BRAD

Chapter 7

SHARE BUY-BACKS, TAX CONSOLIDATION OF COMPANY GROUPS, AND PARTNERSHIPS

BRAD

Chapter 7: reviewing share buy-backs, tax consolidation of company groups, and partnerships

The Chairman and other committee members of the Investment Income Tax Review have been selected by the government of the country of our tireless Tax Department policy team, Claudia, Brad and Sami.

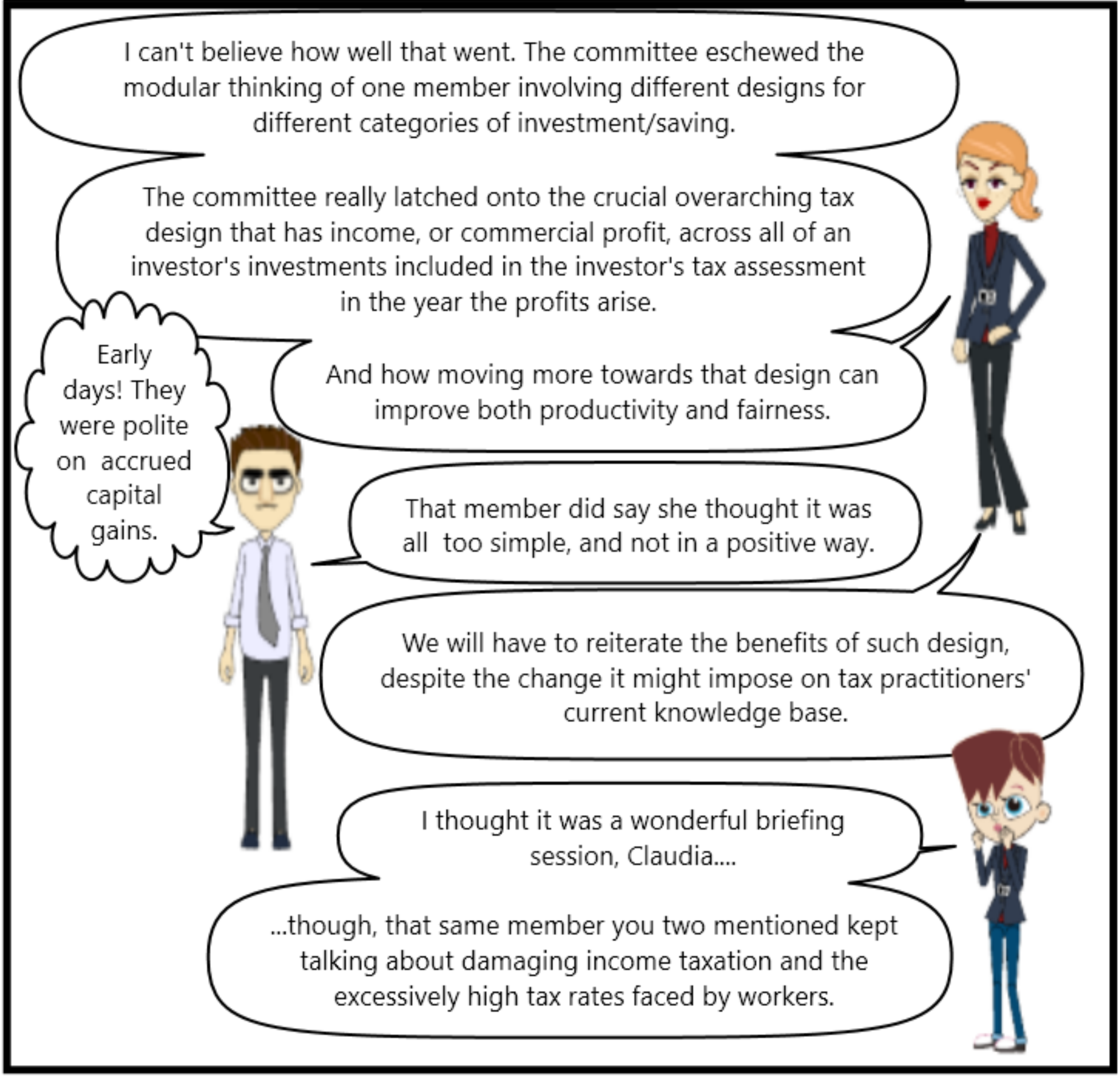
The Tax Minister has introduced the Tax Review committee to the tax policy team - now the review's secretariat. The minister has asked the team to provide the committee a comprehensive briefing of all the material on which the team has briefed him over recent months - set, of course, against the review's terms of reference.

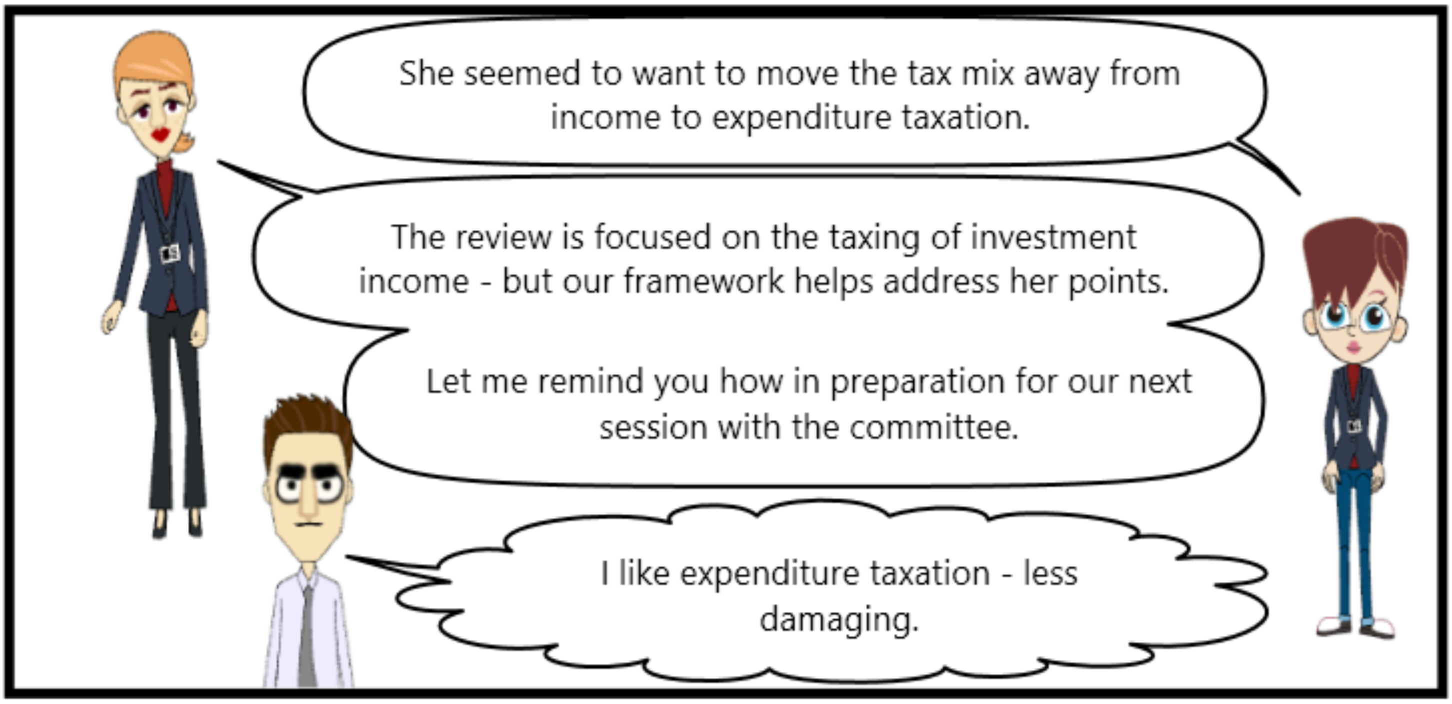
The team, or at least some in the team, enthusiastically take up this request and look forward to the committee's initial response and directions for further work. Claudia hopes to be able to influence the direction of that work by pointing to tax changes that would achieve both increased productivity from income taxation's interfering less with commercial investment decisions and greater fairness in tax treatment between investors in varying circumstances.

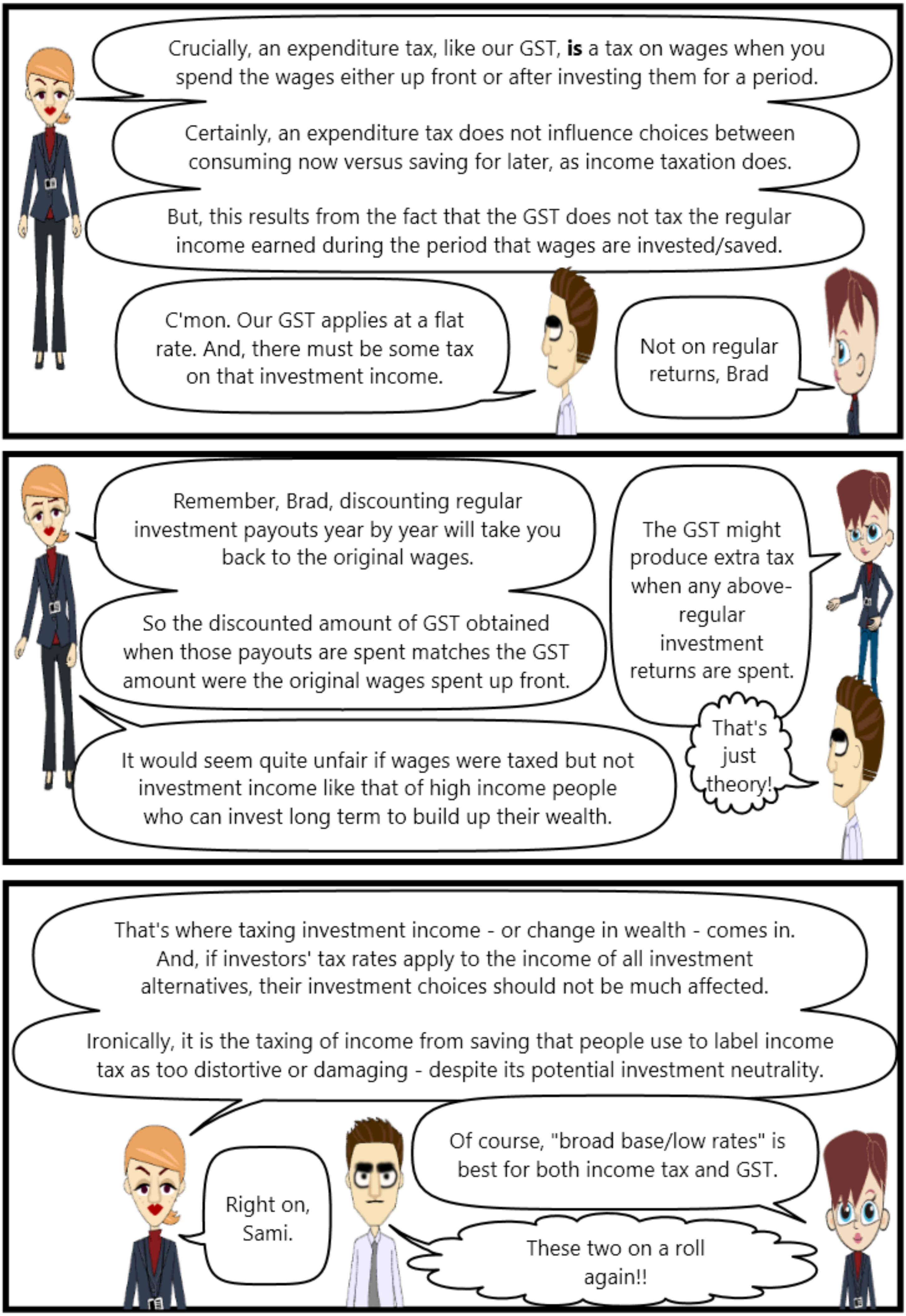
The team then sets about preparing to brief the Tax Review committee on those item that were included in the terms of reference as a result of the Tax Minister's discussions with other ministers and business groups: share buy-backs; tax consolidation of company groups; and, partnerships. Each of these extra items brings with it particular focus on associated design of capital gains tax (CGT). The preparation on consolidation naturally extends into tax loss or profit duplication and CGT value shifting.

Again, the income tax laws in the team's country are remarkably similar to those in Australia. Consequently, the team's preparation for the Tax Review committee's briefing draws from reports of Australia's last wide-ranging review of the tax treatment of investment income, the Ralph Platform and Ralph Review (see Preface). Mayo (2011) adds some assistance in relation to share buy-backs.

After a very lengthy meeting with the Tax Review committee.........

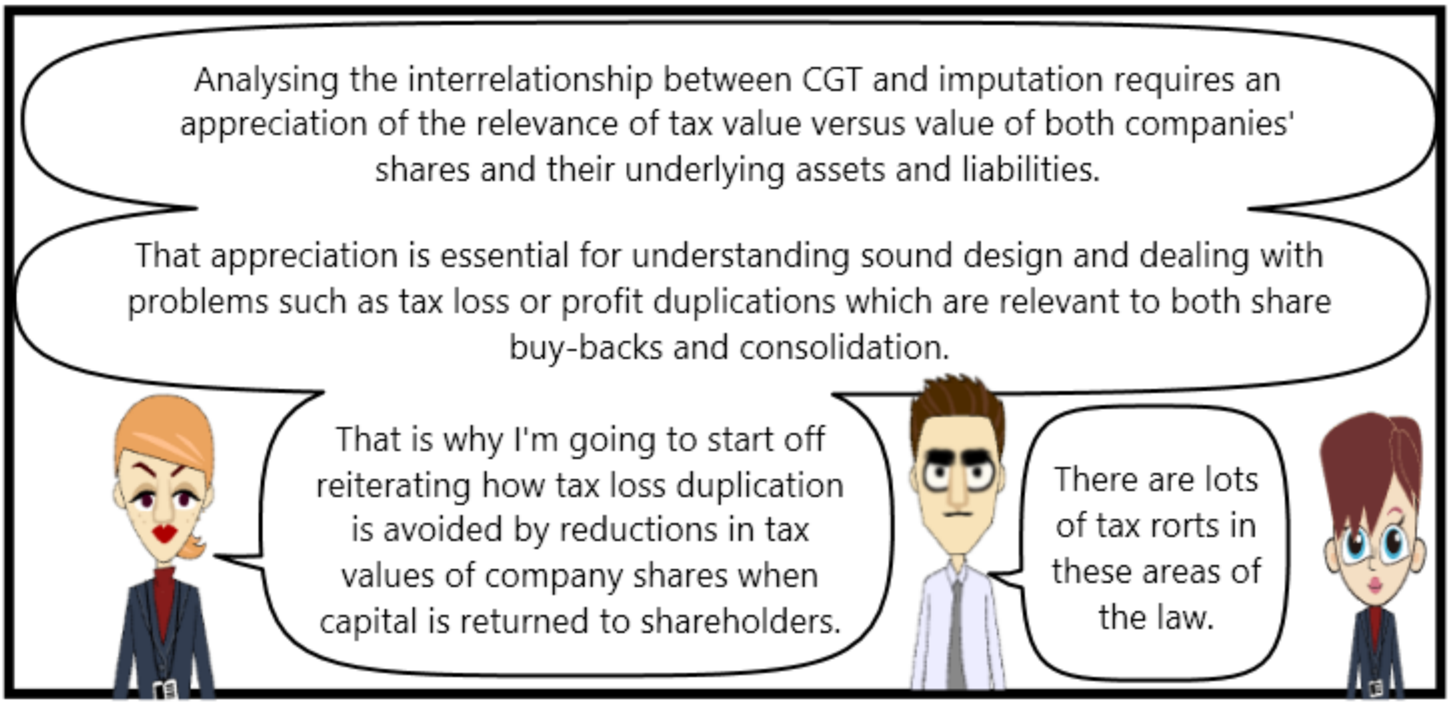


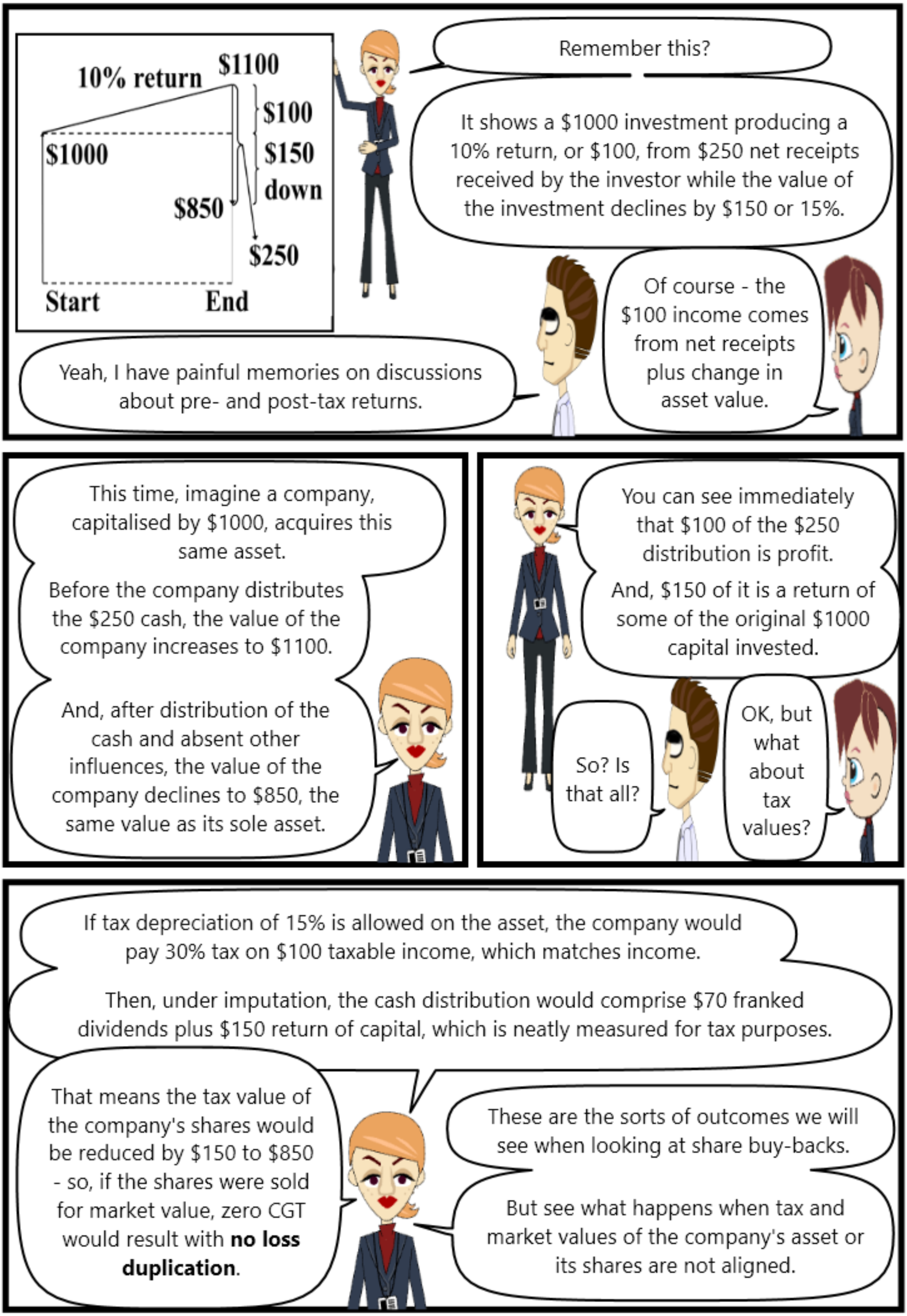


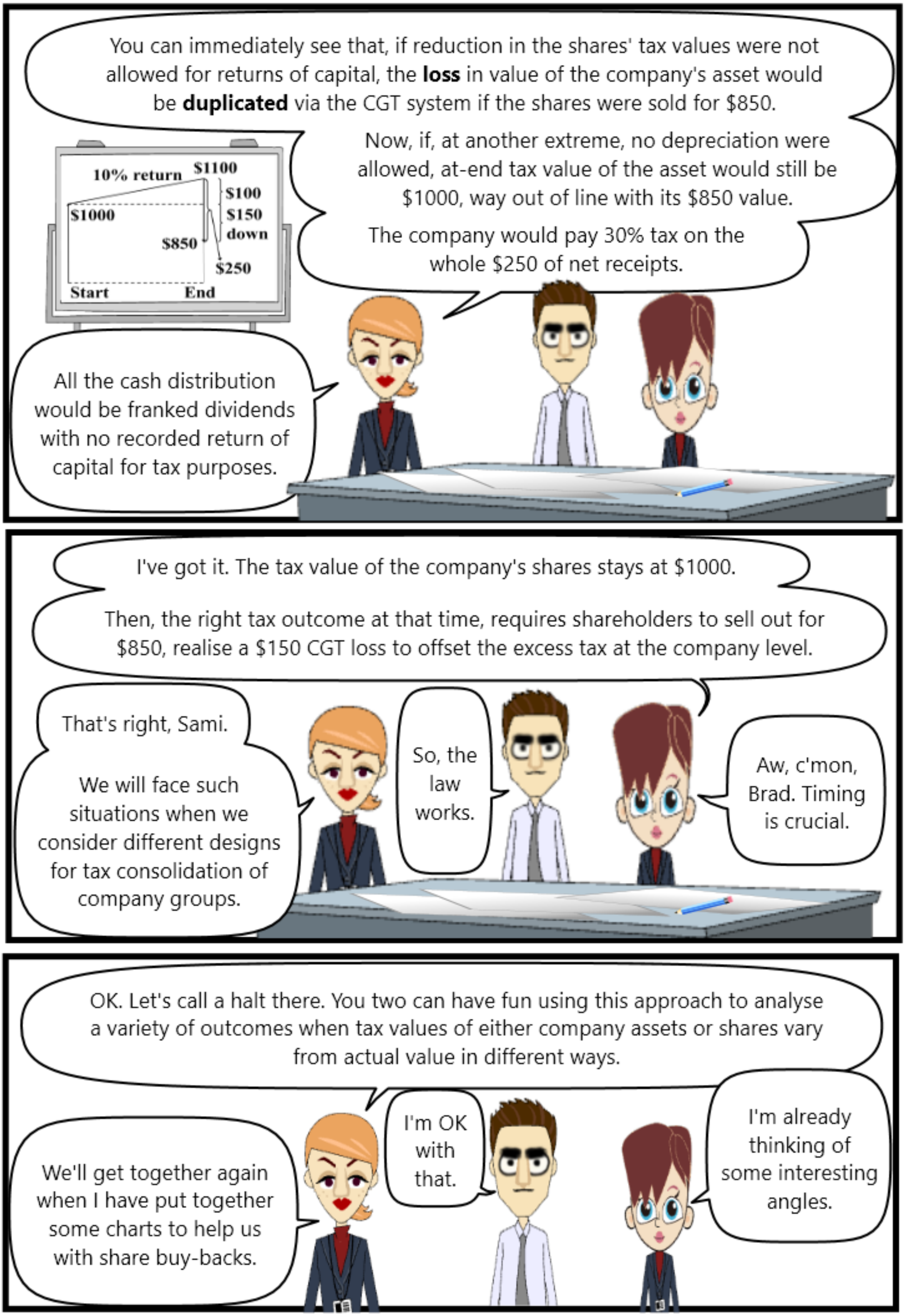

Crucially, an expenditure tax, like our GST, **is** a tax on wages when you spend the wages either up front or after investing them for a period.
Certainly, an expenditure tax does not influence choices between consuming now versus saving for later, as income taxation does.
But, this results from the fact that the GST does not tax the regular income earned during the period that wages are invested/saved.
C'mon. Our GST applies at a flat rate. And, there must be some tax on that investment income.
Not on regular returns, Brad
Remember, Brad, discounting regular investment payouts year by year will take you back to the original wages.
So the discounted amount of GST obtained when those payouts are spent matches the GST amount were the original wages spent up front.
The GST might produce extra tax when any above-regular investment returns are spent.
That's just theory!
It would seem quite unfair if wages were taxed but not investment income like that of high income people who can invest long term to build up their wealth.
That's where taxing investment income - or change in wealth - comes in. And, if investors' tax rates apply to the income of all investment alternatives, their investment choices should not be much affected.
Ironically, it is the taxing of income from saving that people use to label income tax as too distortive or damaging - despite its potential investment neutrality.
Right on, Sami.
Of course, "broad base/low rates" is best for both income tax and GST.
These two on a roll again!!

Claudia focuses her team on the extra items in the terms of reference

Background analysis: value versus tax value of shares and company assets

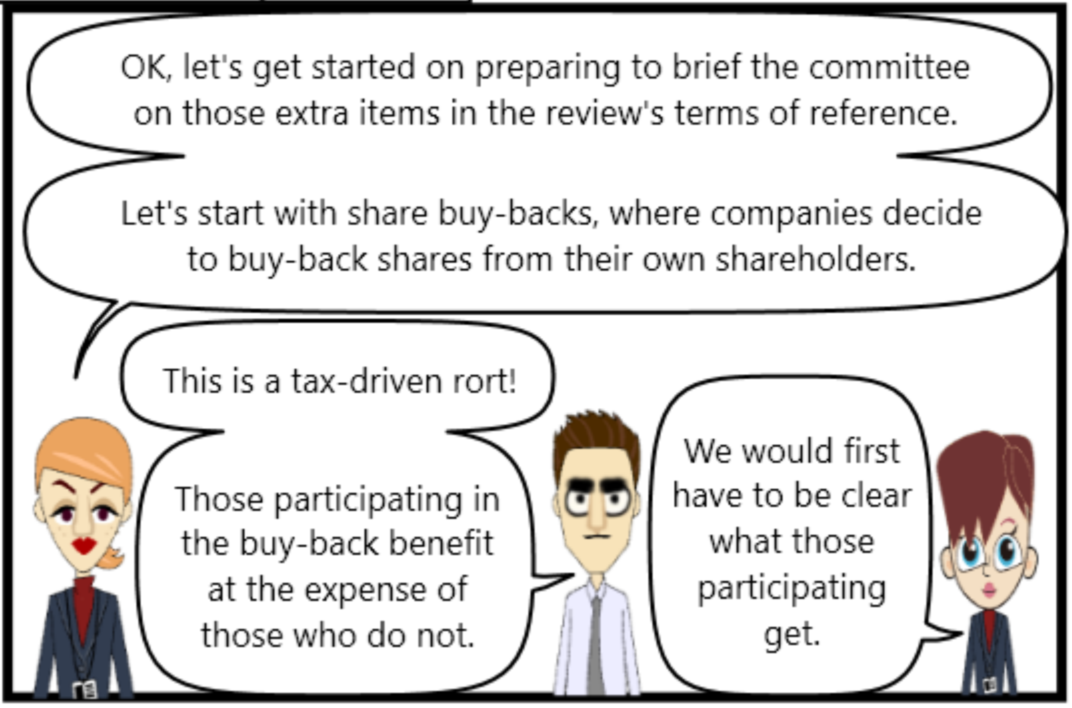


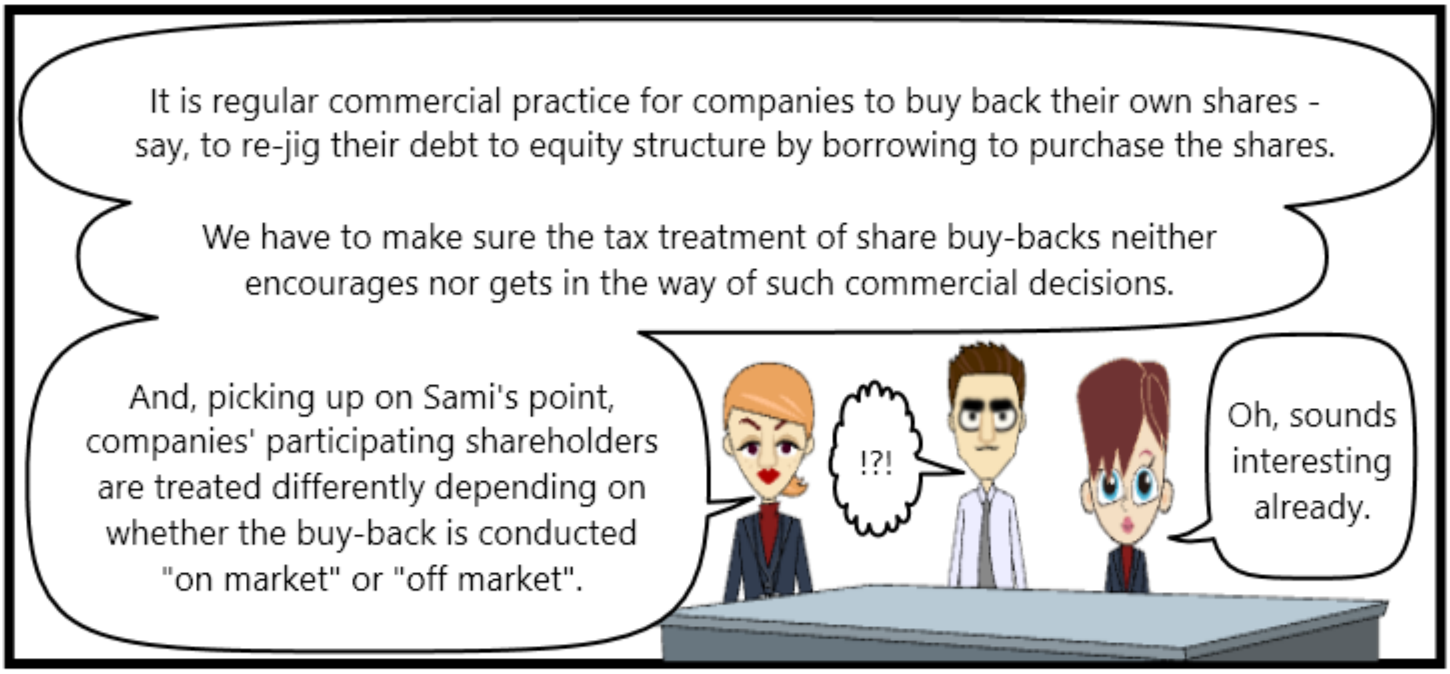

10% return
$1100
$100
$150
down
$1000
$850
$250
Start
End
Remember this?
It shows a $1000 investment producing a 10% return, or $100, from $250 net receipts received by the investor while the value of the investment declines by $150 or 15%.
Of course - the $100 income comes from net receipts plus change in asset value.
Yeah, I have painful memories on discussions about pre- and post-tax returns.
This time, imagine a company, capitalised by $1000, acquires this same asset.
Before the company distributes the $250 cash, the value of the company increases to $1100.
And, after distribution of the cash and absent other influences, the value of the company declines to $850, the same value as its sole asset.
You can see immediately that $100 of the $250 distribution is profit.
And, $150 of it is a return of some of the original $1000 capital invested.
OK, but what about tax values?
So? Is that all?
If tax depreciation of 15% is allowed on the asset, the company would pay 30% tax on $100 taxable income, which matches income.
Then, under imputation, the cash distribution would comprise $70 franked dividends plus $150 return of capital, which is neatly measured for tax purposes.
That means the tax value of the company's shares would be reduced by $150 to $850 - so, if the shares were sold for market value, zero CGT would result with **no loss duplication**.
These are the sorts of outcomes we will see when looking at share buy-backs.
But see what happens when tax and market values of the company's asset or its shares are not aligned.

