BACKGROUND TO THE INQUIRY

The Taxation Laws Amendment Bill (No.7) 1997 was introduced into the House of Representatives on 4 December 1997, and the second reading adjourned on the same day. On 26 March 1998, the Senate referred provisions of the Bill to the Senate Economics Legislation Committee for inquiry and report by 2 April 1998. Subsequently, the Committee's reporting date was extended to 6 April 1998.

The Committee received 19 submissions to its inquiry and conducted public hearings on Monday, 30 March 1998 and Friday, 3 April 1998. A list of submissions and witnesses who gave evidence at the public hearings appears in appendix 1.

INTRODUCTION TO TAXATION LAWS AMENDMENT BILL (NO.7) 1997

The Taxation Laws Amendment Bill (No.7) 1997 ('the Bill') contains 10 schedules proposing amendments to a range of legislation.

The Explanatory Memorandum to the Bill provides a summary of the main amendments proposed:

Income Tax deductions: constitutional convention

Amends the Income Tax Assessment Act 1997 to provide for the tax deductibility of expenses incurred in contesting an election for delegates to the Constitutional Convention.

Income Tax deductions: National Nurses' Memorial Trust

Amends the income tax law to allow income tax deductions for gifts made to the National Nurses' Memorial Trust.

Sales Tax: Malaysian Visiting Force

Exempts certain goods from sales tax so as to give effect to the Status of Forces Agreement between the Government of Australia and the Government of Malaysia which was entered into on 3 February 1997.

Charitable Trusts

Amends *Income Tax Assessment Act 1997* to ensure that the rewrite of the income tax law reflects changes to the exempt entities provisions.

Payments of RPS, PAYE and PPS deductions to Commissioner

Inserts new division 1AAA to provide for the rationalisation of the withholding arrangements for Pay-As-You-Earn (PAYE), Prescribed Payments (PPS) and Reportable Payments (RPS).

Choice of Superannuation Funds

Amends the *Superannuation Guarantee (Administration) Act 1992* (SGAA) to:

- Require employers to make superannuation contributions on behalf of their employees to a complying superannuation fund or scheme or retirements savings account (RSA) in compliance with the 'choice of fund requirements'; and
- Increase the amount of the Superannuation Guarantee Charge (SGC) payable by the employer (if any) where these contributions do not comply with the choice of fund requirements.

Technical amendments: quasi-ownership of plant

Technical amendments are being made to provisions of the *Income Tax Assessment Act 1997* to ensure that depreciation rules relating to ownership of lessors' fixtures operate appropriately and properly reflect connecting provisions in the *Income Tax Assessment Act 1936*.

CGT asset register

Amends the *Income Tax Assessment Act 1936* to allow taxpayers to use an asset register instead of source documents for capital gains tax (CGT) record keeping purposes.

Franking of dividends and other distributions

Amends the *Income Tax Assessment Act 1936* by introducing a general anti-avoidance provision that applies to franking credit trading and dividend streaming schemes where one of the purposes (other than an incidental purpose) of the scheme is to obtain a franking credit benefit.

The amendments will also prevent dividend streaming by:

- Introducing into the Act a specific anti-streaming rule which will apply where a company streams dividends so as to provide franking credit benefits to shareholders who benefit most in preference to others; and
- Modifying the definition of what constitutes a class of shares within the dividend imputation provisions.

Distributions from private companies

Amends the *Income Tax Assessment Act 1936* to ensure that all advances, loans and other credits (unless they come within a defined class of exclusions) by private companies to shareholders and their associates are deemed to be dividends to the extent that there are realised or unrealised profits in the company. Ensures that debts owed by shareholders or their associates which are forgiven by private companies are treated as dividends.

Savings tax offset (Savings rebate)

Inserts new Subdivision 61-A in the *Income Tax Assessment Act 1997* to provide a new tax offset (commonly known as the savings rebate). The offset will apply at a rate of 15% (7.5% in 1998-99 assessments) to undeducted superannuation contributions made by employees and the self-employed and net personal income from savings and investment (including net business income) up to an annual cap of $3,000.

ISSUES RAISED IN EVIDENCE TO THE INQUIRY

Payment of RPS, PAYE and PPS Deductions (Schedule 4)

Changes to the timing of the remittance of tax collected under the Pay As You Earn (PAYE), Prescribed Payments System (PPS), and Reportable Payments Scheme (RPS) were announced in the 1997-98 Budget. The Treasurer summarised the proposed changes in a Press Release of 13 May 1997:

- The remittance time for large taxpayers will be 7 days after the deduction was made, rather than the current 14 days. This is estimated to result in $830 million in collections being brought forward in 1998-99;
- Large taxpayers will be required to remit electronically;
- The threshold for small taxpayers that remit quarterly will be increased to $25,000. This is estimated to allow another 133,000 employers under the PAYE system, and 178,000 businesses with obligations to deduct tax instalments under the PPS and the RPS to remit quarterly, and is estimated to result in revenue deferral of $500 million in 1998-99;
- The time for remittance of PAYE, PPS and RPS will be aligned; and
- When calculating the category the employer falls into, total PAYE, PPS and RPS remittances will be combined. This is likely to result in some taxpayers whose current PAYE obligation does not put them in the large taxpayer category falling into that category when PAYE, PPS and RPS remittances are combined. No estimates are given of the number who could be affected by this move.

