Australian Government
The Treasury

10 May, 2010
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Mr John Hawkins
Committee Secretary
Senate Standing Committee on Economics
PO Box 6100
Parliament House
Canberra ACT 2600

Dear Mr Hawkins

TAX LAWS AMENDMENT (2010 MEASURES NO.2) BILL 2010 COMMITTEE HEARING

At the Senate Committee hearing into the Tax Laws Amendment (2010 Measures No.2) Bill 2010 (the Bill) on 30 April 2010, Treasury officers were presented with several propositions regarding the non-commercial loans tax integrity measure in Schedule 1 of the Bill (amendments to Division 7A of the *Income Tax Assessment Act 1936* (ITAA 1936)).

We were asked to provide further comment on concerns that the amendments make Division 7A overly complex and to comment on the issues of compliance costs in one particular scenario and the need for rollover relief for private companies that allow shareholders' associates the use of company property at no charge in another scenario.

As I stated at the outset of Treasury's evidence, the scheme of this aspect of company taxation is relatively simple — any value that is removed from a company and distributed to shareholders should be subject to tax as a deemed dividend. The current Division 7A makes it clear that, in addition to cash received, non-cash distributions by way of payment, loan or debt forgiveness are to be treated as deemed dividends unless they meet exceptions in the general scheme of Division 7A.

The provisions also already cover a transfer of property, which includes a gift of an asset and a lease of real property. The measure in Schedule 1 of the Bill merely extends the principle about value transferred to shareholders, so that it covers not only transfers by way of leases of real property for less than market value, but also the granting of rights and licences to use real property and other assets.

Nevertheless, I acknowledge that tax law is, generally, complex. One reason for its length and complexity is too much detail. In recent years, we have tried to simplify and clarify the tax law by using statements of policy intention and principle-based provisions, and by dispensing with unnecessary detail that obscures understanding of the legislative purpose and of the tax law itself. A number of subsidiary design principles help in deciding what is unnecessary detail. These principles include:

- Do not include specific rules to deal with cases that are merely theoretical or likely to be rare, especially when an appropriate outcome in those cases can be inferred from the stated objects and principles of the measure, and of the income tax law as a whole.

- In particular, do not cater for situations that can arise only if taxpayers are poorly advised or make choices that are not in their best interests.

- Giving taxpayers choices almost always results in *more* complexity, the costs of which, in many cases, outweigh the benefits of the choice.

Specifically, in respect of Division 7A, complexity can arise because taxpayers create various separate legal entities for tax and other purposes, but, nonetheless treat the group as a single economic entity, not taking into consideration possible taxation and other implications of having multiple entities. It is expected that once a taxpayer has decided to use a company structure in conjunction with one or more trusts, complexity will arise. In this regard, I note that 95 per cent of businesses use tax agents to complete their tax return.

The best approach with respect to the operation of Division 7A is for taxpayers to treat arrangements between associates or related entities on an arm's length commercial basis. A simple way of doing this is to ensure that loans between entities are made compliant with Division 7A requirements and, where assets are provided for use between entities, they too are provided on arm's length terms.

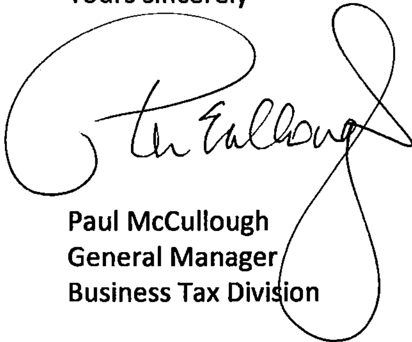
In determining an arm's length value, the ATO may issue administrative guidelines on how to value some assets. However, some assets are too unique to value accurately and it will be necessary to have those assets valued professionally in the same way that they would be valued if they were provided to an employee and taxed under the *Fringe Benefits Tax Assessment Act 1986* (FBTAA 1986).

In respect of rollover relief, as mentioned at the Committee hearing, Treasury considers it would be very difficult to target capital gains tax relief for private companies wishing to restructure because of Division 7A implications. It would be difficult to limit relief to those companies with shareholders or associates that may have an adverse tax implication from using company assets for free. Any private company could manipulate such a provision to obtain unintended tax benefits. I would also note that stamp duty relief is a State and Territory government matter.

Specific comments on the examples raised by the Committee are in the Attachment.

If you require further detail on any of the information provided, please contact me on 02 6263 3820 or by email: Paul.McCullough@treasury.gov.au.

Yours sincerely



Paul McCullough
General Manager
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ATTACHMENT A

Example 1: Need for roll-over relief where parents establish a company to hold property for a child

A scenario put to Treasury officers was that of parents who purchased a home through a private company. The home was paid for with share capital and the company did not carry on a business. In the given scenario, the disabled daughter lived with her parents during the week and lived in the home owned by the company on weekends.

Generally, asset protection is the *non-tax* reason given for such arrangements. The merits of this justification are, however, questionable. As set out by in Mr Beharis' testimony to you on Thursday, 29 April 2010 in Melbourne, it is unlikely that anyone would place a residential property, or any other appreciating asset in a company in the way mentioned, as this would forfeit the capital gains tax 50% discount that would have accrued on disposal if the property had been owned by an individual or trust. If a company were inclined to purchase a property in the situation described, the company could hold legal title, but it might do so as trustee. The circumstances of parents vesting property in a company for the purpose of the company holding that property on behalf of a child beneficiary accords with the general understanding of the creation of a trust. As the measure applies to companies, and not trusts, a situation such as this may not be subject to the measure.

Moreover, the use of real property in the form of exclusive possession may result in a lease, rather than a mere right to use. The current Division 7A law already captures leases of real property, so they are not affected by the measure in the Bill.

Example 2: Non-salaried owner of a plumbing company

Another scenario put to Treasury officers was that of a plumber who uses a company structure to carry on the plumbing business where the plumber is the sole director and shareholder of the company. The company owns a car. The director/shareholder uses the car to drive from job to job carrying tools. The car is garaged at the director's/shareholder's home in the evenings and on weekends, but is not used privately.

The ATO has advised that it is likely that the provision of the car for use by the plumber in providing plumbing services is likely to be treated as non-cash remuneration. Section 137 of the FBTAA 1986 extends the definition of 'employee' to include persons who receive non-cash remuneration for services rendered in these circumstances. As such, the plumber is likely to be treated as an employee even though there is no employment contract or cash remuneration. It follows that the use of the car will be caught by the FBTAA 1986 and not Division 7A. Assuming the plumber is an employee, their use of the car to generate assessable income will be exempt from FBT.

If there was an element of private use the car, along with certain other assets, would be taxed concessionally under the FBTAA 1986. The overwhelming majority of plumbers who run companies will have employees and will themselves draw salaries, so the company would be able to use FBT valuation methods that they are already familiar with.

If an employment relationship did not exist, there are two situations where a controlling shareholder of a plumbing business might not wish the company to pay him or her a salary.

- First, where the company is in operational loss and the principal wishes to leave as much cash in the company as possible to keep the business afloat, agreeing to accept remuneration out of dividends paid when profits are ultimately made.
  - This measure would not apply in this situation as it only applies where the companies has a distributable surplus (effectively this means net assets to the extent the value exceeds the paid up capital in the company).

- Second, where the principal is paying tax on income from other sources at a rate higher than the company rate and wishes to shelter private consumption from being taxed at a higher marginal rate.
  - This measure is specifically designed to address this situation. Accordingly, this is precisely the situation in which compliance costs (such as they are) should be secondary to the equity of the outcome.