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1 February 2010

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Dear Sir

Exposure draft legislation
Tax Laws Amendment (2010 Measures No. 1) Bill 2010: Division 7A

The Taxation Institute of Australia (**Taxation Institute**) is pleased to provide its comments on the exposure draft *Tax Laws Amendment (2010 Measures No. 1) Bill: Division 7A* (the **exposure draft**) and the draft explanatory memorandum (**EM**) which were released for public comment on 4 January 2010.

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

- Multiple taxation of benefits not actually provided;
- Uncertainty caused by excessive reliance on the formation of opinions by the Commissioner of Taxation (**Commissioner**);
- The commencement and application of the proposed legislation;
- Fairness and equity concerns arising from the different taxation valuation methodologies applied to shareholders compared to employees; and
- Potential denial of entitlement to the Small Business and General Business Tax Break.

1 Use of company assets – proposed paragraph 109C(3)(d)

The Taxation Institute notes that proposed paragraph 109C(3)(d) includes in the definition of *payment* for the purposes of Division 7A “a grant of a lease, or a licence or other right to use an asset, to [an] entity (other than a transfer of property to the entity)”.

1.1 “Right to use” v actual use

This proposed paragraph refers specifically to a company “granting” such a right, which suggests some express grant of a lease, licence or other right would be required. This language is inconsistent with examples in the exposure draft. Further, those examples are also inconsistent in their application of the proposed new paragraph.

Other difficulties with the wording of the proposed paragraph arise in the typical case of “lifestyle” assets where arrangements concerning their use are typically informal and not reduced to writing.

In such a situation it would be unusual for a company to resolve to allow for a shareholder or their associate to use an asset and, accordingly, the use of such an asset of the company may be “involuntary” on the part of the company. As drafted, proposed paragraph 109C(3)(d) implies that a company must resolve to grant the lease, licence or right to use the asset.

Paragraph 109C(3)(d) specifically refers to a grant of a right to use an asset. Example 1.1 of the exposure draft EM refers to the relevant private company “allowing” Ben to use an asset of the company every second weekend. The wording of the provision and the EM example indicate an express agreement for the use of an asset will be treated as a payment.

Examples 1.2 and 1.3 of the EM, however, do not refer to any such express arrangement. In example 1.2, Peter “takes one of these company cars home for private use”. In example 1.3, John “used once” a trailer owned by a company “to move furniture and household items”. The indication in these examples is that a shareholder who makes use of company owned assets has received a payment without any express agreement with the company.

This gives rise to a fundamental issue in the drafting and application of proposed paragraph 109C(3)(d). If a private company shareholder is taken to have received a payment when they are granted a right to use a company asset, even if they do not actually use the asset in that time (example 1.2), there may be an argument that the shareholder has a “right to use” that asset at any time – not just for the period during which the shareholder actually takes the asset home (example 1.2) or makes a “one-off use” (example 1.3).

It is conceivable the Commissioner may take the view that the “implied” ability of a shareholder to make use of company assets for their own use causes a payment to the shareholder on the basis the asset is “available to” them (example 1.2) at all times – notwithstanding that arm’s length consideration is paid for any actual use by the shareholder.

This approach may be particularly tempting if a private company holds an asset which is used on occasion by shareholders, even though an appropriate arm’s length price is paid for that use, where the company does not use the asset in carrying on a business for the remainder of the time.

Presumably, if John in example 1.3 could use a trailer at the time that he desired to, “to move furniture and other household items”, there may be an argument that he had a “right to use”, whether implied or not, at any time (especially for those periods the trailers are not actually used by third parties). On that basis there would be a payment to John in respect of the use of the trailer – and therefore of every trailer owned by his company if there are more than one – every day of the year. This would have a catastrophic result for most private companies holding assets that can or could potentially be used by shareholders.

There are many circumstances where for liability, confidentiality, succession and other reasons assets are held in a corporate entity – often funded by the shareholders from their own (after tax) resources. Such assets may appreciate in value within the company and on a sale any gain would be taxable without the benefit of the CGT discount. Whilst the asset is not used in a business, any actual use is paid for by shareholders at an arm’s length rate. In such circumstances, there is no mischief; however, despite paying an arm’s length price for use of the asset, those shareholders would be deemed by paragraph 109C(3)(d) to have received a payment (and therefore a deemed dividend) for the entire year due to the “availability” of the asset. This creates an untenable result, particularly for taxpayers who have held assets in such structures for many years consistent with the law and the Commissioner’s published policy.

This result may be open on the literal wording of paragraph 109C(3)(d), but it is submitted is inconsistent with the policy intent of the provision as expressed in the EM.

It is submitted that the simple wording of proposed paragraph 109C(3)(d) is not sufficiently clear to provide any certainty to taxpayers as to how the provision will apply in practice.

Further difficulties potentially apply if the exposure draft does not address assets held by a company which are not actually “available to” a shareholder, but for which the company might be taken impliedly or otherwise to have granted a right to use. The following examples illustrate this point.

