BTR/Section16 -

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16

FLOW-THROUGH TAXATION

A specific regime for collective investment vehicles

Recommendation

16.1 Definition of a collective investment vehicle

That a collective investment vehicle (CIV) be defined as an entity that:

(i) is a unit trust which is based in Australia;

(ii) is 'widely held' (see Recommendation 16.8);

(iii) has units giving members a fixed equal beneficial interest in all the income and property of the trust;

(iv) undertakes only 'eligible investment business' (that is, not trading business) broadly as defined in section 102M and 102N of the 1936 Act; and

(v) has made an irrevocable election to be excluded from the entity tax regime and taxed as a CIV.

Recommendation

16.2 Full distribution requirement for CIVs

Exclusion from entity taxation

(a) That CIVs be excluded from entity taxation only if all, or virtually all, of their taxable income (representing income that would be taxable if received directly by a resident taxpayer) is distributed each year.

Tax consequences of partial distribution of taxable income

(b) That if less than full distribution of taxable income occurs:

(i) the deficiency be taxed in the CIV at the company rate; and

(ii) the ultimate distribution be taxed in members' hands, with no credit allowed for tax paid by the CIV.

Recommendation

16.3 Taxation of CIV distributions (other than redemptions)

Distributions retain character in members' hands

(a) That distributions of taxable income be taxed in the hands of members, with the income retaining its character — for example, as capital gains on pre- or post-CGT assets, dividends (including attached imputation credits on distributions received through CIVs) or interest.

Distributions of tax-preferred income

(b) That distributions of tax-preferred income:

(i) not be taxed when received by members; and

(ii) reduce the tax value of membership interests in a CIV unless the distribution consists of exempt income from Pooled Development Funds or from infrastructure bonds.

Distributions of contributed capital

(c) That distributions of contributed capital that do not extinguish membership interests (redemptions) reduce the tax value of membership interests in a CIV.

Re-investment of distributions

(d) That taxable income formally distributed to members but concurrently re-invested in the CIV at members' instructions be treated as distributions of taxable income.

Income year for distributions

(e) That distributions of taxable income:

(i) generally be included as taxable income of a member in the income year in which the distribution is received; but

(ii) where made by the CIV in respect of an income year within two months of the end of that year — be deemed to be paid and received in that year of income.

Recommendation

16.4 Taxation of capital gains realised by members and by CIVs

Capital gains realised by individual and complying superannuation fund members

(a) That for capital gains realised by individual and complying superannuation fund members of CIVs on the sale or redemption of units held for a year or more — those members be allowed the choice (under Recommendations 18.2 and 18.3) of either:

(i) the relevant percentage reduction in the amount of the gain to be included for capital gains taxation; or

(ii) calculating the gain from the 'frozen' indexed cost base.

Capital gains realised by CIVs

(b) That for capital gains realised by CIVs:

(i) the whole of the gain be included in the taxable income of the CIV; and

(ii) for gains on assets held for a year or more, individual and complying superannuation fund members be required to adopt the relevant percentage reduction in the amount of the gain to be included for capital gains taxation (with no option of calculating the gain from the frozen indexed cost base).

Recommendation

16.5 Loss of CIV status subject to safe harbours

Liability to entity taxation upon loss of CIV status

(a) That entities electing to be taxed as CIVs but failing at any time to meet the requirements of Recommendation 16.1 be taxed under the entity regime.

Safe harbours against loss of CIV status

(b) That liability to entity taxation be subject to the following exceptions where loss of CIV status results from a failure to meet:

(i) the widely held requirement:

- **following start-up — for the first six months of operation;**

- **where the Commissioner of Taxation agrees — for the agreed extension of time; or**
- **where the CIV has announced an intention to wind down — for a period of up to 12 months from the date of that announcement;**

(ii) any other requirement — where the Commissioner of Taxation agrees to an extension of time during which to meet that requirement.

In broad terms, CIVs are widely held entities which offer managed investments in local and overseas equities, property and securities and fully distribute profits. They allow investors to obtain the benefits of portfolio diversification and professional investment selection. Exclusion of CIVs from the entity regime and adoption of a flow-through approach to CIV taxation are consistent with the treatment of direct investment and avoid the cash flow detriment recognised in Chapter 16 of *A Platform for Consultation* and the Treasurer's Press Release of 22 February 1999. If tax were imposed on these vehicles at the entity level, low marginal tax rate investors would face a delay before refunds of imputation credits were received and they would also suffer additional compliance requirements.

Full distribution requirement

The distribution requirement for the operation of flow-through taxation could be specified as the annual taxable income of the CIV (after allowance for any applicable carry-forward loss) or in terms of an adjusted accounting profit concept of distributable profit. While the latter approach would be more consistent with the notion of full distribution of CIV income, the recommended approach (see Recommendation 16.2(a)) has the advantage that it does not require definition of another concept of income in tax legislation solely for the purpose of specifying required annual profit distributions from CIVs.

Distributions of tax-preferred income

Two options for the taxation of tax-preferred income distributed by CIVs are canvassed in Chapter 16 of *A Platform for Consultation*:

- Option 1 — not taxing tax-preferred income; and
- Option 2 — taxing tax-preferred income in members' hands immediately on distribution.

There are arguments in favour of both options.

Option 2 would promote competitive neutrality with investment through entities and provide simpler design. Nevertheless, submissions to the Review

supported Option 1 on the ground that it was consistent with the treatment of direct investment. This ensures that less well off investors, who rely on investing through CIVs to achieve portfolio diversification, will not be disadvantaged. The Review has recommended Option 1 as providing the more equitable outcome (see Recommendation 16.3(b)).

Consistency with direct investment

Seeking to achieve consistency with direct investment is complicated by the dual cost bases involved: the cost base of the CIV's assets and the cost base of the member's CIV units.

It is necessary to ensure that the combination of the dual cost bases and flow-through CIV treatment does not provide a more favourable outcome when membership interests in CIVs are sold compared with the treatment of the sale of an interest in a partnership or the business of a direct investor. Thus, reductions in the cost base of CIV units are needed when 'temporary' tax-preferred income is distributed. For example, with the distribution of profits freed from tax by accelerated depreciation allowances, a cost base reduction is needed to produce an equivalent tax outcome for a member of a CIV as for a member of a partnership. When a partner sells an interest in a partnership and the member has benefited from accelerated depreciation on the assets of the partnership, the partner selling the interest becomes liable for tax on any gain arising from the difference between the disposal price and the tax value of the underlying assets. The deferral benefit from depreciation is effectively clawed back when the partnership interest is sold. A cost base reduction in a member's interest in a CIV will ensure an equivalent tax outcome when the member sells his or her interest in the CIV (see Recommendation 16.3(b)).

A cost base reduction is also required when a distribution consists of a return of contributed capital (including amounts representing economic or non-accelerated depreciation) but membership interests are not extinguished. When there is a return of contributed capital the tax value of the member's units will be reduced to reflect the corresponding reduction in the value of the net assets of the CIV. Unless a cost base reduction is made the member would obtain a corresponding tax loss on disposal of his or her interest, in addition to the capital distribution. Accordingly, receipts by a CIV that do not form part of taxable income because of depreciation deductions (including building allowances) will reduce the tax value of membership interests in a CIV when distributed.

'Permanent' tax preferences — those which would provide a permanent benefit to a direct investor and to a partner when a membership interest was subsequently sold — do not require a cost base adjustment when the associated tax-preferred income is distributed via a CIV. Currently this may

consist of exempt income from Pooled Development Funds or exempt income from infrastructure bonds.

