

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.

I can't believe how well that went. The committee eschewed the modular thinking of one member involving different designs for different categories of investment/saving.

The committee really latched onto the crucial overarching tax design that has income, or commercial profit, across all of an investor's investments included in the investor's tax assessment in the year the profits arise.

Early days! They were polite on accrued capital gains.

And how moving more towards that design can improve both productivity and fairness.

That member did say she thought it was all too simple, and not in a positive way.

We will have to reiterate the benefits of such design, despite the change it might impose on tax practitioners' current knowledge base.

I thought it was a wonderful briefing session, Claudia....

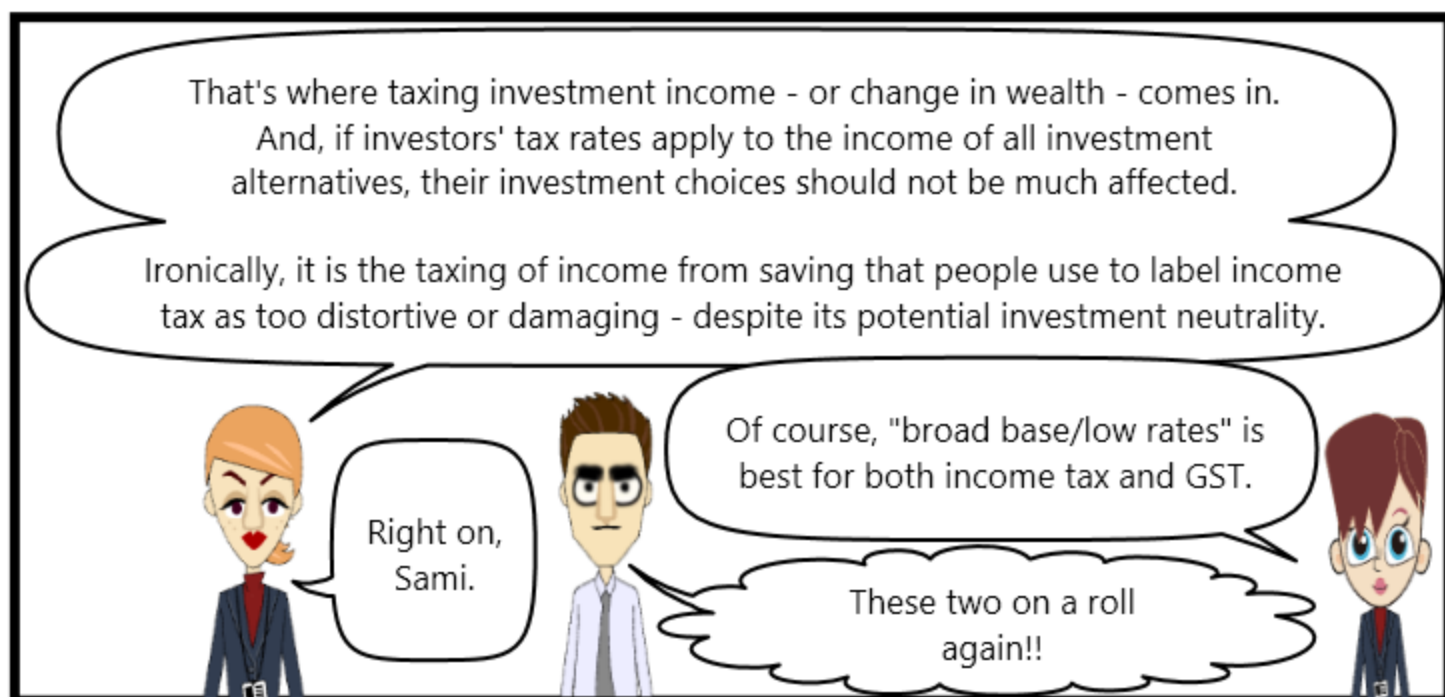
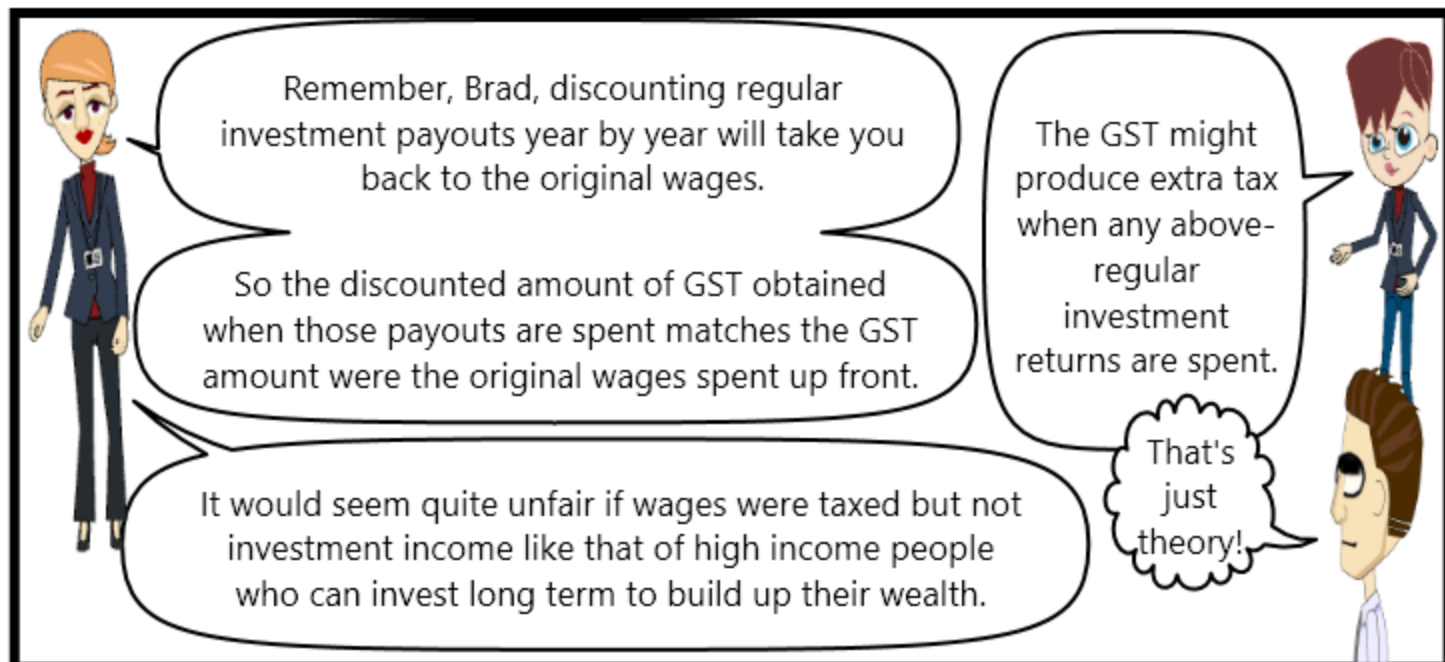
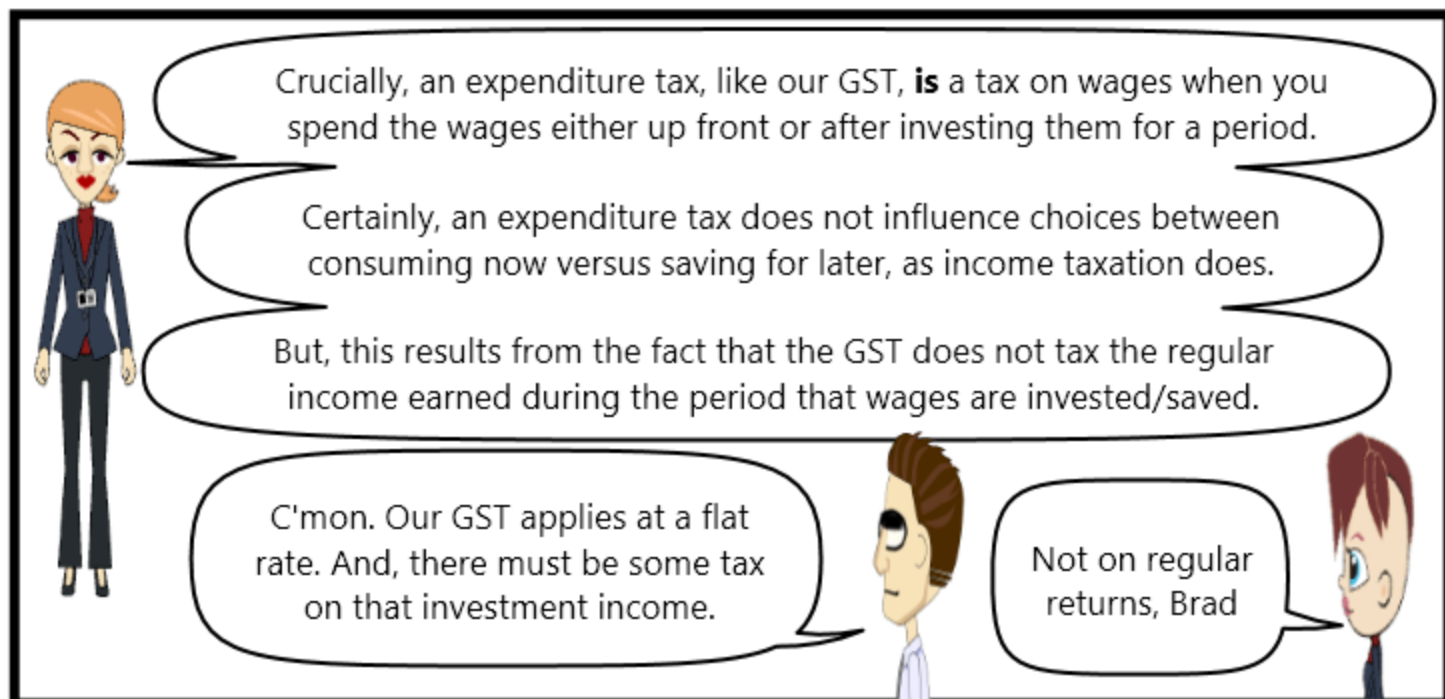
...though, that same member you two mentioned kept talking about damaging income taxation and the excessively high tax rates faced by workers.

She seemed to want to move the tax mix away from income to expenditure taxation.

The review is focused on the taxing of investment income - but our framework helps address her points.

Let me remind you how in preparation for our next session with the committee.

I like expenditure taxation - less damaging.



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



OK. Now we have to turn to those items added to the committee's terms of reference via consultations with selected government members and business people.

We need to prepare for briefings for the committee on share buy-backs, tax consolidation of company groups and partnerships.

We already have functioning income tax law in those three areas.



Oh, I'm so looking forward to this.



I appreciate that, Brad, but we will be helping the committee to understand questions of design that apply across these issues and to consider possible design improvements.

Our realisations-based CGT is an issue common to these parts of the law.

With partnerships, we will be looking particularly at the question of consistency, or lack of it, in the tax treatment of CGT assets versus other partnership assets.

With share buy-backs and consolidation, we will be delving further into the interplay between CGT and full imputation arrangements for companies - with potential extension to integration design.

Analysing the interrelationship between CGT and imputation requires an appreciation of the relevance of tax value versus value of both companies' shares and their underlying assets and liabilities.

That appreciation is essential for understanding sound design and dealing with problems such as tax loss or profit duplications which are relevant to both share buy-backs and consolidation.

