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Our Ref: PDH:3127038

16 April 2010

Department of the Senate
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Dear Sir/Madam

**Inquiry into Tax Laws Amendment (2010 Measures No. 2) Bill 2010**

I am writing in response to a request for submissions in relation to an inquiry into the *Tax Laws Amendment (2010 Measures No. 2) Bill 2010* **(No 2 Bill)**.

This submission is based upon an article published in CCH Tax Week on 8 April 2010.

**DIVISION 7A – USE OF ASSETS**

The purpose of this submission is to deal with the proposed changes to the definition of 'payment' in Div 7A of Part III of the *Income Tax Assessment Act 1936* (**ITAA 36**) that deal with the use of a private company's assets by its shareholders or associates of its shareholders. Broadly, the No 2 Bill has addressed various concerns that were raised with the Exposure Draft, and the No 2 Bill is more concessionary to taxpayers than the Exposure Draft. However, in my opinion, there are still significant concerns with the No 2 Bill.

**Use of Assets**

The purpose of the change to the definition of 'payment' is to treat the use of an asset as a dividend. So where the user of the asset owned by a private company is a shareholder or associate of the shareholder, then there will be a deemed dividend, subject to certain exceptions and the company's 'distributable surplus'. The exceptions being introduced by the No 2 Bill relate to minor use of assets, certain payments that would otherwise be deductible, and the use of certain dwellings.

**Leases and licences of real estate**

There are significant issues in relation to leases and licences of real estate which I will consider first.

**Treasury and Commissioner of Taxation's views**

Both the Commissioner of Taxation (**Commissioner**) and Treasury consider that the changes to the law do not apply to leases of real estate to shareholders or associates of shareholders. This

is extremely important in relation to when leases began to be caught by Div 7A, and the exceptions that the No 2 Bill will introduce.

The current definition of 'payment' includes a transfer of property (s109C(3)(c) ITAA 36). The Commissioner's view can be found in 'Division 7A – answers to frequently asked questions', question 21, and the fact sheet 'Division 7A – Payments by private companies'. The Commissioner's view in these publications is that a right to use real estate that is made by way of a lease involves a transfer of property to the lessee and is a payment for Division 7A purposes. However, a licence which does nothing more than provide a mere permission to enter onto and use real estate is not a transfer of property, and so is not a payment for Div 7A.

Treasury's view can be found in the Treasury consultation paper that the Assistant Treasurer released on 5 June 2009 (**Consultation Paper**). The Consultation Paper outlined the proposed changes to Div 7A that were announced by the Government on 12 May 2009 as part of the 2009-10 Budget. On page 3 of the Consultation Paper, Treasury stated that an example of a transfer of property currently caught by Div 7A is a right to use conferred by a lease of real estate. It stated that this was because the grantee (ie tenant) receives an interest in property (ie a leasehold interest). This is in contrast to a licence to use real estate, which would not be caught by Div 7A (hence the need to change the law).

This view is then adopted in the proposed new law, as can be seen in both the exposure draft explanatory memorandum to the exposure draft legislation (**Exposure Draft**) (see paragraphs 1.6 and 1.23) and to the explanatory memorandum to the No 2 Bill (see paragraphs 1.6 and 1.31).

If leases of real estate are already transfers of property, and no amendment to the law is required to treat leases as dividends under Div 7A, then it seems to me that the Commissioner and Treasury's view must be that leases of real estate have been deemed dividends since the commencement of Div 7A.

**Are leases 'transfers of property'?**

'Transfer' is not defined in s109C, s109ZD (which defines certain terms for the purpose of Div 7A) or s6(1) ITAA 36. This means that it would take its ordinary meaning, subject to its context.

All the cases that I have been able to find indicate that a transfer of property involves the passing of ownership of property from one person to another. So it seems to me that the creation of rights is not a transfer.

In *Littlewoods Mail Order Stores Ltd v Inland Revenue Commissioners* [1961] Ch 597, the UK Court of Appeal considered the stamp duty issues associated with a number of transactions. In the course of that case, they discussed whether a lease involved a 'transfer'. The court held that the subject matter of a lease is not 'transferred'. Rather, it is created.

In *Commissioner of Taxes (Queensland) v Camphin* (1937) 57 CLR 127, Latham CJ considered whether the money paid for a grant of an option was income from the sale of personal property under the *Income Tax Acts 1924 to 1933* (Qld). He held that an option created an equitable interest. However, the creation was not a sale, as it was not a right that the owner of the property ever had. Latham CJ held that the creation of the right was not the transfer of any right, so was not the sale of any property.