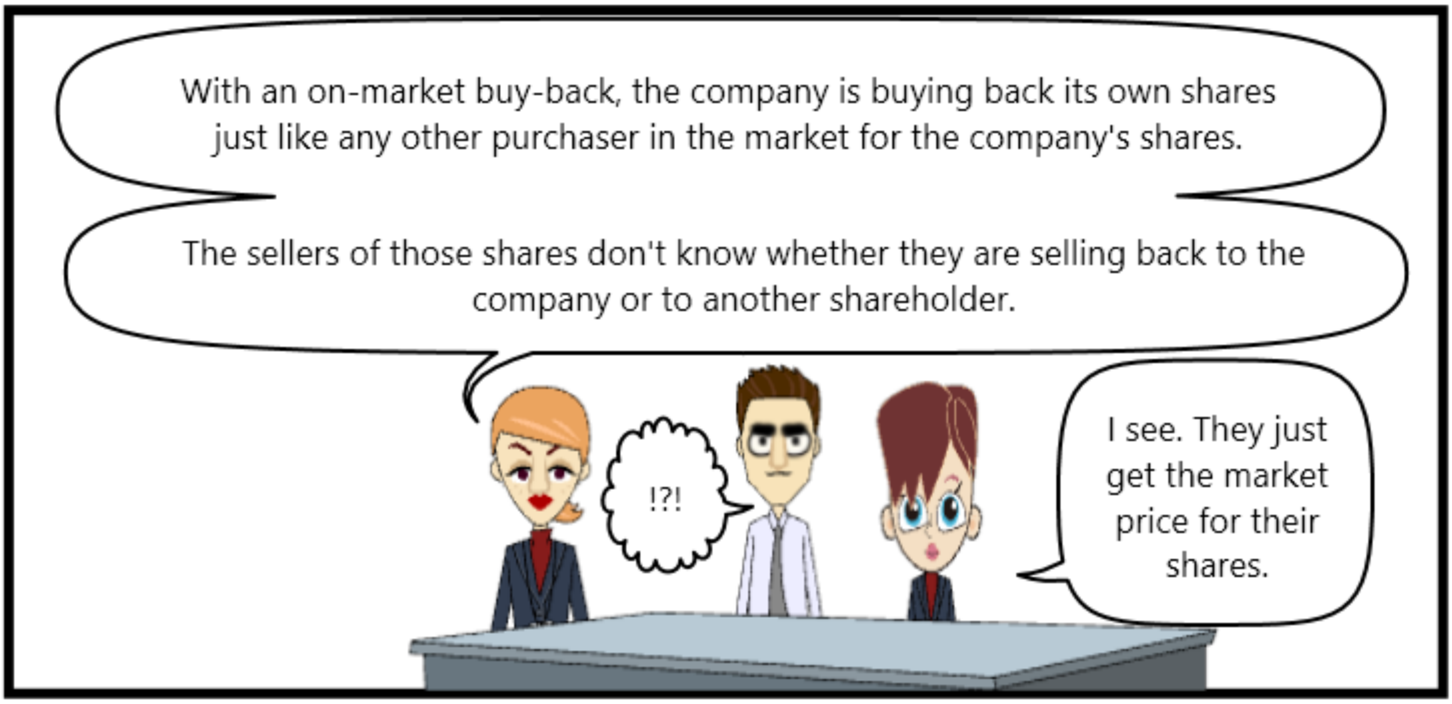

You can immediately see that, if reduction in the shares' tax values were not allowed for returns of capital, the **loss** in value of the company's asset would be **duplicated** via the CGT system if the shares were sold for $850.
10% return
$1100
$100
$1000
$150
down
$850
$250
Start
End
Now, if, at another extreme, no depreciation were allowed, at-end tax value of the asset would still be $1000, way out of line with its $850 value.
The company would pay 30% tax on the whole $250 of net receipts.
All the cash distribution would be franked dividends with no recorded return of capital for tax purposes.
I've got it. The tax value of the company's shares stays at $1000.
Then, the right tax outcome at that time, requires shareholders to sell out for $850, realise a $150 CGT loss to offset the excess tax at the company level.
That's right, Sami.
We will face such situations when we consider different designs for tax consolidation of company groups.
So, the law works.
Aw, c'mon, Brad. Timing is crucial.
OK. Let's call a halt there. You two can have fun using this approach to analyse a variety of outcomes when tax values of either company assets or shares vary from actual value in different ways.
We'll get together again when I have put together some charts to help us with share buy-backs.
I'm OK with that.
I'm already thinking of some interesting angles.

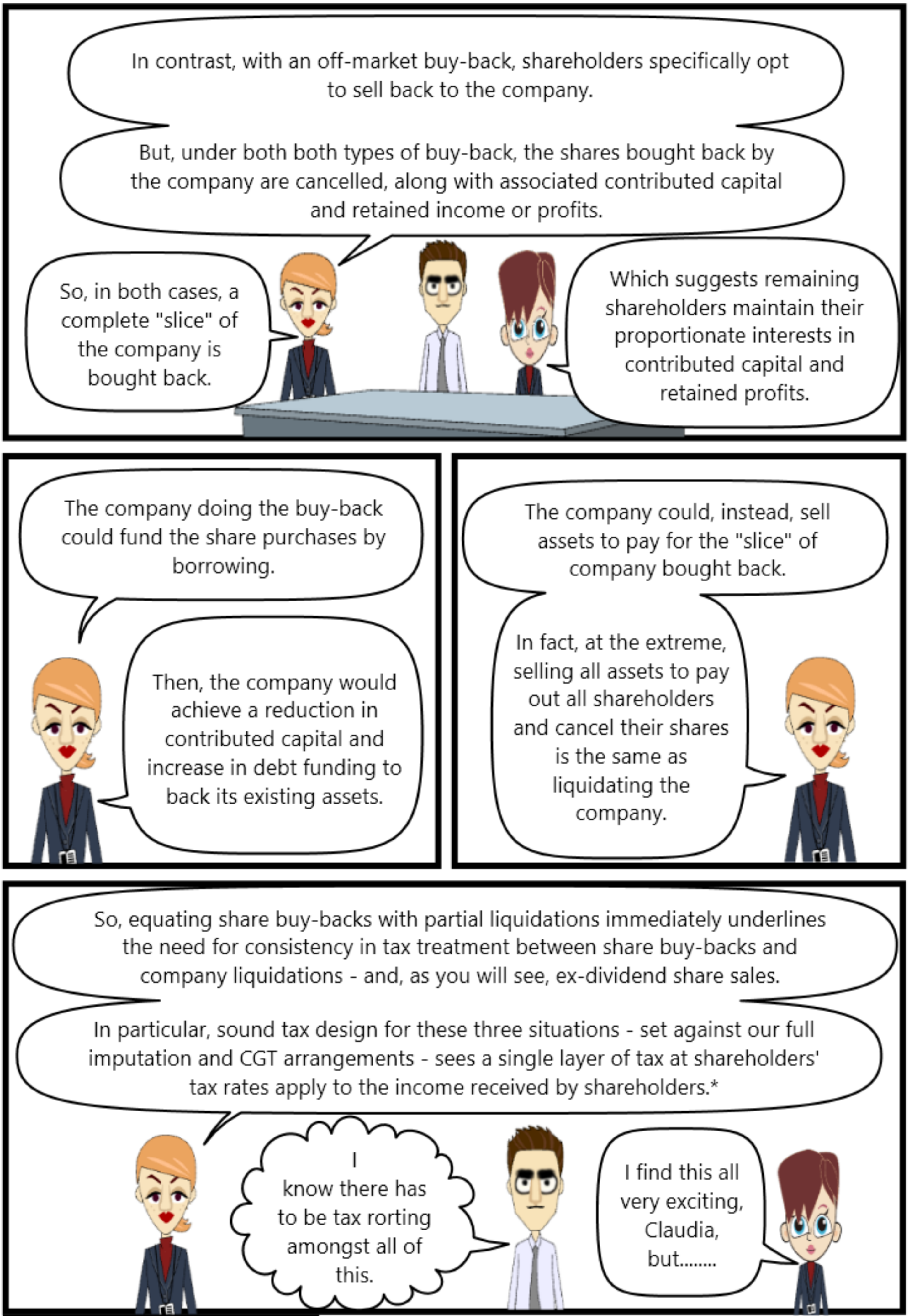
Income tax treatment of share buy-backs

Share buy-backs

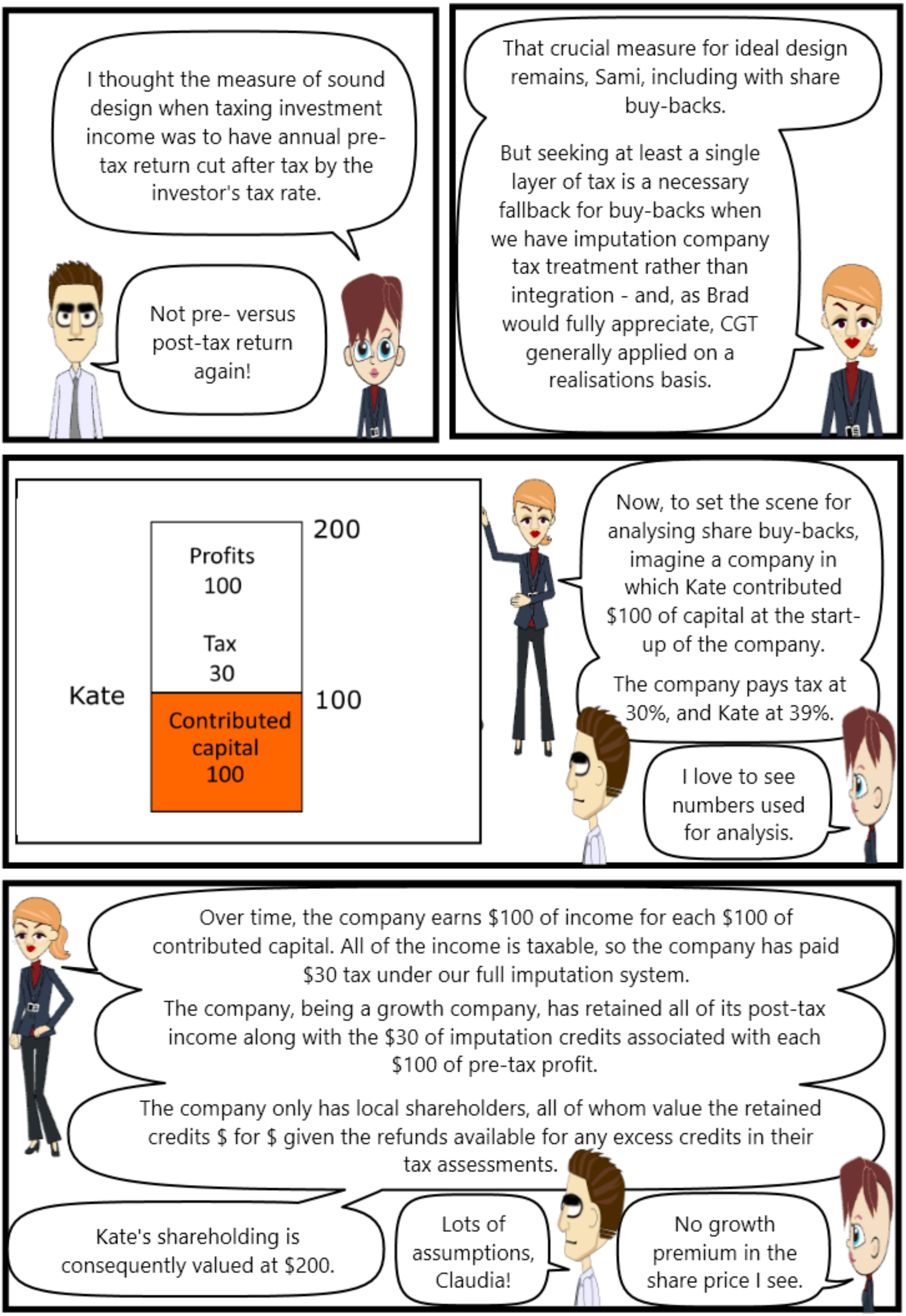




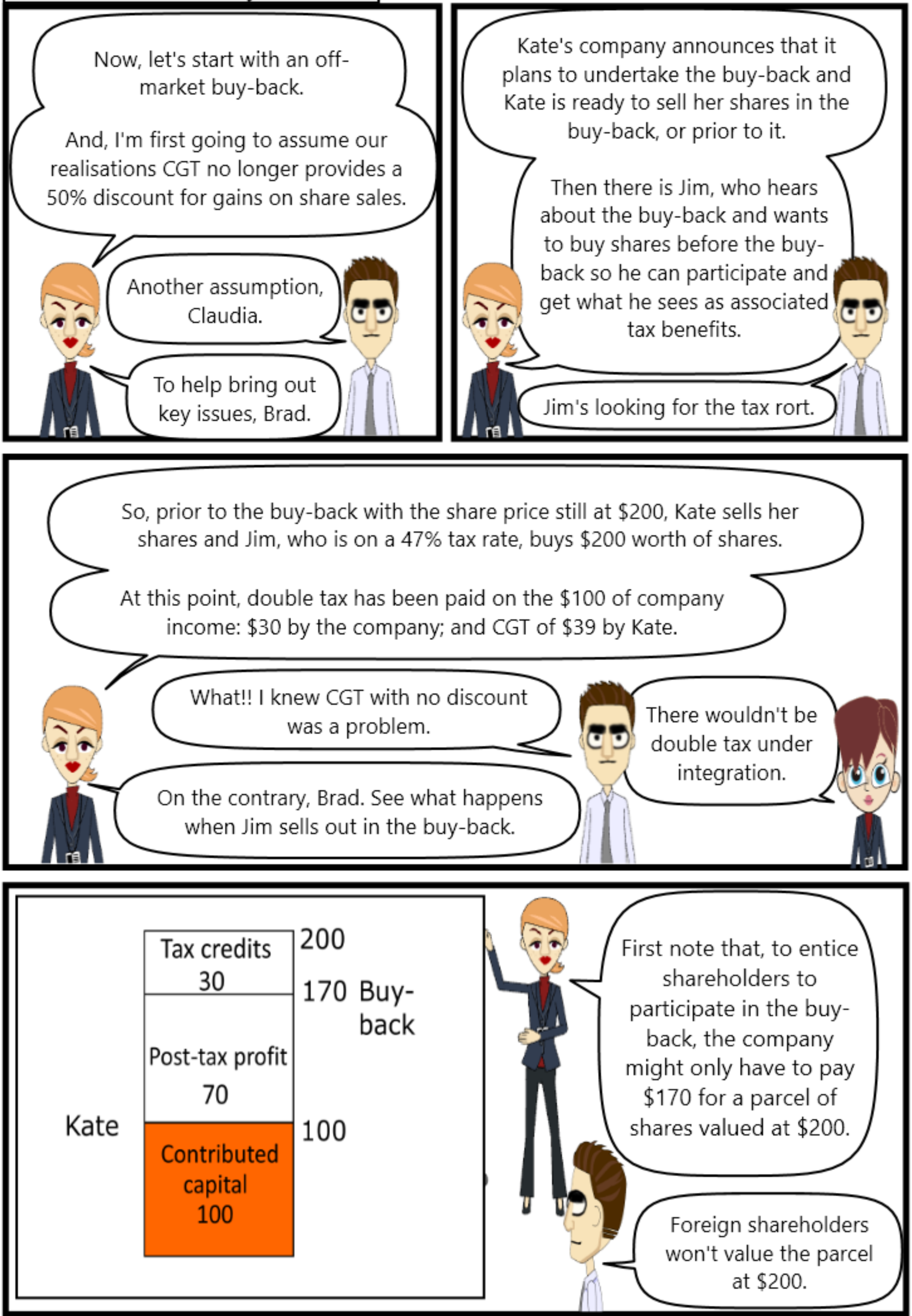




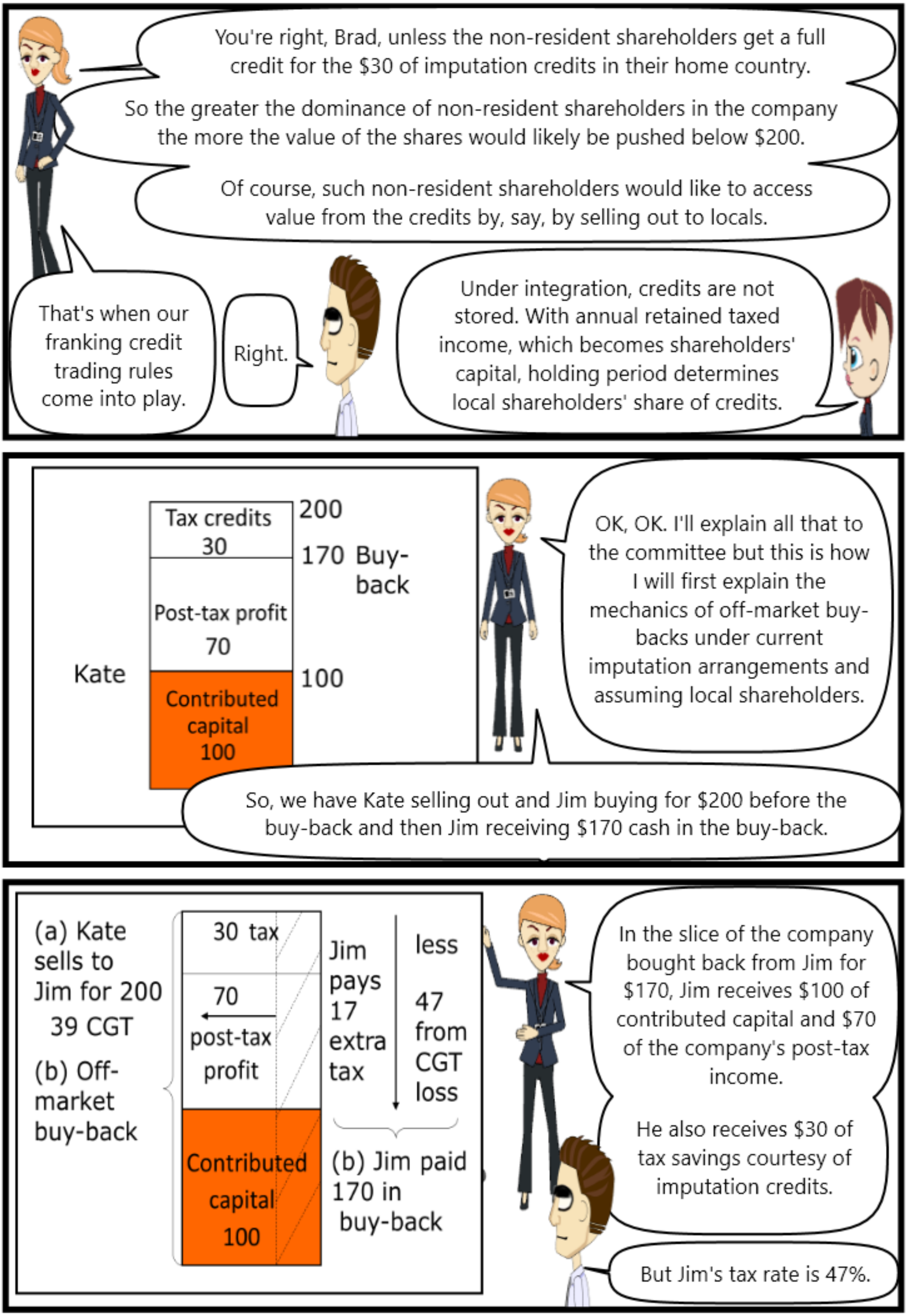
* Ralph Platform, pp 453-458 (Chapter 20).

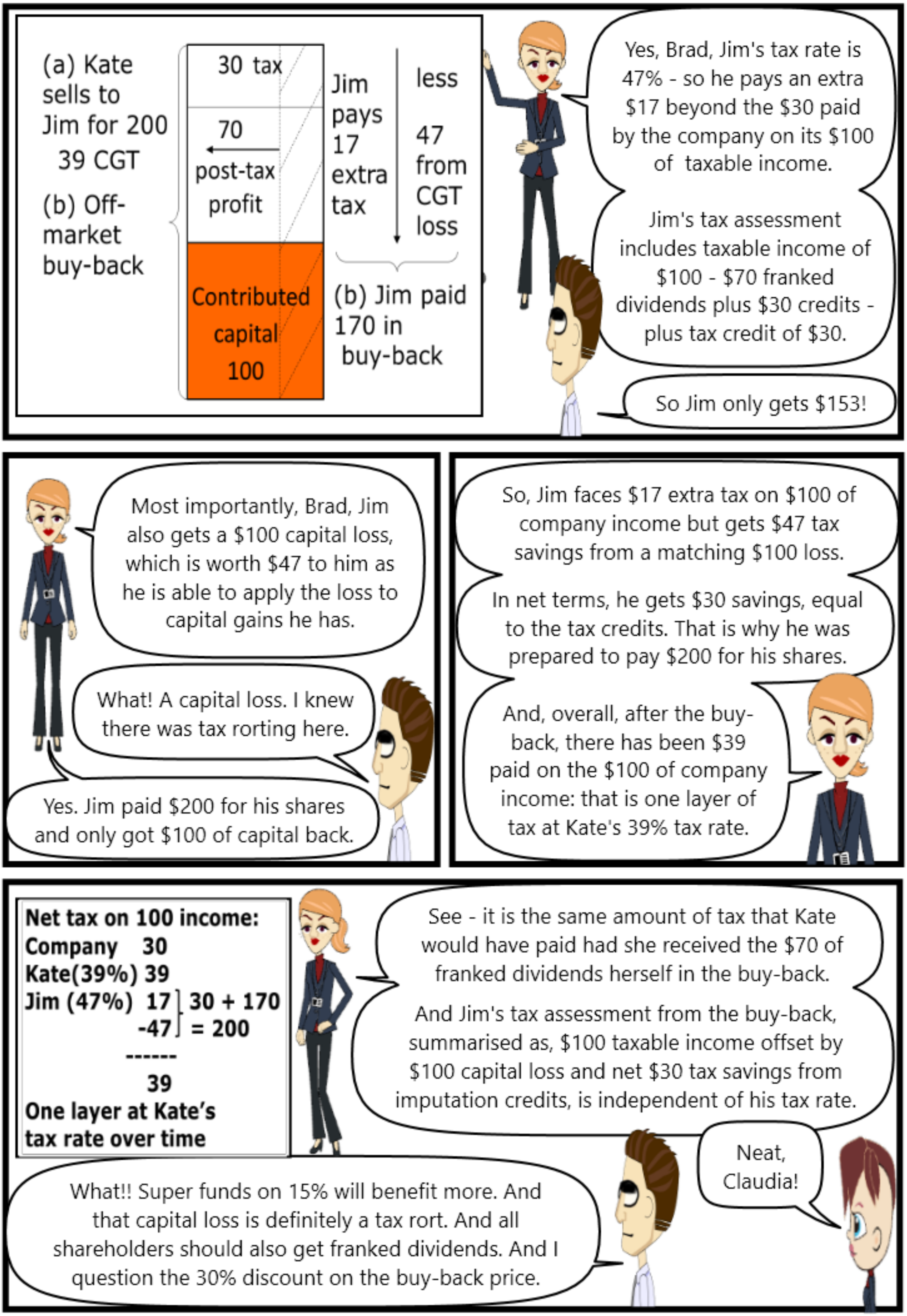

I thought the measure of sound design when taxing investment income was to have annual pre-tax return cut after tax by the investor's tax rate.
Not pre- versus post-tax return again!
That crucial measure for ideal design remains, Sami, including with share buy-backs.
But seeking at least a single layer of tax is a necessary fallback for buy-backs when we have imputation company tax treatment rather than integration - and, as Brad would fully appreciate, CGT generally applied on a realisations basis.
Kate
Profits 100
Tax 30
Contributed capital 100
200
100
Now, to set the scene for analysing share buy-backs, imagine a company in which Kate contributed $100 of capital at the start-up of the company.
The company pays tax at 30%, and Kate at 39%.
I love to see numbers used for analysis.
Over time, the company earns $100 of income for each $100 of contributed capital. All of the income is taxable, so the company has paid $30 tax under our full imputation system.
The company, being a growth company, has retained all of its post-tax income along with the $30 of imputation credits associated with each $100 of pre-tax profit.
The company only has local shareholders, all of whom value the retained credits $ for $ given the refunds available for any excess credits in their tax assessments.
Kate's shareholding is consequently valued at $200.
Lots of assumptions, Claudia!
No growth premium in the share price I see.

