure this.⁹⁷ Uncertainty surrounding the tax treatment of LLCs in the United States saw only two states enact LLC legislation prior to the 1988 tax ruling specifying its tax treatment. The improved certainty provided by the 1988 tax ruling, led to the remaining 48 states and the District of Columbia enacting LLC legislation within six years.⁹⁸

⁹⁵ An important issue for closely held businesses is compliance with the governance regime that regulates the business form. This can be because the governance regime can be drafted for when membership is widely held, with non-active members and a separation between management and members. Such characteristics are not indicative of many closely held businesses, and therefore they can be an 'ill fit'.

⁹⁶ If blending occurs within the legislation, then future networking benefits may be established when case law develops around a standard set of 'blended' legislated principles. 'Networking benefits' refers to the idea that legislating for laws to govern business forms can reduce transactions costs. Callison JW, "Venture Capital and Corporate Governance: Evolving the Limited Liability Company to Finance the Entrepreneurial Business" (2000-2001) Fall 26 *Journal of Corporation Law* 97 at 117.

⁹⁷ Otherwise such a business form would be taxed as a corporation or a limited partnership.

⁹⁸ Between 1977 and the 1988 tax ruling that provided some certainty about the LLC's tax treatment, only two American states had introduced LLC legislation and less than 100 businesses filed as LLCs in Wyoming. After the 1988 tax ruling, LLC legislation was rapidly introduced by all American states within six years. Five years after the 1988 tax ruling, LLCs represented just 0.32 per cent of business forms lodging tax returns (excluding sole proprietorships). The certainty for LLC's tax treatment with the introduction of Check-the-Box in 1998 was further improved. In 1998

While there are a number of models that could be utilised for the development of this new form transparent company, of the two studied for this article, it is argued that the LLC governance regime is the preferable model for closely held businesses.⁹⁹ This model is most definitely the preferred paradigm, given that the United Kingdom's LLP governance has a number of characteristics that are problematic for closely held businesses.¹⁰⁰ Of course it would be beneficial to consider business forms in other jurisdictions beyond the analysis in this article.

While there are potential benefits of introducing a new form transparent company, these may be diminished by evidence that would tend to indicate that new form transparent companies could result in greater tax compliance cost, which could be regressive for small businesses.¹⁰¹ It is for this reason that the introduction of a special tax rule company deserves greater attention.

1.5.3 Australia's own 'special tax rule company'

Another alternative to make tax transparent companies broadly available in Australia is the introduction of a special tax rule company with full transparency. This model could be similar to S Corporations insofar as members and managers would elect for tax transparency, rather than the corporate imputation system. To reinforce this argument, the ICAA proposal put forward a model similar to S Corporations, extending unit trusts as well.¹⁰² In terms of S Corporations there are a number of eligibility requirements for tax transparency, including one class of membership interest; residency of the business form and/or members; and trading activities.¹⁰³ It is argued that provided an adequate loss restriction rule applies then the eligibility restrictions need not be so severe.¹⁰⁴

LLCs represented 7.10 per cent of all business forms lodging tax returns. By 2003 this had increased to 14.14 per cent.

⁹⁹ This is a sentiment shared by other commentators: McCahery and Vermeulen, n 88, at p 195.

¹⁰⁰ For example the LLP has no standard set of comprehensive default rules, requires at least two members, and has members' duties regardless of their involvement in the business. This topic will be the subject of a forthcoming article by the author.

¹⁰¹ DeLuca, Greenland, Guyton, Hennessy and Kindlon, n 65.

¹⁰² Institute of Chartered Accountants in Australia and Deloitte, n 24.

¹⁰³ *IRC 1986 (US)*, s 1361. For S Corporation status to be obtained: a) the corporation itself and its members must be United States residents, b) there must be only one class of membership

Also, if a special tax rule company was introduced, reliance on existing corporations law may reduce the potential uncertainty cost.¹⁰⁵ This may mean that the introduction of a special tax rule company is easier to facilitate in Australia due to lower costs. However, the benefits of such a model for closely held businesses would depend upon, in part, the appropriateness of the underlying corporation law.

