

# *Losing my Losses: Are the loss restriction rules applying to Australia's tax transparent companies adequate?*

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## **Abstract**

*It has been argued that the Australian government prefers an entity tax approach for business forms providing member(s) with limited liability and separate entity status.<sup>1</sup> This contrasts a number of foreign jurisdictions that have provided tax transparency to such business forms ('tax transparent companies'), with income and/or losses directly allocated to members for tax purposes. Examples of foreign tax transparent companies include S Corporations and Limited Liability Companies in the United States, Limited Liability Partnerships in the United Kingdom; and Loss Attributing Qualifying Companies and new limited partnerships in New Zealand.*

*A reason for the Australian government's preference is that unfettered access to tax losses by limited members could distort investments. Nevertheless, recently the Australian government provided restricted tax transparency for Incorporated Limited Partnerships used for venture capital investments ('venture capital ILPs') and controlled foreign hybrid companies ('CFC hybrids'). To address distortion concerns*

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1 Vann, RJ. (2001). Australia's Policy on Entity Taxation. Australian Tax Forum 16.

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*there are restrictions applying to allocated losses through these Australian transparent companies. However, are these restrictions adequate? This article considers whether the loss restriction rules applying to venture capital ILPs and CFC hybrids are adequate by comparing them to rules utilised in foreign jurisdictions with a history of transparent companies. This article will conclude by considering whether sufficient 'losses are lost' to justify broadening the availability of tax transparency in Australia.*

## 1. Introduction

A fundamental question confronting a tax system is how will tax be imposed and who will bear the liability for its payment. This question can be considered on a purely legal basis, that is who has the legal obligation for the payment. Alternatively, it can be construed from an economical point of view, considering who effectively pays the tax. These alternatives may not result in the same conclusions, particularly for the taxation of business forms. For example, if the business form is granted separate legal status to its members, should the business form as a legal person be subject to tax itself separate to its members? Legally this may seem a foregone conclusion, however, economically it is considered preferable that the business income and/or losses are directly allocated to members. Indeed, tax transparency (full integration) has been argued as an economically superior model,<sup>2</sup> although it is not without its critics. Criticisms against tax transparency include the risk to tax revenue and the potential for investment decisions to be distorted when allocated losses exceed a member's financial exposure.<sup>3</sup> Nonetheless, a number of foreign jurisdictions have provided tax transparency to certain business forms that are characterised by separate legal status and limited liability for members (referred as "tax transparent companies" or "transparent companies"). Examples include the United States' S Corporations and Limited Liability Companies (LLC), the United Kingdom's Limited Liability Partnership (LLP) and New Zealand's Loss Attribution Qualifying Company (LAQC).<sup>4</sup> The Australian government has been reluctant to embrace transparent companies, preferring an entity tax approach combined with a full imputation system for corporate distributions. However, in response to pressure the Australian government has recently introduced two transparent companies, although they are not broadly available.<sup>5</sup> These Australian transparent companies are Incorporated

2 Id at 36.

3 Australian Treasury. (1999). *A Tax System Redesigned* (Ralph Report No 4) at [277] of Overview.

4 The LAQC is not a fully transparent company, but instead is a "partial loss transparent company", allowing the direct allocation of losses to members, with income being initially assessed at the entity level. An imputation system applies to the LAQC and other New Zealand corporations. An LAQC member is only assessable on an LAQC's taxable income on an actual payment of a dividend. The LAQC must impute any dividend payment to the fullest extent possible, known as an imputed dividend: Income Tax Act 2007 (NZ) (ITA), s HA 15. If an LAQC member receives an unimputed dividend this is regarded as exempt income.

5 Freudenberg, B. (2006). Are transparent companies the way of the future for Australia? 35(3) *Australian Tax Review* 200, at 218.

Limited Partnerships used for venture capital investments (**venture capital ILPs**) and controlled foreign hybrid companies (**CFC hybrids**).

Acknowledging the concerns with transparency, restrictions are imposed on losses allocated through these Australian transparent companies. However, are these Australian loss restriction rules adequate, too rigorous, or insufficient? This article will analyse the Australian rules by comparing and contrasting them to those that apply to transparent companies in selected foreign jurisdictions with a history of transparent companies.

This article will initially consider how the unfettered allocation of losses to limited members could distort investment decisions. Then the article will briefly outline the Australian government's recent adoption of venture capital ILPs and CFC hybrids, and the losses restriction rules imposed. These Australian rules will then be compared and contrasted to the loss restriction rules applying to S Corporations and LLCs in the United States, the United Kingdom's LLP; and LAQCs and new limited partnerships in New Zealand. Through this analysis it will be argued that with minor amendments the CFC hybrid loss restriction rules are adequate and the preferable Australian rule set. It will be argued that with the recommended changes these loss restrictions rules are adequate to allow for the broad availability of tax transparency in Australia. That is, there are sufficient "losses lost" to ensure that the integrity of the Australian tax system is maintained.

## 2. Unfettered access to losses

It has been previously argued that the Australian government is reluctant to allow for the flow through of losses to members when the business form provides a separate legal entity and limited liability.<sup>6</sup> These concerns are based on the potential for the loss of tax revenue, especially in relation to tax shelter arrangements, particularly if members can deduct losses (including tax preferences) in excess of their financial exposure.<sup>7</sup> The Australian Treasury recognised this potential in 1974,<sup>8</sup> as did the Australian government in its 1985 Draft White Paper when tax transparent companies were discussed.<sup>9</sup> This was reiterated in the Ralph Report, which described it as not feasible from a revenue point of view.<sup>10</sup> This concern about unfettered access to losses is epitomised by Australia's 1990s reforms to tax limited partnerships as corporations rather than on a flow through basis.<sup>11</sup>

6 Id at 214-215.

7 Stewart, M. (2003). Towards flow through taxation of limited partnerships: It's time to repeal Div 5A. 32 *Australian Tax Review* 171, at 179.

8 Treasury. (1974). *Taxation Paper No 1*, AGPS, Canberra.

9 Treasury. (1985). *Reform of the Australian Tax System* (Draft White Paper), AGPS, Canberra.

10 Above n 3, at [277] of Overview.

11 The transparent tax treatment of limited partnerships was eliminated by the introduction of Div 5A *Income Tax Assessment Act 1936* (Cth) (**ITAA**), with limited partnerships being defined as "corporate limited partnerships". This concern may have been based on an earlier United Kingdom decision which held that a limited member of limited partnership could deduct tax

**Example 1: Funding investment**

Assume that a member (Cooper) on the highest marginal tax rate (46.5 per cent) invests \$10,000 into a tax transparent company. The \$10,000 represents the extent of Cooper's financial exposure for the business operations. The transparent company borrows another \$40,000 from a third party. The business invests the money, and generates tax losses of \$50,000 for the first three years. After three years it is projected the business may generate income.

If Cooper were able to utilise these tax losses to offset against other assessable income, Cooper would not pay tax on \$50,000 of income, because the \$50,000 worth of tax losses could be offset against assessable income of \$50,000. Over the three years this would amount to a tax saving of \$23,250 (being \$50,000 \* 46.5 per cent).

*Example 1: Funding Investment* provides a simple scenario to demonstrate how unfettered access to losses could result in the tax system distorting an investment's return for a member. The scenario illustrates that regardless of whether the investment ever delivers positive returns to Cooper; with tax savings Cooper has an effective return of \$23,250 over the first three years. That is, Cooper recovers the initial \$10,000 investment plus an additional \$13,250, representing a return of 132.5 percent. This return is facilitated by the tax system funding the investment by lowering Cooper's overall tax burden. If not for the tax savings, Cooper may not have made the investment at all. This scenario demonstrates how a country's tax system can fund or decrease the effective cost of capital for an investor and thereby distort investment decisions.

Of course, individuals who invest in their own name can achieve similar returns, although a fundamental difference is that an individual would have full liability exposure for a poor investment decision. Whereas when the investment is made via a transparent company, then the member's liability can be limited. It is this lack of full financial exposure that raises concerns with transparent companies.

The importance of an appropriate loss restriction rule was recently raised with the loss restriction rules for New Zealand's new limited partnerships, were it was stated:

[The] ...absence of loss limitation rules is likely to distort efficient risk-bearing decision-making and efficient resource allocation by encouraging investors to enter arrangements or schemes whereby small amounts of capital are invested to get access to larger net losses.

This could result in abuse...may potentially create large fiscal costs to the government.<sup>12</sup>

It appears that the New Zealand Government may have realised this too late after already establishing the LAQC regime some 15 years earlier. The lack of appropriate loss restriction rules for LAQCs may have generated the potential for a "large fiscal

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losses in excess of their liability exposure: *Reed v Young* HL 1986, 59 TC 196, STC 285.

12 Cullen, M (Minister of Finance), and Dunne, P (Minister of Revenue). (2006). *General and limited partnerships - proposed tax changes: A government discussion document*. Wellington, at 34.

cost” to the New Zealand Government.<sup>13</sup> In 1994, there was already \$200 million worth of losses flowing through LAQCs, and by 1998 this had increased to \$365 million.<sup>14</sup>

Has the Australian government with implementing transparency for venture capital ILPs and CFC hybrids ensured that sufficient losses are lost so not to create such a “large fiscal cost”? Before analysing in detail the loss restriction rules that apply to Australia’s transparent companies, a brief description of their governance and tax treatment will first be provided.

### 3. Australia’s recent transparent companies

Despite its prior opposition to transparent companies, the Australian government has responded to pressure to introduced two transparent regimes.<sup>15</sup> One for venture capital ILPs and the other for Australian residents investing in foreign transparent entities (CFC hybrids). Each of these two regimes is briefly described below.

#### 3.1 Venture capital ILPS

Commencing 1 July 2002, the introduction of venture capital ILPs involved both state and federal governments of Australia enacting legislation. At the federal level, the government enacted legislation establishing a new tightly regulated regime for the venture capital industry in Australia,<sup>16</sup> which if satisfied applies tax transparency as well as certain tax concessions for non-resident investors.<sup>17</sup>

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13 For proposed reforms to New Zealand’s LAQC regime refer to: Freudenberg, B. (2008). “The Troubled Teen Years” Is the repeal of New Zealand’s LAQC regime required? *New Zealand Journal of Taxation Law and Policy* 14 (1) 67, at 94-96.

14 Freudenberg, B. (2005). Is the New Zealand Qualifying Company regime achieving its original objectives? *New Zealand Journal of Taxation Law and Policy* 11 (2) 185, at 205.

15 For a discussion of the reason behind Australia’s introduction see: Freudenberg, B. (2006). Are transparent companies the way of the future for Australia? *Australian Tax Review* 35 (3) 200, at 214-221.

16 Subdivision 118-F ITAA97 (Cth). The new venture capital regime was introduced on 1 July 2002 by two pieces of legislation, being: *Venture Capital Act 2002* (Cth) and *Taxation Laws Amendment (Venture Capital) Act 2002* (Cth). Australia has two other venture capital programs being (a) PDF program introduced in 1992; and (b) the Foreign Superannuation Fund program introduced in 1999. These prior programs have been criticised as being flawed in a number of ways. See: Ernst and Young, “Review of International Tax Arrangements: Submission to the Board of Taxation” (2002) p 87; <http://www.taxboard.gov.au/submissions.asp> viewed 22 December 2005.

17 The venture capital tax concessions are aimed primarily at capital gains by non-resident investors. In contrast, Australian investors would be taxed under normal rules. There has been a recent amendment to this regime, with the Early Stage Venture Capital Limited Partnership (ESVCLP) that will progressively replace the Pool Development Fund program: *Tax Laws Amendment (2007 Measures No 2) Act 2007* (Cth). This has seen New South Wales recently introduce amendments to its *Partnership Act 1892* (NSW) to allow such ESVCLPs to be regarded as ILPs: *Partnership Amendment (Venture Capital) Act 2007* (NSW); enacted in October 2007. This article does not consider s in any detail as it does not allow members to claim losses. That is, its loss restriction rule is absolute: *ITAA97* (Cth), s 26-68.