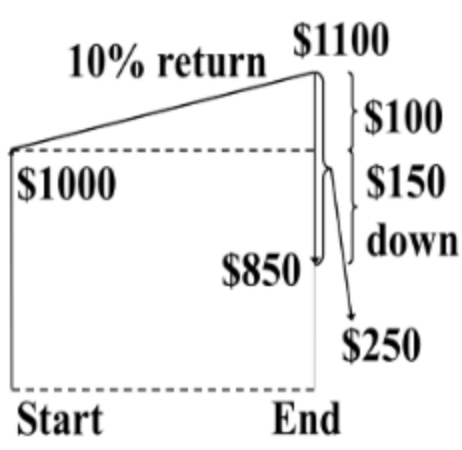


That is why I'm going to start off reiterating how tax loss duplication is avoided by reductions in tax values of company shares when capital is returned to shareholders.



There are lots of tax rorts in these areas of the law.





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.

So? Is that all?

OK, but what about tax values?

If tax depreciation of 15% is allowed on the asset, the company would pay 30% tax on \$100 taxable income, which matches income.

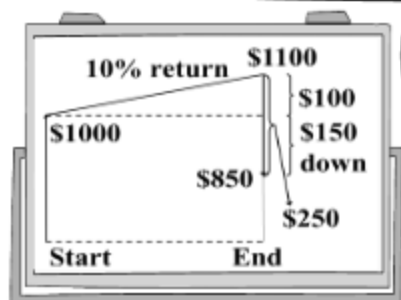
Then, under imputation, the cash distribution would comprise \$70 franked dividends plus \$150 return of capital, which is neatly measured for tax purposes.

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.



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.



Share buy-backs

OK, let's get started on preparing to brief the committee on those extra items in the review's terms of reference.

Let's start with share buy-backs, where companies decide to buy-back shares from their own shareholders.

This is a tax-driven rort!

Those participating in the buy-back benefit at the expense of those who do not.

We would first have to be clear what those participating get.

It is regular commercial practice for companies to buy back their own shares - say, to re-jig their debt to equity structure by borrowing to purchase the shares.

We have to make sure the tax treatment of share buy-backs neither encourages nor gets in the way of such commercial decisions.

And, picking up on Sami's point, companies' participating shareholders are treated differently depending on whether the buy-back is conducted "on market" or "off market".

!?!?

Oh, sounds interesting already.

With an on-market buy-back, the company is buying back its own shares just like any other purchaser in the market for the company's shares.

The sellers of those shares don't know whether they are selling back to the company or to another shareholder.

!?!?

I see. They just get the market price for their shares.

In contrast, with an off-market buy-back, shareholders specifically opt to sell back to the company.

But, under both both types of buy-back, the shares bought back by the company are cancelled, along with associated contributed capital and retained income or profits.

So, in both cases, a complete "slice" of the company is bought back.



Which suggests remaining shareholders maintain their proportionate interests in contributed capital and retained profits.

The company doing the buy-back could fund the share purchases by borrowing.



Then, the company would achieve a reduction in contributed capital and increase in debt funding to back its existing assets.

The company could, instead, sell assets to pay for the "slice" of company bought back.

In fact, at the extreme, selling all assets to pay out all shareholders and cancel their shares is the same as liquidating the company.



So, equating share buy-backs with partial liquidations immediately underlines the need for consistency in tax treatment between share buy-backs and company liquidations - and, as you will see, ex-dividend share sales.

In particular, sound tax design for these three situations - set against our full imputation and CGT arrangements - sees a single layer of tax at shareholders' tax rates apply to the income received by shareholders.*



I know there has to be tax rorting amongst all of this.



I find this all very exciting, Claudia, but.....

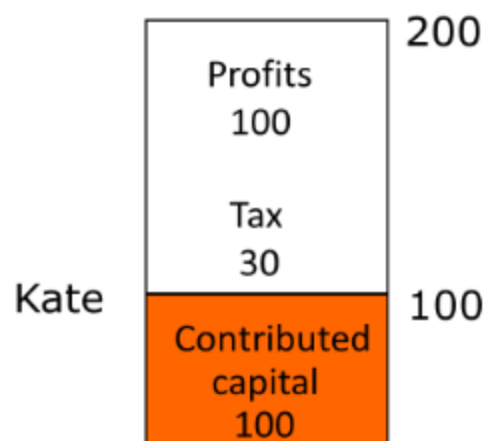


I thought the measure of sound design when taxing investment income was to have annual pre-tax return cut after tax by the investor's tax rate.

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.



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.

Now, let's start with an off-market buy-back.

And, I'm first going to assume our realisations CGT no longer provides a 50% discount for gains on share sales.

Another assumption, Claudia.

To help bring out key issues, Brad.

Kate's company announces that it plans to undertake the buy-back and Kate is ready to sell her shares in the buy-back, or prior to it.

Then there is Jim, who hears about the buy-back and wants to buy shares before the buy-back so he can participate and get what he sees as associated tax benefits.

Jim's looking for the tax rolt.

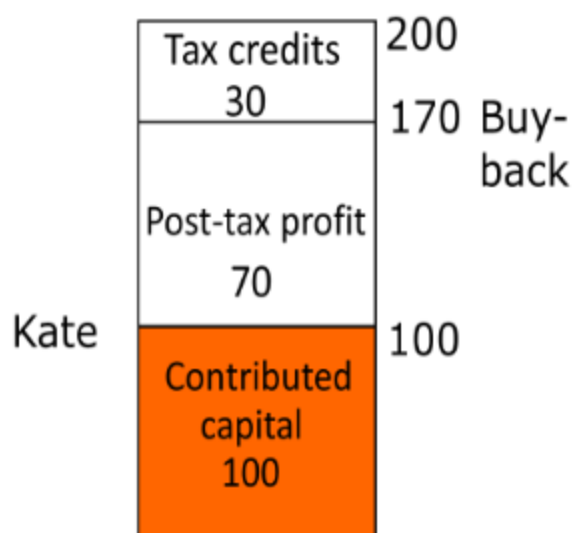
So, prior to the buy-back with the share price still at \$200, Kate sells her shares and Jim, who is on a 47% tax rate, buys \$200 worth of shares.

At this point, double tax has been paid on the \$100 of company income: \$30 by the company; and CGT of \$39 by Kate.

What!! I knew CGT with no discount was a problem.

There wouldn't be double tax under integration.

On the contrary, Brad. See what happens when Jim sells out in the buy-back.



First note that, to entice shareholders to participate in the buy-back, the company might only have to pay \$170 for a parcel of shares valued at \$200.

Foreign shareholders won't value the parcel at \$200.

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.

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.

Kate	Tax credits	200	Buy-back
	30	170	
	Post-tax profit	70	
	Contributed capital	100	

(a) Kate sells to Jim for 200
39 CGT

(b) Off-market buy-back

30 tax	Jim pays 17 extra tax	less 47 from CGT loss
70 post-tax profit		
Contributed capital 100		

(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



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.

Neat, Claudia!

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.

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 } $6.5 + 170$
 -23.5 } = 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 } $22.5 + 170$
 -7.5 } = 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!

Talking about fairness, Jim and others participating in the buy-back are getting franked dividends while other shareholders - likely the vast majority of shareholders - are not!

The dividends paid to Jim in the tax-driven buy-back belong equitably to all shareholders whose proportionate interests in those dividends are consequently trampled on.

All shareholders are morally and legally entitled to share in these buy-back dividends.



Brad, we have seen that a buy-back does not just involve a dividend distribution.

It is a part liquidation with profits plus associated capital being bought and cancelled.

If the same profits and capital were distributed to all shareholders, that would liquidate the company.

It is, nevertheless, important that the slice of of company being bought back does represent a proportionate share of contributed capital, untaxed profits and taxed profits with associated franking credits.

Those not participating in the buy-back would then retain their interests in undistributed profits and credits.*

But, on pricing of off-market buy-backs, I have seen stats showing the discount to market price is often less than associated fully-valued franking credits.

In your example, more than \$170 is paid.

Meaning remaining shareholders are worse off because too much is paid to those selling out.

Usually shareholders get the chance to offer to sell in the buy-back at a specific discount to market price, which will reflect their view of their companys' future prospects.

But, lack of available capital gains to offset capital losses and, as we have seen, only half loss allowed can only push up shareholders' offer price.

On that note, let's now turn to on-market buy-backs.

Again our company decides to re-jig its capital structure by borrowing to buy back a specific number of its own shares.

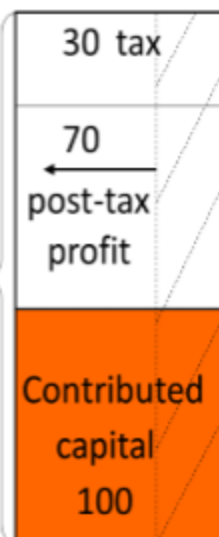
This time, however, the company announces that it is simply going to buy the shares back like any other share purchaser - perhaps because of simplicity, despite there being no prospect of buying back at a discount to market price.

And again we have Kate selling shares, and Jim buying shares, prior to the buy-back. Jim buys so he can participate in the buy-back.



(a) Kate sells to Jim for 200
39 CGT

(b) On-market buy-back



(b) Jim paid 200 in buy-back

Includes 30 for tax credits

Remaining holders get credits later



During the on-market buy-back, it does not matter whether Jim sells to the company or someone else.

Jim gets the \$200 back that he paid for his shares, including full value for the \$30 of associated franking credits.

He just pays, and then gets back, \$200!?



Again, the shares bought back by the company are cancelled, along with associated contributed capital and retained profits

But, unlike the off-market variety, the company retains the franking credits associated with the profits bought back.

Those credits will be distributed later to 'remaining' shareholders along with untaxed profits.



Thus, the double tax that occurs when Kate sells her shares is not offset until those credits are distributed - at the extreme, when the company liquidates - perhaps increasing franked dividends, reducing capital returns and producing a capital loss.**



All very theoretical, Claudia.

Please let me show the tax numbers.



* 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' 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!

Hey, before we go, I've got a great idea for share buy-back redesign.

This would simplify things greatly and remove the scope for tax rorting.

All we have to do is tax off-market buy-backs like on-market buy-backs.



Brad, we have seen how shares bought back by companies are cancelled.

And an important general principle applies when membership interests in any collective investment vehicle are cancelled.

That is, that those whose interests are cancelled should receive a slice of the vehicle's capital and profits reflective of their levels of ownership.*



And, Brad, we have seen how that principle is achieved with current design of off-market share buy-backs.

In fact, it would be nice if we could achieve that same outcome with on-market buy-backs.

But, of course, that is not possible because companies don't know which shareholders are selling when they buy on market.



And we have seen the practical effects of this fundamental difference between off- and on-market buy-backs.

Off-market buy-backs set the scene for removal of prior double tax. In contrast, companies' buying back on market engenders double tax, removal of which requires franking credits associated with the shares bought back not to be cancelled.

And, under imputation, removal has to wait for those credits to be distributed to remaining shareholders.

Ok, let's call it a day.



* Ralph Review, pp 454-455.

Hey, Sami, you know companies don't get the CGT discount.

Yep, that's good isn't it?

So, if a company participates in an off-market buy-back its tax assessment would include any capital loss in full.

Yep, that's good isn't it?

It's just like the CGT loss when a company acquires another company and the acquired company distributes all its retained income - taxed or not - and the acquiring company then sells the acquired company.

Shareholders selling out just before the buy-back or acquisition pay CGT on their sales and any double tax is removed by subsequent utilisation of CGT losses.

But, if retained profits of the acquired company are all untaxed, there is no double tax.

And the capital loss could effectively result in no net tax paid by the acquiring company on the unfranked dividends distributed to it.

Brad, if the capital loss were not allowed, double tax would arise when the acquiring company paid tax on the unfranked dividends.

The effect of the capital loss is to offset the company's tax on the unfranked dividends leaving matching untaxed income for later distribution to shareholders, who may then attract a balancing capital loss on share sales.

Both here and Claudia's buy-back examples with untaxed income only, net tax comes from initial CGT paid.

So, if the retained profits of the acquired company are taxed.....

Yes, no extra tax is paid on them when distributed as franked dividends to the acquiring company.