Increase in taxpayers' operational costs

The proposed requirement that large remitters electronically transfer their payments to the Australian Taxation Office (ATO) was criticised by the Taxation Institute of Australia as a shifting of obligations. The ATO's compliance costs would be reduced at the expense of taxpayers' operational costs, leading the Taxation Institute to submit that a compulsory electronic transfer of remittances:

> Is contrary to the spirit of legislation which deals with currency and the satisfaction of debts in Australia. The proposals enforce entities to suffer the cost of developing new systems to deal with, in some cases, the collection of relatively small amounts so that it also is capable of interfacing with the electronic transfer system – which will also result in an additional cost. This will be particularly the case where an entity has only a small obligation in relation to, for example, RPS, despite a quite large overall withholding obligation and choses to keep a manual system in relation to RPS.[1]

Choice of superannuation funds (Schedule 5)

The Government's rationale for wishing to introduce a choice of superannuation funds is outlined in the Second Reading Speech to the Bill:

> The choice of fund arrangements are designed to give employees greater choice and control over their superannuation savings, which in turn will give them greater sense of ownership of these savings. The arrangements will increase competition and efficiency in the superannuation industry, leading to improved returns on superannuation savings.[2]

The Committee notes that the Senate Select Committee on Superannuation recently has completed a thorough inquiry into the issues surrounding choice of superannuation funds[3], and in accordance with this, the Economics Legislation Committee's examination of Taxation Laws Amendment Bill (No.7) has tended to focus on other schedules, aside from schedule 5.

Notwithstanding this, the Committee notes the predominant view in submissions to its inquiry that employees would be better off if provided with a greater choice of superannuation funds. The general belief is that with greater competition between superannuation providers, employees would be able to obtain a more efficient and productive superannuation fund to suit their needs. In the words of the Association of Superannuation Funds of Australia – "if choice of fund is implemented effectively it

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1 Submission No. 9, Taxation Institute of Australia, p.2.

2 Taxation Laws Amendment Bill (No.7) 1997, Second Reading Speech, p.2.

3 *Choice of Fund*, Twenty Eighth Report of the Senate Select Committee on Superannuation, March 1998.

has the potential to significantly benefit superannuation fund members."[4]. However, while there is clear support for the principle of choice of funds, some parties have expressed reservations regarding implementation of the scheme.

The main concerns raised in evidence to the inquiry fall into the categories of:

- The need for an educational campaign concerning choice of funds;
- Problems associated with the changeover period; and
- The imminent commencement date for the new scheme of July this year.

Need for educational campaign regarding choice of fund

A common view among inquiry participants is that the scheme proposed by Schedule 5 would best be served if the Government offered education or advisory services in relation to choice of funds. The Committee supports this view of the Australian Society of CPAs and others that:

> …the Government should encourage education [including the distribution of 'product-neutral' materials] and provision of quality advice to ensure choice is understood and beneficial for the community[5].

Problems associated with changeover period

The Taxation Institute of Australia suggested amendments be made to take into account possible implementation problems regarding the interim change over period. The Institute stated that the provisions of the Bill 'create insurance problems during an interim changeover period. Currently there are administrative inconveniences encountered in insuring a fund member during this interim period for accident and death cover.'[6]

Imminent implementation of scheme

Much of the evidence, both to this Committee and the Senate Select Committee on Superannuation, indicates that there is a deep division in responses to the proposed July commencement date for the choice of fund scheme. Specialist providers of financial products are anxious that choice proceed in accordance with the Government's announced schedule, while others, for a variety of reasons, advocate a delay, or propose that choice be optional for a limited period, or that choice be limited to investment within a fund[7].

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4 Submission No. 6, Association of Superannuation Funds of Australia, p.1.

5 Submission No. 2, Australian Society of CPAs, p.2.

6 Submission No. 9, Taxation Institute of Australia, p.3.

7 *Choice of Fund*, Twenty Eighth Report of the Senate Select Committee on Superannuation, March 1998, p.87,para. 13.1.

