Law Council
OF AUSTRALIA
Business Law Section

Tax White Paper Task Force
The Treasury Langton Crescent
PARKES ACT 2600
Via email: bettertax@treasury.gov.au

1 June 2015

Dear Sir or Madam,

Re-think: Tax Discussion paper

Small business – Chapter 6

Introduction

The Law Council of Australia (**Law Council**) is the peak national body representing the legal profession in Australia.

The following submission is made by the SMS Business Law Committee of the Business Law Section of the Law Council of Australia (**Committee**) in response to Chapter 6 ("Small Business") of the Tax Discussion Paper – Re:think released in March 2015 (**Paper**).

It is noted at the outset that the Taxation Committee of the Business Law Section (**Taxation Committee**) has lodged a submission in response to the Paper as a whole.

This submission is intended to be read in conjunction with the Taxation Committee submission and to address in particular the issues and queries raised for discussion in the above Chapter with regard to those aspects of the Australian tax system that impact on small businesses and their owners.

It is further noted at the outset that the Taxation Committee made a submission to the Board of Taxation in May of 2014 concerning some of the issues touched upon below. A copy of that submission is **attached.**

Preliminary observation – different imperatives of ownership and operation from large business

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Tax is a significant cost to business and will inevitably play a role in considerations concerning the structuring of small business entities and the conduct of small business transactions.
However, the impact of the tax system in terms of the decision-making processes of small business operators and the costs of compliance will depend to a considerable extent on the manner in which that system identifies and accommodates the structural and commercial imperatives which apply to small business operations.

In particular, it is important to appreciate from the outset that an essential characteristic of small businesses generally is that the assets and undertakings of those businesses are essentially seen as extensions of the assets and undertakings of the individuals and families who conduct them.

It is submitted that unless and until this fundamental aspect of small business operation is properly taken into consideration when identifying the policy considerations and setting the operational framework of the tax system going forward, the interface between small business operators and that system will continue to be problematic.

On the other hand, it is submitted that if this distinction is borne in mind when framing a system in which taxes are to be lower, simpler and fairer, many of the problems which currently confront small businesses in their tax affairs can be adequately addressed.

Relevant principles

The Committee considers the following principles to be of central importance to the operation of a small business from a tax perspective:

1. A rate of tax which enables the small business to be competitive in an increasingly global environment;
2. The ability to apply or accumulate current year income of the small business to fund working capital at a concessional rate of tax;
3. The option for "flow through" taxation treatment for taxation of income, capital gains (without any priority differentiation such as a "profits first" rule) and application of losses (including the ability to apply losses retrospectively and thus have the opportunity to obtain the tax benefit in the year in which the loss is realised);
4. Limitation of liability and the ability to conduct different businesses or different aspects of business through separate entities which can be readily treated as a group;
5. Flexibility in the distribution and utilisation of income , capital and losses amongst group entities;
6. The reporting requirements for the preparation of tax returns to be consistent with the small business' financial accounts as prepared from standard accounting packages;

The Committee further considers a fundamental principle for the formulation of a taxation system framework within which the above principles should operate requires that framework to be based upon commercial structures and business practices that are determined by the market place and the operation of the rule of law, rather than upon legislative constructs which best suit the collection of revenue.

Commentary and examples of issues which inform those principles are set out below.

Rethinking business structures

In the absence of any stated policy alternative, the Committee has assumed in the comments below that Australia will continue to have a system based on progressive taxation as far as individual income tax is concerned.

Under that system there will be tension between taxation of certain business entities at fixed rates and individual taxation at higher and lower marginal rates.

In terms of the application of company tax to small businesses, subject to the comments below (concerning the interface with discretionary trusts), the Committee is of the view that the dividend imputation system works well and delivers equitable outcomes.

However for many small businesses, the ability to operate on the basis of a “flow through” of income and losses directly to the desired recipients provides both simplicity and the benefits of offsetting losses against other sources of income. This is often particularly the case in the establishment period of a small business.

The Committee sees merit in considering the proposal for the creation of a new “small business entity” at law. It is understood that such an entity would combine some of the characteristics of a partnership with limited liability and would be treated for tax purposes in the same manner as a partnership.

However the Committee is of the view that taxation alone should not be the motivation for the establishment of such an entity and that there must be demonstrable commercial benefits beyond tax if that proposal is to be advanced.