The pursuit of this alternative in Australia would have a number of advantages. Firstly, it would allow taxpayers to have networking benefits in terms of utilising an established business form, the corporation, with its existing body of case law and understanding in terms of governance. This alternative would address, in part, concerns that new transparent company forms create increasing uncertainty.¹⁰⁶

Furthermore, it would be possible to have single membership¹⁰⁷ with member-management not prejudicing liability protection for members.¹⁰⁸ Related to this is the fact that membership interest could be freely transferable or restrictions imposed if desired. If the argued eligibility requirements were adopted then the on-going monitoring cost should be mitigated, although the loss restriction rules would need to be satisfied. Such a vehicle would allow potential listing on a stock exchange if desired in the future. Upon listing the underlying business form would not change, but the applicable tax rules would alter from tax transparency to the corporate imputation system. In terms of finance, while a special tax rule company would facilitate the raising of equity, the tax benefits of transparency compared to imputation may be minimal.

interest, c) membership must not exceed 100, and d) there must be a valid election for S Corporation status. Additionally, certain trading activities and asset holdings are prohibited

¹⁰⁴ The complexity of a tax transparency regime could be mitigated by adopting the following eligibility criteria: that the membership interests are not publicly traded; that a majority election exists by members (and managers); and that, if the business form is resident in another jurisdiction, then tax transparency applies there. Additionally, there could be the option to exclude certain tax integrity measures if one class of membership interest exists.

¹⁰⁵ Cost could be in terms of uncertainty and tax compliance.

¹⁰⁶ Freedman J, "Limited Liability Partnerships in the United Kingdom: Do They Have a Role for Small Firms?" in McCahery J, Raaijmakers T and Vermeulen E (eds) *The Governance of Close Corporations and Partnerships: US and European Perspectives* (Oxford University Press, 2004) p 512.

¹⁰⁷ *Corporations Act 2001* (Cth), s 114.

¹⁰⁸ Although such activity may expose an active corporate member to liability in other capacities, such as a director or an employee.

However, in addition to the flow-through of tax losses and preferences, there would be benefits in certain avoidance provisions not applying, such as Division 7A¹⁰⁹ and the personal services income provisions.¹¹⁰ Other complex provisions that need not necessarily apply to a transparent company could include share value shifting,¹¹¹ tracing capital gain discounts,¹¹² and tracing rules for capital assets acquired prior to 20 September 1985.¹¹³ Furthermore, a tax transparent company could provide an alternative path of tax consolidations, which is often problematic for small businesses.¹¹⁴ While ‘tax benefits’ of themselves should not be a driving motivation of a transparent company, such a consequence reflects the cynical observation that special tax rule companies could be seen as a ‘carve out’ for closely held businesses from the normal tax rules applying to corporations.¹¹⁵

Another tax concession potentially available is that FBT would not apply to benefits provided to member-managers, thus decreasing compliance cost particularly if there are no other employees. This concession is on the proviso that active members are treated as self-employed. However, certain fringe benefits are concessionaly taxed, so this treatment could increase the tax impost for active members of a transparent company compared to active members of a corporation subject to an imputation system.

A problem with this alternative is the suitability of the Australian corporation for utilisation by closely held businesses, although this has not stopped many businesses utilising this form. Even with the improvements of the Corporations Act simplification program, there are still criticisms that a corporation’s internal governance rules are too onerous for

¹⁰⁹ *ITAA 1936* (Cth). Div 7A was, introduced (effective from 4 December 1997) to address the practice by private corporations of effectively distributing profits to members, or associates of members, via non-assessable payments, loans or forgiven debts. When Div 7A applies to a payment, loan or forgiven debt, under s 109D of the *ITAA 1936*, an amount is deemed to be a dividend paid by the private corporation to a member, and is then assessable income for the member.

¹¹⁰ *ITAA 1997* (Cth), Div 84 to 87. The operation of these provisions restrict taxpayer’s ability to shelter personal services income in an entity taxed at a lower rate, to split income among a number of taxpayers, and the ability to access concessional fringe benefits and superannuation provided to employee-members. *ITAA 1997* (Cth), s 86-15.

¹¹¹ *ITAA 1997* (Cth), Div 723 to 727.

