The Institute of Chartered Accountants in Australia

16 April 2010

Committee Secretariat
Department of the Senate
PO Box 6100
Parliament House
Canberra ACT 2600
Australia

By email: economics.sen@aph.gov.au

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

Dear Sir/Madam,

The Institute of Chartered Accountants in Australia (the Institute) welcomes opportunity to make a submission to the Senate Standing Committee on Economics (SEC) in relation to its inquiry into the *Tax Laws Amendment (2010 Measures No.2) Bill 2010* (the Bill).

The Institute is the leading tax and accounting professional body in Australia. Our reach extends to more than 62,000 of today's and tomorrow's business leaders, representing over 50,000 Chartered Accountants and 12,000 of Australia's best accounting graduates who are currently enrolled in our world class Chartered Accountants postgraduate program.

In our submission, we have sought to comment on the unintended consequences that may result from the following schedules:

- Schedule 1 which amends the non-commercial loan rules in Division 7A of the *Income Tax Assessment Act 1936* (ITAA 1936) 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
- Schedule 2 which amends the taxation laws to extend tax file number (TFN) withholding arrangements to closely held trusts, including family trusts

Our summary and detailed submissions on schedule 1 and schedule 2 of the Bill are contained in Appendix 1 and Appendix 2 respectively.

Please do not hesitate to contact me on (02) 9290 5623 if you need further clarification of our comments.

Yours sincerely

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Schedule 1 - amendments to the non-commercial loan rules under Division 7A

Background

Division 7A was originally introduced with effect from 4 December 1997 as a replacement provision of section 108 of the ITAA 1936. By way of history, section 108 was an anti-avoidance provision intended to prevent private companies distributing profits to shareholders and their associates tax free, in the form of loans, property distributions, debt forgiveness transactions or other advances. Section 108 required the Commissioner to exercise his discretion as to whether such an amount was to be treated as a dividend.

Division 7A has the same purpose as section 108, however, is intended to be a self-operating provision (rather than via a Commissioner's discretion)[1]. Accordingly, Division 7A is aimed at ensuring that private companies are not able to make tax-free distributions of profits to shareholders (and their associates) in the form of payments, loans or debt forgiveness transactions[2]. Broadly, Division 7A treats:

- all loans, payments and debts forgiven by private companies to shareholders (or their associates) as assessable dividends to the extent that there are realised or unrealised profits in the company (under Subdivision B of the ITAA 1936); and
- all loans, payments and debts forgiven by a trustee of a trust to shareholders (or their associates) as dividends where that trustee has made a private company beneficiary presently entitled to trust income without paying the cash to the company (under Subdivision EA of the ITAA 1936).

On 4 January 2010, the Assistant Treasurer, released for public consultation the exposure draft legislation (ED) and explanatory material (EM) for the amendments to Division 7A announced in the 2009 - 2010 Federal Budget. In the ED, key amendments to Division 7A included:

- broadening the meaning of 'payment' to include the use of assets by a shareholder (or their associate) subject to certain exceptions ('use of asset' provisions); and
- extending Subdivision EA of the ITAA 1936 to cover scenarios where there are interposed entities either between the trust making a payment/loan and the target shareholder (or their associate) or between a trust and the private company that holds an unpaid present entitlement to an amount from the net income of the trust (proposed Subdivision EB).

The Institute lodged a submission on the ED on 4 February 2010 and is pleased that some improvements have been made to the Bill which address some of the issues raised in our submission including improving the exceptions to Division 7A for certain use of dwellings (includes a new exception for the main residence of an entity that was acquired by a private company before 1 July 2009).

Nonetheless, the Institute is significantly concerned that our issues in relation to the extension of Subdivision EA, ie. the proposed Subdivision EB, have not been appropriately addressed in the Bill. Furthermore, we are also concerned with the proposed 'use of asset' provisions, which apply inappropriately to assets that were purchased by a company prior to 1 July 2009 and also require onerous valuations for small business taxpayers.

The above concerns are explained in the submission below.