The Committee’s preferred view in terms of an initiative for further consideration is for companies which carry on small businesses to be able to “tick the box” to be able to elect to be taxed on a “flow through” basis similar to partnerships (i.e. in a manner similar to “S-Corporations” in the United States).

However, as with the “small business entity” proposal, careful consideration will need to be given to how the attribution of a tax liability to the ultimate recipients is to be matched with an entitlement to the proceeds under the constitution of the entity which is making that attribution.

The Committee is of the view that the primary objective of structures should be the performance of a commercial function with clearly-defined legal rights and obligations in place for persons who participate in those structures. Taxation treatment should not be the primary objective for creating a new form of entity.

Whatever structural options are considered, it will be important to bear in mind that small businesses are commonly conducted as “grouped” entities in which, for asset protection purposes, operating assets are held in one entity and business(es) are conducted through one or more different entities.

The Committee is of the view that transfers of income and assets between members of such groups should be treated in a “neutral” manner for income and capital gains tax purposes.

The Committee submits that in the case of family and other closely held groups, the determination of the membership of the relevant group tends to be self-determining and should not require excessive definition or "integrity" protection beyond its definition.[1]

For example, in the case of discretionary trusts with wide classes of beneficiaries, the proper test for whether a beneficiary is or is not an "outsider" of the relevant group can readily be ascertained by applying the test which underlies section 100A of the *Income Tax Assessment Act 1936* (**36 Act**) – namely whether, to receive a distribution, that person is required to provide some consideration or reimbursement.

Current structures as a fall-back alternative to a total rethink

The evolution of current small business structures using combinations of family discretionary trusts (or partnerships of discretionary trusts) and proprietary companies has demonstrated a practical response by small business owners to some of the hurdles faced by them under the existing tax regime.

In particular, an increasingly-common structural adaptation in recent years involves the use a family discretionary trust having a proprietary company as trustee (to provide limited liability) and another proprietary company as a beneficiary, to which distributions of income can be made (to fund working capital of the business using funds taxed at the 30% corporate rate).

This can be a complex and costly solution for a small business. However it offers an effective solution to many of the tax difficulties posed by the current tax system and may ultimately prove to be no more expensive than the alternatives to be considered under a re-thought regime.

However, that current complexity is added to by the overlay of the administrative regime now imposed by the Commissioner of Taxation under Tax Ruling TR 2010/3 and Practice Statement PS LA 2010/4 in respect of unpaid corporate beneficiary entitlements.

Nevertheless, in the absence of an acceptable comprehensive rethink of the tax treatment of small businesses based on the principles outlined above, the Committee is of the view that the following should be considered:

- allowing trading trusts to accumulate income at a concessional rate of tax (e.g. the corporate rate); and/or
- excluding unpaid present entitlements in favour of proprietary companies from being deemed to be "loans" for under Division 7A of the 36 Act.[2]

A significant driver of compliance costs - tax laws that do not reflect the operation of the market place but are instead predicated on requiring market place entities to conduct their affairs to suit revenue collection objectives.

The Committee submits that the preferred course for the taxation of business is for tax to be imposed having regard to the operations and structures of the market place.

[1] See comments below regarding the "trust loss" regime provisions
[2] This can be achieved by a simple amendment to section 109D(3) of the 36 Act.

The alternative course is to require market place entities and activities to be conducted under rules that suit revenue collection objectives.

The alternative course adds complexity to the tax system and increases compliance costs. The use of trusts as commercial entities has grown significantly since the year 2000, but the origin of their growth traces back to the 1960s and 1970s.

At that time, the “ratchet effect” of inflation on Australia’s tax brackets meant that many middle-class income earners were shifted into the “high income” bracket (around 60%).

In the absence of Government response to relief from tax rates imposed at that level, the emergence of a trading entity that enabled income to be distributed in a manner which minimised the tax impact is not surprising.

However, the broader benefits of the use of trusts as flexible commercial entities - particularly for family businesses - became increasingly apparent over time and has resulted in their on-going popularity as small business entities.

Consequently, discretionary family trusts and unit trusts are now an established feature of the market place and must be addressed as such.

The Committee acknowledges that specific integrity provisions are necessary to some extent to supplement a general anti-avoidance provision within a system of progressive taxation.

The Committee further acknowledges that there are significant social policy merits in maintaining a progressive tax system.

However, the Committee considers that there has been an increasing tendency over time for taxation legislation to focus on integrity outcomes.

