

[1] INTRO TO ENTITY TAXATION

Taxation of intermediaries (entities) and their owners:

Why break up operations into so many entities?

- Ownership structure/capital raising (restrictions on the amount an entity can borrow)
- Limited liability
- Regulatory (foreign jurisdiction)
- Tax planning

Policy/design options for taxing income derived via entities:

- It is only the human owners of the entities who matter

Ideal:

- Want to have uniformity of taxation across all different types of entities
- Want to ignore all intermediaries/entities and only tax human beings,
- Want the taxation of entities to emulate as much as possible the world that would exist had the entity not existed at all, and the individual humans had earned \$ directly
- But, this is not possible in the real world

Implementing a 'conduit system'

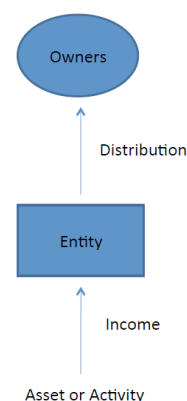
- View the entity as merely a conduit to getting the \$ to the individual humans (owners)
- But, valuation is hard when dealing with many human owners (cf 1 entity)

Entity life cycle:

<i>Formation</i>	<ul style="list-style-type: none">• Cash contributions• Transfer of assets/liabilities from current owner
<i>Treatment of earnings/losses</i>	<ul style="list-style-type: none">• Who is the TP?• Retention vs. distribution of earnings• <i>Second order effects</i><ul style="list-style-type: none">◦ Does the source and character of income change when it flows-through the company to the individuals?
<i>Distributions</i>	<ul style="list-style-type: none">• Taxed earnings• Untaxed earnings• Partial refunds of capital (contributed)
<i>Reorganisations</i>	<ul style="list-style-type: none">• Changing form/nature of interests by splitting/consolidating• Varying rights attached to interests
<i>Termination</i>	<ul style="list-style-type: none">• Disposal of interests• Winding up of entity

Design questions:

1	<i>Who pays tax?</i>	<ul style="list-style-type: none">• Owners• Entity• Both
2	<i>On what income?</i>	<ul style="list-style-type: none">• All income• Distributed income• Retained income
3	<i>When (timing)?</i>	<ul style="list-style-type: none">• When earned• When distributed



<i>Classical system (separate taxation)</i>	<i>Full integration (full conduit system)</i>
<ul style="list-style-type: none"> • Recognise company as TP 	<ul style="list-style-type: none"> • Ignores entity for tax purposes
<ul style="list-style-type: none"> • Intermediary/entity is separate for legal and tax purposes (tax both entity + owners) • At entity level, ignore ultimate ownership issues (just look at the company) • Tax income when derived by entity + again when taxed profits distributed to owners • Retained profits (taxed once when the company earns them, and if not distributed) taxed again when the owner sells his ownership interests (if CGT applies) • Multiple layers of tax 	<p><i>Tax owners on all income when derived by entity, regardless of whether they receive distributions/not</i></p> <ul style="list-style-type: none"> • Ignore entity for tax purposes • Tax all income at investor level (also pass through losses); or • Tax all income at entity level (with fully refundable tax credit to owners for underlying tax paid by entity) (tax entity but not owners when income is distributed/otherwise)

Why is integration preferable to the classical system?

[1] Equity:

<i>Over-taxation</i>	<p><i>For low-income owners → retained profits</i></p> <ul style="list-style-type: none"> • 15% TP, 30% TP, • If tax income only once at company level (and not when tax is distributed), • Then 15% TP is getting ripped off, as he should only be paying tax at 15%, • But, the company (as proxy) pays tax as 30% <p><i>For all owners → distributed profits (taxed twice)</i></p> <ul style="list-style-type: none"> • Once money is distributed, all TPs are taxed twice <p><i>Losses could be trapped in some intermediaries</i></p>
<i>Under-taxation</i>	<p><i>For high-income owners → retained profits</i></p> <ul style="list-style-type: none"> • 45% (high income) TP fine with the company retaining profits • All other things being equal, happy to leave money in the company which is subject to only 30% • (But, once money is distributed, he will be taxed twice)

	Distribution			Retention	
	50%	25%	TP rate	50%	25%
1. Profit	100	100		100	100
2. Tax (co)	30	30		30	30
3. Dividend	70	70		0	0
4. Income tax (TP)	35	17.5		0	0
5. Capital gain	0	0		70	70
6. CGT	0	0		17.5	8.75
7. Total tax (2 + 4 + 6)	65	47.5		47.5	38.75

In most cases, a classical system (because of the 2 layers of tax) will lead to over-taxation, regardless of whether the corporation's earnings are distributed (as dividend) to owners/not

- Classical system benefits high rate TPs when income is retained by the company

Alternatives for SHs

- If company distributes earnings, SH is taxed on receipt of a dividend, or
- If company retains earnings, SH can sell shares, giving rise to a CG (not OI)

[2] Efficiency:

- Preference for debt rather than equity (making loans to rather than buying shares from the company) (distortions)
- Incentive to retain profits
- Substitute unusual (non-corporate) trading forms
- Avoidance strategies (also an equity concern)
- Changes the impact of tax incentives that are delivered at the entity level (as those incentives may only act on the company, and not the ultimate owners)

Options for achieving integration (eliminate entity-level tax):

- Attribution (of income to the company's ultimate owners)
- Distributions received + Δ in value of his interest (for what he does not receive)
- Distributions received + gains on realisation (if and when he does sell shares)

However, even in a classical system:

- Companies can and do raise equity + pay dividends

Why?