Off-market share buy-back*

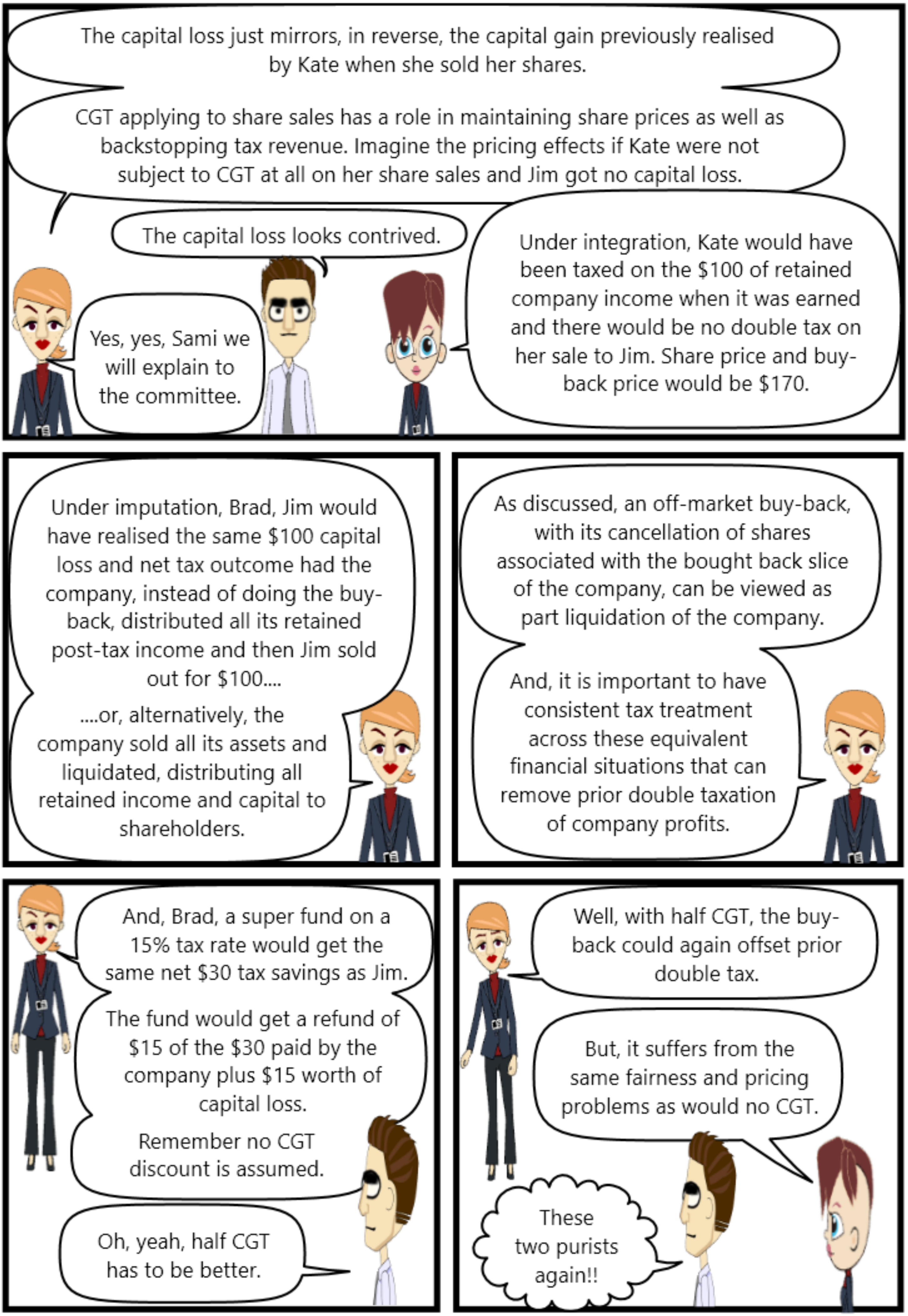


* Mayo (2011), pp 242-250.

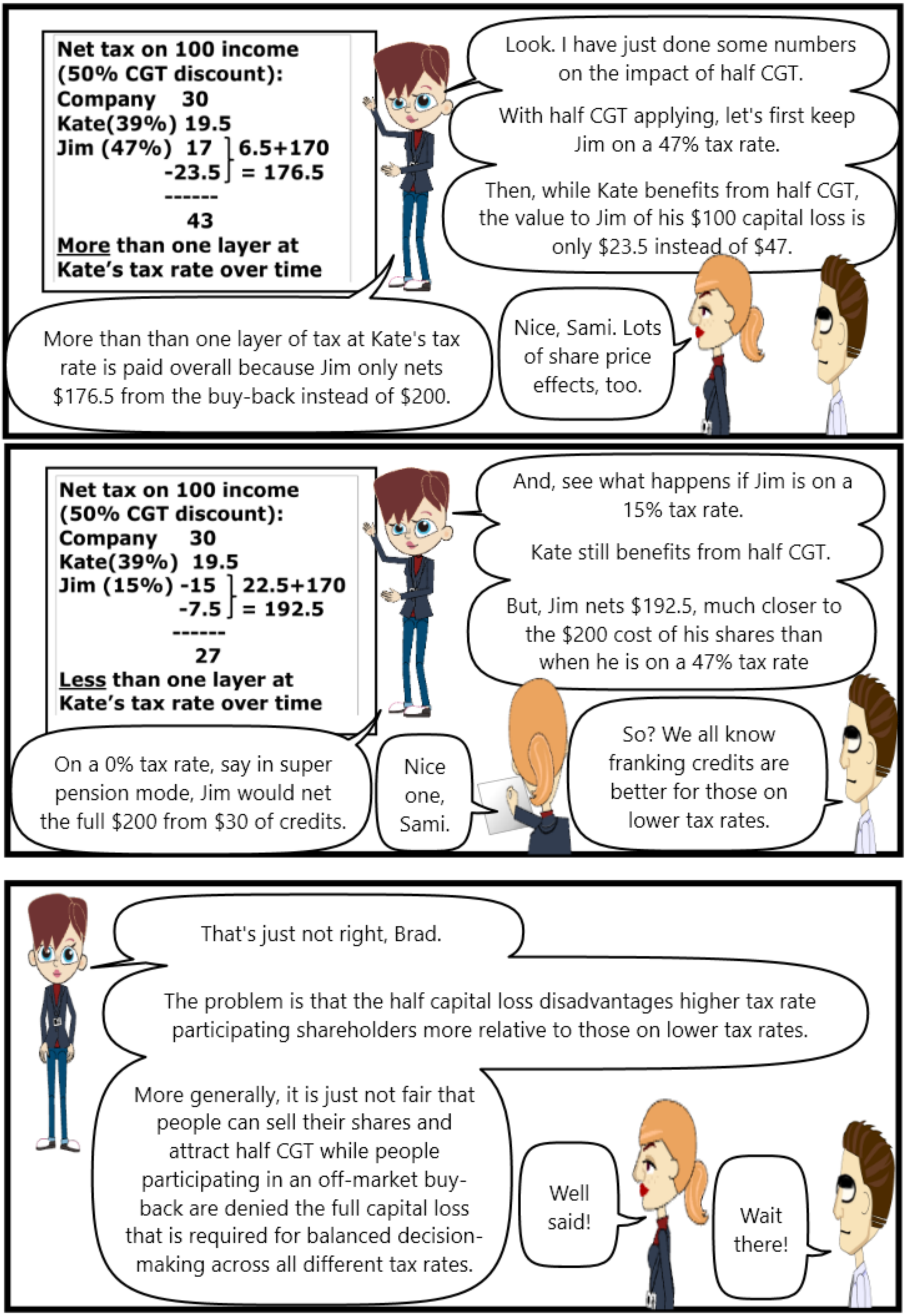

You're right, Brad, unless the non-resident shareholders get a full credit for the $30 of imputation credits in their home country.
So the greater the dominance of non-resident shareholders in the company the more the value of the shares would likely be pushed below $200.
Of course, such non-resident shareholders would like to access value from the credits by, say, by selling out to locals.
That's when our franking credit trading rules come into play.
Right.
Under integration, credits are not stored. With annual retained taxed income, which becomes shareholders' capital, holding period determines local shareholders' share of credits.
Tax credits 30
Post-tax profit 70
Contributed capital 100
200
170 Buy-back
100
Kate
OK, OK. I'll explain all that to the committee but this is how I will first explain the mechanics of off-market buy-backs under current imputation arrangements and assuming local shareholders.
So, we have Kate selling out and Jim buying for $200 before the buy-back and then Jim receiving $170 cash in the buy-back.
(a) Kate sells to Jim for 200
39 CGT
(b) Off-market buy-back
30 tax
70 post-tax profit
Contributed capital 100
Jim pays 17 extra tax
less 47 from CGT loss
(b) Jim paid 170 in buy-back
In the slice of the company bought back from Jim for $170, Jim receives $100 of contributed capital and $70 of the company's post-tax income.
He also receives $30 of tax savings courtesy of imputation credits.
But Jim's tax rate is 47%.


(a) Kate sells to Jim for 200
39 CGT
(b) Off-market buy-back
30 tax
70
post-tax profit
Contributed capital 100
Jim pays 17 extra tax
less 47 from CGT loss
(b) Jim paid 170 in buy-back
Yes, Brad, Jim's tax rate is 47% - so he pays an extra $17 beyond the $30 paid by the company on its $100 of taxable income.
Jim's tax assessment includes taxable income of $100 - $70 franked dividends plus $30 credits - plus tax credit of $30.
So Jim only gets $153!
Most importantly, Brad, Jim also gets a $100 capital loss, which is worth $47 to him as he is able to apply the loss to capital gains he has.
What! A capital loss. I knew there was tax rorting here.
Yes. Jim paid $200 for his shares and only got $100 of capital back.
So, Jim faces $17 extra tax on $100 of company income but gets $47 tax savings from a matching $100 loss.
In net terms, he gets $30 savings, equal to the tax credits. That is why he was prepared to pay $200 for his shares.
And, overall, after the buy-back, there has been $39 paid on the $100 of company income: that is one layer of tax at Kate's 39% tax rate.
Net tax on 100 income:
Company 30
Kate(39%) 39
Jim (47%) 17] 30 + 170
-47] = 200

39
One layer at Kate's tax rate over time
See - it is the same amount of tax that Kate would have paid had she received the $70 of franked dividends herself in the buy-back.
And Jim's tax assessment from the buy-back, summarised as, $100 taxable income offset by $100 capital loss and net $30 tax savings from imputation credits, is independent of his tax rate.
What!! Super funds on 15% will benefit more. And that capital loss is definitely a tax rort. And all shareholders should also get franked dividends. And I question the 30% discount on the buy-back price.
Neat, Claudia!

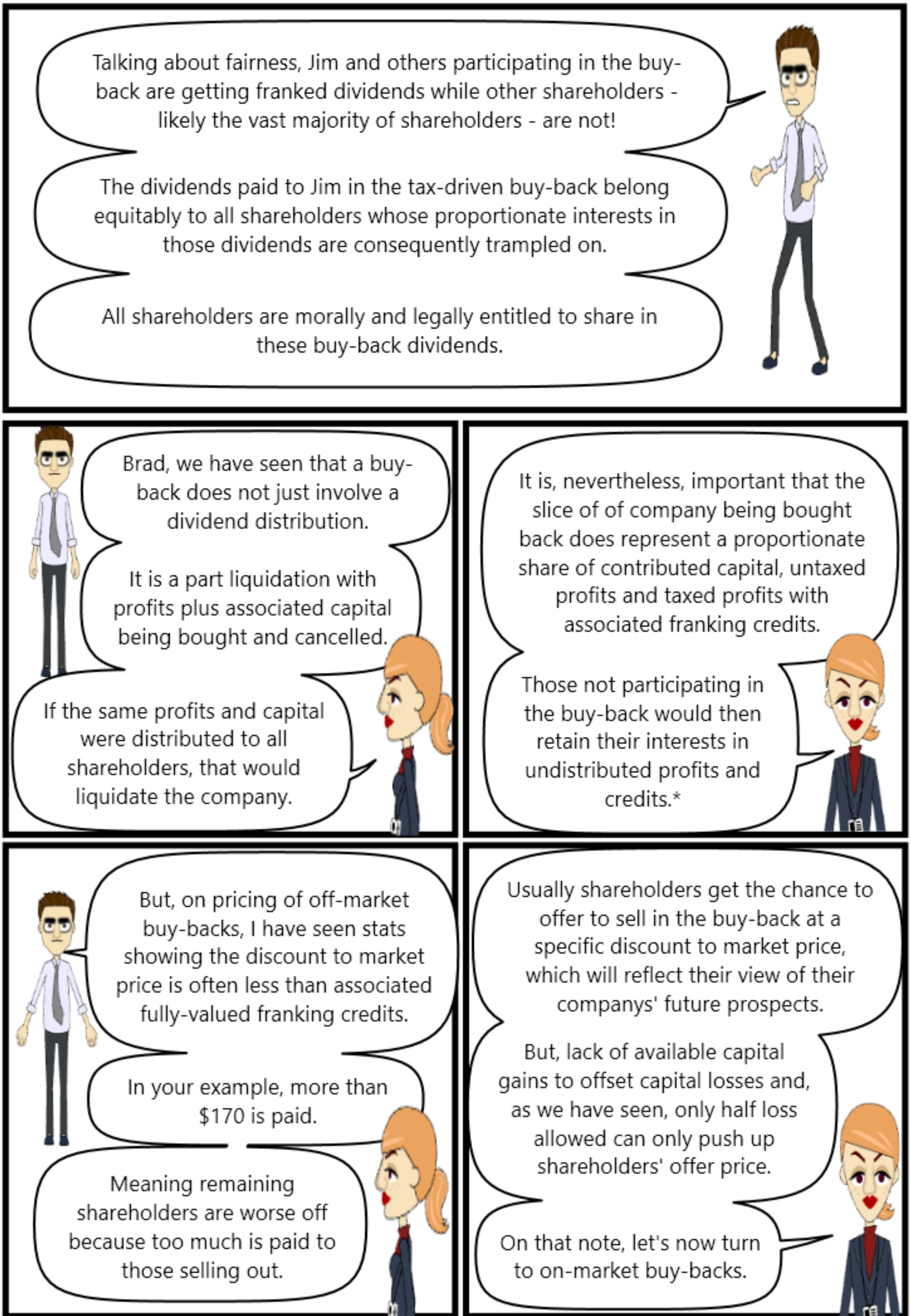


The capital loss just mirrors, in reverse, the capital gain previously realised by Kate when she sold her shares.
CGT applying to share sales has a role in maintaining share prices as well as backstopping tax revenue. Imagine the pricing effects if Kate were not subject to CGT at all on her share sales and Jim got no capital loss.
The capital loss looks contrived.
Yes, yes, Sami we will explain to the committee.
Under integration, Kate would have been taxed on the $100 of retained company income when it was earned and there would be no double tax on her sale to Jim. Share price and buy-back price would be $170.
Under imputation, Brad, Jim would have realised the same $100 capital loss and net tax outcome had the company, instead of doing the buy-back, distributed all its retained post-tax income and then Jim sold out for $100....
....or, alternatively, the company sold all its assets and liquidated, distributing all retained income and capital to shareholders.
As discussed, an off-market buy-back, with its cancellation of shares associated with the bought back slice of the company, can be viewed as part liquidation of the company.
And, it is important to have consistent tax treatment across these equivalent financial situations that can remove prior double taxation of company profits.
And, Brad, a super fund on a 15% tax rate would get the same net $30 tax savings as Jim.
The fund would get a refund of $15 of the $30 paid by the company plus $15 worth of capital loss.
Remember no CGT discount is assumed.
Oh, yeah, half CGT has to be better.
Well, with half CGT, the buy-back could again offset prior double tax.
But, it suffers from the same fairness and pricing problems as would no CGT.
These two purists again!!


Net tax on 100 income (50% CGT discount):
Company 30
Kate(39%) 19.5
Jim (47%) 17 -23.5 6.5+170 = 176.5

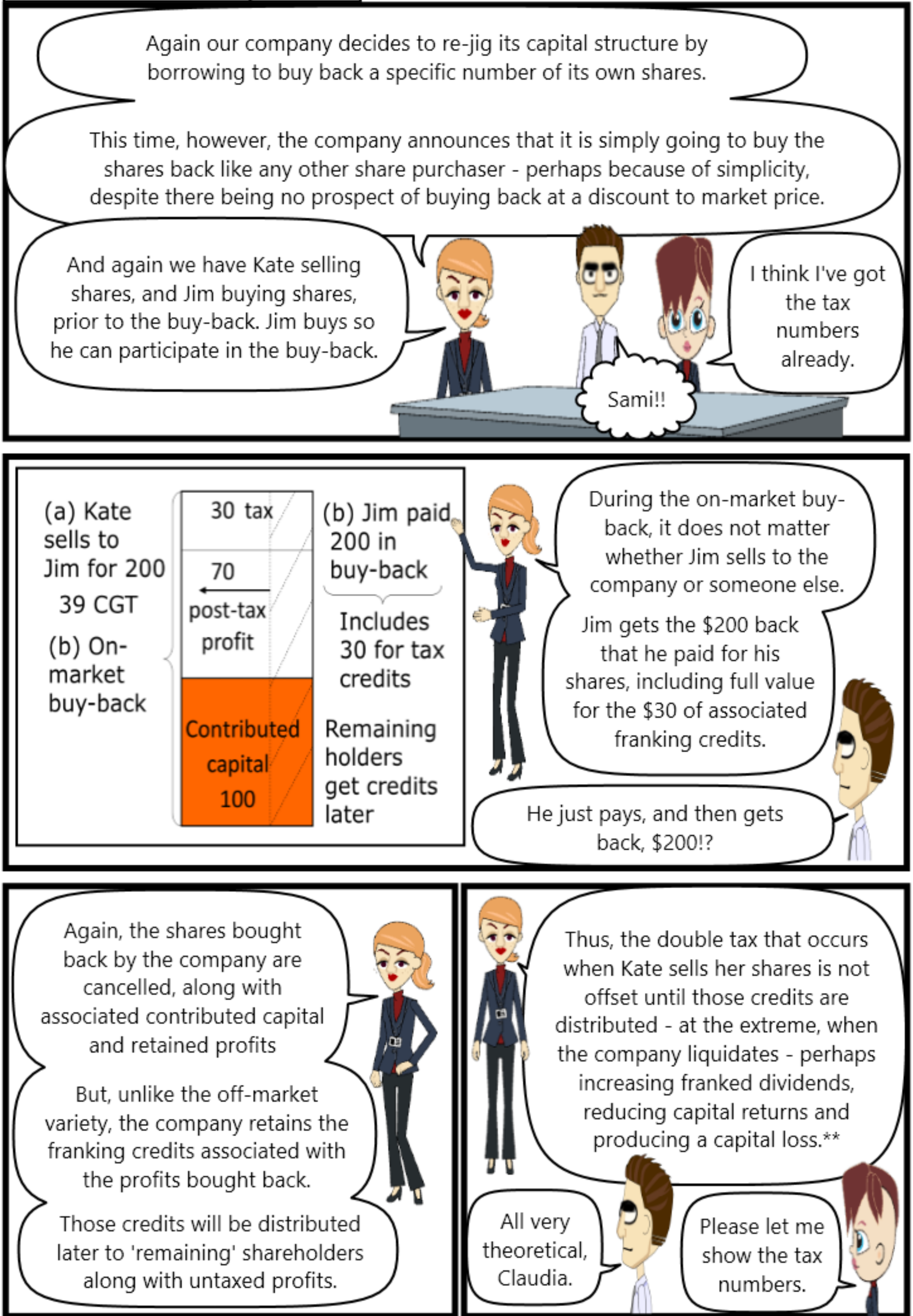
43
More than one layer at Kate's tax rate over time
Look. I have just done some numbers on the impact of half CGT.
With half CGT applying, let's first keep Jim on a 47% tax rate.
Then, while Kate benefits from half CGT, the value to Jim of his $100 capital loss is only $23.5 instead of $47.
More than than one layer of tax at Kate's tax rate is paid overall because Jim only nets $176.5 from the buy-back instead of $200.
Nice, Sami. Lots of share price effects, too.
Net tax on 100 income (50% CGT discount):
Company 30
Kate(39%) 19.5
Jim (15%) -15 -7.5 22.5+170 = 192.5

27
Less than one layer at Kate's tax rate over time
And, see what happens if Jim is on a 15% tax rate.
Kate still benefits from half CGT.
But, Jim nets $192.5, much closer to the $200 cost of his shares than when he is on a 47% tax rate
On a 0% tax rate, say in super pension mode, Jim would net the full $200 from $30 of credits.
Nice one, Sami.
So? We all know franking credits are better for those on lower tax rates.
That's just not right, Brad.
The problem is that the half capital loss disadvantages higher tax rate participating shareholders more relative to those on lower tax rates.
More generally, it is just not fair that people can sell their shares and attract half CGT while people participating in an off-market buy-back are denied the full capital loss that is required for balanced decision-making across all different tax rates.
Well said!
Wait there!



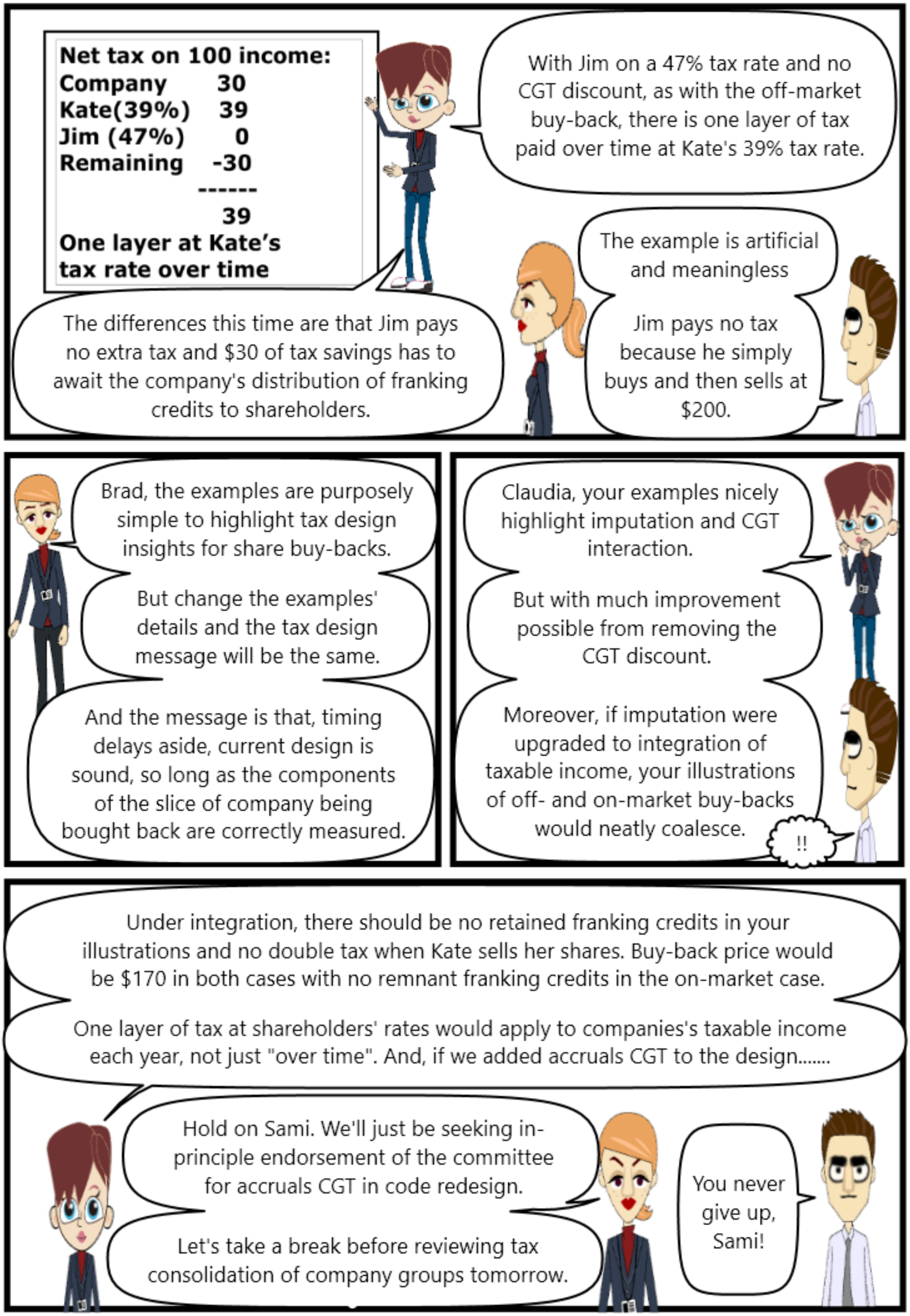
* Ralph Review, pp 454-455 (Section 12).

On-market share buy-back*



* Mayo (2011), pp 250-256.

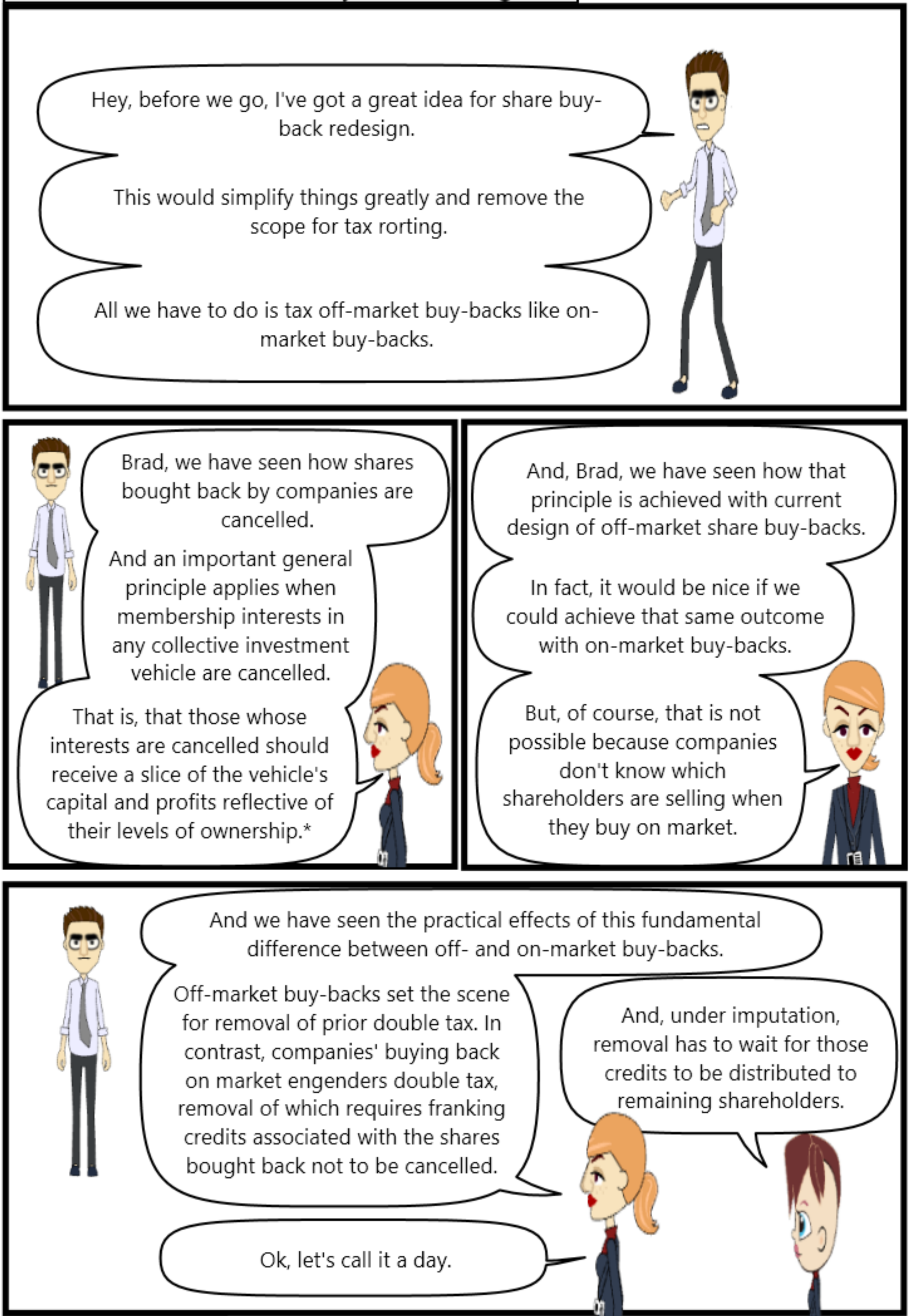
** See alternative design in Ralph Review, pp 456-457 .



