Brett Freudenberg
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AFTS Secretariat
The Treasury
Langton Crescent
Parkes ACT 2600

SUBMISSION: ENTITY FLOW-THROUGH TAXATION

Please find attached a submission for consideration pursuant to the consultation paper: *Australia's future tax system*, in particular:

> Question 6.6: Should the tax system be structured to cater for the specific circumstances of small businesses, and if so, how?

My submission is based on research that I have undertaken as part of my dissertation titled: *Tax Transparent Companies: Striving for tax neutrality? A legal international comparative study of tax transparent companies and their potential application for Australian closely held businesses.* The term 'tax transparent company' is equivalent to 'entity flow-through' used in the ICAA and Deloitte proposal.

Within my dissertation I analyse what has been the experience in the United States, the United Kingdom and New Zealand with their tax transparent companies – and in particular what benefit, if any, has accrued to closely held businesses in terms of complexity, financing and governance. The transparent companies studied were the United States' S Corporations and limited liability companies, the United Kingdom's limited liability partnerships and New Zealand's Loss Attribution Qualifying Companies (LAQC).

Through this analysis I conclude that it is unlikely that there would be any substantial benefit for closely held businesses if Australia introduced a fully tax transparent company, particularly if transparency was introduced as an 'alternative' way of taxing businesses. This conclusion was based upon findings that:

- a tax transparent company is likely to increase compliance cost,
- due to the current taxation of trusts and corporations in Australia there may not be significant demand for a transparent company; and
- a transparent company may increase the financial burdens for businesses.

At best, I argue that if transparency is to be introduced then the model adopted by New Zealand with its LAQC should be implemented. The LAQC is a partial loss transparent company, with only losses automatically allocated to members, with income initially taxed to the business form with an imputation system applying. However, while franked distributions are assessed to LAQC members, unfranked distributions are exempt income allowing for tax preferences to flow through to members. Such a methodology applying to the LAQC best compliments Australia's existing imputation system, and is an appropriate compromise in striving for the economic ideal. Also due to greater entity acknowledgement in terms of asset holdings, this should alleviate concerns about compliance cost. Note however, I argue that stricter loss restriction rules (based on the CFC hybrid rules in Div 830 with suggested amendments) would need to apply.

An advantage of such a partial loss transparent company is that it could also be used by the mining industry to address their concerns about exploration expenditure.

I have published a number of articles addressing this issue, which may be a useful in giving a broader understanding. These articles are listed in Appendix #1. Attached as Appendix #2 is my submission critiquing the model of transparency advocated in the ICAA and Deloitte proposal, and instead advocating, at most, for a partial loss transparent company.

Listed in Appendix #3 are chapter summaries of my dissertation. If you would like complete copies of one or more of the chapters please do not hesitate to ask for them.

I would be more than pleased to discuss my findings and recommendations with the Review. Please do not hesitate to contact me. My direct line is [removed for privacy reasons]

Yours faithfully

Brett Freudenberg

Appendix #1: Articles considering tax transparent companies

Author	Article Title	Journal
B Freudenberg	A Model Idea: Is the ICAA proposal for a tax transparent company the ideal model for Australia?	Forthcoming
B Freudenberg	Fact or Fiction? A sustainable tax transparent form for closely held businesses in Australia	Forthcoming
B Freudenberg	Losing my Losses: Are the loss restriction rules applying to Australia's tax transparent companies adequate?	Australian Tax Forum Vol 23 (2), 2008, pp 125-163
B Freudenberg	What the new CFC amendments mean: Australians structuring their investments into the United States of America through LLCs	Asia Pacific Tax Bulletin Vol 14 (3), 2008, pp 188-197
B Freudenberg	The Troubled Teen Years: Is the repeal of New Zealand's LAQC regime required?	New Zealand Journal of Taxation Law and Policy Vol 14 (1), 2008, pp 67-97
B Freudenberg	Australia's Struggle with Tax Transparent Companies	Tax Notes International Vol 48(1), 2007, pp 83-102
B Freudenberg	Are transparent companies the way of the future for Australia?	Australian Tax Review Vol 35(3), 2006, pp 200-223
B Freudenberg	Is the New Zealand Qualifying Company regime achieving its original objectives?	New Zealand Journal of Taxation Law and Policy Vol 11 (2), 2005, pp 185-215
B Freudenberg	Entity Taxation: The inconsistency between stated policy and actual application	Journal of the Australasian Tax Teachers Association Vol 1 (2), 2005, pp 458-490

Appendix #2: Submission on Entity flow-through (tax transparent companies)

1.1 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.[1] For the Australian government to adopt a tax transparent company it would need to be satisfied that transparency does reduce the regulatory burden for small businesses. 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.[2] 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.[3] Indeed, such an optional additional approach may encourage taxpayers to choose a business form due to tax arbitrages.