- Debt becomes increasingly costly
- Signalling
- 'New view that prices of ownership interests already capture future tax on retained profits

Henry Tax Review:

- Goal in taxing entities should be to approximate integration

Multiple existing systems in Australia:

<i>Non-entity (flow-through) treatment</i>	<ul style="list-style-type: none"> • (Ignore the entity completely) • Non-entity joint ventures • Mutual association
<i>Transparent entities</i>	<ul style="list-style-type: none"> • (Do not ignore the entity completely, but look through the entity) • Partnerships • Foreign hybrids
<i>Proxy taxation</i>	<ul style="list-style-type: none"> • (In a trust situation, tax the trustee on behalf of the beneficiary (similar to a look through))
<i>Classical system</i>	<ul style="list-style-type: none"> • (Tax the corporation and then tax the SH) • Non-qualified persons • Dividend stripping
<i>Imputation</i>	<ul style="list-style-type: none"> • (Alleviate impacts of the classical system from SH's perspective) • Companies
<i>Attribution</i>	<ul style="list-style-type: none"> • Controlled foreign companies

ENTITIES

s 2-15(3) ITAA

- Items 2, 4, 5, 6, 7, 8, 9

s 4-5 ITAA

- 'You' – entities generally
- 'Entities'

S 4-1 ITAA

- Income tax is payable by individuals, companies, and some other entities

s 9-1 ITAA

- Entities that are liable to income tax
- (Partnerships are absent (partnerships do not pay tax))

s 960-100 ITAA

(1)	<p><i>Entity means any of the following:</i></p> <ul style="list-style-type: none">(a) an individual;(b) a body corporate;(c) a body politic;(d) a partnership;(e) any other unincorporated association/body of persons;(f) a trust;(g) a superannuation fund;(h) an approved deposit fund <p><i>(N.B. The term entity is used in a number of different but related senses. It covers all kinds of legal person. It also covers groups of legal persons, and other things, that in practice are treated as having a separate identity in same way as a legal person does)</i></p>
(1A)	(1)(e) not include non-entity joint venture (which is merely contractual arrangement)

s 995-1 ITAA

<i>Individual</i>	<ul style="list-style-type: none">• A human
<i>Company</i>	<ul style="list-style-type: none">• Body corporate• Any other unincorporated association/body of person (but not partnership)
<i>Partnership</i>	<p><i>An association of persons carrying on business</i></p> <ul style="list-style-type: none">• As partners (<i>general law partnership</i>), or• In receipt of OI/SI jointly (but not a company) (<i>tax law partnership</i>)
<i>Trust</i>	
<i>NFP</i>	

PARTNERSHIPS

Distinguish from joint ventures

- Partnerships share profits with each other
- JVs share something before the derivation of profits (share costs, equipment), but separately earn profits (just come together for various purposes along the way)

Partnerships do not pay tax, but are required to file returns that show the net income/loss of the partnership (which is allocated to partners according to percentage interests)

- (Thus, ATO can cross-reference with the individual partners and confirm that each is appropriately recording his income. All the partners together should record as much profit as the partnership had in total)
- Full integration (1 level of tax for both the entity and its owners, no entity tax that is separate from individual taxation, look through the entity)

Existence of a partnership is a question of fact and law

Relevant factors include

- Intention of the partners (to be in a partnership) – objective evidence of mutual assent
- Conduct as partners
- Marriage does not itself constitute being in a partnership
- *Being in a partnership enables splitting of income (benefit 2 tax free thresholds)*
 - Wife is jobless, husband has a high income
 - H and W wish to hold assets that generate passive income in partnership
 - If H and W write a legitimate partnership agreement, they can flow the income to W, and the losses to H
 - This reduces H's high MTR, and taxes income to W with her lower MTR
 - Reduces the effect of progressive marginal rates
 - (But, this purpose is largely serviced by trusts in Australia)

Tax law partnership:

- Not dependent on general law concepts (purely a creation of tax law)
- (Treat persons who are holding property as joint tenants – treat as a 50/50 partnership, if the parties do not want this, can write an agreement stating otherwise)

McDonald

Facts	<ul style="list-style-type: none">• Husband and wife owned rental properties (passive property income rather than actively running a business)• When audited, they purported to have a partnership agreement (where W had most of the income attributed to her, and H had most of the losses attributed to him)• (H probably had other income, but W did not)
Decision	<ul style="list-style-type: none">• Could do this, if valid partnership agreement re splitting of income• But, no written agreement here• H and W merely held the property jointly (joint tenancy), thus gains and losses derived from the property split evenly between H and W