Put shortly, there are aspects of our current tax system where the fiscal tail now wags the commercial dog.

This has particularly been the case with trusts and can be illustrated by reference to the their treatment under the “integrity” provisions of the tax Acts discussed below:

- The “trust loss” provisions of Schedule 2F of the 36 Act which, amongst other things:
    - seek to apply concepts of “underlying ownership” to discretionary trusts which, by their nature as creatures of equity, have no such ownership;
    - create a concept of a *family trust* which bears little resemblance to that structure as it is commonly understood and applied to small business entities;
    - create a concept of *fixed trust* which conflicts with the commercial understanding of that term, particularly as it applies to unit trusts (which are commonly used as part of small business structures); and
    - impose *family trust distribution tax* at a penal rate to a concept of trust *distributions* which bears little resemblance to that word as it is commonly understood.

- The provisions dealing with the denial of franking credits[3] to franked dividends which flow through any discretionary trust that has not made a valid *family trust election* under the "trust loss" provisions discussed above*.*
- The rationale for this election having to be made is based on a perceived failure by discretionary trusts to be able to satisfy a *45 day holding period* rule for dividends*.*
- That rule was introduced as an integrity measure for the dividend imputation regime.
- The operation of that rule is determined by reference to a concept of *materially diminished risk* on shares which, in turn, is determined by reference to a defined concept based on a securities trading concept called a *delta*.[4]

The above provisions seek to attribute to trusts, as commercial entities, characteristics which are foreign to them and involve an inordinate degree of unnecessary complexity in doing so.

The Committee recommends that in any rethink of the tax system, consideration should be given to accommodating structures as they operate in practice and as a matter of law, and to avoid seeking to characterise their operations in terms that suit revenue objectives.

Reduced small business tax rates and small business concessions

The Committee has some concerns about determining the relative values and merits of trading off reductions in the tax rate for small businesses against some or all of the current concessions.

The Committee also considers that there are likely to be significant practical difficulties in effectively administering a regime based on a nil or a reduced rate of tax on small business incomes over the range of entities which currently occupy the small business space.

Further, if it is correct to assume that there will be no ability to incur deductible tax losses in a zero tax rate regime, this may itself be a disadvantage for many start-ups small businesses and farms facing difficult times.

In those cases, the absence of losses as a deduction against other income may have a serious adverse impact at a personal level.

With regard to tax concessions, the Committee is of the view that consideration of this aspect of tax policy may require departures from the track of pure economic logic.

Put shortly, the Committee believes that, in the perception of most small business operators, considerations based on the time value of money are unlikely to have the same impact as lump sum amounts. The prospect of the benefits of a reduced tax rate over time will invariably lose out to the prospect of a tax-free capital gain, notwithstanding that they may be of equal value.

The Committee notes that the small business CGT concessions are complex and that the advice concerning them can be costly to obtain. Further, the benefits are not received until towards the end of the life of the enterprise.

[3] Subject to a $5,000 exclusion.
[4] See section 160APHJ of the 36 Act, which was repealed in 2002, but which is incorporated by reference in the 97 Act by operation of S207-145(1)(a).

Nevertheless, the Committee urges that, leaving aside issues of perception, any suggestion of the removal of these concessions be approached with great care.

Although the matter may arguably fall more strictly into social policy than tax policy, the Committee notes that many small business operators provide inadequately for their retirement irrespective of the prevailing tax rate. Those operators are likely to continue to be dependent on capital gains from the sale of goodwill and other business assets being contributed into their superannuation funds upon retirement[5] .

Similarly, in the case farm management deposits and (to a lesser extent) averaging for farmers, those concessions fall more readily into the category of encouraging effective cash management planning and address concerns that will continue to exist notwithstanding a reduction in the tax rate for small businesses.

Further discussion

The SME Committee would be happy to discuss any aspect of this submission.

Please contact Coralie Kenny, the Chair of the SME Committee, on 0409 919 082 if you would like to do so.

Yours faithfully

John Keeves, Chairman
Business Law Section

Enc.

[5] under sections 292-100 and 292-105 of the 97 Act

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Ms Teresa Dyson
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3 June 2014

Dear Ms Dyson

Review of impediments facing small business

The Taxation Committee of the Business Law Section of the Law Council of Australia (**Committee**) notes that the Board is due to report to Government by 31 August 2014.