Unfortunately, it is such an 'additional' methodology advocated in the ICAA proposal. This is further aggravated by the fact that the ICAA proposal does not provide for a conversion mechanism for established businesses, and instead is proposed only to apply to new businesses.[4] 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.[5] To explain more fully, in Australia

[1] See generally: Burton M, "The Australian small business tax concessions - public choice, public interest or public folly?" (2006) 21(1) *Australian Tax Forum* 71.
[2] 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.
[3] 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".
[4] Of course, this would not prevent taxpayers from transferring assets from an established form to a new business form that elects to be part of the regime. However, such transfers may have adverse CGT and stamp duty consequences.
[5] Freudenberg B, "Are transparent companies the way of the future for Australia?" (2006) 35(3) *AT Rev* 200. However, it could be argued that the use of discretionary trusts for tax planning strategies actually breaches tax neutrality.

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.[6] 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.[7] 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.[8] 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.[9] However, wages[10] paid to an active member could be subject to payroll taxes levied by the various Australian states and territories, whereas the allocation of profits would not be.[11] 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.[12] Currently, it is not possible for a sole proprietor or a member of a general or limited partnership to obtain employee

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[6] 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.

[7] 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.

[8] 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.

[9] 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.

[10] Including fringe benefits and superannuation.

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

[12] 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 there have been introduced caps on the extent of salary packaging allowed for employees of tax-exempt employers.

status,[13] 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 FBT to benefits provided to employee-members, as they should not be regarded as an 'employee'.[14]

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.[15] This means that tax transparency in New Zealand can provide, to an extent, the unfettered access to losses for LAQC members.[16] The other peculiarity in New Zealand is its large tax preference of the non-taxation of capital gains,[17] with LAQC members being able to access this tax preference.[18] 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.[19] Furthermore, since 1985 Australia has included most capital gains in taxpayers' assessable income, thereby having the effect 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.[20]

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,

[13] However, it appears that it is possible for 'salaried partners' who are not equity members of a general partnership to obtain 'employee' status.

[14] Institute of Chartered Accountants in Australia and Deloitte, *Entity flow-through (EFT) submission* (Institute of Chartered Accountants, 2008) p 12.

[15] 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 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.

[16] 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* 67at 75.

[17] 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.

[18] *ITA 2007* (NZ), s HA 16 and CW 15. 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* 67at 69.

[19] This is reflected with the introduction of venture capital ILPs and the CFC hybrid amendments. See: Freudenberg B, "Are transparent companies the way of the future for Australia?" (2006) 35(3) *AT Rev* 200 at 216. 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.

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

and even more so if they are ‘new form’ transparent companies.[21] 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. 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.[22] 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 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.[23] Furthermore, transparency in some circumstances decrease the overall tax burden for the business and its members, compared to the treatment of corporations.[24]

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.

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[21] 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 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) p 329.

[22] 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.

[23] The savings that losses present, especially as they could be in early years of operation is that decrease the overall financing cost of the business operations and alleviate pressure on debt funding.

[24] For example, consideration of 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.

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 characteristics[25] and integrated approaches applying to corporations.[26] 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.[27]

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 have on raising equity. Also the relationship between corporate, capital and individual tax rates is critical in determining the overall tax benefit.[28] 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, 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 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.[29] This focus is reinforced by the recent ICAA proposal that advocates for a transparent company.

[25] That is, general partnerships and sole proprietors.

[26] The studies include: 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; and Ritchie K, *New Zealand Small Business Tax Compliance Costs – Some Empirical Evidence (*Inland Revenue, 2002).

[27] This potential relationship of complexity and tax transparent companies is the subject of a forthcoming article by the author.

[28] 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.

[29] Freudenberg B, “Are transparent companies the way of the future for Australia?” (2006) 35(3) *AT Rev* 200.

However, there are a number of alternative models of how this could be achieved; each of which will now be considered.[30]

1.2 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 company.[31] 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 forth 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, cumulating in the preferred approach.