¹¹² *ITAA 1997* (Cth), s 115-40.

¹¹³ *ITAA 1997* (Cth), CGT event K6.

¹¹⁴ Institute of Chartered Accountants in Australia and Deloitte, n 24, at p 10.

¹¹⁵ This carve-out includes the direct allocation of losses, as well as in the United States relief from the entity tax system applying to C Corporations; and in New Zealand the flow-through of exempt capital gains to members.

closely held businesses.¹¹⁶ It is argued that it would be preferable, in the process of introducing a special tax rule company to take the opportunity to critically evaluate whether the current governance rules provided by the Corporation's Law are appropriate for closely held businesses. It may be that new governance rules starting from a general partnership model be created.¹¹⁷ Indeed it may be worthwhile reconsidering the benefits of the *Close Corporations Act* which was 'lost' in the constitutional challenges of the early 1990s.¹¹⁸ Another relevant point to note here is that there could be a greater role of membership agreements in making the corporations law more appropriate. It is argued that the jurisdictions studied would have benefited from such a holistic approach when introducing their special tax rule companies.

The ICAA proposal argues for such a special tax rule company; while the author sees some merit in this proposal, there are a number of concerns with it, including the applicable loss restriction rule; lack of entity acknowledgement; eligibility requirements; and failure to consider underlying governance rules.

The ICAA proposal suggests that the venture capital ILP loss restriction should apply to its suggested transparent company based on simplicity grounds.¹¹⁹ However, in the proposal, the reasoning for this is not explicitly articulated with any clarity nor, indeed, does it consider the adequacy or efficacy of the restriction in any meaningful way. It is

¹¹⁶ Farrar JH, *Corporate Governance in Australia and New Zealand* (Oxford University Press, 2001); Whincop MJ, "Trivial Pursuit: A Theoretical Perspective on Simplification Initiatives" (1997) 7 AJCL 250 and Hill J, "Close Corporations in Australia: The Close Corporations Bill 1988" (1989) 15 *Canadian Business Law Journal* 43 at 49.

¹¹⁷ It is such a perspective that current corporations law reform is occurring in the United Kingdom in terms of the *Companies Act 2006* (UK). The *Companies Act 2006* (UK) is to be introduced in stages which are estimated to be complete in October 2009.

¹¹⁸ In the late 1980s the Australian government attempted to introduce the *Australian Close Corporations Act 1989* (Cth), which provided for a distinct corporate model for closely held businesses. However, when the suite of legislation was ruled by the High Court as being unconstitutional, the *Close Corporation* rules were subsequently removed in the negotiations that occurred between the states and the Federal government. Lipton P and Herzberg A, *Understanding Company Law*, 11th ed. (Pyrmont: Lawbook Co, 2003) p 4: "This approach to the interpretation of s 51 (xx) was followed by the High Court in *New South Wales v Commonwealth* (1990) 8 ACLC 120. This case concerned a challenge by several States to the constitutional validity of certain sections of the Commonwealth Corporations Act 1989 which provided among other things for the incorporation of trading and financial corporations. By a six to one majority, the High Court held that s 51(xx) did not empower the Commonwealth to make laws with respect to the incorporation of trading and financial corporations. Consequently, provisions that related to incorporation were invalid".

¹¹⁹ Institute of Chartered Accountants in Australia and Deloitte, n 24, at [3.15.6].

argued that the CFC hybrid rules are not significantly more complex than the venture capital ILPs. It has been argued that the CFC hybrid rules are more comprehensive than the venture capital ILPs rules, and are the more appropriate loss restriction rules with recommended amendments.¹²⁰

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,¹²¹ with members of the proposed flow-through entity having direct fractional interest in the CGT assets held.¹²² This means that changes in membership can potentially trigger partial disposals.¹²³ It is submitted that this full aggregate approach could impose greater complexity for Australian businesses, particularly if there are large asset holdings. As an alternative, it is argued that some entity acknowledgement is preferential while overall still achieving a level of transparency.¹²⁴

The ICAA proposal largely overlays general partnership tax principles for its flow-through entity. It is argued that this is not preferable, as the superimposing of partnership tax rules could be awkward when applied to a business form with separate legal entity status and limited liability for members. Instead, having particular tax rules drafted for a transparent company could mitigate uncertainty.

