COMMONWEALTH OF AUSTRALIA

Proof Committee Hansard

SENATE

ECONOMICS LEGISLATION COMMITTEE

Reference: Tax Laws Amendment (2010 Measures No. 2) Bill 2010

WEDNESDAY, 28 APRIL 2010

SYDNEY

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SENATE ECONOMICS

LEGISLATION COMMITTEE

Wednesday, 28 April 2010

Members: Senator Hurley *(Chair)*, Senator Eggleston *(Deputy Chair)*, Senators Cameron, Joyce, Pratt and Xenophon

Substitute members: (As per most recent Senate Notice Paper)

Participating members: Senators Abetz, Adams, Back, Barnett, Bernardi, Bilyk, Birmingham, Mark Bishop, Boswell, Boyce, Brandis, Bob Brown, Carol Brown, Bushby, Cash, Colbeck, Jacinta Collins, Coonan, Cormann, Crossin, Farrell, Feeney, Ferguson, Fielding, Fierravanti-Wells, Fifield, Fisher, Forshaw, Furner, Hanson-Young, Heffernan, Humphries, Hutchins, Johnston, Kroger, Ludlam, Lundy, Ian Macdonald, McEwen, McGauran, McLucas, Marshall, Mason, Milne, Minchin, Moore, Nash, O'Brien, Parry, Payne, Polley, Ronaldson, Ryan, Scullion, Siewert, Sterle, Troeth, Trood, Williams and Wortley

Senators in attendance: Senators Bushby, Cameron, Eggleston, Hurley and Pratt

Terms of reference for the inquiry:

To inquire into and report on:

Tax Laws Amendment (2010 Measures No. 2) Bill 2010

WITNESSES

Committee met at 2.44 pm

CHAIR (Senator Hurley)—I declare open this first hearing of the Senate Economics Legislation Committee into the provisions of the Tax Laws Amendment (2010 Measures No. 2) Bill 2010. The bill was referred to the Senate Economics Legislation Committee for inquiry on 18 March 2010. In referring the bill for consideration, the Senate requested that the committee ensure that there be no unintended consequences as a result of the bill, particularly as a result of the amendments set out in schedule 1. The committee is due to report on 11 May 2010.

These are public proceedings, although the committee may agree to a request to have evidence heard in camera or may determine that certain evidence should be heard in camera. I remind all witnesses that, in giving evidence to the committee, they are protected by parliamentary privilege. It is unlawful for anyone to threaten or disadvantage a witness on account of evidence given to a committee, and such action may be treated by the Senate as a contempt. It is also a contempt to give false or misleading evidence to a committee. If a witness objects to answering a question, the witness should state the ground upon which the objection is taken and the committee will determine whether it will insist on an answer, having regard to the ground which is claimed. If the committee determines to insist on an answer, a witness may request that the answer be given in camera.

[2.46 pm]

APPLEBY, Mr Daniel, Member, Taxation Committee, Law Council of Australia

BALAZS, Mr John George, Member, Taxation Committee, Law Council of Australia

CHAIR—Welcome. I invite you to make an opening statement.

Mr Appleby—On behalf of the Law Council we thank senators very much for receiving our written submission on the Tax Laws Amendment (2010 Measures No. 2) Bill 2010 and for the opportunity to speak today. We might start very briefly with a succinct history of the particular amendments with which the Law Council's submission is concerned. Schedule 1 proposes certain amendments to division 7A of the 1936 tax act. Those are the provisions with which the Law Council's submission is concerned. Division 7A was originally inserted into the tax act in 1998 to replace then existing provisions which required the commissioner to make certain determinations with a comprehensive division which operated automatically to deal with the mismatch between the private company tax rate, now 30 per cent, and the tax rates for individuals, which in many cases will exceed the corporate tax rate.

The original policy intent behind division 7A was to prevent companies from making what are described as tax-free distributions of profits to their shareholders or the associates of shareholders by treating the effective distribution of company profits as though that was an actual dividend. Put simply, division 7A is designed to prevent disguised dividends from private companies in the form of interest-free loans, payments or transfers of company profits to shareholders. The Law Council does not dispute the policy behind division 7A or the operation of the division as it currently stands.

The concern of Law Council is that the bill currently before us goes well beyond the scope of division 7A. The Law Council considers the bill will significantly extend the operation of division 7A in a way which is not consistent with the intent of the division and which will produce unfairness, inequality and unreasonable compliance costs for all private companies, in particular small businesses. The proposed amendments will apply in respect of virtually any asset of a private company, regardless of when that asset was acquired, and it will operate to deem a dividend to the shareholders of a company where the company has merely provided an asset for the use of a shareholder or their associate, without any disguised or other distribution of company profits.

The extension of the division goes well beyond the original intent of the division. It will apply where there is no transfer of company resources away from the company, it will apply where those assets being used were not acquired with company profits and it will apply where there are simply no company profits. It will deem a dividend regardless. The proposed amendment of division 7A was described by the then Assistant Treasurer in June 2009 as being required to prevent effective tax-free distributions to shareholders using company profits.

The proposed extension of the division as it is worded in the bill, however, seeks to apply a notional dividend treatment to things that do not constitute a distribution of profits tax-free to shareholders. The amendments are not targeted to that perceived mischief and they will impose a significant tax and compliance burden to situations where there is simply no tax advantage of the type sought to be prevented. In many cases—whether it is for asset protection, succession or other reasons—individuals will use a company structure funded from their own after-tax moneys to hold assets. The money used on those circumstances by the company is the shareholder's own after-tax funds. It is not company profits. The bill will, however, tax the use of such an asset acquired in that fashion as if it was a dividend made out of profits, which it is not.

A disguised dividend under division 7A today does require an effective actual transfer of company funds to the shareholders being paid in a way other than as a traditional dividend. The ability to use, or the provision for use of a company owned asset, we consider, does not effect a transfer of funds of the company to the shareholder, and attempting to extend 7A to that use is inconsistent, particularly where a company is used merely for holding assets and there are no company profits being diverted.

A primary concern of the Law Council is that this bill operates retrospectively. When division 7A was first introduced in 1998 existing arrangements in place at that time—existing interest free loans with which the division was concerned—were expressly excluded from the new obligation. They were grandfathered by express provision. There is no express grandfathering for existing assets of companies in the current bill. The new rules will apply to any use provided from 1 July 2009, without exception. There is, further, no stamp duty or capital gains tax rollover or relief for those structures that are already in place to give them an opportunity to restructure, to get company assets out of a company and back into individual hands, if they wish to prevent the division applying.

One particular asset or type of asset is of grave concern to the Law Council, and that is company title real estate. There is no exclusion in the act for company title real estate, for any company titled home acquired after 1 July 2009, and it is questionable whether the particular main residence and other exclusions in the bill would apply to pre-existing company title. The owners of company title apartments or duplexes—their own homes—will be deemed to have received income, taxable to them, every year equal to the notional rental of their own home. The bill before us seeks to treat as a dividend not just the use of an asset but what is described as ‘the provision of use of an asset’. The notion of ‘provision of’ or providing an asset is not defined for the purposes of the division and the Law Council considers it may be very difficult, particularly for small business operators, to determine just when an asset has been provided for their use, in the absence of very prescriptive provisions. There are certain examples in the Law Council’s submission that detail some of the examples of how difficult this may be and there are some examples and statements in the explanatory memorandum to the bill which some people, particularly small business operators or suburban accountants, will find not only inconclusive but in some cases simply inconsistent. The provision of an asset, therefore, might encompass actual use or express, exclusive use to one shareholder, but it might also include a mere ability to use an asset without the actual use of it. For most businesses this will be a very onerous and difficult test to apply.

The Law Council is also very concerned with what we imagine will be unreasonable and extremely high compliance costs for many businesses, particularly small businesses. The explanatory memorandum to the bill states that the compliance cost impact is likely to be low for these provisions and that the measures will affect only a small proportion of individuals and businesses. The Law Council expects that these provisions will probably affect every small business that operates through a company structure. The Law Council considers that any new tax provision should be fair, equitable and simple to apply without unreasonable compliance costs. The impact on small business, in particular, will be substantial. Those small businesses or any private company will need to determine the extent of any provision of an asset for use—not just the actual use. They then need to determine the market value of that use on a year-by-year basis. That will require valuations to be obtained every single year.

A detailed analysis of the extent that an asset has been provided for use will then need to be applied to that market valuation. GST will, in most cases, be added on top. The result of that is an extensive range of obtaining valuations, tax reporting and GST reporting. And other things may arise on top of that. Just trying to determine, for example, whether the minor benefits exclusion applies in this provision will be very difficult. My colleague can go through some examples of that if necessary. The Law Council considers a simple, safe-harbour proxy would be a more appropriate method and one that is used for existing division 7A loans where they are particularly made as a complying loan with an interest rate.

The bill has a proposed start date of 1 July 2009. As at 1 July 2009 these provisions were not known to any taxpayers. In fact, the consultation on a discussion paper on the proposed changes had not then yet closed. That consultation only allowed one month’s consultation on a discussion paper. Nothing further then occurred until 4 January, when an exposure draft was released which requested comments by 1 February, in the holiday period. The current state of the provisions was not revealed until the bill was introduced on 17 March, and this committee is now considering the effect and wording of the provisions. Small business taxpayers and all private companies, from 1 July 2009, will potentially have dividends deemed to them on a basis that they do not yet know.