1.2.1 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.[32] If these requirements are not satisfied then tax transparency will not apply.[33]

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 LLC[34] or LLP[35]

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

[31] 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.

[32] Instead an integrated tax approach would apply – the consequence being that the ILP is taxed similarly to a corporation.

[33] *ITAA 1936* (Cth), Div 5A.

[34] 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 Australian 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

is likely be regarded as an Australian resident and therefore would be excluded from the transparency applying pursuant to the CFC hybrid amendments.[36]

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.[37] Additionally, the Federal government would need to extend tax transparency to all ILPs operations and not just venture capital investment.[38] The broad availability of an ILP form is what the New Zealand government recently implemented with its new limited partnership.[39]

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.

[35] 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 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. Note 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).

[36] *ITAA 1997* (Cth), s 830-15(c).

[37] Known previously as the Pooled Development Fund Board up to 21 June 2007.

[38] With the application of the loss restriction rule.

[39] 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.

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 instance, the ILP does not allow for single membership,[40] 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.[41] 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.[42]

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.[43] 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'.[44] 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 could easy lead to 'inconvenience' and complexity.[45]

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[40] 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.

[41] *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.

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

[43] 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).

[44] 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.

[45] 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*

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.

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.[46] 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.[47]

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 overlayed. In view of this, it is argued that the interaction between foreign and domestic law may outweigh any perceived benefits.[48] In this context, there could be some associated issues about the overall suitability of the governance laws, especially for LLPs, for closely held businesses.[49] For 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.

Corporations and Partnerships: US and European Perspectives (Oxford University Press, 2004) p 220.

[46] Such as annual filing requirements.

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

[48] 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 had 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).

[49] 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.

1.2.2 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. A 'new form transparent companies', represents the introduction of a new business form with transparency applying via the general partnerships tax rules.

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.[50] 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 membership interest and a default set of standard rules that could be altered through a membership agreement.[51]

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.

[50] 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.

[51] 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'.

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.[52]

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.[53] 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.[54]

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.[55] 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.[56] 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

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[52] 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.

[53] Otherwise such a business form would be taxed as a corporation or a limited partnership.

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

[55] This is a sentiment shared by other commentators: McCahery JA and EPM Vermeulen, "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 195.

[56] 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 the subject of a forthcoming article by the author.

cost, which could be regressive for small businesses.[57] It is for this reason that the introduction of a special tax rule company deserves greater attention.

1.2.3 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. A 'special tax rule company' achieves tax transparency by applying special tax rules to corporations satisfying certain eligibility requirements 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.[58] 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.[59] It is argued that provided an adequate loss restriction rule applies then the eligibility restrictions need not be so severe.[60]

Also, if a special tax rule company was introduced, reliance on existing corporations law may reduce the potential uncertainty cost.[61] 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

[57] 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.

[58] Institute of Chartered Accountants in Australia and Deloitte, *Entity flow-through (EFT) submission* (Institute of Chartered Accountants, 2008).

[59] *IRC 1986* (US), s 1361. For S Corporation status to be obtained: a) the corporation itself and its members must be United States residents, b) there must be only one class of membership interest, c) membership must not exceed 100, and d) there must be a valid election for S Corporation status. Additionally, certain trading activities and asset holdings are prohibited

[60] 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 exits.

[61] Cost in terms of uncertainty and tax compliance.

alternative would address, in part, concerns that new transparent company forms create increasing uncertainty.[62]

Furthermore, it would be possible to have single membership[63] with member-management not prejudicing liability protection for members.[64] 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.

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 7A[65] and the personal services income provisions.[66] Other complex provision that need not necessarily apply to a transparent company could include share value shifting,[67] tracing capital gain discounts,[68] and tracing rules for capital assets acquired prior to 20 September 1985.[69] Furthermore, a tax transparent company could provide an alternative path of tax consolidations, which is often problematic for small businesses.[70] While 'tax benefits' of themselves should not be a driving motivation of a transparent company, such a consequence reflects the cynical observation that special

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[62] 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.
[63] *Corporations Act 2001* (Cth), s 114.
[64] Although such activity may expose an active corporate member to liability in other capacities, such as a director or an employee.
[65] *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.
[66] *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.
[67] *ITAA 1997* (Cth), Div 723 to 727.
[68] *ITAA 1997* (Cth), s 115-40.
[69] *ITAA 1997* (Cth), CGT event K6.
[70] Institute of Chartered Accountants in Australia and Deloitte, *Entity flow-through (EFT) submission* (Institute of Chartered Accountants, 2008) p 10.

tax rule companies could be seen as a 'carve out' for closely held businesses from the normal tax rules applying to corporations.[71]

Another tax concession potentially available is that fringe benefits tax (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 concessionally taxed, so this treatment could increase the tax impost for active members of a transparent company compared to active members of a corporation.