Competitive neutrality with entities

To address the issue of competitive neutrality with entities, most submissions conceded that some restriction was necessary on the range of investments which could be undertaken by a CIV. The borderline problems of distinguishing 'active' business operations from 'passive' investing were noted in *A Platform for Consultation* (page 374), including in relation to rental properties. Industry representatives have argued that the present exclusion of trading businesses from flow-through taxation would be sufficient to address the neutrality issue.

Section 102M of the 1936 Act defines 'eligible investment business', broadly, as investment in land for rental (including investment in fixtures such as buildings but not, for example, the provision of services in buildings) or investment or trading in a range of financial arrangements including shares, trust units and bonds. Other activities result in the trust being treated as a trading business and taxed in the same way as a company — as does, under Section 102N, direct or indirect control by the trustee of a trading business.

A test of this kind could be circumvented by 'stapled' arrangements where all the assets from which a tax preference can be derived are held by a CIV and trading functions are performed on contract by a related entity. Investors could share in the full returns of the activity by acquiring a stapled interest in both the CIV and the related entity but in the process could receive tax-preferred income through the CIV distributions that was non-assessable in their hands.

Concerns about competitive neutrality with entities have to be balanced against the strong support for Option 1 based on neutrality between the collective investment and direct investment alternatives. On balance, the Review considers the latter design objective is the more important. However, reflecting the favoured position of CIVs relative to entities, at least for certain activities, the Review recommends that a definition of 'eligible investment business' similar to the provisions in sections 102M and 102N of the 1936 Act (but modified to exclude stapled arrangements discussed above) be used to restrict CIV activities (see Recommendation 16.1(iv)). As a consequence, certain tax preferences which are intended to benefit 'active' businesses, such as R&D concessions, will not be available to CIVs.

Other issues

Restricting CIV status to resident entities is necessary to ensure definitional requirements are met (see Recommendation 16.1(i)). It would be difficult to verify compliance in the case of non-resident vehicles. Both Canada and the

US restrict their special collective investment regimes — such as those applying to mutual funds and Real Estate Investment Trusts (REITs) — to resident entities.

Requiring CIV units to provide fixed equivalent interests to members reduces complexity and prevents streaming of different forms of income to different members to obtain a tax-advantaged outcome (see Recommendation 16.1(iii)). The flow-through basis of taxation means that there would be many forms of income that, when paid to non-residents, could be taxable at varying withholding rates, or be exempt. Similarly, several forms of income will have to be separately identified when distributed to residents. Ensuring the correct tax treatment would be very difficult with more than one type of membership interest.

Consideration was given to allowing entities other than unit trusts, for example companies, to operate as CIVs. However, it is considered prudent to restrict the CIV regime to unit trusts (see Recommendation 16.1(i)) because of the risk that limitations under double tax agreements on Australia's right to tax dividends paid to non-residents could make it difficult to apply the CIV basis of taxation to companies. For that reason, the Review is recommending that transitional rollover relief be provided for restructuring from a company to a unit trust that will be taxed under the CIV regime — see Recommendation 13.11(b).

Reflecting the benchmark of direct individual investment, rental income earned by a CIV should be taxed at the entity rate when distributed to non-residents. (Such income is currently taxed at the applicable non-resident rate of income tax but it is recommended that the company rate apply — see Recommendation 21.6.) If the income were earned through a company and distributed as a dividend, Australia's taxing right could be constrained by the maximum rate specified in our double taxation agreements (generally 15 per cent).

Some submissions argued in favour of taxing at the top marginal rate a deficiency arising from less than full distribution of annual taxable income and then exempting subsequent distributions out of that income (in line with the current treatment of trusts). The recommended approach (see Recommendation 16.2(b)) is considered to be more consistent with the taxation of entities in general and avoids having to track previously taxed amounts.

The treatment of capital gains arising from the sale of assets held by a CIV and by the sale or redemption of CIV membership interests (see Recommendation 16.4) is explained as part of the broader discussion of the taxation of capital gains in Recommendations 18.1 to 18.6.

Entities electing to be CIVs but failing at any time to meet all qualifying conditions will lose their CIV status, instead being subject to entity taxation

(see Recommendation 16.5(a)). Various safe harbours will be provided, however (see Recommendation 16.5(b)). In particular, the 'start-up' and 'wind-down' provisions in Recommendations 16.5(b) are considered a necessary part of a practical framework for CIV taxation.

Recommendation

16.6 Foreign source income of a CIV

Taxation of distributions of foreign source income

(a) That a CIV's foreign source income:

(i) when distributed to resident members — be taxable income, with a credit for any foreign dividend, interest and royalty withholding taxes or for other income tax directly incurred by the CIV on foreign source income; and

(ii) when distributed to non-resident members — be free of further Australian tax.

Offshore Investment Trusts

(b) That Offshore Investment Trusts (OITs) existing under the Offshore Banking Unit (OBU) regime:

(i) be brought within the CIV regime; and

(ii) be required to meet the CIV criteria as well as the special requirements of an OIT in order for associated management fees to qualify for the concessional rate of tax under the OBU regime.

Foreign source income earned through a CIV will retain its character. Consequently, foreign tax credits on amounts of income where the CIV was directly liable for the tax (for example, foreign dividend and interest withholding tax and income tax paid on rental income earned on directly owned foreign property) will continue to be available to resident members of the CIV (see Recommendation 16.6(a)(i)).

Credit for foreign underlying tax paid by non-resident companies, and the exemptions for branch income earned in a listed country and non-portfolio dividends paid from profits taxed in a listed comparable tax country, will only apply when the Australian entity is taxed under the entity tax regime.

Consistent with current OBU arrangements, foreign source income (including gains on the sale of foreign assets) flowing through a CIV to non-resident investors should not be subject to Australian tax since Australia does not have a source or residence claim to the income. The law will ensure that

non-residents' foreign source income does not attain an Australian source merely because it is received via a CIV resident in Australia (see Recommendation 16.6(a)(ii)).

More generally in relation to investment in Australia by non-residents, the CIV regime needs to contain design features which make CIVs a suitable investment vehicle for non-resident portfolio investors and facilitate competitive pooling of foreign portfolio investments. As discussed in *A Platform for Consultation* (pages 370 and 642), this will avoid the need for a special regime designed solely for non-resident investors while also supporting the development of Australia as a global financial centre. These design features are handled in Recommendations 16.8 and 16.9.

Recommendation

16.7 Redemptions of CIV units

Redemptions normally taxed like on-market buy-backs

(a) That the entire buy-back amount of daily redemptions of units by unlisted CIVs (and from time to time by listed CIVs) normally be taxed as proceeds on the disposal of the membership interest in the entity (in line with the treatment for on-market share buy-backs in Recommendation 12.20(i)).

Redemptions during wind-down subject to slice approach

(b) That where a CIV has announced an intention to cease operations, all redemptions from that time be required to follow a 'slice' approach (in line with Recommendation 12.17) with each member allocated a proportionate amount of the available current year's taxable income and a proportionate amount of other available income and contributed capital.

This treatment of redemptions by unlisted CIVs maintains parity with the treatment of units in listed CIVs that change hands 'on-market'. A special provision is considered necessary to deal with redemptions when a wind-down of a CIV has been announced. This will ensure that all members are dealt with equitably. Compliance costs can be minimised by the common practice of suspending redemptions once a formal termination process has begun and then processing all redemptions using a consistent 'slice' approach.