To address concerns with the current limited partnership regimes available in Australia, every state government, except Western Australia, has enacted legislation to establish a new business form, being the ILP.<sup>18</sup> This saw the creation of a discrete business form that could utilise the Federal income tax provisions for the venture capital industry, as ILPs are only available for venture capital investment.<sup>19</sup>

The venture capital ILP provides, among other things, for a separate legal entity<sup>20</sup> and limited liability for limited members, with general members having liability exposure. The separate legal entity status is distinctive to other limited partnerships in Australia, and is adopted to re-enforce liability protection for limited members.<sup>21</sup> The limited member is normally a passive investor, with participation in the management of an ILP restricted, as it can diminish their liability protection.<sup>22</sup>

With financing, it is common for the general member to contribute one percent of the equity into the venture capital ILP, and limited members contributing the remaining 99 percent.<sup>23</sup> The venture capital ILP then makes investments typically in the form of membership interests<sup>24</sup> in an underlying eligible corporation (**the venture capital**

- 18 New South Wales the *Partnership Amendment (Venture Capital Funds) Act 2004* (NSW) amending the *Partnership Act 1892* (NSW); Victoria the *Partnership Venture Capital Funds Act 2003* (Vic) amending the *Partnership Act 1958* (Vic); and Queensland the *Partnership and Other Acts Amendment Act 2004* (Qld) amending the *Partnership Act 1891* (Qld); Australian Capital Territory the *Partnership (Venture Capital Funds) Amendment Act 2004* (ACT) amending the *Partnership Act 1963* (ACT); South Australia the *Partnership (Venture Capital Funds) Amendment Act 2005* (SA) amending the *Partnership Act 1891* (SA); and Northern Territory the *Partnership Amendment (Venture Capital Funds) Act 2006* (NT) amending the *Partnership Act 1997* (NT).
- 19 *Partnership Act 1892* (NSW), s 53D(3); *Partnership Act 1958* (Vic), s 87(2); *Partnership Act 1891* (Qld), s 75; *Partnership Act 1963* (ACT), s 57(2); *Partnership Act 1891* (SA), s 51D(3); and *Partnership Act 1997* (NT), s 55(2). Note every state except for Queensland provides for ILPs to be used for other purposes as provided by regulation (which there are none at the moment).
- 20 *Partnership Act 1892* (NSW), s 53; *Partnership Act 1958* (Vic), s 84; *Partnership Act 1891* (Qld), s 72; *Partnership Act 1963* (ACT), s 54; *Partnership Act 1891* (SA), s 51; and *Partnership Act 1997* (NT), s 52.
- 21 With no agency relationship between the limited member and either the general member or the ILP: *Partnership Act 1892* (NSW), s 53C; *Partnership Act 1958* (Vic), s 96; *Partnership Act 1891* (Qld), s 84; *Partnership Act 1963* (ACT), s 66; *Partnership Act 1891* (SA), s 51C; and *Partnership Act 1997* (NT), s 64.
- 22 Although there are broader allowances for participation in management without losing limited liability protection: *Partnership Act 1892* (NSW), ss 66A and 67A; *Partnership Act 1958* (Vic), ss 97 and 98; *Partnership Act 1891* (Qld), ss 86 and 87; *Partnership Act 1963* (ACT), ss 67 and 68; *Partnership Act 1891* (SA), ss 64A and 65A; and *Partnership Act 1997* (NT), ss 65 and 66. Even with the reforms, members are not allowed full management without infringing their liability protection unlike the reforms for the United States' *Uniform Limited Partnership Act (2001)*. *Uniform Limited Partnership Act 2001*, s 303. Drafted by the National Conference of Commissioners of Uniform State Law.
- 23 For a comprehension discussion about the venture capital industry see: Stewart, M. (2005). Venture Capital Tax Reform in Australia and New Zealand. *New Zealand Journal of Taxation Law and Policy* 11 (2):216, at 226.
- 24 Or options to acquire shares.

**corporation**) that conducts a business activity.<sup>25</sup> In addition to equity contributions in the venture capital corporation, benefits such as business experience, special expertise and mentoring can be provided by the ILP to the venture capital corporation.<sup>26</sup>

Tax transparency does not automatically apply to venture capital ILPs, as they must qualify for registration with the Australian government's Venture Capital Registration Board<sup>27</sup> (the "Board"), and comply with the registration requirements of the *Venture Capital Act 2002* (Cth).<sup>28</sup> There are two types of venture capital ILPs that can register with the Board, being Venture Capital Limited Partnerships (VCLP)<sup>29</sup> and Australian Venture Funds of Funds (AFOF).<sup>30</sup> A VCLP directly invests into eligible venture capital corporations. Whereas, the AFOF pools capital and becomes a limited member across a number of VCLPs. There is also a third type of investment provided for, being a Venture Capital Management Partnership (VCMP) which is a limited partnership

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25 From 1 July 2007 this is now extended to investments in unit trusts: *Act No 78 2007* (Cth).

26 Barkoczy, S, and Sandler, D. (2007). *Government Venture Capital Incentives: A multi-jurisdiction comparative analysis, Research Study No 46*. Sydney: Australian Tax Research Foundation, at 7.

27 Previously known as the Pooled Development Fund Board up to 21 June 2007.

28 *Venture Capital Act 2002* (Cth), ss 9-1 and 9-5.

29 To be able to register as a VCLP, the venture capital ILP must comply with a number of requirements: These requirements are found in the *Venture Capital Act 2002* (Cth), ss 9-1 and 13-1. Firstly, the venture capital ILP must be formed under a law in Australia or a Double Tax Agreement Country (Prior to 1 July 2007 this was more restricted to Six Listed Countries being Canada, France, Germany, Japan, the United Kingdom or the United States.); with the general member resident in either Australia or Double Tax Agreement Country. Also the partnership agreement must specify that the venture capital ILP will be in existence for at least five years but not more than 15 years, and the partnership will be carrying on activities related to eligible venture capital investment. Furthermore, there must be committed capital of at least \$10 million (Prior to 1 July 2007 this was \$20 million), with investments only in eligible venture capital investments, particularly venture capital corporations (From 1 July 2007 this can now extend to unit trusts as well). Finally, the only debt interests of the limited partnership in the eligible venture capital investment must be permitted loans (These are defined as either (a) loans repayable within six months if no eligible venture capital investment; or (b) loans where there is at least 10 percent of equity in eligible venture capital investment. See *Venture Capital Act 2002* (Cth), s 9-10), and the general member must notify the Board that it holds sufficient funds to begin its investment program.

30 For a limited partnership to be able to register as an AFOF, the venture capital ILP must meet slightly different requirements. *Venture Capital Act 2002* (Cth), ss 9-5 and 13-5. One notable difference is that an AFOF can remain in existence for 20 years, compared to only 15 for a VCLP. These registration requirements include that the limited partnership: (a) must be formed in Australia; (b) that every general member must be an Australian resident; (c) that the partnership agreement specifies that the partnership is to remain in existence for at least five years but not greater than 20 years, (d) only carry on activities related to eligible venture capital investment, (e) only invests in a VCLP, or a corporation in which a VCLP (that the AFOF is a partner) already holds an investment, (f) only has debt interests that are permitted loans; and (g) must notify the Board, through the general partner, that the AFOF has sufficient funds to begin its investment program.

that acts as the general member of a number of VCLPs and/or AFOFs.<sup>31</sup> VCMPs do not need to separately register, because they are indirectly registered through their participation in VCLPs and AFOFs, which are themselves registered. The *Appendix* provides a diagrammatical representation of the different ways that venture capital investment can be facilitated in Australia. For the purposes of this article, VCLPs, AFOFs and VCMPs come within the umbrella term of “venture capital ILPs” unless otherwise specified.

If numerous requirements are satisfied then venture capital ILPs, unlike other limited partnerships in Australia,<sup>32</sup> are taxed as general partnerships.<sup>33</sup> Being taxed as a general partnership means that the “net income” of the partnership is calculated, being the assessable income of the partnership less allowable deductions calculated as if the partnership was a resident taxpayer.<sup>34</sup> This “net income” calculation would exclude any capital gains, because members make any capital gains or capital losses in relation to CGT assets held through the venture capital ILP individually.<sup>35</sup> An obvious CGT asset that could be held through a venture capital ILP is the membership interest in the venture capital corporation.<sup>36</sup>

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31 *ITAA36* (Cth), s 94D(3) defines a VCMP as a general member of one or more VCLPs and/or AFOFs, and only carries on activities relating to being such a general partner.

32 A limited partnership is defined for tax purposes as either: (a) an association of persons (other than a company) carrying on business as partners or in receipt of ordinary income or statutory income jointly, where the liability of at least one of these persons is limited; or (b) an association of persons with a separate legal personality that was formed solely for the purpose of becoming a VCLP, an AFOF or a VCMP and to carry on activities that are carried on by a body of that kind: *ITAA97* (Cth), s 995-1.

33 Division 5 *ITAA36* governs the taxation of general partnerships, with essentially each member including their share of the net income of the partnership in their own assessable income: see *ITAA36* (Cth), s 92. Note this treatment of VCLP, AFOF and VCMP as general partnerships is achieved through a number of definitions: the definition of “companies” excludes partnership (*ITAA36* (Cth), s 6(1)), and the definition of “partnership” includes a limited partnership (*ITAA97* (Cth), s 995-1), and then the definition of “limited partnership” is defined to include a VCLP, AFOF and VCMP (*ITAA97* (Cth), s 995-1), and *ITAA97* (Cth), s 960-115 confirms these entity types are not corporate tax entities.

34 *ITAA36* (Cth), s 90.

35 *ITAA97* (Cth), ss 106-5 and 108-5(2)(c). For capital gains tax (CGT) purposes each member is treated as having acquired an individual fractional interest in the assets held by the partnership. This is because for Australian tax purposes members of a partnership are treated as having direct “fractional interests” in the CGT assets held.

36 However, there is some contention as to whether this membership interest is held on revenue or capital account by the members of the venture capital ILP. It could be argued that the sale of shares in the eligible venture capital corporation are revenue in nature and not capital, particularly as they are acquired for the purpose of resale within ten to 15 years. See: Above n 23, at 233. This issue requires clarification, because if a membership interest is held on revenue account then the concessional tax treatment applying to capital gains does not apply.

This net income calculation could be either positive or negative, and each member would include their share of net income or loss in their own assessable income.<sup>37</sup> The venture capital ILP itself would not pay income tax on this net income.<sup>38</sup> When “net income” is negative, that is a losses is generated, then pursuant to industry practice a greater percentage of these losses are allocated to limited members.<sup>39</sup> These allocated losses would then be potentially available to offset the limited member’s other income, subject to the new loss restriction rule for limited members.<sup>40</sup>

This rule restricts the utilisation of losses to the amount a limited member has contributed less the sum of amounts repaid, deductions previously allowed and amounts of all debt interests issued by the member to the extent that they are secured by the member’s interest in the venture capital ILP.<sup>41</sup> Any losses unable to be utilised because of the application of this rule may be carried forward by the limited member for potential future use.<sup>42</sup>

### 3.2 CFC hybrids

Commencing 1 July 2003, the CFC hybrid amendments were introduced to address the asymmetrical tax treatment applying to Australian residents investing in certain foreign transparent companies. Asymmetrical tax treatment occurred between the country of origin, where tax transparency applied,<sup>43</sup> and Australia with the business form being taxed separately from its members as a corporation. Such asymmetrical treatment between jurisdictions has been commonly referred to as “hybrid” treatment.<sup>44</sup>

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37 *ITAA36* (Cth), s 92. Note the partners’ share would be determined by the partnership agreement. When “net income” is positive, there are no specific tax concessions given to these net income receipts.

38 *ITAA36* (Cth), s 91.

39 These deductions may relate to the management fees paid to the general member and interest paid on financial borrowings. However, given the restrictions on venture capital ILPs in terms of borrowings, investments, and treatment of capital gains/losses, the quantum of revenue losses may be comparatively small.

40 *ITAA36* (Cth), s 92(2AA).

41 *ITAA36* (Cth), s 92(2AA).

42 *ITAA36* (Cth), s 92(2A).

