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The General Manager
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Dear Sir

**Consultation paper – Tightening the non-commercial loan rules in Division 7A of the *Income Tax Assessment Act 1936***

The Taxation Institute of Australia (**Taxation Institute**) is pleased to provide its comments on the Consultation Paper titled *Improving fairness and integrity in the tax system – Tightening the non-commercial loan rules in Division 7A of the Income Tax Assessment Act 1936* (**Consultation Paper**), which was released for public comment on 5 June 2009.

Generally, the Taxation Institute supports the proposed amendments and recognises the need to address integrity issues. However, the Taxation Institute has some concerns regarding:

- the date of application;
- unintended consequences that may arise; and
- increased legislative complexity and compliance costs.

The Taxation Institute's comments and recommendations are outlined in detail below.

## 1 Use of company assets – Item 1

The Taxation Institute understands the need for the integrity measure outlined at Item 1 of the Consultation Paper and welcomes the proposed carve-out for minor and infrequent use of company assets. However, the Taxation Institute has concerns about the proposed measure.

### *1.1 Date of application*

The Treasurer's press release states that it is intended that the proposed amendments apply from 1 July 2009. The Taxation Institute considers that the amendments should only apply to assets acquired after 1 July 2009 and, preferably, only to assets acquired after the date of Royal Assent to the amending legislation. Applying the rules to the use of assets acquired before Royal Assent effectively introduces retrospective legislation. Further, it will impose costs on taxpayers where arrangements had been entered into at a time and in a manner which did not attract the operation of the provisions or the associated costs.

Taxpayers will not always be able to transfer assets back to individuals or to pay the fair market rent for a number of reasons, including:

- Shareholders do not always have the funds available to acquire the assets.

- Assets cannot simply be transferred for nominal consideration as that would attract the operation of the capital gains tax (**CGT**) market value substitution rule and Division 7A.
- If the asset is real property, the transfer would be subject to stamp duty.
- Determining an arm's length rental (if the asset is to be allowed to remain in the name of the company) is not as simple as is often assumed, especially in relation to primary production land.

If contrary to the recommendation above, the provisions are to apply to all assets held as at the date of commencement, the Taxation Institute considers that concessions should be made available to those taxpayers who need to rearrange their affairs so as not to attract the operation of Division 7A. In particular, CGT rollover and an exception from the application of Division 7A should be made available to taxpayers who need to transfer assets out of private companies in order to comply with the new rules.

### *1.2 Proposed exclusion – otherwise deductible rule*

The Taxation Institute considers that Division 7A should not be applied to benefits provided to shareholders if any hypothetical cost to a shareholder of a benefit provided by a private company would be otherwise deductible to that shareholder or their associate. This exclusion could be structured in a similar manner to the fringe benefits tax (**FBT**) "otherwise deductible rule". However, there is no justification for excluding shareholders' associates from its operation in the same way as employees' associates are excluded under the FBT rules.

### *1.3 Proposed exclusion – real estate*

The Taxation Institute considers that a general exemption from Division 7A should be available where the relevant asset is an interest in real property. Such an exemption is justified for the following reasons:

- Without such an exemption, unintended outcomes may arise (refer example 1 below).
- Where a main residence is held by a company rather than an individual, the CGT main residence exemption is not available. As a result, capital gains on the property may end up being distributed as a taxable dividend and taxed at the individual shareholders' marginal tax rates.
- Where an appreciating asset is held by a company, the CGT discount is not available. As a result, capital gains on the asset will be taxed at the shareholders' marginal tax rates upon eventual distribution instead of at a maximum effective rate of 23.25%.
- The "otherwise deductible rule" would be simplified if real estate were exempt.
- In many situations involving real estate held by private companies, the real estate is a pre-CGT asset. As a result, the use of the property would not be taxable and gains on disposal of the property may be distributed tax free on liquidation of the company.

*Example 1*

A farming property is owned by a company, but the farming operations are carried on by a partnership of individuals who are shareholders or associates of shareholders in that private company. This is quite a common structure and either nominal or no rent is generally paid.