But the capital loss removes the double tax that occurred when CGT applied to the acquisition as in Claudia's examples.

I reckon, Brad, that good design for relief of double tax via CGT should rightly be independent of the composition of retained profits of a company either being acquired or undertaking a share buy-back.

Oh, always the purist, Sami!

TAX

DEPT

Duplication of tax losses and profits - and value shifting outside consolidation

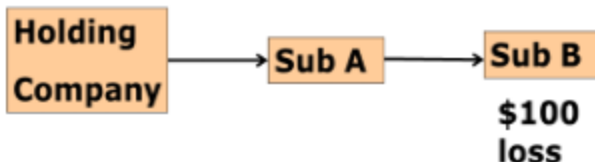
We have discussed double taxing of retained company profits under **imputation** when individual shareholders sell their shares.

And how that double tax is removed via share buy-backs or distribution of the profits followed by sale of shares.

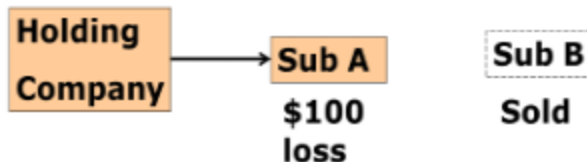
And I have helped Sami understand similar effects when chains of companies are involved.

What.....?!

1. Initial loss



2. Loss duplication, cascading



Now, as a lead-in to consolidation, let me show you how losses may be duplicated down company chains.*

Here, a holding company capitalises a wholly-owned Subsidiary A, which in turn capitalises its own Subsidiary B with the same funds.

Yeah, I know about this rorting.

Subsidiary B makes a very poor investment and realises a net \$100 loss, with the value of the subsidiary declining commensurately by \$100.

Subsidiary A then sells Subsidiary B and realises a duplicate \$100 loss on the sale.

Yeah, I know.

Subsidiaries A and B may be able to use the duplicate losses to offset later profits.

Such outcomes could cascade down company chains, exacerbated by any ability to transfer losses back to a holding company.

Hang on. This is all sorted you know.

* 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.



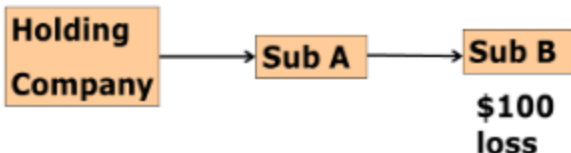
Whatever that means.



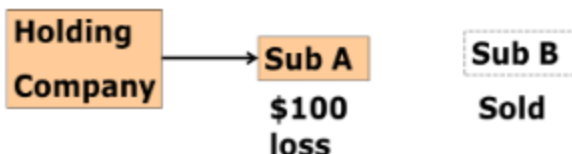
Oh, I like that approach, Claudia.



1. Initial loss



2. Loss duplication, cascading



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 taxable 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.

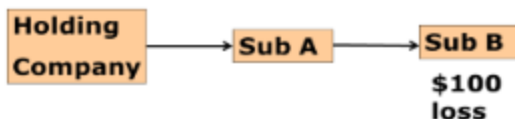
Oh, er, sure.....

And, Sami, we did not discuss losses in the design of integration of taxable income but.....

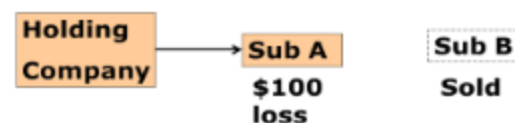
Yes, yes, let me deal with losses.

Sami's on a roll.

1. Initial loss



2. Loss duplication, cascading



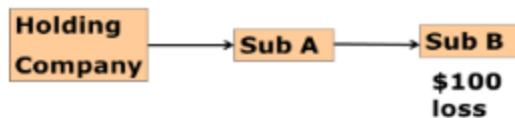
In your loss duplication case, Claudia, Subsidiary B makes a \$100 tax loss and its value drops commensurately.

And Subsidiary A duplicates the loss by selling its Subsidiary B shares whose CGT tax values remain unchanged.

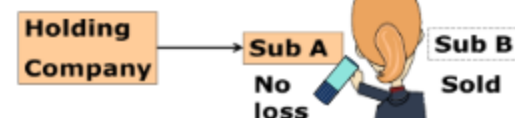
I'm thinking that under integration design, treatment of tax losses could mirror tax value increases that would roll through the company chain and out to individual shareholders if Subsidiary B retained taxed income.

Go on, Sami

1. Initial loss



2. Loss duplication, cascading



And, then, \$100 loss would not be duplicated in Sub A on its sale of Sub B.

So, under integration, the loss would still stay with Subsidiary B and not roll out to individual shareholders.

Darn right!

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.

Brad, I know the continuity of ownership and same business tests would remain to deal with access to losses.

But, Sam's idea opens up the way to consider a structural solution to loss duplication, along with double tax on profits, outside consolidation, if the committee recommends integration of taxable income be pursued.

I would worry if any operative avoidance-type provisions were removed.

I would like to raise full tax offset for losses 'cause investors need to recoup the value of their losses to balance the tax on their profits.*

But I'm learning about timing.

In any case, Claudia, the \$100 loss in your example is a tax loss, which might not match the actual loss in value of Subsidiary B.

Good point, Brad.

But, you would appreciate that existing provisions aimed at loss duplication are also aimed at tax losses.

And an **unrealised tax loss** in value of Sub B could give rise to a loss in Sub A on its sale of B, a loss which could be duplicated later in Sub B when the loss is realised.

Another good point, Brad.

Yeah, Brad.

If the loss is initially unrealised in Sub B but realised in Sub A, CGT tax value reductions could cascade down the chain from Sub A instead.

Later, with income earned and sheltered by the realised tax loss in Sub B, CGT gains on any sales of Sub B's shares would match prior losses. And, Sub B's income should be taxed as unfranked dividends when distributed.

Such timing differences in the removal of the initial duplication are inevitable so long as we have CGT on a realisations basis.

And taxable income different from commercial profit and no full loss offset.

Hmmm. What about value shifting rorts?

Value shifting arrangements cause the value of one asset to decline and the value of another to get a matching increase, with no change to the CGT tax value of either.

The assets could be owned by different taxpayers and could include shares or interests in trusts.



Value shifting causes problems by messing with CGT measurement, creating artificial losses and deferred gains.

Usually CGT value shifting is classed into two groups: **direct** shifting at the asset level; and, shifting of asset values that **indirectly** affects the value of shares or trust interests.



Inspired by Australia's last wide-ranging review of taxing investment income*, we now have a **generalised shifting regime** to address these rorts.

Thanks, Brad. How is value shifted between individual assets?

Leases or rights could be granted over assets, including changing the rights attaching to different share classes.



That's really useful, Brad.

I think the committee would agree to current law on direct value shifting being revisited against all our hard work on taxing leases and rights, as well as on different share classes under integration design for companies.

But, current law.....



What about **indirect value shifting**, Brad?

As with direct shifting, there are numerous provisions dealing with indirect shifting, particularly shifting at other than market value.

I could show you a simple asset-stripping example.

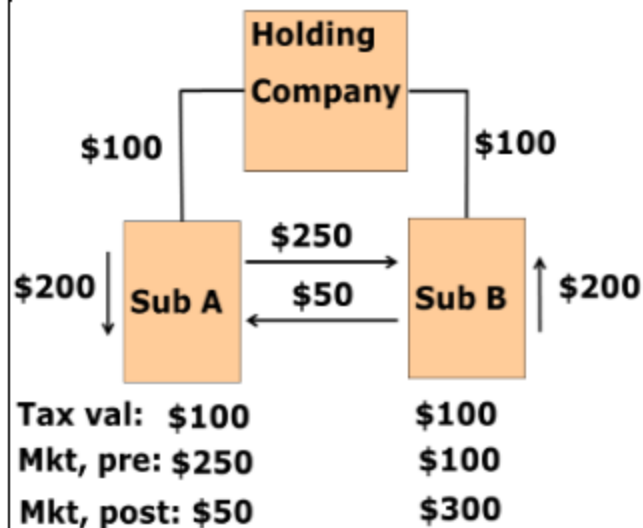
Great. We don't need a lot of detail.

This is mostly background to the benefits of consolidation.



Illustrations help so much, Brad.





OK, here is a 100% owned group of companies.*

The parent capitalises its two subsidiaries with \$100 each - so its shares in each have a tax value of \$100.

Over time, the market value of Sub A increases to \$250 while that of Sub B stays at \$100.

Then the two subsidiaries effect a value shift by swapping assets with different market values.

Sub A swaps assets worth \$250 in exchange for \$50 worth of assets from Sub B.

Wow - looks like all of Sub A's initial assets are stripped out.

Anyway, while the value of the parent is unchanged at \$350, the value of the parent's shares in Sub A and Sub B decline and increase by \$200, respectively.

But, because the tax value of the parent's shares in both subsidiaries stay at \$100, its shares in Sub A could be sold for a \$50 CGT loss.

Wow, it's one thing not to tax the \$150 gain in value of the parent's shares in Sub A when that accrues.

It seems quite another when all the \$250 of assets are stripped out of Sub A into Sub B - presumably done by using rollover provisions for company groups.

Mostly, the response to indirect value shifts is to adjust the tax values of affected shares, like the \$100 tax values of shares in Subs A and B. But, sometimes CGT gains are triggered.

Thanks, Brad. This is a great lead-in for the committee to tax consolidation of company groups.

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

Tax consolidation of company groups

I have now taken the committee through the complexities associated with measures to address tax **loss and profit duplication**, as well as **value shifting**.

The committee saw how that **complexity is removed** from company groups **by consolidating their tax**.



Didn't take us in!



Could you remind us how consolidation does that, Claudia?

Certainly, Sami - the design is again inspired by work in Australia.*

And then we will work up a response to the committee's request for further detail on consolidation design.



Oh yeah, "we".



Oh, I love this so much!

You would have noted the key driver of tax loss and profit duplication, as well as many CGT value shifting problems.



And that is the divergence between market values and tax values of company shares.

I would therefore add the realisations basis of CGT design as a key driver.

Yes, yes, Sami - we understand!



You never give up, Sami.



The point I'm trying to make is that, under consolidation of 100% owned company groups, divergence between the value of a subsidiary and the tax values of the subsidiary's shares - or the tax values of its assets and liabilities - becomes irrelevant.



And that is regardless of the number of wholly-owned subsidiaries in the group.

* 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.

CGT profits and losses realised on the sale of assets during consolidation are reflected in the assets' tax values on exit.

But, unrealised CGT profits or losses on assets within a company on exit will not be reflected in their tax values.

This again could mean the group's CGT losses or gains on sale of a company being duplicated when the new owner sells those assets.



This is a regular situation we saw with loss duplication, Brad.

The buyer may realise a CGT loss, say, on the sale of a newly acquired asset.

But, subsequently realised CGT gains sheltered by that loss would be taxed as unfranked dividends when ultimately distributed.

The delays involved are inevitable with a realisations CGT.



Alright, but my main concern is with aligning the tax values of the assets of a company on entry with the amount paid for that company.

Surely, when tax values of assets are increased to match a higher sale value, tax should be paid on those increased tax values - which I call balancing adjustments.



No, Brad. The sellers might have been taxed on that very same difference. The buyer can't be taxed on it too.

How did this crazy design get up?



Well Brad, the committee, too, has asked me to explain the basis of the design.

As practice for my next session with the committee, let me see if I can convince you that it is best simply to change the tax values to match sale value without any change in tax liability.

I've had the tax analysis people do some modelling for me using a model similar to the Australian Treasury's Kyscope model.* No CGT discount is assumed.



Modelling!
This'll be good.