William M. Mercer stated, in evidence to the Superannuation Committee, that the mechanics of the legislation was far from complete and that 'there is a great deal of work to do to determine the key features statements'.[8] Mercer suggested that before the legislation be enacted, the Government consider the selection of funds; carry out due diligence on the selection of funds; make amendments to existing funds to make them more competitive; put in place robust insurance features; negotiate workplace agreements; create an information package for members; and put in place administrative procedures for paying contributions to a number of funds[9]

On the other hand, other witnesses supported the Government's intention to introduce the legislation as scheduled for July 1988. They stated simply that the sooner the legislation can be enacted, the sooner a competitive change can permeate the market.

CGT Asset register (Schedule 7)

Schedule 7 of the Bill implements and extends the Small Business Deregulation Taskforce's recommendation to introduce an asset register for capital gains tax purposes. The Second Reading Speech delivered at the time of the Bill's introduction into the House of Representatives indicates that the CGT asset register proposal will allow all taxpayers to transfer all or some of the information they are required to retain for capital gains tax purposes (that has been certified as correct by a suitably qualified person) into an asset register.

The Taxation Institute of Australia applauds the principle of a CGT asset register, however, identifies some room for improvement in the detail of the register outlined in schedule 7 of the Bill. In particular, the Institute questioned provisions which require taxpayers' certified documentation to be retained for five years after transfer of the relevant contents to the asset register. The Institute described this requirement as 'self defeating', in that "If taxpayers are aware that they must still keep original source documents for a further five years after information is transferred to the register, it is likely that many taxpayers will fail to see the benefit of using an Assets Register."[10]

An additional concern of the Taxation of Institute of Australia relates to the process of certifying documentation for lodgement with the proposed register. Proposed subsection 160ZZU(9)(c) provides for certification of the documentation by a registered tax agent. The Institute questions why other, suitably qualified, professionals such as solicitors and registered company auditors, could not also be authorised to certify documentation.

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8 *Choice of Fund*, Twenty Eighth Report of the Senate Select Committee on Superannuation, March 1998, p.45,para. 7.14.

9 *Choice of Fund*, Twenty Eighth Report of the Senate Select Committee on Superannuation, March 1998, p.45,para. 7.14.

10 Submission No. 9, Taxation Institute of Australia, p.4.

Franked Dividends and Other Distributions (Schedule 8)

In relation to the franking of dividends and other distributions the Government stated that it set out to achieve the following:

> The Bill will implement some of the measures announced by the Government in the 1997-98 Budget to prevent franking credit trading and dividend streaming, namely, the introduction of a general anti-avoidance rule and anti-streaming measures. These measures are designed to protect the integrity of the company tax imputation system. The remaining measures announced in the Budget will be introduced into the Parliament as soon as possible.
>
> Subject to a transitional measure explained in the Bill, these amendments apply from 7.30pm AEST, 13 May 1997.[11]

Franking of dividends refers to the situation where a company has paid company tax and the amount of tax paid is credited to a franking account or accounts. When dividends are paid they can be franked, which means that the credits available from the franking account are distributed to the shareholders. These are then used to offset the amount of tax payable by the recipient of the dividends. The measures contained in the Bill are intended to curtail schemes used to maximise the value of the franking credits to certain classes of shareholders. By definition another class of shareholder sees a reduction in the franking credits provided to them. These schemes are commonly known as dividend streaming.[12]

The measures mentioned in the Minister's second reading speech were first set out in a press release by the Treasurer dated 13 May 1997 (Budget night). The aim of the measures was to curtail schemes, as described above, being used to maximise the value of the franking credits to certain classes of shareholders.

Concerns Raised in Evidence

In summary the concerns were:

- The lack of a definition of 'dividend streaming' in the legislation;
- The nature of the test applied in the anti avoidance provisions;
- The discretion available to the Commissioner;
- The piecemeal approach to introducing the legislation; and
- The measures should not have any retrospective impact.

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11 Second Reading Speech, Taxation Laws Amendment Bill (No.7), by the Parliamentary Secretary to the Prime Minister, the Hon. Chris Miles MP.

12 Parliamentary Library, Bills Digest, No. 129 of 1997-98, p.6.

Definition of 'Dividend Streaming'

Streaming occurs when dividends are paid in such a way that more franking credit benefits are received by shareholders that would derive a greater benefit from the franking credits. The Australian Society of CPAs (ASCPA) believes that the legislation lacks guidance in that it does not define the concept of a company streaming the payment of dividends. The ASCPAs believes the term to be tax jargon, rather than an understood judicial phrase. Furthermore there is an absence of any material definitions and examples in either the draft legislation or the Explanatory Memorandum.[13]

Other witnesses raised the same concern. The Investment and Financial Services Association Ltd (IFSA) told the Committee that the legislation as currently drafted provides taxpayers with 'no clue' of what is meant by the expression 'streams the payment of dividend'. IFSA comments that it is unfortunate that an expression so fundamental to the operation of the proposed legislation is undefined.[14]