The proposed amendments require rent to be charged and paid at market rates. If the farming operation were operating at a loss, this rent would only increase the operation's losses and result in taxable profits being made by the company. This would compound cash flow problems in times of low prices or drought when loss making enterprises would be required to fund tax payments.

### *1.4 Compliance issues*

> *Example 2*
>
> On 1 July 2009, Mr A incorporated a company and capitalised it with $200,000 of share capital. Once the company received the capital, it used $50,000 to buy a car and $150,000 to invest in other business assets and working capital. The car is used by the shareholder, Mr A. As at 1 July 2009 it can be seen that the purchase of the car was funded by the shareholder's own money. During the year ended 30 June 2010, the company made a $100,000 profit.
>
> Although the purchase of the car was initially funded by the shareholder's own funds, the proposed amendments appear to require Mr A to pay a market value rental for the use of the car because the company made a profit and would thereby have a distributable surplus by 30 June 2010.

Example 2 demonstrates the practical difficulties to be faced where assets are used over several years when further profits are made even though the asset may have been purchased using the shareholder's own personal funds. Conceptually, the Taxation Institute considers that it should not make any difference if the purchase of the car was funded by a loan from the shareholder to the company instead of paid up share capital.

Taxpayers in the SME market (typically the target of Division 7A) generally have unsophisticated record keeping systems. Even if a sophisticated accounting system was used, companies would not generally have the records to be able to demonstrate or trace how share capital or loan capital was applied. In the Taxation Institute's opinion, the application of a test equivalent to that in section 45B in an attempt to address such asset-use issues would be inappropriate and raise significant compliance difficulties for taxpayers.

## 2 Multiple trust structures – Item 3.2

The Taxation Institute's comments under this heading are in relation to the proposed amendment described in Item 3.2 of the Consultation Paper.

### *2.1 Date of application*

This new integrity rule is intended to apply from 1 July 2009. However, because taxpayers have no certainty about how the rules are to be applied, the Taxation Institute recommends that the new integrity rule should only be applied to present entitlements which come into existence after the date of Royal Assent of the amending legislation.

### *2.2 Certainty*

SME taxpayer groups commonly channel trust distributions through a single trust in order to simplify recordkeeping and beneficiaries' entitlements. A feature of this arrangement which can readily be seen is the centralisation of beneficiaries' entitlements into a single entity rather than having multiple loan accounts spread across several entities. That centralised trust then typically distributes to beneficiaries, including companies. Example 3, illustrates some issues which may arise in these circumstances.

> *Example 3*
>
> Trust A, Trust B, Trust C and Trust D are discretionary trusts. Each year, their profit is distributed to Trust E which, in turn, distributes to individuals and a related corporate beneficiary. In this arrangement, individual beneficiaries' loan accounts are only with Trust E instead of in the four other trusts. If Trust A happened to make a payment or loan to a shareholder of the corporate beneficiary or their associate, that payment or loan would appear to be caught by the proposed amendments when there has not necessarily been a tax avoidance purpose involved.

Further, if Trust A were to make a loan to Trust C, because Trust C would be an associate of a shareholder in the corporate beneficiary, that loan would potentially be subject to the proposed amendments even though value has not left the group. Further, assume that both Trust B and Trust D made payments for loans to shareholders or associates of the corporate beneficiary. The allocation of Division 7A deemed dividends between the recipients of those loans in this situation (especially if the total of the loans exceeded the company's present entitlement or distributable surplus) will need to be carefully considered when the amending legislation is drafted.

SME groups often comprise multiple trusts. Money is shifted via trust distributions and loans between layers of trusts for working capital and other funding reasons (eg the business or investment profits of one trust are used to subsidise the funding shortfall of a cash poor or loss making business or investments of another trust in the same family group).

The proposal in the Consultation Paper does not take into account such genuine financial needs within groups of trusts and will have the unintended consequence of denying funding within a group of trusts (including trusts that have made inter-connected family trust and interposed entity elections). In the current economic climate where external funding is extremely difficult to raise, and given that SME groups do not have the same access as large corporates to external capital raisings, nothing should be done which creates an obstacle to internal funding within SME groups comprising multiple trusts. Such trusts should be freely able to assist in the funding of each other. Accordingly, the Taxation Institute considers that the proposed amendments should include an exemption where funding remains within a group of trusts.