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 closely held businesses.[72] 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.[73] Indeed it may be worthwhile reconsidering the benefits of the *Closed Corporations Act* which was 'lost' in the constitutional challenges of the early 1990s.[74] 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.

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[71] 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 allowance of the flow-through of exempt capital gains to members.

[72] 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.

[73] 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.

[74] 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".

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.[75] However, in the proposal, the reasoning for this is not explicitly articulated with any clarity nor, indeed, does it consider the adequacy or efficacy of the restriction in any meaningful way. It is argued that the CFC hybrid rules are not significantly more complex than the venture capital ILPs. 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.[76]

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,[77] with members of the proposed flow-through entity having direct fractional interest in the CGT assets held.[78] This means that changes in membership can potentially trigger partial disposals.[79] 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. [80]

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.

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[75] Institute of Chartered Accountants in Australia and Deloitte, *Entity flow-through (EFT) submission* (Institute of Chartered Accountants, 2008) at [3.15.6].
[76] 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.
[77] Institute of Chartered Accountants in Australia and Deloitte, *Entity flow-through (EFT) submission* (Institute of Chartered Accountants, 2008) at [3.18.1].
[78] Institute of Chartered Accountants in Australia and Deloitte, *Entity flow-through (EFT) submission* (Institute of Chartered Accountants, 2008) at [3.18.2].
[79] 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)].
[80] 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.

For example, it is argued that unnecessary tax compliance costs arise for the United States' LLCs because they are taxed pursuant to Sub-Chapter K of the *Internal Revenue Code 1986* (US), which was drafted for general partnerships characterised by no liability protection for members. The differences between business forms mean that the provisions of Sub-Chapter K do not adequately deal with the potential legal nuisances. This awkwardness in terms of the tax regime and a company structure 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.[81] 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.[82]

Also the ICAA proposal suggested that its flow-through regime be restricted to entities that are private[83] with five or fewer members.[84] However, this low quantum of members is based on the proposal only extending to 'micro-SME groups',[85] to reduce the potential impact on tax revenue. It is argued that such a limitation is artificial and will be lead to practices to circumvent the limitation anyway or alternatively to 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.

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 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.

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[81] 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. Note this inclusion is then reversed out by the 'at risk' rule.

[82] Crawford C and Freedman J, "Small Business Taxation" in *Prepared for the Report of a Commission on Reforming the Tax System for the 21st Century* Chaired by Sir James Mirrless (The Institute of Fiscal Studies, 2008): suggest that for the United Kingdom an optional transparent system would just result in taxpayers seeking tax arbitrages.

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

[84] Institute of Chartered Accountants in Australia and Deloitte, *Entity flow-through (EFT) submission* (Institute of Chartered Accountants, 2008) at [3.7.10].

[85] Institute of Chartered Accountants in Australia and Deloitte, *Entity flow-through (EFT) submission* (Institute of Chartered Accountants, 2008) at [3.7.10].

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.[86]

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

1.2.4 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 would influence their ability to utilise any losses allocated by the partial loss transparent company.[87] Such a mechanism would be consistent with the policy recommended by Pizzacalla to improve the capital of small and medium enterprises.[88]

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

[86] Burton M, "The Australian small business tax concessions - public choice, public interest or public folly?" (2006) 21(1) *Australian Tax Forum* 71.
[87] 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.
[88] Pizzacalla M, "Global SME tax policy conundrum" (2008) 23(1) *Australian Tax Forum* 40 at 85.

members offsetting their tax liability with franking credits.[89] 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.[90] Also such distributions would decrease a membership cost basis. 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).[91]

To reduce the tax arbitrage between the partial loss transparent company and members, allocated tax losses could be converted to a 'loss tax credit' calculated at the corporate tax rate. Such an allocated loss tax credit could be used by members to offset their tax payable, or be refunded if exceeding the member's tax liability. For example, a $1000 worth of losses would be converted to a loss tax credit of $300 and allocated to members to use as an offset. This mechanism would be mean that allocated losses would shelter income at the member level a 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.[92]

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,[93] which allows re-invested unincorporated business income to be taxed at the corporate rate, with only distributions taxed at the individual marginal tax rates.[94] The tax advantage of

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[89] Such distributions would decrease the membership cost basis.
[90] 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.
[91] 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.
[92] 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.
[93] Also known as the dual tax system.
[94] 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:

allowing for a partial loss transparent company could be important in influencing the overall utilisation rates of such a transparent form.