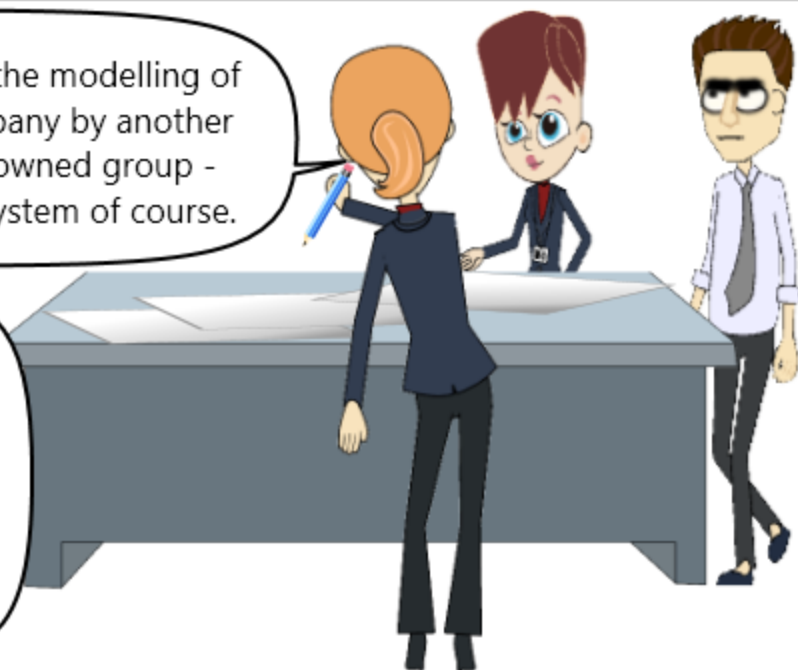


Oh, I'm looking forward to this, Claudia.

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

Have a look at the printouts of the modelling of the full acquisition of one company by another to form a consolidated 100% owned group - under our current imputation system of course.

You can see that the acquired company has just one depreciating asset, perhaps manufacturing plant or agricultural plants, and one appreciating asset, perhaps land.



The acquiring company has been capitalised just to acquire the other company.

The modelling shows two different consolidation designs - one with, and one without, uplift of asset tax values to match the price paid for the acquired company on its entry to the group.



Wow, aggregate tax revenue is the same for both situations.

That's right. Well spotted, Sami.

Numbers! Numbers!



The modelling looks at the acquiring company operating over a number of years, then reselling the two assets as a company and liquidating.

And, each year over the period of operation of the acquiring company, and on liquidation, annual cash from the two assets - and their sale as a company - is distributed to group shareholders.



As a result, all the group's income from the two assets is distributed to be taxed at group shareholders' 47% rate over the acquiring company's period of operation.

Were there no annual distributions at all, distribution of the group's income, including taxed income and credits, would have been delayed until liquidation.



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.

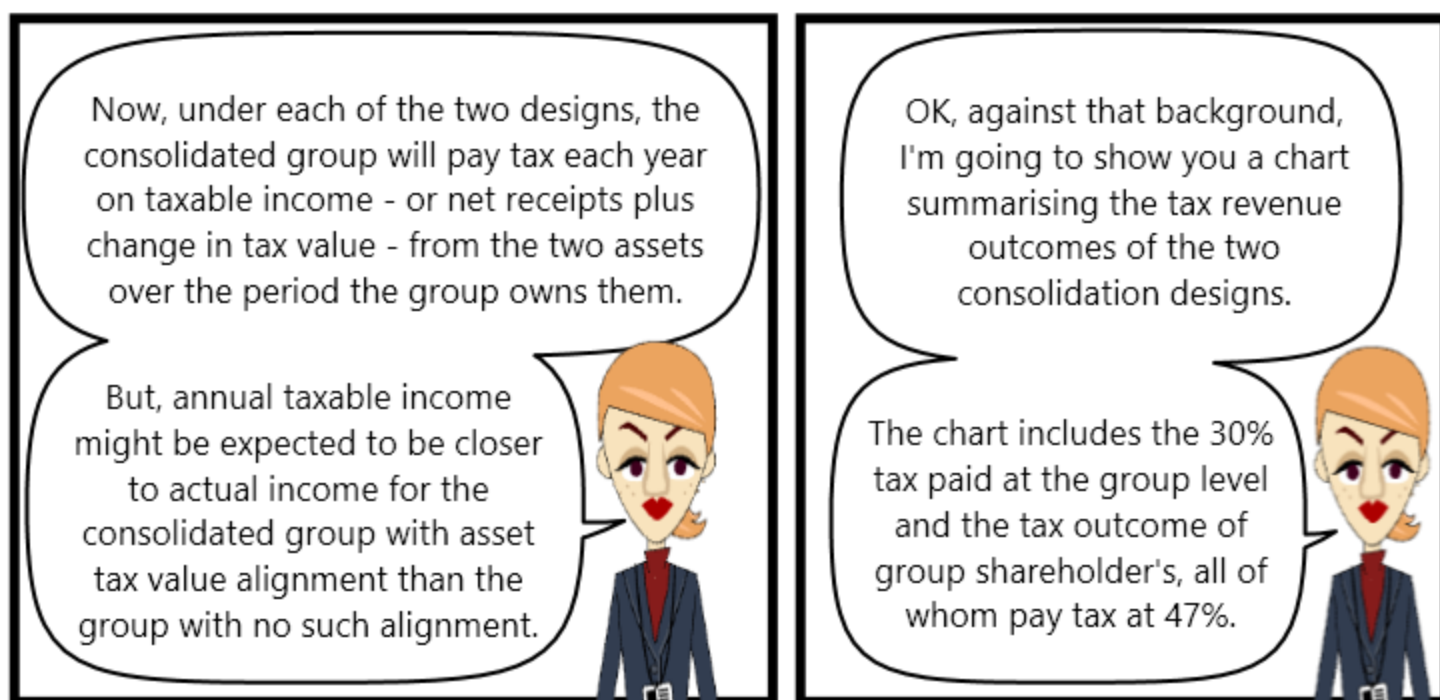
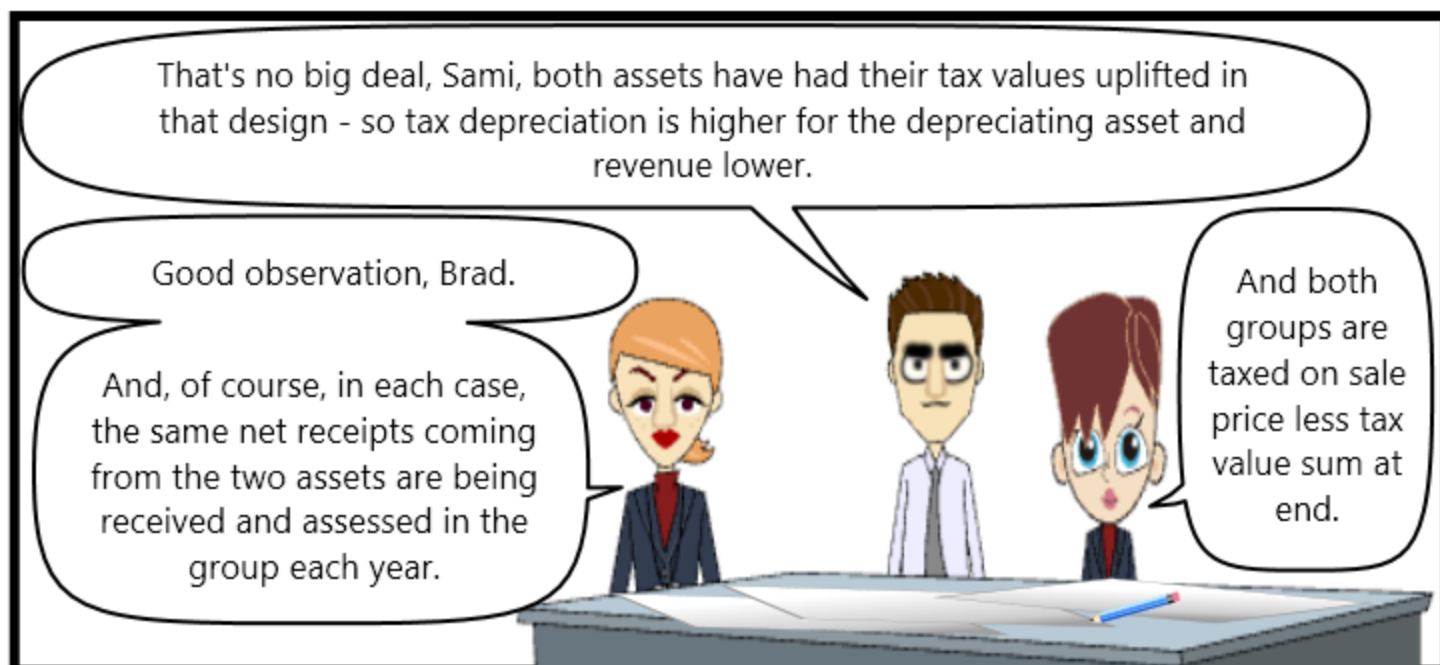
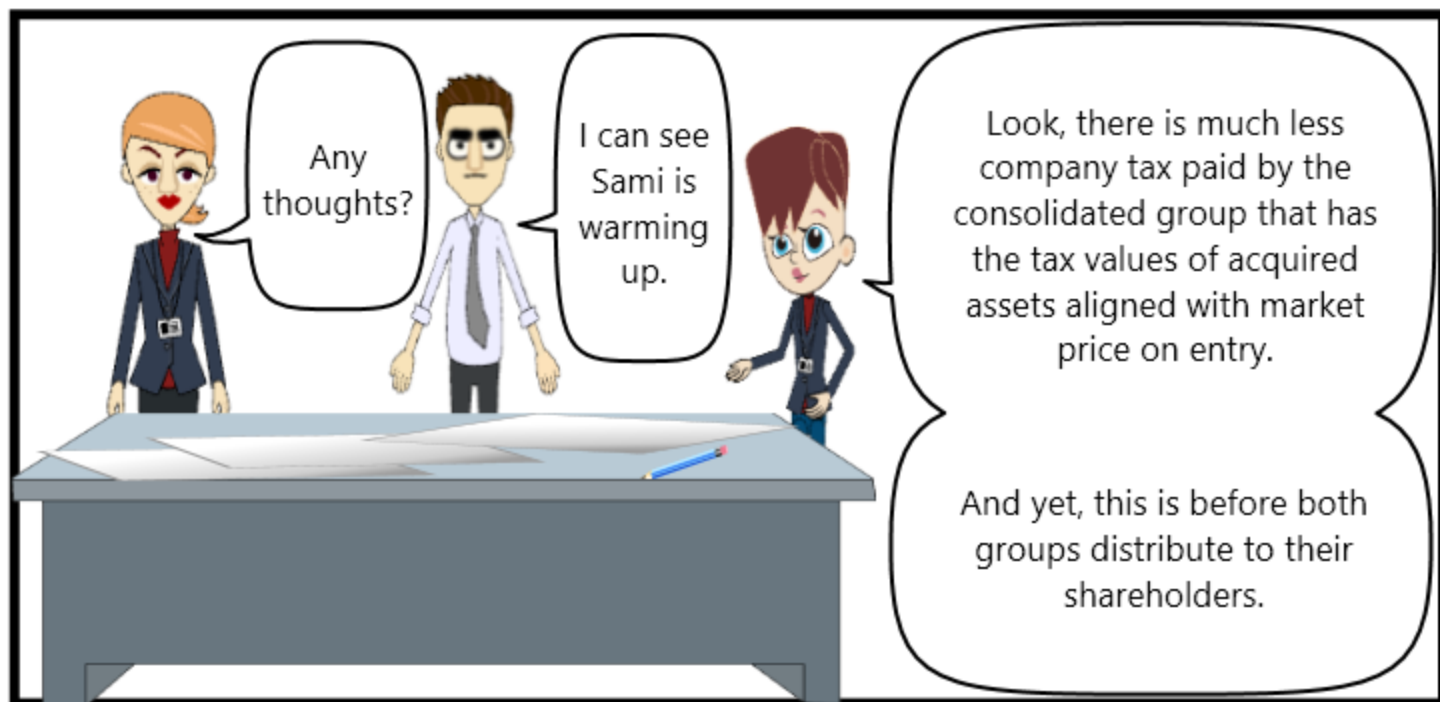
OK. Let's look in detail at the modelling.