In view of the limited period for submissions, the Committee has addressed in detail three issues which merit consideration by Government to reduce tax impediments to the growth of small business. They are:

1. small business CGT concessions: the loss of those concessions on "passive" assets such as office premises provided for use in SME businesses when additional owners are added to those businesses;

2. anti –avoidance provisions: addressing provisions which currently hinder the ability of SME companies to restructure by demerger; and

3. taxation of SME entities: further consideration of "flow-through" election option for SME companies.

In addition to those issues, the Committee wishes to endorse the following issues raised at the recent meeting with Board representatives:

- the $6 million maximum net asset value and $2 million aggregated turnover thresholds have remained unchanged for a significant period and should be reviewed. The Committee considers that the preferred course would be for those thresholds to be amended annually;

- the confusion which currently exists regarding the engagement of contractors is a matter of ongoing concern. In particular, the Committee considers that the differences in the definition of "employee" for PAYG purposes under section 12-35 of Schedule 1 to the *Taxation Administration Act 1953* (which adopts the common law concept) and section 12(3) of the *Superannuation Guarantee (Administration)*

Act 1992 (which adopts a broader definition) should be harmonised in favour of the common law definition.

- in the second discussion paper to the Post-implementation Review of Division 7A, the Board noted that consideration may be given to providing specific tax relief for working capital requirements of SMEs generally. If such further consideration is given, the Committee would welcome the opportunity to make submissions on any proposals for reform.

SMALL BUSINESS CGT CONCESSIONS

Loss of CGT small business concessions for passive assets upon admission of new owners to SME businesses

The current CGT small business concession treatment of assets (**CGT Assets)** held in asset-owning entities and provided for use by SME businesses is an impediment to the growth of some of those businesses.

A typical example which illustrates the issue involves:

1. A two-person SME business partnership (**Business Entity**) in which, for liability protection purposes, an asset used in that business is held by a unit trust (**Asset Holding Entity**).

2. all of the interests in Asset Holding Entity are held by the family discretionary trusts of the two partners (**Associated Entities)**.

Such structures are common to SME professional partnerships (legal practitioners, accountants, medical practitioners, surveyors, radiologists etc). The partnership may comprise individuals, companies and/or discretionary trusts.

It is relevant to note at the outset that the issue is not limited to SME partnerships and assets held in unit trusts: the example is used for the purposes of illustration.

For the purposes of the example, it is assumed that:

1. the original partners hold their interests 50% each;

2. the Asset Holding Entity is a unit trust which owns the premises from which the partnership business is conducted; and

3. the Associated entities each hold 50% of the units in the Asset Holding Entity.

The CGT Asset may be supplied to the partnership under a lease or indirectly (e.g. by being leased to a service entity and provided to the Partnership on commercial terms under a licence or lease by that service entity as part of a broader service arrangement).

The problem

The partnership business wishes to expand by admitting a third partner to equal equity. The new partner's Associated Entity may or may not wish to acquire units in the Asset

Holding Entity (this will not affect the outcome for the purposes of this example). The problem that arises is that, unless the CGT Asset has already been held by the Asset Holding Entity for a sufficient period to have qualified as an *active asset,* then upon the admission of the new partner:

1. the CGT Asset will cease with effect from the time of admission to qualify for the small business CGT concessions under Division 152 as an *active asset*[1];

2. the units held by Associated Entities of the existing partners will also cease from that time to qualify for the small business CGT concessions, as they will not be *active assets* either; and

3. any units acquired by the new partner's Associated Entity will never qualify for the small business CGT concessions, as they can never be *active assets*.

The only way in which the business premises could access those concessions would be for it to be acquired by the partnership and be held "at risk" with other partnership business assets.
Therefore the problem in terms of access to the small business concessions emerges at two levels:

1. The business premises in the hands of the unit trust (i.e. the capital gains tax consequences arising on the disposal of the premises); and

2. The units in the unit trust in the hands of the Associated Entities (i.e the capital gains tax consequences arising on disposal of the units to the Associated Entity of an incoming partner or upon the ultimate winding up of the unit trust).

Why the problem arises

One of the basic conditions for a CGT asset to qualify for the concessions is for that asset to satisfy the *active asset test* [2].