Government Response

In evidence Mr Walmsley, Assistant Commissioner, (Tax Counsel Network), Australian Taxation Office, told the Committee that the term 'dividend streaming' had been around for quite a long time. New Zealand legislation has used the term since around 1989 without further defining it. The provisions in the Bill are modelled on the New Zealand legislation. Mr Walmsley told the Committee that the problem with any anti-avoidance provision is that “...if you make it wide enough to catch everything that it should catch that it may catch something that it should not, which is why we put discretions into the law in these sort of provisions.”[15] Conversely if the definition is made too narrow it may exclude some things which should fall into it. Mr Walmsley pointed to the New Zealand experience which showed that the provisions were not particularly problematic once they had been administered. The administration process results in consultation and interpretation which supports the legislative provisions. The alternative to this proven and accepted approach, is more detailed and complex legislation. The Committee agrees that even more detailed legislation is not preferred. However the administration process referred to above should include rulings to clarify industry questions, for example, dividend streaming.

Anti-Avoidance Provisions

The ASCPA and a number of other witnesses expressed concerns regarding the general anti-avoidance provisions and the definition of the test to be applied. The critical phrase in the general anti-avoidance provision is 'Having regard to the relevant circumstances it would be concluded that a person who carried out the scheme did so for more than an incidental purpose of enabling a taxpayer to obtain a franking credit benefit'. The Society's concern is with the phrase 'more than incidental purpose'. The

13 Submission No.2, Australian Society of CPAs, p.28.

14 Evidence, p. E24.

15 Evidence, p. E45

point is made that in other parts of the anti-avoidance provisions, in Part IVA, the phrase 'dominant purpose' is used.[16] The Taxation Institute of Australia (TIA), IFSA, the ASCPA and other witnesses were critical of this widened test. TIA believed that the test of dominant purpose had been 'turned on its head' in the Bill where all that is required is an incidental purpose for the provisions to apply. TIA believed this to be 'far too wide an extension'.[17]

The ASCPAs told the Committee that the provision should be re-phrased to at least require a substantial or dominant purpose of providing franking credit benefits to the relevant shareholder.[18] While witnesses acknowledged that there were indications a supplementary Explanatory Memorandum would address interpretation of 'incidental purpose', there were still significant concerns about interpretation of this test by the ATO and the uncertainty that would result. For example, IFSA told the Committee that in discussions with the ATO the 'relevant purpose in new section 177EA must be substantial, big or large'.[19] The ambiguity of these words caused greater concern. IFSA suggested that the section should refer to a substantial purpose rather than a 'not incidental purpose'. IFSA recommended that the clause be amended so that Part IVA operates in a consistent fashion and that clause 177EA should apply only where there is a dominant purpose of obtaining a franking advantage. IFSA suggested that the test should relate to a substantial or significant purpose rather than a not incidental one.[20]

Government Response

The Government's position was explained as follows:

> As Senator Kemp explained, if it were placed at the dominant purpose level, the measure simply would not work. There are many arrangements which the measure is intended to catch. The object of obtaining a franking credit benefit is a substantial purpose of the arrangement, but it is not the dominant purpose. The measure uses an identical test to the test which has been employed in New Zealand without problem for about a decade.
>
> The intention of the legislation really is reasonably clear. On one end of the scale, there is a dominant purpose; on the other end of the scale, there is an incidental purpose. The legislation puts it as clearly as it possibly can that it is interested in the middle, which is what you might call a main or a substantial purpose. In one of the meetings I was alluding to about consultations, I described it as a big purpose. In the nature of something like purpose, I am not sure how we could express the intention any more clearly than the way in which it has in fact been expressed.[21]

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16 Evidence, p. E7.

17 Evidence, p. E39.

18 Evidence, p. E7.

19 Evidence, p. E24.

20 Evidence, p. E24.

21 Evidence, p. E57.

The Committee makes the same suggestion in relation to the operation of the anti-avoidance provisions that it made previously in relation to definitions. That is, that the Commissioner move quickly to issue rulings to assist administration of these provisions in order to provide greater certainty.