Division 7A, as I mentioned earlier, is designed to treat as a dividend those distributions of company profits that are disguised as something other than dividends. That means that the provisions apply to the extent that there are profits in the company. Division 7A is designed to account for a disguised distribution of company profits. Companies do this by limiting the amount of a dividend to what is called the distributable surplus. This bill amends that definition of a distributable surplus to add into it the value of the use of an asset or the value of some other payment. The result is that even if a company does not have any profits it is still now deemed to be a profit and deemed to be a distribution of that profit. The result of that is that there are many circumstances, which we can run through, where there is absolutely no tax mischief, where a company is used to hold assets where there is no diverting of company profits in what the then Assistant Treasurer described as ‘a tax-free manner’, but which will now not only be deemed to be a dividend but deemed to be a dividend paid out of deemed profits, and taxable to those shareholders every year.

There is an example in the explanatory memorandum that is given in support of the reason for that particular change. However, we consider that that example is somewhat deficient in that it ignores the impact what I will call the capital gains tax market-value substitution provisions which, in the example giving in the EM, will cause the tax to be imposed on the company for what is called a distribution to a shareholder or sale to a shareholder at a less-than-arm's-length value. We do not think the example in the EM supports the reason for that particular change, or any of the changes.

The Law Council has placed in its written submission—I will conclude our remarks with these—the following recommendations. The Law Council recommends that the bill should operate from a commencement date not of 1 July 2009, which has already passed, but 1 July 2010 or 2011. The Law Council considers that the bill should not operate in respect of the use of private company assets acquired by the company before the commencement of these provisions. The Law Council considers the bill should not operate in respect of company titled assets, that the bill should apply to deem a dividend only to the extent of actual use of company asset, and not to the more amorphous 'provision for use'.

We consider the bill should not apply to assets in respect of which the company has not obtained any tax deduction and to the extent that the asset was acquired by a company using funds other than actual retained or current-year earnings. We consider that the bill should provide a very simple safe-harbour calculation method in order to minimise compliance costs—a system which is currently used for the provision of loans at an interest rate, which is deemed to be perfectly acceptable. Lastly, the Law Council recommends that the bill should not add to the distributable surplus of a private company a deemed amount equal to a deeming of the profits equal to the use of company assets.

CHAIR—In terms of the company title issue, you are saying that people will have their own private house in a company title structure. I find it difficult to understand why anyone would do that without some sort of other benefit. Your example is that a couple may put a house in a company title due to the funding difficulties sometimes encountered arising from company title acquisitions.

Mr Appleby—John might be able to give a bit more detail, but I can speak from some experience because I know there are some people in my street who have company title assets. It was not designed that way. They bought the house, which was in a company title. Company title is a very, very old method of real estate ownership, where a company owns the real estate, and the shareholders of the company are the ones that then have the right to use the asset, the house. When one person in the apartment building wants to sell their asset, they do not sell the apartment. They share. It is one title owned by the company. They sell their class X shares that give an entitlement to occupy unit No. 10. It is a very old method of real estate ownership.

CHAIR—For an apartment title or for multiple dwellings.

Mr Appleby—For multiple dwellings. That is right.

CHAIR—But the example you give here is just one house.

Mr Appleby—The example there is a duplex. A duplex there is two houses built on one parcel of land with a common wall between the two.

CHAIR—So the company would be getting some income from the rental of the other—

Mr Appleby—No. If it is a duplex, there will be two classes of shares—one for each half of the house. So different people live in each house.

Senator BUSHBY—Different owners.

CHAIR—I see. They are all owners of the company.

Mr Appleby—Yes.

CHAIR—But there is no compulsion to do it that way, is there?

Mr Balazs—If I can explain, the issue goes back and applies to all existing company title. Strata title only came into existence at the beginning of the 1960s, if I recollect rightly. All apartment buildings built in Sydney—at Potts Point and Kings Cross, for example—were built in company title. The people who own those buildings are a company, and the shareholders own rights to shares only. Those shares in turn give them a right to occupy the premises. That is a very common form of ownership for parts of Sydney for buildings that were built in the twenties, thirties, forties or whatever. The person who buys the shares and occupies those premises pays no rent because they have paid the market value for the shares and the shares give to them, through the constitution of the company, a right to occupy. These rules will tax the person that lives in that apartment, because they have bought the shares. They occupy the apartment. They bought it to live in it. These rules will tax them every year on the equivalent of the rental value of that apartment, even though they are the homeowners.

CHAIR—I am from South Australia, and we have had strata titling since the sixties, I think, and we now have a community titling. It has been progressively changed over.

Mr Appleby—I might just complete that explanation. Certainly in some areas of Sydney company title is being used today for new dwellings, mostly because a number of local environment plans do not permit the subdivision of lots below a certain size. For example, if someone comes along and buys a parcel of land of 600 square metres, they are not allowed to subdivide that into two parcels of 300 square metres, because each parcel size is too small. However, in an era when we are being encouraged to increase the density of housing, it is perfectly acceptable to a number of those councils, provided the land is not physically subdivided, to put the title into a company, build the duplex with the two parcels of shares and create a brand-new company title. If you build two houses on the parcel of land, you double the number of families who can live on the 600 square metre block.

CHAIR—It seems to me to be more like an argument for changing the planning laws than the tax laws.

Mr Appleby—That might be the case but the problem is for those people who have purchased a house like that. They have come along into Randwick, Mosman or Hurstville and bought one of those homes. By buying the shares, they will now be deemed to have received an income equal—

CHAIR—Unless they change their title.

Mr Appleby—They cannot change their title because that is the title of the property.

Mr Balas—There are provisions for conversion. We are not experts on property law, but I know as a former owner and occupier of a company title apartment that conversion was never something that was given great consideration. Some people are quite happy with company title—until now. It works for them. It tends to limit who gets to buy because the company normally has to approve the acquirers, and so some people are quite happy with company title. It has worked. It has functioned until now. It just seems to be odd that these rules will significantly penalise people merely for owning an apartment through a company title structure.

Senator BUSHBY—The company title seems to be an oversight by the drafters, I would imagine. It is certainly not something that they intended; but, nonetheless, it is right to point out that it is a massive, unintended consequence from the perspective of owners of company title.

Mr Appleby—The amendments that are contained in the legislation are a very wide blanket. They apply to any use of an asset owned by a private company.

Senator BUSHBY—It is really quite a fundamental change to company use in Australia.

Mr Appleby—Correct.

Senator BUSHBY—But not all companies are used to carry on an enterprise.

Mr Appleby—That is 100 per cent correct.

Senator BUSHBY—I think you have highlighted that in your submission. Companies are used for all sorts of reasons.

Mr Appleby—They could be used to invest in assets. Companies are used to hold assets for private ownership for reasons other than tax.

Senator BUSHBY—This fundamental change will mean that the taxation treatment of static assets that are held in companies that are not carrying on an enterprise or earning any sort of income will mean that the shareholders will be deemed to earn an income as a result.

Mr Appleby—That is right. Yes.

Senator BUSHBY—That would require a massive change for all sorts of companies that are not carrying on activities.

Mr Appleby—Correct.

Senator BUSHBY—What about body corporates? Have you looked at that? Body corporates hold assets in terms of the common area of strata titles.

Mr Balazs—That is probably correct. There may be an issue. I do not think either of us has gone into that level of detail. There is bound to be an issue with body corporates where there is common property. If common property is available for use, which it must be by definition, there could potentially be an issue. The question then is whether—

Mr Appleby—There could be. Most body corporates are statutory corporations, so they do not have a shareholder. That might fix those. But that said, it is not always that simple.

Senator BUSHBY—You have raised lots of issues. In your view, all small businesses that operate through a company will be impacted and also, as we discussed, any company, whether it is operating a small business or not.

Mr Appleby—Any proprietary limited company or private company and any investment company that holds its assets for growth and pays tax is going to be affected. These days, holding investments in a company is not a very tax efficient structure. You get no capital gains tax discount that an individual would get, but now the shareholders of that company will be deemed to have received income from those assets every single year. With small businesses, just about every plumber, builder or carpenter that I have come across operates through a company and they all have a truck, a van or a utility that they use to cart things around. The moment they drop the kids off at school or take the kids to soccer on a Saturday, that is the use of a company asset.

Senator BUSHBY—What will they actually have to do then to comply with the rules under this legislation?

Mr Appleby—Those people will need to firstly sit down with their accountants and try to work out the extent of the use of that asset, to the extent that it was provided or available to them, not just actually physically used. They will need to go and get a valuation every year to determine what is called the arms-length value of the use. They will need to apply that to the extent of their use, add GST, report that, pay that to the company from their own after-tax funds, pay a deemed arms-length use for that, otherwise they will be deemed to have received a dividend equal to that value.

Senator BUSHBY—Would a company car that they use to go home at night and then back to work the next day be considered personal use?

Mr Appleby—Yes, it would.

Senator BUSHBY—What about a plumber who does not use the car to take his kids to the soccer on a Saturday? All he does is get up in the morning, hop into his ute and drive to his work.

Mr Appleby—That is correct. In fact, the Treasury have used the example of someone who takes their car home and then chooses not to drive it. They say that that would be a provision of the use. If it is stored in the garage or in the driveway and sitting there, it is available for use. They hold the keys to it. That means it is available 24 hours a day, 365 days a year.