Recommendation

16.8 Definition of 'widely held' for CIVs

That a 'widely held' entity for purposes of defining a CIV be an entity satisfying one of the following three conditions:

Standard definition

(i) an entity meeting the standard definition of 'widely held' provided by Recommendation 6.21;

Where CIV interests held by pooled investment entities, governments or non-resident entities

(ii) an entity where all of the interests are collectively held at all times by:

- **pooled investment entities - comprising CIVs, complying superannuation funds (other than excluded funds), approved deposit funds, pooled superannuation trusts, statutory funds of life insurance companies, or life insurance business of friendly societies;**
- **governments and government bodies that are exempt from income tax; or**
- **non-residents (other than individuals); or**

Where the CIV is a registered managed investment scheme mainly held by pooled investment entities

(iii) the CIV is a registered managed investment scheme and at least 75 per cent of CIV interests are held at all times by pooled investment entities.

The first part of the 'widely held' definition ensures that only genuinely broadly-based funds receive CIV treatment. The second and third parts are designed to make the CIV regime available to 'wholesale' vehicles primarily used by CIVs and by superannuation and life insurance vehicles to obtain specialised investment services. Pooled superannuation trusts will probably continue to be the main wholesale vehicle for complying superannuation funds, but CIV treatment should be available to other wholesale investment vehicles used by complying superannuation and approved deposit funds. Governments and their tax-exempt authorities that use centrally pooled entities or specialist fund managers to manage funds will be able to maintain those arrangements without the entities being subject to company tax. This part of the proposed definition also caters for investment by non-resident organisations through a wholesale structure — for example, foreign managed investment funds and pension funds, as well as foreign entities generally.

Any non-resident entity or group of entities could establish a CIV — so avoiding any requirement to establish a separate Non-Resident Investment Fund regime, an option discussed in Chapter 30 of *A Platform for Consultation* (page 642). In the absence of this provision, non-residents using a trust vehicle to invest in Australian bonds or portfolio equity holdings would face

taxation at the entity rate on interest, unfranked dividends and taxable capital gains. That outcome would likely see the management of these assets shift to offshore entities because the Australian tax would thereby be reduced to interest or dividend withholding tax rates, or, in the case of capital gains arising from portfolio holdings in listed equities, be removed altogether.

Non-resident and government entities aside, individuals or entities other than the specified pooled investment entities can only be brought in to make up 25 per cent or less of a 'wholesale' fund if the fund is registered under the *Managed Investments Act 1998*. This ensures that, generally, there are at least 20 members with 75 per cent of the interests held by pooled investment entities that would have a further number of indirect members. In addition, registration under the *Managed Investments Act 1998* conveys a number of regulatory safeguards to ensure that the CIV regime is only available for *bona fide* managed investment activities. For example, in deciding whether or not to issue a licence, the Australian Securities and Investments Commission is required to consider the applicant's good fame and character, expertise and ability to perform duties associated with being a responsible entity. The responsible entity is also required to hold a securities dealer's licence which will authorise it to operate a managed investment scheme.

Recommendation

16.9 Domestic source income of non-resident members

Withholding taxes deductible from gross amounts

(a) That when non-resident members receive domestic source dividend, interest or royalty income through a CIV, final withholding tax, if applicable, be deducted by the CIV from the gross amount received and on-paid by the CIV (that is, before taking account of CIV expenses).

Other taxable domestic source income

(b) That, consistent with Recommendation 21.6, when non-resident members receive other amounts of taxable domestic source income through a CIV, tax be withheld at the company rate from the net amount distributed (that is, after taking account of applicable CIV expenses) with the amount withheld being creditable to the non-resident on assessment.

Final withholding taxes on dividends, interest and royalties are intended by current law to be calculated on the basis of the gross amounts paid. This is the same basis of taxation that applies to dividends, interest and royalties paid directly to non-resident investors. Because of uncertainty about how the law is meant to operate in relation to existing widely held unit trusts, common practice has been to withhold on the basis of the net payment to non-resident

members. This should not continue as it breaches the principle of equal treatment.

The rationale for applying a flat rate of tax at the company rate to Australian source income, other than dividends, interest and royalties, paid to non-resident members, is discussed in Recommendation 21.6. Unlike the position of dividends, interest and royalties, this would not be a final withholding tax and would be creditable at the option of the non-resident taxpayer on assessment.

Excluding certain trusts from entity taxation

Recommendation

16.10 Trusts excluded from entity taxation

Specification

(a) That the tax law specify a list of 'excluded trusts' to which entity taxation will not apply, with 'excluded trusts' initially being those shown in Attachment A.

Tax treatment

(b) That excluded trusts be taxed under a version of the existing legislation for the taxation of trusts (Division 6 of the 1936 Act) modified to include some of the features of the treatment recommended for collective investment vehicles.

The general principle for exclusion from the new entity tax regime proposed in *A New Tax System* is that trusts which have been created or settled only as a legal requirement or subject to a legal test or sanction will be excluded. The principle is aimed at those trusts where the beneficiary (and the settlor or parent or guardian) would not have the option to use a non-trust structure. This principle distinguishes such trusts from trusts created at a settlor's direction or settlor's choice as to how to meet a legal requirement, test or sanction. Attachment A lists those trusts that will be excluded from the new entity tax system on the basis of the general principle.

An individual taxation treatment benchmark for excluded trusts is appropriate to reflect the nature of excluded trusts, including the limited potential for such trusts to be used for commercial activities and for interests in such trusts to be sold. However, the trusts set out in Attachment A do operate as separate entities rather than simply as the agent of the beneficiaries. The trustees have

very extensive independent powers. It is necessary to recognise the existence of a member interest in the entity.

A modified version of the current system for taxing trusts, set out in Division 6 of the 1936 Act, will be used as the basic operative provisions for the taxation treatment of excluded trusts. While these modifications would not reflect all of the features of the regime proposed for CIVs — it would be inappropriate with these excluded trusts to require the full distribution of annual taxable income — some features would be in common with the CIV treatment.

- Beneficiaries will be assessed on the basis of their present entitlement to a share of the income of the trust.
- Losses incurred by the trust estate will remain in the trust.
- Consistent with the recommended CIV treatment (Recommendation 16.2):
  - capital gains will be included in the trust's 'net income' and each beneficiary would be taxed on the basis of their present entitlement to a share of that capital gain. Gains on assets realised by the trust after being held for at least a year will be subject only to the 50 per cent inclusion rule;
  - under the recommended changes to the taxation of capital gains, a beneficiary who is an individual and disposes of his or her interest in an excluded trust could choose to have the capital gain taxed on the basis of either the relevant percentage reduction in the amount of the gain or the frozen indexed cost base; and
  - distributions of tax-preferred income will result in a corresponding reduction in the tax value of the fixed interest in the trust in respect of which the distribution is made.

The modified Division 6 will also address certain anomalies in the current provisions. For example, capital gains may currently be included in the 'net income' of the trust for tax purposes. Income only beneficiaries could be assessed on such capital gains even though they have no right to receive those gains under trust law. This anomaly will be addressed by having separate, but parallel, provisions dealing with a beneficiary's entitlement to the income and capital of the trust.

Recommendation

16.11 Trusts for absolutely entitled beneficiaries disregarded for tax purposes

That if a trustee merely holds property on trust — with no interest in or active duty as to the management of the trust property other than to hold each item of that property for the absolute benefit of a specific beneficiary or of joint beneficiaries, who have an absolute entitlement to that property from the outset of the trust — the trust relationship be

ignored and the acts of the trustee be treated as those of the beneficiary or joint beneficiaries.