Discretion Available to the Commissioner

The ASCPA questioned the wide discretionary power of the Commissioner in determining the purpose of particular schemes. The Society pointed out that the Bill allows the Commissioner to debit the franking account of a company or disallow the credits to the shareholder. While acknowledging that the Commissioner would rarely use this power, the Society still believed the power to be too arbitrary. The ability to use such a discretion creates uncertainty as it could be used years later to disallow people's dividends.[22]

IFSA also told the Committee that the Bill provides the Commissioner with extraordinarily wide discretions as to whether the proposed new dividend streaming or franking credit scheme rules apply. IFSA shared the Society's concern that no time frame is provided within which the discretion should be exercised. Additionally no guidance is provided as to factors for the Commissioner to take into account when exercising this discretion. IFSA believes that strict guidelines should be set out to direct the Commissioner when applying this discretion, and that when it is applied, reasons should be given.[23]

Government Response

At issue was the wide discretionary power available to the Commissioner and the lack of guidelines as to how the discretion should be exercised. In response to those concerns ATO advised the Committee that guidelines and rulings by the Commissioner would be issued following the passing of the legislation. Further amendment would not be required to the legislation to clarify matters in relation to the discretion.[24] The Committee supports this approach to clarify these matters through the issuing of rulings following the passing of the legislation, including in relation to timing and the reasons for decisions.

Piecemeal Approach to Introducing the Legislation

IFSA stated a general concern that as a result of the piecemeal nature of the introduction of the budget announcements, the package of measures is likely to be contained in a number of separate bills as well as regulations which will collectively be introduced over an extended period of time.

> Aspects of the measures are likely to be incorrect or obsolete, even as they are introduced. Evidence of this is already apparent from the amendments

22 Evidence, p. E7.

23 Evidence, p. E25.

24 Evidence, p. E56.

> contained in Taxation Laws Amendment Bill (No. 4) 1998, introduced into the House of Representatives on Wednesday. This Bill is already seeking to make obsolete provisions contained in the Bill No.7 that we are discussing today. It is this continual lack of certainty as to the intended operation of the law that leads to significant disquiet amongst the tax paying community and its advisers[25]

Government Response

Concern was expressed about the introduction of the measures announced in the budget in a number of separate pieces of legislation. The ATO acknowledged that this was unfortunate but noted that, the package was being dealt with as a whole, in so far as earlier provisions were designed to take into account later provisions and could modified where necessary.

Retrospective Application

Problems surrounding the retrospective application of schedule 8 were specifically noted by the Investment and Financial Services Association Ltd. While the legislation applies to dividends paid on or after 13 May 1997, the measures contained also expressly apply to dividends paid in relation to schemes that were entered into before that time. IFSA argued that the legislation therefore will have a retrospective effect where taxpayers who had entered into arrangements, which prior to Budget night were otherwise acceptable, now find those arrangements retrospectively subject to scrutiny. IFSA proposed that the new provisions apply only to schemes entered into or carried out on or after 13 May 1997. TIA stated in their submission that the legislation should apply from the year commencing on 1 July 1998 (assuming availability of the remainder of the provisions which are yet to be drafted).[26]

Distributions by Private Companies (Schedule 9)

The 'distributions by private companies' provisions contained within schedule 9 are designed to prevent various transactions by private companies being used to reduce the amount of tax payable through distribution of funds by the company. The schedule proposes to introduce a new Division 7A to the *Income Tax Assessment Act 1936* which will "..ensure that payments, loans, or debts forgiven by private companies to shareholders (and associates of shareholders) are treated as assessable dividends to the extent that they are realised or unrealised profits in the company (unless they come within specified exclusions)."[27]

On 9 March 1988 the Government announced that the proposed Division 7A contained within Taxation Laws Amendment Bill (No.7) 1997 would be amended to

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25 Evidence, p. E23.

26 Submission No. 9, Taxation Institute of Australia, p.5.

27 Senator the Hon. Rod Kemp, Assistant Treasurer, Press Release – *Taxation of Distributions Disguised as Loans from Private Companies*, 27 March 1998, p.1

ensure that it did not apply to payments by private companies to, or on behalf of, shareholders in their capacity as employees. Further refinements to Division 7A were announced by the Assistant Treasurer on 27 March 1998 in respect of: loan guarantees; loans for employee share scheme purchases; distributions by liquidators and winding up loans; trust distributions to corporate beneficiaries; amounts that are not otherwise assessable treated as dividends; and written loan agreements. A copy of the Assistant Treasurer's Press Release and proposed amendments is contained in appendix III

Concerns Raised in Evidence

The Committee notes that the Government amendments of 27 March 1998 address many, but not all, concerns raised in evidence to the inquiry. In particular, inquiry participants expressed continuing concern in relation to:

- the inadvertently broad nature of the Schedule;
- operation of interposed entity provisions;
- the cost of compliance with the schedule;
- the apparently artificial definition of 'distributable surplus'; and
- the impact upon employee share acquisition schemes.

