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Looking Through and Looking Forward: Should Australia introduce a tax flow-through company?

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Tax Flow-Through Companies

- In 2015 one of the potential reforms considered by the **Re:Think** Treasury discussion was for the introduction of a entity flow-through regime:
  - » 'entity flow-through' is equivalent to 'tax transparent company' or 'tax flow-through company'

- Gained support from major accounting and tax professional bodies:
  - » CPA Australia; The Tax Institute; Taxpayers Australia Limited, and BDO.
- Previously, in 2008 a ICAA proposal argued that tax transparency applying to closely held corporations and unit trusts.

- Also, accounting firm Pitcher Partners in 2015 made a submission that a dual income tax (DIT) system, which can have flow-through for closely held corporations).

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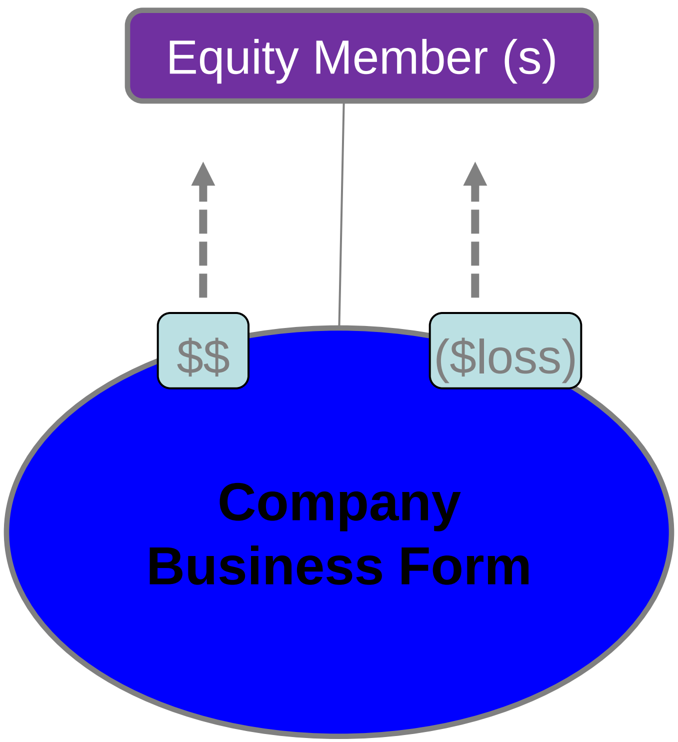
Tax Flow-Through Companies

- Generally tax flow-through companies are argued as advantageous for small closely-held businesses:
  - Approximately 2,044,860 small businesses, representing **97%** of businesses in Australia (ABS, 2015):
  - Account for **43%** of nonfinancial private sector **employment** and around **33%** of **GDP** during 2012–13;
  - **61%** of trading businesses are **non-employing**, and are generally operated by family members.
- ***Cf***: Freudenberg (2009) arguments that easier to implement for small closely held businesses

What is a tax flow-through company?



“Tax flow-through”: Instead of the business form being liable for income tax, the member(s) is assessed directly on all of the business’:

- income and/or
- losses

“Company”: The business form is characterised by:

- Separate legal entity status; &
- Limited liability for members

Definition

- Economists have advocated for tax transparency as an ideal model, as it can improve tax neutrality.
- Australia has been reluctant to embrace tax flow-through companies.
- However, Australia has introduced two flow-through companies, but not broadly available:
  - » Incorporated Limited Partnerships used for venture capital investments (‘venture capital ILPs’); and
  - » Amendments to controlled foreign hybrid companies (‘CFC hybrids’).

…… and the use of (discretionary) trusts (but no flow-through of losses)

Foreign examples

- There are several examples of foreign jurisdictions embracing a tax flow-through approach for business forms with separate legal status and liability protection for members:
  - » the United States' **S Corporations**
    - and Limited Liability Companies ('**LLCs**'),
  - » the United Kingdom's Limited Liability Partnership ('**LLPs**');
  - » New Zealand's Loss Attribution Qualifying Company ('**LAQCs**').