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[1] Paragraphs 9.138 and 9.139 of the Explanatory Memorandum to *Taxation Laws Amendment Act (No. 3) 1998* which introduced Division 7A

[2] Above, paragraph 9.2

Summary of submission

1. Proposed Subdivision EB

The Institute agrees that proposed Subdivision EB, as contained in Schedule 1, Item 25 of the Bill is necessary to bring Subdivision EA in line with Subdivision E of Division 7A of the ITAA 1936. Subdivision E allows a private company to be taken under Subdivision B to pay a dividend to a shareholder (or their associate) if an entity interposed between the company and the shareholder/associate makes a payment or loan to the shareholder/associate under an arrangement involving the private company.

However, the Australian Taxation Office (ATO) released its view on the treatment of unpaid present entitlements[3] in draft Taxation Ruling TR 2009/D8 *Income tax: Division 7A loans: trust entitlements* ("the Draft Ruling") on 16 December 2009. The view contained in the Draft Ruling results in unpaid present entitlements being treated as loans under Subdivision B for Division 7A purposes. As Subdivision EB requires that there be an unpaid present entitlement (rather than a loan), the Draft Ruling renders Subdivision EB as having no practical effect or application.

While the ATO is entitled to administer the law as it sees it applying, we highlight that the view held by the ATO is not shared by the Institute and the taxpaying community at large. This is reflected in many submissions and discussions that have already occurred with the ATO on its Draft Ruling. We also highlight that, until 16 December 2009, the ATO also shared a common view on the Division 7A treatment of unpaid present entitlements to that of the Institute and the taxpaying community. The Division 7A provisions were thus developed and moulded on this common, pre-16 December 2009, understanding of the law.

On this point, we note that there are over 660,000 trust tax returns lodged on an annual basis in Australia[4]. Subdivision EB, together with Subdivision EA, contain some very technical and complicated interposed entity provisions relating to unpaid present entitlements. This coupled with the differing views on the operation of Division 7A to unpaid present entitlements will, in our view, result in significant ambiguity in the provisions and mass unintentional non-compliance by those small business taxpayers trying to apply these provisions.

Accordingly, it is our view that the introduction of Subdivision EB requires an accompanying amendment to section 109D under Subdivision B. The amendment is required to clarify that an unpaid present entitlement is not a loan for the purpose of applying Division 7A. We believe that this amendment will restore the original intent of the provisions and will restore certainty in the operation of these provisions post 16 December 2009. Without such an amendment to section 109D, the Institute would not support the introduction of Subdivision EB and the compliance issues associated with the introduction of those provisions.

Should the ATO have integrity concerns with Division 7A that may result from the introduction of the amendment proposed in this submission, then it is our view that such concerns should be addressed in the legislation rather than by way of an interpretation which has such a significant impact on the effective operation of Subdivision EA and proposed Subdivision EB. We highlight our continued support for the introduction of Subdivision EB (with the amendment proposed in this submission) and any other measures that are appropriate to address integrity concerns with the application of our taxation laws.

2. 'Use of asset' provisions

The 'use of asset' provisions cover either (a) the actual use of an asset or (b) an asset that is 'available for use' by the shareholder or associate to the exclusion of the company. In our view, the 'available for use' rule is problematic where the company asset is not actually used by the shareholder / associate but (because of the nature of the asset) is not stored by the company. In our view, as with main residences, assets which are

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[3] This is the description given for the amount of trust income that a trustee of a trust determines that a private company beneficiary is presently entitled to but not paid to the company in cash.

[4] Australian Taxation Office, "Taxation statistics 2007-08", 24 March 2010, Chapter 6, http://www.ato.gov.au/content/downloads/cor00225078_2008CH6TRU.pdf accessed 12 April 2010.

'available for use' by the shareholder / associate that were acquired by the company before 1 July 2009 should be excluded from Division 7A.

Furthermore, from a policy perspective, the actual 'use of asset' rule contained in the Bill should not extend to assets acquired before the introduction of Division 7A, ie. before 4 December 1997. That is, we believe that such assets should only be covered by the general provisions of Division 7A (i.e. the existing definition of payment), where the use of the assets amounts to a payment under the existing provisions. If these options are not accepted, then we request that the SEC consider recommending a restructuring provision to allow these transitional assets to be moved from the company to avoid significant compliance costs for small business taxpayers.

Finally, as the 'use of asset' provisions will require taxpayers to value the use of assets owned by the relevant company, we believe that this will significantly increase compliance burdens. An optional safe harbour valuation method should be considered by the SEC and included in the Bill.