Inadvertently broad nature of the Schedule

A common and strong complaint among inquiry participants was that, in attempting to tax all profits released from companies in a tax free form, the net thrown by Schedule 9 will be too wide and have inadvertent consequences particularly for small to medium enterprises. Despite supporting the principle of Schedule 9, key witnesses such as the Australian Society of CPAs, the Law Council of Australia and the Australian Taxpayers' Association, submitted that the schedule is particularly prescriptive and complex and may impose tax burdens beyond the intended parameters of the policy:

> (Schedule 9) is founded upon the principle that every loan, every payment, every debt forgiveness and every loan guarantee in relation to a shareholder or an associate is a deemed dividend unless the transaction is expressly excluded. As a consequence, if the exclusions are inadequate, many amounts can be subject to tax pursuant to Schedule 9 when the policy objective (of taxing profits released from companies in a tax free form) is not satisfied.[28]

In light of these concerns regarding the unintended consequences of the Bill, the ASCPA submitted that it is imperative that there be a discretion within the provisions, permitting the Commissioner to waive the provisions where there has been an inadvertent error, which has been rectified.

28 Submission No. 2a, Australian Institute of CPAs, p.2.

The unintended implications of the schedule may be particularly pronounced for farmers, specifically concerning provisions relating to the use of company property by shareholders, and the loan guarantee arrangements. While welcoming many of the Assistant Treasurer's amendments of 27 March 1988, Australian Women in Agriculture NSW-Inc identified continuing problems with the draft legislation for rural Australia. In relation to the 'use of company property' provisions, Ms Elizabeth Wells, Secretary of Australian Women in Agriculture NSW – Inc identified a number of weaknesses in the draft legislation:

> Advances of moneys from farm company holdings to its shareholders, say for the purchase of education….would be considered income and they would be taxed as such. The purchase by a farming company of laptop computers or mobile phones and company vehicles could see the family member who is the user, whether they are a shareholder in the company or not, be deemed to have received a transfer of property when using the company work ute or mobile phone or computer, and therefore the value of these items would be added to their personal income and taxed as such.[29]

Additional problems were identified by the Australian Women in Agriculture NSW – Inc concerning the loan guarantee provisions of Schedule 9. In respect of the Tax Commissioner's discretion to exclude an amount treated as a dividend as a result of a liability arising under a guarantee if it would cause undue hardship to the shareholder or associate, Australian Women in Agriculture seek clarification of the term 'associate'. It is unclear whether the definition of associate would include blood relations of a shareholder in a family farm company or marital partners of a shareholder in a family farm company. If this is the case, Australian Women in Agriculture:

> ..stress the unfairness of this definition not only on the grounds of hardship….but in terms of the basic human decency such a provision ignores. People should not be penalised for their genetic heritage or marital status.[30]

Further concerns regarding the guaranteed loans provisions of the Schedule were identified by the Law Council of Australia. In its amendments of 27 March, the Government announced that the "…creation of a liability to make a payment upon default under a guarantee will be the triggering event for a deemed dividend."[31] The Law Council of Australia expressed dissatisfaction with this proposal stressing "..why as a matter of policy is it necessary in fact on default under a guarantee to activate the legislation?….Why is it necessary for a default under a guarantee as distinct from a

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29 Evidence, p. E13.

30 Submission No. 7a, Australian Women in Agriculture, p.1

31 Senator the Hon. Rod Kemp, Assistant Treasurer, Press Release – *Taxation of Distributions Disguised as Loans from Private Companies*, 27 March 1998, p.1

payment under a guarantee – because until there is payment there is no movement of profits out of (a) company?"[32]

Government response

In response to concerns regarding payment of liabilities under guaranteed loans, representatives of the Australian Taxation Office defended the Government's policy position that a liability would be triggered at the time of default under a guarantee, rather than payment. Assistant Commissioner, Mr Tom Meredith explained:

> We do not agree….that it should be at the time of payment. In fact the triggering of a liability at a time after default under loan agreement, in our view, would enable private companies to arrange alternative means of satisfying their obligations to lenders without incurring a tax liability under division 7A……(For example, companies) could arrange for another entity to make the payment; that is a very simple way of getting around those arrangements. There may well be other contra arrangements that might be entered into, particularly by sophisticated taxpayers, that will enable them to avoid the operation of these provisions. The (Law Council of Australia's) primary concern, as I understood it, was that some taxpayers would be caught as a result of a technical default where no payment is made. What the government has done in its amendments is to include a commissioner's discretion to overcome that concern in particular.[33]

In addition, in relation to the concern that some taxpayers would incur a liability as a result of a technical default which is remedied before any payment is made under the guarantee, the Australian Taxation Office submitted a supplementary statement to the Committee highlighting the Government's proposed amendment concerning the Commissioner's discretion to:

> …exclude an amount treated as a dividend as a result of a liability arising under a guarantee if it would cause undue hardship to the shareholder (or associate). This will allow the Commissioner a discretion in circumstances where, for example, a shareholder is financially unable to meet loan repayments through no fault of their own, or where a shareholder technically defaults under a loan agreement by failing to make a payment by the due date, but makes that payment within a short period of time thereafter.[34]