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.[95]

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,[96] the treatment of unfranked dividends as exempt income would allow tax preferences to flow through to members.[97] 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).[98]

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

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Crawford C and Freedman J, "Small Business Taxation" in *Prepared for the Report of a Commission on Reforming the Tax System for the 21st Century* Chaired by Sir James Mirrless (The Institute of Fiscal Studies, 2008):"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.

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

[96] That is, capital profits realised at the entity level would not retain there capital nature on distribution to members.

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

[98] 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.

could be possible for existing corporations to transfer into the regime on the payment of corporate tax on any retained profit not covered by franking credits.[99] 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).[100] Furthermore, in New Zealand the possible repeal of the LAQC regime has been raised a number of times.[101] However, it is argued that this is due to inadequate loss restriction rules applying to LAQCs.[102] 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.

It is for these reasons, that if Australia is to introduce a flow-through regime, it is preferable that it is a partial loss transparent company.

[99] 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.
[100] Such a proposal in the United States was considered too complex, and instead a basic 15 per cent concessional rate was introduced.
[101] For the most recent consideration see: Cullen M (Minister of Finance) and Dunne P (Minister of Revenue), *General and limited partnerships — proposed tax changes: A government discussion document* (Wellington, 2006).
[102] 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.

Appendix #3: Dissertation Chapter Summaries

Below is detailed the chapter summaries of the dissertation titled: *'Tax Transparent Companies: Striving for tax neutrality? A legal international comparative study of tax transparent companies and their potential application for Australian closely held businesses.'* by Brett Freudenberg.

Chapter One

It was highlighted in Chapter One that 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.[103] 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. Such a tax transparent approach is stated to improve tax neutrality, and thus reduce the tax system's potential to distort investment decisions.

Historically, due to concerns about the practicality and the integrity of the tax system, implementation of such an economic ideal has been regarded as problematic for business forms with limited liability and separate legal status. However, examples were provided of how some jurisdictions have recently moved towards this economic ideal by introducing tax transparent companies. The introduction of these transparent companies have received mixed reactions, with some academics praising them – particularly for closely held businesses – while others question what has really been achieved.

Until this point in time Australia has given only restricted recognition to tax transparent companies, with the implementation of venture capital incorporated limited partnerships (venture capital ILPs) and amendments to controlled foreign hybrid companies (CFC hybrids). Despite this, there have been calls for the broader availability of a transparent company in Australia, most recently from the Institute of Chartered Accountants in Australia and Deloitte (the ICAA proposal).[104] Given the touted benefits of tax transparency, including the potential benefits to closely held businesses, it was argued that a more detailed and critical understanding of these transparent companies is needed. The dissertation proposed to analyse tax transparent companies in the United States of America (United States), the United Kingdom and New Zealand using a comparative legal framework. Theoretical and doctrinal research would be used to critically evaluate the research questions espoused.

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[103] 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.

[104] Institute of Chartered Accountants in Australia and Deloitte. (2008). Entity flow-through (EFT) submission. Sydney: Institute of Chartered Accountants.

Chapter Two

The underlying theoretical rational of tax neutrality and its relationship with tax transparent companies was detailed in Chapter Two. This analysis highlighted that in the absence of tax neutrality, the productive capacity of an economy may be impeded due to the distortion of investment decisions. With a view to illustrating the potential for investors to be influenced by changes in the tax system, prior studies were discussed, including Holub's research.[105] Furthermore, it was argued that governments were placing greater emphasis on the goal of tax neutrality in operating their tax systems.

Tax neutrality was then discussed in terms of business forms, and the key question was raised regarding how a business form's legal characteristics could influence the way a government resolved to tax it and its members. Specifically, in Chapter Two it was highlighted that breaches of tax neutrality can occur when an entity approach is used to tax a business form.[106]

In comparison, tax transparent treatment is argued as improving tax neutrality, with the Organisation for Economic Co-operation and Development (OECD) expressing how transparency would achieve greater neutrality and equity.[107] Part of the analysis in this chapter addressed the importance of tax neutrality for cross-boarder transactions – particularly in the context of globalisation of trade and capital movements.