Detail of Submission

1. Proposed Subdivision EB

1.1 Requirement for an unpaid present entitlement

The proposed Subdivision EB requires a company to be presently entitled to an amount of the net income of the trust estate, ie. where a trustee of a trust makes a company beneficiary presently entitled to trust income without paying the cash to the company (an unpaid present entitlement). For example, proposed section 109XF under Subdivision EB extends the operation of section 109XA under Subdivision EA, whereby a condition of section 109XA is that there be a company that is presently entitled to an amount of the net income of the trust estate (refer to paragraph 109XA(1)(c) of the ITAA 1936).

Accordingly, for the new provisions to have operation, the law must recognise first and foremost an unpaid present entitlement.

1.2 Example to demonstrate issue

Prior to discussing the differing views of an unpaid present entitlement, we present the following example. This example is used consistently throughout this submission to demonstrate this issue.

> **Example A – unpaid present entitlement**
> Trust A operates a business and makes business profits on a yearly basis. For the X1 year, it derives $100 of income. It distributes this amount to a company (Aco) by the end of the year, but does not pay this amount to the company by year end (i.e. there is an unpaid present entitlement to the company). Aco pays tax on the income distribution at 30% (i.e. $30). During the following year, Trust A lends $5 to a shareholder of Aco (Mr Smith). The remaining $95 is retained in the trust to be used as working capital of the trust in its business.

It is highlighted that the above example, although simplified, depicts a common use of a corporate beneficiary in a small business trust context. The above example will be referred to as <u>Example A</u> throughout this submission.

1.3 ATO view that unpaid present entitlements are loans for Division 7A purposes

On 16 December 2009, the ATO released its Draft Ruling, which expressed the Commissioner's opinion on when a company's unpaid present entitlement from a trust (both are typically part of the same family group) will be taken to be a loan to the trust for purposes of section 109D of Subdivision B.

The Draft Ruling holds that a private company will be taken to have provided a Division 7A loan by the conscious non-doing of an act, such as intentionally not calling for payment of an unpaid present entitlement. Accordingly, in <u>Example A</u>, the company (Aco) would be taken to have made a loan to the trust (Trust A) of $100. This is evidenced by Example 5 of the Draft Ruling, which is factually the same as <u>Example A.</u>

The practical effect of the Commissioner's view in the Draft Ruling is that, in all but one limited circumstance, an unpaid present entitlement will be considered a loan for purposes of Division 7A. This exceptional circumstance is discussed at Section 1.5 of this submission below. The practical consequence of the ATO view is that Subdivision B of Division 7A would apply to unpaid present entitlements and Subdivision EA would become effectively inoperative. This would further render the changes proposed by Schedule 1, Item 25 of the Bill as also being inoperative provisions once enacted, as Subdivision E would apply to such arrangements rather than Subdivision EB. This is demonstrated in further detail in Section 1.6 of this submission.

1.4 ATO view prior to the release of the Draft Ruling

Prior to the release of the Draft Ruling on 16 December 2009, the ATO were of the opinion that the retention on trust of an unpaid present entitlement was not a loan for Division 7A purposes. This view was evidenced in their general administrative practice[5] and a number of publicly published ATO documents, including its Division 7A fact sheet 'Division 7A - Answers to frequently asked questions' which indicated as follows:

> **94. Will a dividend be taken to arise simply because the trustee retains on trust an unpaid present entitlement of a private company?**
> No. The retention on trust of an unpaid present entitlement is not a loan by the private company to the trustee. Accordingly, the general loan provisions of Division 7A do not apply.
> Section 109UB and subsection 109XA(2) have no application because the trustee does not make a loan to a shareholder or shareholder's associate of the private company.
> Also, the creation of a present entitlement is not, of itself, a payment for the purposes of subdivision EA.

This pre-16 December 2009 view, we believe, is consistent with our view of the law, and what we would consider the intention of Subdivision EA as evidenced by the history to the provisions (as outlined in Section 1.7 of this submission).

Accordingly, in Example A, if this view were to be applied, the unpaid present entitlement of $100 would not have constituted a loan under subsection 109D(3) (contains the definition of 'loan' for Division 7A purposes). In this case, Subdivision EA would apply so that the $5 lent to the individual would be deemed to be a dividend under section 109XB of Subdivision EA.