A Platform for Consultation (page 482) explained that in many circumstances a trustee never has real management or control over trust property which is always passively held for the benefit of known beneficiaries. In such cases the trustee only deals with the trust property as specifically directed by the beneficiary.

Trusts of this type can arise, for example, in respect of:

- each parcel of shares purchased by a stockbroker; and
- each property transaction dealt with through trust accounts maintained by some professions (such as lawyers, accountants and real estate agents).

In these circumstances the acts of the trustee should be treated for tax purposes as the acts of the real economic owner, the beneficiaries.

Drawing a clear line between this type of trust and many other trust arrangements is often difficult, particularly when there is more than one beneficiary. Any fixed trust for adult beneficiaries who are not under a legal disability may fall within the above description as those beneficiaries will collectively have the power to direct the activities of the trustee.

In order to maintain the integrity of the entity tax regime, and to simplify the legislative rules, the exception will apply where a single beneficiary is absolutely entitled to the particular asset from the outset of the trust. The exception will also apply where beneficiaries are absolutely entitled to the particular asset as joint owners from the outset of the trust and under its terms. An example would be a stockbroker holding a parcel of shares as nominee for a couple owning the shares jointly.

Recommendation

16.12 Bank accounts of minors excluded from entity taxation

That the bank account of a minor, where representing a trust in equity, not come within the entity tax regime.

In many situations the bank account of a minor will amount, in equity, to a trust of which the minor is the sole beneficiary. If such a trust exists, the minor may be legally unable to call for the trust property (the bank balance) or direct its application. Consequently, the minor will not have an absolute entitlement to trust property, even though in many cases the minor will be the economic owner of the account. This is a fine legal distinction that could, in the absence of specific treatment, result in many bank accounts of minors being treated as entities.

This could in many cases lead to increased compliance and administration costs. A bank account should not come within the entity tax regime merely because that account is a trust under the law of equity.

Where not a trust in equity, the bank account of a minor is necessarily excluded from falling within the entity tax regime.

Recommendation

16.13 Certain stakeholder arrangements excluded from entity taxation

That stakeholder arrangements which result in the creation of a trust not be treated as an entity for taxation purposes unless the arrangement is to extend, or is reasonably likely to extend, beyond six months.

Some stakeholder arrangements may amount to a trust under the law of equity. Such a trust should be subject to the entity tax regime until all the beneficial interests in the trust property have been extinguished.

The rule will only apply if the trust will, or is likely to, continue for more than six months after its creation. This will reduce the number of situations in which the rule will apply to transactions such as:

- holding stakes in a wager; or
- holding deposits prior to the completion of the sale of land.

Recommendation

16.14 Purchaser trusts

That where members of a trust are, as such, in the position of purchasers of the trust property under an uncompleted sale of the property:

(i) the trust of the property be ignored; and

(ii) the actions of the trustee be treated as the actions of those members.

Trusts of this kind are similar to stakeholder arrangements, but will not necessarily be covered by the stakeholder recommendation. They arise when assets being sold are held in trust for both vendor and purchaser until the sale is completed, for instance by the payment of instalments of purchase price. They may allow for tradability of the purchaser's interest in the trust, so that purchase obligations effectively transfer to the holder of the interest from time to time. There may be benefits for the purchaser while the trust continues to hold the asset — for instance, rent (from land being sold) or dividends (from shares). These benefits would be taxed to the purchaser.

Recommendation

16.15 Constructive trusts disregarded for tax purposes

That constructive trusts, and any interest in such trusts, be ignored for taxation purposes.

An option was canvassed in *A Platform for Consultation* (page 485) to ignore for taxation purposes a constructive trust and any interest in such a trust.

A constructive trust is a means whereby the law of equity imposes a liability upon a person to account for certain property as if that person were a trustee. Once recognised by a court, the trust is viewed as having existed from the date of the original breach or other action or inaction that gave rise to the finding of a constructive trust. Thus a trust can exist even though neither the trustee nor the beneficiary is aware of its existence.

Constructive trusts come within the principle that trusts that arise by operation of law rather than by the choice of a settlor should be excluded from the entity tax regime. The correct treatment would be to ignore the constructive trust, and any interest in that trust, for taxation purposes. Prior to the recognition of the existence of the trust by a court, a constructive trustee should generally be taxed as if the income received by the trust was the trustee's own income. Income received by the trust after the trust has been recognised by a court should generally be treated as received by the beneficiary.

Once the constructive trustee pays the beneficiary the income and capital of the trust, balancing adjustments should apply to ensure that the taxpayer that ultimately benefits from that income and capital pays the tax liability.

A Platform for Consultation (page 484) illustrates the operation of the recommendation to ignore a constructive trust for tax purposes.

One of the policy intentions of Recommendation 16.15 is to draw a distinction between:

- trusts which arise as a consequence of the operation of the law where the parties involved do not know, and reasonably could not know, from the outset that a trust was created (a constructive trust); and
- trusts which arise as a consequence of the operation of the law where the parties involved know, or reasonably could have known, from the outset that a trust was created.

If the parties know, or ought to know, that a trust has come into existence they are able to meet the requirements of the entity tax regime. However, if the parties do not know, and cannot reasonably be expected to know, that a trust has come into existence they are unable to meet the requirements of the entity tax regime. Simplicity and certainty argue for a clear boundary between the two situations.

The law of equity draws a similar distinction between a constructive trust and a resulting trust. A resulting trust can arise where a trust is expressly created but the express interests of beneficiaries do not include all the potential beneficial interests in the trust estate. A resulting trust may also arise when title to property is transferred and the person making the transfer does not intend to dispose of the beneficial interest. However, under the law of equity the precise boundary between a constructive trust and a resulting trust is often difficult to draw. Rather than rely upon the equity law distinction between constructive and resulting trusts, a clear legislative boundary will be provided for tax purposes between constructive trusts and other trusts.

Rationalising the taxation of partnerships and other joint activities

Recommendation

16.16 Rationalised treatment for partnerships and joint activities

'Fractional interest' approach the default treatment

(a) That, as the standard treatment, a 'fractional interest' approach apply to ordinary partnerships and unincorporated joint ventures in calculating:

(i) members' shares of the taxable income or loss of the partnership or joint venture; and

(ii) gains or losses on the disposal of interests in the partnership or joint venture.

Election available to apply 'joint' approach

(b) That ordinary partnerships and unincorporated joint ventures have the option to apply a 'joint' approach to some or all of their transactions and assets in calculating:

(i) members' shares of the taxable income or loss of the partnership or joint venture; and

(ii) gains or losses on the disposal of interests in the partnership or joint venture.

Implementation with further consultation

(c) That further consultation on design issues accompany implementation of these recommendations for the 2001-02 income year.

In Chapter 14 of *A Platform for Consultation*, the following problems are identified with the current treatment of partnerships:

- the current capital gains tax (CGT) obligations associated with the fractional interest approach to the taxation of partnership assets can be difficult to comply with; and
- the balancing adjustment rollover relief for disposals of ownership interests in depreciable assets — resulting in an 'entity-style' treatment — is open to exploitation or can produce inappropriate outcomes.
  - The balancing adjustment rollover allows the transfer of unrealised losses to purchasers, at the same time that vendors obtain corresponding capital losses.
  - Various tax avoidance activities have developed from these features — including the assignment of 'lease tails' (addressed by transitional measures in Recommendation 10.13 pending structural reform of the law via a number of the Review's recommendations including Recommendation 16.16).