Senator BUSHBY—How would they work out the obligation to pay tax on that?

Mr Appleby—That is a great question.

Senator BUSHBY—If you have not used it at all but it was available for use—

Mr Appleby—At the moment, there is a very real risk, particularly according to the examples that are given in the explanatory memorandum, that it might be as complicated as working out a daily rental for that car and then multiplying that to the extent of the provision of the use. And they are deemed to have received that rental every single day.

Senator BUSHBY—The retrospectivity aspect of it concerns me, primarily because there are hundreds of thousands of companies across the country where people have set up asset structures whether as part of active enterprises or passive companies that are old assets. When they have set up these structures on the basis of tax advice that they have obtained from their tax advisers and for other reasons, this is going to impact significantly on all of those arrangements but, as you note, give them no ability to get stamp duty relief or capital gains tax relief to allow them to put it into an appropriate structure that reflects the law after these bills are passed.

Mr Appleby—Correct. When you look at the operation division 7A when it was introduced in 1998, it specifically recognised that people had no notice of the impending law change to existing arrangements. It was announced on 4 December 1997. The provisions of the act specifically state that it does not apply to an existing interest free loan made before that date. Nobody had notice. There is no such provision here so that—

Senator BUSHBY—It is always a good idea not to give notice.

Mr Appleby—It is a good idea not to give notice. I do agree with that. But then to penalise those who are not given an opportunity to restructure their affairs and—

Senator BUSHBY—You do not give notice so you do not have people jumping in to take advantage of things before the changes.

Mr Appleby—That is exactly right.

Senator BUSHBY—But you then make it effective from the day you announce it.

Mr Appleby—The amendments are specific in that regard in that they say they do apply for the use of any asset from 1 July 2009 even if the asset already existed and had been used prior to that.

Senator BUSHBY—It does not really matter what day it starts. If it is a day before today, it can be any time because the assets are as they were.

Mr Appleby—That is right.

Senator BUSHBY—We discussed the compliance and the retrospectivity issues. I think you have done a very good job. It was a good introduction and it is a comprehensive submission which outlines the fundamental changes that this legislation will introduce. I would hope that most of them are unintended rather than a policy decision to force these impositions on small business and companies in general.

Mr Appleby—To the extent that the policy is trying to bring to tax those things which are disguised as an effective distribution of company profits, I suspect it is entirely appropriate.

Senator BUSHBY—There is probably a mischief out there that needs to be addressed in that respect, where companies do fund assets which are used by shareholders which should otherwise have been treated as profits.

Mr Appleby—The real mischief is the company—

Senator BUSHBY—It is a sledgehammer to crack a nut.

Mr Appleby—That is exactly right.

Senator EGGLESTON—In those sorts of cases, isn't the taxation treatment that you can deem so much personal use? Is that not the case with the use of a car, for example?

Mr Appleby—We have existing provisions that say where a company, for example, does own an asset, to the extent of private use it is not entitled to any tax deductions—which is entirely appropriate. So it is not entitled to pick up any loss on a sale of the asset to the extent that the asset was used for private use. To that extent there is no mischief for those things because the company is not allowed to pick up those deductions. On the other hand, there is the situation where there is a gain on the asset—take an investment company which is investing for a gain. The explanatory memorandum and Treasury have used the example of boats and things. There are a lot of boats out there that do appreciate in value.

The company will be taxed on that, at a full rate of tax. The company pays 30 per cent. To get that money out you have to pay a dividend and pay the top-up tax where the personal tax rate exceeds 30 per cent. There is no benefit of the capital gains tax discount for an asset held in the company. So for those company assets we deny deductions to the extent of personal use but we also tax the upside. To that extent, yes, there is existing accounting for personal use but it has never been to this extent.

CHAIR—Thank you to the Australian Law Council. Thank you for your assistance this afternoon.

[3.17 pm]

de HAAN, Mr Philip, Partner, Thomson Playford Cutlers

CHAIR—Good afternoon. Thank you for coming in today. Do you have an opening submission that you would like to make?

Mr de Haan—I have a brief summary of the points in our submission. Our submission relates to the proposed changes to the law in relation to payment, so only part of the changes to division 7A. The first aspect of our submission is that the legislation seems to be drafted on the basis that leases are currently caught by the definition of 'payment' as in a transfer of property, when, to us, it does not seem the law supports that fundamental assumption that is in the legislation. We consider that the solution to this is that the legislation and explanatory memorandum should accept that leases are not currently caught and that the new law applies to leases. We think that is important, firstly, in relation to how the legislation works and, secondly, in relation to the various exceptions that are proposed in the new legislation. The policy that comes from the explanatory memorandum is that these various concessions that will be introduced apply to licences of property but not to leases of property when, in our view, the explanatory memorandum is not based upon the current and correct interpretation of the law and that leases are not currently caught and so the proposed exceptions will apply to leases. And, if that is not the case, then we are asking why it should be parliament's intention that the various concessions will relate to a lease of real estate but not to a licence of real estate when, in practice, it can be very difficult to determine the difference. When it comes to an application of the law where accountants and taxpayers will be primarily involved in the application, it will be very difficult for them to determine the difference.

So they are the two main submissions in relation to leases, and we feel that is a fundamental aspect of the proposed changes. Further, subsidiary, aspects are these. As to the provisions in relation to 'available for use': when an asset is available for use, the proposed legislation makes it clear that, if the company has a right to use the asset, the proposed changes will not apply. But the explanatory memorandum does not seem to be consistent with that legislation. It also seems to be that, with the deemed payment arising, there is an opportunity for the shareholder or associate to make an arms-length payment to avoid that deemed dividend applying. But the timing rules do not really seem to give time for the payment to be made—unlike the legislation relating to loans, where a time is given up to the lodgement date for the return for the company to make a payment without there being a deemed dividend. It seems to us that a similar provision should apply to payments as well, to give some time to make the payment. And the final submission is that the 'minor use, minor benefits' concession, clearly, on the face of the bill, does not apply to minor transfers of property. It seems to us that this is a limitation which would cause reasonable compliance difficulties in companies having to identify the minor transfers of property and treat those as deemed dividends, even though they would not be treated as fringe benefits if provided to an employee. So that is the essence of our submission.

CHAIR—Can you give a concrete example of how that might affect people?

Mr de Haan—I can give a concrete example in relation to the concession that the bill is introducing dealing with someone who uses the property of a company as their home—as their main residence. The way the legislation is drafted, if the company leases the property to the person, the explanatory memorandum considers that that would be treated as a dividend and the concession would not apply, whereas the proposed new legislation—which was drafted on the assumption that, if it is a lease, the concession would not apply—would allow there not to be a dividend if the person used the property not under a lease but under a licence. But it seems very difficult to distinguish what would be a lease and what would be a licence, because what we are talking about is private companies which would often not have a document in place. A lot of these arrangements would have been in place for many, many years because, generally, people do not acquire real estate in companies anymore. So it could be that there is in fact a lease but no-one is going to be aware of that. Our submission is that it should not make any difference whether it is a lease or a licence, in the finer niceties of the law about whether you do or do not have a lease or a licence, and it should be that the proposed concessions and exemptions should apply no matter whether the property is used under a lease or under a licence.

CHAIR—Thank you. Are there any further questions—Senator Eggleston or Senator Bushby?

Senator EGGLESTON—I want to talk to my accountants first! I mean that quite seriously, actually.

Senator BUSHBY—Thank you very much for coming along and assisting us today. The Law Council appeared before you and raised a number of issues in addition to the sorts of issues you are raising. In your general view, do you think that the way this has been enacted is consistent with the existing 7A?

Mr de Haan—No, because I think the existing division 7A does not treat as a dividend a lease of real estate, because, I believe, that is not a transfer of property. I believe that that is a creation of rights, not a transfer of rights, so in my view it is drafted inconsistently with the legislation, because it is drafted on the assumption and the basic principle that a lease of real estate is currently treated as a transfer of property, whereas I do not believe that that is in fact the case.

Senator BUSHBY—So in that respect it proceeds on an assumption that is false and therefore the outcome is questionable.

Mr de Haan—Yes, that is exactly right.

Senator BUSHBY—On that issue, your recommendation is that, whether it is a lease or a licence, it should be treated the same—that is, it is not subject to—

Mr de Haan—Leases and licences of real estate should be caught by the new provisions, and I believe that it should be accepted that they are not currently caught by the existing transfer of property provision. So all the various concessions which are expressly dealing with leases of real estate should apply to leases and licences and should not be relevant, and nobody—taxpayers, tax agents or accountants—should be required to determine the difference, because the law should be the same irrespective of what it is.

Senator BUSHBY—Most of your submission—certainly what you have talked to—relates to group licences in relation to real estate. Obviously the impact of these changes is a lot broader than that.

Mr de Haan—Yes.

Senator BUSHBY—It applies to all assets that are owned by a company and being used by a shareholder or could be used by a shareholder—are available to be used.

Mr de Haan—Yes.

Senator BUSHBY—The Law Council is of the view that that has the potential to have significant impact on compliance costs and on the structure of a lot of companies that have been set up—as you note in relation to real estate, that will be so for many, many years—without providing any exemption for stamp duty or capital gains tax to allow companies to restructure to reflect the law as it will stand afterwards. Do you agree with the Law Council that that is not an ideal way to approach the situation given the way that a lot of companies around the country have structured their assets and holdings?