To appreciate the hesitation to implement tax transparency, some potential difficulties were canvassed, including administrative difficulties, unfunded tax liabilities for members and the potential risk to revenue for governments.

Empirical research that discussed the characteristics of closely held businesses and their economic significance was then considered. The inherent characteristics of a closely held business were that: the membership was not widely dispersed – particularly not publicly traded – it was independently owned and operated, with most capital contributed by members and managers. It was also outlined that members are likely to be active in the management of the business. While it was acknowledged that 'closely held' and 'small business' are not interchangeable *per se*, the vast majority of closely held businesses will, nonetheless, be small to medium enterprises.[108]

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[105] Holub's thesis considered the reaction of taxpayers when the tax method applying to public unit trusts in Australia was altered so that they were taxed as corporations: Holub, M. (2001). Taxes and the Choice of Organisational Form in Australia. PhD, Department of Accounting and Finance, University of Western Australia.
[106] For example, an entity approach can result in a preference for retention of profits and differences between debt and equity funding.
[107] OECD.(1991). *Taxing Profits in a Global Economy: Domestic and International Issues*, at p 23
[108] Freedman, J, and Ward, J. (2000). Taxation of Small and Medium-Sized Enterprises. *European Taxation* May:158, at p 159.

Despite this, however, it was pointed out that there can be a number of closely held businesses that are indeed large.[109] To a substantial extent this dissertation focused on small and medium closely held businesses, although at times the implications for larger closely held businesses were raised.

An analysis of the literature concluded that challenges faced by closely held businesses included complexity, financing and governance. This analysis provided the basis for a critical examination of whether tax transparent companies were advantageous for closely held businesses.

Chapter Three

Within Chapter Three a definitional basis of what is meant by a 'tax transparent company' was provided, which was predicated on three attributes: separate legal entity status; limited liability; and tax transparent treatment. It was demonstrated how the foreign business forms studied exemplified this, particularly S Corporations and limited liability companies (LLCs) from the United States, and limited liability partnerships (LLPs) from the United Kingdom. The Loss Attributing Qualifying Company (LAQCs) from New Zealand, also studied, was not a fully transparent company, and instead was a partial loss one ─ with only losses automatically allocated to members.

It was concluded that the transparent companies studied could be classified as 'special tax rule companies' which achieved tax transparency by applying special tax rules to corporations satisfying certain eligibility requirements; or alternately, 'new form transparent companies', representing the introduction of a new business form with transparency applying via the general partnerships tax rules.

It was then demonstrated that Australia's restricted recognition of tax transparent companies to date ─ venture capital ILPs and CFC hybrids ─ have the characteristics of tax transparent companies. Empirical data demonstrated that in the United States and New Zealand transparent companies had become a popular business form. In the United States, the transparent companies studied accounted for a majority of business forms (excluding sole traders), whereas in New Zealand the LAQC accounted for approximately 12 per cent of business forms. The United Kingdom's LLP had the lowest utilisation, although it was acknowledged that the LLP had been introduced only recently there.

[109] Also, corporate groups with subsidiary companies could themselves be regarded as closely held.

Chapter Four

In order to address the first guiding research question, the discussion in Chapter Four considered whether the introduction of the foreign transparent companies studied was motivated by the desire to achieve greater tax neutrality or whether ulterior motives were more explanative. Furthermore, this analysis considered the role of closely held businesses in their introduction.

It was argued that a relationship was extant between the identified classifications of transparent companies, tax neutrality and closely held businesses. For 'special tax rule companies', the key motivating factor for both the United States and the New Zealand governments in introducing S Corporations and LAQCs was to improve tax neutrality for closely held businesses. That is, there was a desire that the tax system would have *less* influence on whether a business opted for an incorporated or unincorporated form. The relationship with closely held businesses was particularly evident through the membership restriction rules that were imposed in order to be eligible for tax transparency. However, a cynical explanation could be that, despite government sentiments, these transparent companies were a 'carve out' for closely held businesses from the normal tax treatment of corporations, providing them with concessional tax treatment.