In the course of the judgment Latham CJ discussed the grant of a lease, and considered that the owner does not sell property to the lessee. Rather, the owner creates a term in the lessee.

Rich J and McTiernan J, who were the other members of the court, agreed with Latham CJ.

Stamp duty legislation (eg the *Duties Act 1997* (NSW)) imposes duty on the transfer of land and interests in land. However, there is no suggestion that a lease of land involves a transfer of an interest in land, even if a lease creates an interest in land. Leases were previously subject to lease duty. Lease duty has now been repealed. But I'm fairly confident that without specific provisions (eg s8(1)(b)(viii) of the *Duties Act 1997* (NSW) which imposes duty on a lease in respect of which a premium is paid or agreed to be paid) the state revenue offices won't be imposing conveyancing rates of duty on leases. If a grant of a lease is not a transfer of an interest in land in the duties context, why is a lease a transfer of land for Div 7A?

And if the Commissioner and Treasury are correct, why is a grant of a lease not a transfer and so a CGT event A1 in the CGT context, and why then the need for special CGT events dealing with leases (eg CGT events F1 and F2)?

It seems to me that leases of real estate would not be transfers of property and so would not be caught by the current definition of payment in Div 7A.

**What is the new definition of 'payment'?**

The No 2 Bill proposes to introduce s109CA. Section 109CA(1) will provide that 'In this Division, ***payment*** to an entity includes the provision of an asset for use by the entity'. The proposed note to s109CA(1) states that 'This includes provision under a lease or licence'. So clearly, if a lease is not currently caught by the definition of payment, it will be caught by s109CA(1).

Section 109CA(1) is significantly different from the proposed changes in the Exposure Draft. In the Exposure Draft, it was proposed to add s109C(3)(d) to the definition of 'payment', which was to provide that a payment would also include 'a ***grant*** of a lease, or a licence or other right to use an asset, to the entity (other than the transfer of property to the entity)' (emphasis added).

What is the significance of the difference in wording between the currently proposed s109CA(1) and the previously proposed s109C(3)(d)? It seems that the intention is that under the current proposal, the payment occurs as the use occurs, not when the initial grant of the right to use occurs. Paragraph 1.19 of the explanatory memorandum supports this view.

However, in my view, the proposed legislation doesn't make this clear.

**Actual use**

Proposed s109CA(2)(a) provides that the time of payment is when the entity ***first uses*** the asset with the permission of the provider of the asset. Proposed s109CA(3) provides that if the use continues into another income year, the provision of the asset for use is treated as a separate payment made at the ***start*** of the income year.

Proposed s109CA(10) provides that the amount of the payment that may be deemed to be a dividend is essentially the arm's length amount that would be payable for the provision of the asset less the consideration ***given***.

So it seems to me that the effect of the proposed legislation is that the deemed payment occurs when the entity first uses the asset, and at the beginning of each subsequent income year when the use continues. Proposed s109CA(10) seems to have the effect that, for there to not be a payment, the arm's length consideration needs to be provided at the time of the ***first*** use, and then at the ***beginning*** of each income year where the use continues. The use of the word 'given'

seems to indicate that there is no time allowed to make the payment, and so the giving of a monthly arm's length licence fee would still give rise to a payment and so potentially a deemed dividend. There is no provision like current s109D(1)(b) which allows a loan to be repaid before the lodgment day of the company to avoid a loan being a deemed dividend.

Current s109D(4A) provides that if a company makes a payment, and the payment is converted to a loan before the end of the company's lodgment day, the company is treated as making a loan at the time that the payment is made. So it seems that to avoid the payment being treated as a dividend where the arm's length consideration is not provided at the time of first use (or the beginning of each income year where the use continues), the payment must be converted into a loan. While the extended definition of 'loan' in current s109D(3) can be relied upon, it is likely that some type of positive action (eg entering into an express loan agreement relating to any unpaid consideration for the use of an asset) must be undertaken.

Should such a process be necessary? Why can't the legislation provide that the user may pay before the end of the company's lodgement day to avoid a deemed dividend?