Example 1

Following on from example 1.2 in the EM, Peter as a shareholder (in particular, for example, the sole shareholder of the private company) is potentially able to use any one of a fleet of company cars. The fleet is located in various cities around Australia and New Zealand. If Peter were held to have a right to use any of those cars, then he might be taken to have received a payment of the right to use every one of those vehicles, notwithstanding that he would be physically unable to do so.

Example 2

PropertyCo Pty Ltd owns a property in Sydney and has a distributable surplus. This property was formerly rented out to third parties, but because of bad rental experience is now no longer rented out. The property is used by PropertyCo’s shareholders when in Sydney on business and is vacant when not used for business.

If proposed paragraph 109C(3)(d) were to be legislated in its current form, PropertyCo Pty Ltd’s shareholders could be deemed to have received a payment from PropertyCo on the basis that the property was potentially available to be used by them privately when not used for business accommodation.

Again, in situations such as the above, private company shareholders could be taxable upon the value of deemed payments to them even though they were either incapable of using the assets concerned or otherwise simply received no actual private benefit from them at all. The Taxation Institute understands that the policy behind proposed paragraph 109C(3)(d) is to tax private company shareholders on their private use of company assets. Accordingly, the proposed provision is inconsistent with this policy as it is capable of taxing them on the mere availability of an asset rather than its actual use.

1.2 Capacity

The Taxation Institute notes that existing section 109ZB(3) gives the Fringe Benefits Tax provisions primary taxing power over “payments” made to shareholders who are also employees. The Taxation Institute also notes the proposed “otherwise deductible” rule contained in proposed subsection 109C(3C).

The Taxation Institute would like to point out that it is common for owners of SME businesses not to draw a salary or wage in order to minimise numerous on-costs and compliance requirements. Instead, they rely on increased dividends or other profit distributions from the business. In such a situation it is therefore unclear whether the business owner who has the use of, for example, a company car would be in receipt of that benefit in their director/employee capacity or in their shareholder capacity.

As a result, the exposure draft in its current form doubles the uncertainty about the application of the tax law to such an arrangement in that one must consider whether the business owner is an employee (and hence their benefit is subject to tax under the FBT regime) or whether they receive the benefit in their capacity as shareholder (with the result that the value of their benefit is taxed under Division 7A). This uncertainty is compounded because of the lack of symmetry between the persons subject to the applicable tax: FBT being imposed on the employer and taxation under Division 7A on the shareholder or shareholder’s associate.

Miscellaneous Tax Ruling MT2016 includes at paragraph 7 a list of benefits accepted by the Commissioner as being provided otherwise than in respect of employment and consequently outside the scope of FBT. The Taxation Institute is concerned that such benefits may now be brought within the scope of Div 7A, especially the provision of accommodation and meals to children of a farming family.

1.3 Multiple taxation

There will be many circumstances where a private company is taken to have made a payment by way of a grant of a lease, licence or right to use an asset, to more than one entity.

> *Example 3*
>
> Drawing on example 1.2 of the EM, Peter uses a company car on weekends. If Peter's wife is also a shareholder in the company (or a shareholder's associate), the right to use the car may be taken to be a payment to both shareholders.

This example illustrates that the current wording of proposed paragraph 109C(3)(d) – relying as it does on the "grant" rather than actual "use" – may produce unintended consequences.

This tax liability is exaggerated for a private company with multiple shareholders, each of whom is taken to have a right to use the same asset, as illustrated in the following example.

> *Example 4*
>
> Five shareholders invest in a boat charter business, putting their own funds into a company to purchase a yacht.
>
> If each shareholder, by agreement or otherwise, was considered to have a right to use that yacht when it is not being chartered, each shareholder would presumably be taken to have received a payment equal to the total value of the days that the yacht was not chartered to third parties.
>
> Accordingly, even if none of those shareholders actually used the yacht (or were to pay arm's length consideration to the company for the actual use of it), each of the shareholders may be liable to tax on a deemed dividend consisting of a deemed payment of the availability (or use) of the yacht.

Such a result would clearly be inappropriate. As a result, proposed paragraph 109C(3D) should contain a specific anti-overlap provision to ensure that only one entity is treated as having received a payment in respect of the use of any one asset or, at a minimum, that any deemed dividend is to be shared between them on an objective, fair and equitable basis.

1.4 Valuation rules

The Taxation Institute is concerned that private company shareholders and employees would be subject to tax at different rates or on different amounts if the same or similar benefits were provided to them. A benefit most commonly provided in a business context is the use of a motor vehicle. It is well understood that an employee's use of a motor vehicle is subject to tax under the FBT regime, with its particular valuation and calculation methodologies.