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Foreign examples

Prior research considered:

- Reason(s) and process of their introduction
  - » Classification of tax flow-through companies:
    - **Special tax rule companies** (S Corps & LAQCs); and
    - **New form transparent companies** (LLCs & LLPs).
- Loss restriction rules
- Compliance cost evidence
- Financing effect
- Governance

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Recent evidence

- **Utilisation rates** of the studied foreign tax flow-through companies demonstrates that:
  - » excluding sole proprietorships, the transparent companies studied in the United States (S Corporations and LLCs) account **for a majority** of the business forms there.
  - » New Zealand's transparent company, the LAQC, did represent approximately **12 per cent** of business forms there in 2006 (excluding sole proprietors).
  - » The utilisation of the United Kingdom's LLP is not as prevalent as the other jurisdictions, although this could be attributed to its **recent introduction**.

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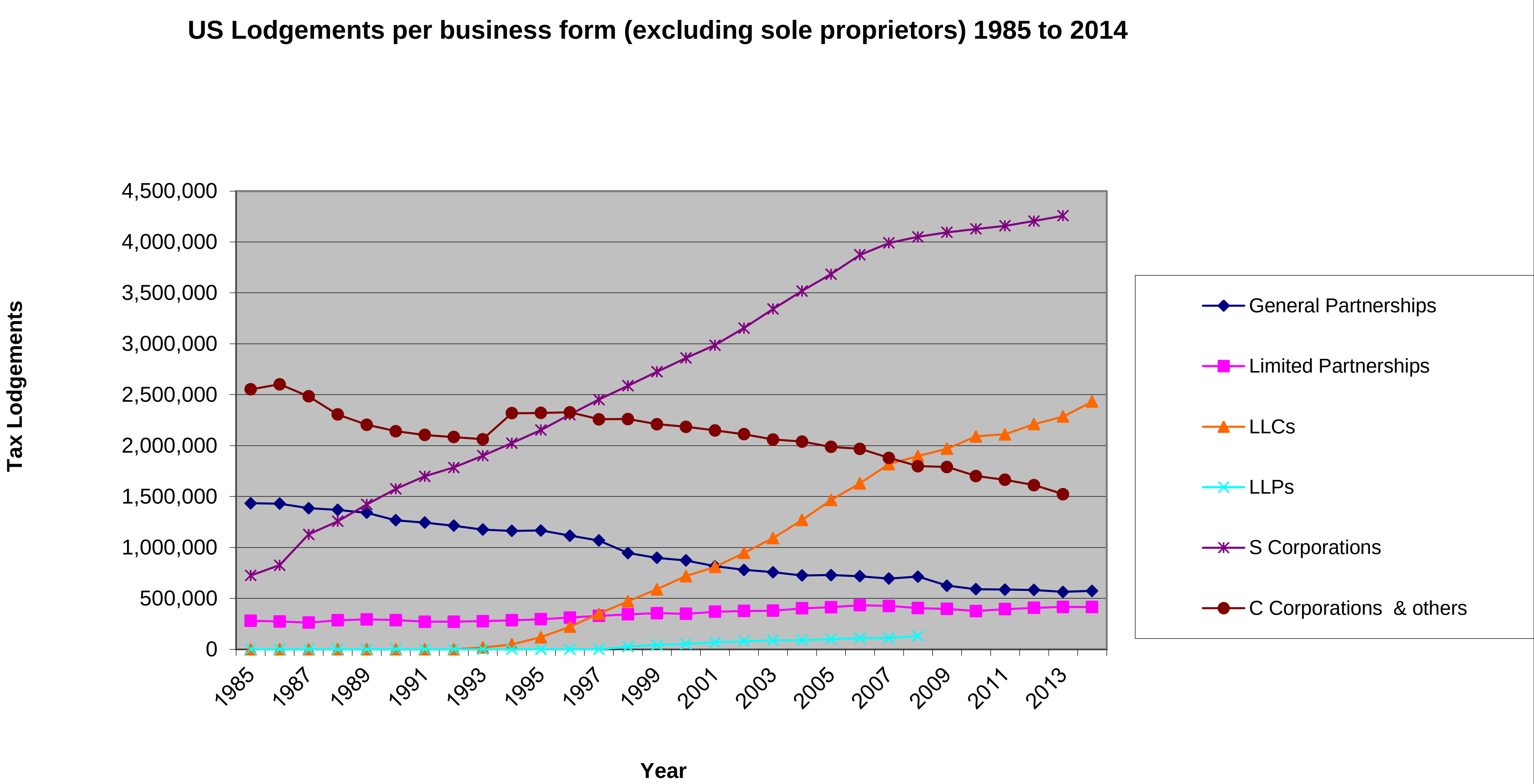
Foreign examples