**Right to use**

Proposed s109CA(2)(b) deals with when a payment is made where an entity has the right to use an asset. It provides that a payment is made when the entity first has a right to use the asset, at a time when either the provider of the asset does not have a right to use the asset, or the provider of the asset does not have the right to provide the asset for use by another entity. The proposed note to proposed s109CA(2) gives the example of a company car parked at the shareholder's house or another place of their choosing.

Paragraph 1.21 of the explanatory memorandum provides that an asset may be available for the shareholder's use without a formal agreement, and an asset may be available for use even though there is no actual use. That paragraph gives the example of Brian, a shareholder in a private company that owns a luxury yacht. Brian takes the yacht out every second weekend. So this actual use is a payment.

However, Brian takes the keys home, and stores several personal items on the yacht. Even though the yacht is kept at the company's business premises, the explanatory memorandum considers that the yacht is available for Brian's use because the yacht is not readily available for use by the company. This is because the company would need to get the key from Brian, and get Brian to remove his personal items.

It seems to me difficult to see how this example relating to availability is consistent with the proposed legislation. To be a payment in these circumstances (ie the time when the payment is made), the company must not have the ***right*** to use the asset (proposed s109CA(2)(b)). This would seem to be a legal right. Why in this example does the company not have a legal right to use the yacht just because Brian happens to have the key and may not be as tidy as his wife would like? Just because the company does not have the key doesn't mean that it doesn't have the legal right to use the yacht.

This example seems to be even more difficult if Brian is both a shareholder and director. Say Brian is the only director. Why wouldn't he take the key? Why would it make any difference if he kept the key at home or at the office? Either way, it is still accessible to Brian and still readily available to the company.

**Proposed exceptions**

The use of an asset will not be a payment if it is covered by one of 4 exceptions (the Exposure Draft only had 3 exceptions).

**Minor benefits**

Proposed s109CA(4) provides that proposed s109CA(1) will not apply if the provision of the asset would, if done in respect of employment of an employee, be a minor benefit under s58P of the *Fringe Benefits Tax Assessment Act 1986* (**FBTAA**). This is essentially the same as was proposed in the Exposure Draft.

In applying this exception, it needs to be appreciated that s58P FBTAA is not that easy to apply. It applies where, very broadly, the 'notional taxable value' is less than $300, ***and*** having regard to the infrequency and irregularity of identical or similar benefits, the practical difficulty in determining the value, and the circumstances surrounding the provision of the benefits, it would be concluded that it would be unreasonable to treat the minor benefit as a fringe benefit. If this were so easy to apply, why is there the need for a ruling of over 30 pages (Taxation Ruling TR 2007/12)?

An important point to appreciate is that this exception only applies to payments covered by proposed s109CA(1). Proposed s109CA(1) does not apply to the provision of an asset to the extent that it is a transfer of property to the entity (proposed s109CA(9)). So, for example, if a private company gave Easter eggs to all its staff, and some of those staff were shareholders (eg shareholders under an employee share scheme, irrespective of the percentage of shares held) there should be no FBT (because of the minor benefits rule), but there would still be a payment and so a deemed dividend. To me, there doesn't seem to be a sound policy reason why the minor benefits exception should also not apply to transfers of property.

**Otherwise deductible payments**

Proposed s109CA(5) provides that proposed s109CA(1) will not apply if, broadly, payment for the provision of the asset would have given rise to a once only deduction (eg a s8-1 deduction and not a capital allowance deduction). This is essentially the same as was proposed in the Exposure Draft.

The effect of s109CA(9) and the Commissioner and Treasury's view that a lease is a payment already covered by current s109C(3)(c) is that if, for example, a shareholder leases real estate for use in the shareholder's business, and does not pay rent, the use of the real estate will give rise to a payment and so potentially to a deemed dividend. But a licence of the real estate would not give rise to a payment. The last paragraph of example 1.9 in paragraph 1.31 of the explanatory memorandum confirms this.

However, in my view, as a lease of real estate does not seem to be a payment under current s109(3)(c), then proposed s109CA(1) would apply to a lease of real estate, and so the otherwise deductible exception would apply to a lease of real estate.

If I am wrong on my view of a lease not currently being a payment, what is the policy reason for not having the otherwise deductible exception apply to a lease?

**Dwellings used in connection with a business**

Proposed s109CA(6) provides that proposed s109CA(1) will not apply if, for example, the entity or associate carries on a business and the entity or associate uses land for the purpose of carrying on the business and the provision of the dwelling is connected with the use of that land.