A requirement for satisfying that test is that the asset must be an *active asset.*[3]

The addition of a further partner to the partnership will result in the business premises owned by the unit trust ceasing to be an *active asset.*

Office premises

For an asset which is owned by an entity that does not itself carry on a business to be an *active asset,* it must either be used or held ready for use in a business carried on:

- by an *affiliate* of the owner; or

- by another entity which is *connected with* the owner.[4]

[1] Under section 152-40 *Income Tax Assessment Act 1997*
[2] Section 152-10(d) *Income Tax Assessment Act 1997*
[3] Section 152-35 *Income Tax Assessment Act 1997*
[4] Section 152-40(1)(a)(i) and (ii) *Income Tax Assessment Act 1997*

Since the amendments made in 2009 to the definition of *affiliate*, a partnership cannot be an *affiliate* of another entity.

Therefore, to qualify for the small business concessions, the unit trust must be *connected with* the partnership.

An entity will be *connected with* another entity if:

- either entity controls the other entity in a way described in section 328-125; or
- both entities are controlled in a way described in section 328-125 by the same third entity.[5]

Under section 328-125, *control* of an entity is essentially determined by looking to a direct or indirect *control percentage* of 40% or more of distributions of income or capital.[6]

Accordingly, the link which connects the partnership and the unit trust for the purposes of the business premises being an *active asset* is to identify a common 40% *control.*

However an essential feature of the control predicated by section 328-125 is that it requires 40% *control percentage* in the unit trust and the partnership to be held by a single entity.

Therefore, in the case of a two partner firm and a unit trust in which the units are held as to 50% by each of the two family trusts of the partners, the 40% requirement will be satisfied.

However, once a new equal partner is added to the partnership (or, alternatively, if more than 20% of the units in the unit trust are sold to a third party) the common 40% *control percentage* in the “underlying” ownership of the two entities is lost.

As a consequence, the partnership and the unit trust cease to be *connected with* each other and the business premises cease to be an *active asset* which qualifies for the small business CGT concessions.

Units in the unit trust

For a unit in the unit trust to qualify for the CGT small business concessions as an *active asset,* 80% or more of all assets owned by the unit trust must be *active assets.*[7]

Concessional relief on any disposal of the units held by the two family trusts is therefore contingent on the unit trust being *connected with* the partnership.

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[5] Section 328-125(1) *Income Tax Assessment Act 1997*
[6] Section 328-125(2) *Income Tax Assessment Act 1997* Note that in the case of a partnership, the *control percentage* test is based solely on the *net income* of that partnership (section 328-125(2)(a)(ii). Accordingly, admitting an income partner with no equity rights may also result in the Partnership no longer being *connected with* the Asset Holding Entity.
[7] Section 152-40(3) *Income Tax Assessment Act 1997.*

Consequently, if the unit trust ceases to be *connected with* the partnership as a result of the admission of the new partner, the units held by the discretionary family trusts of the partners will cease to qualify as *active assets.*

The practical outcome of the existing provisions

The current position poses an impediment to well advised SME taxpayers expanding their businesses.

It can also result in harsh and unfair consequences for poorly advised SME taxpayers who proceed with their expansion and inadvertently lose the benefits of CGT concessions. It is a reasonable expectation that the partners in the above example will not discover that they have been disqualified from the concessions as a result of admitting the third partner until the time of disposal of the office premises arrives.

As a consequence, their retirement planning may be seriously compromised.

Contrasting the CGT treatment of passive assets held by individuals

The issue of passive assets held by individual family members and provided to a Business Entity has already been successfully addressed.

Where such assets are held by a spouse or child of an individual, the spouse or child are deemed by subsections 152-47(2) and (4) of the *Income Tax Assessment Act 1997* to be *affiliates of* or *connected with* that individual for the purposes of Subdivision 152 and of sections 328-110 to 328-125.

The use of entities, particularly trusts, to hold assets of SME participants is now commonplace in Australia.

It is submitted that a similar approach to section 152-47, which addresses passive assets held by an Asset Holding Entity and provided to a Business Entity, is also warranted.

Recommended amendment

It is submitted that the preferred treatment for passive assets which are held in entities and used in SME businesses involves identifying a more effective and commercial basis for identifying commonality between the Business Entity and the Asset Holding Entity than currently exists.

In particular, the problem lies with a test which currently requires a common 40% *control percentage* in those entities being held by a single third party entity.

What is required is a commonality test which allows for a group concept of ownership of one entity which is capable of holding 40% of the other entity.