For example, it is argued that unnecessary tax compliance costs arise for the United States' LLCs because they are taxed pursuant to Sub-Chapter K of the *Internal Revenue Code 1986* (US), which was drafted for general partnerships characterised by no liability protection for members. The differences between business forms mean that the

¹²⁰ Freudenberg B, n 57.

¹²¹ Institute of Chartered Accountants in Australia and Deloitte, n 24, at [3.18.1].

¹²² Institute of Chartered Accountants in Australia and Deloitte, n 24, at [3.18.2].

¹²³ Also in terms of revenue assets held, such as depreciating assets, trading stock and work in progress, changes in membership can cause disposal. However, there is the potential for rollover relief to disregard these disposals in certain circumstances: depreciating assets [*ITAA 1997* (Cth), s 40-340(3)]; trading stock [*ITAA 1997* (Cth), s 70-100(6)]. Note to decrease the complexity due to direct fractional interests it is possible to hold the CGT assets outside of the general partnership – for example in a service trust. However, this concurrent use of business forms in itself increases complexity.

¹²⁴ This could be achieved by providing for tax calculations first at the entity level with subsequent allocations to members. This mechanism provides for one global calculation, rather than for a number of discrete individual ones, and is similar to what occurs for trusts in Australia in terms of CGT assets.

provisions of Sub-Chapter K do not adequately deal with the potential legal nuisances. This awkwardness in terms of the tax regime and a company structure is demonstrated by how an LLC's outside loan increases the membership cost basis despite the LLC member having no personal liability for the loan.¹²⁵ It is argued that if tax transparency is to be applicable to an entity that has limited liability and separate legal entity status, it is preferable to have provisions drafted specifically for it.

It is for a similar reason that a United States' style of Check-the-Box, allowing businesses to choose which tax methodology will apply to them is not advocated. It is argued that such a wide discretion is fraught with difficulties as the particular legal characteristics of business forms may require particular tax rules, otherwise unforeseen tax arbitrages may arise. A similar conclusion has recently been articulated in the United Kingdom.¹²⁶

Also the ICAA proposal suggested that its flow-through regime be restricted to entities that are private¹²⁷ with five or fewer members.¹²⁸ However, this low quantum of members is based on the proposal only extending to 'micro-SME groups',¹²⁹ to reduce the potential impact on tax revenue. It is argued that such a limitation is artificial and will lead to practices to circumvent the limitation anyway or alternatively unduly exclude entities from being eligible. Instead, it is argued that in terms of a membership restriction it should be based on the non-listing of membership interest rather than an exact quantum.¹³⁰

The ICAA proposal does not consider in any detail the suitability of the underlying governance framework of corporations and unit trusts to which the flow-through would apply; it considers only the tax rules. It is argued that a more holistic approach is

¹²⁵ Freudenberg B, n 57. Note this inclusion is then reversed out by the 'at risk' rule.

¹²⁶ Crawford and Freedman, n 3: suggest that for the United Kingdom an optional transparent system would just result in taxpayers seeking tax arbitrages.

¹²⁷ A 'private' entity based on a definition similar to that found in *ITAA 1936* (Cth), s 103A.

¹²⁸ Institute of Chartered Accountants in Australia and Deloitte, n 24, at [3.7.10].

¹²⁹ Institute of Chartered Accountants in Australia and Deloitte, n 24, at [3.7.10].

¹³⁰ 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. Therefore, in widely-held circumstances, an entity or an integrated tax system may be preferable. Harris, n 15, at p 44.

preferable, and the opportunity should be taken to examine the appropriateness of the underlying governance rules.

Furthermore, a negative factor with a special tax rule company 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 per cent, compared to the top individual marginal tax rate of 45 per cent plus 1.5 per cent Medicare levy. This means the allocation of income to members of an Australian transparent company could be subject to a greater rate of tax compared to profits accumulated in a corporation.