Compliance problems arise currently, in part, because the capital gains of each partner are assessed separately under the fractional interest approach while the 'entity-style' treatment applies to partnerships for all other taxation purposes.

Current problems with disposals of interests in depreciable assets by one partner occur as a result of allowing the balancing adjustment rollover to ensure that other partners are not affected by the sale. The partner selling the interest in the asset is taxed concessionally compared with a direct investor in the asset subject to full balancing adjustments under Recommendation 8.11.

In Chapter 14 of *A Platform for Consultation*, the Review canvasses two options for reforming the treatment of partnerships: a fractional interest approach and an 'entity' approach (now referred to as the 'joint' approach so as to avoid confusion with the Review's separate recommendations on the taxation of entities).

Both options address the current problem with rollover relief without affecting ongoing partners but each has potential disadvantages as follows.

- The fractional interest approach can impose significant record keeping obligations where many assets are involved and partners continually change.
- The joint approach can disadvantage taxpayers where they acquire a partnership interest at a price greater than the tax values at that time of the depreciable assets of the partnership — their depreciation allowances do not reflect the price paid. (This arises because of the separation between

partnership assets and interests in the partnership — as with, say, company assets and the shares in the company.)

Allowing partnerships the flexibility of applying the fractional interest approach to selected assets (and associated transactions) and the joint approach to the remaining assets and transactions — the 'hybrid' approach — has a number of advantages. It will allow partners to choose the mix that minimises potential disadvantages and best suits their particular circumstances. It will mean that many partnerships will be little affected by the reforms and transitional effects on others will be minimised.

Fractional interest approach

The operation of the fractional interest approach is explained on page 335 of *A Platform for Consultation*.

Partners will separately account for their shares of partnership receipts and payments and assets and liabilities, thus obviating the need for the balancing adjustment rollover relief. Only the person selling an interest in the partnership or partnership asset will need to account for the disposal. Continuing owners will be unaffected. A purchaser of an interest in a partnership will be able to claim depreciation deductions based on the price paid for the interests in the depreciable assets of the partnership.

In practice, partnerships will be able to produce a single set of accounts for partnership receipts and payments, with partners accounting for their share. Where there are no changes in the interests of partners, it will be possible to keep a single set of records for partnership assets. Where there is a change of interests, it will be necessary for partners to keep a record of their interest in each partnership asset and, where relevant, to make separate calculations of their depreciation claims.

An explanation, with examples, of how the fractional interest approach will work is in Attachment B.

Unincorporated joint ventures

Adoption of a comprehensive fractional interest approach will also address a number of problems with the current treatment of unincorporated joint ventures. Broadly, unincorporated joint ventures refer to associations of persons or entities either jointly carrying on a business activity or jointly owning assets for business use, but which do not receive income jointly. The following are examples of joint ventures:

- two companies jointly operate a coal mine but separately deal with their share of production — for example, one sells its share while the other uses its share to generate electricity for sale;

- two farmers jointly acquire a tractor for use on a shared basis in their separate businesses.

Currently, a fractional interest approach generally applies to unincorporated joint ventures. That is, each joint venturer separately accounts for its share of joint expenditures and, where relevant, the proceeds of disposal of shares of output. Specific problems with the current law include the following issues:

- A literal interpretation requires that a taxpayer own the whole of an item of plant. On that basis, a joint venturer is not entitled to depreciation deductions because it owns an interest only. Also, as the law does not deem the joint venture to be a taxpayer, the joint venture is not entitled to depreciation deductions. Administrative practice has had to intervene to allow joint venturers to depreciate the cost of interests in jointly owned plant. That issue is now addressed by Recommendation 8.3.
- The general wording of the balancing adjustment rollover provisions accessed by partnerships means that the provisions potentially apply whenever there is a disposal of an interest in an item of plant. That includes circumstances where a joint venturer disposes of an interest in joint venture plant. That is not consistent with the general treatment of joint venturers who ought to be allowed to account separately for their interests in assets. Accordingly, it has been administrative practice not to apply the provisions to joint ventures. Nevertheless, some taxpayers have sought to have the provisions apply to them when it produces a more favourable tax outcome.

Joint approach

The operation of the joint approach is set out in *A Platform for Consultation* (pages 336 and 339).

Under the joint approach, a partnership will calculate its taxable income or loss as if it were a single taxpayer. In particular, it will account for all gains and losses on the disposal of partnership assets (currently partnerships account only for non-CGT gains and losses on assets in this way).

As is now the case, the partnership itself will not be liable to tax. Rather, each partner will include their share of the taxable income or loss in their own return. Gains or losses derived by the partnership will retain their character in the hands of the partners and will be treated in the same manner as gains and losses derived by the partners directly.

Unlike the current treatment, partners will not be required to account for their interests in each and every partnership asset. Rather, a partner's interest in a partnership will be treated as an asset. The tax value of interests in partnerships will be adjusted periodically to reflect the tax values of the underlying assets of the partnership. Gains or losses on the disposal of an

interest in a partnership will be calculated by comparing the disposal proceeds with the tax value of the interest at the time.

By taxing an outgoing partner on any unrealised gains in respect of partnership assets, the joint approach addresses the balancing adjustment rollover issue without continuing partners being affected. Moreover, it will be easier to comply with than the fractional interest approach if there is a high rate of turnover of partners — exacerbated when a partnership holds a large number of assets.

The principal disadvantage of the approach is the tax timing differences, relative to the fractional interest approach, that will occur where an interest is acquired in a partnership that holds assets with unrealised gains. The tax values of partnership assets will remain unchanged by the change in the membership of the partnership. As a result, the incoming partner's share of depreciation deductions, for example, will be based on the unchanged tax values of the depreciable assets and not the price that the partner paid for an interest in those assets.

Unlike companies and trusts, there will be full flow-through to partners of partnership taxable income and losses, with the consequence that the tax value of partnership interests will reflect more closely the tax value of the underlying assets of the partnership.

An explanation with examples of how the joint approach will work is in Attachment C.

A hybrid approach

The Review received suggestions that another option would be to retain the current hybrid treatment (fractional interest for assets with capital gains and joint treatment for other assets) and address the problems with the balancing adjustment rollover provisions. That approach is said to have the following advantages.

- The current treatment is now well understood and taxpayers and their advisers have developed appropriate record keeping aids.
- Record keeping will be simplified under the Review's proposal that full balancing adjustments apply on the sale of wasting assets — resulting in the excess of sale price over original cost being added directly to taxable income and not being treated as capital gains. Under current partnership arrangements, that will exclude wasting assets from the fractional interest treatment.

As noted, the fractional interest and the joint approach each has advantages and disadvantages which will weigh differently depending on the characteristics and circumstances of a partnership, including the types of assets involved. Allowing partnerships to use the fractional and joint approaches for different

groups of assets and associated transactions — as will be available under the reformed hybrid approach — will therefore offer advantages.

- Timing differences under the joint approach will not be a significant factor for many partnership assets such as trading stock and depreciable assets. Accordingly, taxpayers might prefer to use the joint approach for those assets.
- Timing differences might be more significant for appreciating assets such as land and goodwill, so that taxpayers might prefer to use the fractional interest approach for them. For example, a more recent partner will then be likely to have a higher cost base for an interest in partnership land than an earlier partner.

Retaining a (reformed) hybrid approach will also facilitate the treatment of assets where the interests of one or more partners in a partnership were acquired before the introduction of CGT while the other partner or partners acquired theirs after the introduction of CGT. The hybrid approach will allow partners to continue with the current fractional interest approach for pre-CGT interests in partnership assets but to apply a joint approach to their other partnership assets and trading activities.