Mr de Haan—It makes perfect sense for the government to want to treat the use of property as a deemed dividend, but with this change to the law that is taking place it would be, in my view, an ideal opportunity to allow some type of rollover relief so people could restructure their affairs so that they could then take the new law as it comes. It is very costly to change ownership of real estate with capital gains tax and stamp duty.

Senator BUSHBY—Yes. That is probably what would happen with it. The other thing about it is that there may be a lot of companies that own assets that are not active enterprises.

Mr de Haan—That is right.

Senator BUSHBY—They are not earning any income or profits. At this stage they may hold assets which are being used by the shareholders, real estate or otherwise, and therefore there is no real mischief or tax consequences for the revenue from the way they are currently being held, yet these changes will impose an obligation on them, or on the shareholders, to pay tax on the deemed value of the use of those assets.

Mr de Haan—Yes.

Senator BUSHBY—In that sense, it is going beyond addressing a mischief of shareholders trying to avoid paying tax on dividends for assets in active companies; it is going much further than that. That is something the Law Council highlighted.

Mr de Haan—It does go further than that. You would not necessarily do it now, because there is a different tax treatment, but previously companies could own someone’s home and it could simply be funded by share capital or by a loan. The only reason there would be a deemed dividend now is because such a company happened to have gone up in value. That would create a surplus which the commissioner could treat as a distributable surplus and subject to tax. There would be no retained profits as such, no trading and no inappropriate use of profits that have been taxed at the 30 per cent rate leaking out of that company to people who would otherwise be taxed at a higher tax rate.

Senator BUSHBY—There would not be any land tax exemptions for primary residences that would apply if they were held by companies either.

Mr de Haan—No.

Senator BUSHBY—There would be land tax paid every year.

Mr de Haan—That is right.

Senator BUSHBY—If there were a decision to sell it then there would be capital gains tax and no deductions available to an individual—

Mr de Haan—That is right.

Senator BUSHBY—Yet, under the proposal, the shareholders in the company that owned the real estate would still be liable for all of those things but would also have to pay tax on the deemed value of the use of those assets.

Mr de Haan—Yes, where their real estate has gone up in value and the commissioner chooses to use the market value rather than the historical cost in determining that.

Senator BUSHBY—As I understand it, the company would have to get the land valued each year or get regular valuations to explain the value of the use or justify the value that they assign to the use.

Mr de Haan—Yes. The accounts of the company may, on the face of it, not show any profit, because it is just at the cost—

Senator BUSHBY—But it is not about profit; it is about the use of the asset.

Mr de Haan—That is right, but there is only a dividend if there is a distributable surplus, so the commissioner would have to treat the—

Senator BUSHBY—But that is not how the Law Council see it. Their view is that, even if the company is not actively trading and there is no income and no profit, if they are using an asset that belongs to that company they still have to obtain a valuation, in the case of real estate, of their use of that property. And then, regardless of whether there is a profit, the value of the use—which would be a rental equivalent of some sort, I imagine—would be added to the shareholders' income as assessable income.

Mr de Haan—That is exactly right, subject to there being what is called a distributable surplus, which is essentially the value of the assets exceeding the value of the liabilities. The commissioner would have to treat the market value, which you would of course be able to do, because the market value of property held by these companies might be four, five or 10 times its actual cost. So the commissioner has the ability, irrespective of the accounts, to treat that as a distributable surplus, and it is that action that creates the tax problem for the use of the asset.

Senator BUSHBY—Okay. One of the other issues the Law Council raised that relate to real estate but not to the issues that you are raising is company title: the potential for owners of units under company title to be treated as using an asset of the company and, therefore, over and above what they paid for the right to reside in that unit, having to pay for the value of the use of that asset. Is that consistent with your reading of the legislation?

Mr de Haan—I think it would be good if the legislation had an express provision which said that company title arrangements would not give rise to a deemed dividend. The potential issue is whether, in a company title arrangement, it is the company itself that is granting the right or it is a provision in the constitution of the company itself, its memorandum and articles, that creates the right. You get into some complex legal issues about whether the legislation applies to company title. But, because it potentially could apply, I think—

Senator BUSHBY—It is sufficiently grey to warrant clarification.

Mr de Haan—Exactly, and there seems to be no point in taxing that type of arrangement.

Senator BUSHBY—I do not imagine that would have been the intention of the drafters when it was put together.

Mr de Haan—No, I would not think so.

Senator BUSHBY—Certainly, the government should be looking to ensure that people who are avoiding paying tax by buying assets through a company for their own personal use are caught. But the Law Council suggests, as does my reading of the legislation, that they have gone much broader than that. They have cast a much wider net, and they will catch a lot of things in that net that they did not really intend to catch.

Mr de Haan—That is right. The basic thrust of division 7A is to treat as a dividend the use of or the access to the tax profits of the company which have been taxed at a lower rate than an individual would be. It all comes about by the difference between the corporate tax rate and the top marginal rate. But for that, there would be no need for division 7A. If there are no tax profits, there is no mischief. What we have been talking about are examples where there is no mischief, so division 7A should not apply to those.

Senator BUSHBY—And the activities of the companies and their shareholders are having no detrimental effect on the revenues of the Commonwealth.

Mr de Haan—That is right.

Senator BUSHBY—Obviously, making these changes may well have a significantly positive effect but, in terms of the way that the laws currently exist, those activities are not actually having a detrimental effect. So in that sense it is a new tax.

Mr de Haan—Yes, that is right.

Senator BUSHBY—Thank you.

Senator EGGLESTON—What do you see as the purpose of the government having introduced these proposals? Do you think there is such an extent of rorting of the system that they feel that they have to take action to minimise it? To what extent do we really think this is a problem?

Mr de Haan—I am probably not the best person to say, because I am not aware of all of the situations, but I suspect that there are a lot fewer yachts in private companies than the Commissioner of Taxation may be concerned about. I can appreciate that the Commissioner has a concern about access to assets accumulated out of a profits tax at the corporate tax rate. I am not aware of the extent of that being an issue.

Senator EGGLESTON—What organisations, if any, do you think would be able to answer that? I suppose the Institute of Chartered Accountants, who are our next witnesses, might well have some views on that.

Mr de Haan—They may have a view on the extent to which assets in private companies are being used by shareholders in a way that would be caught by these particular provisions. There would be a lot of real estate owned by companies, particularly if it was acquired prior to the capital gains tax coming in. There would be a lot of that, where the assets would be used. Even with one of the concessions that apply, where the company owns real estate and leases it to another entity for its business, under this proposed legislation if there is a lease the concession will not apply—it will be taxed as a dividend—whereas if there is a licence the concession will apply. Most of the time it would be very difficult to tell the difference because people would probably think that they have a lease arrangement even though nothing is documented. If that were the case, all of these concessions that the government is proposing to introduce, which make sense, would not actually apply in practice.

Senator EGGLESTON—That is very interesting. So there would appear to be a lot of unintended consequences, perhaps, in this legislation.

Mr de Haan—Yes, I believe so. I think that it comes from the fundamental approach that leases of real estate are currently treated as payments when I do not think that is legally correct. When I looked at the cases when I was putting my submission together, they all seemed to indicate that a lease created property but did not transfer property. The existing provision talks about transferring property, so if that is the way a court would interpret that provision—and I believe it is—then the fundamental basis to the drafting of these provisions and the concessions are flawed.

Senator EGGLESTON—Thank you very much, Mr de Haan.

CHAIR—Thank you for coming in this afternoon, Mr de Haan. We will now have a five-minute suspension.

[3.47 pm]

EL-ANSARY, Mr Yasser, Tax Counsel, Institute of Chartered Accountants in Australia

KOKKINOS, Mr Alexis, Chair, National Tax Technical Committee, Institute of Chartered Accountants in Australia

CHAIR—The committee will resume. I welcome Mr El-Ansary and Mr Kokkinos from the Institute of Chartered Accountants in Australia. Do you have an opening statement you would like to make?

Mr El-Ansary—I do, Chair. Firstly, thank you for the opportunity to appear before the committee today. I am joined today by Alexis Kokkinos, who is chair of the institute's National Tax Technical Committee, which has primary oversight of any major changes or reforms to Australia's rather complex tax system; and, when he is not doing that, Alexis is also a tax partner with Deloitte.

As I am sure the committee will be aware, the Institute of Chartered Accountants in Australia is Australia's peak professional body, representing over 50,000 chartered accountants across the country as well as abroad. The institute's membership comprises chartered accountants who work in diverse roles across public practice, commerce, academia, government and the not-for-profit sector. Due to the diversity of its members, the institute considers itself to be well positioned to provide independent advice to the government and other stakeholders on tax policy and the operation of our tax system. In all of its dealings and in all of its policy development, the institute is unambiguously committed to promoting a simpler and fairer tax system in Australia.

Turning to the subject of this inquiry—that is, the Tax Laws Amendment (2010 Measures No. 2) Bill 2010—in this hearing, the institute will provide our comments and insight into both schedule 1, which contains amendments to the non-commercial loan rules laid out in division 7A of the Income Tax Assessment Act 1936, and schedule 2, which contains amendments that seek to extend the TFN withholding rules to closely held trusts, including family trusts. It is worth pointing out for the committee's benefit that these amendments have the potential to impact hundreds and thousands of trusts and businesses operating across Australia. For that reason, these changes need to be considered very carefully, and the changes we will outline this afternoon should be made before the passage of these amendments through parliament, in an effort to ensure that these new laws are both workable and understandable by impacted taxpayers.