The Australian Taxation Office provided additional comments relating to many of the concerns raised by the Australian Women in Agriculture. In respect of issues

32 Evidence, p. E29.

33 Evidence, p. E43.

34 Australian Taxation Office, correspondence to the Senate Economics Legislation Committee of 4 April 1998, p.3.

surrounding transfer of property, specifically inter-generational transfer of farming land from a private company to associated entities, the Tax Office stated:

- The transfer of property by a private company to a shareholder (or associate) in their capacity as a shareholder for no consideration is likely to be treated as a payment by the company under the new Division 7A, and hence as a deemed dividend, if the company has a distributable surplus;
- This treatment is essentially the same as under the existing section 108, because it is likely that the Commissioner would consider such a transfer of property to be a distribution of profits. Section 108 specifically deems a transfer of property to be a payment of an amount equal to the value of the property;
- These provisions would apply irrespective of the type of property that is being transferred to a shareholder (or associate). For example, the property transferred could be real estate or a motor vehicle owned by the company.[35]

On the subject of the taxation implications of allowing shareholders the right to use company property such as a motor vehicle, the Australian Taxation Office states:

- If a company purchases a motor vehicle in its own name and a shareholder uses that vehicle, Division 7A would have no application to the extent that the vehicle is used in the ordinary course of the company's business.
- If a vehicle is provided to a shareholder in their capacity as an employee, the value of any private use of that vehicle would be subject to the fringe benefits tax rules and not new Division 7A.
- On the other hand, if a vehicle is provided to a shareholder in their capacity as a shareholder, the value of any private use of that vehicle may be subject to the new Division 7A.[36]

Operation of interposed entity provisions

A number of witnesses including the Law Council of Australia and the Australian Society of CPAs argued that the interposed entity provisions of Schedule 9 would operate inappropriately. In particular, there was concern that the provisions would apply in circumstances such as where an amount paid by a private company to an interposed entity is then lent to a shareholder (or associate) who repays an amount owed to the company.

Government response

The Australian Taxation Office states that concerns regarding the operation of the interposed entity provision ignore the requirement that for the provision to operate:

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35 Australian Taxation Office, correspondence to the Senate Economics Legislation Committee of 4 April 1998, p.1.

36 Australian Taxation Office, correspondence to the Senate Economics Legislation Committee of 4 April 1998, p.1.

> ..it must be reasonable for a person to conclude that the sole or main purpose of the private company in making the payment or loan to the interposed entity was to enable an amount to be paid or lent to a shareholder of the private company or a shareholder's associate.[37]

Cost of compliance

While the Explanatory Memorandum to the Bill states that the impact of Schedule 9 on compliance costs is not expected to be substantial, a number of inquiry participants submitted otherwise. The Taxation Institute of Australia indicated the extensive concern among its members in respect of schedule 9, and consequently, need for educational programs to advise of the new obligations required by the schedule:

> From the level of interest in those educational programs, we have had thousands of our members Australia wide attend educational functions on division 7A. Obviously that has involved a cost for those practitioners and, obviously, when the provisions do eventually get passed and receive royal assent, in whatever form that may be, that will result in massive costs of compliance, particularly for small business.[38]

Artificial definition of distributable surplus

Notwithstanding the proposed amendments to Schedule 9, significant problems were identified by inquiry participants in respect of provisions relating to distributable surplus. Schedule 9 proposes that the calculation of the deemed dividend is by reference to the company's distributable surplus. Yet, as drafted, the definition of distributable surplus, is considered likely to cause shareholders or their associates to be taxed on profits which do not exist. The ASCPA submits that "..the relevant definitions exclude from the calculation of distribution surplus amounts which a reasonable person would regard as being obligations of the company which reduce the profits of the company."[39]

Impact upon Employee Share Ownership Plans

In press releases of 9 and 27 March, the Assistant Treasurer announced amendments to Taxation Laws Amendment Bill (No.7) 1997 to ensure the provisions of Schedule 9 would not apply to payments made to shareholders in their capacity as employees. While the amendments were acknowledged by inquiry participants as well intended, they were broadly condemned as inadequate in scope. The Australian Employee Ownership Association and the Remuneration Planning Corporation highlighted certain areas of the draft legislation where the clarity and force of amendments could be improved, including:

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37 Australian Taxation Office, correspondence to the Senate Economics Legislation Committee of 4 April 1998, p.2.