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!



\$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

The modelling has the company being bought for \$2.42b with \$713m of income earned during the group's operation.

With tax value uplift on entry, \$214m of tax is paid by the group: 30% of the \$713m total income.

In sharp contrast, the group pays \$340m with no tax value uplift.

And yet, as I said, total tax is \$335m under both designs when all cash is distributed.

Good to see you getting into the numbers, Brad

With tax value uplift, group shareholders pay an extra \$121m to get the total tax to \$335m, or 47% of the \$713 total income.

But, with no uplift, because the group pays \$340m, shareholders have to get tax savings of \$5m.

Looks like modelling magic to me!

Not magic, Brad.

In fact, the numbers show that, up until the group's liquidation, total annual tax from the group plus shareholders is the same for both designs.

What? No! Tax depreciation has to be higher with uplift on entry.

Certainly, Brad, the modelling shows that, before the final year, lower annual group tax is paid with uplift on entry.

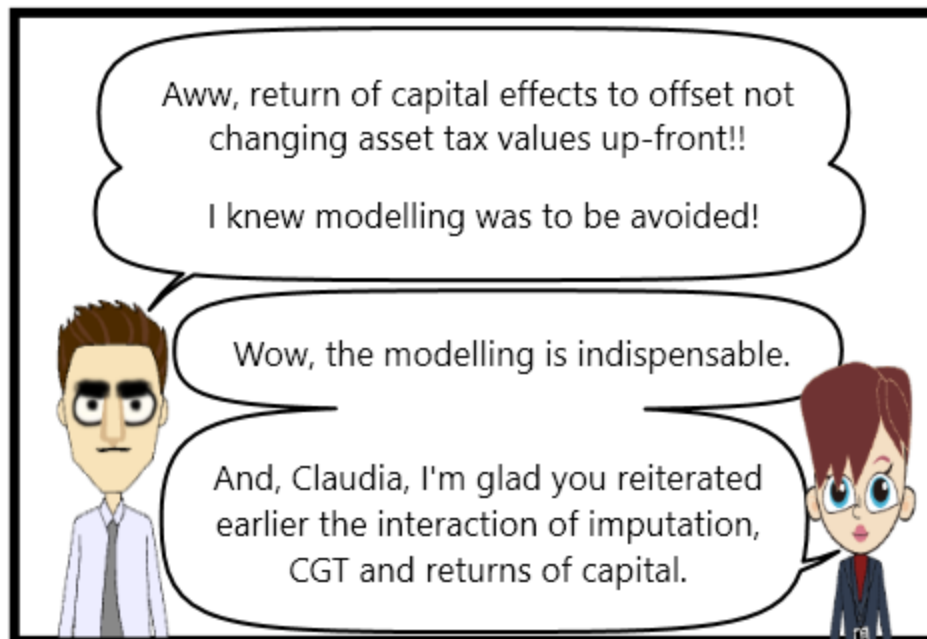
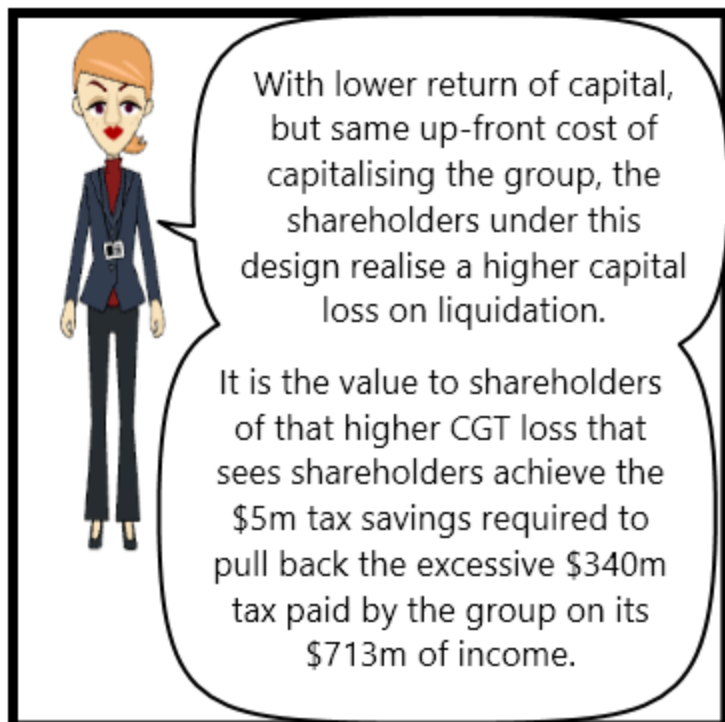
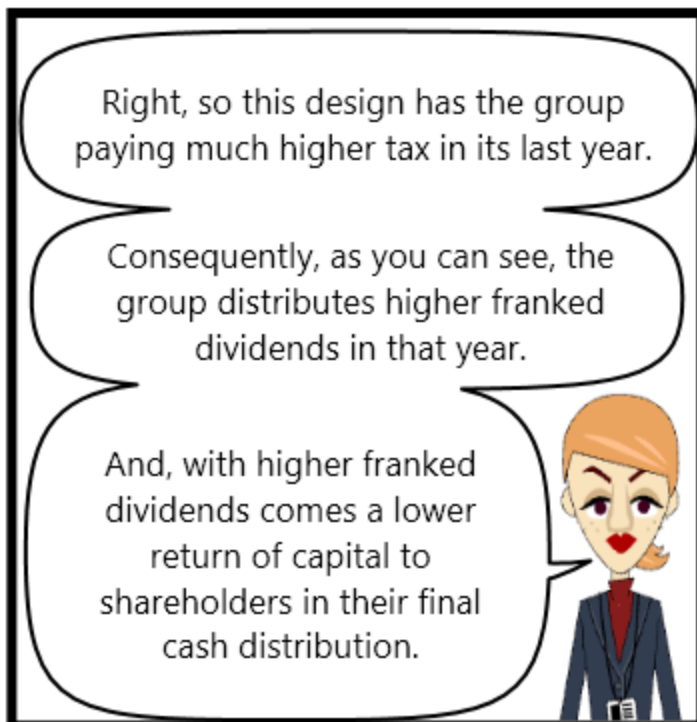
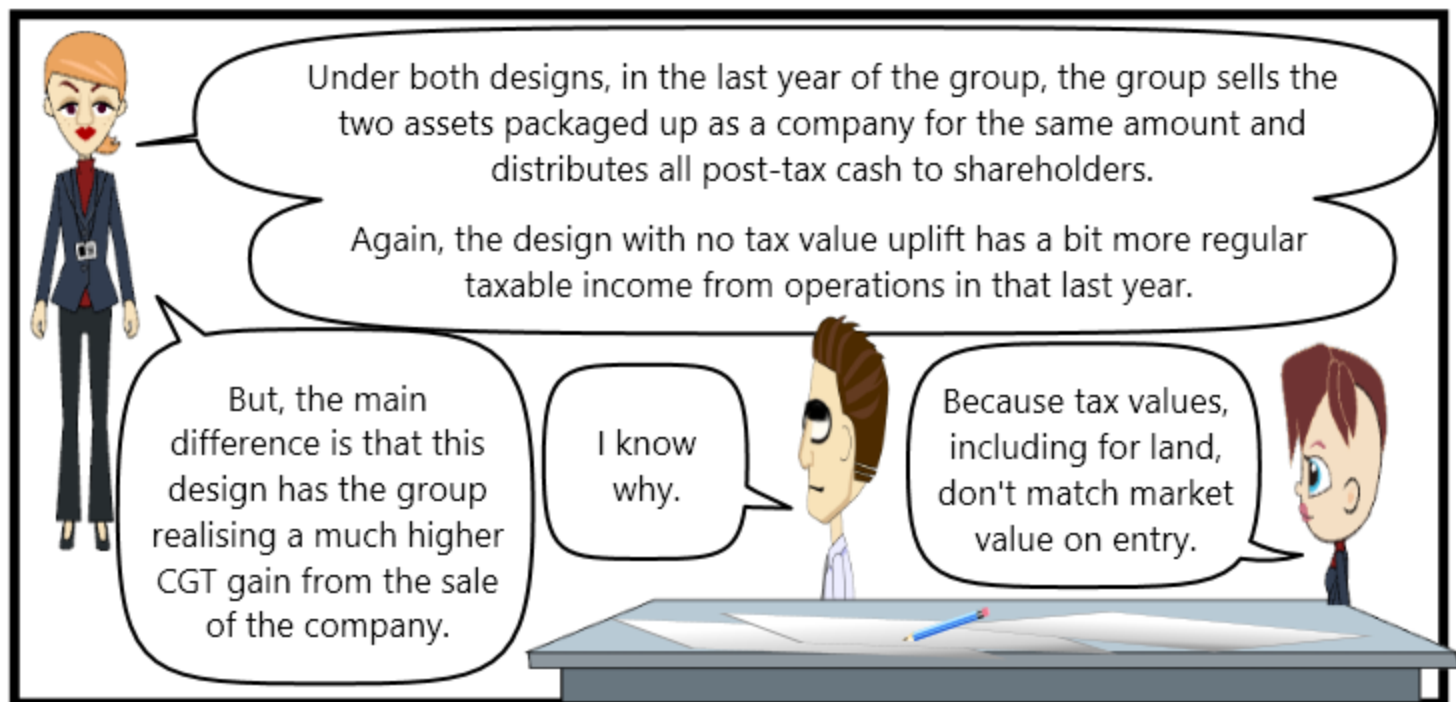
But, in those years, lower tax at the group level results in higher tax at the shareholder level, resulting in matching total annual tax for the two designs.

With cash paid out annually, the modelling has any income untaxed at the group level subsequently taxed as unfranked dividends at shareholder level.

So the explanation of different tax outcomes is all in the last year.

Oh, yeah. Modelling assumptions!!

Yes, Brad.
Impossible to decipher all this without modelling.



\$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.