I wanted to also point out for the benefit of the committee that the amendments proposed in this bill relate to very complex provisions in the income tax laws. As I am sure you will be aware, our current tax system suffers from a 'catch revenue at all costs' approach that unfortunately often results in detailed and highly technical amendments being necessary to achieve the government's overarching policy objectives. The amendments that are the subject of this inquiry are no different. In this hearing it will sometimes be the case that we need to refer to very specific and technical features of both our existing tax law and the proposed amendments in this bill. This is unavoidable, but it is necessary. In the course of this hearing or in your deliberations afterwards, if any clarification is required about the operation of the law, please let us know.

Before we comment on schedule 1, I thought it would be beneficial to outline some fundamental attributes of division 7A, including its history. Division 7A commenced in December 1997 and was introduced to replace section 108 of the Income Tax Assessment Act 1936. Section 108 was an anti-avoidance provision that existed to prevent private companies distributing profits to shareholders and their associates which were masked as loans, property distributions, debt forgiveness transactions or other types of financial advances. The objective was to ensure that any distribution of profits was taxed in an appropriate fashion, rather than being made on a tax-free basis and thereby delivering a tax advantage through the use of alternative legal structures.

Division 7A, then, was introduced to have precisely the same purpose as section 108. The difference, however, is that division 7A was always intended to be a self-operating provision—that is to say that taxpayers would clearly understand the circumstances in which certain types of activities and certain types of distributions were subject to tax, rather than having to rely on the exercise of the Commissioner of Taxation's discretion under the old section 108, which it replaced. Sadly, division 7A today resembles very little the original policy framework in this area.

Having said what division 7A was originally intended to do, it is necessary to also point out what it was never intended to do. Division 7A was not intended to tax shareholders or their associates on arrangements which do not fundamentally represent a distribution of company profits. Division 7A was not meant to tax something that does not amount to the obtaining of some form of benefit via the use of company profits.

Unfortunately, certain aspects of the amendments contained in this bill that is the subject of today's hearing do in fact result in such an outcome, and for that reason the institute believes that changes must be made to this legislation before it is passed through parliament if it is to work as intended.

Turning now to the division 7A amendments in the bill, the institute would like to make the following high-level points. Without question, we fully support the government's overarching objective of improving fairness and integrity in our tax system. However, the proposed changes to division 7A, in our view, go much further than this policy aspiration. The proposed changes in fact go well beyond the government's own public announcement in relation to these changes which was made as part of last year's federal budget package on 12 May. Firstly, the scope of the proposed use of asset rules reaches well past what was stated in the budget night announcement. There was no indication on budget night or in the budget papers that company assets merely available for use, rather than in fact put to use, by shareholders would be caught by the new laws. Secondly, due to the recent changes made by the ATO to the way in which they plan to interpret certain aspects of the current laws within division 7A, the proposed new measures dealing with unpaid present entitlements of a corporate beneficiary, as contained in proposed subdivision EB of this bill, add a significant amount of complexity to these laws for no perceptible reason, in our opinion.

The existing division 7A laws are already hugely complex due to successive legislative changes that have been made over recent income years. Those changes started in 1998 and were passed in the 2002, 2004, 2005, 2007 and 2010 income years. As a consequence of these numerous, never-ending changes, the capacity of thousands of taxpayers to effectively comply with their obligations has been, and continues to be, eroded. The institute believes that schedule 1 should be amended to ensure that the proposed rules operate appropriately. If no amendments are able to be made within the time frames available to the committee then, at a minimum, the institute believes that item 25 of schedule 1 should be completely excised from the bill before passage through parliament. In a few moments Alexis Kokkinos will provide further details as to why, in our view, amendments need to be made to the bill in these areas.

In relation to the TFN withholding amendments contained in schedule 2, the institute makes the following high level comments. While the institute supports the objective of the measures, which are to facilitate data matching and enhance taxpayer compliance, we have significant concerns about the additional compliance workloads that will be placed on tax agents who handle the affairs of closely held trusts if the measures proposed in the bill are passed into law in their current form. The institute considers that the current provisions dealing with TFN withholding by trustees, in addition to this proposed measure, are more complex than they need to be. The institute's view is that those current laws should be streamlined and simplified rather than there being continuing introduction of new provisions that appear to overlap each other. However, if the bill in its current form is to proceed, the institute believes that crucial refinements must be made to reduce the emerging compliance burden on trustees and their tax agents. The institute's recommendations in respect of this are to, one, seek to minimise those reporting requirements currently envisaged in the bill; two, remove duplication in reporting the same information more than once; three, provide more realistic time frames, particularly in the initial year of operation of the measures, having due regard to the tax agents' current lodgement program and deadlines; and, four, facilitate a smoother transition to the new requirements.

I will now hand over to Alexis, who will be able to provide more detail on our concerns, but at this point I am happy to stop and receive questions from the committee.

CHAIR—Thank you for that submission. The committee has heard evidence from a couple of other groups. We have not yet heard any submissions or had a briefing from Treasury. They did not put in a submission and we are not due to hear from them until the day after tomorrow. So, in a lot of senses, we have not had the official view of some of the problems that have been highlighted in the submissions. We do have an extensive series of questions, and it may be that you want to go in camera and have an informal discussion at some time just to illuminate on what are seen to be the problems with the bill. I think it might be beneficial if Mr Kokkinos goes through his portion of the bill and we ask questions after that.

Mr Kokkinos—Sure. Yasser has, I think, provided a fairly detailed overview of some of the main issues, and I would like to reiterate from the start that we support the measures in the bill in terms of what they are trying to achieve. The fundamental issues that we are highlighting are around complexity and compliance issues that are associated with some of these measures. I will touch on the schedule 1 amendments proposed and what some of those issues are. The first item, which Yasser mentioned, was item 25 in schedule 1. Effectively, that involves the introduction of subdivision EB, being some interposed entity provisions. For those provisions to apply, as we have highlighted in our submission, there needs to be an unpaid present entitlement as the key criteria.

As you will be aware from our submission, the ATO have released ruling TR 2009/D8. Within that ruling the ATO have concluded that an unpaid present entitlement for the purposes of division 7A, in their view, is a loan. So, as soon as they have defined that unpaid present entitlement as a loan, effectively subdivisions EA and EB have become redundant provisions, or they will not operate unless there is an unpaid present entitlement for the purpose of revisions. The ruling goes on further to state that, although legally it would be an unpaid present entitlement, for the purposes of the provisions it is a loan, which means it is not an unpaid present entitlement just for the operation of these provisions.

In order to address that issue and restore purpose to subdivisions EA and EB, we propose an amendment specifically highlighting that an unpaid present entitlement is not a loan for the purposes of division 7A. In terms of providing that amendment, we believe that it provides certainty to the provisions so that taxpayers know exactly why EA and EB are there and what they are intended to address as issues, and there is no uncertainty or ambiguity in terms of the ATO view as contained in the ruling. That is one of the major items in our submission.

The second item is the use of assets amendment, which is the amendment covered by 109CA in the bill. Once again, we support the policy objective of that provision. One of the positions that were highlighted in Yasser’s speech as well as in our submission was the extent to which 109CA applies. It applies not only to actual use of assets but to assets that are available for use. We see that as an issue because assets can sit in companies which are not taxpaying companies holding assets when those assets have been funded completely by, for example, shareholder debt. So shareholders have funded the acquisition of an asset, and then they sit inside a company and may be available for use by the individuals or the shareholders. Again, there is no tax mischief there. If the asset is sold, you would pay more tax in the company, as opposed to paying tax at the individual discounted rates. So there is a 30 per cent tax rate paid in a company if the asset was sold, versus a 23.25 per cent tax rate if it was in the individuals’ names. So there is no tax mischief in holding the assets in the company. But, because they are already held in the company and these measures will apply to any asset available for use after 1 July 2009, effectively these structures will be penalised under the new measures.

Our submission in terms of these points is that we would have preferred to have seen, firstly, a measure that would allow entities to restructure their assets so they can move them outside of the company structure in a tax-effective manner and, secondly, these measures apply on a prospective basis to new assets acquired after the relevant date so they do not unfairly apply to assets that have already been acquired in a company structure.

CHAIR—Thank you very much. We will probably be asking you about submissions that were made by other people. If you want to go in camera in order not to be seen to be criticising someone else, we are perfectly happy to do that. There was some discussion about use of company titled residences. The explanatory memorandum says:

> The Government has also included a provision that excepts the use of main residences that were purchased prior to 1 July 2009 as part of these amendments. This exception ensures that taxpayers who used a company structure to purchase a home, are not impacted by these amendments (subject to a company continuity of ownership test).

It seems to me that company titles were used earlier last century but have not been used very much lately, so would you agree that solves that problem?

Mr Kokkinos—The institute supports that measure, and it came about through a number of submissions. Our only issue is that it does not go far enough in terms of the assets. It only applies to a main residence that is acquired in the company. So, if you had your holiday home acquired in the same company or another company, effectively you apply division 7A for the use of that property as well. Although that is a welcome addition to the package, we do not believe that it goes far enough in terms of residence and these measures.