38 Evidence, p. E37.

39 Submission 2a, Australian Society of CPAs, p.4.

- Proposed new section 109H which lists the kinds of payments and loans that are not treated as dividends, yet has not been amended by the Government to clarify that Division 7A does not apply to payments to shareholders or associates in their capacity as an employee;
- That proposed section 109H be further amended to include payments made for the purpose of funding the purchase of shares and rights under an employee share scheme; and that a new section be inserted after section 109H to give effect to this amendment and clarify that the terms of the amendment are such as to cover both qualifying (in terms of Division 13A ITAA) and non-qualifying share plans.[40]

Government Response

On the subject of loans for employee share acquisition scheme, the Australian Taxation Office defended the Government's position by stating:

> The exclusion of loans to finance the acquisition of shares under employee share schemes is consistent with the requirements that apply under Division 13A (which provides concessional income tax treatment for such schemes).[41]

Savings Rebate (Schedule 10)

Schedule 10 of the Bill inserts a new sub-division 61-A into the *Income Tax Assessment Act 1997* concerning a tax offset or 'savings rebate' relating to savings and investment income. The rebate will apply from 1 July 1998 to undeducted superannuation contributions made by employees and the self-employed and net personal income from savings and investment (including net business income) up to an annual cap of $3,000. In the first year it will apply at a transitional rate of 7.5% and increase 15% thereafter. According to the Second Reading Speech to the Bill, this will deliver a tax saving of up to $450 per year.[42]

In terms of encouraging a savings culture in Australia, the principle of the savings rebate was welcomed by the Investment & Financial Services Association (IFSA) and praised for its simplicity, universality and equity. In supporting the rebate, IFSA noted that currently savings are made out of after tax income and the interest earned is again taxed. "A rational consumer therefore has little incentive to save under the double taxation regime." [43]

While supporting the savings rebate in general terms, IFSA noted one significant problem area in the rebate, as presently envisaged. The rebate will not apply to in-

40 Submission No. 3a, Australian Employee Ownership Association, pp2-3.

41 Australian Taxation Office, correspondence to the Senate Economics Legislation Committee of 4 April 1998, p.2.

42 Taxation Laws Amendment Bill (No.7) 1997, Second Reading Speech, p.1.

43 Submission No. 16, Investment and Financial Services Association Ltd, p.1.

force life insurance policies as distinct from paid out bonuses (i.e taxable surrenders within ten years of purchase). Accordingly, IFSA advocates:

> ….a practical means to have the rebate apply without having to 'cash-in' life insurance policies – which would be a perverse result for a measure intended to promote savings. The policies in question currently bear tax period-by-period on the returns accruing to them in statutory funds levied at a 'trustee rate' of 39 per cent. In principle, therefore the rebate should apply.[44]

The Australian Society of CPAs joins with IFSA in supporting the principle of promoting savings. However, the ASCPAs is concerned that the ultimate aims of the savings rebate will be compromised by the manner in which the rebate will be applied. The ASCPA submits that the savings rebate: "..in rewarding past as well as new savings, and in not being means tested, will spread the benefit too widely and too lightly to make the desired impact."[45] The Australian Council of Social Service (ACOSS) echoes this concern of the ASCPA, submitting that, in its current form, the proposed rebate will spread public support for savings too thinly to have any real impact on saving, yet will cost the federal budget over $2 billion per annum by the turn of the century.[46]

The equity, or perceived inequity, of the rebate also attracted extensive comment from ACOSS, and was noted by the Australian Women in Agriculture – NSW Inc. ACOSS condemns the rebate as offering little assistance to low income people and failing to address major inequities in the present tax regime for saving and investment. ACOSS contends that, in theory, the rebate will benefit low and middle income earners. While in reality:

> …few low income earners (apart from a minority of retirees with substantial assets) would be able to save enough to derive much benefit, especially in the context of the compulsory savings regime. However, the rebate offers windfall gains for high income wage earners who are likely to save or invest in any event.[47]

In stark contrast to the ACOSS position, however, IFSA strongly defends the rebate as being equitable on the grounds that it is capped, and thus, in proportionate terms, higher income earners "..will not benefit greatly".[48] In support of its position IFSA cites a study commissioned by one of its member companies, with the National Centre for Social and Economic Modelling at the University of Canberra. The study found that two important points generally were overlooked in reaching the conclusion that the savings rebate amounted to a tax cut for the rich:

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44 Submission No. 16, Investment and Financial Services Association Ltd, p.2.

45 Submission No. 2, Australian Society of CPAs, p.16

46 Submission No. 8, Australian Council of Social Service, p.1.

47 Submission No.8, Australian Council of Social Service, p.1

48 Submission No. 16, Investment and Financial Services Association Ltd, p.2.

> First, the distribution of savings by income is far different from the distribution of saving. Many people on relatively low incomes have significant savings – retirees are an obvious example. Second, the cap of $3,000 for eligible savings obviously "handicaps" the rich.[49]

RECOMMENDATION

The Committee recommends that the Bill proceed as printed, without delay.

Senator A.B. Ferguson

Chairman

49 Submission No. 16, Investment and Financial Services Association Ltd, p 5