Under such an elective hybrid approach, the taxable income or loss associated with the aggregation of assets and liabilities to which the joint approach applies will be calculated as described in Attachment C. Partners will calculate the tax value for their interest in this aggregation of assets.

On the disposal of an interest in a partnership, the partner will need to apportion the disposal proceeds between the two classes of assets — that is, those to which the joint approach applies and those to which the fractional interest approach applies. Any gain or loss on the disposal of the interest in the aggregation of assets subject to the joint approach will be calculated by comparing the portion of the disposal proceeds applicable to that interest with its tax value at the time.

An example of how an elective hybrid approach could work is given in Attachment D.

Consultation on transitional and design issues

The submissions received on Chapter 14 of *A Platform for Consultation* were supportive of a joint approach if suitable transitional rules could be developed. Moreover, allowing taxpayers flexibility in terms of treating assets under a hybrid approach should minimise transitional problems. Nevertheless, the

Review has not been able to consult fully on all the transitional and design issues associated with the recommendations. Accordingly, further consultation while implementing the new arrangements is recommended.

Attachment E lists some transitional and design issues that require consideration during further consultation.

Attachment A

List of excluded trusts

Trusts in relation to bankruptcy and court trusts

A trust where all of the property, which is the subject of the trust, falls within one or more of the following circumstances:

Bankruptcy

- the property of a person who has become a bankrupt has been vested in the Official Trustee or a registered trustee in Bankruptcy under the *Bankruptcy Act 1966*;
- property is administered under Part XI of the Bankruptcy Act;

Court trusts

- a court orders a trust (other than a child maintenance trust) to be set up to preserve the assets of and/or provide an income stream to, a person suffering a legal disability;
- a court orders a trust set up to administer the proceeds of crime or similar orders; or
- money or property paid into a trust controlled by a Federal or State Court, or by an officer of such a Court, in respect of litigation commenced in that Court.

Trusts in respect of legal disability, compensation, death or necessitous circumstances of a person

A trust that exists under the law of equity such that it would be reasonable to assume that the beneficiary (or beneficiaries) of the trust will acquire the property of the trust estate (other than as trustee) no later than when the trust ends, provided that the only income of the trust was from one or more of the following sources:

Legal disability

- the employment of a legally incapacitated person, provided that the legally incapacitated person is the sole beneficiary of the trust;
- property transferred to the trustee solely for the benefit of a person under a legal disability (for example, a child under the age of 18 years):
  - by way of, or in satisfaction of a claim for damages for

- loss by the beneficiary of parental support through death or injury, or
- personal injury to the beneficiary, any disease suffered by the beneficiary or any impairment of the beneficiary's physical or mental condition;

Compensation

- pursuant to any law relating to workers' compensation;
- pursuant to any law relating to the payment of compensation in respect of criminal injuries;

Result of death

- directly as the result of the death of a person and under the terms of a policy of life insurance out of a provident, benefit, superannuation or retirement fund (provided that the property is transferred within two years from the death of the person or at a later date if the Commissioner of Taxation so determines);
- directly by an employer as the result of the death of an employee (provided that the property is transferred within two years from the death of the person or at a later date if the Commissioner of Taxation so determines); or

Public fund for persons in necessitous circumstances

- out of a public fund established and maintained exclusively for the relief of persons in necessitous circumstances.

Complying superannuation funds

A complying superannuation fund within the meaning of section 45 of the *Superannuation Industry (Supervision) Act 1993*, and a complying approved deposit fund within the meaning of section 47 of that Act.

Deceased estates

Deceased estates provided that the administration is completed within two years (or such longer period as the Commissioner determines) from the date of death and provided that they result from the following:

- a will, a codicil, or an order of a court that varied or modified the provisions of a will or codicil; or
- an intestacy or an order of a court that varied or modified the application, in relation to the estate of a deceased person, of the provisions of the law relating to the distribution of the estates of persons who die intestate.

Attachment B

How the fractional interest approach will work

Under the fractional interest approach, partners will account separately for their shares of partnership receipts and payments, and assets and liabilities. The following will be the implications of that approach for partnership assets.

- When a partnership acquires an asset, each partner will be treated as acquiring an asset consisting of their interest in the partnership asset. The tax value of each interest will be equal to their share of the cost of the asset to the partnership.
- When a person acquires an interest, or a further interest, in a partnership, the person will be taken to have acquired a proportional interest in each partnership asset. The tax value of each interest will be equal to the portion of the total purchase price that relates to each of those interests.
- When a partnership disposes of an asset, the partners will be treated as having disposed of their interests in the asset. The disposal proceeds will be allocated to the partners according to their interests in the partnership and each will calculate separately their gain or loss.
- When a partner disposes of an interest in a partnership in whole or in part, the partner will be treated as having disposed of their interests in the assets of the partnership in whole or in part. The disposal proceeds will be allocated to the interest in each asset and gains and losses will be worked out accordingly. The continuing partners will be unaffected.
- The assumption by an incoming partner of a share of partnership debt will constitute part of the disposal proceeds for the partner selling the interest and part of the purchase price for the income partner.

Calculating taxable income and capital gains of a partner

Assume the following are the transactions for the first year following the formation of the partnership of A and B.

Table 16.B1 First year transactions for partnership of A and B

Transaction	Bank $	Partner A's share $	Partner B's share $
Capital contributed	400	200	200
Purchase depreciable asset	(100)	(50)	(50)
Purchase shares	(200)	(100)	(100)
Trading receipts	250	125	125
Trading expenses	(110)	(55)	(55)
Proceeds of sale of shares	240	120	120
Drawings	(180)	(90)	(90)
Entertainment expenses	(10)	(5)	(5)
Closing balance	290	145	145

Under the fractional interest approach, partners will account separately for their shares of partnership receipts and payments.

Calculation of partners' taxable income (other than capital gains)

Table 16.B2 Partners' net income

Item	Total $	Partner A's share $	Partner B's share $
Trading receipts	250	125	125
Trading expenses	(110)	(55)	(55)
Depreciation (40% of $50 each)	(40)	(20)	(20)
Private element of depreciation	20	10	10
Taxable income	120	60	60

Calculation of partners' capital gain

Table 16.B3 Partners' capital gain

Item	Total $	Partner A's share $	Partner B's share $
Proceeds of sale of shares	240	120	120
Cost of shares	(200)	(100)	(100)
Capital gain	40	20	20

Disposal of interests in a partnership

The fractional interest approach treats the disposal of an interest in a partnership as a disposal of the partner's interests in the assets of the partnership. That requires the disposal proceeds to be apportioned between the various interests.

From the above example, assume that the market value of the depreciable asset is $80. On that basis, the market value of a 50 per cent interest in the partnership of A and B will be $185 (half share each of $290 cash and $80 depreciable asset). If B sold his interest to an incoming partner C, B will calculate the gain on disposal as follows:

Table 16.B4 Disposal of B's interest

	Total $	Bank $	Depreciable asset $
Disposal proceeds	185	145	40
Tax value	(175)	(145)	(30)
Gain	10	Nil	10

The $30 tax value of B's half interest in the depreciable asset was calculated as $50 (half share of $100 cost) less $20 depreciation allowed as a deduction to B.

Treatment of partners after a change in the membership of a partnership

Assume the following are the transactions for the partnership of A and C for the year following C's entry into the partnership.