In effect, the application of the law in this manner resulted in $5 (rather than $100) of the company's profits being treated as a deemed dividend, as this amount represented the payment of company profits to the shareholder.

1.5 ATO view of when Subdivision EA has effect post 16 December 2009

Under the Draft Ruling, the ATO takes the view that one must first consider whether an unpaid present entitlement is a loan, as defined in subsection 109D(3). The broad conclusion of their view is contained in paragraphs 21 to 23.

> 21. Accordingly, where there is knowledge that funds representing the UPE are being used for trust purposes, rather than for the private company's absolute benefit without any benefit from use accruing to the trust, the non-calling for payment of the UPE amounts to the provision of financial accommodation and, by extension, the making of a Division 7A loan.
>
> 22. Moreover, in these circumstances, the mere declaration of the private company's trust entitlements does not embody the real nature of the overall transaction between the trustee and the beneficiary. Here the overall transaction between the private company beneficiary and the trustee includes the beneficiary's authorisation (or acquiescence with knowledge) that funds representing the UPE can be used for the benefit of the main trust and effects, in substance, a loan of money to the main trust.

[5] The ATO acknowledge in paragraph 56 of the Draft Ruling that their prior general administrative practice is contrary to their views in the Draft Ruling (specifically section 3)

> 23. As the trust and beneficiary form part of the same family group, the Commissioner will form the view that the private company has knowledge of the trustee's use of the funds representing the UPE for trust purposes, subject to sufficient evidence to the contrary.

This view means that unpaid present entitlements are therefore treated as a loan under subsection 109D(3). Furthermore, in accordance with paragraph 25, the ATO conclude that for the purpose of Division 7A, the legally recognised unpaid present entitlement will not be treated as such when applying Subdivision EA.

> 25. However, where the private company beneficiary has a subsisting UPE but has also provided financial accommodation or an in-substance loan to the trustee of the trust as discussed in paragraphs 21 and 22 of this draft Ruling, the relevant arrangement will have gone beyond the creation of a present entitlement 'of itself'. Accordingly, to the extent of that UPE, the private company is not treated as having a present entitlement to an amount of the net income of the trust estate of the main-trust that remains 'unpaid' for Subdivision EA purposes. This means that in situations where the private company beneficiary has made a Division 7A loan in respect of a subsisting UPE, <u>Subdivision EA will have no subsequent operation in respect of that UPE. [emphasis added]</u>

As highlighted, the conclusion means that Subdivision EA will have no subsequent operation in respect of that unpaid present entitlement.

During consultations, the ATO had suggested that Division 7A has always been intended to operate in this manner, and that Subdivision EA has a limited role to play. That is, the ATO included Example 6 in the Draft Ruling to demonstrate when Subdivision EA may apply.

> 51. Assume the facts are as for Example 5, except that in its capacity as trustee of the sub-trust (and not as agent of X Co) Trustee Ltd ensures that the investment in the main-trust is on terms entitling the sub-trust to all the benefits that flow from use of those funds by the main-trust. As the sole beneficiary of the sub-trust, X Co will be entitled to any income derived by the sub-trust from this investment.
>
> 52. X Co has not made any loan to, or provided financial accommodation or an in-substance loan to the main-trust or the sub-trust. Rather, X Co has a UPE that is being invested for its sole benefit, and it has not made a Division 7A loan under section 109D.
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> 53. However, if the main-trust on-lends funds to a shareholder or an associate of a shareholder of X Co, Subdivision EA may apply to treat such on-lending as a relevant dividend.

We highlight that, in practice, we are not aware of any trusts being administered in accordance with Example 6. Accordingly, we find it difficult to accept that the provisions were drafted based on an example which does not occur in common practice. On this point, it would be beneficial if examples of trusts administered in accordance with Example 6 could be provided (eg,from the ATO, Treasury or tax practitioners). We believe that such information could help the SEC in determining the correct policy of the operation of Subdivision EA and thus Subdivision EB.

Again, we stress (as outlined in the history of Division 7A in Section 1.7 of this submission below), that we do not believe Subdivision EA, being one of the most complex provisions contained in Division 7A and being a provision that has involved significant resources of Government and Treasury, was drafted to cater for situations that do not occur in common practice. Accordingly, we disagree with the ATO that Subdivision EA has a limited role to play and that Division 7A was always intended to operate in the manner set out in the Draft Ruling to the limited scenarios covered by Example 6.