In contrast, a private company shareholder's use of a car is not subject to any such rules other than the "otherwise deductible" rule contained in proposed subsection 109C(3C). Although the operation of this otherwise deductible rule would not result in the shareholder being taxable on the business use proportion of the benefit they received, it does not allow the shareholder to be subject to tax on an equivalent basis to an employee whose private use of a company car may be taxed under the FBT statutory formula method.

Inconsistencies also arise in respect of other benefits eligible for exemption or reduction of their FBT taxable value such as portable computers, mobile phones, PDAs and other work-related items that would not be covered by the otherwise deductible exception in proposed subsection 109C(3C).

In such situations it can therefore be seen that private use of company assets by shareholders and employees would be taxable on different bases. The Taxation Institute therefore questions the fairness and equity of such a result.

A potential solution would be for the FBT taxable value calculation rules to be used as the basis for determining the amount of a deemed dividend arising because of proposed paragraph 109C(3)(d).

The Taxation Institute also notes the de minimus exemption provided in proposed subsection 109C(3B). As with FBT, this provision raises the practical problem of valuing benefits provided to private company shareholders where, for example, the use permitted is of an unusual asset; for example, the storage of personal papers in a safe in the company office.

1.5 Farmhouse exemption

The Taxation Institute notes the exception contained in proposed subsection 109C(3D), where a licence or other right to use a dwelling is granted in certain circumstances. The Taxation Institute understands that the policy behind this provision is intended to exempt from the provisions a residence on a farming property or in a hotel, but the Taxation Institute has concerns about the way in which this proposed exception would apply to common forms of business structure employed in the farming industry. Our concerns are illustrated by the following examples.

Example 5

FarmCo 1 Pty Ltd is a private company which operates a 100 hectare farm and on which the farming operations are undertaken. Mr and Mrs Farmer, who own FarmCo 1 Pty Ltd, live in the farmhouse on the property. Pursuant to Miscellaneous Tax Ruling MT2016, their occupation of the farmhouse has not been subject to FBT on the basis that that occupation was a result of their ownership position in FarmCo 1 Pty Ltd rather than their employment with the company.

Applying the provisions of subsection 109C(3D), neither Mr nor Mrs Farmer carry on a business in their own right as the farming operation is carried out by FarmCo 1 Pty Ltd. Accordingly, even if the area of the farmhouse is less than 10% of the area of the land, Mr and Mrs Farmer will be deemed to have received a payment consisting of the grant of a lease of, or of a licence or other right to use, the farmhouse which is property of the private company, FarmCo 1 Pty Ltd. Consequently, Mr and Mrs Farmer would be taxable on the deemed value of the use of that farmhouse.

The proposed exception in subsection 109C(3D) also does not protect from Division 7A taxation the use of a farmhouse where the farming activities are carried on by a family trust associated with the shareholders of a private company which owns the farming land. This is a very common business structure employed by farmers and allowing the exposure draft legislation to proceed to finalisation in its current form would unduly penalise members of the farming community who have arranged their business affairs in this manner.

Further, the proposed exception does not adequately protect shareholders residing in premises co-located with a hotel and owned by a private company as featured in the Assistant Treasurer's Media Release No. 51 of 14 September 2009.

The otherwise deductible rule can also produce unexpected results, as illustrated below.

Example 6

FarmCo 2 Pty Ltd operates a small 10 hectare farm four hours drive out of Melbourne. The farm is managed on a part time basis by FarmCo 2's shareholder, Joe, who works in Melbourne Monday to Friday. Joe travels to the farm on weekends in order to tend to the various necessary activities there. Joe derives assessable income from his work on the farm.

Joe would be entitled to apply the otherwise deductible rule contained in proposed subsection 109C(3C) as his use of the farmhouse would be involved in the pursuit of Joe's assessable income. This result is in contrast to that arising in Example 5 above.

The Taxation Institute considers that such contradictory outcomes between full time and part time farmers cannot be justified on any policy grounds and would clearly be inappropriate.

The Taxation Institute is also concerned that the strict 10% test applied in proposed subsection 109C(3D) will unduly disadvantage some small businesses as it may be too low; for example, a small motel (less than ten units) owned by a private company where the company's shareholders live in one of the units.

In order to address this potential result, consideration should be given to amending the provision to exclude premises co-located with the business property or which would be considered "adjacent" to the business property (akin to the requirements of section 118-20 for CGT main residence exemption).

2 Commencement and application provisions

2.1 Previously unannounced measures

The Taxation Institute notes that the draft legislation includes a measure that was not previously announced.

The original material released for consultation reported that the definition of *distributable surplus* was to be amended to include the amount of any deemed dividend arising from "payments". However, it mentioned nothing about deemed dividends that arose in respect of forgiven debts. The debt forgiveness rules are a separate set of provisions in Division 7A and the original announcements made absolutely no reference to these in the comments explaining why the changes to the definition of distributable surplus were necessary. Those explanatory comments related only to "payments".

