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13 April 2010

The Committee Secretary
Senate Standing Committee on Economics
PO Box 6100
Parliament House
Canberra ACT 2600
Australia

Dear Sir,

TAXATION LAWS AMENDMENT (2010 MEASURES NO. 2) BILL 2010 (the *Bill*)

We refer to the call for submissions regarding the Bill.

Please find enclosed our submission regarding some of the amendments to be made should Schedule 1 of the Bill be enacted without amendment.

Yours faithfully,

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SUBMISSION TO THE SENATE ECONOMIC LEGISLATION COMMITTEE

TAXATION LAWS AMENDMENT (2010 MEASURES NO. 2) BILL 2010 (the *Bill*)

This submission addresses 4 aspects of Schedule 1 of the Bill (***Schedule 1***).

Summary

Schedule 1 is primarily concerned with amendments to Division 7A (***Division 7A***) of Part III of the *Income Tax Assessment Act 1936* (the ***Act***). Division 7A is concerned with events that give rise to deemed dividends.

We submit that:

1 Proposed section 109CA should not be proceeded with. The amendments purport to bring within the deemed dividend rules the "provision of an asset for use". As currently conceived, the amendments are unfair and will add significantly to the costs of compliance.

2 The rules regarding "unpaid present entitlements", both those proposed in the Bill and those currently in place in Subdivision EA of Division 7A, should be replaced by a simple provision that taxes the trustee if a present entitlement remains unpaid for a specified period.

3 The changes should not be retrospective.

4 If the amendments regarding non-resident companies are to proceed (proposed section 109BC), taxpayers should not be faced with "double jeopardy". To avoid "double jeopardy", section 47A of the Act must be amended.

1 Proposed Section 109CA

1.1 The Proposed Change

Division 7A currently (through section 109C) treats a payment or a transfer of property for less than its arm's length value from a company to a shareholder or an associate of a shareholder as a deemed dividend.

Proposed section 109CA seeks to extend the application of section 109C by defining a "payment" for the purposes of section 109C to include the "provision of an asset for use by an entity".

1.2 Is the Proposed Change Equitable, Simple to Administer and Inexpensive to Taxpayers?

The test of any change is whether it is equitable and does not add complexity and cost.

Unfortunately, the proposed change and the proposed carve-outs have not been carefully thought through and the result will be inequity, complexity and cost.

In effect, an additional tax, akin to a wealth tax, as well as a significant compliance burden will be imposed on those who have made the mistake of holding personal assets through a private company rather than directly or through a trust.

Whilst there are genuine examples of untaxed benefits being obtained by individuals who acquire assets through companies, especially if the assets have been acquired out of profits that have been untaxed or suffered a lower rate of tax than the individuals would have borne, the proposed amendments fail to discriminate between those who genuinely benefit and those who have either historically held such assets through a company (acquired before trusts became fashionable and tax effective) or have acquired them through a company to minimise (occupier) liability issues, where the acquisition was funded out of after tax income of the individuals.

To illustrate the inequity, we need only compare the following very simple situations involving a farm (although the asset could just as easily be a boat, a car or a tractor):

1 A buys a farm in his name.

2 B buys a farm through a family trust.

3 C buys a farm through a private company funded by the private company from its after tax earnings.

4 D buys a farm through a private company funded by D from his after tax earnings.

The farm is not run as a business.

Any use of the farm by A or B is not taxable.

However, under the proposed rule, any use by C or D or any of their relatives of the farm will be taxable if there is a "distributable surplus" (unless a carve-out applies).

A "distributable surplus" is likely to exist if the farm has increased in value, albeit that no profit has been realised.

In the case of C, there is an argument that the benefit should be taxed to C, but the tax should truly only be by reference to the tax saved on the profits taxed to the private company.

However, it is not clear what policy or how equity is served by discriminating against D, especially when one realises that under the current law, a sale of the farm will almost certainly mean that D will be taxed at a higher rate than A or B will be on the capital gain.

Another example of where the new rules may result in an inequitable outcome is in relation to company title apartments.