1.6 Effect of the ATO view on proposed Subdivision EB

The Institute reiterates its prima facie support for the changes contained in Schedule 1, Item 25 of the Bill. However, if the law is administered in accordance with the ATO view, we believe that the amendments will give rise to significant ambiguity in the provisions. Consider the following example, which extends <u>Example A</u> so that it would otherwise fall within the ambit of Subdivision EB.

> **Example B – unpaid present entitlement through multiple trusts**
> Trust A operates a business and makes business profits on a yearly basis. For the X1 year, it derives $100 of income. It distributes this amount to another trust (Trust B), which in turn distributes this amount to a company (Aco) by the end of the year. Trust B does not pay this amount to the company by year end (i.e. there is an unpaid present entitlement of the company). Aco pays tax on the income distribution at 30% (i.e. $30). During

> the following year, Trust A lends $5 to a shareholder of Aco (Mr Smith). The remaining $95 is retained in the trust to be used as working capital of the trust in its business.

In Example B, there is a deficiency with the current deemed dividend provision, section 109XB, in Subdivision EA. As Trust A does not have an unpaid present entitlement to a company (ie. it is with Trust B), section 109XB cannot operate to treat the $5 lent to Mr Smith as a deemed dividend. We believe that this issue is addressed appropriately by the proposed amendments contained in section 109XI in proposed Subdivision EB. That is, subsection 109XI(1), together with subsection 109XI(4), would deem the unpaid present entitlement of Aco to be with Trust A when applying Subdivision EA. Accordingly, this would result in section 109XB treating the $5 loan to Mr Smith as a deemed dividend.

However, if the ATO view contained in the Draft Ruling were to be applied to Example B, we highlight that section 109XI cannot operate. That is, the unpaid present entitlement from Trust B to Aco would be treated as a loan under subsection 109D(3), which would mean that Subdivisions EA and EB would not have operation. Instead, the whole of the $100 would be a deemed dividend to Trust B under section 109D in Subdivision B.

Furthermore, the ATO could also apply the existing interposed entity rules under Subdivision E to target the $5 loan paid to Mr Smith through Trust A. That is, section 109T in Subdivision E applies if the company has made a 'loan' (as defined) to an interposed entity (Trust B), where the interposed entity or entities makes a loan to a target entity (Trust A or Mr Smith).

As outlined above, the ATO view in the Draft Ruling renders Subdivision EA and the proposed Subdivision EB as effectively inoperative. We stress that tax practitioners are unlikely to understand this complex interaction as outlined above. Thus the introduction of Subdivision EB without amendment will result in significant ambiguity and confusion amongst tax practitioners in the application of Division 7A. We believe that this will result in mass unintentional non-compliance with the provisions by the tax practitioners and taxpayers, predominantly impacting small business taxpayers. Trust structures are widely used amongst small businesses and due to the lack of resources that they have available to be able to understand the complex interactions between the Draft Ruling, Subdivision EA and Subdivision EB, it is likely that this market will suffer as a result of the Bill if there is no amendment.

It is our view that Division 7A is predicated on the basis that a legal unpaid present entitlement should not constitute a loan under subsection 109D(3). Our view is supported by the history of the provisions as outlined in Section 1.7 below. In order to avoid the ambiguity and confusion highlighted above, we request the SEC to recommend the proposed change as outlined in Section 1.10 below.

1.7 History of Subdivision EA

We have previously provided a lengthy submission to the ATO on the history of Subdivision EA, outlining what we believe to be the context of the provisions.

We have attached this detailed submission on the history of the provisions as 'Attachment to Schedule 1'. We believe that it is critical to take into account the history of the provisions when analysing the context of the provisions and what is required to restore clarity to the provisions. Accordingly, we have provided a summary of the history in this section of the submission.

Original press release

The history of the Subdivision EA provisions applying to trusts can be traced back to the Division 7A amendments made pursuant to an announcement by Assistant Treasurer Kemp on 27 March 1998 which stated that:

> It was argued that the proposed legislation does not apply to arrangements where a corporate beneficiary has become presently entitled to net income of a trust and the amount is not paid by the trustee to the corporate beneficiary, but continues to be held by the trustee who then provides a loan to a shareholder (or their associate) of the corporate beneficiary.