Accordingly, the Taxation Institute considers that the amendment to the definition of distributable surplus contained in section 109Y (as far as it relates to forgiven debts) should not apply from 1 July 2009, but only in respect of debts forgiven on or after 1 July 2010 or, at a minimum, from the date of release of the exposure draft.

2.2 Uncertainty – time of "grant"

The exposure draft's application provisions simply state that the amendments apply in relation to payments made on or after 1 July 2009.

When read in conjunction with proposed paragraph 109C(3)(d), this means that leases, licences or other rights to use assets which were "granted" on or after 1 July 2009 will be subject to the new provisions.

The Taxation Institute is concerned that the application of these provisions is unclear because the provisions as worded assume that a single point in time can readily be identified when such a lease, licence or other right was granted.

In most private company arrangements, a high level of informality exists in which such arrangements for the use of company assets are not documented nor recorded. Accordingly, shareholders who may have been regularly using company assets for many years would have no certainty about whether they would be regarded as being granted a series of rights to use company assets from time to time or, alternatively, once at the start of the arrangement. In other words, it will be unclear whether there is a single grant or a series of grants.

Because of this uncertainty, the Taxation Institute considers that the legislation should only apply to assets acquired on or after 1 July 2009.

Alternatively, the legislation needs to clearly specify when a lease, licence or other right would be treated as having been granted for the purposes of proposed new paragraph 109C(3)(d). Any such transitional rules would also need to address the consequences if a pre-existing arrangement were to be formalised and documented after the exposure draft legislation has been passed into law.

2.3 Uncertainty – pre-existing arrangements

The Taxation Institute also notes that the Commissioner of Taxation has issued numerous rulings on the interpretation of Division 7A to the effect that no deemed dividend would arise for shareholders of a private company where the mere use of company assets was previously permitted. On the basis of the existing and well established law and the Commissioner's clearly stated views, many taxpayers have made use of company assets and have acquired assets, including "leisure" assets for which no deductions are claimed, in company structures. This has been particularly the case for liability protection purposes, succession planning and similar reasons.

Typically, in accordance with the Commissioner's published views, those shareholders meet all costs associated with the use of the asset or pay arm's length consideration for any actual use. If the asset appreciates in value, the company owner will not be entitled to any CGT discount in respect of the gain on sale of the asset, which would become a dividend to the shareholders upon distribution by the company. This is an appropriate result and is a structure that has been adopted by many taxpayers.

No opportunity has been afforded to those companies to change those arrangements without additional tax consequences and there is no protection offered to existing structures, particularly where transferring assets out would be costly because of, for example, stamp duties.

Accordingly, the Taxation Institute considers that the above underscores the practicality of grandfathering assets held by private companies prior to 1 July 2009.

Further, the proposals contained in the exposure draft were announced by the Government in the May 2009 budget and the exposure draft was only released for comment on 4 January 2010, although it is stated to apply to leases, licences and other rights to use granted on or after 1 July 2009. Taxpayers have not been, and are still not, in a position to know the state of the law and, in particular, how to determine whether the announcement had application and how it would apply to them. The Taxation Institute considers that it would be good policy for the commencement date of the Bill to be deferred to 1 July 2010.

3 Extension to non-resident companies – proposed section 109BC

3.1 Double taxation

The Taxation Institute notes that proposed section 109BC is intended to extend the operation of Division 7A to companies which are not Australian residents.

The Taxation Institute is concerned that such foreign companies that are controlled by Australian residents already have their income potentially subject to attribution under either the controlled foreign company (**CFC**) regime or the foreign investment funds (**FIF**) regime (until the proposed repeal of the FIF regime).

Accordingly, such a foreign company's distributable surplus as calculated under section 109Y is capable of including a profit, or part of a profit, that has already been subject to attribution under either of the above sets of provisions. If that foreign company were to make a loan to an Australian resident shareholder, the loan is potentially subject to taxation twice: first when the profit was originally attributed and, second, when the loan is actually made out of that profit to the shareholder.

The Taxation Institute considers that proposed section 109BC should be amended to exclude payments, loans and debt forgiveness arising out of profits that have been attributed under the CFC and/or FIF provisions. Alternatively, the distributable surplus calculations set out in section 109Y should be amended to carve out any such previously attributed amounts.

4 Effect on entitlement to Small Business and General Business Tax Break

The Taxation Institute is concerned that the proposed amendments to Division 7A may disqualify taxpayers from entitlement to the Small Business and General Business Tax Break (the **investment allowance**).

The issue of whether a company would be entitled to deductions in respect of an asset held by that company and used by a shareholder or their associate also needs to be addressed.

Generally, a company can only claim a tax deduction for losses and outgoings incurred in respect of an asset if that asset is used in an income-producing activity. If an asset is used by a shareholder and that use results in a deemed Division 7A dividend, it is open to doubt whether the income-producing use of the asset can be demonstrated.