43 Particularly the United States and the United Kingdom.

44 In Larking, B, ed. (2005). *IBFD International Tax Glossary*. 5th ed. Amsterdam: IBFD defines a “hybrid entity” as an “entity that is characterized as transparent for tax purposes (eg as a partnership) in one jurisdiction and non-transparent (eg as a corporation) in another jurisdiction.” It is argued that this an unfortunate use of the term “hybrid” and is not an appropriate given the English meaning of the word. This is because the IBFD describes the one entity being treated differently in two jurisdictions, rather than the one entity that has characteristics of two different species.

This asymmetrical tax treatment can lead to a number of problems and the potential for double taxation. Particularly, the treatment of a “foreign transparent company” for Australian taxation purposes as a “corporation” meant its members could be subject to the Australia’s CFC and Foreign Investment Funds (FIF) provisions.<sup>45</sup> The application of CFC or the FIF measures to foreign transparent companies results in an exception to the entity tax treatment of corporations, with the entity’s income or losses being allocated for Australian tax purposes to the Australian member. Initially, one might consider that this treatment would therefore eliminate asymmetry as a form of tax transparency applies in both jurisdictions. However, the CFC or FIF provisions do not facilitate any credit for the foreign tax paid directly by a member, for example the United States’ tax directly assessed to an LLC member.<sup>46</sup> Another problem with the CFC and FIF provisions is the allocation of a wider range of income, as the active income test and the allocation of comparably taxed income test cannot be used.<sup>47</sup>

To address these difficulties, the CFC hybrid amendments specify that certain foreign transparent companies are to be taxed as “general partnerships” rather than as “corporations”. This mechanism means that such CFC hybrids will be subject to tax transparency in Australia, which is more aligned with their foreign treatment, but not necessarily identical.<sup>48</sup> Recognised CFC hybrids include a “foreign hybrid limited partnership”<sup>49</sup> and a “foreign hybrid company”<sup>50</sup> which are defined by statute and regulation.<sup>51</sup>

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45 ITAA36 (Cth), s 316: CFCs, and ITAA36 (Cth), s 468 (Part XI): FIF. The CFC and FIF provisions are an integrity measure that try to address taxpayers sheltering income overseas in a foreign legal entity by allocating income to the member even though there has been no distribution.

46 Explanatory Memorandum accompanying Taxation Laws Amendment Bill (No 7) 2003 (Cth), at para 9.10. This was because the CFC and FIF provisions were drafted on the premise that the business entity paid the foreign tax not the member and therefore no credit was provided for member’s own payment of foreign tax. That is, in the foreign jurisdiction, the business form did not pay tax itself and instead tax was levied directly on the members’ allocated income.

47 Explanatory Memorandum accompanying Taxation Laws Amendment Bill (No 7) 2003 (Cth), at para 9.5.

48 Whether the amendments will achieve the elimination of all problems is questionable given that Australian members of the LLC will be treated as having fractional interests in the LLC’s assets, although for United States’ tax purposes this is not the case: Explanatory Memorandum accompanying Taxation Laws Amendment Bill (No 7) 2003 (Cth), at para 9.21: Table; and para 9.46. This inconsistency means that there is the potential for double tax: Explanatory Memorandum accompanying Taxation Laws Amendment Bill (No 7) 2003 (Cth), at para 9.46 to 9.48. This is attempted to be dealt with in s 830-75(1) and (2).

49 ITAA97 (Cth), s 830-10.

50 ITAA97 (Cth), s 830-20.

51 ITAA97 (Cth), s 830-15(2)(b). Broadly these require, apart from other things, that members be subject to tax and not the entity “as a partnership”. Currently included as CFC hybrids are the United States’ LLC and the United Kingdom’s LLP. In respect of the other two transparent companies studied in this article, the S Corporation and LAQC, these do not come within the term “foreign hybrid company”. This is because tax transparency is not provided to these entities “as a partnership” and is instead achieved through special tax rules applying to them to exclude them from normal corporate tax treatment applying in their jurisdictions.

Similar to venture capital ILPs, when the CFC hybrid amendments do apply, then for Australian tax purposes the foreign transparent company calculates its “net income” as a general partnership,<sup>52</sup> with the members including their share of it in their own assessable income.<sup>53</sup> When a net income loss or a capital loss is generated, then the CFC hybrid members must satisfy a restriction rule, known as the “loss exposure amount”.<sup>54</sup> This rule is distinct to those applying to venture capital ILPs.<sup>55</sup> If revenue and capital losses are within this amount then either a deduction is allowable to the limited member or the limited member makes a capital loss.<sup>56</sup> If the loss exposure amount is exceeded then the amount of revenue and or capital losses to be utilised for the year is reduced to the loss exposure amount,<sup>57</sup> and any excess is carried forward until the rule is satisfied in the future.<sup>58</sup>

The “loss exposure amount” is defined to be the addition of amounts or market value of member contributions that at the end of the year have not been repaid or returned, and have been contributed for at least 180 days.<sup>59</sup> From this calculation the following are subtracted: (a) all limited recourse debts owed by the member at the end of the income year to the extent that borrowings were for the purpose of enabling the member to make contributions and are secured by the membership interest in the foreign hybrid;<sup>60</sup> (b) previous years revenue losses claimed by the member; (c) previous years net capital losses claimed by the member; (d) subsequent deductions under outstanding revenue losses<sup>61</sup> or capital loss from previous years.<sup>62</sup>

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52 *ITAA97* (Cth), s 830-20 specifies to treat company as partnership

53 *ITAA36* (Cth), s 90 and 92. Similar to other general partnerships, this net income would not include capital gains as these are determined at the individual member level.

54 In terms of foreign losses, when the CFC hybrids were originally introduced the explanatory memorandum suggested that foreign losses of a CFC hybrid would not be subject to Australian loss restriction rules at all, as at that time a rule applied to restrict foreign losses to foreign income: Explanatory Memorandum accompanying Taxation Laws Amendment Bill (No 7) 2003 (Cth), at para 9.54, referring to *ITAA36* (Cth), s 79D. However, this rule is to be repealed and such foreign losses would be subject to the loss restriction rule: *Tax Law Amendment (2007 Measures No 4) Act 2007* (Cth): Act 143 of 2007: from 1 July 2008 repeals s 79D.

55 *ITAA97* (Cth), s 830-45.

56 *ITAA97* (Cth), s 104-270: CGT event K12.

57 *ITAA97* (Cth), s 830-45(2) and 830-50(3).

58 *ITAA97* (Cth), s 830-65 for outstanding revenue losses and 830-70 for outstanding capital losses.

59 Or intended to remain contributed for at least 180 days. *ITAA97* (Cth), s 830-60: Step One.

60 The term used is “limited recourse debt” and this is defined in *ITAA97* (Cth), s 243-20.

61 *ITAA97* (Cth), s 830-50(2) or (3).

62 *ITAA97* (Cth), s 830-60: Step Two. CGT event K12 *ITAA97* (Cth), s 104-270: foreign hybrid loss exposure adjustment. CGT event K12 refers to carried forward capital losses that previously could not be used because of the loss exposure amount. CGT event K12 occurs when these carried forward losses are subsequently made available in a future income tax year.

## 4. Loss restriction rules

How have foreign jurisdictions with tax transparent tax companies ensured that their tax systems are not distorting investment decisions? To maintain the integrity of their tax systems the jurisdictions studied have implemented a range of loss restriction rules. The United States has a number of overlapping rules. The United Kingdom has more of a targeted but a somewhat ad hoc approach. It is argued that New Zealand currently has the weakest rules for LAQCs, which explains why it introduced rules with its new limited partnership regime.<sup>63</sup>

Within these foreign jurisdictions it is argued that there are four categories of loss restrictions rules, being the membership cost basis, risk rules, passivity and streaming. The first restriction involves the notion that members are able to utilise allocated losses to the extent of the member's equity investment in the transparent company (**membership cost basis**). The next restriction considers the level of a member's risk exposure in terms of their equity investment in the transparent company or in terms of being exposed to movements in value of their membership interest. An additional restriction considers the extent of a member's involvement in the transparent company's business. The final restriction deals with the ability of transparent companies to stream losses to some members in preference to others. Each of these restrictions are now analysed in detail and compared to the Australian rules.

### 4.1 Membership cost basis

The United States and the United Kingdom provides for a membership cost basis restriction for allocated losses.<sup>64</sup> However, the United Kingdom only applies its rule to

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63 The new limited partnership regime would replace New Zealand's "special partnership" which is similar to the limited partnership, although it requires re-registration every seven years. The new limited partnership will provide for a separate legal entity and limited liability for some members who are not active management: Above n 12. The draft legislation introducing the new limited partnership regime was originally released on 7 August 2007: Limited Partnerships Bill 2007. (Referred to as "Limited Partnership Bill 2007 (August)" or "August Bill"). Since then submissions have been received resulting in the release in November 2007 of (a) Inland Revenue (NZ) (Policy Advice Division), *Officials' Report on Parts 5 and 6 of the Limited Partnerships Bill: Tax Aspects*, (Wellington, 2007); and (b) Commerce Committee (House of Representatives), *Limited Partnerships Bill: Government Bill*, (Wellington, 2007) with attached recommended amendments to Limited Partnerships Bill 2007 (referred to as "Limited Partnership Bill 2007 (November)" or "November Bill"). This was finalised by the *Limited Partnerships Act 2008* (assented to 13 March 2008), commencing 1 April 2008.

64 *Internal Revenue Code 1986 (US) (IRC)*, s 1366 and s 704.

Trade LLPs and not Professional LLPs.<sup>65</sup> New Zealand does not have such a restriction for LAQCs whereas it does for its new limited partnerships.<sup>66</sup>

This restriction allows members to utilise allocated losses only to the extent of their membership cost basis. Generally, if allocated losses exceed this amount then excess losses may be carried forward until the membership cost basis increases or the transparent company allocates profit.

To illustrate the application of a membership cost basis rule with the facts presented by *Example 1: Funding Investment*, Cooper would only be entitled to claim \$10,000 in losses and thus save tax of \$4,650. Cooper would carry forward the remaining \$40,000 of allocated losses until an increase in membership cost basis or the transparent company allocates income. Due to this restriction Cooper to-date has only received \$4,650 of the initial \$10,000 investment with no guarantee of further returns. This means that to date Cooper's return has reduced from \$23,250 to \$4,650.

Broadly, the membership cost basis represents the equity a member has invested in the business form and could potentially lose even with the liability protection offered by the transparent company. Measuring this equity contribution can be contentious and there are variations between the jurisdictions studied. Indeed, even within the United States there are discrepancies between S Corporations and LLCs. These discrepancies relate to the treatment of (a) member loans to the transparent company (including unpaid allocations) (**member loans**); (b) member guarantees of the transparent company's obligations; (c) loans to the transparent company from third parties (**outside loans**); and (d) the use of non-recourse or limited recourse financing by the member to fund their equity contribution to the transparent company. Each of these issues is considered below.

#### 4.1.1 Member loans (including unpaid allocations)

Fundamental to determining the membership cost basis is whether a member contribution is considered "equity" or "debt". For Australia tax purposes definitions of equity and debt have been formulated for corporations;<sup>67</sup> which are applied with modification to partnerships and trusts.<sup>68</sup> These definitions are based on economical substance rather than mere legal form.<sup>69</sup> Given that tax transparency reflects economic

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65 *Income and Corporation Taxes Act* (UK), s 117. It is not clear why the United Kingdom distinguishes between Trade and Professional LLPs, although it might be that Professional LLPs by their nature are not perceived as a tax planning vehicle since members are likely to be part of a professional organisation. Also it may be due to uncertainties about the completeness of liability protection offered by the Profession LLP to its members; however such uncertainty would equally apply to Trade LLPs.

66 *ITA 2007* (NZ), new s HG 11 inserted by *Taxation (Limited Partnerships) Act 2008* (NZ). Referred to as a "partner's basis" in the legislation. Above n 12, at 2.

67 *ITAA97* (Cth), s 974-20 defining "debt interest", s 974-75 defining "equity". In the event an instrument is included in both definitions then the tie breaker rule is that it will be regarded as debt: *ITAA97* (Cth), s 974-5(4).