*Example 4*

Business Trust is a discretionary trust which carries on a business. Each year, Business Trust's profits are distributed to Investment Trust, another discretionary trust which holds a number of investments and derives income from them. Investment Trust distributes some of its profit to a corporate beneficiary and the rest to individuals.

In the Taxation Institute's opinion, it would be inappropriate to apply Division 7A to 100% of any loan made by Business Trust to a shareholder or their associate as it could not be said that Business Trust's profits (which funded that loan) were the ones distributed to the corporate beneficiary because of the mixing of those profits with Investment Trust's other income.

Whilst the Taxation Institute acknowledges that the drafting of provisions to attack the mischief which is the target of the proposed amendments will be difficult, it must be done in a way which will not inadvertently catch "innocent" transactions and which provides certainty to taxpayers rather than relying on the Commissioner forming a particular opinion or exercising a discretion. This is because a majority of taxpayers who need to deal with Division 7A are in the SME market and need certainty about their taxation affairs as they do not have the time or resources to seek rulings from the Commissioner each time a transaction is entered.

### *2.3 Proposed exclusion*

The Taxation Institute recommends that Treasury consider including a carve-out from the proposed provisions where there is no choice about distributions available to the entity which makes the payment or loan to the private company shareholder (refer example 5). Specifically, the Taxation Institute recommends that a carve-out be introduced in respect of payments or loans made by entities which are not discretionary trusts.\

*Example 5*

Business Unit Trust is a unit trust which is owned by two arm's length families and is obliged, by its trust deed, to distribute all of its profit each year to its unitholders. Each family's ownership is held

by a family discretionary trust. If the Business Unit Trust were to make a payment or loan to one of the family members and that family's discretionary trust were to make a distribution to a corporate beneficiary, that payment or loan by Business Unit Trust would fall within the scope of the proposed amendments. However, the management of the Business Unit Trust will not necessarily know whether the unitholders would have made distributions to corporate beneficiaries, nor the amount of those distributions and outstanding present entitlements, and so compliance with the provisions will be made difficult in this context.

**3 Revaluation arrangement – Item 3.3**

If a revaluation as described in Item 3.3 of the Consultation Paper been made, and an amount borrowed from an external financier and paid out to a beneficiary (representing a distribution of this revaluation increment), Division 7A would only apply to that payment to the extent of the private company's unpaid present entitlements in the trust. Subsequent repayments of the bank debt would not be taxed as dividends pursuant to Division 7A.

The proposed amendment, therefore, seeks to penalise taxpayers who choose to retain value in their own entity rather than extract that value funded by external borrowings. Accordingly, the Taxation Institute does not support this proposed amendment.

**4 Distributable surplus calculation – Item 3.9**

The Taxation Institute considers that this proposed amendment needs to include a carve-out for asset transfers from a company to a spouse upon marital break up. If a company has no retained earnings, but has unrealised gains on an asset, the transfer of that asset out to a former spouse will attract the operation of Division 7A to the extent of that unrealised gain. Although technically capable of being franked, the company would not have franking credits in this situation as tax would only be paid by the company on its disposal in the subsequent financial year.

**5 Interaction with other provisions**

If the valuation rules proposed for Division 7A are to be equivalent to those applicable under the FBT rules yet not precisely matched, there should be some consideration given to whether the FBT legislation or Division 7A legislation should prevail in the event of an inconsistency. For example, the FBT legislation provides for a concessional calculation of the taxable value of certain fringe benefits (eg car fringe benefits). If Division 7A were to prevail over the FBT values, taxpayers could find themselves in receipt of a deemed dividend pursuant to Division 7A even though the application of the FBT valuation rule would not result in any FBT being payable.

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If you require any further information or assistance in respect of our submission, please contact the Taxation Institute's Senior Tax Counsel, Dr Michael Dirkis, on 02 8223 0011.

Yours sincerely

Joan Roberts