A shareholder in a company (that owns a block of apartments) is provided the use of an asset, the apartment, and does so because he or she is a shareholder. Consequently, if the company has "distributable profits", a shareholder may be subject to tax periodically on the use of what is his or her home.

1.3 The Carve-outs

Amongst the few proposed carve-outs from the application of the proposed section 109CA is a carve-out for "minor benefits" - see proposed subsection 109CA(4).

Just how mean-spirited the changes are can be seen by the way this minor benefits carve-out works.

Broadly, the carve-out allows a benefit worth less than $300 to escape taxation but only if the other requirements of section 58P of the *Fringe Benefits Tax Assessment Act 1986* are satisfied (aside from an associate or shareholder being an employee as that is taken to be satisfied).

One of the conditions is that the benefit must be infrequent and irregular.

So, referring to the earlier example, if C's or D's relatives use the farm occasionally, they may well be required to pay tax on a deemed dividend unless they pay an arm's length fee for use.

A relative includes a child so if D's daughter regularly rides a horse owned by the company, then she may be faced with paying tax on a deemed dividend if she does not pay an arm's length fee for the right to use the company's asset.

To avoid the deemed dividend, it will be necessary to (a) ascertain the arm's length cost of each such benefit and then (b) organise for the person benefitting to pay that amount to the company.

Clearly, if the Government is to proceed with proposed section 109CA, then the carve-out for minor benefits must be drafted to ensure that very insignificant benefits are excluded from taxation even if they are provided on a regular basis.

2 Subdivision EA of Division 7A

Both the existing provisions of Subdivision EA and the proposed changes to the Subdivision bring a ridiculous level of complexity to a problem that exists solely because the tax rules allow assessable income to be diverted to a company by a trust without requiring the trustee to make a matching distribution.

The problem that the Subdivision seeks to deal with occurs when a private company is presently entitled to income of a trust, but the funds remain with the trustee of the trust who then arranges for a loan or other benefit to be

provided to a shareholder or an associate of a shareholder of the private company.

The Commissioner is seeking to challenge existing arrangements that are not caught by the Subdivision through a public ruling (currently issued in draft form as TR 2009/D8).

Rather than persist with the existing rules and then overlaying them with more complex rules, the Government should simply do away with the Subdivision and replace it with a simple and easy to administer rule that requires the trustee to distribute the cash that represent the "unpaid present entitlement" within a given period (say 3 months of the end of the relevant income year) or to formalise the unpaid present entitlement as a complying Division 7A loan to the trustee. Failure to make the distribution or convert it into a complying loan within the relevant period would result in the trustee being liable to tax at the highest marginal rate on the unpaid present entitlement.

3 Retrospectivity

It is now almost 12 months since the Government announced that it would amend Division 7A. Whilst that is a relatively short period when compared to other changes (see for example the changes to the consolidation rules in *Tax Laws Amendment (2010 Measures No.1) Bill 2010* and the unlegislated changes to the rules governing foreign exchange first announced in 2004), the complexity and unfairness of the changes demand that they be prospective in effect from 1 July 2010 or 1 July 2011.

4 Proposed Section 109BC and Section 47A

Proposed section 109BC seeks to extend the application of Division 7A to non-resident private companies. In other words, loans, payments, etc. that are made by non-resident private companies are to be subject to the same rules as loans, payments, etc. made by resident private companies.

The amendments do not address the existing provision, section 47A of the Act, which applies different tests for assessability for loans, payments, etc. made by non-resident companies that are controlled foreign companies.

Section 47A should be amended if it is intended to proceed with enacting section 109BC to ensure that taxpayers are not subject to two sets of rules that seek to achieve the same outcome but which apply different tests for assessability. For example, Division 7A mandates that loans be on certain terms, whereas section 47A applies where the parties are not at arm's length with each other in relation to the loan. Therefore, whilst the loan may comply with Division 7A, section 47A may still apply. Correspondingly, a loan that is at arm's length for the purposes of section 47A may still be caught by Division 7A.

Balazs Lazanas and Welch LLP

13 April 2010