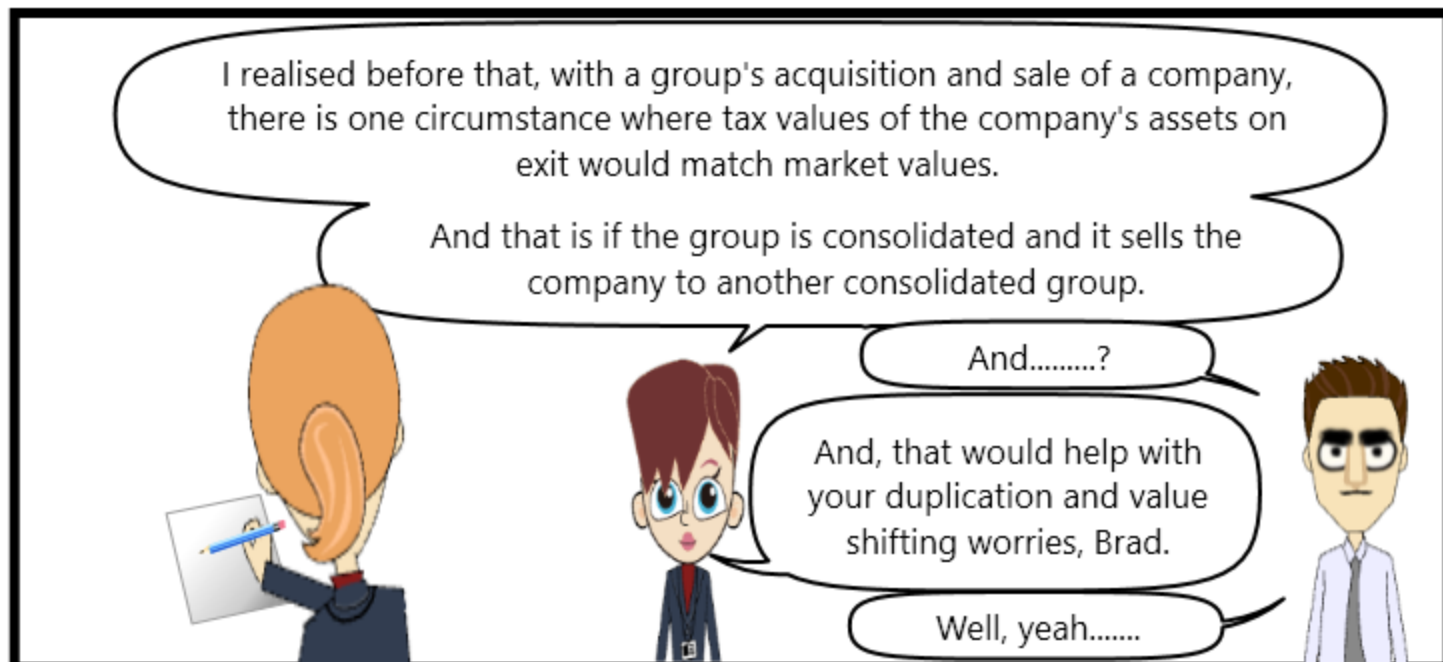
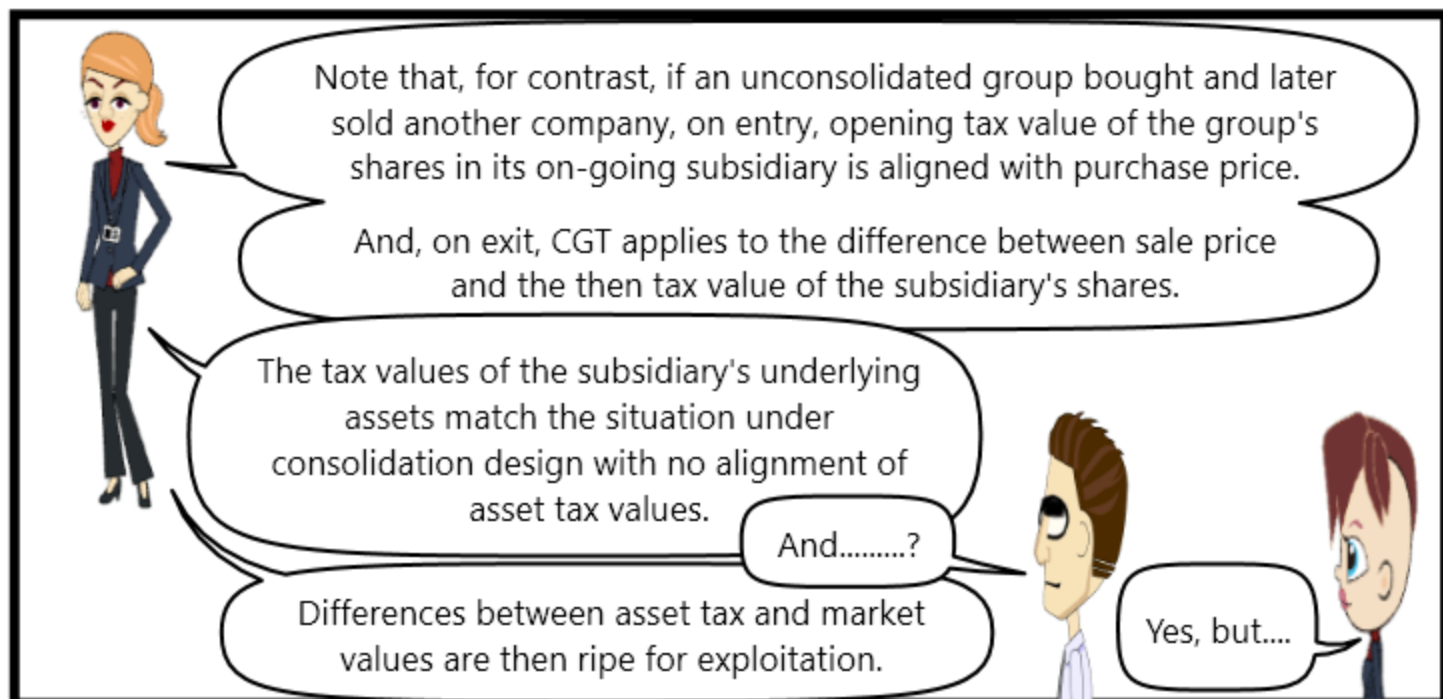
In any case, tax values may have to be reduced rather than increased when aligning them with purchase price, reversing the relative group tax outcomes.

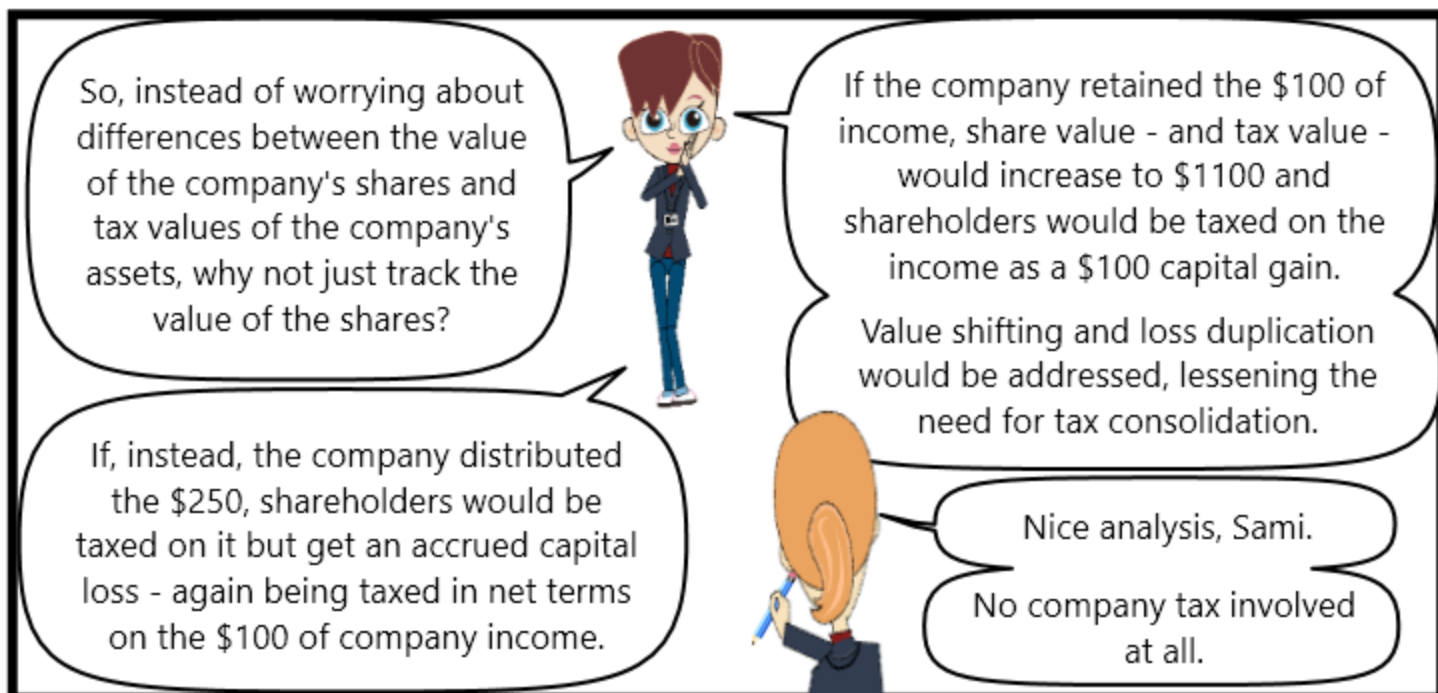
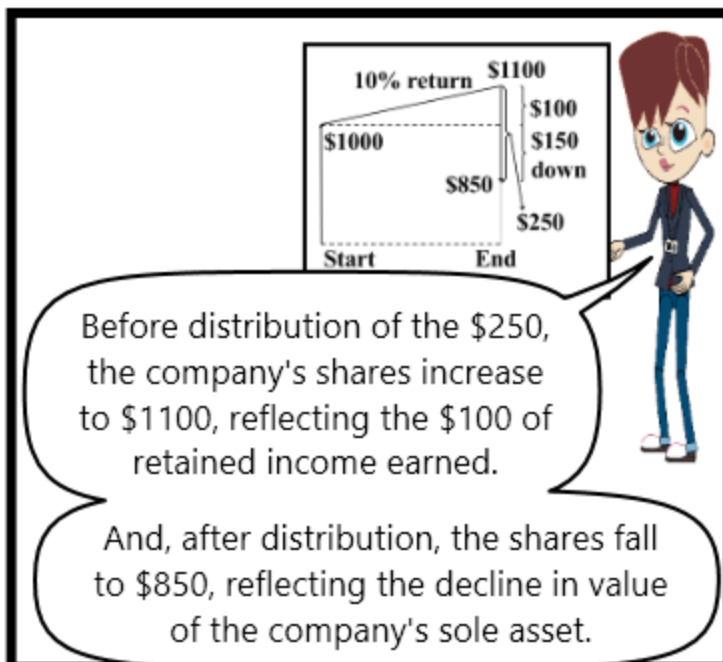
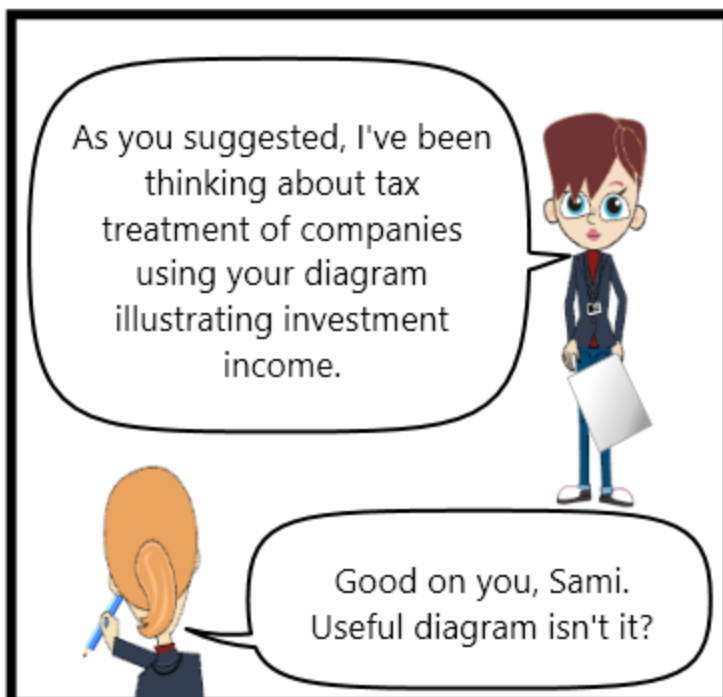
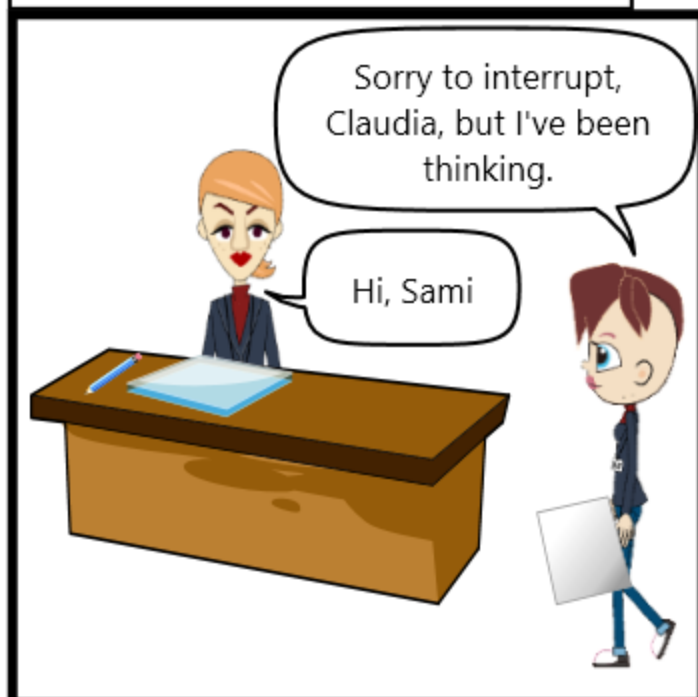
But, most importantly, aligning tax values on entry means taxable income is likely closer to income each year - so that the group's total income from the assets is taxed relatively steadily over the period that the group holds them.