Net tax on 100 income:
Company 30
Kate(39%) 39
Jim (47%) 0
Remaining -30

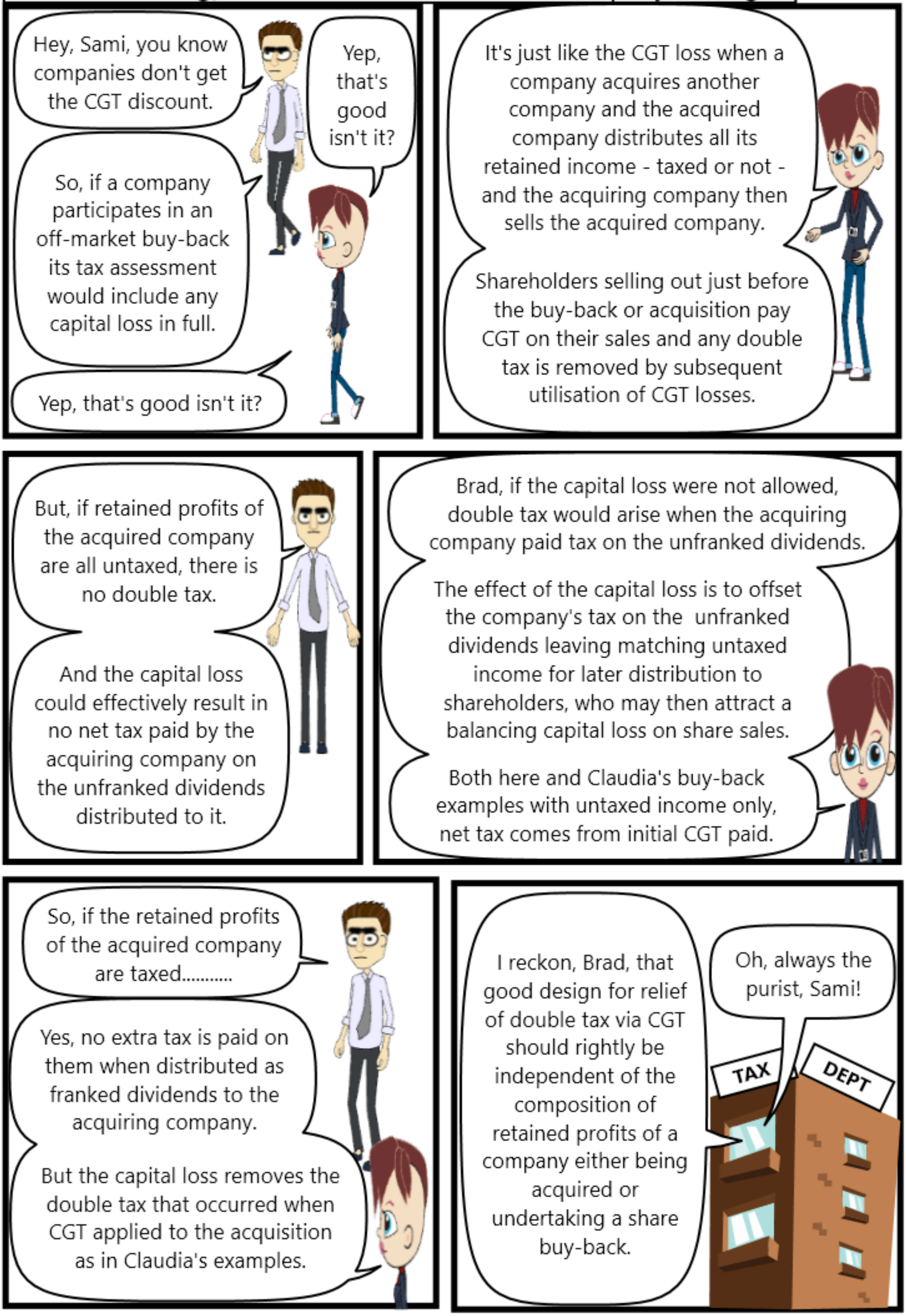
39
One layer at Kate's tax rate over time
With Jim on a 47% tax rate and no CGT discount, as with the off-market buy-back, there is one layer of tax paid over time at Kate's 39% tax rate.
The differences this time are that Jim pays no extra tax and $30 of tax savings has to await the company's distribution of franking credits to shareholders.
The example is artificial and meaningless
Jim pays no tax because he simply buys and then sells at $200.
Brad, the examples are purposely simple to highlight tax design insights for share buy-backs.
But change the examples' details and the tax design message will be the same.
And the message is that, timing delays aside, current design is sound, so long as the components of the slice of company being bought back are correctly measured.
Claudia, your examples nicely highlight imputation and CGT interaction.
But with much improvement possible from removing the CGT discount.
Moreover, if imputation were upgraded to integration of taxable income, your illustrations of off- and on-market buy-backs would neatly coalesce.
!!
Under integration, there should be no retained franking credits in your illustrations and no double tax when Kate sells her shares. Buy-back price would be $170 in both cases with no remnant franking credits in the on-market case.
One layer of tax at shareholders' rates would apply to companies's taxable income each year, not just "over time". And, if we added accruals CGT to the design.......
Hold on Sami. We'll just be seeking in-principle endorsement of the committee for accruals CGT in code redesign.
Let's take a break before reviewing tax consolidation of company groups tomorrow.
You never give up, Sami!

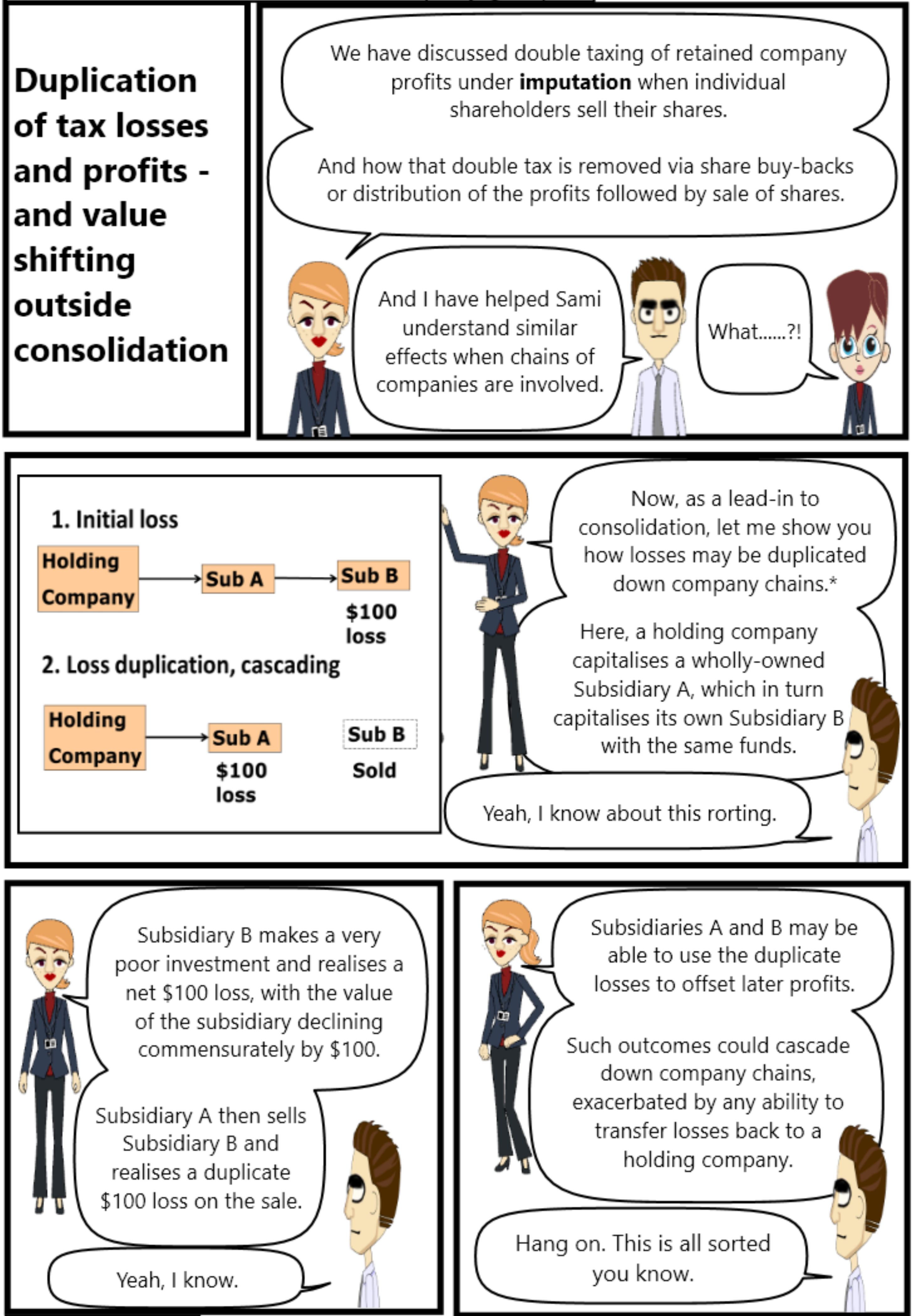
Brad has a novel idea for buy-back redesign



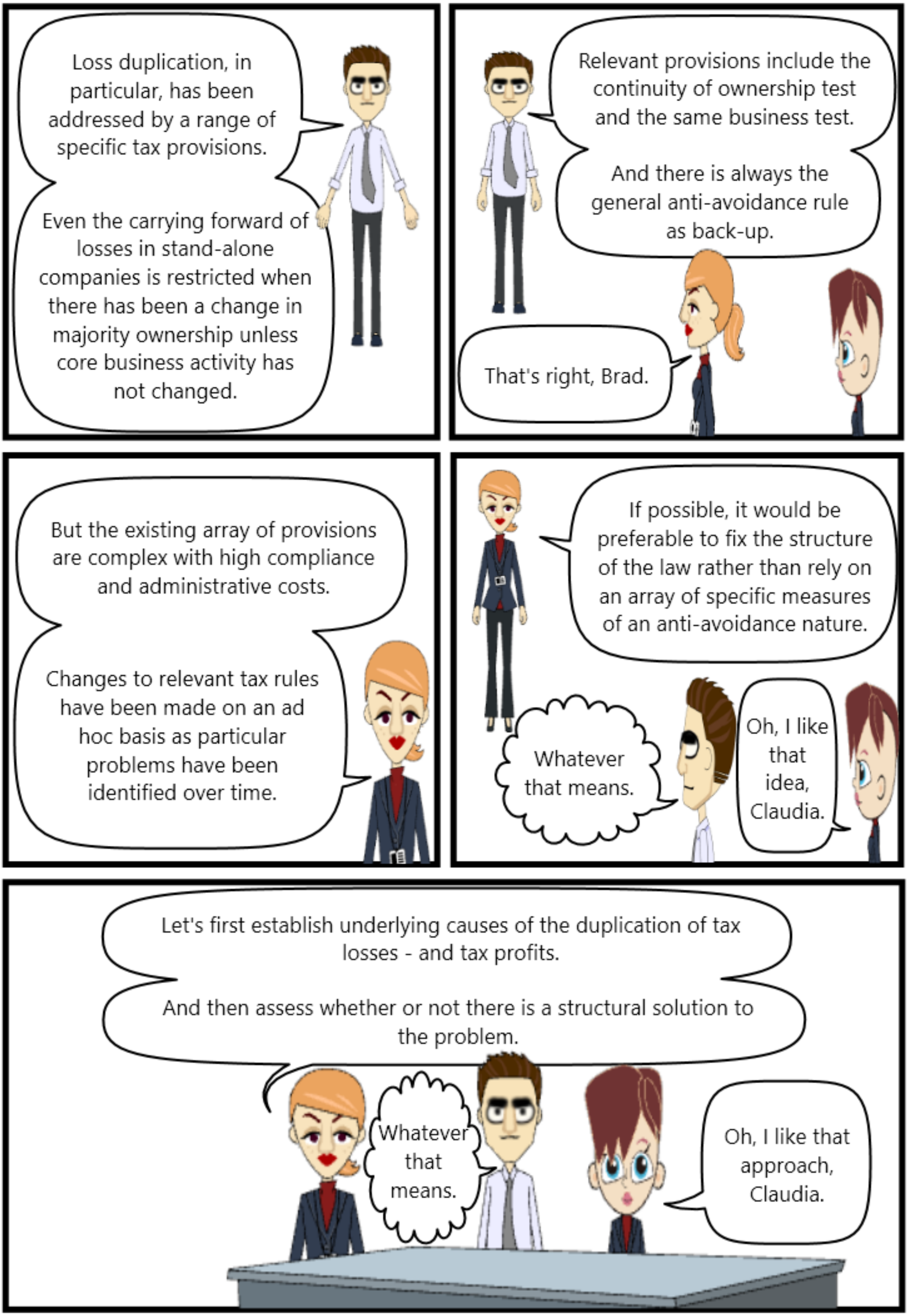
* Ralph Review, pp 454-455.

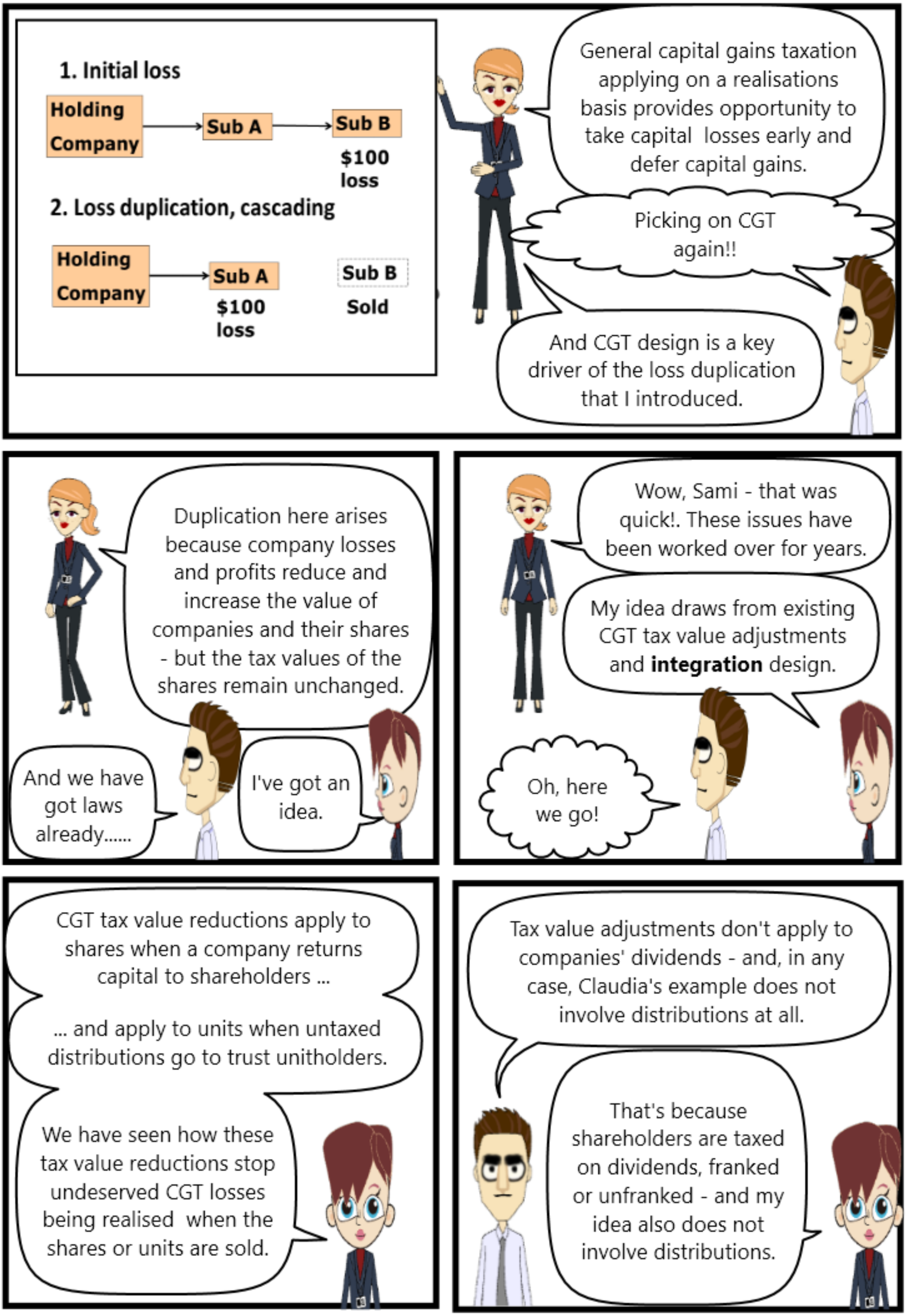
After the meeting, Brad and Sami discuss inter-company dealings

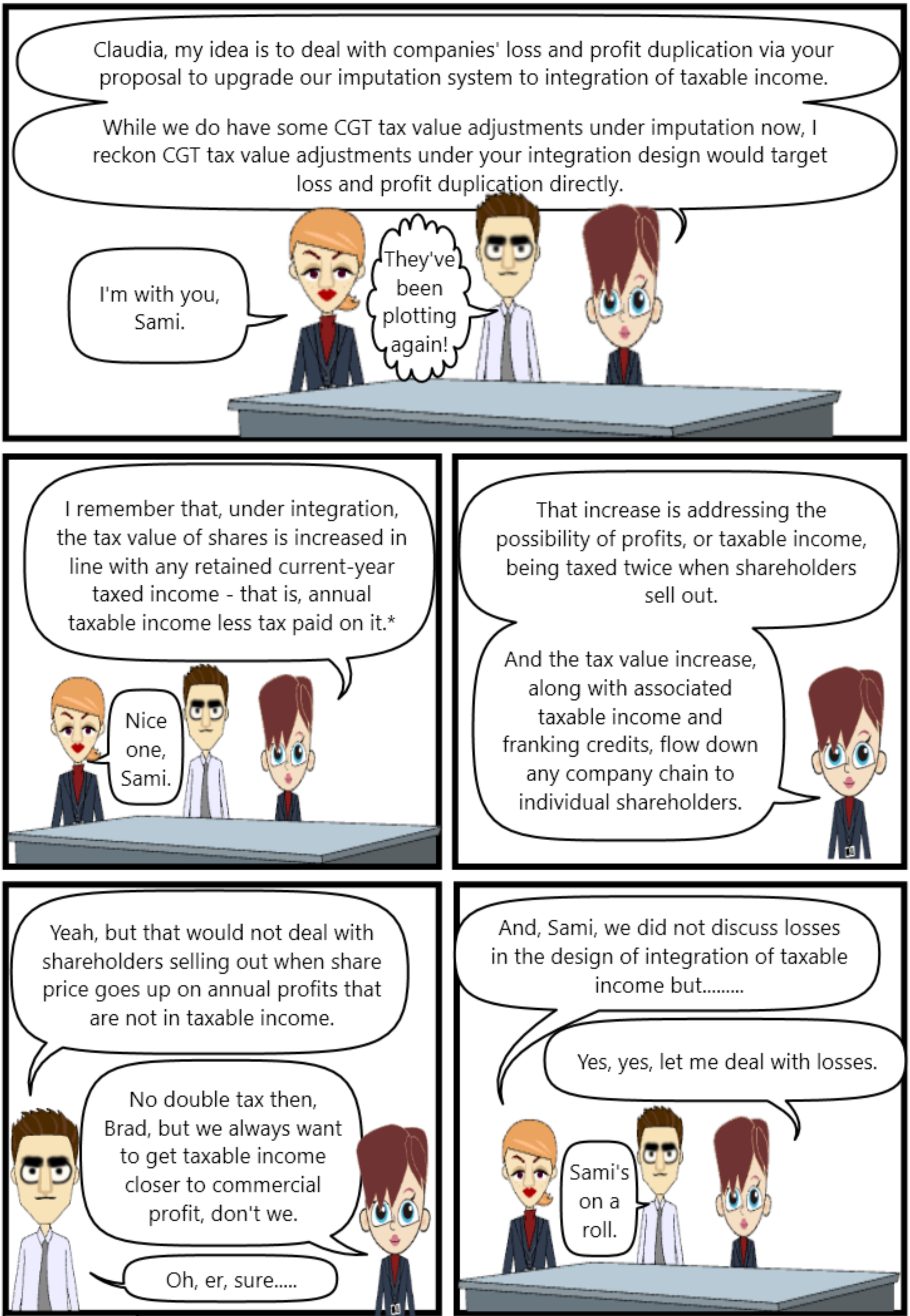




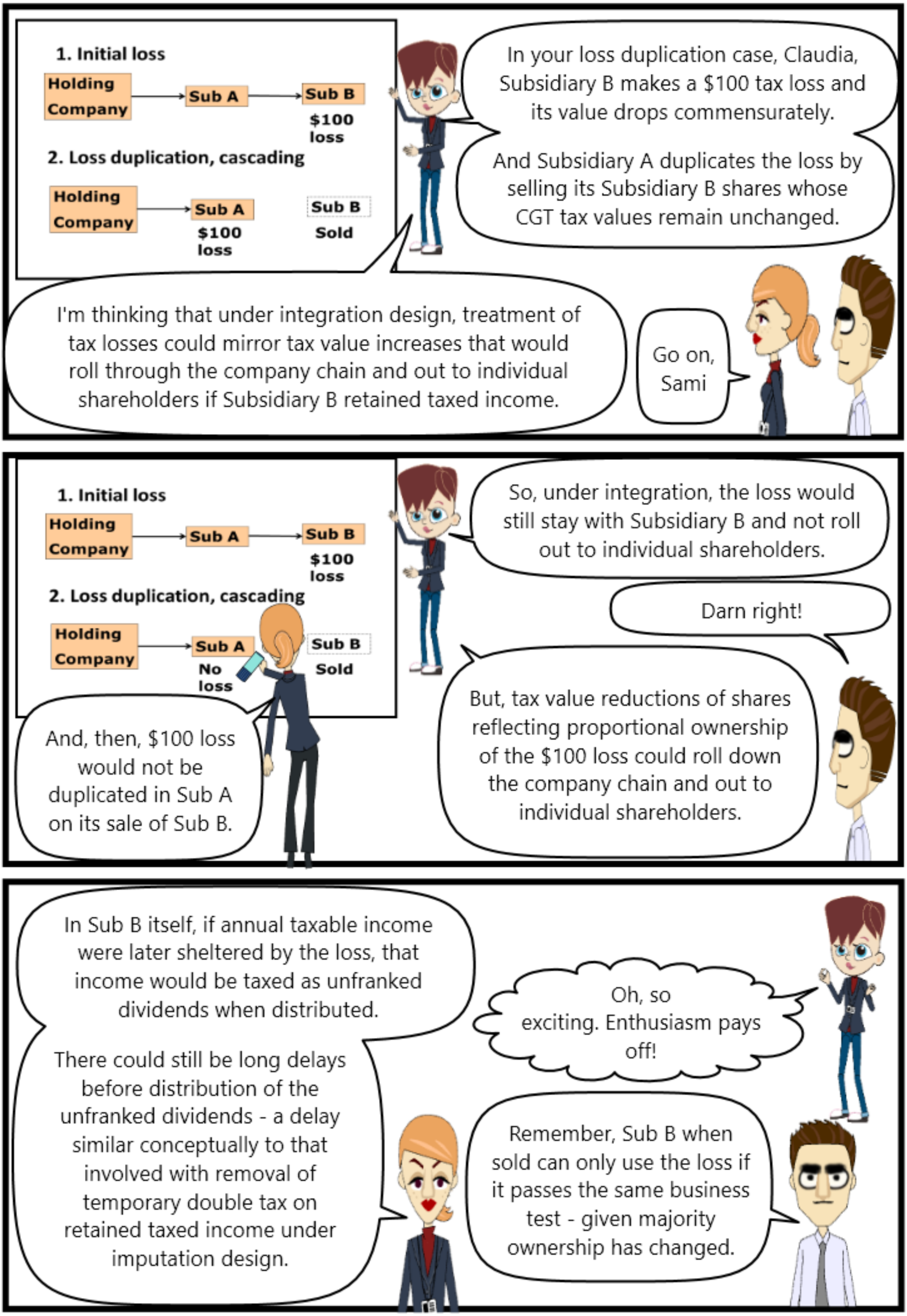
* Ralph Platform, p 535.

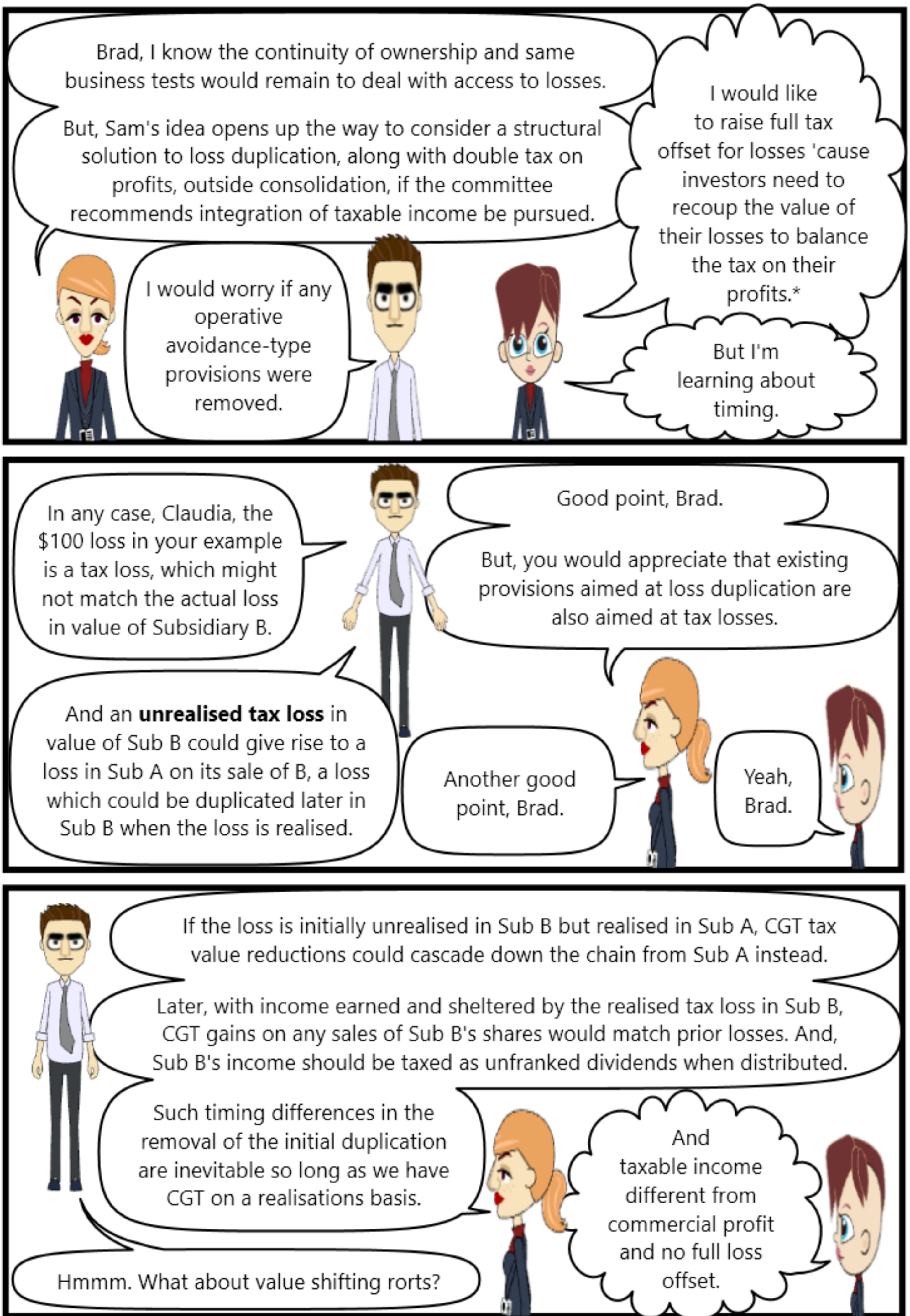

Loss duplication, in particular, has been addressed by a range of specific tax provisions.
Even the carrying forward of losses in stand-alone companies is restricted when there has been a change in majority ownership unless core business activity has not changed.
Relevant provisions include the continuity of ownership test and the same business test.
And there is always the general anti-avoidance rule as back-up.
That's right, Brad.
But the existing array of provisions are complex with high compliance and administrative costs.
Changes to relevant tax rules have been made on an ad hoc basis as particular problems have been identified over time.
If possible, it would be preferable to fix the structure of the law rather than rely on an array of specific measures of an anti-avoidance nature.
Whatever that means.
Oh, I like that idea, Claudia.
Let's first establish underlying causes of the duplication of tax losses - and tax profits.
And then assess whether or not there is a structural solution to the problem.
Whatever that means.
Oh, I like that approach, Claudia.