Table 16.B5 First year transaction for partnership of A and C

Item	Total $	Partner A's share $	Partner C's share $
Opening balance	290	145	145
Purchase shares	(300)	(150)	(150)
Trading receipts	200	100	100
Trading expenses	(100)	(50)	(50)
Sale of depreciable asset	80	40	40
Drawings	(300)	(150)	(150)
Entertainment expenses	(20)	(10)	(10)
Closing balance	(150)	(75)	(75)

Calculation of partners' taxable income

Table 16.B6 Taxable income of A and C

Item	Total $	Partner A's share $	Partner C's Share $
Trading receipts	200	100	100
Trading expenses	(100)	(50)	(50)
Gain on sale of depreciable asset	10	10	Nil
Taxable income	110	60	50

The gain on sale of the depreciable asset is calculated as follows:

Table 16.B7 Gain on disposal of depreciable asset

Item	Partner A $	Partner C $
Share of proceeds of disposal of depreciable asset	40	40
Tax value of 50% interest	(30)	(40)
Gain on sale of depreciable asset	10	Nil

Moving to a fractional interest approach

As a transitional issue, partners who elect for the fractional interest approach will need to establish the tax values of their interests in partnership assets. They are currently required to keep a record of the tax values of most assets for CGT purposes and they will continue with those values.

The tax value of a partner's interests in trading stock and depreciable assets will be based on the partner's share of the tax value of those assets in the hands of the partnership. In particular, the tax value of interests in partnership depreciable assets will be calculated by reference to a partner's share of the tax written down value of the assets in the accounts of the partnership.

Attachment C

How the joint approach will work

Under the joint approach, a partnership will calculate its taxable income or loss as if it were a taxpayer. In particular, it will account for capital gains and losses on the disposal of partnership assets. Each partner will include their share of the taxable income or loss in their own return. Capital gains or losses derived by the partnership will retain their character in the hands of the partners and will be treated in the same manner as capital gains and losses derived by the partners directly.

Partners will not have to account for interests in partnership assets as they do currently. Rather, an interest in a partnership will itself be an asset and any gains or losses on their disposal, in whole or in part, will be accounted for directly.

The tax value of interests in partnerships will be adjusted to reflect the following:

Increases in tax value

- purchase price;
- capital contributions;
- share of taxable income;
- share of non-taxable receipts (for example, recoupment of private use element of depreciation);

Reductions in tax value

- drawings, including non-deductible amounts such as private use of depreciable assets and entertainment expenses;
- share of taxation losses.

A partner will be able to keep a single record of all interests acquired over time. The cost of additional interests will be added to the tax value of the existing interest. The combined amount will then be adjusted over time as described above. If indexation were to be retained for the purpose of determining the taxable component of capital gains, it will need to be calculated periodically as the tax value of an interest was adjusted up and or down.

Calculating the tax value of interests in partnerships

A and B enter into partnership as equal partners. The following are the transactions for the first year.

Table 16.C1 First year transactions for partnership of A and B

Transaction	Bank $	Depreciable asset $	Shares $	Taxable income $	Partner A $	Partner B $
Capital contributed	400				(200)	(200)
Purchase depreciable asset	(100)	100				
Purchase shares	(200)		200			
Trading receipts	250			(250)		
Trading expenses	(110)			110		
Proceeds of sale of shares	240		(240)			
Drawings	(180)				90	90
Entertainment expenses	(10)				5	5
Depreciation (40%)		(40)		40		
Private element of depreciation				(20)	10	10
Allocation of capital gain			40	(40)		
Allocation of taxable income for year				160	(80)	(80)
Closing balances	290	60	Nil	Nil	(175)	(175)

The example illustrates how the tax value of an interest will be calculated. The aggregate of the tax values of the partners' interests ($175 each for a total of $350) equals the sum of the tax values of the partnership assets ($290 cash and $60 depreciable asset).

In the example, A and B will each be taxed on $80 being their share of the partnership taxable income of $160, which includes the capital gain of $40. That is the same overall outcome as under the fractional interest approach (see Tables B2 and B3).

Disposal of interests in a partnership

Using the above example, assume that the market value of the depreciable asset is $80. On that basis, the market value of a 50 per cent interest in the partnership of A and B will be $185 (half share of $290 cash and $80 depreciable asset). If B sold his or her interest to C, B will derive a gain of $10 ($185 sale price less $175 tax value). After the change, A's 50 per cent interest will have a tax value of $175 while C's will have a tax value of $185.

Calculating the tax values of acquired interests in partnerships

The calculation of the tax value of an acquired interest is the same as an initial interest except that the incoming partner's initial tax value is based on the price paid while the continuing partner's remains unchanged. Assume the following are the transactions for the partnership of A and C for the year following C entering the partnership.

Table 16.C2 First year transactions for partnership of A and C

Transaction	Bank $	Depreciable asset $	Shares $	Taxable income $	Partner A $	Partner C $
Opening balances	290	60			(175)	(185)
Purchase shares	(300)		300			
Trading receipts	200			(200)		
Trading expenses	(100)			100		
Proceeds of sale depreciable asset	80	(80)				
Drawings	(300)				150	150
Entertainment expenses	(20)				10	10
Allocation of gain on disposal of depreciable asset		20		(20)		
Allocation of taxable income for year				120	(60)	(60)
Closing balances	(150)		300		(75)	(85)

In the example, A and C will each be taxed on $60 being their share of the partnership taxable income of $120. That outcome contrasts with the outcome under the fractional interest approach — where, in the same example, C did not derive any gain on the disposal of the interest in the depreciable asset (see Table B7). This demonstrates the comparative advantage of the fractional interest approach over the joint approach.

Under the joint approach, the tax value of C's interest remains $10 higher than A's (in recognition of the fact that C paid for the unrealised gain subsisting in the depreciable asset at the time C acquired the interest). C will obtain the benefit of that higher value at the time of disposal of the interest.

For example, assume that the market value of the shares is $350, meaning that the market value of a 50 per cent interest in the partnership will be $100 (half share of $350 shares less $150 bank overdraft). If A and B both sold their interests, A's gain will be $10 larger than C's.

Attachment D

How an elective hybrid approach could work

Attachments A and B respectively explain how the fractional interest and joint approaches will work. The following explains how partners could apply the joint approach to a part of their interests in a partnership and the fractional interest approach to the remainder.

Example 16.D1

X and Y are equal partners in a partnership that they formed to establish a new business. After trading for a number of years, the partnership balance sheet is as follows.

	Cash $	Land $	Goodwill $	Depreciable Asset 1 $	Depreciable Asset 2 $	Total $	50% interest $
Tax value	100	200	Nil	60	110	470	235
Market value	100	300	250	80	120	850	425

X and Y adopted the joint approach. As the partnership is an original partnership, the tax value of their 50 per cent interests will be $235 each and the market value of each will be $425. Y sells his or her 50 per cent interest in the partnership to Z at its market value. Y will derive a gain of $190 ($425 less $235).

X and Z decide that the joint approach will be simpler for them for trading purposes and their depreciable assets, as that will mean that they could produce a single profit and loss account and depreciation schedule. However, they are thinking of selling the land and part of the business in a few years. Accordingly, in view of the significant disparity in the respective costs of their interests in the land and goodwill, they agree to adopt the fractional interest for those assets.

Joint treatment

Initial tax values of assets of partnership of X and Z

The initial tax values of the assets to be treated by X and Z under the joint approach will be the same as the tax values of those assets in the hands of the former partnership of X and Y immediately before the sale of Y's interest.