Estimated: **54%** of private sector employment via tax flow-throughs



Recent evidence from the USA

S Corporations

- Sill popular due to status of active owner/shareholder for employment taxes
- Seen as a simpler structure (one class of membership interest)
- Preferred business structure for personal services income
- Owning assets can have tax disadvantages on distribution
- 2013 US Joint Committee reviewed tax flow-through
  - » Unified approach; distributions of property concern; restriction of flexibility of distributions (3 categories: ordinary, capital gains and tax credits)
- Lobbying to reduce tax rate for tax flow-through (especially with discussion about corporate tax rate reduction to 15%)

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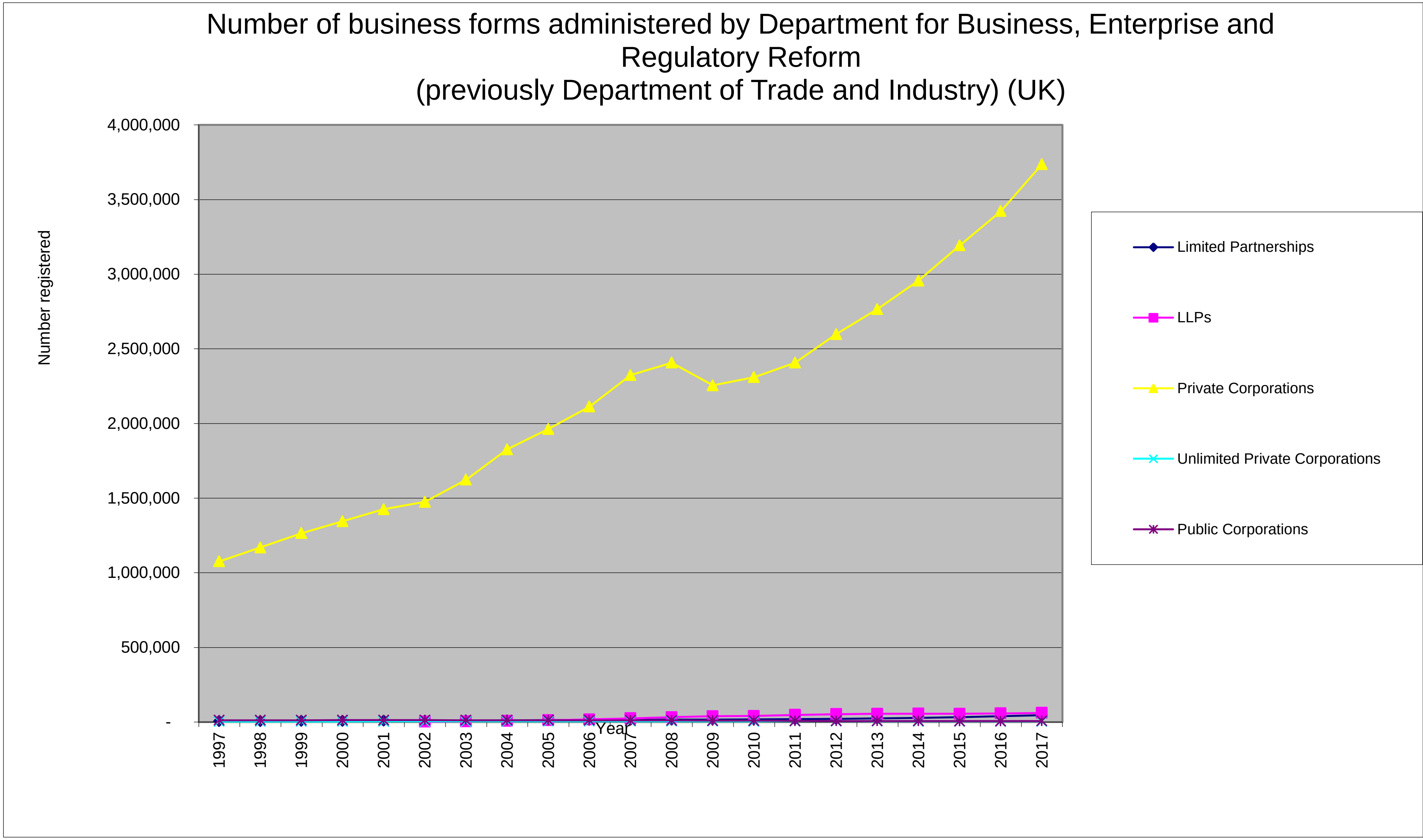
Recent evidence from the USA