68 *ITAA97* (Cth), s 820-930 applies Div 974 with modifications to partnerships and trusts.

69 *ITAA97* (Cth), s 974-5.

rather than legal substance,<sup>70</sup> this focus is consistent with the notions underpinning tax transparency. For corporations and partnerships, equity has been defined in terms of an interest in the business that is contingent on the economic performance of the business.<sup>71</sup> In comparison, a debt interest has been defined as a financial arrangement<sup>72</sup> involving the receipt of a financial benefit,<sup>73</sup> which has effectively a non-contingent obligation to provide a financial benefit.<sup>74</sup> Accordingly, “contingency” appears to be informative in distinguishing between equity and debt. This definition has the potential to treat a member’s at call loan without a fixed term as an equity interest rather than debt for tax purposes.<sup>75</sup> If pursuant to this Australian tax definition an amount is regarded as “equity” then it appears uncontentious that it should be included in the membership cost basis. However, what if a member contribution is regarded as debt, should this “member loan” also increase the membership cost basis?

In the United States, an LLC member loan automatically increases the membership costs basis,<sup>76</sup> even though this does not occur for an equivalent S Corporation.<sup>77</sup> This inconsistency between the United States’ transparent companies is because an LLC’s transparency is conferred by the application of the general partnership tax provisions in Sub-Chapter K rather than Sub-Chapter S of the *IRC 1986* (US) for S Corporations. However, this discrepancy is largely mitigated as S Corporation members are able to use allocated losses to the extent of their membership cost basis *plus* member loans.<sup>78</sup>

A member loan for the United Kingdom’s LLP does not count towards the membership cost basis.<sup>79</sup> While LAQCs do not have a membership cost basis restriction, the rule for New Zealand’s new limited partnership does not include member loans.<sup>80</sup>

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70 That is, ignoring the legal form and allocating income and or losses to the economic owners of the business activity compared to the legal owner being the business entity itself.

71 *ITAA97* (Cth), s 974-75(1).

72 *ITAA97* (Cth), s 974-130.

73 *ITAA97* (Cth), s 974-30.

74 *ITAA97* (Cth), s 974-135(3): defines this as an obligation not contingent on any event, condition or situation (including economic performance of the entity); other than the ability or willingness of that entity to meet the obligations.

75 *ITAA97* (Cth), s 974-75(4). An “at call loan” is defined as a loan to a business form by a connected entity, the loan does not have a fixed term and either (i) the loan is repayable on demand of the connected entity and repayment required immediately or within a reasonable period; or (ii) loan is repayable on death of connected entity. There are certain exclusion for loans prior to 30 June 2005 or when business’s turnover is less than \$20 million: s 974-75(4) and (6).

76 *IRC 1986* (US), s 752. Section 1.752-1(e) Treasury Regulation.

77 Altieri, MP and WJ Cenker. (2002). Partnerships, LLCs, LLPs and S Corporations, 72(10) *The CPA Journal* 40, at 45.

78 *Ibid.*

79 BIM72625 – Partnerships: loss relief restrictions: LLP members.

80 *ITA 2007* (NZ), new s HG 11 inserted by *Limited Partnerships Act 2008* (NZ).

The loss restriction for Australia's venture capital LLPs refers to "member contributions" without clearly specifying whether these are "equity" or "debt" contributions by the member.<sup>81</sup> However, the Explanatory Memorandum refers to the amount of "capital contributed by the limited partners".<sup>82</sup> Similarly, for CFC hybrids the "loss exposure amount" is defined to include "member contributions"<sup>83</sup> without distinguishing between "equity" and "debt". Again the Explanatory Memorandum appears to indicate that Parliament's intention was that these should be "equity".<sup>84</sup> However, this is not conclusive as later examples in the Explanatory Memorandum specify that certain debt contributions by a member are included in the membership cost basis.<sup>85</sup>

For both Australian transparent companies it would have been preferable if the legislation had used the term "equity" if the intention was only to include members' equity contributions. This is particularly the case as Parliament has been at pains to define debt and equity in Div 974.

A related issue is the treatment of unpaid profit allocations to members,<sup>86</sup> which could be regarded as a member loan, further equity contribution or something else.<sup>87</sup> For S Corporations and LLCs in the United States unpaid profit allocations automatically increase membership cost basis, as they are seen as an amount of retained profits in the business form.<sup>88</sup> This is even though members with unpaid allocations might technically rank equally with unsecured creditors upon winding up.<sup>89</sup> The allocation of the United Kingdom LLP's income to a member will not automatically increase the membership cost basis even if the allocation is unpaid.<sup>90</sup> What is required in the United Kingdom is that the LLP Agreement must specifically provide that an unpaid allocation becomes part of a member's capital contribution.<sup>91</sup> While New Zealand's LAQCs do not have a membership cost basis restriction, the rule

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81 *ITAA36* (Cth), s 92(2AA).

82 Explanatory Memorandum accompanying Venture Capital Bill 2002 Taxation Laws Amendment (Venture Capital) Bill 2002 (Cth), at para 2.15.

83 *ITAA97* (Cth), s 830-60. Note in the circumstance of buying a pre-existing membership interest then the purchase price is taken to be a contribution: s 830-60(2).

84 Explanatory Memorandum accompanying Taxation Laws Amendment Bill (No 7) 2003 (Cth), at para 9.58, refers to members "capital contributions" which are reflected in the various partner's capital accounts of the foreign hybrid.

85 Explanatory Memorandum accompanying Taxation Laws Amendment Bill (No 7) 2003 (Cth), at para 9.59.

86 That is, the transparent company has allocated profit to the members which the member has been assessed on but currently the profit remains within the transparent company

87 For example with a discretionary trust it has been argued that an unpaid present entitlement of a beneficiary is held on separate trust for the beneficiary.

88 Joint Committee on Taxation. (2006). Present Law and Background Relating to Selected Business Tax Issues. Washington DC: Senate Committee on Finance, at 8.

89 *Model Corporation Act* (US), s 6.40(f) and *Revised ULLC Act* (US), s 405(d).

90 Inland Revenue (UK). (2000). Limited Liability Partnerships, *Inland Revenue Tax Bulletin – Issue 50*, at 802: See <http://www.hmrc.gov.uk/bulletins/tb50.htm#2> viewed 20 September 2006.

91 Whittaker, J, and J Machell. (2001). *Limited Liability Partnerships: The new law*. Bristol: Jordans, at 200.

for the new limited partnership automatically includes unpaid profit allocations in the measurement of the cost basis.<sup>92</sup>

For Australia's venture capital ILPs, unpaid allocations to members are not automatically included in the membership cost basis, and would only be included if considered "equity" contribution pursuant to the tax rules distinguishing debt and equity interests as previously discussed. For CFC hybrids, if the foreign entity is a limited partnership, as opposed to an LLC, the Explanatory Memorandum indicates that a member's access to losses will be increased by a member's share of undrawn profits in the foreign hybrid.<sup>93</sup> The Explanatory Memorandum is silent as to whether this would extend to a CFC hybrid that is a company, such as the LLC, although it appears the intention is that it will not.

In the author's view if member loans (including unpaid allocations) are indeed legally debt owing by the transparent company to the member that rank equally with unsecured creditors, then they should not be included in the membership cost basis. If instead a member loan ranks below unsecured creditors then such a loan should increase membership cost basis (referred to as a "member-subordinated loan"). This is because such a member-subordinated loan is at greater risk and is more akin to equity due to the requirement to satisfy unsecured creditors prior to its payment. In determining the ranking of a member loan all of the relevant regulatory provisions would need to be considered, particularly the capital protection rules. It is acknowledged that such ordering could be complicated and would add to tax compliance costs. The idea of including member-subordinated loans in the membership cost basis is supported by the Explanatory Memorandum accompanying the CFC hybrid amendments. The Explanatory Memorandum specifies that other amounts considered to contributed by limited members' includes "subordinated debt" contributed by the member which is not a debt interest issued by the foreign hybrid and which, in the event of liquidation, ranks after claims by all other creditors (both secured and unsecured).<sup>94</sup>

#### **4.1.2 Member guarantees**

Another matter of contention is whether member guarantees of the transparent company's obligations should be included in the membership cost basis. This is an important consideration given that member guarantees can be a common occurrence for closely-held businesses, and cover such things as premises leases, equipment financing and overdraft facilities. Within the jurisdictions studied, only New Zealand's

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92 Unpaid allocations of profit are included through *ITA 2007* (NZ), new s HG 11 (7)(a) inserted by *Limited Partnerships Act 2008* (NZ).

93 Explanatory Memorandum accompanying Taxation Laws Amendment Bill (No 7) 2003 (Cth), at para 9.59.

94 Explanatory Memorandum accompanying Taxation Laws Amendment Bill (No 7) 2003 (Cth), a para 9.59.

new limited partnerships provide for the inclusion of member guarantees for the transparent company's obligations in the membership cost basis.<sup>95</sup>

In the author's opinion the compelling consideration should be whether a member guarantee is regarded as a debt or equity contribution by the member. If it is debt, then consideration should be given to whether it ranks equally or below unsecured creditors on winding-up. If the ranking priority is lower than unsecured creditors, then the relevant obligation should increase membership cost basis. For debt ranking equal to or above unsecured creditors then it should not increase membership cost basis.

This conclusion requires consideration of the legal nature of a guarantee. Indeed, a member's guarantee may be best regarded as neither equity nor debt, and instead is only a "contingent" debt until called upon. If the guarantee is called upon and payment is made, then it is likely that the member would have a right of reimbursement from the transparent company through the rules of subrogation and contribution.<sup>96</sup> These rights as they relate to the transparent company could then be treated at this later date as an equity contribution.<sup>97</sup>

For members of Australia's venture capital ILPs it would appear that member guarantees do not increase the membership cost basis. Similarly, for CFC hybrids the notion of contributions does not appear to extend to member guarantees. This is re-enforced by the Explanatory Memorandum's statement that typical contributions include cash, goods or marketable assets like land and buildings, and does not refer to guarantees.<sup>98</sup> The author argues that if the guarantee is called upon and satisfied by the member, then at this time it may be a subordinated debt owing to the member. At this later time it may then increase their membership cost basis.

### 4.1.3 Outside loans

Given the prior analysis it may seem a foregone conclusion that outside loans borrowed by the transparent company from third parties would not be included in the membership cost basis. Indeed an outside loan represents a debt contribution by an outside party rather than a member, and therefore represents an amount that the outside party has at risk.

Notwithstanding this, curiously members of the United States' LLC can increase their membership cost basis by outside loans.<sup>99</sup> This appears to occur because LLCs are granted transparency through the general partnership tax provisions that cater for a business form where traditionally members would have joint and several liability

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95 *ITA 2007* (NZ), new sHG 11 (12) definition of "secured amounts" inserted by *Limited Partnerships Act 2008* (NZ).

96 Now the reimbursement right is essentially a member loan.

97 However, there could be problems with quantification because of the rules of contribution.

98 Explanatory Memorandum accompanying Taxation Laws Amendment Bill (No 7) 2003 (Cth), at para 9.58.

99 Which are shared among members pursuant to their profit sharing ratios: Treasury Regulation, 1.752-3(a)(3).

for debts.<sup>100</sup> For the other transparent companies studied, S Corporations, the United Kingdom's LLPs and New Zealand's LAQC and new limited partnership, outside loans do not increase the membership cost basis.

Pursuant to the Australian tax legislative definitions of "debt" and "equity" an "outside loan" to the transparent company is a debt of the transparent company and not an equity contribution by a member. This conclusion is not altered by the member providing a personal guarantee as security for the repayment of the outside loan to the transparent company.

For venture capital ILPs, outside loans would not be a "contribution" by a member and therefore not included in the membership cost basis. While the United States' LLC could be a foreign entity treated as a CFC hybrid, it does not appear that the Australian membership cost basis for such an LLC is increased by outside loans. Therefore, an Australian member of an LLC could have different membership cost basis in the United States to that for Australian tax purposes. The author argues that outside loans should not be part of the membership cost basis.