1. Initial loss
Holding Company
Sub A
Sub B
$100 loss
2. Loss duplication, cascading
Holding Company
Sub A
Sub B
$100 loss
Sold
General capital gains taxation applying on a realisations basis provides opportunity to take capital losses early and defer capital gains.
Picking on CGT again!!
And CGT design is a key driver of the loss duplication that I introduced.
Duplication here arises because company losses and profits reduce and increase the value of companies and their shares - but the tax values of the shares remain unchanged.
And we have got laws already......
I've got an idea.
Wow, Sami - that was quick!. These issues have been worked over for years.
My idea draws from existing CGT tax value adjustments and **integration** design.
Oh, here we go!
CGT tax value reductions apply to shares when a company returns capital to shareholders ...
... and apply to units when untaxed distributions go to trust unitholders.
We have seen how these tax value reductions stop undeserved CGT losses being realised when the shares or units are sold.
Tax value adjustments don't apply to companies' dividends - and, in any case, Claudia's example does not involve distributions at all.
That's because shareholders are taxed on dividends, franked or unfranked - and my idea also does not involve distributions.


Claudia, my idea is to deal with companies' loss and profit duplication via your proposal to upgrade our imputation system to integration of taxable income.
While we do have some CGT tax value adjustments under imputation now, I reckon CGT tax value adjustments under your integration design would target loss and profit duplication directly.
I'm with you, Sami.
They've been plotting again!
I remember that, under integration, the tax value of shares is increased in line with any retained current-year taxed income - that is, annual taxable income less tax paid on it.*
Nice one, Sami.
That increase is addressing the possibility of profits, or taxable income, being taxed twice when shareholders sell out.
And the tax value increase, along with associated taxable income and franking credits, flow down any company chain to individual shareholders.
Yeah, but that would not deal with shareholders selling out when share price goes up on annual profits that are not in taxable income.
No double tax then, Brad, but we always want to get taxable income closer to commercial profit, don't we.
Oh, er, sure.....
And, Sami, we did not discuss losses in the design of integration of taxable income but.........
Yes, yes, let me deal with losses.
Sami's on a roll.

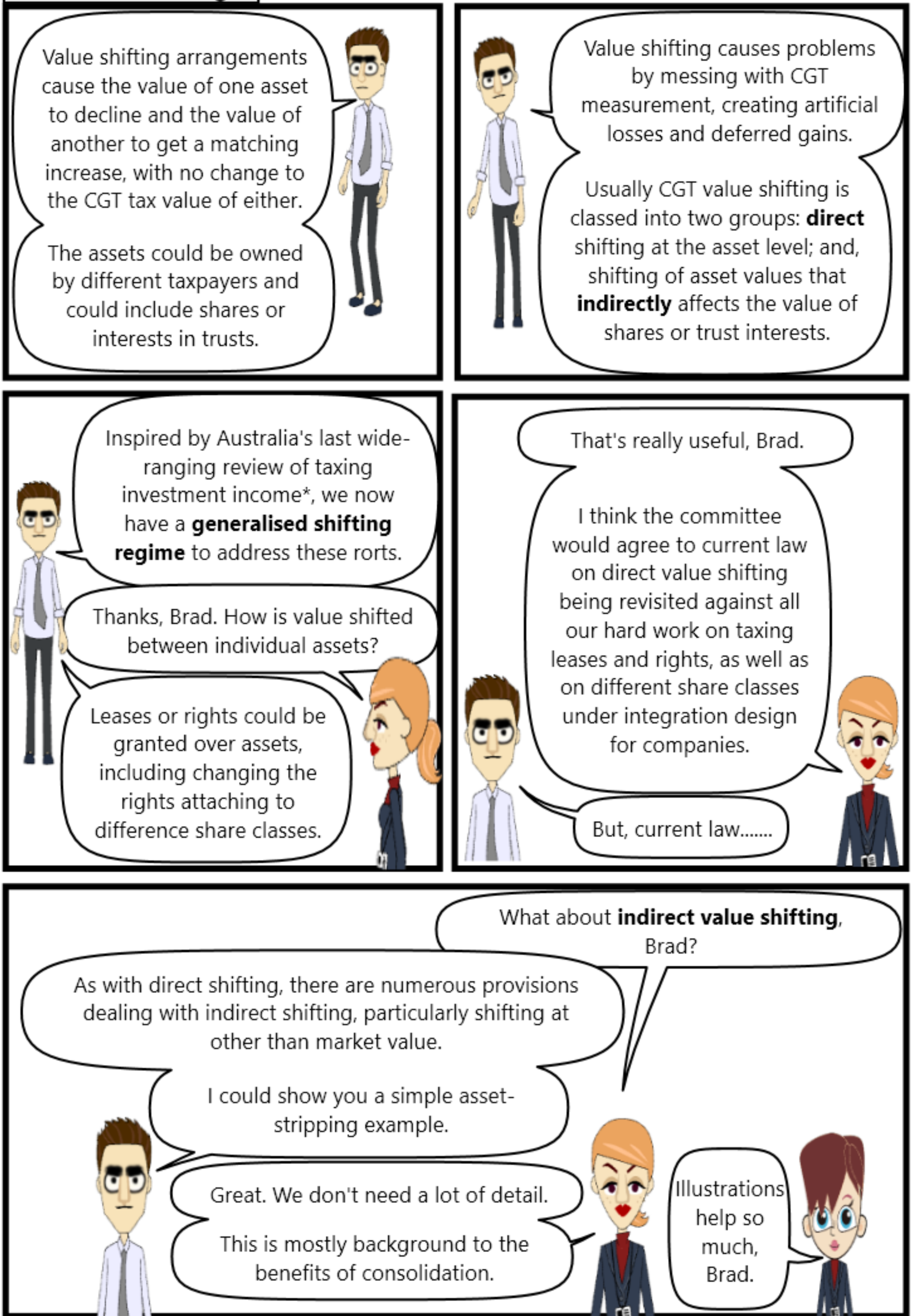
* Ch3, pp 13-14.


1. Initial loss
Holding Company
Sub A
Sub B
$100 loss
2. Loss duplication, cascading
Holding Company
Sub A
$100 loss
Sub B
Sold
In your loss duplication case, Claudia, Subsidiary B makes a $100 tax loss and its value drops commensurately.
And Subsidiary A duplicates the loss by selling its Subsidiary B shares whose CGT tax values remain unchanged.
I'm thinking that under integration design, treatment of tax losses could mirror tax value increases that would roll through the company chain and out to individual shareholders if Subsidiary B retained taxed income.
Go on, Sami
1. Initial loss
Holding Company
Sub A
Sub B
$100 loss
2. Loss duplication, cascading
Holding Company
Sub A
No loss
Sub B
Sold
So, under integration, the loss would still stay with Subsidiary B and not roll out to individual shareholders.
Darn right!
And, then, $100 loss would not be duplicated in Sub A on its sale of Sub B.
But, tax value reductions of shares reflecting proportional ownership of the $100 loss could roll down the company chain and out to individual shareholders.
In Sub B itself, if annual taxable income were later sheltered by the loss, that income would be taxed as unfranked dividends when distributed.
There could still be long delays before distribution of the unfranked dividends - a delay similar conceptually to that involved with removal of temporary double tax on retained taxed income under imputation design.
Oh, so exciting. Enthusiasm pays off!
Remember, Sub B when sold can only use the loss if it passes the same business test - given majority ownership has changed.



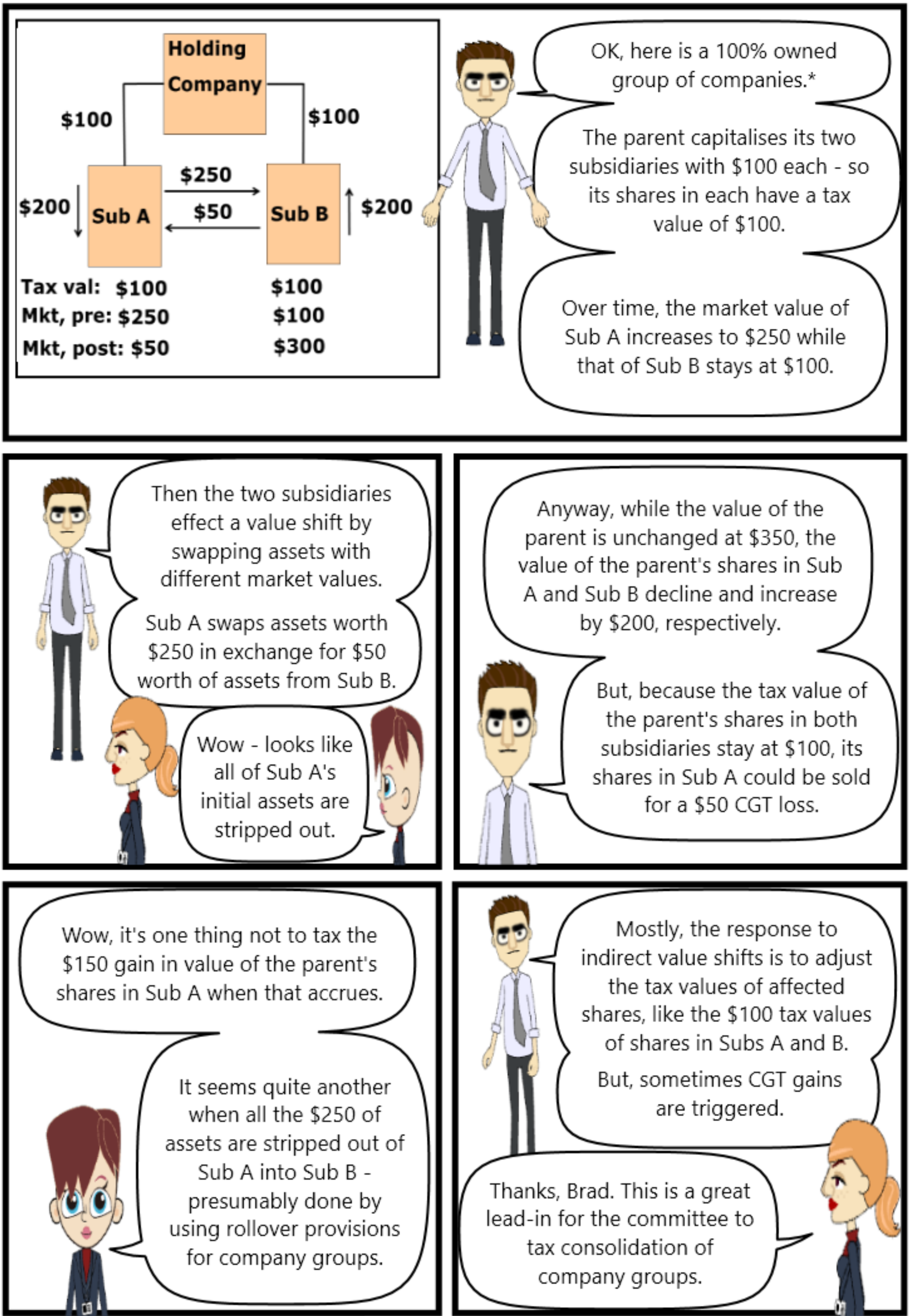
* Ralph Platform, pp 593-596.

CGT value shifting

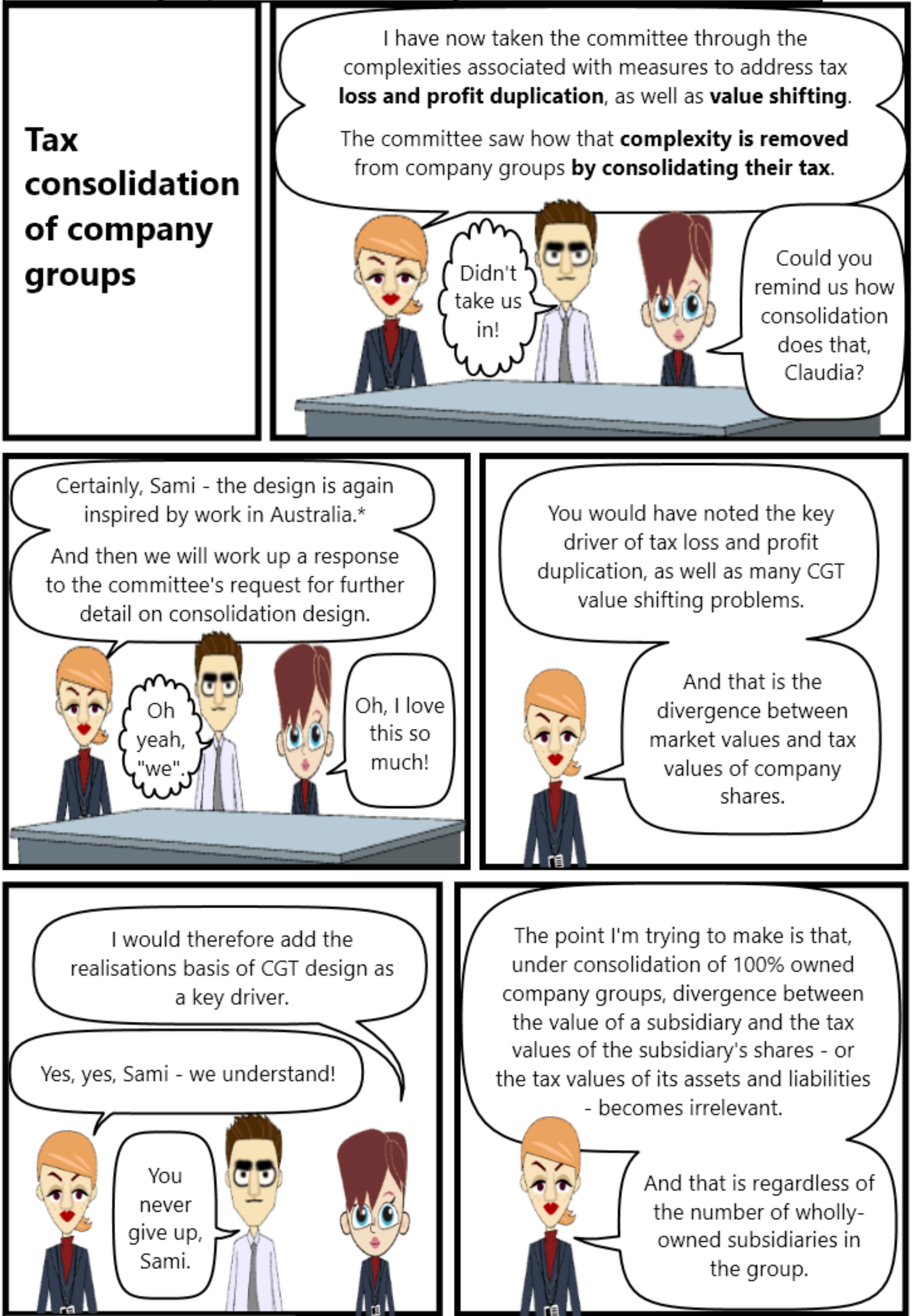


* Ralph Platform, Chapter 29.

* Ralph Review, pp 261-266.

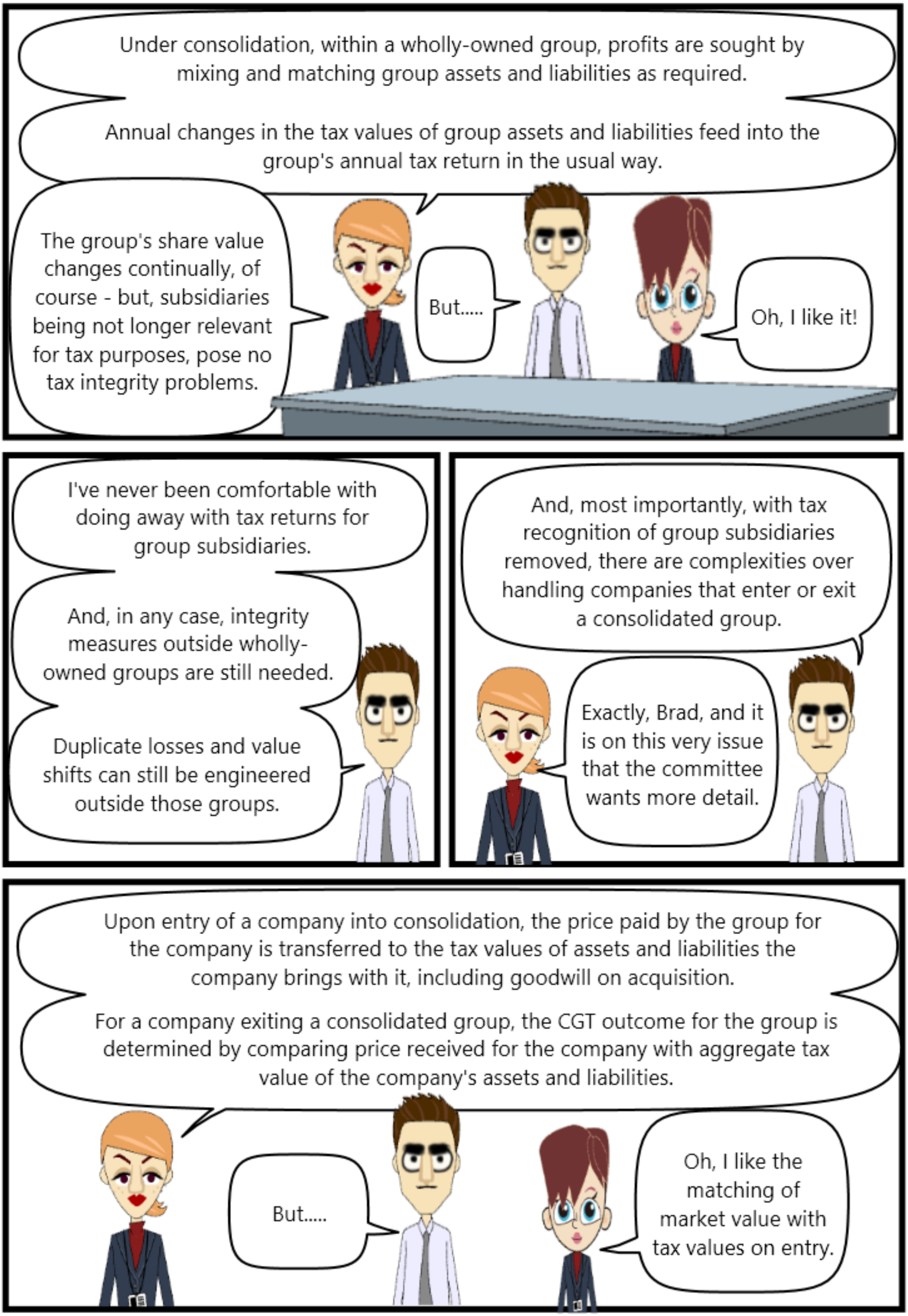


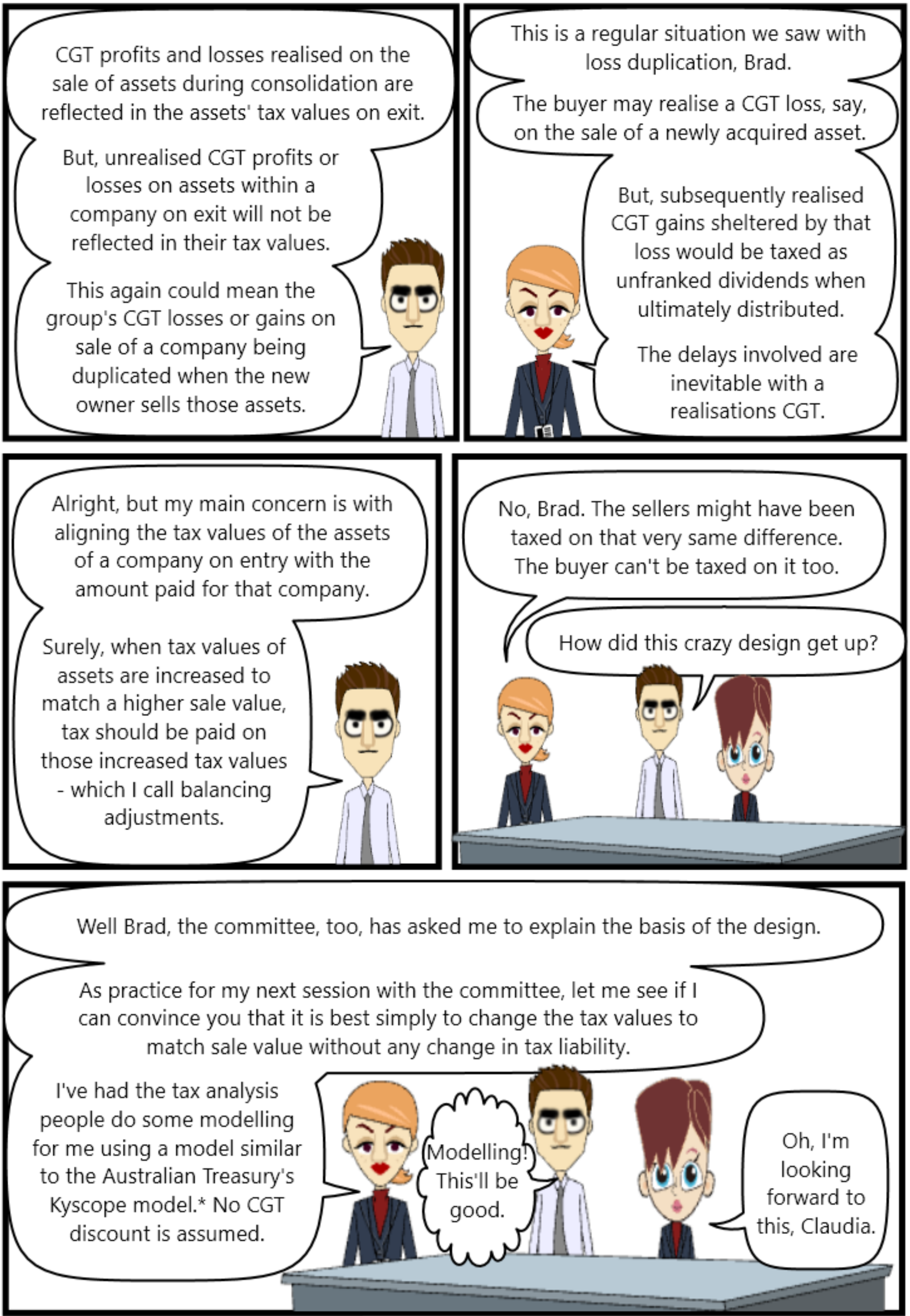
* See examples in Ralph Platform, pp 542, 626-627.



* Ralph Platform, Chapters 25, 26, 27.

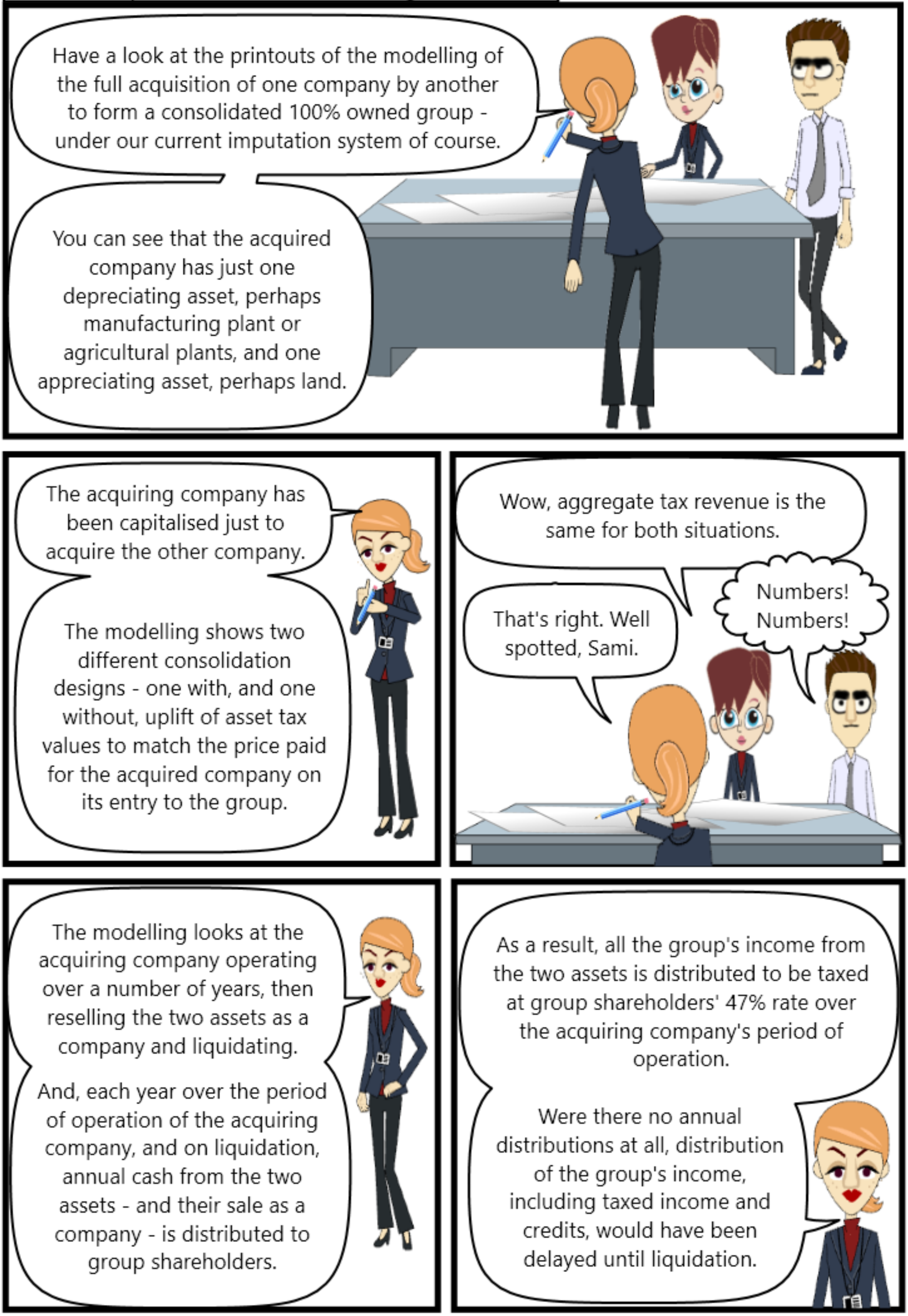
* Ralph Review, Section 15.