CHAIR—What about the argument that it should be recognised that people will want to change their main residence out of that company title and that it is expensive and difficult to do that?

Mr Kokkinos—If there was an ability for shareholders to restructure their assets out of the company structure without incurring significant stamp duty and tax costs, because a sale out of the company effectively would incur both stamp duty and income tax costs, then our proposition is that would help to deal with the issue.

Senator BUSHBY—Chair, I have a point of clarification. You were asking questions about company title in the context of the conversation that we had with the previous witness about company title, which is actually a specific form of holding title for property. I am confused about what you are asking. Are you asking about titles held by companies, or are you asking about real estate held in the form of title known as company title? They are quite different.

CHAIR—I am interested that you raise that. I would not have seen there being too much of a difference in the tax treatment.

Senator BUSHBY—The tax treatment could be quite different. If you are a shareholder in a company that holds Torrens title land, that is one thing. What the previous witness was talking about was having shares in a company where the only asset and the only right that gives you is the right to reside in a house.

CHAIR—I would not have seen much difference myself, but I am interested in your response.

Mr El-Ansary—Chair, I would like to provide our comment. Certainly, from our perspective, the institute is focused on assets, whether they be real property or other property assets, held within companies as opposed to the legal concept of title being held in company title, which I think is a separate legal concept more akin to the differences between freehold and strata title of real property.

CHAIR—Yes. So you are dealing more with the assets that are held within a company?

Mr El-Ansary—Correct, whether it is real property or any other form of asset.

CHAIR—One example that was given was the setting up of a company so that one of the daughters in the family could live in it on the weekend, I think. So this company was set up with its only asset being this house. The complaint was that the daughter who is living in it on the weekend would be deemed to have received dividends out of that company because she does not pay rent. Would you agree or disagree that that is a worthy change to the tax act?

Mr Kokkinos—I will go back. Because these measures will apply to use after 1 July 2009, where you set up a structure as demonstrated in that example, these provisions will effectively be retrospective and will apply to existing structures. There is no way to remove that asset from the company without incurring significant costs. So, even though that company is not an operating company, the way that division 7A technically applies is that any increment in value is deemed to be profits of the company. Therefore, there is a profit in there that is deemed to be an unfranked dividend. Not only is it a dividend; it is seen to be unfranked and is taxed at the highest marginal rate, so a significant cost is incurred by the shareholder under these proposed amendments. Therefore, they have to make contributions to the company in order to alleviate that, which has further compliance costs in the valuing of the property and valuing of the rental and then making contributions to the company.

CHAIR—So the only way to resolve that would be to remove that structure, which is facilitated under your proposed amendment whereby it would not be taxed?

Mr Kokkinos—We say that there are two possible solutions. The first would be one where there is an allowance for a restructuring. We understand that, to insert provisions like that, would require significant consultation and, potentially, require a lot of thought by Treasury. We understand that that could be a complicated interaction provision to insert at this late time. Our second solution would be for the bill to at least have a prospective application—that is, it would apply to new assets from 1 July 2009. In the meantime, Treasury could work on other amendments that they could say could apply to existing assets but also develop something that would allow taxpayers to remove these from the structures. Again, we are only coming back to fairness and compliance in respect of the measures. We support what the measures are trying to achieve, but we are trying to come up with something that can apply fairly to taxpayers.

CHAIR—The other major issue I had in mind as a result of the other submissions is the ‘available for use’ part. The contention is that that was not expected by the profession in the budget announcement. The example that was put to us previously is that, if a company has a car that goes home and sits in someone’s garage, that is available for their use and it would then be deemed to be a dividend. Is that your interpretation as well?

Mr Kokkinos—That is correct. I believe there is an example in the explanatory memorandum which deals with an available asset being a motor vehicle.

CHAIR—It seems strange to me that the use of the vehicle is not already accounted for under the fringe benefits tax. It seems to me that, on the surface, that would be a second tax.

Mr Kokkinos—There is an anti-overlap rule between division 7A and the FBT provisions in respect of both payments and loans. The first issue in terms of applying those provisions is that, for FBT to apply, it needs to be in respect of employment. For division 7A to apply, it is in respect of being a shareholder or associate. There can be a case where you are not both of those but, when you are both, there are specific anti-overlap provisions that give priority to one of the provisions, so there should not be a duplication.

Senator BUSHBY—You talked about trusts earlier on. How would this apply to assets that are held by a trustee company or on behalf of a trust?

Mr Kokkinos—Which part are you referring to?

Senator BUSHBY—If a trust were set up for the purposes of running a business and the trustee of that trust was a company, would these provisions apply to assets owned by that company as trustee?

Mr Kokkinos—In a general sense, division 7A applies to payments or loans made by a company. Effectively, because those are in substitute for a dividend, these provisions treat them as dividends. When we have a trustee company that owns assets, prima facie those trusts are not within division 7A.

Senator BUSHBY—That is fine. I thought of that when you are talking about it before. Often trustee companies own all the assets and I would hope that it would not impact on that.

Mr Kokkinos—No.

Senator BUSHBY—You have put my mind at rest on that. I would have thought there would be a potential for some shareholders of companies to manipulate the way they run their company to buy assets which they use and which do represent the mischief that the government is trying to address with this. I do not think anybody would deny that there is potentially some mischief out there. In terms of ensuring that the government raises the revenue that it should under the laws it has set up, making some changes to catch that is probably a good thing. But it seems to me that, on the basis of the evidence we have received so far today, this seems to throw the net far wider than is required to address that mischief. As a general statement is that something you would agree with?

Mr El-Ansary—I think that is right.

Mr Kokkinos—Again, as pointed out, we support the measure in terms of what it is trying to achieve. Our suggestions are only to allow taxpayers to appropriately restructure where it will apply in a manner that is inappropriate.

Senator BUSHBY—It seems to me that this is a fundamental change to the tax treatment of assets that are passively held in all sorts of companies—that is, companies that are active in running enterprises and some companies that are not active in any income-earning capacity at all. Most of them would probably have set up the structures of the companies and the way they hold their assets on the basis of the advice received from their advisers, which in turn was provided on the basis of the laws as they stood at the time. This has the potential to fundamentally, to use that word again, alter their obligations to the Commonwealth without giving them any ability to change the structures they put in place in good faith to reflect the ongoing situation. In that sense I used the term with the previous witness that many of them are not doing anything that is depriving the Commonwealth of any revenue. But this change will attract new revenue for the government so, in that sense, it is a new tax because it is a new tax treatment of assets they currently hold. Would you disagree with anything I have just said?

Mr El-Ansary—I think it is fair to say that it is an expansion of the tax base that previously existed in relation to the taxation of private companies and, therefore, this measure will undoubtedly generate new revenue, so I would have to agree with that logic.

Senator BUSHBY—But it is not generating new revenue because it is a tax integrity measure; it is, as you say, expanding the tax base and treating assets currently held that would not ordinarily or rightly attract any tax and bringing those within the scope of assets that do.

Mr El-Ansary—Yes, that is correct. It is a series of measures that are aimed at clearly expanding the base of certain types of activities that previously were untaxed; therefore, the conclusion must be that this generates new revenue as a consequence. That is something we would agree with.

Senator BUSHBY—Do you see that compliance costs for small businesses is going to increase in any substantial manner as a result of these changes if they are passed?

Mr El-Ansary—I think without question these measures, as I suggested in my opening statement, will add further complexity to the tax compliance obligations of hundreds of thousands of businesses in Australia not only in so far as they have to come up to speed with these changes and the impact of these changes on their current affairs but also in light of the fact that there have been successive changes made to this part of the law over six or seven various income years since 1998.

When you have regard to the fact that this part of the law was designed and implemented in order to impact the activities and the tax obligations of typically the small to medium sized business market, it is reasonable then to conclude from a tax policy perspective that all of this complexity and all of the successive years of changes are starting to amount to what in effect is a very complex part of the income tax law and the skills and expertise required of SME market businesses and their advisers, who are typically SME level advisers as well, is starting to grow disproportionately to whatever mischief the government might perceive needs to be addressed there.

That is a consideration that we pointed to in our submissions to Treasury on this proposed legislation. It is an issue we have put in our submission to this inquiry. It is also an issue we have pointed to in our most recent federal budget submission to the government in January. We made the case that division 7A has become far too complex for what it was intended to do. We need to stop now and look closely at the objectives of this division and conduct some sort of review into how best to simplify what has become a very complex set of rules and obligations.

Senator BUSHBY—In terms of complexity you sort of highlighted what in my mind appear to be two different avenues which are imposing complexity: one is the constant change and the need to keep up to date with the changing law and ensure that you are compliant and then there is the specific introduction of ongoing compliance which small business might need to do. I will use the example that Senator Hurley used of the plumber who might drive his ute home each night. According to the explanatory memorandum, because he has it available to use that actually triggers the provisions. Will he then need to increase his record keeping to cover what he does with that ute, whether he uses it or not, to meet his obligations? That is a micro example of how this might increase practically what they need to do to comply with their obligations as a result.