#### **4.1.4 Non-recourse borrowings**

Central to the membership cost basis restriction is that the greater the equity a member has invested in a transparent company, then the greater their ability to utilise allocated losses. This is because such equity is at risk to creditors despite the liability protection provided by the business form. However, what should occur if members increase their equity contribution without necessarily increasing the amount of their financial exposure? Members can achieve this by borrowing on non-recourse or limited recourse terms,<sup>101</sup> and then using these borrowed funds to subscribe for further membership interests in the transparent company. When a member does not meet their obligations to repay a limited recourse loan, then the creditor only has recourse against the secured asset and the member has no further personal liability.<sup>102</sup> Through such mechanisms, the member's other assets are not at risk if default occurs. If the asset used as security for the limited recourse loan is only the subscribed membership interest itself, then the member can increase their equity contribution without actually increasing their overall economic exposure. Limited recourse borrowings of this nature can achieve an economic financial exposure for the member similar to that where the transparent company had raised finance through an outside loan. This is because the member's financial exposure to the outside loan is only as great as their equity contribution.

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100 Although given the business reform in the United States over the last 20 years the entities eligible for general partnership tax treatment has expanded to include such entities as LLCs, LLPs and LLLPs.

101 If member borrowings are on a limited basis, this means that specific property has been pledged as sole security for the loan.

102 Note the courts can look through this in the United States when there has been bad faith: *Nippon Credit Bank Ltd v 1333 North California Boulevard* 86 Cal. App 4<sup>th</sup> 486 (2001).

Members' ability to increase their membership cost basis by such non-recourse or limited recourse borrowings and thereby increase access to allocated losses, is inconsistent with the treatment of outside loans generally, and breaches tax neutrality. Also the use of non-recourse or limited recourse borrowings by members could artificially inflate tax deductions (losses), and thereby lead to the tax system distorting investment decisions.

Both of the United States' transparent companies allow for an increase in the membership cost basis through non-recourse borrowings.<sup>103</sup> The United Kingdom has rules to exclude member contributions that have been financed through non-recourse or limited recourse borrowings by the member.<sup>104</sup> With New Zealand's new limited partnership regime, the membership cost basis could be increased through such limited recourse borrowings by the member to fund their capital contribution.<sup>105</sup> However, New Zealand does have the deferred deduction rules, which require a taxpayer to defer deductions or losses arising from a transaction involving the acquisition of certain intangible property and software which is financed by a majority of limited recourse loans.<sup>106</sup> This deferred deduction rule only has a narrow scope and would not prevent limited recourse loans from increasing the membership cost basis as described.

For Australia's transparent companies there are a number of provisions that consider non-recourse borrowings. Firstly, there are the limited recourse debt provisions which apply to all taxpayers.<sup>107</sup> These provisions include in a taxpayer's assessable income

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103 In the United States such a non-recourse or limited recourse borrowing by a member to contribute equity appears to allow for an increase in membership cost basis, and therefore greater utilisation of losses. However, this is then reversed by the application of another loss restriction rule, the "at risk rule": *IRC 1986* (US), s 465(b)(2).

104 The United Kingdom Government has introduced a number of provisions to deal with the use of non-recourse borrowings. For example from 2 December 2004, a membership cost basis will not include amounts where the member does not bear the financial costs of contributing: *Income and Corporation Taxes Act 1988* (UK), ss 118ZB, 118ZC and 118ZN. *Finance Act 2005* (UK) and the *Partnership (Restrictions on Contributions to a Trade) Regulations*, SI 2005 No 2017. Also excluded from capital contributions in the United Kingdom are liabilities incurred if the financial burden of meeting the liability is or may be borne, assumed or released by someone else.

105 *ITA 2007* (NZ), new s HG 11(5) inserted by *Limited Partnerships Act 2008* (NZ).

106 In 2004, New Zealand also introduced rules to address the use of non-recourse borrowings, although the rules are not restricted to only LAQC members and have broad application: *ITA 2007* (NZ), ss GB 45 to 48. These rules are known as the "deferred deduction rules" and acknowledge that a taxpayer through the use of non-recourse or limited recourse borrowings can limit risk exposure contractually. The New Zealand deferred deduction rules require a taxpayer to defer deductions or losses arising from a transaction involving the acquisition of certain intangible property and software that is financed by a majority of limited recourse loans, when gross income from the arrangement is less than the total deductions or losses. In such circumstances, losses are deferred until income arises from the arrangement, or if no income arises, the deferral will become permanent. Smith A and Dunbar D. (2005). *Tax Avoidance Schemes in New Zealand: Limited Recourse Loans and the Deferred Deduction Rule*. Paper read at 17th Annual Australasian Tax Teachers Association Conference, January 2005, at Victoria University of Wellington, at 13.

107 *ITAA97* (Cth), Div 243.

an amount at the termination of a limited recourse debt<sup>108</sup> arrangement when the capital allowance (depreciation) deductions that have been obtained for expenditure funded by the debt are excessive<sup>109</sup> given the amount of the debt that was repaid. The notion behind this provision appears to be similar to the United Kingdom rules for when borrowings terms are altered from recourse to non-recourse.<sup>110</sup> While these Australian provisions apply to all taxpayers, their application is restricted to the financing of capital allowance deductions (and not other deductions); and only apply at the end of the arrangement.<sup>111</sup> Also, there is ambiguity in their application as to what are “excessive” deductions. Consequently, this rule’s application to members of Australia’s transparent companies is not without doubt.

In addition to this rule, there are some specific measures in the membership cost basis to reduce the impact of limited recourse financing. For venture capital ILPs, the membership cost basis is reduced by limited recourse loans to the member if they are secured by the membership interest in the venture capital ILP.<sup>112</sup> Similarly, the CFC hybrids reduce the membership cost basis by limited recourse debts to the member when used to contribute to the foreign hybrid and the debt is secured by the member’s interest in the foreign hybrid.<sup>113</sup>

These rules thereby exclude such limited recourse loans from funding increases to the membership cost basis, and equate them to the treatment of outside loans. However, these restrictions appear not to prevent a member getting a non-recourse loan, compared with limited recourse loan, to increase their membership cost basis. It is argued that non-recourse loans should also be excluded from increasing membership cost basis for Australia’s transparent companies. *Example 2: Membership Cost basis* provides a comparison of the various membership cost basis rules operating in Australia and the foreign jurisdictions studied.

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108 ITAA97 (Cth), s 243-20 defines “limited recourse debt”. Which is defined to be where the rights of the creditor as against the debtor in the event of default are limited wholly or predominantly to: (a) rights to (i) debt property (being property that is the financed property ie the finance has been used to acquire or create the property : s 243-30(1)/(3); (ii) goods produced ..by means of the debt property; (iii) loss or disposal of debt property or debtor’s interest in a debt property; (b) rights in respect of a mortgage or other security over the debt property; (c) rights that arise out of any arrangement relating to financial obligations of an end user of the financed property towards the debtor. Sections 243-20(2) and (3) expand the definition to limited recourse debt.

109 ITAA97 (Cth), s 243-35 details how to work out if deductions have been excessive.

110 *Income and Corporation Taxes Act 1988* (UK), s 362.

111 This may make recovery hashier and the time value of money.

112 ITAA36 (Cth), s 92(2AA) (b): Step 4 in the method statement. Particularly, the VCLP and AFOF.

113 ITAA97 (Cth), s 830-60(1): Step 2 (a) in the method statement.

***Example 2: Membership cost basis***

Assume the following has occurred:

- Cooper has contributed \$10,000 cash as equity to the transparent company;
- The transparent company has borrowed \$40,000 from a third party (outside loan) for which Cooper has provided a personal guarantee;
- Currently the transparent company has allocated income to Cooper of \$5,000 which has not been paid (unpaid allocation);
- Cooper has borrowed \$3,000 to contribute further equity to the on a limited recourse basis. Only Cooper's membership interest in the transparent company stands as security for the repayment of this limited recourse borrowing.

Cooper's membership cost basis pursuant to the jurisdictions studied is as follows:

Description	Venture capital ILP (Aust)	CFC hybrids (Aust)	S Corp (USA)	LLC (USA)	Trade LLP (UK)	Prof LLP (UK)	LAQC (NZ)	New limited partnership (NZ)
Member equity cash contribution – \$10,000	\$10,000	\$10,000	\$10,000	\$10,000	\$10,000	NA	NA	\$10,000
Outside loan – \$40,000	Nil	Nil	Nil	\$40,000	Nil	NA	NA	Nil
Member guarantee – \$40,000	Nil	Nil	Nil	Nil	Nil	NA	NA	\$40,000
Unpaid allocation – \$5,000	Nil	Potentially#	\$5,000	\$5,000	Nil	NA	NA	\$5,000
Limited recourse borrowings – \$3,000	Nil	Nil	\$3,000	\$3,000	Nil	NA	NA	\$3,000
Total membership cost basis	\$10,000	\$10,000	\$18,000	\$58,000	\$10,000	NA	NA	\$58,000

# If foreign hybrid is an LLP then an unpaid allocation according to the Explanatory Memorandum would increase the membership cost basis.

*Example 2: Membership Cost basis* demonstrates that the Australian loss restriction rules for the venture capital ILP and CFC hybrid amendments are very conservative compared to the foreign jurisdictions studies. The Australian measures are equivalent to the United Kingdom. The differences with the United States relate to the treatment of limited recourse borrowings and unpaid allocations. The Australian rules compare favourably to the New Zealand's measures for its new limited partnerships. This in part can be attributed to the lack of a comprehensive capital gains tax in New Zealand, but it is argued there should be concern about the adequacy of the New Zealand rules. For both the United Kingdom's Professional LLPs and New Zealand's LAQCs, the membership cost basis does not influence members' ability to utilise allocated losses. However, the subsequent application of a jurisdiction's risk rules can alter the overall access to losses.

## 4.2 Risk rules

Further restrictions imposed on the utilisation of losses are rules that consider a member's risk. Within the studied jurisdictions, some times these risk rules are integrated into the membership cost basis rule, or are separate.

In the United States the "at risk rule" is a separate rule that applies in addition to the membership cost basis rule.<sup>114</sup> In the United States a member's at-risk amount equals the sum of the cash or the adjusted basis of non-cash property contributed to the business, plus most recourse borrowings by the business for which the member has personal liability or has secured by property not connected with the business,<sup>115</sup> plus the member's share of amounts borrowed for use in the business that are qualified non-recourse financing,<sup>116</sup> plus the member's share of allocated income items.<sup>117</sup> This calculation is then decreased by actual distributions to the member, the member's share of allocated (and deducted) loss items, and the repayment of loans that had earlier increased the member's at risk amount.<sup>118</sup> Excluded from this calculation are non-recourse recourse borrowings and guarantees provided by members.<sup>119</sup> The application of the United States' at risk rule reverses some of the anomalies detailed previously in the membership cost basis.<sup>120</sup>

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114 *IRC 1986 (US)*, s 465.

115 Most outside loans would be regarded as non-recourse for both S Corporation and LLC members, because third party creditors would not have recourse to the assets held personally by members.

116 *IRC 1986 (US)*, s 465(b)(6). Qualified non-recourse financing is present if the business has non-recourse debt collateralised with real property it uses in its business. This is because real estate non-recourse financing provided by a bank, retirement plan, or similar party or by a Federal, state, or local government generally is deemed to be at risk.

117 *IRC 1986 (US)*, s 465(b)(1) and (2).

118 *IRC 1986 (US)*, s 465.

119 *IRC 1986 (US)*, s 465(b)(4).

120 Such as outside loans increasing an LLC members access to losses and limited recourse borrowings secured over the membership interest.

The United Kingdom's risk rule is argued as being embedded in the second limb of determining a Trade LLP member's "contribution" in terms of the quantum of the member's liability on winding-up of the LLP.<sup>121</sup>

New Zealand's risk rule for LAQCs is different to that used in the United States and the United Kingdom. The New Zealand rule looks at whether the value of the membership interest in a LAQC is exposed to changes due to the LAQC's losses.<sup>122</sup> New Zealand's new limited partnership regime does not include a separate at risk rule, with only the membership cost basis determining a member's potential to utilise allocated losses.<sup>123</sup> However, there is some acknowledgment of financial exposure, as the membership cost basis rule largely only applies to limited members and not general members of the new limited partnership.<sup>124</sup> While, this has slightly been extended to general members when there has been switching in membership status, it still acknowledges that general members have liability exposure.