If a private company were to acquire an asset such as a car principally for the purpose of providing it to an employee in the course of operating the company's business, there would appear little doubt that the investment allowance would be available in respect of it. Private use of the vehicle by the employee would not affect the deductibility of the costs in the hands of the company because – from the company's perspective – the car was acquired primarily and principally as a means of providing remuneration for an employee of the company. Private use of the car would, of course, be dealt with in the context of the FBT rules.

If the person was instead a shareholder or an associate of a shareholder who was engaged in the company's business but did not draw a salary or wage, a deemed dividend under Division 7A would follow from the use of that asset as that use would not be dealt with under the FBT rules. One must therefore question whether the motor vehicle was acquired primarily and principally as remuneration for an employee of the company or otherwise for the principal purpose of carrying on the company's business if the legislation deems the provision of the car to be a dividend paid to the shareholder or associate. This is because the provision of benefits or other like things to shareholders by a company is generally considered to be an affair of capital and unlikely to produce allowable deductions for the company.

Following on from the above, if a car provided to a shareholder were financed under a hire purchase arrangement, it is open to doubt whether the company would be entitled to claim an interest deduction for the finance component of its hire purchase repayments if the use of the car constituted a deemed dividend paid by the company to the shareholder.

Since SME companies and their shareholders have already made their decisions to acquire assets prior to the release of the exposure draft (since the investment allowance only applies to assets acquired before 31 December 2009), the Taxation Institute considers that denying a company a tax deduction for interest or the investment allowance in such circumstances would be unfair and go beyond what would otherwise be an acceptable use of retrospective legislation.

The Taxation Institute does not consider such an outcome to be in accordance with the policy intent of the proposed amendments. Accordingly, the Taxation Institute recommends that entitlement to the investment allowance be clarified as a matter of the highest priority.

5 Repayment rule – proposed subsection 109R(2)

The Taxation Institute acknowledges and respects the "anti avoidance" nature of proposed subsection 109R(2). Even so, the Taxation Institute is concerned that it is common for shareholders and associates to borrow funds from a private company on a regular basis each year and for loan repayments to occur by way of a dividend distribution to the shareholder which is then set off against the amounts drawn.[1] Because of the informal nature of most SME arrangements, with company owners regularly accessing company funds for their personal use, it is often difficult to trace the use of borrowed funds each time they are drawn out.

Inevitably, some part of the borrowings that arise each year would be mixed with the personal funds of the shareholder that may be used either in whole or in part to fund a repayment of a Division 7A loan previously drawn. Consequently, shareholders and their associates may inadvertently trigger section 109R and have their repayments disregarded.

The Taxation Institute considers that if subsequent borrowings were mixed with other funds of the shareholder and were inadvertently used to make a Division 7A loan repayment, then section 109R should not apply.

The Taxation Institute is also concerned that the "reasonable person" test contained in proposed subparagraph 109R(2)(b)(ii) may not be sufficient to protect private company shareholders and their associates from unwarranted application of Division 7A where all that has been done is a continuation of prior practice whereby shareholders would occasionally access company funds and also make repayments on or of the amounts they previously borrowed from the company.

6 Error in EM example

The Taxation Institute is concerned that example 1.10 in paragraph 1.47 of the EM contains an error.

In particular, the example is based on a trust revaluing an asset and making the distribution of that revaluation increment to Lucas. The example reads: "When Lucas receives the payment from Trust A he immediately enters into a commercial loan agreement with the trust for $4.5 million." The example refers several times to Lucas receiving a "payment" from Trust A.

The error is evident in that a revaluation by its very nature does not involve a flow of cash and so cannot result in any "payment" to anybody. The example, therefore, mistakenly treats a crediting of an amount the same as if a payment had been made. The Taxation Institute would like to point out that such a revaluation increment would only produce cash which could be paid to Lucas if the trust were to sell its asset(s), in which case the amount distributed would no longer represent an unrealised revaluation increment, but rather a realised capital gain.

The Taxation Institute considers that the example should be amended.

[1] Such repayments by set-off are specifically addressed by existing subsection 109R(3).

7 Double taxation arising from subsection 109XA(1A)

The Taxation Institute is concerned that proposed subsection 109XA(1A) will result in the double taxation of gains made by trusts because of the open ended nature of the amendment.

Example 1.10 in paragraph 1.47 of the EM demonstrates that the repayment of a loan account created out of a distribution of an unrealised gain when there is an unpaid present entitlement in favour of a corporate beneficiary will result in those repayments being treated as dividends for the purposes of Division 7A.

However, if the facts of the example were to be extended to include the ultimate sale of the asset by the trust and the distribution of the resulting capital gain to Lucas, the example would also illustrate that the payment to Lucas of that capital gain (which would not have produced a book profit in the hands of the trust and so would only be able to be paid out to Lucas in the form of a repayment of his credit loan account) would also be counted towards the calculation of the deemed dividend to Lucas by the corporate beneficiary.