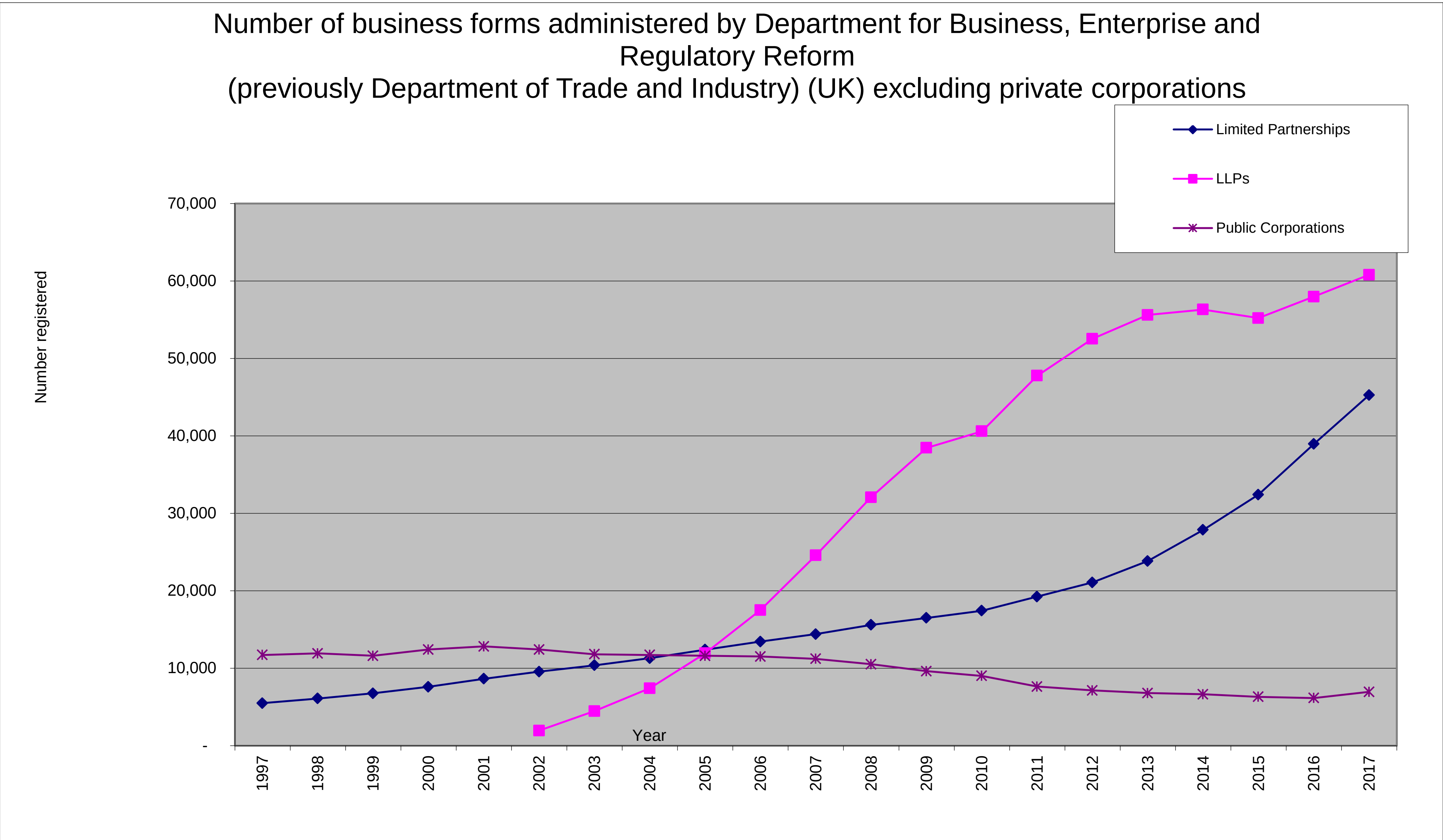
LLCS

- Seen as more appropriate for sophisticated activities
- Increase in flexibility of distributions leading to complex tax integrity rule (economic effect rules)
  - » Flexibility is not only tax planning but also various equity financing options
- More appropriate if holding property that will appreciate in value (step up in membership cost basis for debt)
- Development of 'series LLCs' when different LLCs have different risk factors (such as real estate developments)
- Filing costs in various states could affect choice between LLC and corporations