The notion of risk appears in a number of ways within the Australian rules. For example Australia's legislative approach has been to combine the "risk" notion within the membership cost basis rule, by excluding limited recourse borrowings secured on the membership interest for both venture capital LLPs<sup>125</sup> and foreign hybrids.<sup>126</sup> It is argued that this is more concise drafting compared to the United States with its at risk rule separate to the membership cost basis rule. The Australian rules appear to be similar to that adopted in the United Kingdom, although the United Kingdom does include a member's expanded liability. That is the member's liability for five years from winding-up of the LLP is included.<sup>127</sup> Given Australia's broadening of its bankruptcy rules, such an extended liability period does appear to be reasonable. It is argued such liability after winding up should be taken into account in determining Australia's membership cost basis.<sup>128</sup>

121 *Income and Corporation Taxes Act 1988* (UK), s 118ZC(2). A Trade LLP member's "liability on a winding-up" is defined as the amount the member is liable to contribute to the Trade LLP's assets upon winding-up; and to which the member remains liable for at least five years from the end of the year of loss or until winding up, if earlier: *Income and Corporation Taxes Act 1988* (UK), s 118ZC(4). BIM72625 – Partnerships: loss relief restrictions: LLP members: for losses sustained by non-active members of LLPs and by non-active general partners.

122 *ITA 2007* (NZ), s HA 27. The rule is not satisfied if the LAQC's losses result in a reduction in the value of the membership interests in the LAQC and a member suffers no, or almost no part, of any such reduction. For example, because of any factors, such as the right of a member over any other person to sell any thing or any right of any other person to require the member or other person to sell any thing.

123 *ITA 2007* (NZ), new s HG 11 inserted by *Limited Partnerships Act 2008* (NZ).

124 Dunne, P (Minister of Revenue).(2007). *Limited Partnerships Bill: Commentary on Parts 5 and 6 of the Bill – associated tax changes*, Wellington, at 17 and above n 12, at 39.

125 *ITAA36* (Cth), s 92(2AA).

126 *ITAA97* (Cth), s 830-60(1).

127 *Income and Corporation Taxes Act 1988* (UK), s 118ZC(4). BIM72625 – Partnerships: loss relief restrictions: LLP members: for losses sustained by non-active members of LLPs and by non-active general partners.

128 This could be facilitated through the lodgement of an amended return.

The notion of risk is also integrated with the Australian loss restriction rules only applying to “limited” members<sup>129</sup> rather than general members.<sup>130</sup> This acknowledges the fact that general members do not receive liability protection through the venture capital ILP or CFC hybrid structure itself.<sup>131</sup> This tax treatment of venture capital ILPs and CFC hybrids appears to be a more consistent implementation of policy compared to what occurs for general members of other limited partnerships in Australia. This is because since 1992 limited partnerships in Australia have been excluded from transparent tax treatment and are taxed in a similar manner to corporations, even though general members do not have liability protection afforded by the business structure.<sup>132</sup>

However, should the loss limitation rules apply to all members of Australia’s transparent companies, regardless of whether their status is as a limited or general member? It needs to be acknowledged that the business structure is not the only means for members to reduce or limit their liability exposure. In the pursuit of tax neutrality if a consistent policy is going to be applied, losses should be restricted to the amount of equity that members really have at risk regardless of their status as limited or general member. Also an application to all members could prevent manipulation, with members changing status between “limited” and “general” at times when loss may be generated.

The notion of risk is also present in providing for exempt capital gains of venture capital ILPs in the eligible venture capital investments. To be an “eligible venture capital investment”<sup>133</sup> the investment must be held at risk,<sup>134</sup> through the acquisition of shares in a non-listed Australian resident corporation.<sup>135</sup> An investment will be held “at risk” if the entity owning the investment has no arrangement as to either the maintenance of the value of the membership interest; or the maintenance of any earnings. In comparison to the risk notion used for revenue losses, this rule looks more to whether the value of membership interest is affected by the investments made. This assessment of risk is similar to the rule used in New Zealand in relation to LAQC membership interests.

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129 ITAA97 (Cth), s 995-1 definition of “limited partner” means a member of a limited partnership whose liability is limited.

130 ITAA36 (Cth), s 92(2AA). Note ITAA97 (Cth), s 995-1 defines a “general partner” as a member of a limited partnership whose liability is not limited. ITAA97 (Cth), s 830-45: CFC hybrids.

131 Explanatory Memorandum accompanying Taxation Laws Amendment Bill (No 7) 2003 (Cth), at para 9.53 states that “this is consistent with the policy principle of limiting deductions for losses to amounts to which a partner is exposed.”

132 ITAA36 (Cth), Div 5A.

133 Subdivision 118-F ITAA97: see Howe, B and Howell B. (2004). Amendments of the Venture Capital Regime, 8(1) *The Tax Specialist* 23, at 24.

134 Defined in ITAA97 (Cth), s 118-430.

135 Or options to acquire shares. Note in some circumstances investments in a holding corporation can be eligible. ITAA97, ss 118-425 and 118-435.

*Example 3: Risk Rules* builds on the scenario developed in *Example 2: Membership Cost basis* to consider the application of the risk rules. This example demonstrates that after considering the “risk rules” there is greater consistency between Australia, United States and the United Kingdom. New Zealand’s new limited partnership regime still has the greatest access to losses and may signal that the New Zealand rules are inadequate. Also, the mechanism of the New Zealand’s risk rule for LAQCs is hard to quantify and may be part of the reason why there has been consideration of repealing the LAQC regime from time to time.<sup>136</sup>

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136 Above n 12 for the most recent consideration.

**Example 3: Risk rules**

Refer to the facts for Example 2: Membership Cost basis now also applying the jurisdictions' risk rules. Cooper's risk amount would be as follows:

Description	Venture ILP (Aust)	CFC Hybrid (Aust)	S Corp (USA)	LLC (USA)	Trade LLP (UK)	Prof LLP (UK)	LAQC (NZ)	New limited partner- ship (NZ)
Member cash contribution – \$10,000	\$10,000	\$10,000	\$10,000	\$10,000	\$10,000	NA	NA	\$10,000
Outside loan – \$40,000	Nil	Nil	Nil	Nil	Nil	NA	NA	Nil
Member guarantee – \$40,000	Nil	Nil	Nil	Nil	Nil	NA	NA	\$40,000
Unpaid allocation – \$5,000	Nil	Potentially	\$5,000	\$5,000	Nil	NA	NA	\$5,000
Limited recourse borrowings – \$3,000	Nil	Nil	Nil	Nil	Nil	NA	NA	\$3,000
At risk amount	\$10,000	\$10,000	\$15,000	\$15,000	\$10,000	NA	NA	\$58,000

### 4.3 Passivity

In determining the utilisation of losses, some of the jurisdictions studied distinguish between whether a member is active in the transparent company's business. If a member is not active in the business, then the losses can be regarded as "passive" and may only offset other passive income of the member. While these passivity rules do not eliminate the losses allocated, they restrict what income the losses can offset. The quarantining of losses in this manner may prevent a member from the timely utilisation of losses if there is not sufficient passive income.

The United States applies passive loss rules to most taxpayers, including both S Corporation and LLC members.<sup>137</sup> These passivity rules are considered in addition to the membership cost basis and the at risk rule.<sup>138</sup> In the United Kingdom from 10 February 2004 if a Trade LLP member is regarded as non-active in the first four years of operation,<sup>139</sup> then only amounts actually contributed on a winding-up count towards the second cap in determining the utilisation of losses.<sup>140</sup> Accordingly, the United Kingdom uses passivity to restrict the "quantum" of losses to be utilised, whereas the United States use passivity to "quarantine" passive losses.

New Zealand does not impose any broad rules that distinguish between active and passive losses flowing through a LAQC to members, although, if an allocated loss is in

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- 137 The passive activity loss rules apply to individuals, a corporation in which five or fewer individuals own more than 50 percent of the membership interest or to corporations or a corporation engaged in rendering certain professional services and in which the employees of the corporation own more than 10 percent of the membership interest: *IRC 1986* (US), s 469(a)(2).
- 138 For losses allocated from a transparent company to be regarded as active in the United States, the member must have a material participation in the business on a regular, continual and substantial basis. There are a number of tests to determine whether the member has material participation, including a need to participate in the activity for more than 500 hours during the taxable year (being approximately 10 hours per week for a 50 week working year): Section 1.469-5T(a) Treasury Regulations.
- 139 *Income and Corporation Taxes Act* (UK), s 118ZE(3). The restriction applies to loss sustained in the tax year in which the member first carries on the trade and in any of the next three years. The *Partnerships (Restrictions on Contributions to a Trade) Regulations 2005* (SI 2005:20 7) came into force on 22 July 2005. The non-active member restrictions apply to members of LLPs, and do so in priority to *Income and Corporation Taxes Act 1988* (UK), section 117 where both sets of restrictions would otherwise apply to the same loss (or interest). BIM72640 – Partnerships: loss relief restrictions: non-active partners.
- 140 BIM72640 – Partnerships: loss relief restrictions: non-active partners. Pinfeld, L., ed. (2005). *Tolley's Tax Planning 2005-06*. Vol. 1. London: LexisNexis Butterworths, at 1351: "Capital withdrawn" is widely defined (*Income and Corporation Taxes Act 1988* (UK), s 118ZG(4)) to include capital which the taxpayer receives back during a five-year period following the time when the "contribution to the trade" test is applied (*Income and Corporation Taxes Act 1988* (UK), s 118ZG(1)) and also includes any amount he is or may be entitled to draw out at any time. No amount drawn out on which income tax is payable will fall to be treated as withdrawn capital (*Income and Corporation Taxes Act 1988* (UK), s 118ZG(5)).

respect of CFCs or FIF losses, it can only be offset against income of a similar nature.<sup>141</sup> Previously there was a rule for special partnerships, which required forfeiture of tax losses if in the same year there was no New Zealand income.<sup>142</sup> The absence of any broad passivity rule is unlikely to alter with the introduction of the new limited partnership regime in New Zealand.

Australia has no restriction on the use of domestic passive losses against other income. Indeed, a popular passive loss in Australia is the negative gearing of rental properties, which have been widely used by individual taxpayers to decrease their tax payable on other income. For example, the quantum of the Australian rental losses for individuals in 2005 was \$4,101 million.<sup>143</sup> Curiously, while passive losses are freely available in Australia there is the potential for active business losses conducted by an individual<sup>144</sup> to be quarantined if one of the commerciality tests in Div 35 ITAA97 (Cth) is not satisfied.<sup>145</sup> These rules are directed at operations that are technically businesses, but the Government does not consider them of a commercial scale to warrant the use of the business losses against other income of the taxpayer.

This Australian preference for passivity appears to be reiterated with the venture capital ILPs at first consideration, as the vast majority of losses are allocated to limited members, who by the nature of a limited partnership will be passive.<sup>146</sup> For general members of the venture capital ILP they would likely be active in the venture capital ILP; but their allocated losses are only one percent pursuant to industry practice.<sup>147</sup>

141 *ITA 2007* (NZ), s HA 24. Committee of Experts on Tax Compliance. (1998) *Tax Compliance*, Wellington, Report to the Treasurer and the Minister of Revenue, Chapter 6 – Tax Mitigation, Avoidance and Evasion, at 26.

142 *ITA 2004* (NZ), s IE 1 (2B).

143 Australian Tax Office. (2007). *Taxation Statistics 2004-05: A summary of income tax returns for the 2004-05 income year and other reported tax information for the 2005-06 financial year*, Australian Tax Office, Canberra, at 13.

144 Either in the individual's own name or as a member of a general partnership.

145 *ITAA97* (Cth), Div 35.