It is submitted that, in respect of an entity which holds a passive CGT asset (**asset owner**) and which provides that asset directly or indirectly to be used or held ready for use by another entity in carrying on a business (**business entity),** the asset owner and the business entity be deemed to be *affiliates* of each other and *connected with* each other in the tax year in which a CGT event happens to that passive CGT asset if entities which each hold not less than a 20% *control interest* in the asset owner also hold collectively not less than a 40% *control interest* in the business entity.

To simplify application of the process, it is recommended that in the case of trusts and companies, an individual who is a *significant individual* of a trust or company for the purposes of section 152-55 should be taken to hold a 20% *control interest* indirectly in the ownership entity for the purposes applying the above provision.

The outcome of recommended amendment

In the example given above, the result would be that upon admission of a new partner to the Partnership and that partner's Associated Entity being admitted as a 1/3rd unitholder in the Asset Holding Entity[8], the respective 20% and 40% *control interest* requirements would be satisfied and the CGT Asset would be deemed to be an *active asset*.

Subject to the unit trust satisfying the 80% test in subsection 152-40, it would also mean that the units in the unit trust held by the family discretionary trusts would also qualify as *active assets.*

Effect on the maximum net asset value test

Because the provisions would be limited to extending the definition of *affiliate* and *connected with* to circumstances involving only the provision of passive assets to business entities, there would be no general broadening of the *maximum net asset value test* in section 152-15 – that test would only be broadened in respect of passive assets for which access to the small business CGT concessions was sought.

DEMERGER RELIEF

Section 45B impediments to SME groups obtaining demerger relief.

There are large SME family groups for whom consolidation for income tax purposes is inappropriate. Those unconsolidated family groups may consist of at least two corporate entities, where the entities are in a holding / subsidiary relationship. In other words, both entities are private companies, and the holding entity holds all of the equity interests in the subsidiary entity.

There may also come a time where, for reasons of succession, introducing external investors, or asset protection that the holding / subsidiary relationship must end.

Generally speaking, a demerger happens when the head entity declares a dividend to its shareholders, that is satisfied by the transfer of equity interests in the subsidiary entity which becomes the demerged entity, and the head entity shareholders, now also directly proportionately own shares in the subsidiary. There may be other means by which a demerger may occur, but this is the the most common form in an SME sense.

Prior to the introduction of the demerger rules in 2002 following the enactment of the *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Act 2002*, a demerger would have triggered the usual consequences where the

[8] And assuming that at least two of the Associated Entities that held units in the unit trust had *significant individuals* who were also partners in the partnership

shareholders would receive a dividend and the holding company itself a potential gain on the disposal of the shares.

However, since 2002, under Division 125 of the ITAA97, a demerger could potentially avoid the above consequences in the form of rollover relief and NANE treatment for a demerger dividend. (A reference to "demerger relief" is a reference to both the CGT and dividend relief provided as a consequence of the introduction of the demerger rules in 2002.)

The Explanatory Memorandum (**EM**) introducing the provisions said that relief applied to "genuine demergers", but did not define or characterise what might constitute a "genuine" as opposed to a "non-genuine" demerger. However the EM does state that a demerger that is directed at obtaining the dividend exemption would not be genuine and would attract the operation of section 45B as an integrity measure.

Section 45B

Section 45B acts to treat a "demerger benefit" or "capital benefit" as an unfranked distribution, where the Commissioner objectively assesses a relevant scheme in a similar fashion to that as required under Part IVA.

A plain literal reading of the legislation in Division 125 reveals no limitation in the nature of entities that are able to obtain demerger relief. Clearly they would, and should, apply to widely-held entities, but there is nothing that, conceptually, prevents a closely-held entity from applying the demerger rules and obtaining demerger relief.

Commissioner's discretion

Prior to 2008, a number of private rulings were published by the Commissioner, some of which provided demerger relief, but some rulings were issued, where the Commissioner advised that he would exercise his discretion under section 45B to treat a dividend as an unfranked distribution (for example, see PBR 63027).

A review of the private rulings indicates that where there are commercial imperatives that drive the demerger of a closely-held entity, the Commissioner is unlikely to exercise his discretion to invoke the operation of section 45B. However, where reasons are given that focus on the effect of the outcome of the transaction, the opposite is likely to be correct.