Table 16.D1 Initial tax values of assets subject to the joint approach

Assets of partnership of X and Z	Tax value $
Cash	100
Depreciable asset 1	60
Depreciable asset 2	110
Total	270

Initial tax value of interests in partnership of X and Z in aggregation of assets subject to the joint approach

The initial tax value of X's interest in the aggregation of assets subject to the joint approach will be calculated by reference to the tax value of the assets of the former partnership of X and Y. It will be calculated as the sum of X's share of the tax values of those assets in the hands of the old partnership immediately before the sale of Y's interest. The initial tax value of Z's interest will be calculated the same way as for X except that it will be based on the price paid by Z for a 50 per cent interest in those assets.

Table 16.D2 Initial tax values of interests in aggregated assets

Asset	Partner X $	Partner Z $
Cash	50	50
Depreciable asset 1	30	40
Depreciable asset 2	55	60
Initial tax value of interests	135	150

Treatment of subsequent transactions

Calculation of taxable income

Table 16.D3 Taxable income of partners X and Z

Transaction	Bank $	Depreciable asset 1 $	Depreciable asset 2 $	Taxable income $	Partner X $	Partner Z $
Opening balances	100	60	110		(135)	(150)
Trading receipts	200			(200)		
Trading expenses	(100)			100		
Proceeds of sale of land	350				(175)	(175)
Drawings	(400)				200	200
Depreciation		(10)	(20)	30		
Allocation of taxable income for year				70	(35)	(35)
Closing balances	150	50	90	Nil	(145)	160

In the example, X and Z will each be taxable on $35 being their share of the partnership taxable income of $70. The tax value of Z's interest remains $15 higher than X's reflecting Z's higher starting value.

Calculation of capital gains

The capital gains derived by X and Z on the sale of the land will be calculated under the fractional interest approach as follows.

Table 16.D4 Partners' capital gains on disposal of land

Item	Partner X $	Partner Z $
Share of proceeds of sale of land	175	175
Tax value of 50% interest	100	150
Capital gain	75	25

The example demonstrates the relative advantages of the joint and fractional interest approaches. The joint approach has simplified the calculation of taxable income. However, the fractional interest approach has allowed Z to avoid the distortion that can arise under the joint approach where there are unrealised gains in respect of partnership assets at the time of acquiring an interest. Had the land been treated as a partnership asset, Z would have been taxable on the same amount as X.

Attachment E

Moving to a joint approach — transitional and other design issues

Interests in existing partnerships

Initial tax value of an interest in an existing partnership

In principle, the initial tax value of an interest in an existing partnership will be the sum of:

- the partner's share of the tax value of partnership depreciable assets and trading stock at the time; and
- the tax values of the partner's interests in all other partnership assets (for example, land and goodwill).

Under the current treatment of depreciable assets for which balancing adjustments are required on disposal, the excess of the disposal proceeds over the written down value of the assets at the time is assessable as ordinary income to the extent of deductions allowed. Any excess of the disposal proceeds over the (indexed) cost base of the asset is a capital gain.

For partners, the issue is the appropriate amount to absorb into the initial tax value of the interest in the partnership. Simply absorbing a partner's interest in the written down value of depreciable assets could result in more tax being paid than under the current rules where the asset, or an interest in the asset, is sold for more than its cost. However, depreciable assets tend not to appreciate over their original cost. Accordingly, for simplicity, taxpayers may be prepared to accept tax written down values as the basis for working out the tax value of partnership interests.

Identifying pre-CGT and post-CGT interests of partners

The CGT status of interests will be determined on the basis of when they were acquired. The reconstitution of a partnership will not change the pre-CGT status of interests of continuing partners.

Disposals of pre-CGT interests where accrued gains in respect of partnership assets relate largely to post-CGT assets or non-CGT assets

Allowing pre-CGT interests in partnerships would raise issues regarding the treatment of their disposal where the partnership held post-CGT assets and non-CGT assets.

Options:

- Tax the portion of the gain in respect of a disposal of a pre-CGT interest that related to unrealised gains in respect of non-pre-CGT assets and other assets.
- Deny pre-CGT status for interests in partnerships. Rather, if taxpayers wish to retain pre-CGT status of interests in assets, they should adopt the fractional interest approach for those assets.

Disposals of post-CGT interests in partnerships where assets of partnership are a mixture of CGT and non-CGT assets

Interests in partnerships will not be listed assets for capital gains and loss quarantining treatment. Nevertheless, there is a case for allowing the gain or loss on the disposal of an interest in a partnership to be treated consistently with the underlying assets.

The need for value shifting rules

The joint approach will require the extension of the value shifting rules to partnerships.

Treatment of assets in the hands of existing partnerships

Determining the CGT status of partnership assets where there are both pre-CGT and post-CGT interests in the asset

Ideally, partnership assets should have a single CGT characteristic. Alternatively, partnerships could record the CGT status of partners' interests and account for them as such when the partnership disposes of the asset.

If partnerships are to have pre-CGT assets, those assets ought to be re-characterised as post-CGT assets as pre-CGT interests are sold. That would be consistent with the current treatment of companies and unit trusts.

Those complexities could be avoided in one of the following ways:

- require assets to which the joint approach applies to be treated as post-CGT assets with a cost base equal to their market value at the time; or
- require taxpayers to use the fractional interest approach if they wish to retain the pre-CGT status of their interests in partnership assets.

Determining the tax values of post-CGT assets in the hands of the partnership where partners' interests in the assets have different tax values

Ideally, partnership assets should have a single tax value.

- Partnership trading stock and depreciable assets already have a single tax value in the hands of the partnership. That should be the value for the assets under the joint approach.
- For CGT assets, simply aggregating the tax values of partners' interests in an asset will produce winners and losers where the values were not consonant. An alternative approach would be for the partnership to record the partners' different tax values and allocate any profit or loss when the partnership disposes of the asset according to those tax values.

Other design issues

Treatment of unrealised losses in respect of partnership assets

Unrealised losses should not transfer to incoming partners. An option would be to trigger a deemed disposal of loss assets at the time of the disposal of an interest in a partnership so that any accrued losses will accrue to the existing partners.

Treatment of assets introduced into a partnership

An issue will be the treatment of assets introduced into a partnership — for example, where a sole trader takes in a partner. Options include the following:

- Treat the assets as being sold to the partnership at their market value. That would tax the vendor on any unrealised gain in respect of the retained interest and could be seen to be inconsistent with taxation generally on a realisation basis. Taxpayers could avoid that outcome by adopting the fractional interest approach.
- Treat the sole trader as if an entity, so that the sole trader will be treated as disposing of an interest in that entity. The partnership will be treated as acquiring the assets at their tax values in the hands of the sole trader. That approach would be consistent with the proposed treatment of reconstituted partnerships.

Negative tax values of interests in partnerships

Because there will be a full flow-through of partnership net losses to the partners, it will be possible for partners to be allocated losses greater than the tax value of their interests in the partnership. That could happen where the majority of partnership assets are depreciable assets that have been funded by

partnership borrowings so that the partners' interests have low tax values. If the partnership incurred a loss for the year — for example, due to depreciation deductions exceeding income — the tax value of the interest will become negative.

Options:

- Do not treat partnership liabilities as part of the partnership so that negative tax values could not arise.
- Recognise the concept of negative tax values and calculate gains on the disposal of such interests by summing any disposal proceeds with the amount of the negative tax value. For example, if a partnership interest with a negative cost base of $50 were sold for $40, the gain will be $90.