146 As they are excluded from participation in the business activity of the venture capital ILP to retain their liability shield. Of course a feature of the new venture capital ILPs are the broader safe harbour provisions that are provided for to allow the limited member some participation in the management without losing liability protection: *Partnership Act 1892* (NSW), ss 66A and 67A; *Partnership Act 1958* (Vic), ss 97 and 98; *Partnership Act 1891* (Qld), ss 86 and 87; *Partnership Act 1963* (ACT), ss 67 and 68; *Partnership Act 1891* (SA), ss 64A and 65A; and *Partnership Act 1997* (NT), ss 65 and 66. Of course if the limited member is resident of a foreign jurisdiction with a passivity test, such as the United States, the member would have to comply with the foreign jurisdiction's passivity tests.

147 If the venture capital ILP's investment in the venture capital corporation fails and a loss is generated, then pursuant to standard agreements the general member is entitled to one percent of the loss, with the limited members entitled to the remaining 99 percent. Accordingly, general and limited members' share of losses is normally in proportion to their equity investments, whereas general members will have greater share for successful investments, profit, compared to their equity contribution. Due to this dichotomy between equity investment and entitlement to profit, the general member's equity in the venture capital industry is referred to as the "carried interest", as the general members are effectively "carried" by the limited members. See: Above n 23, at 226.

However, it is argued that there is an indirect restriction on passive losses generated through the venture capital provisions. This is because any losses generated within the venture capital corporation (that is the corporation in which the venture capital ILP has invested) are trapped within that corporation and are not allocated to its members (which include the venture capital ILP).<sup>148</sup> The quantum of losses generated by the venture capital corporation may be much higher than at the venture capital ILP level. The venture capital corporation is the entity conducting an active business and is taxed as a separate legal entity with no transparency compared to the venture capital ILP that facilitates equity investments.<sup>149</sup> It is argued that the practical operation of the venture capital tax provisions in this way places a restriction on active losses compared to passive losses. Stewart has noted that the most valuable tax losses generated in an eligible venture capital corporation are trapped inside it and do not reach the venture capital ILP at all.<sup>150</sup> Also for a corporation to have the status of being an “venture capital corporation” it can only have minor passive activities, as certain passive or finance activities, such as property development, rental, banking, leasing; and securitisation cannot be 25 percent or greater of its business.<sup>151</sup>

Unlike the venture capital ILPs, the CFC hybrid amendments do not implicitly contain any passivity tests in terms of losses allocated to members. For example, while the loss restriction rules only apply to limited members, some of the foreign entities included as CFC hybrids, such as LLCs and LLPs, limited members can be actively involved in the business without impinging their liability protection.<sup>152</sup>

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148 This treatment has not been altered with the extension of eligible investments to include unit trusts, as losses would be trapped within this forms as well. *Venture Capital Act 2002* (Cth), and *ITAA97* (Cth), s 118-427. Operative from 1 July 2007.

149 There is likely to be losses generated within the eligible venture capital corporation due to the level of risk in venture capital operations. For example an eligible venture capital corporation is likely to be in losses for several years at the early stage of its operations. The revenue losses could comprise of deductible expenditures on salaries, trading stock and depreciations. See: Above n 23, at 226.

150 Above n 23, at 226.

151 *ITAA97* (Cth), s 118-425 (2): 75 percent or more of the corporation's business cannot “ineligible” activities. To satisfy this the corporation must meet at least two of these requirements: (a) more than 75 percent of the company's assets (determined by value) must be used primarily in activities that are not ineligible activities mentioned in subs (13); or (b) more than 75 percent of the company's employees must be engaged primarily in activities that are not ineligible activities mentioned in subs (13); or (c) more than 75 percent of the company's total assessable income, exempt income and non-assessable non-exempt income must come from activities that are not ineligible activities mentioned in subs (13). *ITAA97*, ss 118425(13): Ineligible activities include (a) property development, land ownership, (b) finance activities of banking, providing capital to others, leasing; factoring and securitisation, (c) insurance, (d) construction or infrastructure facilities, (e) investments that derive income in the nature of interest, rents, dividends, royalties or lease payments.

152 For example LLCs: Section 201 *Uniform LLC Act* and United Kingdom's LLP: Section 1(4) *LLP Act 2000* (UK).

**Example 4: Passivity Rules**

Refer to the assumptions given in Example 2: Membership Cost basis with the following additional scenarios:

- (a) Cooper is actively engaged in the business for approximately 30 hours per week (active member); and
- (b) Cooper has little involvement in the business for approximately one hour per week (passive member).

Description	Venture capital ILPs (Aust)	CFC Hybrids (Aust)	S Corps (USA)	LLC (USA)	Trade LLP (UK)	Prof LLP (UK)	LAQC (NZ)	New limited partnership (NZ)
Active member	NA – but could adversely affect liability protection	NA	Available#	Available#	Available#	NA	NA	NA – but could adversely affect liability protection
Passive member	NA	NA	Quarantined*	Quarantined*	Could affect amount counted towards winding up	NA	NA	NA

Key: # subject to membership cost basis and risk rule.

\* subject to membership cost basis and at risk rule and quarantined for offset against passive income only.

*Example 4: Passivity Rules* demonstrates how the passivity test can impose additional restrictions on losses allocated through the studied jurisdictions. Australia and New Zealand did not use members' activity to determine the ability to use allocated losses, whereas in the United States and the United Kingdom a member's involvement may influence the utilisation of losses.

#### 4.4 Streaming

Another integrity measure that has been introduced in connection with transparent companies are rules dealing with the ability to stream losses to some members in preference to others. In any year a member's ability to utilise allocated losses (or other tax preferences) may vary due to their specific tax profile. For example a transparent company with losses may have two members, Cooper and Jodi. Cooper will have no other income for three years, whereas Jodi will have substantial other income. In these circumstances there will be a greater tax benefit if the losses for the first three years are allocated only to Jodi who can immediately utilise them.<sup>153</sup> In comparison, Cooper would have to wait three years to utilise any allocated losses. The allocation of losses (or income) according to a member's tax profile is referred to as "streaming".<sup>154</sup> Streaming may be seen as infringing the integrity of a tax system because it facilitates the exploitation of losses and tax preferences. An alternative view is that streaming enables the most effective utilisation of resources between members.

In the jurisdictions studied there are a number of mechanisms to restrict the streaming of losses from transparent companies. These include the initial eligibility requirements for transparency and special allocation rules.

The eligibility requirements for the S Corporation and the LAQC to have only one class of membership interest is one way streaming can be addressed.<sup>155</sup> This is because all membership interest in these transparent companies must carry the same entitlement to losses according to the number of days the members hold their membership interest. However, the author argues that the requirement for one class of membership interest does not entirely eliminate the potential for streaming. Streaming could occur by issuing more membership interests to members best able to utilise losses. For this strategy to be effective the membership interests would have to be issued at the beginning of the loss year, and not part way through or at the end of the year when it becomes apparent that a tax loss will be generated.<sup>156</sup> Additionally,

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153 Of course this depends upon Jodi being able to satisfy any loss restriction rules that might operate in the relevant jurisdiction.

154 There are a number of factors that could affect a member's ability to utilise allocated losses, such as their membership cost basis, their at risk amount, whether the member is active or passive in the business, and whether the member is a tax resident or not. For further examples of streaming see: Inland Revenue (NZ) (Policy Advice Division). (2007) *Officials' Report on Parts 5 and 6 of the Limited Partnerships Bill: Tax Aspects*, Wellington, at 6.

155 United States: *IRC 1986* (US), s 1361. New Zealand: *ITA 2007* (NZ), s HA 10.

156 This is because a member's allocation is calculated on a per day basis of the year.

the payment of reasonable wages and other deductible expenses to members could be used to manipulate the overall allocation of losses.<sup>157</sup>

In contrast to S Corporations and LAQCs, the LLC does not require the same class of membership interest for transparency to apply. All that is required is for the LLC to meet the requirements for a Check-the-Box election.<sup>158</sup> For LLCs in the United States, while their Operating Agreement<sup>159</sup> can allow for special allocations<sup>160</sup> of income, deductions, losses or tax credits to different members,<sup>161</sup> for them to be recognised for United States' tax purposes they must satisfy the "substantial economic rule".<sup>162</sup> This is a two-part test requiring the allocation to both have "economic effect", and be "substantial". Essentially this rule requires that there be economic impact associated with the allocation. The United Kingdom's LLP have some ability to stream losses. The default rule is that LLP members share equally in the capital and profits of the LLP,<sup>163</sup> however, this does not automatically means this occurs for tax purposes.<sup>164</sup>

The New Zealand Government appears to be eager to restrict the ability of streaming with the new limited partnerships.<sup>165</sup> This is illustrated by the rule that income, expenditure, losses and other items will be allocated to members in the same proportion determined by the member's share in the partnership income.<sup>166</sup>

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157 For example, if one member were paid wages or lease payments by the transparent company, this would effectively allocate more profit to this member, resulting in less profit in the transparent company to be allocated amongst members.

158 Since 1997, an LLC can simply "Check-the-Box" for transparent tax treatment. Technically by default a multi-member LLC would be classified as a general partnership: Section 301.7701-2(c)(1) and (2) Treasury Regulations.

159 *IRC 1986* (US), s 704(a).

160 For example special allocations could allow for capital gains or depreciation deductions to be allocated disproportionately to one member whose tax profile results in a more effective utilisation of them: Friedman, HM. (2004). *The Silent LLC Revolution – The Social Cost of Academic Neglect*. *Creighton Law Review* 38(1), available at <http://ssrn.com/abstract=613022>, at 23.

161 There are regulations to restrict "shifting tax consequence rule" for foreign members: Treasury Regulation, s 1.704-1(b)(2)(iii)(b).

162 *IRC 1986* (US), s 704. The "substantial economic effect" is elaborately defined in the regulations promulgated: Treasury Regulation, s 1.704-1. If an allocation lacks substantial economic effect then it is modified to conform to the economic arrangement. Yin, GK, and DJ Shakow. (1999). *Taxation of Private Business Enterprises*. In *Federal Income Tax Project*. Philadelphia: The American Law Institute, at 80: The regulations interpret "substantial economic effect" as encompassing two requirements: the allocation must have "economic effect" and must pass a "substantiality" test.

163 *LLP Act 2000* (UK), s 15(c) and *LLP Regulations 2001* (UK), regulation 7.

164 Legal opinion of Robin Potts QC in Appendix 3 of Institute of Chartered Accountants in England and Wales. (2005). *Technical Release: TECH 56/05: Accounting by Limited Liability Partnerships*: Institute of Chartered Accountants in England and Wales.

165 Above n 124, at 2.

166 *ITA 2007* (NZ), new s HG 2(2) inserted by *Limited Partnerships Act 2008* (NZ). The Inland Revenue (NZ) reported that it should be made clear that the rule applies to "losses", which now appears in the November Bill: Above n 154, at 10.

Also, the 60-day rule as part of the membership cost basis rule prevents members artificially inflating their cost basis temporary at year end and then quickly reducing it in the following year.<sup>167</sup>

The Australian government has implemented a number of rules to try to restrict the preferred allocation of income and or capital to taxpayers by business entities. For example there are provisions restricting corporations from the streaming of income and capital,<sup>168</sup> or dividends.<sup>169</sup> A similar intention appears to underlie the denial of imputation credits to members who do not have sufficient economic interest in the entity,<sup>170</sup> or where imputation benefits are streamed to certain members ahead of others.<sup>171</sup> The imputation benchmark rules also try to achieve this,<sup>172</sup> as does the dividend-stripping rule.<sup>173</sup> The ability of a general partnership to manipulate profit distributions, and particularly the creation of losses due to notional member salaries has been ruled against by the Australian Tax Office.<sup>174</sup>

However, in terms of the venture capital ILPs there does not appear to be any prohibition per se on streaming of amounts to different members. Indeed it is the venture capital industry practice to stream net losses and income to different member types. For example it is common practice for the general member to only contribute one percent of the equity into the limited partnership, but be entitled to 20 percent of the profit, with the limited members receiving the remaining 80 percent.<sup>175</sup> Whereas, if the venture capital ILP's generates a loss, then pursuant to the agreement the loss is allocated more in line with equity contributions.<sup>176</sup>

In terms of the CFC hybrids there appears to be some ability for streaming since the provisions indicate that the allocations are primarily made pursuant to the business form's constitution.<sup>177</sup> However, the streaming of precise items of income and or deductions to individual members is not possible as each member needs to calculate

167 *ITA 2007 (NZ)*, new s HG 11(9) inserted by *Limited Partnerships Act 2008 (NZ)*. Refer to the prior discussion about the membership cost basis rule.