Mr Kokkinos—Going forward we would have to look at every asset that a company holds and work out if those assets would be used by the shareholders or be available for use by the shareholders. We would then have to ascertain if there is any risk in terms of them being used or available to be used by way of the technical definition in the act. So we are talking about small businesses understand exactly what that definition means and how wide that definition can be. We then would require them to keep track of their use or their availability for use on an annual basis and we would then have to ask them to value those uses, so we would have to get a market valuation for each of those. We then would have to determined whether those are under the exceptions. They are proposing to introduce a minor benefit exception for infrequent use or if it is under $300 in value. It would have to be ascertained whether it falls within those exceptions. We see that as a significant level of compliance for small business taxpayers.

Senator BUSHBY—You mentioned to some extent you have made some submissions to Treasury. What consultation has the institute had with Treasury or other government officials with respect to these changes and to what extent have your submissions been addressed?

Mr El-Ansary—There certainty has been since budget night last year a consultation process with the Department of the Treasury. It is my understanding that the culmination of that consultation took place in around February this year. The institute participated, as you might expect, in that consultation process.

I will have to take on notice the specific question about to what extent our recommendations and our views have been taken on board in the legislation. I think it is fair to say that there has been to some extent a take-up of some of the issues that we made Treasury aware of, but certainly not all of the concerns we raised have been addressed in the bill before parliament at the moment.

Senator BUSHBY—Have you been fully aware of the scope of the bill as part of those consultations or have things changed as we got closer to the point where they actually introduced the bill? Is the bill what you expected?

Mr Kokkinos—I do not have our submissions in front of me, but my understanding is that we have raised these points in our earlier submissions as well.

Senator BUSHBY—And has any explanation been provided to you by the officials as to why they have not addressed some of the concerns you have raised?

Mr El-Ansary—No, not that I am aware of.

Senator PRATT—Where does a service like telecommunications sit vis-a-vis personal versus company use?

Mr El-Ansary—Just to clarify: do you mean a mobile phone specifically?

Senator PRATT—Or it could be an internet service and those kinds of things.

Mr Kokkinos—Are we talking about an internet service provider where we have internet access at our home?

Senator PRATT—Yes, where a company operates from a home and you cannot stop the kids jumping on the wireless.

Mr Kokkinos—I understand. We probably need to clarify that the amendment in 109CA refers to uses of property which do not require transfer. If there is a payment by the company already on behalf of shareholders and that is for the shareholder, that would be caught under the ordinary definition of 'payment' in itself. The measure we are looking at is specifically an extension that only refers to property of the company that is used by the shareholder, so in the case of internet connections such items may not be covered by the amendment if they are not the property of the company in itself.

Senator PRATT—So in a sense a service would be excluded?

Mr Kokkinos—It may well be, but if we are talking about potentially a mobile phone that is owned by the company then the actual asset—being the mobile phone—could be caught. If the company pays for the bills, the current definition of 'payment' covers that already, so that would not be a new measure in terms of payments on behalf of shareholders. It would only be a physical asset that is owned by the company that is used by the shareholder that would be the extension of the provisions.

Mr El-Ansary—So the same logic might also apply to the computer if you are considering it in the context of an internet connection.

Senator PRATT—Thank you for clarifying that for me.

Senator CAMERON—The government, when it introduced the bill, said on schedule 1 that it was to prevent a shareholder of a private company or an associate of the shareholder accessing tax-free dividends through the use of company assets for less than their market value. Do you agree with that proposition?

Mr El-Ansary—Yes, we do.

Senator CAMERON—You are arguing about how it is done?

Mr El-Ansary—That is correct.

Senator CAMERON—On schedule 2, that amends the tax laws to extend the tax file number withholding arrangements to closely held trusts including family trusts. That is a reasonable proposition as well, isn't it?

Mr El-Ansary—It is. The concerns we harbour around schedule 2 relate predominantly, again, to the compliance burden and the duplication of compliance that appears to be involved in bringing into law schedule 2, over and above what already exists. Certainly from a conceptual perspective, from a policy perspective that is a consideration here, we do not have any philosophical concerns with either the policy around schedule 1 or schedule 2.

Senator CAMERON—I suppose the government has always got to balance the issue of fairness and equity on the one hand and compliance costs on the other.

Mr El-Ansary—Yes, that is to the extent, Senator, that you see them as mutually exclusive. In other words, there are circumstances, in our view, where you can achieve both at the same time and it should always be the case for government and other stakeholders that we strive to achieve that. Certainly in a situation where it is one or the other—and there might be instances like that—then it is a balancing act, I agree.

Senator CAMERON—You say that 7A is now becoming very complex and needs a complete to rework.

Mr El-Ansary—Division 7A has certainly become significantly complex for the target audience to which it is intended to apply.

Senator CAMERON—Is there any part of the tax act that is not complex?

Mr Kokkinos—If I can add some insights on this, in terms of the TFN withholding, as Yasser has pointed out, we agree with the policy there, but when you work through the provisions there are four different withholding provisions that could possibly apply. I believe Yasser has handed out a flow diagram that takes you through effectively the questions you would need to go through in order to work out which withholding regime you would be in and whether you need to withhold or not under these regimes. When you get a flow diagram that complicated and you put that in front of an SME and say, ‘You need to work through exactly where you are at and which of these provisions you need to withhold or disclose under,’ I think the system is getting a little bit complicated.

Our submission has not gone to the extent of saying that these provisions are unnecessary or that we should not have the provisions. We are saying there are potentially four different provisions that require different disclosures, depending on your circumstances, and different amounts to be withheld. Our issue is that we believe there is some benefit in streamlining some of these provisions and putting them together, rather than duplicating provisions and having them overarch each other and have interactions, which they currently have. We think the provisions are very complicated as they are.

Senator CAMERON—There are specific benefits in being in a trust, so if you get benefits then, on the other hand, there are obligations. Again, I suppose the government has to weigh the benefits that apply to taxpayers in a trust against their obligations to actually pay tax. If you look at that flow chart, rather than being overly complex, some small businesses would be dealing with flow charts much more complex than that on a day-to-day basis. An engineering firm would deal with flow charts and answer these types of questions constantly. Even to get a mobile phone you would be dealing with something like this.

Mr El-Ansary—The issue from our point of view, though, is that not only does the flow chart illustrate the complexity but within each of the tests that are laid out on that flow chart, just as an example, are certain very complex legal and tax principles that the person working their way through this chart needs to come to terms with. If it were just a case of answering yes or no along the way and ending up with the answer perhaps it might not be as difficult as some might suggest, but I think there is some inherent difficulty here that extends small businesses well beyond their capacity to answer yes or no simply. In other words, a lot of businesses will be forced, over and above what they are doing at the moment, to go and seek out particular advice in order to reach a conclusion. That is something that in designing a tax system we should always look to minimise and discourage, rather than add further complexity and almost push people towards that outcome.

Senator CAMERON—It is not like personal tax. There could be fair amounts of money involved for some of the small businesses in this.

Mr El-Ansary—There is no doubt that for some businesses there would be significant amounts of money and for others insignificant amounts of money. I think the principle, though, from a policy perspective still needs to be that we need to design laws that are simpler and easier to come to terms with for average taxpayers who should be encouraged to comply with their obligations without having to resort to complex legal and tax advice.

Mr Kokkinos—In our submission we highlight where some of those complexities could be removed. We are suggesting that you can get the same outcome—the same disclosures and the same information—by reducing the complexity, rather than in isolation just adding a chunk of legislation without amending what is currently there. What we have now is a whole lot of provisions all working together, but they are not speaking to each other effectively.

Senator CAMERON—The government has some time frames it wants to try to meet in relation to this. If we go down the track that you are advocating, how long would that push out the government’s application of this process?

Mr El-Ansary—Considering that in another week or two it will have been 12 months since the original policy announcement by the government, on this occasion it makes a lot of sense to stop and address these issues while we can, rather than passing these through and then having to worry about finding an opportunity to come back and make those amendments in the future. Whilst timing is important, it is equally important to get it right the first time so that we do not end up having to revert to amendments and changes and further potential parliamentary inquiries when we could avoid that easily by addressing those issues right now.

Senator CAMERON—I can only assume that the government has had advice that this is getting it right. There would be professionals providing advice to government that this has got it right. It might be complex but it is the price you have to pay for being in a trust.

Mr El-Ansary—Our contention is that in the legislative amendments that comprise schedule 2 the government has not quite got it right yet. On this occasion, near enough is not good enough and we should look to make the changes that we think are appropriate, reasonable and necessary and that still deliver the government's objectives in the time that we have available. As I say, if there is an opportunity to get it right 100 per cent now, we should use it.

Senator CAMERON—Legislation and 100 per cent right is not something I have heard described too often in my short parliamentary career. Looking back over the last 10 to 15 years, some of these things do take some working through. It is only after the laws are in place that you actually get a feel for where it is going.

Mr El-Ansary—That is true and I think that being 100 per cent right is certainly an aspiration we should always strive to achieve even if we rarely get there. But the issue that must be taken into account is that the amendments as proposed, the imposed compliance obligations and complexity on tax agents in particular, are in our view unreasonable. For that reason we should look to do everything we can to ensure that we are not imposing new layers of complexity and obligation on practitioners that create a domino ripple effect through their other obligations on behalf of other clients where they have deadlines they need to meet throughout the course of the year. On this occasion it looks like there is a ready-made solution to that, which we proposed in our submission, and in our view it would be appropriate to see that happen.

Senator CAMERON—Are you saying that if this legislation is passed these domino effects and ripple effects could paralyse the tax agent industry?