For the two 'new form transparent companies' studied (LLCs and LLPs) the role of tax neutrality was not as explicit when they were introduced; rather breaches of it acted as a 'catalyst for change'. For both LLCs and LLPs it was concluded that there was a market drive for the introduction of an entire new business form subject to existing tax transparent rules for general partnerships. It was important that this new business form provided members with liability protection. These factors resulted in interest groups lobbying for their introduction and, led to competition among jurisdictions. Furthermore, large closely held businesses were instrumental in lobbying for, and even drafting original legislation for the enactment of the new form transparent companies.

Chapter Five

Given the underlying reasons identified with the foreign transparent companies studied, the focus within Chapter Five was to consider whether similar factors are extant in Australia. Through this analysis it was concluded that the key motivating institutional, legal and public policy influences observed overseas are not as prevalent in Australia. For special tax rule companies, one impediment is the Australian government's approach to tax neutrality, which is initially oriented to whether or not the business form provides limited liability to members rather than if the business form is closely held. This approach is diametrically opposed to that of the United States and the New Zealand governments with their introduction of S Corporations and LAQCs. The Australian government's position, in part, related to concerns about maintaining the integrity of the tax system. However, it was argued that if adequate loss restriction rules were implemented with a tax transparent company, then the Australian government's concern about the potential risk to revenue could be alleviated.

For new form transparent companies, Australia's full imputation system for corporate distributions and the use of discretionary trust for business operations reduce the extent of breaches of tax neutrality, particularly if compared to an entity approach.[110] Also, peculiarities with the United Kingdom's and New Zealand's integrated tax systems for corporations do not exist in Australia. It was concluded that this meant there may not be the 'catalyst for change' to motivate interest groups to lobbying for reform. However, it was acknowledged that tax transparency could be beneficial in Australia due to the non-application of certain tax integrity measures, such as Division 7A. It was demonstrated that breaches of tax neutrality played a part in the introduction of Australia's restricted recognition of transparent companies to date. For example, the application of tax transparency to venture capital ILPs improved tax neutrality between debt and equity financing, whereas for CFC hybrids it improved import–export neutrality.

Discussion in the chapter further identified that there is currently no major drive for the introduction of a new form transparent company ─ by either businesses or professionals ─ although the recent ICAA proposal has seen the consideration of a flow-through entity become part of a broader tax review. Given the current range of available business forms, the factors of improved governance and limited liability were seen as to be not as significant in Australia. However, it was identified that international factors were instrumental in Australia's recognition of tax transparency for venture capital ILPs and CFC hybrids. It was concluded that international influences could be the most instrumental factor for the future introduction of transparent companies in Australia.

[110] Although the use of these entities for tax planning strategies could be perceived as breaching tax neutrality.

Chapter Six

The analysis in Chapter Six focused on how the jurisdictions studied have ensured that tax transparency for a business form with limited liability for members has not jeopardised their tax systems, particularly the utilisation of losses. It was identified that in the absence of adequate loss restriction rules, unfettered access to losses by limited members could result in the tax system distorting investment decisions which contradicts the proposition that transparency achieves greater tax neutrality.

To ascertain what measures had been adopted in the foreign jurisdictions studied, an analysis was then conducted of the loss restriction rules applicable to tax transparent companies in the United States, the United Kingdom and New Zealand. These foreign rules were compared and contrasted with rules introduced in Australia for venture capital ILPs and CFC hybrids to ascertain their adequacy. It was argued that the foreign jurisdictions in whole or in part had adopted four loss restriction rules based on membership cost basis, risk, passivity and streaming.

The first restriction involved the notion that members are able to utilise allocated losses to the extent of their equity investment in the transparent company (membership cost basis). The second restriction considered the level of a member's risk exposure in terms of their equity investment in the transparent company or, alternately, in terms of being exposed to movements in value of their membership interest. The third restriction was associated with passivity, considering the extent of a member's involvement in the transparent company's business. The final restriction related to the capacity of transparent companies to stream losses to some members in preference to others.

It was concluded that the loss restriction rules applying to Australia's CFC hybrids were more thorough than those applying to venture capital ILPs and compared favourably to the foreign jurisdictions studied. However, amendments and clarifications are required, including the inclusion of members' subordinated debt, the exclusion of non-recourse loans to fund the acquisition of membership interests and the extension of the restriction rules to all members. It was argued in Chapter Six that the Australian loss restriction rules (with amendments) would be adequate to allow for the broad availability of a tax transparent company in Australia.