This is despite the fact that the realisation of a gain would have caused a CGT event to happen which, in the normal course of events, would be distributed to Lucas and he would be assessed to tax on it. As a result, Lucas is taxable both on the taxable capital gain distributed to him by the trust and upon his receipt of the proceeds of the sale which generated that capital gain (up to the amount of the unpaid present entitlement in favour of the corporate beneficiary at that point in time).

Such a result is clearly inappropriate. At a minimum, the Taxation Institute considers that proposed subsection 109XA(1A) should be amended to include an anti-overlap rule to prevent such outcomes.

8 Proposed subdivision EB

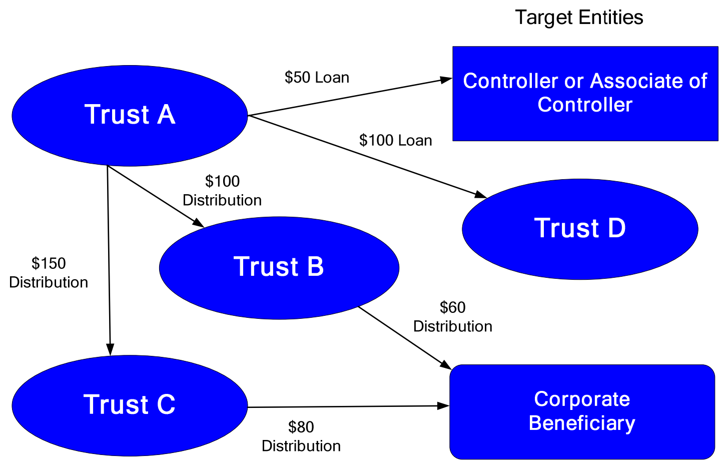
The Taxation Institute notes the anti avoidance policy behind the introduction of proposed subdivision EB and that the subdivision functions by deeming certain things to happen so that the operative provisions of subdivision EA are activated.

8.1 Business and investment structures – unnecessary complexity

The Taxation Institute notes that, primarily for asset protection purposes, businesses are often operated in separate entities. As Treasury would be aware, trusts are a very common structure in which businesses are operated.

The Taxation Institute is concerned that where businesses are operated essentially by the same controllers in separate trusts, it is common practice for profitable and cash flow positive businesses to support others which may be temporarily in need of cash, such as being in start-up mode. The Taxation Institute is concerned that the provisions of proposed subdivision EB add unnecessary complexity and compliance requirements in business structures involving more than one trust as illustrated in the following example.

Example 7



In the above diagram, Trusts A, B, C and D each hold a separate property investment.[2] The trusts are not necessarily discretionary ones and could be unit trusts.[3]

The above diagram indicates that Trust A, with an annual profit of $250 distributes its profit $100 to Trust B and $150 to Trust C. Trusts B and C are associated property-holding entities that have negatively geared their investments. As a result of the negative gearing, some of the profit distributed into them is absorbed by the negative gearing losses, leaving net income in Trust B of $60 and net income in Trust C of $80. Both of these trusts distribute their net income to a corporate beneficiary.

Trust D is another property-owning entity at the start of its development phase and needs financial support. Trust A provides this financial support in the form of a $100 loan.

The example also assumes that one of the controllers of the group who is a shareholder or shareholder's associate of the corporate beneficiary has received a loan of $50 from Trust A.

The above example illustrates that loans may be made between associated trusts as a result of ordinary business or financial dealings. However, the provisions of proposed subdivision EB potentially result in loans between those entities being deemed to be dividends within meaning of Division 7A. In particular, section 109XG is capable of deeming the corporate beneficiary to have been presently entitled to an amount from Trust A because of the passing through of distributions by Trusts B and C to the corporate beneficiary, and Trust A has made a loan to other entities.

In order to avoid taxation of such a deemed dividend, it would be necessary for all loans and unpaid present entitlements within such a group to be formalised so that they comply with section 109N, with consequent requirements for principal and interest repayments.

In order to avoid the complexity and compliance costs associated with formalising such arrangements and imposing requirements for interest and principal repayments where such losses are normally recouped through further distributions, the Taxation Institute recommends that an otherwise deductible rule be introduced for loans in the same way as in an otherwise deductible rule has been introduced for deemed payments. Such an exception from the operation of Division

[2] This is a common structure for property developers and investors because of asset protection concerns and land tax minimisation desires.