168 *ITAA36 (Cth)*, ss 45A, 45B and 45C.

169 *ITAA36 (Cth)*, s 177EA.

170 *ITAA36 (Cth)*, s 177EA.

171 Division 209 *ITAA97 (Cth)*.

172 *ITAA97 (Cth)*, s 203-15.

173 *ITAA97 (Cth)*, s 207-145. For a discussion of other examples see: Above n 7, at 192-193.

174 Commissioner of Taxation. (2005). Tax Ruling TR 2005/7, Canberra.

175 Above n 23, at 226.

176 *Ibid.* General member is entitled to one percent of the loss, with the limited members entitled to the remaining 99 percent.

177 *ITAA97 (Cth)*, s 830-30. For a hybrid company, the interest of a member in its net income or loss is equal to the percentage of the company's profit distributed at the end of the year in accordance with its constitution (or if none as dividends) what the member could reasonably expect to receive. A member's interest in a hybrid companies assets is equal to the percent that the member could reasonably be expected to receive of the total distribution on the winding up of the company at the end of the income year. *ITAA97 (Cth)*, s 830-35. This is supported by the example provided in the Explanatory Memorandum accompanying Taxation Laws Amendment Bill (No 7) 2003 (Cth), at para 9.43, example 9.1.

their overall percentage of profits for the year and then apply this to the net income.<sup>178</sup> This is similar to the rules applying to New Zealand's new limited partnerships.<sup>179</sup>

Also, CFC hybrids have the 180-day component of the "loss exposure amount" which prevents short year-end increases in the membership cost basis to access losses.<sup>180</sup> Again, this rule is similar to the 60-day rule adopted for New Zealand's new limited partnership.<sup>181</sup>

Prior to providing overall conclusions about adequacy of the Australian loss restriction rules, restrictions on capital losses will also be briefly considered.

## 5. Capital losses

It is important to consider the treatment of capital losses, as opposed to revenue losses, and the adequacy of restrictions on their utilisation. The author is unaware of the foreign jurisdictions imposing additional or special rules for capital losses through their transparent companies.<sup>182</sup> In the United States capital losses would be subject to the same rules outlined for revenue losses. For the United Kingdom, losses of a capital nature would occur at the member level of the LLP due to the fractional interest approach applying to capital assets held by general partnerships there. Due to the absence of a comprehensive capital gains tax in New Zealand, there is no separate consideration of capital losses there.

In Australia, one initial broad restriction on capital losses is their quarantining, with capital losses only able to offset capital gains and not revenue gains.<sup>183</sup> For venture capital ILPs the loss restriction rule in s 92(2AA) does not apply to capital losses. However, this does not mean there is unfettered access to capital losses. Indeed, the restriction is absolute, because if a capital loss occurs then it is totally disregarded for Australian tax purposes.<sup>184</sup> Consequently, members of a venture capital ILP cannot use capital losses to offset other capital gains that they may have.<sup>185</sup> The severity of this restriction is counter-balanced, as limited members may be entitled to totally disregard capital gains made through the venture capital ILP.<sup>186</sup>

The CFC hybrid loss restriction rule is a holistic rule applying to both revenue and capital losses.<sup>187</sup> In the event of members exceeding their loss exposure amount when

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178 *ITAA97* (Cth), s 830-30.

179 *ITA 2007* (NZ), new s HG 2(2) inserted by *Limited Partnerships Act 2008* (NZ).

180 *ITAA97* (Cth), s 830-60: Step One. The "loss exposure amount" requires that member contributions have been contributed for at least 180 days or are intended to remain contributed for at least 180 days.

181 *ITA 2007* (NZ), new s HG 11(9) inserted by *Limited Partnerships Act 2008* (NZ).

182 However, the capital losses would be quarantined from other revenue receipts.

183 *ITAA97* (Cth), s 100-50 and 102-10(2).

184 Note any losses whether capital or revenue in nature is also disregarded: Sub-division 118-F *ITAA97* (Cth) and s 26-68.

185 *ITAA97* (Cth), ss 118-405 VCLPs, 118-410 AFOFs and 118-415 for foreign investors.

186 VCLP or AFOF. *ITAA97* (Cth), sub-division 118-F.

187 *ITAA97* (Cth), s 830-45.

they have both revenue and capital losses, then members must choose how much of reduction applies to revenue and/or capital loss amounts.<sup>188</sup>

## 6. Adequacy of Australia's loss restriction rules

Through this article's analysis it has been demonstrated that Australia's loss restriction rules applying to the venture capital ILP and CFC hybrids share similar characteristics to that of the foreign jurisdictions studied. Indeed, *Example 2: Membership Cost basis* to *Example 4: Passivity Rules* demonstrate that the Australian rules appear to provide conservative access to losses, equalling the United Kingdom's rules for Trade LLPs. However, it is argued that this does not necessarily mean that the Australian rules are perfect.

Overall, it is unfortunate that one universal loss restriction rule was not implemented in Australia to cover both venture capital ILPs and CFC hybrids. The reason for a separate rule may be attributable to the desire to provide discrete concessional tax rules for the venture capital industry.<sup>189</sup> Nevertheless, the author argues that this could have been achieved with the referral to a universal loss restriction rule.

In terms of Australia's transparent companies, it is argued that the rules applying to CFC hybrids appear more thorough. The CFC hybrid rules apply a sophisticated rule with application to both revenue and capital losses, and combines within one measure membership cost basis, risk and streaming principles. This is more coherent than some foreign jurisdictions, particularly the United States, which has an array of discrete separate rules applying.

However, a number of amendments should be considered for the CFC hybrid loss rules. Firstly, with regard to the membership cost basis there should be legislative clarification about what member "contributions" are included in the membership cost basis, and whether it extends beyond equity contributions to member loans. It is suggested that both equity and member-subordinated loans should be included in the membership cost basis, as both of these contributions are at greater risk than the unsecured creditors of the entity. Members' loans that rank equally or above unsecured creditors should not be included in the calculation. The current exclusion of member guarantees should continue, with only being potentially included once the guarantee is later called upon and fulfilled.

Given that the CFC hybrid rules apply to foreign entities which may allow for the inclusion of outside loans in membership cost basis,<sup>190</sup> it should be specified that outside loans to the transparent company do not increase the membership cost basis for Australian tax purposes.<sup>191</sup>

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188 ITAA97 (Cth), s 830-45(2).

189 The venture capital ILP rules probably only apply to revenue losses, as the government's desire to provide concessional tax treatment to capital gains realised by venture capital investors.

190 Particularly LLCs.

191 Especially relevant for the CFC hybrids as they apply to United States' LLC that under the United States tax rules can include such outside loans in the membership cost basis.

In terms of the risk component of the CFC hybrid rules, in addition to excluding limited recourse loans secured over the membership interest, the exclusion should be extended to non-recourse loans that are used to increase a membership cost basis. It is suggested that the loss restriction rule should apply to all members, not just limited members, thus excluding the potential of members having short-term change of status to access losses. Also consideration should be given to allowing for adjustments if the member is liable for further contributions on the winding-up of the entity, for example, under the bankruptcy laws.<sup>192</sup>

With respect to passivity, Australia appears to have more restriction on “activity” compared to “passivity”.<sup>193</sup> It is not apparent why there is this dichotomy, and it is argued that if one is going to allow passive investors transparency there does not appear to be any reason why this should not be extended to active business participants.

In terms of streaming, this only becomes an issue when there is differential treatment between different receipts and outgoings. In the author’s opinion streaming rules may be superfluous in the presence of an adequate membership cost basis rule that takes into account a member’s economic risk.<sup>194</sup> Rules that try to restrict streaming may add undue complexity to the tax system compared to the revenue at risk, which in any case is more of a timing issue. Furthermore, an added benefit of streaming is that it could assist closely-held businesses in addressing their financing problem by reducing members’ overall tax liability.

While the CFC hybrid loss restriction rule applies to revenue and capital losses, the calculation of the capital loss can be complicated due to the fractional nature of member’s interest in CGT assets. It is argued that a preferable approach could be to have a partial “entity” approach with the entity having its own cost basis and capital proceeds, and then allocating this net capital gain to members. This would be a similar approach to what occurs for trusts in Australia. The complexity of the fractional approach for CGT assets held through a general partnership form is illustrated by subdiv 830-D that provides for setting tax costs for the CFC hybrids.

Consequently, it is considered that the Australian loss restriction rules for the CFC hybrids with minor changes are adequate to ensure that the allocation of losses to members themselves should not distort investment decisions.<sup>195</sup> Due to this, it is argued that the loss restriction rules applying to the CFC hybrids with suggested modifications would be adequate to allow for the broad availability of tax transparency in Australia. Thus providing for tax transparency beyond Australians investing into certain foreign transparent companies or for venture capital investment.<sup>196</sup>

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192 This later liability may allow for adjustments to be made for prior years.

193 For example, the non-transparency given to venture capital corporations.

194 While streaming may enable the timelier utilisation of losses, these will be restricted to the membership cost basis.

195 It should be acknowledged that the implication of the venture capital tax provisions overall are to encourage greater venture capital investment. That is, distort investment.

196 Indeed, the Australian government must have considered the loss restriction rules to be adequate as an integrity measure to protect the Australian revenue from residents investing in foreign transparent companies. However, it is acknowledged that the rule does not apply to all foreign

The presence of an adequate loss restriction rule should alleviate concerns about the risk to tax revenue due to tax transparent companies.

If there was to be a broadly available transparent company, this then elicits the question about what type of transparent company would be preferable. It is argued that there are two models of transparent companies studied. The first model is when the tax transparent company was created by introducing a special tax rules to an existing business form, the corporation, referred to as “special tax rule company”. The second model is when the transparent company represents the creation of an entirely new business form that is subjected to existing general partnerships tax rules, referred to as “new form transparent company”. The S Corporation and the LAQC fall within the special tax rule company model, since both of these entities are essentially corporations for which the respective governments have introduced tax transparency for closely held corporations. In comparison, LLCs and LLPs are examples of new form transparent companies, as a whole new business form was created subject to the existing tax rules for general partnerships. Therefore, there may be different advantages and disadvantages between these two models. This analysis of which model of transparent company would be beneficial to Australia will be the focus of forthcoming research by the author.

## 7. Conclusion

This article has sought to consider whether the loss restriction rules applying to venture capital ILPs and CFC hybrids compare favourably to the foreign jurisdictions studied. This was considered an important analysis, as prior statements within Australia have expressed concerns about the effect transparent companies could have on the integrity of the tax system. While these statements are not without foundation, it is argued that a critical consideration is whether there are adequate restrictions placed on allocated losses to reflect the limited liability provided to members. That is, provided there is the potential for “*losses to be lost*” with tax transparency then a country’s tax system should not unduly distort investments decisions.

To determine the adequacy of the rules applying to Australia’s transparent companies, the loss restriction rules applying to the venture capital ILPs and CFC hybrids were compared and contrasted to those applying in the United States, the United Kingdom and New Zealand. This analysis provided the observation that Australia’s rules appear very conservative and comparable to the selected jurisdictions. Indeed, the CFC hybrids appear the most complete, applying to both revenue and capital losses. Through the analysis a number of recommendations were made to improve the application of the rules in terms of membership cost basis, risk rule, passivity and streaming. It was argued that the CFC hybrid loss restrictions rules would be adequate to allow for the broad introduction of tax transparency in Australia beyond its current limited application. However, this raises the ancillary question of “which transparency model would be best?” This is a question for another day.

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transparent companies, and just those specified in the legislation or included via regulation. Thus, this “vetting” mechanism adds another layer of protection.

**Appendix: Australian venture capital regime**