Foreign examples



Foreign examples

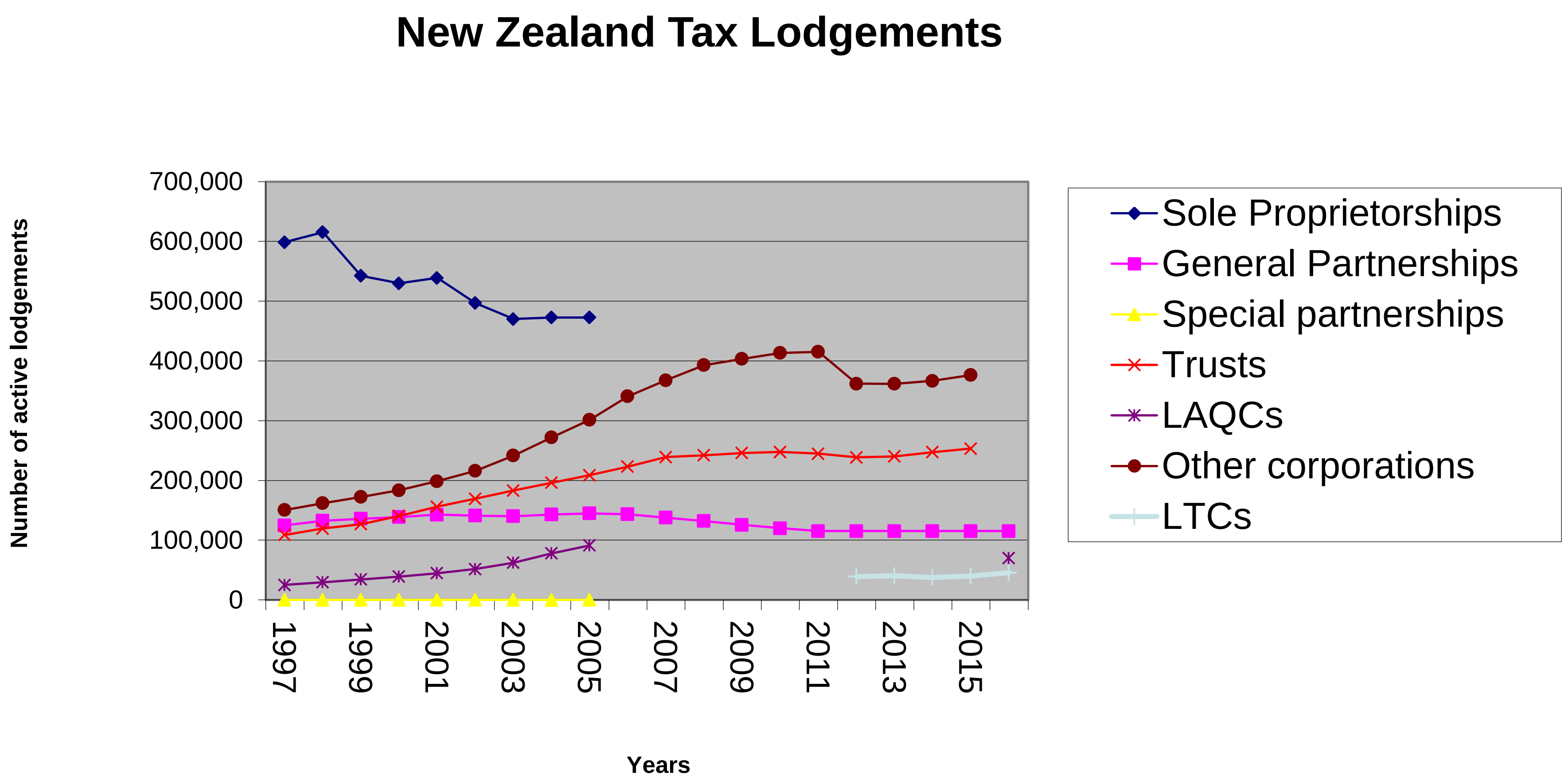


Recent evidence from the UK

- LLPs have been used to manipulate employee/owner status to reduce National Insurance Contribution (NIC)
- Continued downward pressure on corporate tax rates (compared to individuals)
  - » Use of ‘corporate’ partner in LLP to minimise/defer tax

- Fletcher et al. (2013) research:
  - » Estimates about 98% of LLPs are SMEs
  - » 3 major uses:
    - Special purpose vehicle for collaboration (asset management)
    - Purely investment/tax strategy
    - Small professional firms (ie accountants/engineers/lawyers)
  - » Reasons in choosing: 1st Tax; 2nd Limited Liability; 3rd Flexibility

Foreign examples



Recent evidence from NZ

- Repeal of LAQCs in 2011 and replaced with Look Through Companies (**LTCs**) with losses limitation rules (cost basis)

- 1 April 2017 reforms:
  - » removal of loss limitation rules due to concerns about record keeping and complexity (but still for LTCs working together in partnerships or as a joint venture).
  - » Concerns with eligibility rules – especially corporations being shareholders through trusts and foreign income.

- Still 70,000 Qualifying Companies allow for tax free unfranked distributions (now to be grandfathered).

Looking forward for Australia?

- The **demand** or desire for such transparency may be **insufficient** to see it adopted by a large number of taxpayers:
  - » full imputation system for corporations and
  - » the use of discretionary trusts for businesses

- An Australian tax flow-through company would need option of flexibility of distributions (but increases compliance costs due to integrity rules).

- Retention of profits issue.

- Downward pressure on corporate tax not necessarily apply to tax flow-through companies.

- The 'corporation' still appears internationally the most popular business structure (cf LLCs in the USA)

Potential models of tax flow-through

- There are a number of possible alternative models for the introduction of a tax flow-through company in Australia:
  - » A '**partial loss transparent company'**
    - Flow-through of losses
    - Income assessed at the entity level (at corporate tax rate) and distributions either:
      - Franked (with imputation credit)
      - Unfranked - exempt income for members (flow-through of tax preferences)

- ***Cf:*** have a **'Business Tax Scheme'** for individuals – to allow sole traders to access the corporate tax rate for business income while retained (Denmark)

Looking Through and Looking Forward:

Should Australia introduce a tax flow-through company?

Any questions?

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