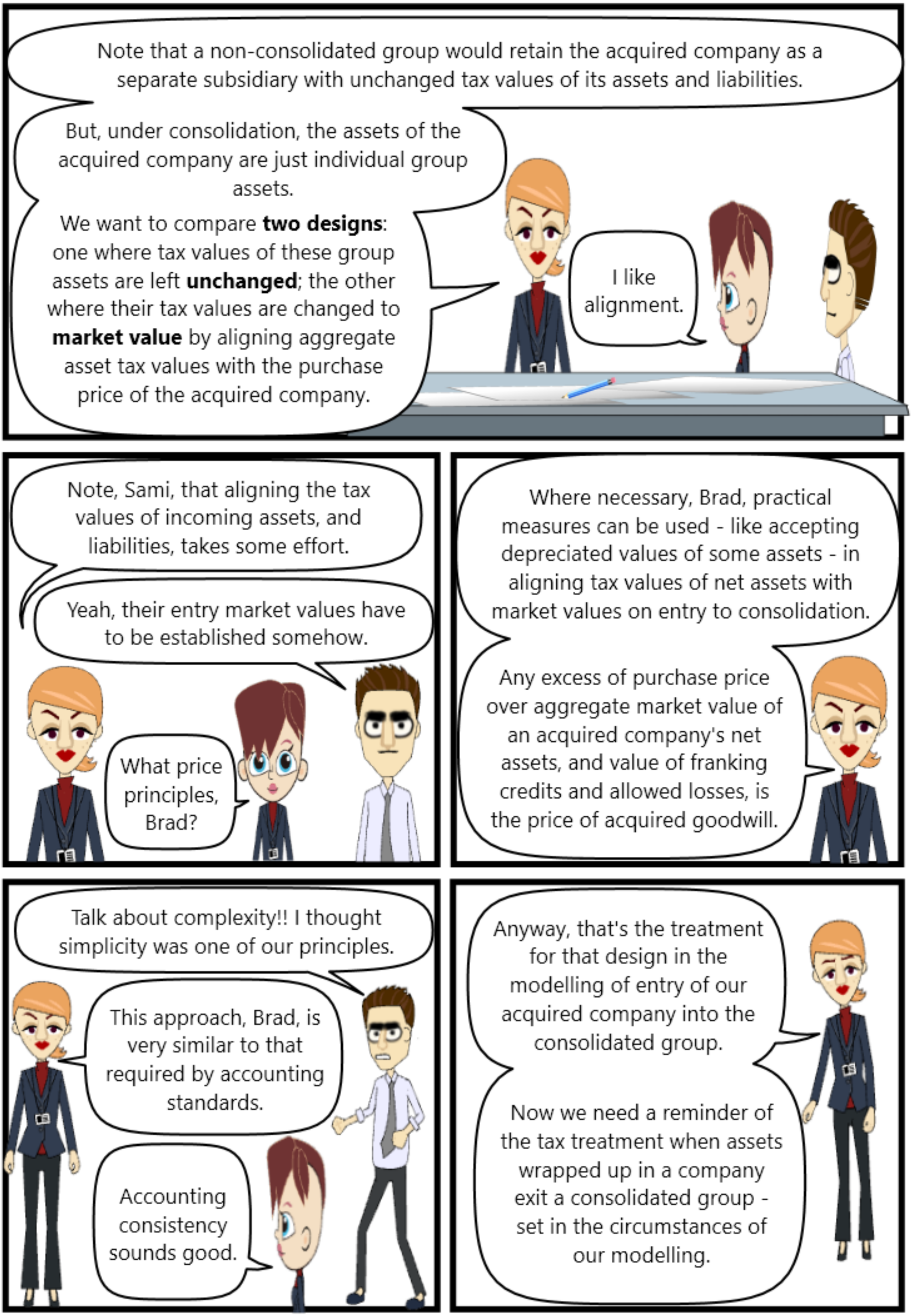

Under consolidation, within a wholly-owned group, profits are sought by mixing and matching group assets and liabilities as required.
Annual changes in the tax values of group assets and liabilities feed into the group's annual tax return in the usual way.
The group's share value changes continually, of course - but, subsidiaries being not longer relevant for tax purposes, pose no tax integrity problems.
But.....
Oh, I like it!
I've never been comfortable with doing away with tax returns for group subsidiaries.
And, in any case, integrity measures outside wholly-owned groups are still needed.
Duplicate losses and value shifts can still be engineered outside those groups.
And, most importantly, with tax recognition of group subsidiaries removed, there are complexities over handling companies that enter or exit a consolidated group.
Exactly, Brad, and it is on this very issue that the committee wants more detail.
Upon entry of a company into consolidation, the price paid by the group for the company is transferred to the tax values of assets and liabilities the company brings with it, including goodwill on acquisition.
For a company exiting a consolidated group, the CGT outcome for the group is determined by comparing price received for the company with aggregate tax value of the company's assets and liabilities.
But.....
Oh, I like the matching of market value with tax values on entry.

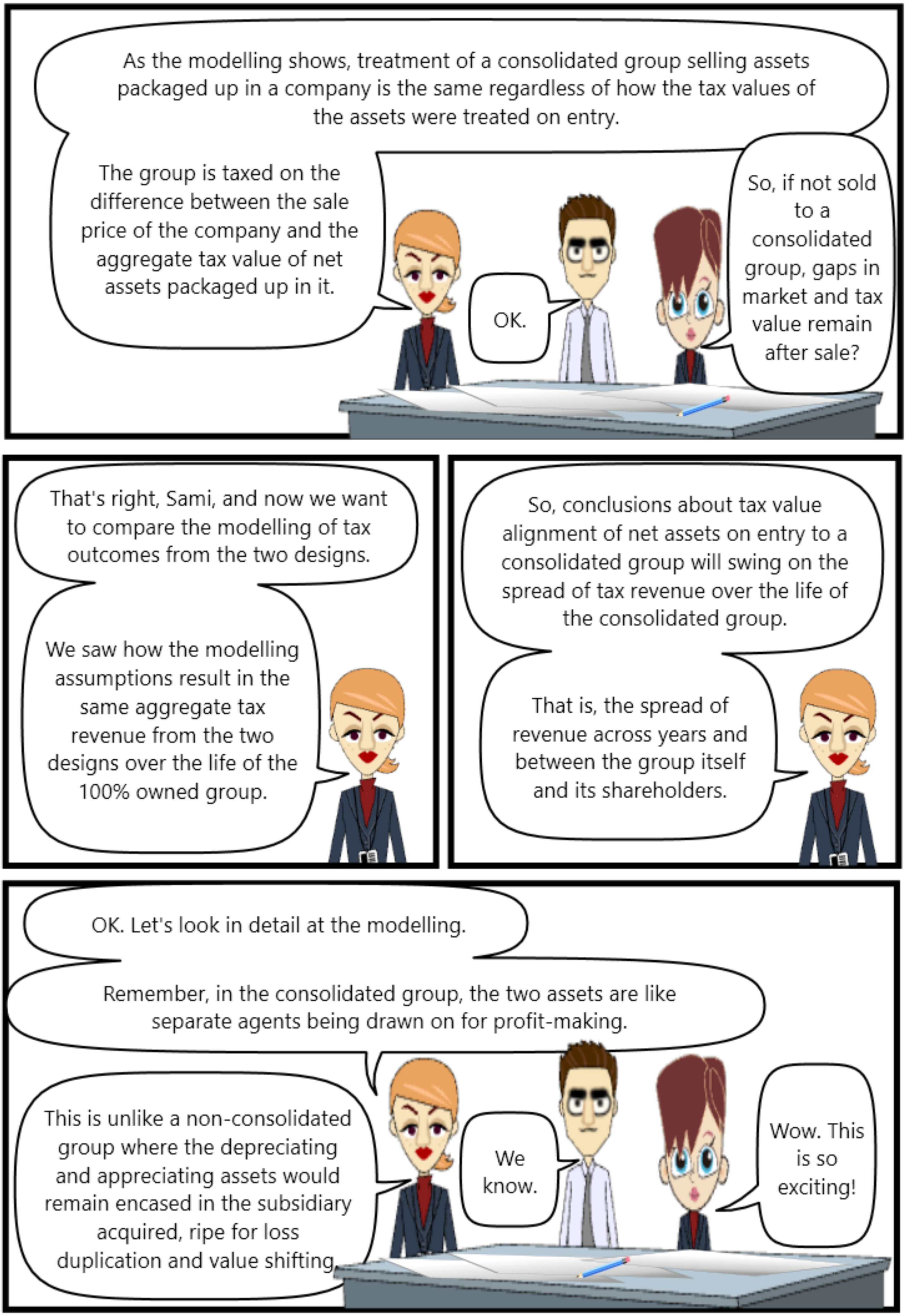


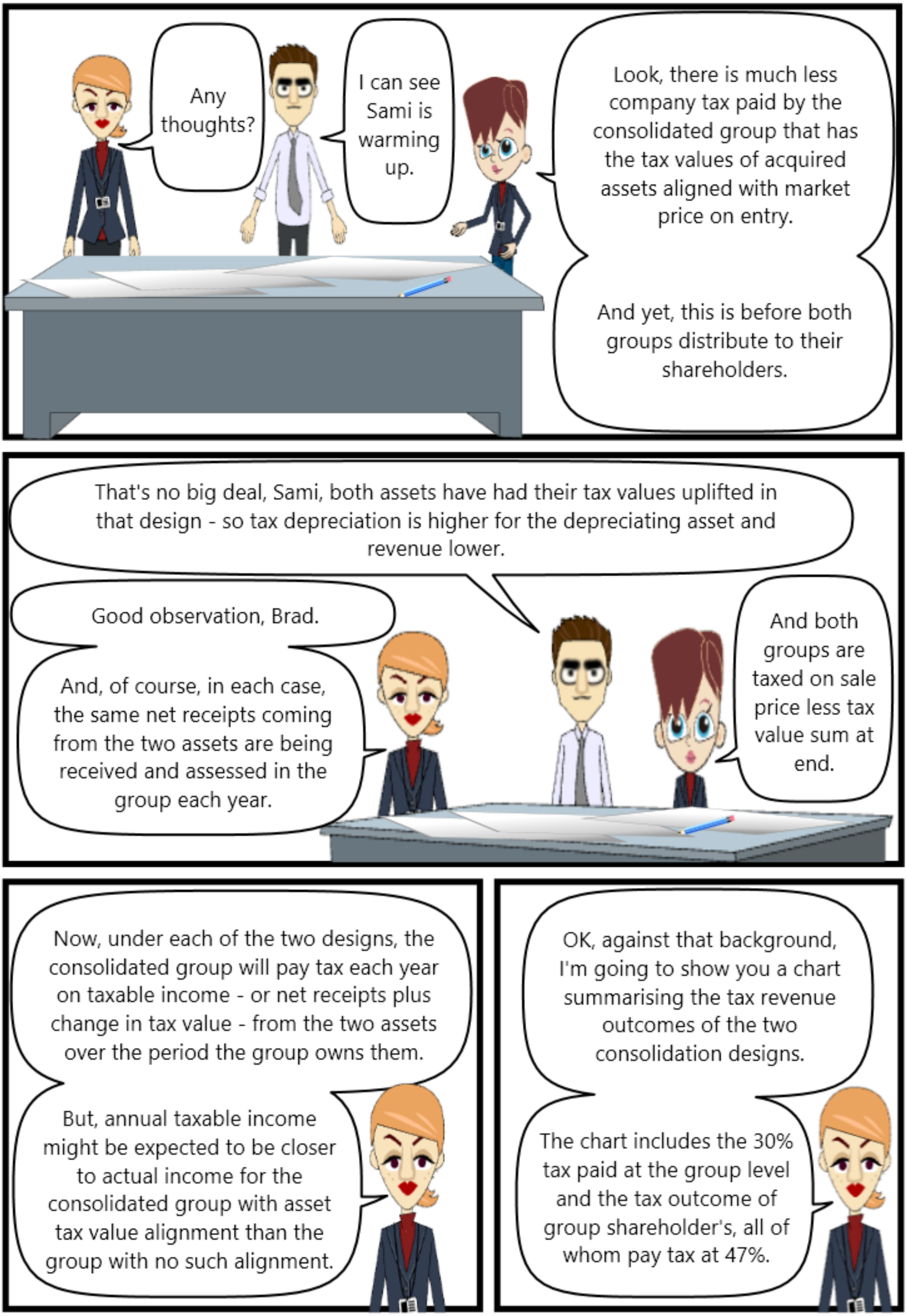
* Ch5, p 41, some details at: www.kyscope.com.au.

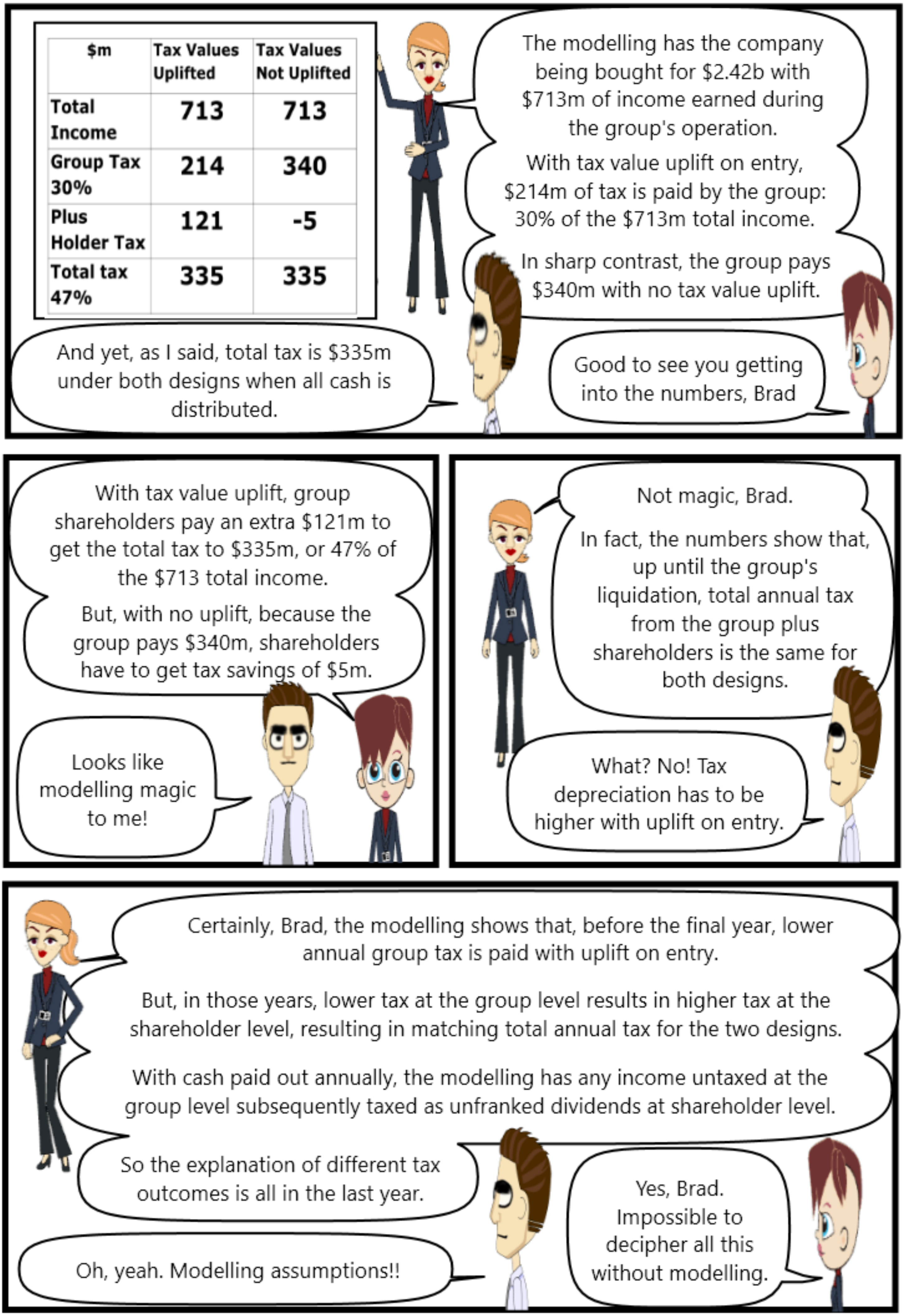
The team pores over the modelling numbers



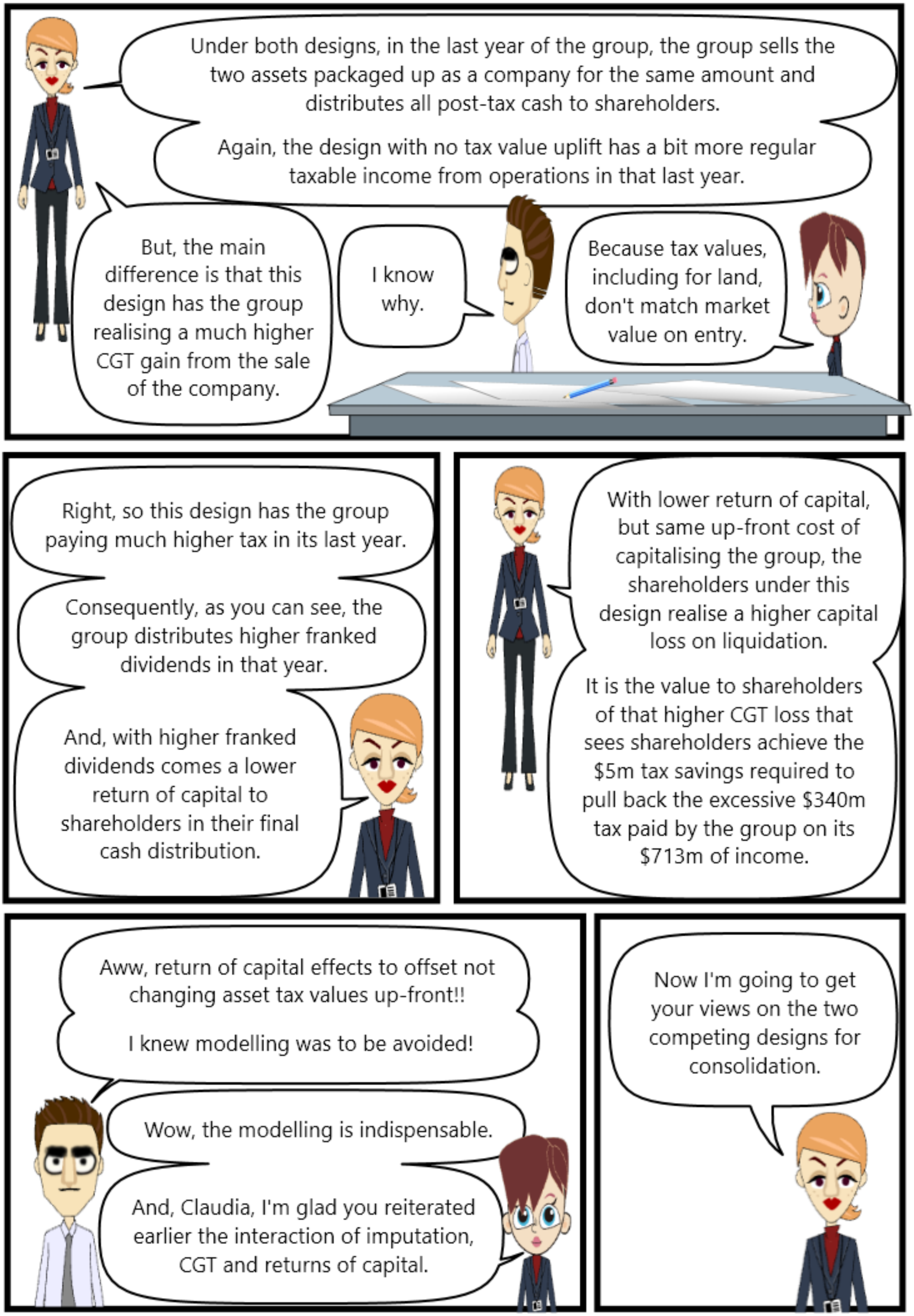

Note that a non-consolidated group would retain the acquired company as a separate subsidiary with unchanged tax values of its assets and liabilities.
But, under consolidation, the assets of the acquired company are just individual group assets.
We want to compare **two designs**: one where tax values of these group assets are left **unchanged**; the other where their tax values are changed to **market value** by aligning aggregate asset tax values with the purchase price of the acquired company.
I like alignment.
Note, Sami, that aligning the tax values of incoming assets, and liabilities, takes some effort.
Yeah, their entry market values have to be established somehow.
What price principles, Brad?
Where necessary, Brad, practical measures can be used - like accepting depreciated values of some assets - in aligning tax values of net assets with market values on entry to consolidation.
Any excess of purchase price over aggregate market value of an acquired company's net assets, and value of franking credits and allowed losses, is the price of acquired goodwill.
Talk about complexity!! I thought simplicity was one of our principles.
This approach, Brad, is very similar to that required by accounting standards.
Accounting consistency sounds good.
Anyway, that's the treatment for that design in the modelling of entry of our acquired company into the consolidated group.
Now we need a reminder of the tax treatment when assets wrapped up in a company exit a consolidated group - set in the circumstances of our modelling.

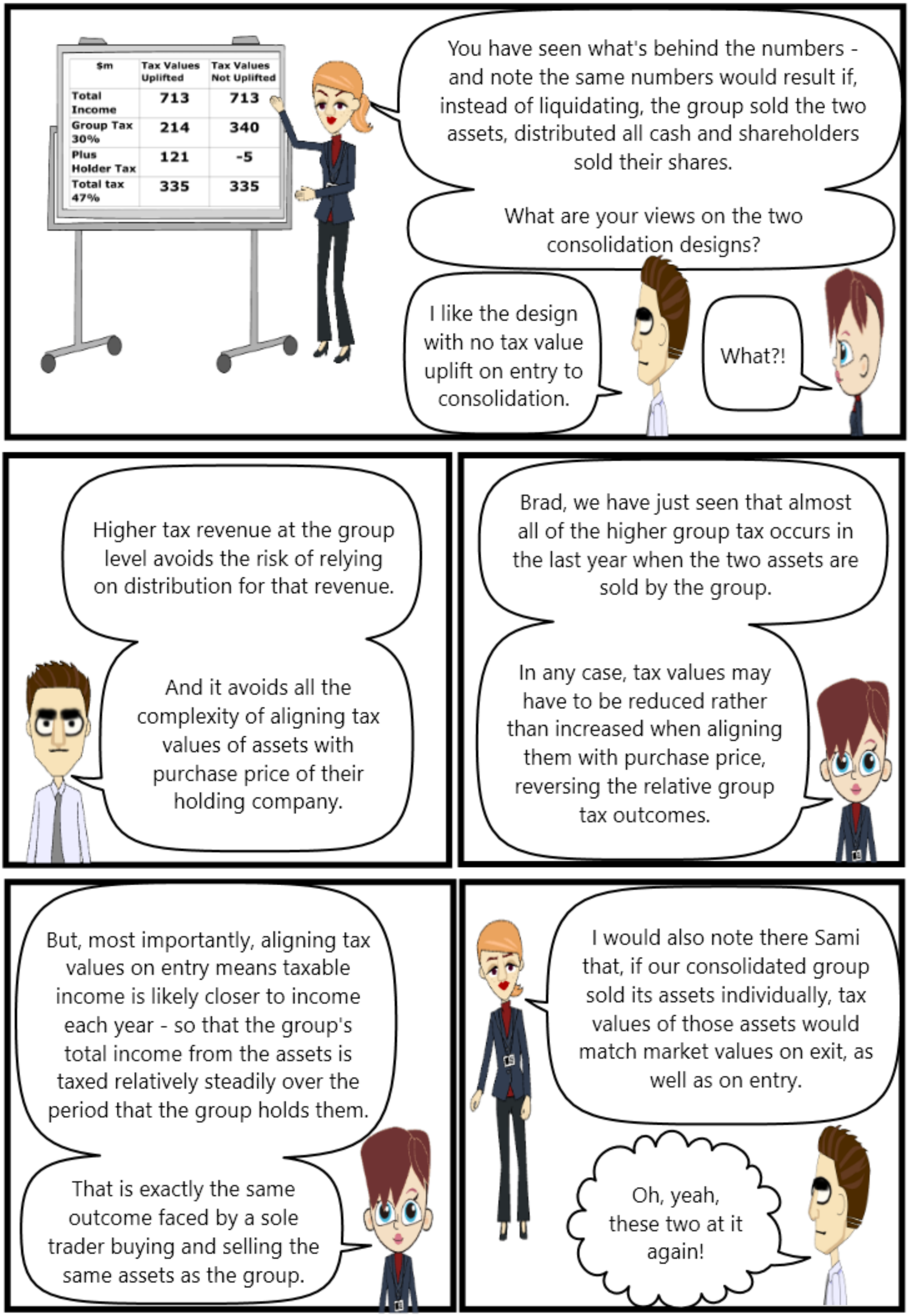

As the modelling shows, treatment of a consolidated group selling assets packaged up in a company is the same regardless of how the tax values of the assets were treated on entry.
The group is taxed on the difference between the sale price of the company and the aggregate tax value of net assets packaged up in it.
OK.
So, if not sold to a consolidated group, gaps in market and tax value remain after sale?
That's right, Sami, and now we want to compare the modelling of tax outcomes from the two designs.
We saw how the modelling assumptions result in the same aggregate tax revenue from the two designs over the life of the 100% owned group.
So, conclusions about tax value alignment of net assets on entry to a consolidated group will swing on the spread of tax revenue over the life of the consolidated group.
That is, the spread of revenue across years and between the group itself and its shareholders.
OK. Let's look in detail at the modelling.
Remember, in the consolidated group, the two assets are like separate agents being drawn on for profit-making.
This is unlike a non-consolidated group where the depreciating and appreciating assets would remain encased in the subsidiary acquired, ripe for loss duplication and value shifting.
We know.
Wow. This is so exciting!

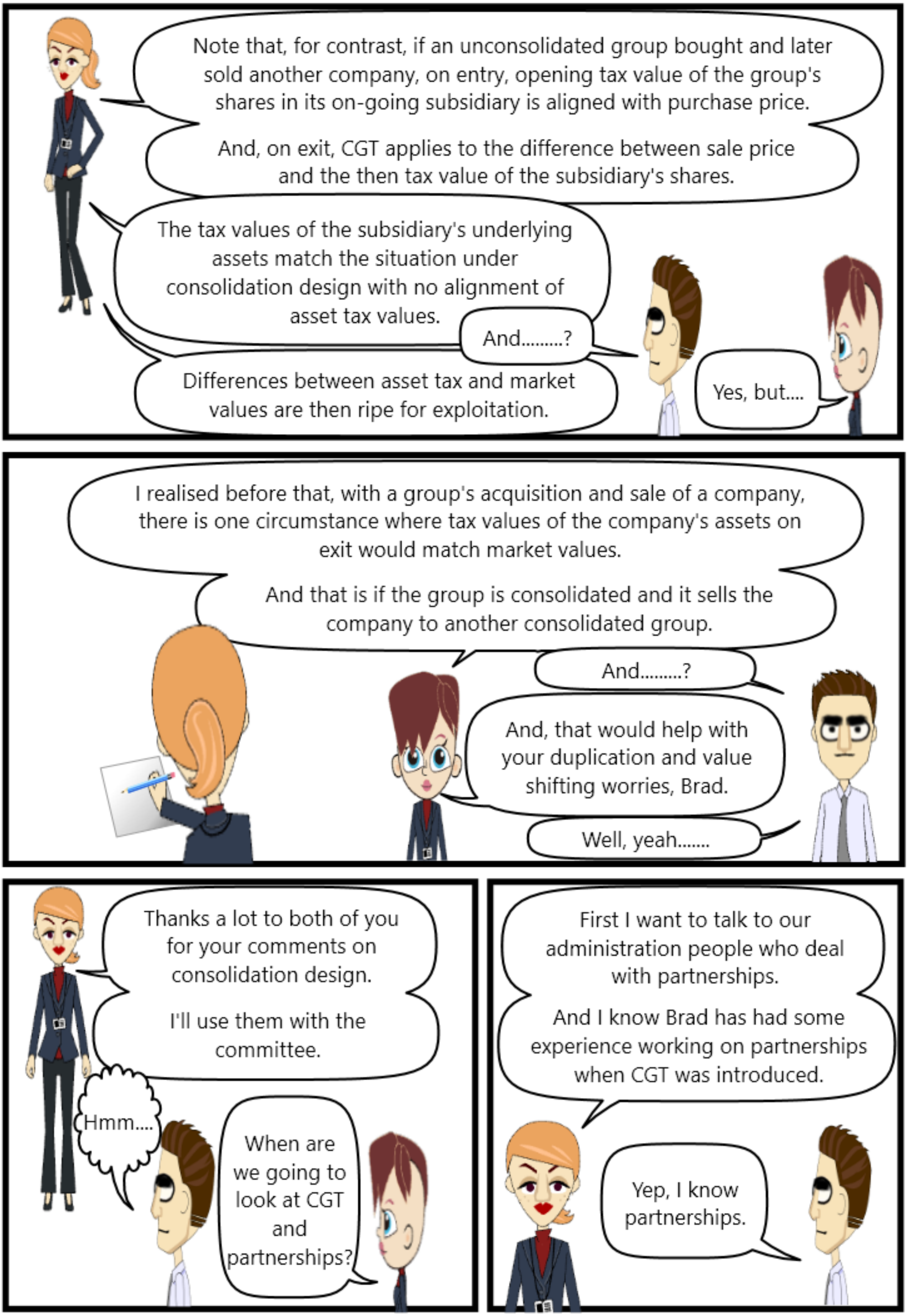

Any thoughts?
I can see Sami is warming up.
Look, there is much less company tax paid by the consolidated group that has the tax values of acquired assets aligned with market price on entry.
And yet, this is before both groups distribute to their shareholders.
That's no big deal, Sami, both assets have had their tax values uplifted in that design - so tax depreciation is higher for the depreciating asset and revenue lower.
Good observation, Brad.
And, of course, in each case, the same net receipts coming from the two assets are being received and assessed in the group each year.
And both groups are taxed on sale price less tax value sum at end.
Now, under each of the two designs, the consolidated group will pay tax each year on taxable income - or net receipts plus change in tax value - from the two assets over the period the group owns them.
But, annual taxable income might be expected to be closer to actual income for the consolidated group with asset tax value alignment than the group with no such alignment.
OK, against that background, I'm going to show you a chart summarising the tax revenue outcomes of the two consolidation designs.
The chart includes the 30% tax paid at the group level and the tax outcome of group shareholder's, all of whom pay tax at 47%.