This may mean that the adoption of such a fully tax transparent company could increase the overall tax burden and thereby reduce the incentive for the 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.¹³¹

It is for all these reasons that a partial loss transparent company is advocated rather than a fully tax transparent company.

1.5.4 A partial loss transparent company

The interaction between corporate and individual tax rates is of particular importance given the financing problem that can confront closely held businesses and their reliance on funding from members. For this reason, it may be preferable to have a partial loss transparent company, similar to New Zealand's LAQC. In this way, when the Australian tax transparent company has income, profits would be initially assessed at the entity level at 30 per cent, with franking credits being generated on the income tax paid.

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

¹³¹ Burton, n 41.

would influence their ability to utilise any losses allocated by the partial loss transparent company.¹³² Such a mechanism would be consistent with the policy recommended by Pizzacalla to improve the capital of small and medium enterprises.¹³³

It is argued that such a partial loss transparent company would provide greater incentive for Australian investors to adopt transparency. Later distributions to members would either be franked or unfranked. 'Distributions' would include profit distributions, loans to taxpayers and the transfer of assets from the transparent company to the member. The inclusion of member loans would negate the need for Division 7A to apply to transparent companies. If a franked distribution was received, it would be assessable to members, with members offsetting their tax liability with franking credits.¹³⁴ 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.¹³⁵ Also such distributions would decrease a membership cost basis. However, there may be the 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 pay exempt 'unfranked' dividends.¹³⁶

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).¹³⁷

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

¹³² 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.

¹³³ Pizzacalla M, "Global SME tax policy conundrum" (2008) 23(1) *Australian Tax Forum* 40 at 85.

¹³⁴ Such distributions would decrease the membership cost basis.

¹³⁵ 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.

¹³⁶ For a discussion about asset revaluation reserve distributions see: Freudenberg, B, "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) *AT Rev* 150.

¹³⁷ Freudenberg B, n 57.

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 per cent. It is such an idea advocated by the Australian mining industry for a flow through share.¹³⁸

Indeed, instead of introducing two discrete transparent regimes, one for closely held businesses and the other for the mining industry, a partial loss transparent company could be a universal transparency regime in Australia.

It is argued that a partial loss transparent company achieves a result similar to the Danish dual tax company system,¹³⁹ which allows re-invested unincorporated business income to be taxed at the corporate rate, with only distributions taxed at the individual marginal tax rates.¹⁴⁰ 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.

¹³⁸ Association of Mining and Exploration Companies, Australasian Institute of Mining and Metallurgy, Australian Securities Exchange, Australian Shareholders Association, The Chamber of Minerals and Energy of Western Australia, Minerals Council of Australia, Queensland Resources Council and South Australian Chamber of Minerals and Energy, *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, at pp 12 – 15.

¹³⁹ Also known as the dual tax system.

¹⁴⁰ Sorensen PB, "Recent Innovations in Nordic Tax Policy: From the Global Income Tax to the Dual Income Tax" in Sorensen, P (ed) *Tax Policy in the Nordic Countries* (MacMillan Press Ltd, 1998); Ganghof S, "Adjusting National Tax Policy to Economic Internationalization: Strategies and Outcomes" in FW Scharpf and V A Schmidt (eds) *Welfare and Work in the Open Economy* (Oxford University Press, 2000) p 619. However, recent research argues that such a dual system can lead to distortions in investment decisions: Kari S and Karikallio H, "Tax treatment of dividends and capital gains and the dividend decision under dual income tax" (2007) 14 *International Tax Public Finance* at 427-456. To address this Norway adopted a residents' shareholder income tax with a rate of return allowance (the RRA) in 2006: Crawford and Freedman, n 3, "the RRA exempts all shareholder income (including both dividends and realised capital gains, which are treated identically) below an imputed normal rate of return on the share basis (the RRA) at the personal level, as this income has already been subject to corporation tax (at a rate corresponding to the capital income tax rate) and should therefore should not be further taxed. The share basis in any given year is defined as the sum of the original share cost plus all unutilised RRAs from previous years: this is equivalent to carrying forward retained profits (postponed capital gains tax liabilities) with a normal return to ensure that only capital gains in excess of the normal return are subject to taxation at the higher labour income rate". A problem with this that there are still distortions between debt and equity funding.