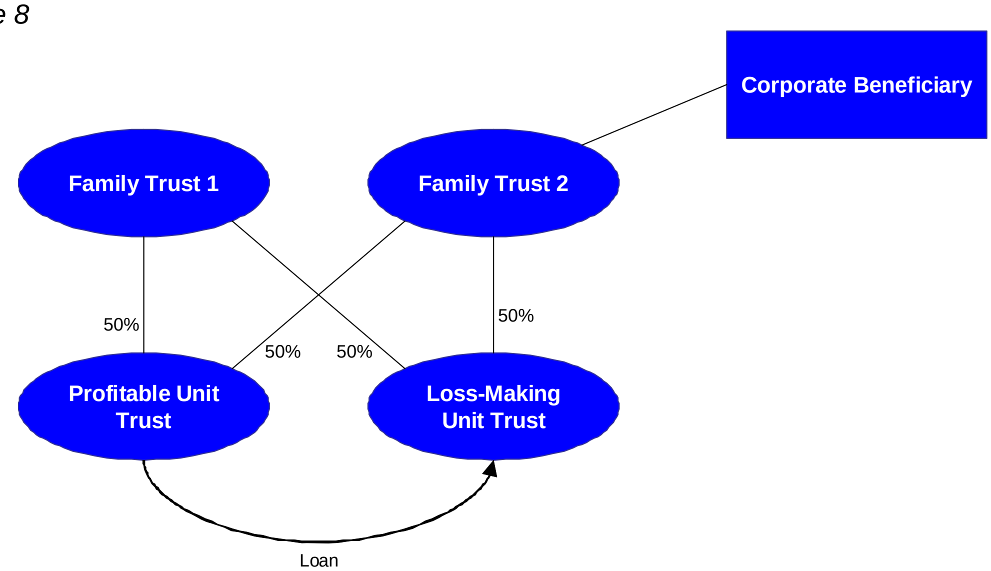
[3] Property developments often occur in unit trusts if there are different investors participating separately in respect of the properties in different proportions. Hence, there could be several arm's length individuals who are unit holders in each trust in different proportions. No single individual is necessarily controller of any one trust.

7A would greatly simplify business operations and remove from the scope of Division 7A arrangements other than those at which Division 7A was originally targeted: the private use of private company wealth by shareholders.

Alternatively, the Taxation Institute submits that such loans between related trusts should not be brought within the scope of Division 7A where all the trusts in the group (in the above example, Trusts A, B, C and D) have all made family trust elections or interposed entity elections nominating the same test individual.

The Taxation Institute also points out that businesses operated by unrelated families are also commonly operated in unit trust structures, with units in those trusts owned by the independent families' own family discretionary trusts, as illustrated in the following example.

Example 8



In the above example, two commonly-owned businesses are operated in separate unit trusts and one of the families' discretionary trusts has distributed part of its net income to a corporate beneficiary.

Funding provided by Profitable Unit Trust to Loss-Making Unit Trust would potentially be brought within the scope of the provisions of proposed subdivision EB. This result would arise because Loss-Making Unit Trust would be an associate of a shareholder of the corporate beneficiary (because of the breadth of the definition of the term *associate*) even though no mischief of the kind which was originally the target of Division 7A is evident. If such a loan were instead to be required to be formalised into a section 109N-compliant loan, losses in Loss-Making Unit Trust would be aggravated and the assessable income and tax burden increased for the owners despite no economic benefit accruing to or being earned by the group when viewed in totality.

The Taxation Institute considers such an outcome to be inappropriate and further underscoring the practicality of including an otherwise deductible rule for loans otherwise caught by the Division.

Further, although proposed paragraph 109XG(1)(b) introduces a “reasonable man” test, the Taxation Institute is concerned that such a test (suffering an absence of objective criteria) in this context introduces an unacceptable level of uncertainty and potential for litigious disagreement about what the paragraph applies to.

8.2 Arbitrary valuation rules

Following on from example 7 above involving Trusts A, B, C and D, the Taxation Institute notes that it is not possible to draw a definite conclusion about the amount which would be subject to Division 7A, if any, in that situation. Possibilities are:

- $150, being the combined loan to the controller and Trust D;
- $140, representing the distribution from Trust B and Trust C to the corporate beneficiary;
- Any amount up to $250 being the original profit made by Trust A;
- Nil; or
- $400, being the combined loan by Trust A to the controller and Trust D, plus $250 being the distribution from Trust A to Trusts B and C, that could, in accordance with Draft Taxation Ruling TR2009/D8 be treated as a transaction that "in substance" effects a loan.

The arbitrariness of the Commissioner's power of determination under section 109XG(4) means that the determination by a taxpayer under self assessment of the amount which is included in their assessable income by subdivision EA through the operation of proposed subdivision EB is impossible to ascertain.

Such uncertainty is clearly undesirable and, in order to obtain the necessary level of certainty, taxpayers may find themselves needing to resort to applying to the Commissioner for private rulings about the valuation and determination of their Division 7A exposures. Such a situation is unworkable and likely to result in significantly increased workload for the Australian Taxation Office.

Rather, if taxpayers are not capable of ascertaining the amount of their assessable income, the validity of the legislation must be questioned. This is because proposed section 109XG delegates the calculation of the amount of the assessable income to the Commissioner without reference to any objective criteria. As the above example demonstrates, the amount that is assessable is unknown and left entirely to the Commissioner for determination. The Taxation Institute queries whether it is constitutional for Parliament to delegate such a power to the Commissioner under paragraph 51(ii) of the Constitution, in particular because the tax on the deemed dividend that results from the Commissioner's exercise of such delegated power is essentially an incontestable tax.