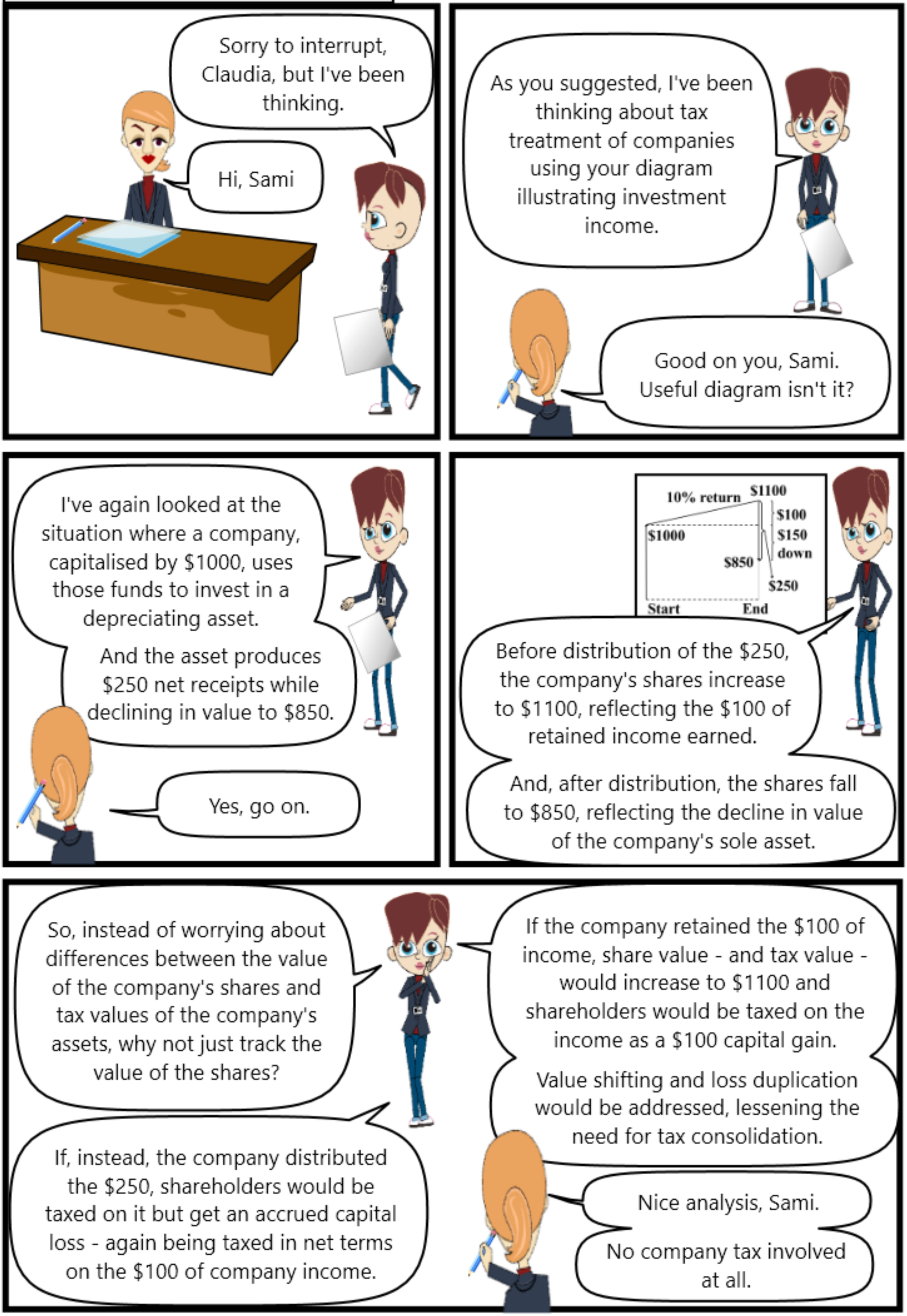
$m	Tax Values Uplifted	Tax Values Not Uplifted
Total Income	713	713
Group Tax 30%	214	340
Plus Holder Tax	121	-5
Total tax 47%	335	335

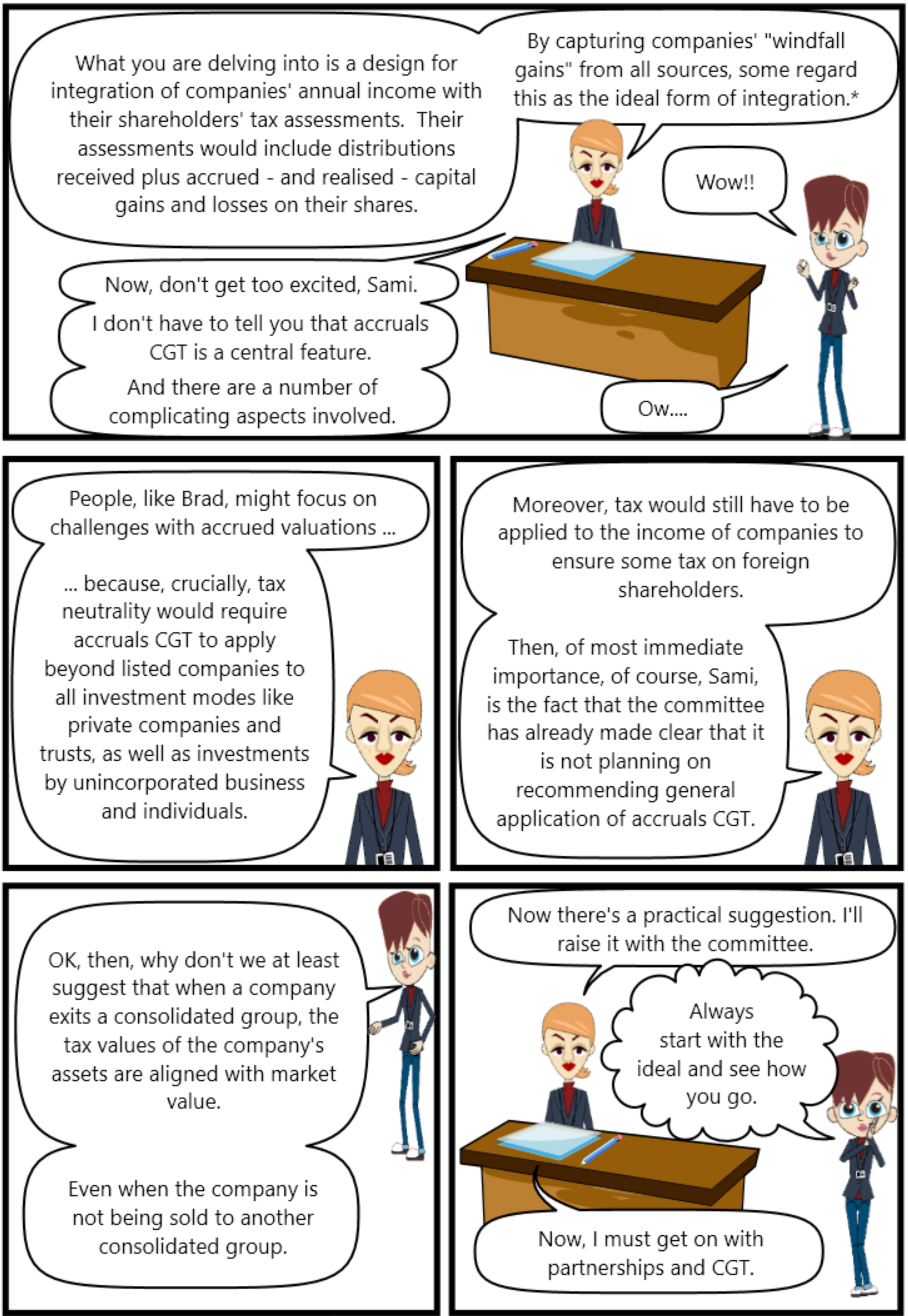

Under both designs, in the last year of the group, the group sells the two assets packaged up as a company for the same amount and distributes all post-tax cash to shareholders.
Again, the design with no tax value uplift has a bit more regular taxable income from operations in that last year.
But, the main difference is that this design has the group realising a much higher CGT gain from the sale of the company.
I know why.
Because tax values, including for land, don't match market value on entry.
Right, so this design has the group paying much higher tax in its last year.
Consequently, as you can see, the group distributes higher franked dividends in that year.
And, with higher franked dividends comes a lower return of capital to shareholders in their final cash distribution.
With lower return of capital, but same up-front cost of capitalising the group, the shareholders under this design realise a higher capital loss on liquidation.
It is the value to shareholders of that higher CGT loss that sees shareholders achieve the $5m tax savings required to pull back the excessive $340m tax paid by the group on its $713m of income.
Aww, return of capital effects to offset not changing asset tax values up-front!!
I knew modelling was to be avoided!
Wow, the modelling is indispensable.
And, Claudia, I'm glad you reiterated earlier the interaction of imputation, CGT and returns of capital.
Now I'm going to get your views on the two competing designs for consolidation.


$m | Tax Values Uplifted | Tax Values Not Uplifted
Total Income | 713 | 713
Group Tax 30% | 214 | 340
Plus Holder Tax | 121 | -5
Total tax 47% | 335 | 335
You have seen what's behind the numbers - and note the same numbers would result if, instead of liquidating, the group sold the two assets, distributed all cash and shareholders sold their shares.
What are your views on the two consolidation designs?
I like the design with no tax value uplift on entry to consolidation.
What?!
Higher tax revenue at the group level avoids the risk of relying on distribution for that revenue.
And it avoids all the complexity of aligning tax values of assets with purchase price of their holding company.
Brad, we have just seen that almost all of the higher group tax occurs in the last year when the two assets are sold by the group.
In any case, tax values may have to be reduced rather than increased when aligning them with purchase price, reversing the relative group tax outcomes.
But, most importantly, aligning tax values on entry means taxable income is likely closer to income each year - so that the group's total income from the assets is taxed relatively steadily over the period that the group holds them.
That is exactly the same outcome faced by a sole trader buying and selling the same assets as the group.
I would also note there Sami that, if our consolidated group sold its assets individually, tax values of those assets would match market values on exit, as well as on entry.
Oh, yeah, these two at it again!

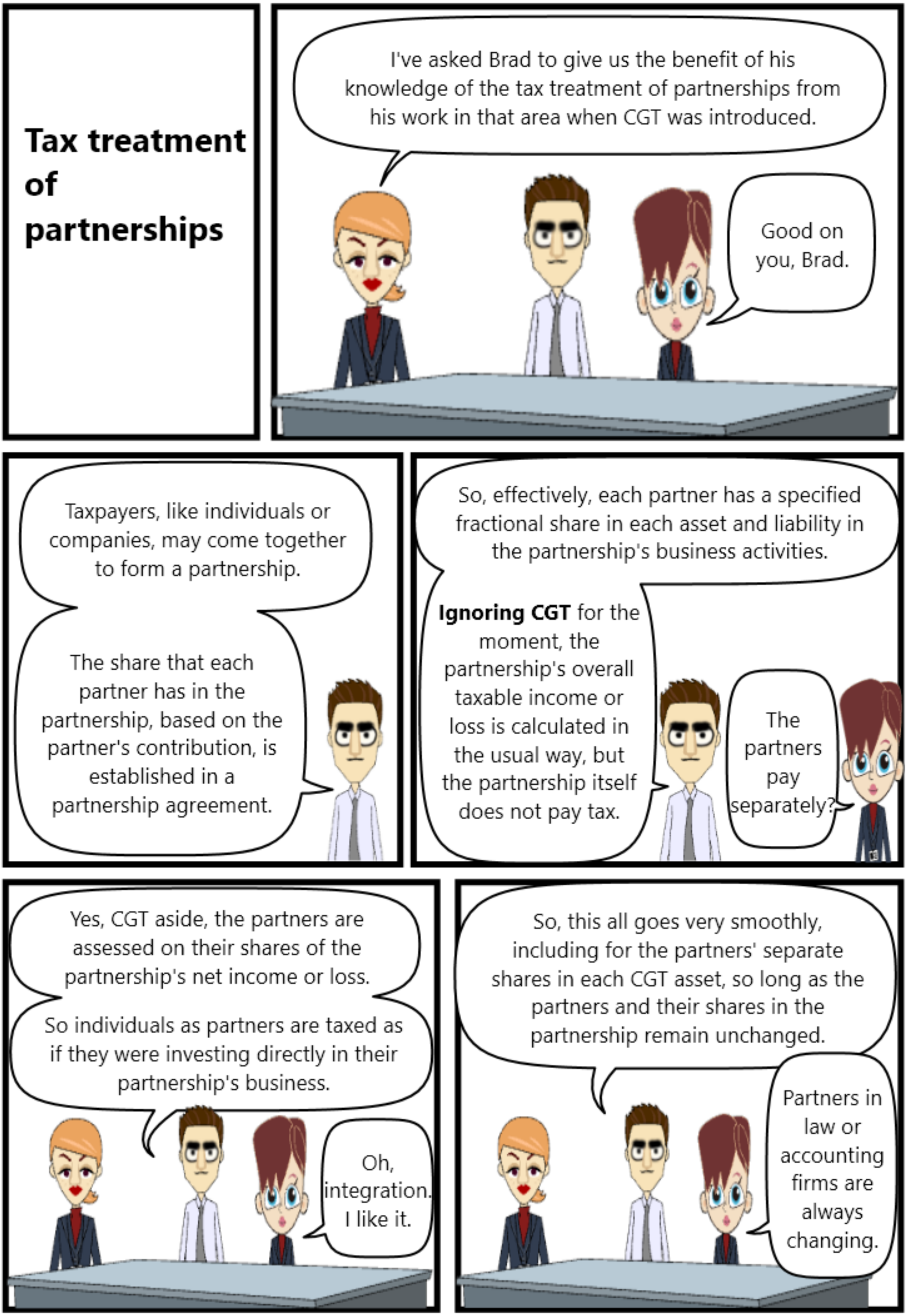

Note that, for contrast, if an unconsolidated group bought and later sold another company, on entry, opening tax value of the group's shares in its on-going subsidiary is aligned with purchase price.
And, on exit, CGT applies to the difference between sale price and the then tax value of the subsidiary's shares.
The tax values of the subsidiary's underlying assets match the situation under consolidation design with no alignment of asset tax values.
And.........?
Differences between asset tax and market values are then ripe for exploitation.
Yes, but....
I realised before that, with a group's acquisition and sale of a company, there is one circumstance where tax values of the company's assets on exit would match market values.
And that is if the group is consolidated and it sells the company to another consolidated group.
And.........?
And, that would help with your duplication and value shifting worries, Brad.
Well, yeah.......
Thanks a lot to both of you for your comments on consolidation design.
I'll use them with the committee.
Hmm....
When are we going to look at CGT and partnerships?
First I want to talk to our administration people who deal with partnerships.
And I know Brad has had some experience working on partnerships when CGT was introduced.
Yep, I know partnerships.

Sami's enthusiasm continues

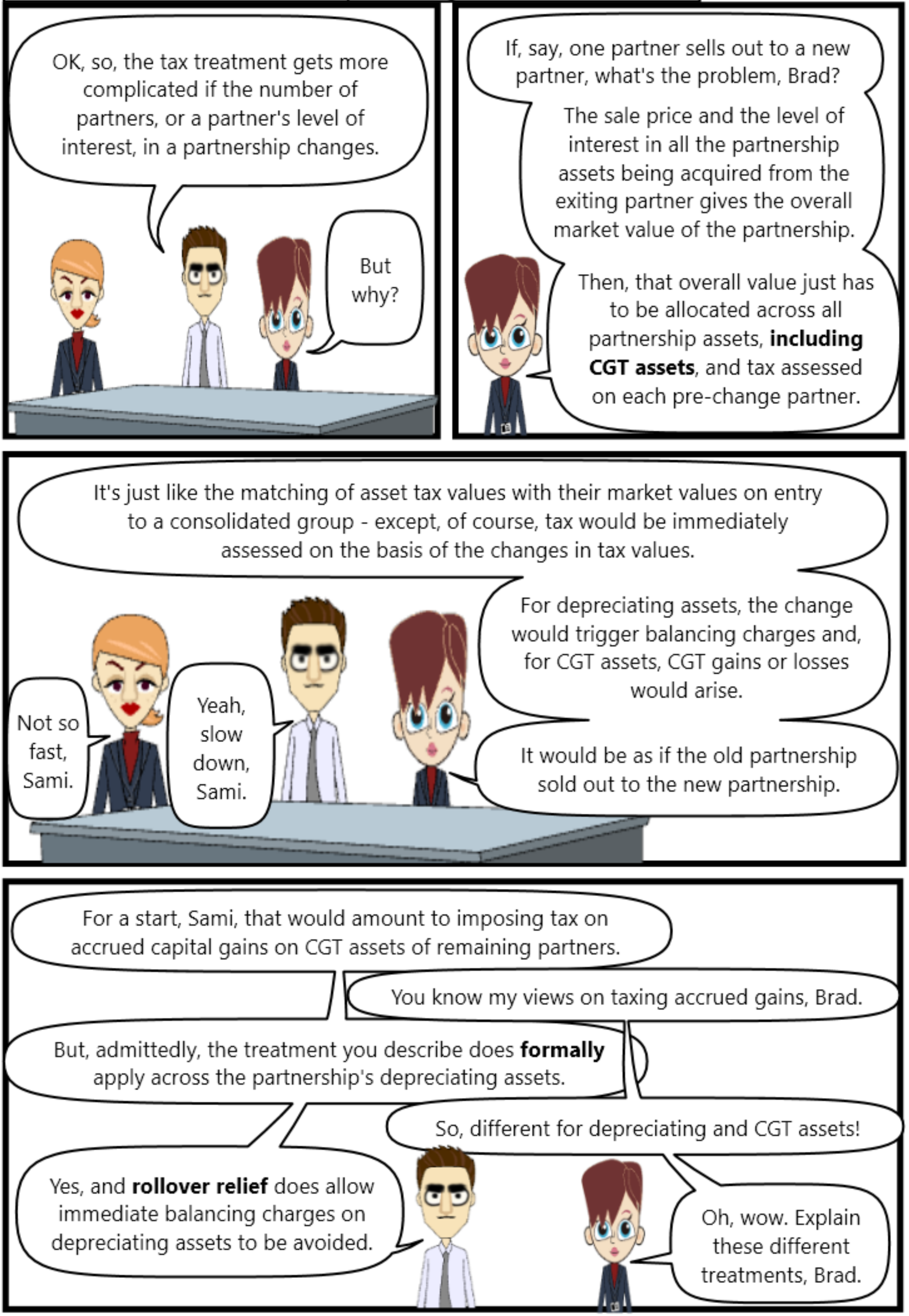




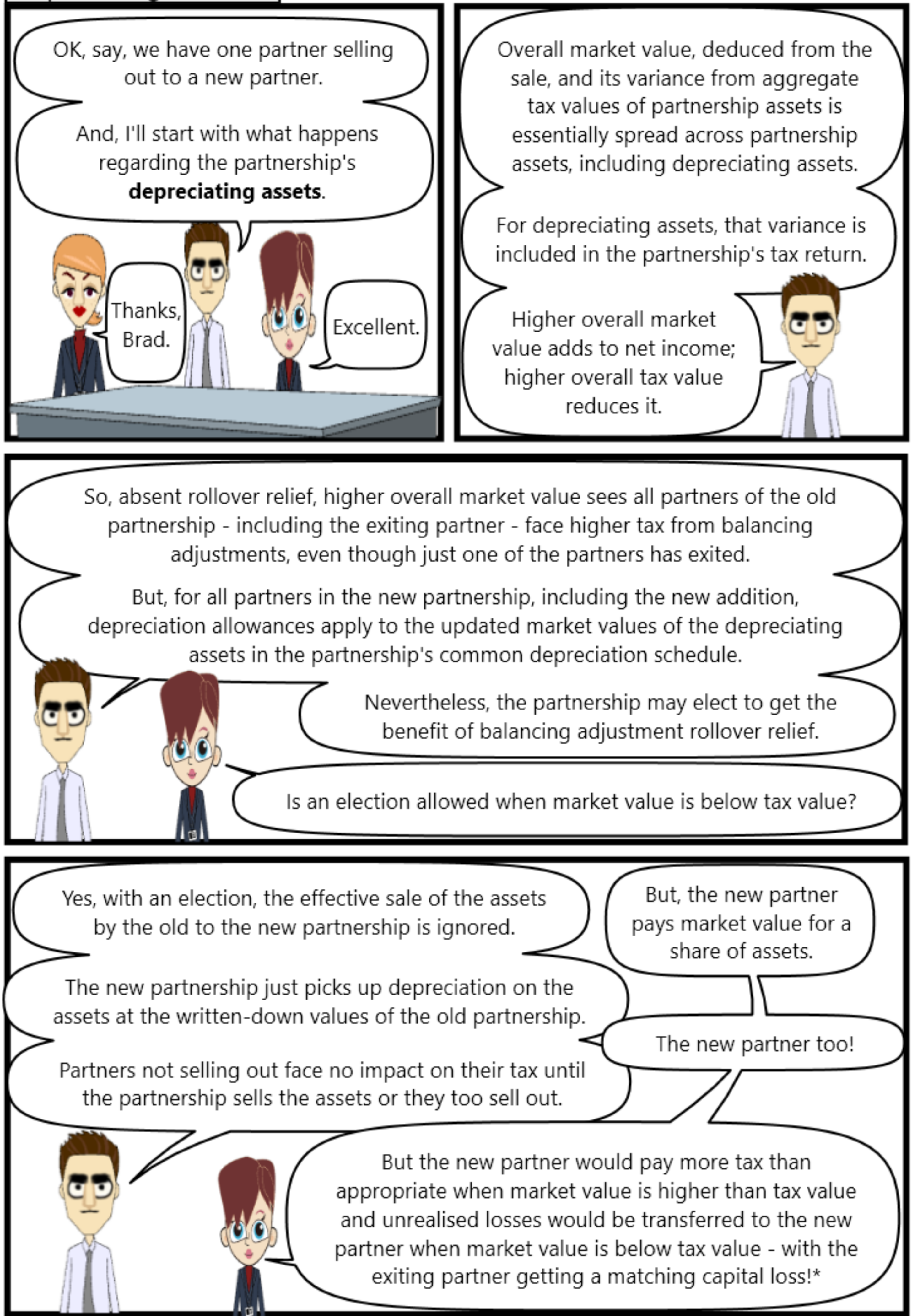
* See, for example, Carter Commission, Vol 4.


Tax treatment of partnerships
I've asked Brad to give us the benefit of his knowledge of the tax treatment of partnerships from his work in that area when CGT was introduced.
Good on you, Brad.
Taxpayers, like individuals or companies, may come together to form a partnership.
The share that each partner has in the partnership, based on the partner's contribution, is established in a partnership agreement.
So, effectively, each partner has a specified fractional share in each asset and liability in the partnership's business activities.
Ignoring CGT for the moment, the partnership's overall taxable income or loss is calculated in the usual way, but the partnership itself does not pay tax.
The partners pay separately?
Yes, CGT aside, the partners are assessed on their shares of the partnership's net income or loss.
So individuals as partners are taxed as if they were investing directly in their partnership's business.
Oh, integration. I like it.
So, this all goes very smoothly, including for the partners' separate shares in each CGT asset, so long as the partners and their shares in the partnership remain unchanged.
Partners in law or accounting firms are always changing.