Chapter Seven

The dissertation then addressed the subsidiary research questions in relation to the implications for closely held businesses of the availability of a transparent company form. The analysis in Chapter Seven reflected upon whether disregarding the legal form for tax purposes would lead to increased tax complexity due to the divergence between legal ownership of assets and earnings (with the transparent company), with the tax consequences (with members). The available empirical evidence suggested that tax transparent companies might result in higher tax compliance costs compared to other business forms. Furthermore, it appeared that new form transparent companies imposed greater compliance costs than special tax rule companies. Also transparent companies could aggravate the regressive nature of compliance cost for small businesses.

This potential to increase compliance costs was then examined in terms of eligibility requirements, the extent of aggregation, loss restriction rules and cross-jurisdictional issues. The chapter concluded by questioning the need for imposing extensive eligibility requirements. Furthermore, it was argued that some ‘entity acknowledgement’ for tax purposes, in terms of asset holdings and membership interest, might be a beneficial compromise in decreasing tax compliance costs, while still achieving the overall aims of tax transparency. This was because full aggregation, with members having direct fractional interests in underlying assets, could result in increased complexity. Additionally, it was argued that a jurisdiction needs to be mindful in drafting loss restriction rules to ensure that they achieve their goals without being too onerous.

Chapter Eight

Given the prior literature highlighting the finance problems faced by closely held businesses, the focus in Chapter Eight was to consider how tax transparency might assist closely held businesses, in terms of their ability to raise equity and their overall tax burden.

It was concluded that the eligibility requirements for special tax rule companies to gain tax transparency could inhibit their ability to raise equity and thereby stifle their development. Given the minimal eligibility requirements for new form transparent companies it was argued that tax transparency could be available when the following conditions existed: membership interests were not publicly traded; a majority election was made by members and managers; and, if the business form is resident of a foreign country, then tax transparency also applied there. It was argued that there may be some benefit in providing that a transparent company with one class of membership interest did not have to comply with anti-streaming rules, to decrease possible compliance cost.

It was concluded that, in comparison to the tax treatment of corporations and their members, transparency did not always result in an overall lower tax burden in the foreign jurisdictions. Also the problem of member assessment for unpaid allocations was discussed.[111] However, tax transparency was

[111] However, this did not apply to the LAQC, as it is a partial loss transparent company with income initially assessed at the entity level.

beneficial compared to the situation for corporations and their members subject to an entity or integrated approach in terms of access to losses, tax preferences and capital gains.

This analysis demonstrated that an important influence on the level of tax burden was the characterisation of active members as either employees or self-employed persons which, depending upon the jurisdiction, could have a negative or positive impact. It was argued, that given the underlying goal of tax transparency, the more appropriate treatment was to treat active members as self-employed rather than as employees. The analysis also identified that tax transparency did improve tax neutrality between debt and equity funding, which is beneficial for closely held businesses as they can be characterised by a reliance on equity funding.

Chapter Nine

While economically it may be preferable for tax purposes to disregard the legal form and allocate income and/or losses directly to members, the governance regime of such a form can be important to facilitate investment. To gain a better appreciation of what legal forms were being disregarded for tax purposes, the underlying governance regimes of the foreign transparent companies studied were analysed in Chapter Nine. This analysis considered the mandatory rules in regards to capital protection and single membership, the default governance rules, member-management and transferability of membership interests.

It was argued that the suitability of special tax rule companies is largely influenced by the governance regime imposed by the relevant corporation law. This can be problematic both in the United States and in New Zealand, as the default governance regime for corporations appears to be more appropriate for widely held rather than for closely held businesses. While the use of membership agreements or operating agreements alleviates the impact of the default governance regime in both the United States and New Zealand, this can increase costs and decrease networking benefits. It was argued that the relevant governments should have had greater consideration to the underlying governance rules in addition to the tax rules when introducing their special tax rule companies.

In terms of the governance regime for the new form transparent companies, LLPs appears a problematic choice of business form for closely held businesses due to the lack of any substantial default rules, the assumed member-management and the requirement for at least two members. This could be traced back in part to the reasons identified in Chapter Four, which indicated that the LLP was originally intended for professional firms. LLCs appeared to have more appropriate governance rules for closely held businesses, although concerns were expressed with recent moves to adopt more default characteristics appropriate to widely held membership.

It was argued that it was preferable for any jurisdiction introducing a tax transparent company to have a holistic approach and not focus only on tax characteristics, and to consider whether the governance regime provided for characteristics exemplified by closely held businesses.

End of submission.