The Full High Court in *MacCormack v FCT* (1984) 158 CLR 622 at paragraph 32 considered that:

> "For an impost to satisfy the description of a tax it must be possible to differentiate it from an arbitrary exaction and this can only be done by reference to the criteria by which liability to pay the tax is imposed. Not only must it be possible to point to the criteria themselves, but it must be possible to show that the way in which they are applied does not involve the imposition of liability in an arbitrary or capricious manner. In *Giris Pty. Ltd. v. Federal Commissioner of Taxation* [1969] HCA 5; (1969) 119 CLR 365, at pp 378-379, Kitto J. pointed out that the expression " incontestable tax " in the sense in which it is used in Hankin and Brown "refers to a tax provided for by a law which, while making the taxpayer's liability depend upon specified criteria, purports to deny him all right to resist an assessment by proving in the courts that the criteria of liability were not satisfied in his case." The purported tax is thereby converted to an impost which is made payable regardless of whether the circumstances of the case satisfy the criteria relied upon for characterisation of the impost as a tax and for characterisation of the law which imposes it as a law with respect to taxation. Such an incontestable impost is not a tax in the constitutional sense and a law imposing such an impost is not a law with respect to taxation within s.51(ii). It is in this sense that an incontestable tax is invalid."

As the above example demonstrates, a number of outcomes are available based on the wording of proposed subsections 109XG(4) and (5) and the determination by the Commissioner could be arbitrary. However, because there are no objective criteria specified in section 109XG upon which a taxpayer can resist an assessment by proving that the criteria for liability were not satisfied, the

Taxation Institute considers that the provisions are reasonably open for challenge on Constitutional grounds. Accordingly, the Taxation Institute considers that these provisions need to be redrafted.

Further, the Taxation Institute considers that such excessive reliance on the Commissioner's determination of an amount without objective criteria will lead to increased litigation and consequent consumption of public resources which would be better directed to other more productive uses.

8.3 Misunderstanding of nature of present entitlement – proposed subsection 109XG(5)(b)

The Taxation Institute is concerned that proposed paragraph 109XG(5)(b) displays a misunderstanding of the nature of a present entitlement as that proposed paragraph assumes that such an amount can include consideration payable to the beneficiary company. By its very nature, a present entitlement is essentially a gift to a beneficiary and cannot include any element of consideration.

The Taxation Institute expects that this provision should instead have referred to consideration payable "by" the beneficiary company as a means of reducing the amount of the present entitlement – this more accurately reflects the nature of the interplay between distributions and consideration payable.

8.4 Other income sources

The Taxation Institute is concerned that the Commissioner's power of determination under section 109XG(4) does not contain any reference to or acknowledgement of an interposed trust's other income sources. Presumably this is to be catered for in the Commissioner's determination, but this is not clear and should be prescribed.

9 Distributable surplus calculation – proposed section 109Y

The Taxation Institute considers that this proposed amendment needs to include a carve-out for transfers of assets from a company to a spouse upon marital break up. This is because such a transfer of an asset constitutes a payment which is not excluded from the operation of Division 7A and so is deemed to be a dividend. Such dividends are permitted to be franked.

Often, the asset to be transferred out of a company in the context of a marital break-up property settlement is the only asset of the company.

If the company has no retained earnings, yet unrealised gains on the asset, the transfer of that asset out to the 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.

10 Further improvements

While technical differences and integrity concerns are being addressed in this piece of legislation, the Taxation Institute urges Treasury to consider including the following simplification and equity measures.

10.1 Repayment ordering rule

At present, Division 7A taxes any shortfall between actual repayments on an amalgamated loan and the minimum yearly repayment: section 109E.

Where there is more than one loan on which repayments are required, the Division does not allow excess repayments on one loan to be applied to the minimum yearly repayment of another. This issue has typically been dealt with in practice through appropriate accounting entries, but greater comfort and certainty would be provided to private companies and their shareholders if there were an express provision in the Division permitting such applications.

10.2 Subsection 109R(3)

Subsection 109R(3) specifies an exhaustive list of things which may be set off against an amount payable in respect of a loan. The Taxation Institute considers that the provision could be greatly simplified by replacing paragraphs (a), (b) and (ba) with a single paragraph allowing set-off of any amount included in the assessable income of the person obliged to make the repayment.

Such an amendment would allow the likes of consulting fees payable by the company (which do not fall within any of the items specifically listed) to be set off against repayment obligations and would be consistent with the intention of the provision.

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Should you have any queries with respect to any of the matters raised above, please do not hesitate to contact David Williams on (02) 9958 5121 or the Taxation Institute's Tax Counsel, Angie Ananda on 02 8223 0011.

Yours faithfully

DWilliams

David Williams
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