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!





What you are delving into is a design for integration of companies' annual income with their shareholders' tax assessments. Their assessments would include distributions received plus accrued - and realised - capital gains and losses on their shares.

By capturing companies' "windfall gains" from all sources, some regard this as the ideal form of integration.*

Now, don't get too excited, Sami. I don't have to tell you that accruals CGT is a central feature. And there are a number of complicating aspects involved.

Wow!!

Ow....

People, like Brad, might focus on challenges with accrued valuations ...

... because, crucially, tax neutrality would require accruals CGT to apply beyond listed companies to all investment modes like private companies and trusts, as well as investments by unincorporated business and individuals.

Moreover, tax would still have to be applied to the income of companies to ensure some tax on foreign shareholders.

Then, of most immediate importance, of course, Sami, is the fact that the committee has already made clear that it is not planning on recommending general application of accruals CGT.

OK, then, why don't we at least suggest that when a company exits a consolidated group, the tax values of the company's assets are aligned with market value.

Even when the company is not being sold to another consolidated group.

Now there's a practical suggestion. I'll raise it with the committee.

Always start with the ideal and see how you go.

Now, I must get on with partnerships and CGT.

* 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.

OK, so, the tax treatment gets more complicated if the number of partners, or a partner's level of interest, in a partnership changes.

But why?

If, say, one partner sells out to a new partner, what's the problem, Brad?

The sale price and the level of interest in all the partnership assets being acquired from the exiting partner gives the overall market value of the partnership.

Then, that overall value just has to be allocated across all partnership assets, **including CGT assets**, and tax assessed on each pre-change partner.

It's just like the matching of asset tax values with their market values on entry to a consolidated group - except, of course, tax would be immediately assessed on the basis of the changes in tax values.

For depreciating assets, the change would trigger balancing charges and, for CGT assets, CGT gains or losses would arise.

It would be as if the old partnership sold out to the new partnership.

Not so fast, Sami.

Yeah, slow down, Sami.

For a start, Sami, that would amount to imposing tax on accrued capital gains on CGT assets of remaining partners.

You know my views on taxing accrued gains, Brad.

But, admittedly, the treatment you describe does **formally** apply across the partnership's depreciating assets.

So, different for depreciating and CGT assets!

Yes, and **rollover relief** does allow immediate balancing charges on depreciating assets to be avoided.

Oh, wow. Explain these different treatments, Brad.

OK, say, we have one partner selling out to a new partner.

And, I'll start with what happens regarding the partnership's **depreciating assets**.

Thanks, Brad.

Excellent.

Overall market value, deduced from the sale, and its variance from aggregate tax values of partnership assets is essentially spread across partnership assets, including depreciating assets.

For depreciating assets, that variance is included in the partnership's tax return.

Higher overall market value adds to net income; higher overall tax value reduces it.

So, absent rollover relief, higher overall market value sees all partners of the old partnership - including the exiting partner - face higher tax from balancing adjustments, even though just one of the partners has exited.

But, for all partners in the new partnership, including the new addition, depreciation allowances apply to the updated market values of the depreciating assets in the partnership's common depreciation schedule.

Nevertheless, the partnership may elect to get the benefit of balancing adjustment rollover relief.

Is an election allowed when market value is below tax value?

Yes, with an election, the effective sale of the assets by the old to the new partnership is ignored.

But, the new partner pays market value for a share of assets.

The new partnership just picks up depreciation on the assets at the written-down values of the old partnership.

The new partner too!

Partners not selling out face no impact on their tax until the partnership sells the assets or they too sell out.

But the new partner would pay more tax than appropriate when market value is higher than tax value and unrealised losses would be transferred to the new partner when market value is below tax value - with the exiting partner getting a matching capital loss!*

* See Ralph Platform, pp 333-335.

Let me see if I've got this right, Brad. Relief from balancing adjustments on partnerships' depreciating assets ensures no tax impact on those remaining as partners when other partners sell their interests.

Nice summary, Sami. Purchasers getting tax value different from market value is a fundamental problem with balancing adjustment rollover relief provisions.

Yep.

But, with such relief, problems arise because new partners purchase assets whose tax values could differ markedly from the market value they paid for them.

So, why not simply have new partners attract depreciation on the market value they pay for their share of the depreciating assets?

Exiting partners would still be assessed on the difference between market and tax values of their share of the assets.

And remaining partners would face no tax impact.

But, Sami, that would require all partners to keep separate records of their own tax values of depreciating assets.

Partnerships could no longer just keep a common depreciation schedule.

People already complain about the complexity of such arrangements for partnerships' CGT assets.

What?!

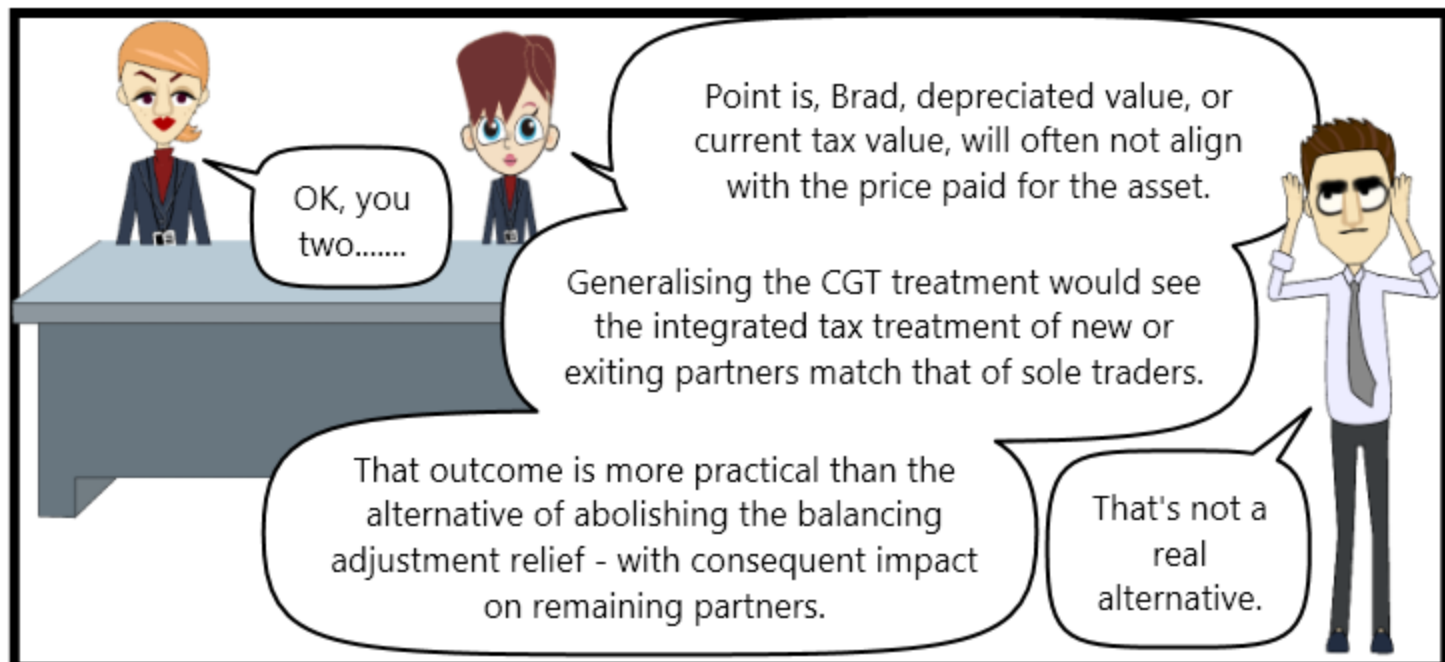
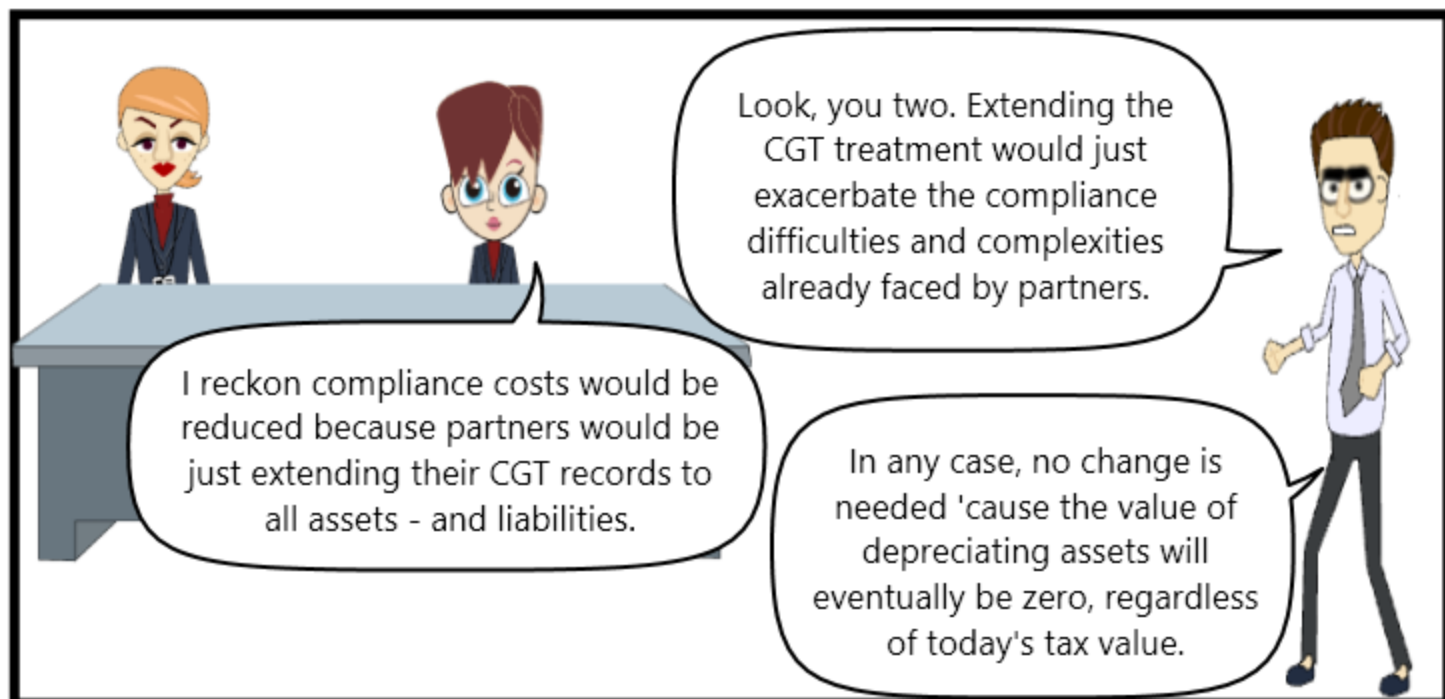
You mean partners already have to keep track of their own tax values for, and interests in, each partnership CGT asset.