For example, in PBR 42233, the following commercial imperatives expected from a demerger were provided to the Commissioner in a private ruling that confirmed the efficacy of the demerger:

- Financing of trading activities;
- Funding of a company's activities;
- Manage management conflicts; and
- Flexibility

Contrast that with PBR 42233 to PBR 64808, where the shareholders of two entities were each to separately own and deal with their equity interests in both entities. In PBR 64808, the Commissioner advised that he would invoke the operation of section 45B.

In the June 2008 NTLG minutes, at Item 14, the scope of the demerger rules were discussed. The agenda item and response is reproduced:

> *There is much anecdotal discussion that the Tax Office has a position that the policy underlying demerger relief is such that it is not available to taxpayers that are not listed entities.*
>
> *Can the Tax Office confirm that this is the case? If not, what are the limitations the Tax Office believes the legislation imposes on non-listed entities which may limit their ability to access the measures?*
>
> *Meeting discussion*
>
> *Chief Tax Counsel, Kevin Fitzpatrick, led the discussion of this item.*
>
> *Clarification of members' concerns was sought. Members advised that there is a perception among tax practitioners that the Tax Office is of the view that demerger relief is not generally available to non-listed entities, despite some of the examples in Law Administration Practice Statement PS LA 2005/21 Application of section 45B of the Income Tax Assessment Act 1936 to demergers of an entity within the meaning of Division 125 of the Income Tax Assessment Act 1997.*
>
> *<u>During discussion it was agreed that it is more difficult for non-listed entities to satisfy the relevant provisions, including the non-application of section 45B</u>, and that the examples contained in the practice statement would be reviewed to include more relevant and practical examples in order to provide improved guidance.* (Emphasis supplied)

Since being amended in 2012, PSLA 2005/21 now provides for six different demerger scenarios that consider if section 45B would apply to deny demerger relief. Of the six scenarios, four involve close-held entities. Although limited in the factual scope of each scenario, there is some useful guidance to be found about the necessary circumstances present that would cause the Commissioner to deny demerger relief.

Nevertheless, there is a clear tension between the policy intent of the law and its drafting, and the Commissioner's ability to deny demerger relief in an SME context.

The Committee considers that demerger relief should be more broadly available to SME structures.

The Committee further considers that, as matters presently stand, the inherent uncertainty resulting from the Commissioner's broad discretion to deny demerger relief is an impediment to SME restructuring for purposes which should legitimately include, amongst other things, succession planning within family groups.

FLOW-THROUGH COMPANY TAXATION

Reconsideration in light of New Zealand experience

In April 2008 Deloitte and the Institute of Chartered Accountants in Australia (ICAA) made a joint submission[9] to government in relation to what is now known in New Zealand as a "look through company"[10].

The joint submission addressed "entity flow-through" (EFT) taxation and recommended that companies (and fixed trusts) with five (5) or fewer members should be able to elect that they be treated for income tax purposes, as a partnership of the shareholders (or beneficiaries). It was not proposed that any new form of company be created to give effect to the proposal. It was noted that Australia has long allowed look through treatment of certain foreign look through structures, under Div 830. The joint submission included draft legislation to give effect to the proposal.

Henry Tax Review

The Henry Tax Review, delivered its final report to government in December 2009, and Recommendation 38, was that "A flow-through entity regime for closely held companies and fixed trusts should not be adopted for now, but would merit further consideration if there is a move away from dividend imputation in the long run." The rational for this Recommendation is set out in the Appendix[11].
Since then, with effect from 1 April 2011, New Zealand has implemented a look though company system which is similar to that proposed by Deloitte and ICAA.

New Zealand experience

It is apparent that the Henry Tax Review did not foresee this development in New Zealand, and so its Recommendation 38 made five (5) years ago, now needs to be reconsidered in the light of the fact that New Zealand has such a new vehicle for small business, for the very reasons it is again proposed it should be introduced in Australia, and there is no published material, and indeed there is no anecdotal evidence, that the measures have been other than a success, although the drafting of the measures may need to be improved[12].