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.¹⁴¹

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.

While a conduit principle would not be directly evident,¹⁴² the treatment of unfranked dividends as exempt income would allow tax preferences to flow through to members.¹⁴³ While such a partial loss transparent company would not be able to access the 50 per cent discount on capital gains provided to individuals, the corporate tax rate of 30 per cent is comparable to the 50 per cent of the highest marginal tax rate applying to individuals (plus Medicare levy).¹⁴⁴

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

¹⁴¹ A similar consequence would follow in respect of superannuation contributions made on behalf of an active member.

¹⁴² That is, capital profits realised at the entity level would not retain their capital nature on distribution to members.

¹⁴³ 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 as an unfranked dividend.

¹⁴⁴ Assuming an individual is on the highest marginal tax rate, then the effective tax rate on a discounted capital gain is 23.25 per cent.

profit not covered by franking credits.¹⁴⁵ Of course disadvantages with this option need to be acknowledged. For example, there could be increased complexity due to measuring the membership cost basis (including altering it for retained profits within the entity).¹⁴⁶ Furthermore, in New Zealand the possible repeal of the LAQC regime has been raised a number of times.¹⁴⁷ However, it is argued that this is due to inadequate loss restriction rules applying to LAQCs.¹⁴⁸ Given the loss restriction rules argued for this should not be the circumstance in Australia.

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.

1.6 Conclusion

Tax transparent companies represent for economists the theoretical 'ideal' model of taxing business forms. However, in striving for this economic ideal to achieve greater tax neutrality, it is important for a jurisdiction to consider the practical applications of such reforms. It needs to be recognised that reform is an 'intellectual, a legal, and a political one'.¹⁴⁹ For example, lawyers and accountants can identify difficulties in how tax transparent companies can be implemented, although foreign practice indicates that is possible. Given the possible benefits that tax transparent companies may represent, it is important that there is greater economic and legal collaboration, as 'development of a sound reform strategy requires a merging of these two approaches'.¹⁵⁰

¹⁴⁵ 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.

¹⁴⁶ A similar proposal in the United States was considered too complex, and instead a basic 15 per cent concessional rate was introduced.

¹⁴⁷ For the most recent consideration see: Cullen and Dunne, n 82.

¹⁴⁸ Freudenberg, n 20.

¹⁴⁹ Weidner DJ, "Pitfalls in Partnership Law Reform: Some US Experience" in McCahery J, Raaijmakers T and Vermeulen E (eds) *The Governance of Close Corporations and Partnerships: US and European Perspectives* (Oxford University Press, 2004) p 370.

¹⁵⁰ Bevin P, *How Should Business Be Taxed? An examination of defects in business taxation and suggestions for reform* (Victoria University Press, 1985) p 67.

This article has sought to critique the ICAA proposal as being considered by the Henry Review to ascertain whether it is the 'ideal model' to achieve a tax transparent company for Australia. Initially it was questioned whether overall there would be much gained through the introduction of a transparent company given the current structure of the Australian tax system. Also, it was observed that rather than transparency necessarily being a benefit to closely held businesses, that it is in closely held circumstances that the implementation of a transparent regime is more feasible for a jurisdiction.

The alternative models of introducing a tax transparent company in Australia were explored. This analysis canvassed broadening Australia's existing transparent company forms, introducing a new form transparent company or a special tax rule company, and, finally, the preferred approach of a partial loss transparent company. It was argued that a partial loss transparent company was the preferred model due to the interaction between corporate and individual tax rates, the ability to accumulate profits within the business form, and the ability to pass through tax preferences and losses to members.

A concern expressed about some of the foreign transparent companies studied was that their introduction was 'not particularly well informed'.¹⁵¹ This article contributes to a greater understanding and appreciation by 'lifting the veil' on several aspects. It is with such an informed perspective that the potential consequences of striving for tax neutrality can be understood and this understanding may, in turn, inform improved policy development. While it is admirable for a jurisdiction to strive for greater tax neutrality, in striving for a model idea it is critical to look to the future to ascertain exactly what will be achieved.

¹⁵¹ Freedman, n 106, at p 303.