Mr El-Ansary—I think there is certainly a case to say that this will impose further obligations on top of tax—

Senator CAMERON—That is not what I am asking. I am asking: will it paralyse the tax agent industry in this country?

Mr El-Ansary—It is very hard to speculate on what may or may not happen as a direct consequence, but certainly our view and our understanding, based on our very wide membership base of over 50,000 chartered accountants across Australia, is that this will impose significant compliance obligations on practitioners who typically deal with small, closely held trusts.

Senator CAMERON—You have made that point. I am not arguing that it does not put significant obligations on tax agents, but you gave the impression that the ripple effects and the domino effects were of such a nature that it would create—my words—chaos in the industry. Is that what you are arguing?

Mr El-Ansary—I cannot vouch for whether or not it will create chaos, but I certainly can vouch for the fact that it will create additional workloads for agents at a time when many, many small practitioners are doing it very, very tough, not least because of the recent challenges that have been faced by those very same practitioners in managing the ATO's new change program IT system.

Senator CAMERON—Wasn't that the same argument I heard when the GST was introduced?

Mr El-Ansary—I am sure at the time the GST was introduced it did create new complexity for tax agents, but at the same time that was the introduction of a whole new tax system, which also was matched with changes that eased compliance in other areas. So there was to an extent an offsetting outcome in that scenario about 10 years ago.

Mr Kokkinos—Can I just add one point there. In terms of these new withholding tax obligations, effectively they require you to quote your TFN and they interact with other provisions that also require you to provide your TFN. The way these provisions interact with each other is that they say: if you quote it under another provision, then you go and apply those provisions, or, if you have paid tax under another provision, do not apply those two provisions; go and apply the third set of provisions. So they have very intricate connections between themselves. In terms of revenue collection, if you quote your tax file number there is no withholding obligation, so there could be next to nothing in terms of revenue collection. It adds a level of compliance. There are four different provisions that all require tax file numbers to be quoted or tax to be collected in these circumstances. We are suggesting that there could be a streamlined approach, with amendments made that could make it more simple for small business to be able to understand in what circumstances they need to provide certain information to the ATO or withhold tax for the ATO.

Senator CAMERON—But you support the argument that the ripple effects and the domino effects of this are really serious? Is that what you are saying to me?

Mr Kokkinos—When we look at the TLAB in total and we look at the impacts for small business, effectively we are talking about some significant measures in here that potentially may add collection to revenue in certain aspects but add a very significant level of compliance. We have spoken about schedule 1 in terms of use of asset and what is required of taxpayers, but that then becomes an obligation on the tax agent to ensure their taxpayers are compliant with the laws. In schedule 1 we have also got the issue about unpaid present entitlements, which we have not looked at, where there is a view by the ATO saying one thing and then we have got some very technical provisions being inserted into this act that say the act applies in this matter. The taxpayer will not know which is the right view—do we apply these provisions or do we take the ATO's view in terms of where the provisions apply? They will need to seek independent advice in terms of how that applies for their trusts and company structures, and then they have the TFN withholding provisions, to add another layer of complexity.

Senator CAMERON—Isn't that manageable? Are you saying this is not manageable?

Mr Kokkinos—I think what we are stating is that there is a level of compliance being added here that is potentially unnecessary.

Senator CAMERON—Forget the issue of unnecessary. The government has got a view that it is necessary. I am now asking about the issue of manageability. Sure, it might be more complex, if that is your argument. Sure, it might be more time consuming, if that is your argument. Is it manageable?

Mr Kokkinos—I think in our submission we have made the statement fairly clearly that the amendments at item 21 will likely result in mass noncompliance in respect of those provisions, subdivisions EA and EB. The fact that we believe that there will be noncompliance in that area at a significant level would seem to indicate that that may not be a manageable set of provisions that are being introduced.

Senator CAMERON—Why would there be noncompliance? What is the key driver of noncompliance?

Mr Kokkinos—We effectively have an ATO ruling that says unpaid entitlements are loans, and then we have two subdivisions within division 7A that apply to unpaid entitlements that are not loans. We have a number of provisions sitting in the act that say they will apply when we have an unpaid entitlement and we have, on the other side, an ATO view saying that there is no such thing. Taxpayers will need to make an ascertainment as to whether they know the ATO's view, so it is all about small business to start off with. The ATO ruling is in excess of 30 pages, a very technical view as to this aspect. Firstly, taxpayers will need to know the ATO's view; secondly, they will need to ascertain whether the ATO's view is correct and why we have a set of provisions in the act that are meant to be dealing with this; then they will need to apply those provisions.

When there is a set of provisions sitting in the act saying that taxpayers are supposed to deal with a transaction, you would expect the common small business taxpayer to try to comply with those provisions. The consequence of the ruling from the ATO may be that those provisions do not apply. Effectively, the ATO's view would be that another set of provisions apply in those circumstances. For that reason only, we say there will be noncompliance with the way the provisions operate.

Senator CAMERON—Aren't there other areas in the taxation act where these sorts of judgments have to be made?

Mr Kokkinos—I believe there need to be judgments made in all areas.

Senator CAMERON—So what is different with this one?

Mr Kokkinos—In the example that I am providing, effectively we are introducing provisions that have no effect.

Senator CAMERON—That have no effect?

Mr Kokkinos—Under the ATO view, correct. The citation we have given is taxation ruling 2009/D8, which is about whether unpaid present entitlements are loans. As I pointed out, subdivisions EA and EB require there to be, as a first condition, an unpaid present entitlement. As soon as you do not have one, those provisions do not have effect. So essentially we are inserting very complex provisions which taxpayers need to be aware of but which can mislead them in terms of them understanding that those provisions have application when they in fact do not have any application.

Senator CAMERON—As a professional, would you be able to advise a client as to whether they apply or do not apply?

Mr Kokkinos—If a client came to me with an issue, the first thing that I would have to point out is that the ATO's view is contentious. So there would be a judgment call as to whether you apply what we would consider the Treasury or legislative view, versus whether you would like to take a view opposite to what the

ATO have put out. So there would be a significant amount of compliance in terms of providing some advice as to which way a taxpayer would need to address that. Then I would be able to inform the taxpayer, depending on which way they wanted to go, how the rules would apply.

Senator CAMERON—So it is manageable.

Mr Kokkinos—In terms of the question that you have put to me, my job is to understand legislation and consult on legislation. It is manageable from my perspective because that is what I do. From the perspective of a practitioner who does not delve into legislation, the finer points of the differences between when a rule will or will not apply will be very difficult to judge.

Mr El-Ansary—The key point is that, whilst Alexis is very well equipped to interpret and apply the law, address the complexity and navigate a way through that for his clients, we must have regard to the intended audience for this legislation. I mentioned in the introduction that Alexis, when he is not working with me at the institute, is a partner at big four accounting firm. That places him in a unique position where he has infinite resources and capacity to delve deeply into legislation even as complex as this. But for suburban and regional practitioners, of whom we have many amongst our membership, interpreting—

Senator CAMERON—Like Barnaby used to be.

Mr El-Ansary—That is probably true. Trying to make sense of very complex laws out there in the regions is a challenge. Those practitioners will not be as well equipped as Alexis is to interpret and navigate their way through very complex legislation like this.

Mr Kokkinos—Yasser has probably better explained the point that I was trying to put forward.

Senator CAMERON—So is this a training issue for suburban accountants? If the law and the obligations change and they are not professionally equipped to handle it, have you got an obligation to advise your membership of the issues and how to deal with them?

Mr El-Ansary—We certainly do take on an obligation around advising our members of changes to tax law and what they need to understand to address those changes.

Senator CAMERON—So they would not be left on their own with this, would they?

Mr El-Ansary—No, they will not be left on their own. The key point is that, in understanding the impact of any amendments as complex as these, there needs to be due recognition of the amount of time it takes for that information to filter through and to become well known and widespread amongst the community, and that is one of the points that we raise in our submission. The rapid pace with which change happens in this part of the law has in itself, quite aside from the actual details of the changes, created a whole lot of uncertainty and placed a whole lot of additional compliance obligations on practitioners, who might find that they have not been able to keep up with the pace of change. For a practitioner in the regions or out there in the suburbs who does not have to deal with this part of the law every day of the week, it is quite a challenge to stay on top of all changes across the tax system. We have to have regard to that and to the impact this has on practitioners who are challenged by the rapid pace of change across the whole of the system.

Mr Kokkinos—Prior to these amendments, the ATO acknowledged the complexity of the existing division 7A provisions. There was an amnesty provided for a period for people to try and correct their errors and there was also a large education program that is still trying to be put forward by the ATO. Trying to educate people on how division 7A applies is a really serious issue. They are very technical provisions as they stand, and adding a layer of complexity makes it even more difficult for suburban accountants to try and comply.

Senator CAMERON—But, if you provide the advice and there is a period of time for the training and knowledge to seep through the suburban accountancy profession, then it is no different from other changes, is it?

Mr Kokkinos—I understand these provisions apply from 1 July 2009 as a starting point, so they are effectively applying to transactions that have already occurred.

Senator CAMERON—So your members had better start learning them.

Mr El-Ansary—Alexis is right. They apply from 1 July 2009, yet we do not have legislation on which practitioners can rely and on which we as an institute can deliver training to our members.

CHAIR—Thank you to the institute for coming in this afternoon. It has been very helpful for us.

Committee adjourned at 4.47 pm