That's right.

Then why don't we simply extend that CGT treatment across all partnership assets?

That would mean rollover relief would become superfluous.

Good question, Sami.



Now, were the current CGT treatment extended to all partnership assets, including depreciating assets, the arrangements would be consistent with **sole trader** treatment.

Moreover, absent changes in number, or level of interests, of partners, annual taxable income of each partner would simply reflect the partner's share of partnership net receipts and change in tax values of partnership assets and liabilities.



Partnership tax values changes would include new assets created from retained profits taxed to the partners.

Oh, wow. That's just like integrating retained company income with shareholder assessments.



Only when the level of interests, or numbers, of partners change would it be necessary for partners to keep track of the tax values of their own assets and liabilities to feed into their tax returns.

Of course, each partner's share of annual net receipts would continue to come from the partnership's records.



There is an alternative where an overall tax assessment is always computed at the partnership level, drawing on changing tax values of all assets and liabilities.*

All partners then include their share of that assessment in their own returns - including any CGT gains or losses on CGT assets.

In order to deal with partners' entering and leaving the partnership, a running tax value of each partner's interest is maintained. An exiting partner is taxed on the difference between market and tax value of this interest.

The tax value of a partner's interest would be adjusted to reflect, for example: capital contribution/purchase price; share of taxable income/loss, including CGT gains/losses; and withdrawals.



Sounds like comparing the tax value of company shares with their value on sale.



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



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 than 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.

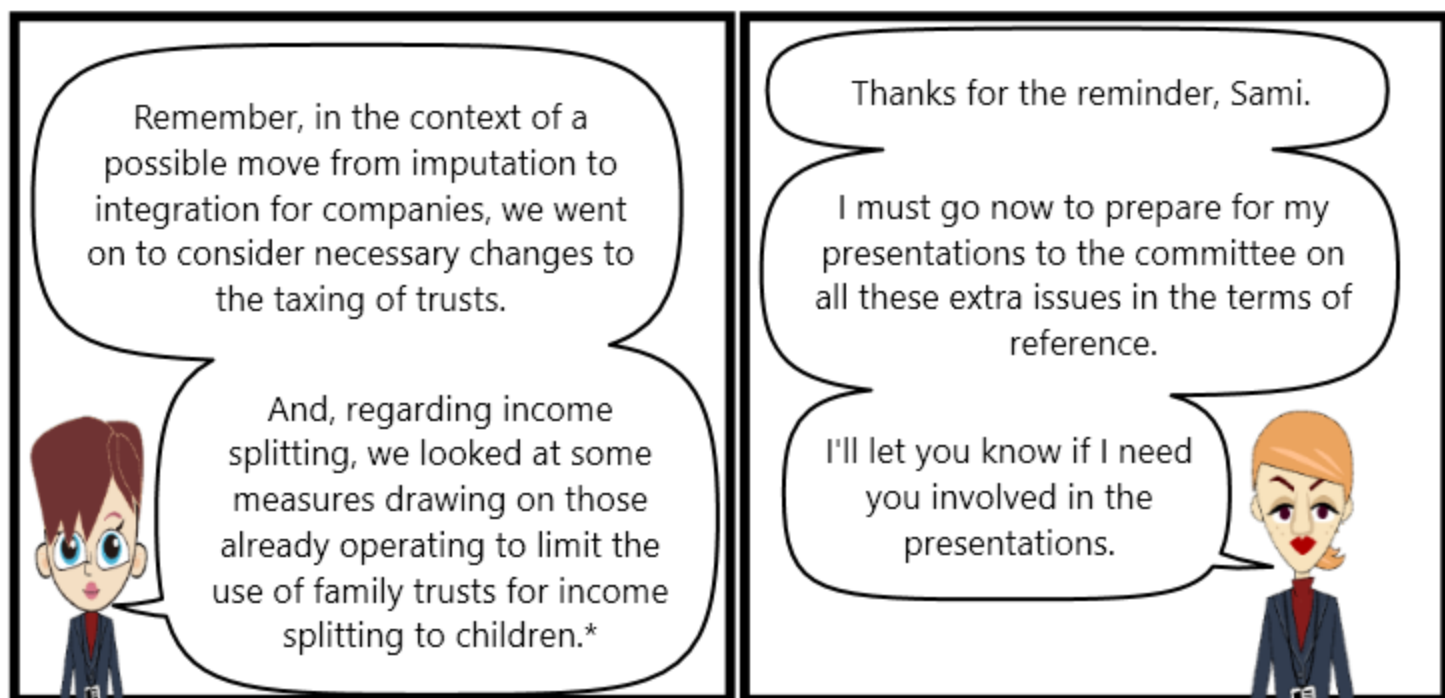
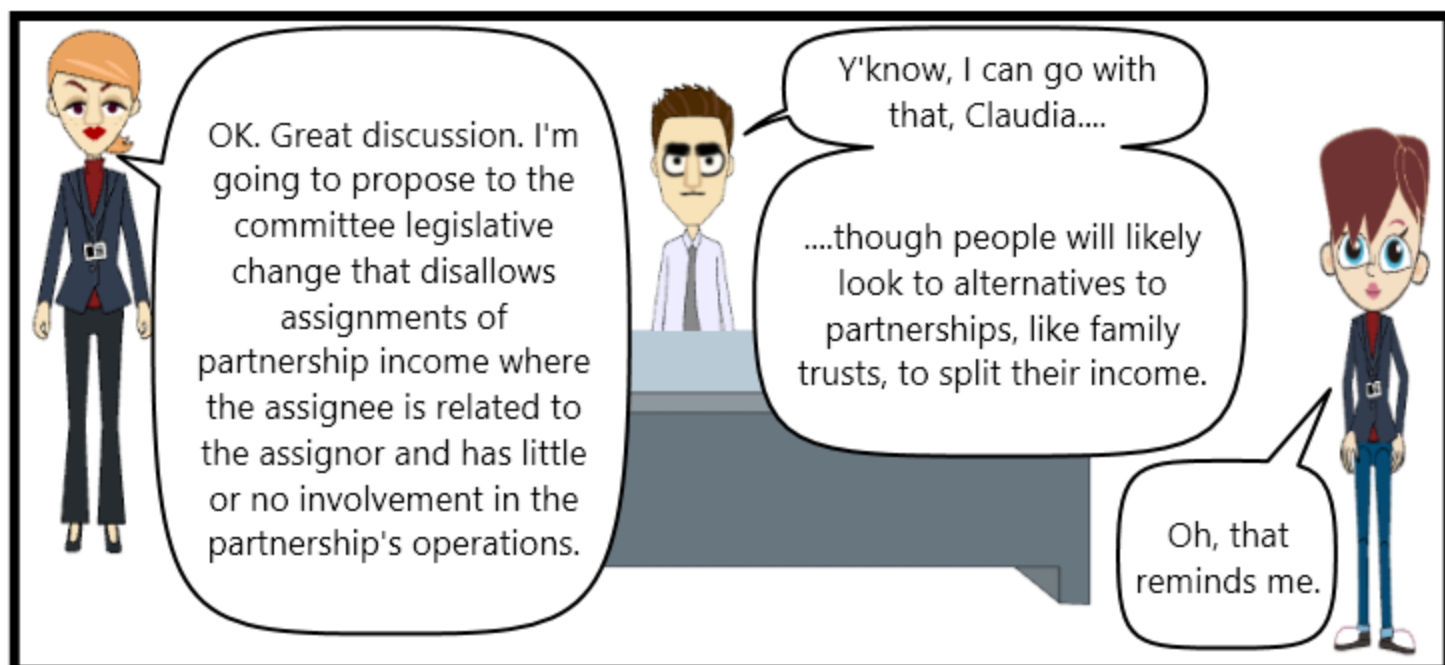
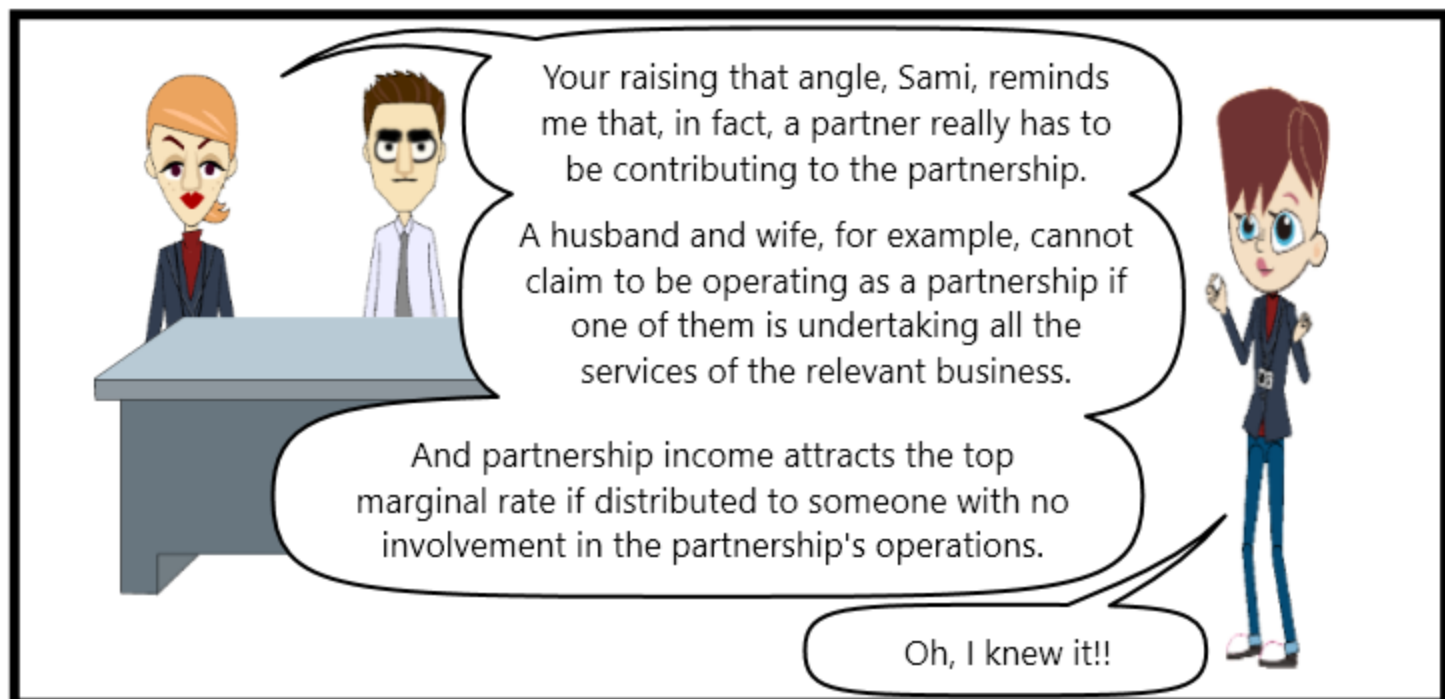
And yet, here we have income splitting assignments that substitute the ideal of the partners' tax rates with those of their spouses who obviously have no involvement or expertise in the business operations of the partnership.

I like your line of thinking, Sami.

Here we go - these two at it again!

It's like giving a partnership interest to someone not involved at all in the partnership's firm....

....or workers simply putting their wages into their wives' tax assessments instead of their own.



* Ch6, pp 16-18.