It is submitted that the Henry Tax Review's approach to look through entities was overly influenced by the significance that was attributed to the ability of the imputation system to

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[9] The joint submission was entitled "Entity flow-through (EFT) submission", and is available at: http://www.charteredaccountants.com.au/Industry-Topics/Tax/Publications-and-tools-NEW/Publications-and-tools/Entity-flow-through-EFT-Submission.aspx

[10] The New Zealand IRD has issued a publication "Look-through companies – A guide to the look-through companies rules" which is available at: http://www.ird.govt.nz/resources/a/f/afcafc804626f487bfe8bf7747109566/ir879.pdf

[11] http://taxreview.treasury.gov.au/content/FinalReport.aspx?doc=html/publications/Papers/Final_Report_Part_2/chapter_b2-4.htm

[12] The Work Programme of the Policy and Strategy Division of Inland Revenue refers to a review of the LTC rules – see http://taxpolicy.ird.govt.nz/work-programme. The precise wording used is "Considering simplification, technical and base maintenance issues that arise under current tax rules applying to closely held companies, including improving the overall coherence of the rules. These include the rules for look-through companies and other close company regimes."

deliver an appropriate result for small business. That Review was looking at the whole tax system, not focusing on small business. In the five (5) years since Henry was delivered, it has become obvious that the complexity of the dividend imputation system with its interaction with deemed dividends for private companies, is inappropriate in the small business context. Indeed, that is one of the reasons the current reference to the BOT has been made.

The New Zealand look through company allows for non-resident shareholders, such that foreign source income of the look through company in the hands of non-resident shareholder, is not subject to New Zealand tax. If Treasury was concerned about allowing for the use of Australian look through entities for international tax arbitrage (as per BEPs Action Item 2), the ability to elect look through treatment could be restricted to where all shareholders (or beneficiaries) are Australian residents.

Additional considerations for an Australian model

However, to facilitate the utility of an Australian look through entity, the Committee sees no good reason to restrict their membership to five (5) or fewer, and would favour a limit of 20, consistent with the limitation on the size of an ordinary partnership under the various Partnership Acts.

Further, the Committee would suggest that consideration be given to including discretionary family trusts as potential members of a look through entity. Although the Deloitte and ICAA submission was limited to individual members, the Committee considers that the problems posed by such an inclusion would provide greater flexibility for SME structures and should not pose insuperable problems of implementation.

We trust the above comments are of assistance. Please do not hesitate to contact the Committee Chair, Mark Friezer, on 02-9353 4129 or by email: mfriezer@claytonutz.com should you wish to discuss these matters further.

Yours sincerely

John Keeves
Chairman, Business Law Section

APPENDIX

Extract from Henry Tax Review

A flow-through entity regime for closely held businesses

The Australian Government asked the Review to consider a proposal to allow small, closely-held companies and fixed trusts the option to effectively be treated as partnerships for tax purposes. Under this approach, income and losses of the company or trust would be assigned to shareholders and beneficiaries regardless of whether they were distributed. The proposal received mixed support in submissions.

The proposal has the potential to reduce the compliance burden for micro-enterprises, as the many sets of rules associated with the current separate entity treatment of companies and some elements of the treatment of trusts would not apply. For example, flow-through taxation would make redundant the deemed dividend rules relating to non-commercial loans from a company to shareholders. The proposal could also allow some multiple entity structures to be simplified.

Flow-through would also allow the tax losses of an entity to be transferred to its owners, who could then offset the losses against other income, rather than leaving the losses trapped in the company or trust. A flow-through regime could therefore also have the benefit of improving loss symmetry, a potentially useful policy outcome if measured tax losses correspond to economic losses (see Section B1).

While flow-through approaches to the taxation of business entities have general merit, flow-through entities could become yet another option for business to consider or another component of an even more complicated business structure. New rules would be required to determine eligibility for, and the consequences of, flow-through treatment, and transitions into and out of such arrangements. Where flow-through treatment is provided for businesses falling below a size threshold, the prospect of losing flow-through treatment could deter small businesses from expanding.

Experience with optional regimes suggests that they can significantly complicate the tax system while doing little to reduce compliance costs (see Section G5 Monitoring and reporting on the system). Research in the United States, where a number of company or company-like flow-through entities are available, has found that the income tax compliance costs of operating a flow-through vehicle are marginally greater than the costs for a normal company (under a classical company income tax) and around one-and-a-half times the costs of a general partnership (DeLuca et al. 2005).

While flow-through companies and related entities are extensively used in the United States, they were developed in the context of a system that at the time provided no credit at the shareholder level for company income tax paid. In Australia, dividend imputation provides reasonably effective integration between shareholders and companies, so the case for running multiple systems is weaker.

However, as part of any consideration of a long-term move away from dividend imputation, adoption of flow-through company and entity arrangements may be a useful means to provide appropriate outcomes for smaller businesses (see Recommendation 38).