Sami's ideal treatment for depreciating and CGT assets

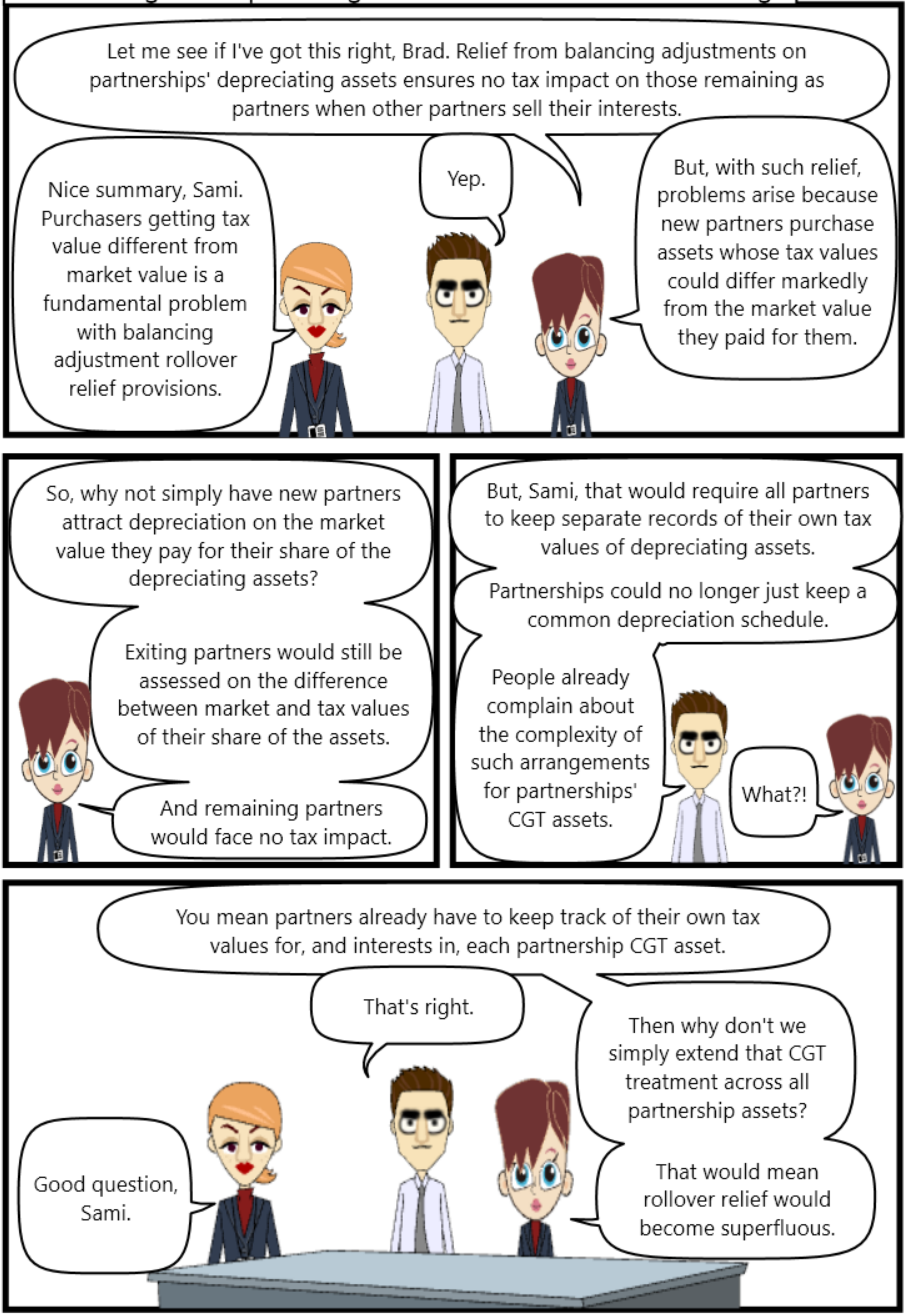


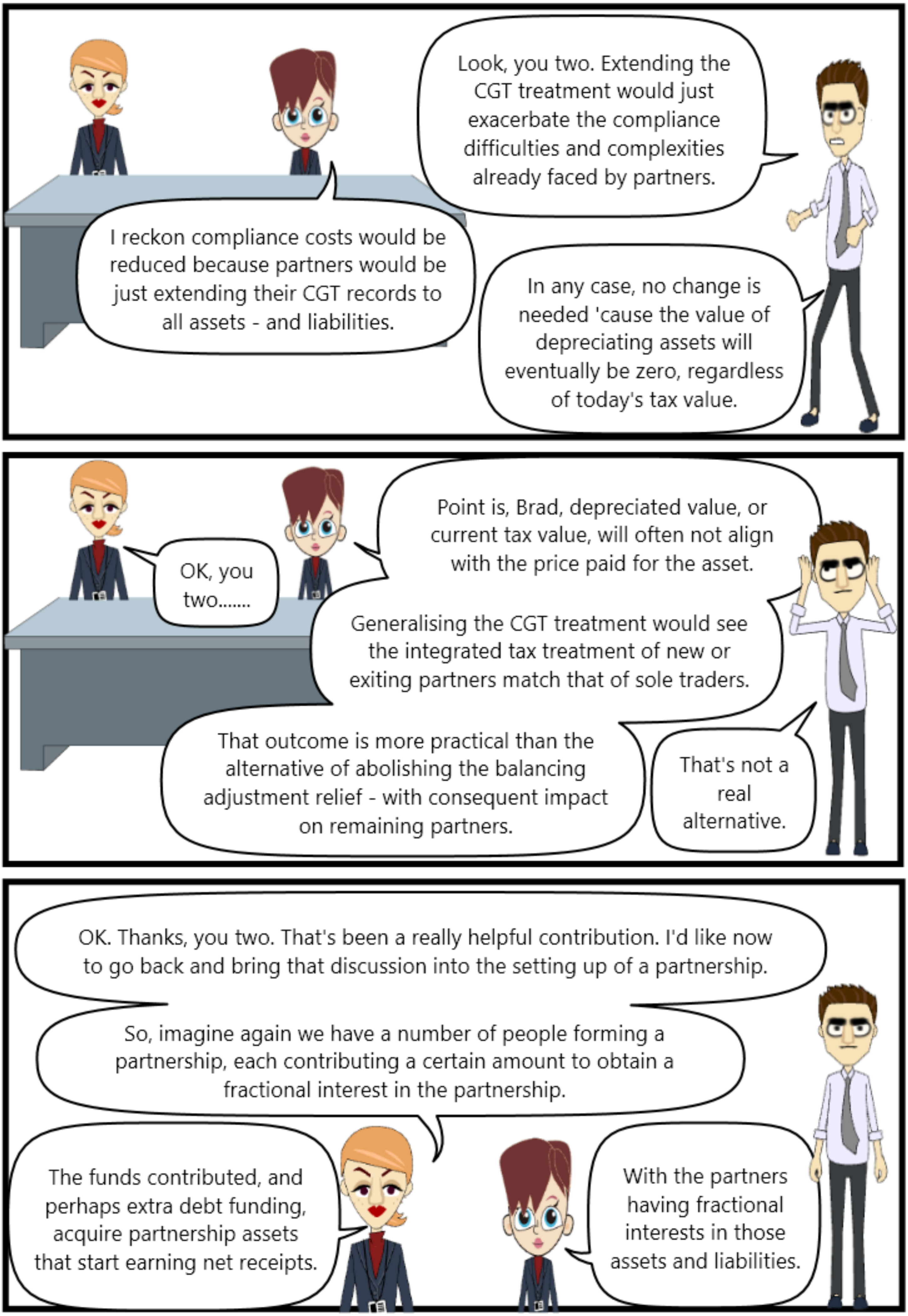
Depreciating assets

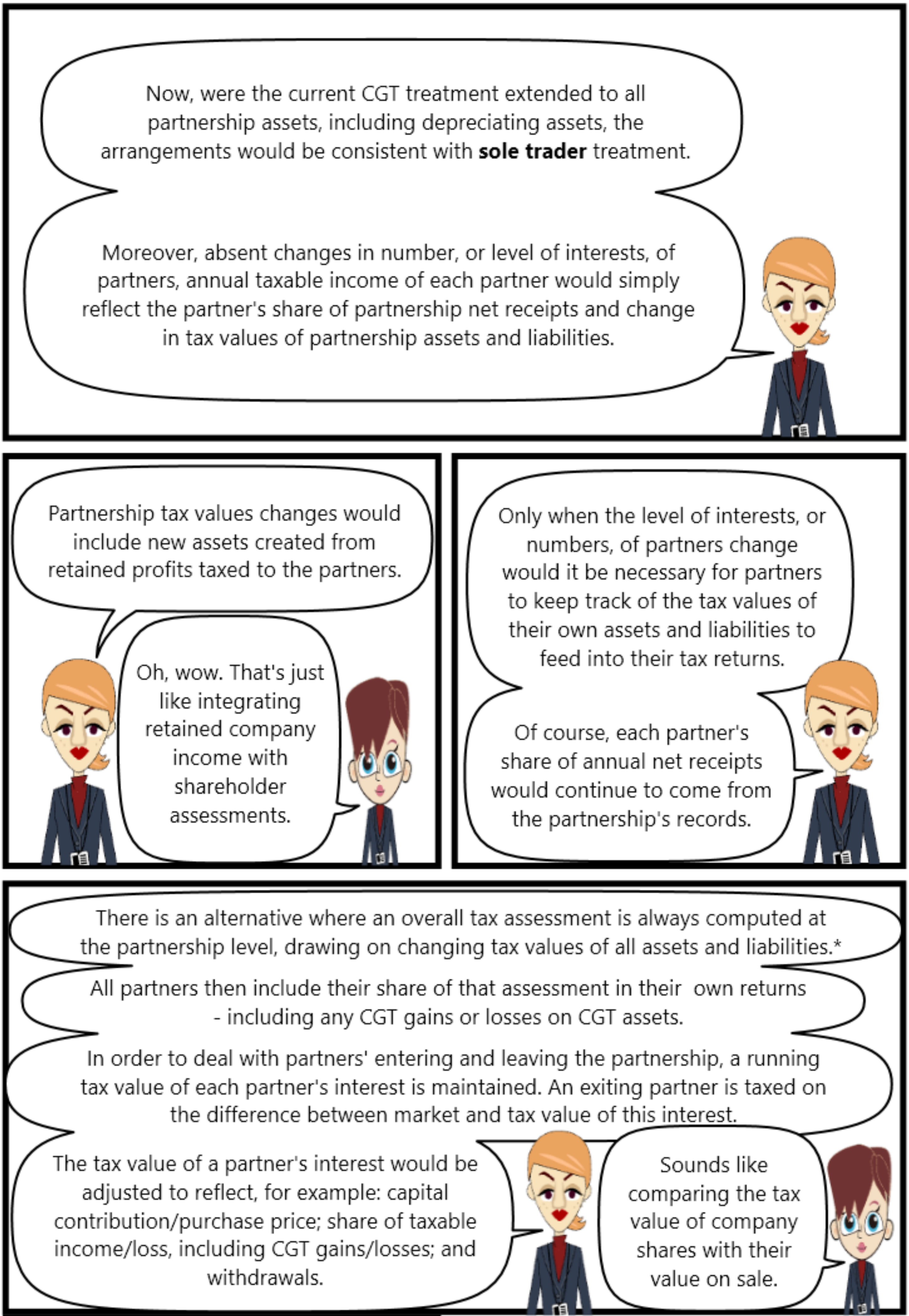


* See Ralph Platform, pp 333-335.

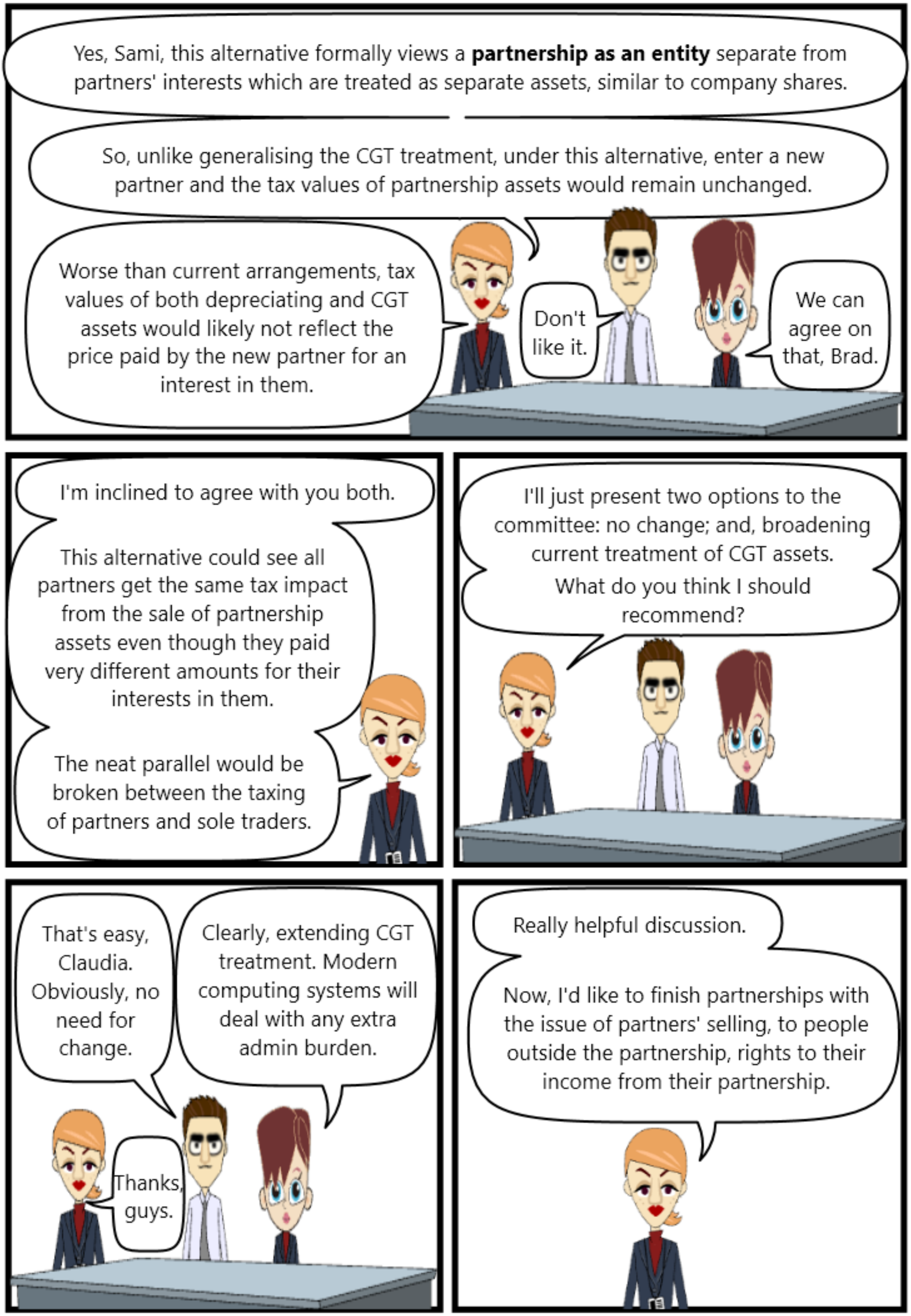
Sami's design for depreciating assets matches CGT assets' design

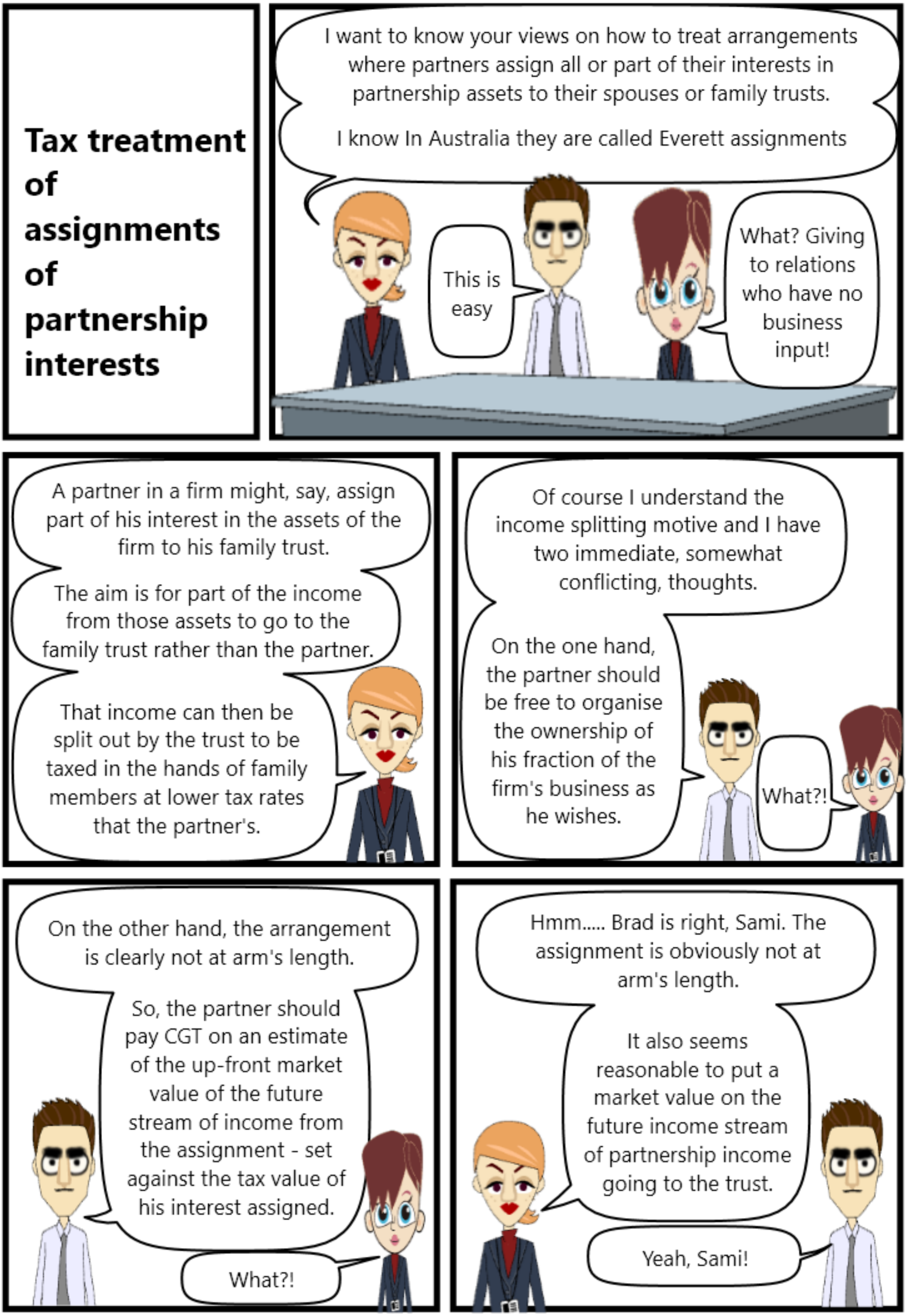


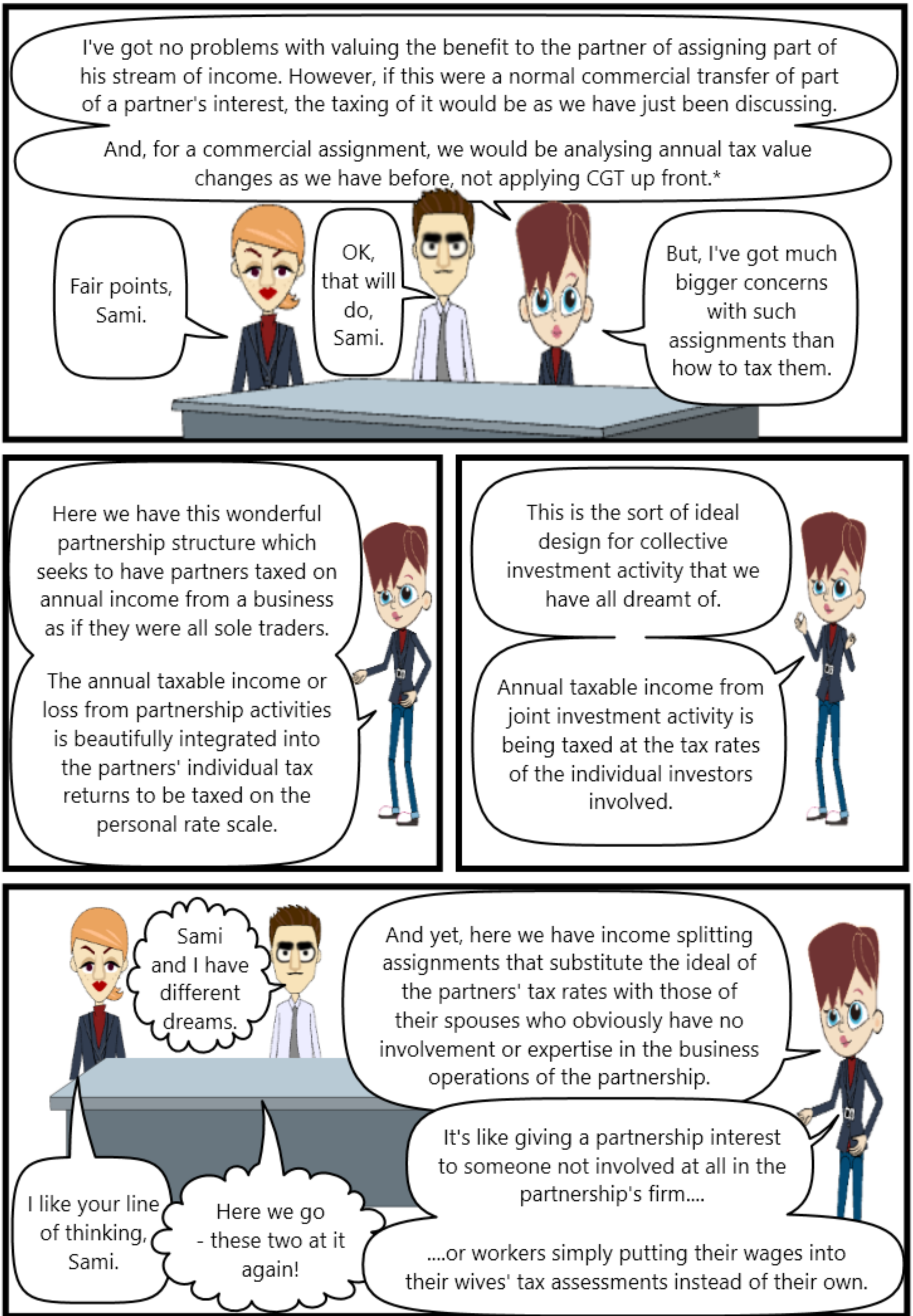

Look, you two. Extending the CGT treatment would just exacerbate the compliance difficulties and complexities already faced by partners.
I reckon compliance costs would be reduced because partners would be just extending their CGT records to all assets - and liabilities.
In any case, no change is needed 'cause the value of depreciating assets will eventually be zero, regardless of today's tax value.
OK, you two.......
Point is, Brad, depreciated value, or current tax value, will often not align with the price paid for the asset.
Generalising the CGT treatment would see the integrated tax treatment of new or exiting partners match that of sole traders.
That outcome is more practical than the alternative of abolishing the balancing adjustment relief - with consequent impact on remaining partners.
That's not a real alternative.
OK. Thanks, you two. That's been a really helpful contribution. I'd like now to go back and bring that discussion into the setting up of a partnership.
So, imagine again we have a number of people forming a partnership, each contributing a certain amount to obtain a fractional interest in the partnership.
The funds contributed, and perhaps extra debt funding, acquire partnership assets that start earning net receipts.
With the partners having fractional interests in those assets and liabilities.



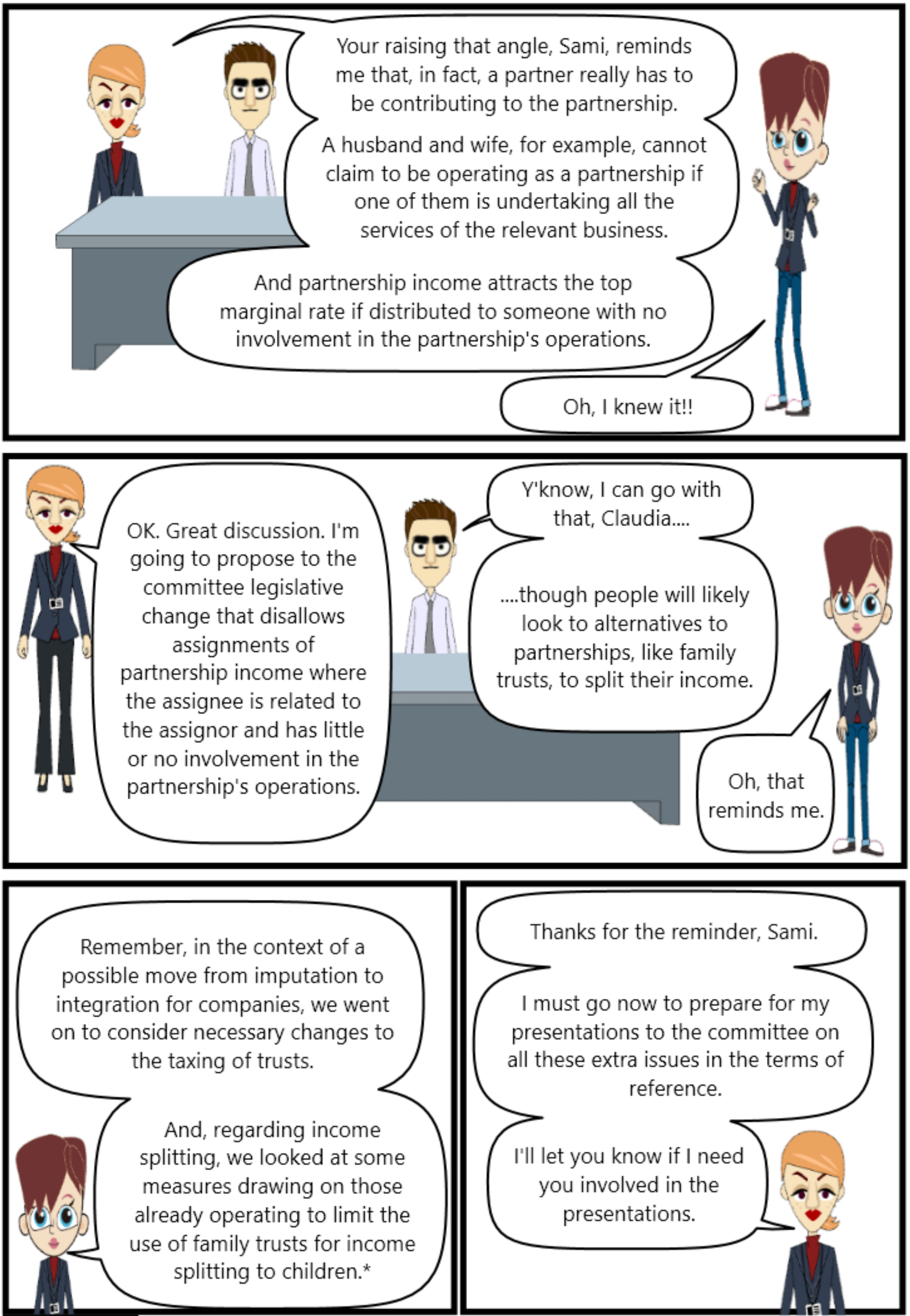
* See alternative designs in Ralph Review, pp 552-556, 559-562.


Yes, Sami, this alternative formally views a **partnership as an entity** separate from partners' interests which are treated as separate assets, similar to company shares.
So, unlike generalising the CGT treatment, under this alternative, enter a new partner and the tax values of partnership assets would remain unchanged.
Worse than current arrangements, tax values of both depreciating and CGT assets would likely not reflect the price paid by the new partner for an interest in them.
Don't like it.
We can agree on that, Brad.
I'm inclined to agree with you both.
This alternative could see all partners get the same tax impact from the sale of partnership assets even though they paid very different amounts for their interests in them.
The neat parallel would be broken between the taxing of partners and sole traders.
I'll just present two options to the committee: no change; and, broadening current treatment of CGT assets.
What do you think I should recommend?
That's easy, Claudia. Obviously, no need for change.
Clearly, extending CGT treatment. Modern computing systems will deal with any extra admin burden.
Thanks, guys.
Really helpful discussion.
Now, I'd like to finish partnerships with the issue of partners' selling, to people outside the partnership, rights to their income from their partnership.


Tax treatment of assignments of partnership interests
I want to know your views on how to treat arrangements where partners assign all or part of their interests in partnership assets to their spouses or family trusts.
I know In Australia they are called Everett assignments
This is easy
What? Giving to relations who have no business input!
A partner in a firm might, say, assign part of his interest in the assets of the firm to his family trust.
The aim is for part of the income from those assets to go to the family trust rather than the partner.
That income can then be split out by the trust to be taxed in the hands of family members at lower tax rates that the partner's.
Of course I understand the income splitting motive and I have two immediate, somewhat conflicting, thoughts.
On the one hand, the partner should be free to organise the ownership of his fraction of the firm's business as he wishes.
What?!
On the other hand, the arrangement is clearly not at arm's length.
So, the partner should pay CGT on an estimate of the up-front market value of the future stream of income from the assignment - set against the tax value of his interest assigned.
What?!
Hmm..... Brad is right, Sami. The assignment is obviously not at arm's length.
It also seems reasonable to put a market value on the future income stream of partnership income going to the trust.
Yeah, Sami!


I've got no problems with valuing the benefit to the partner of assigning part of his stream of income. However, if this were a normal commercial transfer of part of a partner's interest, the taxing of it would be as we have just been discussing.
And, for a commercial assignment, we would be analysing annual tax value changes as we have before, not applying CGT up front.*
Fair points, Sami.
OK, that will do, Sami.
But, I've got much bigger concerns with such assignments than how to tax them.
Here we have this wonderful partnership structure which seeks to have partners taxed on annual income from a business as if they were all sole traders.
The annual taxable income or loss from partnership activities is beautifully integrated into the partners' individual tax returns to be taxed on the personal rate scale.
This is the sort of ideal design for collective investment activity that we have all dreamt of.
Annual taxable income from joint investment activity is being taxed at the tax rates of the individual investors involved.
Sami and I have different dreams.
And yet, here we have income splitting assignments that substitute the ideal of the partners' tax rates with those of their spouses who obviously have no involvement or expertise in the business operations of the partnership.
It's like giving a partnership interest to someone not involved at all in the partnership's firm....
I like your line of thinking, Sami.
Here we go - these two at it again!
....or workers simply putting their wages into their wives' tax assessments instead of their own.

* Ch5, pp 3-11.


Your raising that angle, Sami, reminds me that, in fact, a partner really has to be contributing to the partnership.
A husband and wife, for example, cannot claim to be operating as a partnership if one of them is undertaking all the services of the relevant business.
And partnership income attracts the top marginal rate if distributed to someone with no involvement in the partnership's operations.
Oh, I knew it!!
OK. Great discussion. I'm going to propose to the committee legislative change that disallows assignments of partnership income where the assignee is related to the assignor and has little or no involvement in the partnership's operations.
Y'know, I can go with that, Claudia....
....though people will likely look to alternatives to partnerships, like family trusts, to split their income.
Oh, that reminds me.
Remember, in the context of a possible move from imputation to integration for companies, we went on to consider necessary changes to the taxing of trusts.
And, regarding income splitting, we looked at some measures drawing on those already operating to limit the use of family trusts for income splitting to children.*
Thanks for the reminder, Sami.
I must go now to prepare for my presentations to the committee on all these extra issues in the terms of reference.
I'll let you know if I need you involved in the presentations.

* Ch6, pp 16-18.

After a series of meetings that Claudia has had with the committee