This exception is based upon an exception that was in the Exposure Draft. However, it is much broader than the exception in the Exposure Draft. Under the proposed exception, the business can be carried on by the entity using the dwelling ***or an associate of that entity***. The Exposure Draft did not deal with associates carrying on the business, and this was a significant limitation.

Secondly, the proposed exception does not have any size restriction on the dwelling. The Exposure Draft had a requirement that the dwelling be less than 10% of the area used for the business. So this 10% limit is not in proposed s109CA(6).

However, on the Commissioner and Treasury's view, this exception will not apply to a lease of the dwelling. In my view, this is not correct. And if I am wrong, what is the policy reason for this?

**Dwellings used as main residences**

Proposed s109CA(7) provides that proposed s109CA(1) will not apply if the dwelling is the main residence of the entity and the company acquired the dwelling before 1 July 2009 and the company would satisfy a continuity of ownership test. This exception was not in the Exposure Draft.

Again the Commissioner and Treasury's view would be that if the company gives a lease, this exception would not apply. You may wonder how a dwelling may be someone's main residence if they only have a licence to use the dwelling.

**Leases v licences**

As can be seen from the above, at least in the Commissioner and Treasury's view, there is a significant difference in the application of the proposed changes to the meaning of payment between leases of real estate and licences. If this is correct, how can you tell the difference between a lease and a licence, and if there is a lease, how do you actually apply the current definition of payment?

**What is a lease?**

The essential difference between a lease and a licence is that a lease grants exclusive possession, whereas a licence gives permission to do something that would otherwise not be permitted (eg enter land to use it for a particular purpose). A lease creates an interest in land, but a licence does not. The substance of the arrangement, and not what it is called, will determine whether it is a lease or a licence.

There are different kinds of leases, including leases for a fixed term, periodic leases and tenancies at will. A periodic lease is from period to period. The period may be, for example, daily or monthly. A tenancy at will is a lease with either the landlord or tenant having a right to terminate the lease at any time.

Leases generally must be in writing. However, oral agreements can be enforceable in equity in certain circumstances (eg part performance). And even if not enforceable in equity, there may be a tenancy at will.

Often there will be nothing in writing between a private company and a shareholder using real estate owned by the company. If the shareholder uses the real estate for a significant period, and the shareholder pays the costs associated with the real estate (eg land rates and taxes), is there a lease or a licence? It isn't always that easy to tell the difference between a licence and a tenancy at will where there is no agreement in writing. If there has been in fact exclusive possession by the shareholder, then wouldn't this mean that there is a lease?

So if the Commissioner and Treasury are correct on leases and not licences being covered by the current definition of payment, how will the proposed exceptions actually apply where there is use of real estate owned by a company? For example, how often will a dwelling used by a shareholder as their main residence actually be used under a licence arrangement only?

**How would a lease be treated as a payment?**

If a lease isn't covered by proposed s109CA(1) (ie a lease is a transfer caught by s109C(3)(c)), then the timing and valuation rules in proposed s109CA will not apply. So the valuation rule in current s109C(4) would apply. This is essentially the arm's length amount less any consideration ***given*** (essentially the same as proposed s109CA(10)). So how does this apply? For example, if there is a grant of a lease with a 3 year term, does this mean that the arm's length rent needs to be paid on grant of the lease otherwise there will be a payment and so a potential deemed dividend (unless converted to a loan within the prescribed time)?

**Conclusion**

It seems to me that there are still difficulties with the proposed changes to the definition of payment. The application to situations where the asset is supposed to be available for use will be problematic, particularly where the user is a shareholder who is also a director. The timing rules still seem to be problematic.

The drafting of the changes, on the assumption that the Commissioner and Treasury's view of the current definition of payment applying to leases of real estate is correct, seems to create difficulties. It seems to me that view is not correct, and so, for example, the proposed exceptions will apply to leases (contrary to what is indicated in the explanatory memorandum).

If the Commissioner and Treasury are correct, and if it is intended to reflect Parliament's intention, then it seems to me that the legislation should be amended to expressly provide that a lease of real estate is covered by current s109C(3)(c).

But why would Parliament have this intention? In particular, why should the proposed exceptions to the definition of payment not apply to a lease of real estate, but apply to a licence of real estate?

Yours faithfully

(...)

**Philip de Haan**
Partner

(...)