Therefore, before Division 7A was enacted, it was argued that section 109D in Subdivision B would not apply to unpaid present entitlements as such arrangements would not be loans. As the use of trusts and corporate beneficiaries was a common practice, this created a significant integrity concern for Parliament, as a loan to a target entity (through the trust) may not have been caught by the provisions. The press release went on to confirm that:

> These sorts of arrangements should be caught by Division 7A because, in substance, a loan of money from the private company to the shareholder (or their associate) has been effected via the trust" (emphasis added).

Importantly, the arrangement, as described, only appeared 'mischievous' if the 'amount' was subsequently provided as a loan to a shareholder or associate of the corporate beneficiary. Again, we reiterate that the press release highlighted this as an integrity concern. Parliament did not appear concerned with the retention of the cash in the trust. Accordingly, in examining Example A, it can be said that the Press Release was aimed at the $5 loan to Mr Smith and was not targeted at the $95 retained as working capital.

Drafting instructions

We believe that our conclusion above is consistent with the Drafting Instructions that introduced section 109UB (the predecessor to Subdivision EA). These drafting instructions were obtained through a freedom of information request. The Drafting Instructions state:

> 15. The definition of loan in subsection 109D(3) includes 'a transaction (whatever its terms or form) which in substance effects a loan of money'. There is some doubt whether this phrase covers the situation where income of a trust estate to which a private company beneficiary had become presently entitled is not actually paid over by the trustee but instead is lent by the trustee to a shareholder of the private company beneficiary. There is persuasive opinion that such an amount is held by the trustee under a separate trust for the benefit of the corporate beneficiary. Accordingly, it is arguable that Division 7A would not apply to the amount held in the subtrust if it is lent by the trustee to a shareholder of the corporate beneficiary. This is because the amount held in the subtrust has not actually been lent by the private company to the trust.
>
> 16. To remove this uncertainty, a new provision is needed so that if:
> - a private company is or has been made presently entitled to an amount from a trust's net income; and
> - this amount has not been paid over by the trustee; and
> - the trustee has subsequently made a loan to a shareholder/associate of the private company;
>
> then the amount lent by the trustee, up to the value of the amount held separately on trust for the private company beneficiary, is to be treated as a loan paid by the private company to the shareholder/associate. [emphasis added]

In our view, the Drafting Instructions highlight the uncertainty that existed at the time Division 7A was introduced. The Drafting Instructions clearly state that section 109UB (and therefore Subdivision EA) was inserted to 'remove this uncertainty' on the application of section 109D. Thus, in our view, the intention of the 'new provision' was to provide certainty. Certainty could only be obtained if the arrangement in Example A were to be considered an unpaid present entitlement for Division 7A purposes and not a loan. The ATO's Draft Ruling, which concludes the opposite, has created a significant amount of uncertainty on the application of Subdivision EA and, in our view, is inconsistent with the policy objective stated in the Drafting Instructions.

Accordingly, we believe the Drafting Instructions supports the fact that Parliament intended the "new provision" to be a unique code dealing with unpaid present entitlements, and that such arrangements were not intended to fall within section 109D once the "new provision" was inserted into Division 7A.

Introduction of section 109UB

On 8 April 1998, the revised Bill containing the Division 7A provisions was introduced into the House of Representatives. The revised Bill included section 109UB as the 'new provision'. Section 109UB applied to deem a loan (the deemed loan) to have been made by a private company to a shareholder (or associate of the shareholder) if the private company became presently entitled to a share of the net income of a trust and the trust did not pay the entitlement (in cash or otherwise) to the private company, but rather lent the money to the shareholder (or associate of the shareholder) of the private company.

Specifically, section 109UB stated that:

> [I]f:
> (a) a private company is, or has been, presently entitled to an amount from the net income of a trust estate; and
> (b) the trustee has not paid the amount to the private company; and
> (c) the trustee has made a loan to a shareholder of the private company, or an associate of such a shareholder after the time that the private company first became presently entitled to that amount;
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> the private company is taken to have made a loan to the shareholder or associate, at the time that the trustee made the loan.

First, we highlight that the drafting of the original provision ensured that the unpaid present entitlement could only be 'converted' if it was subsequently repaid. That is, the reference to 'or has been' in paragraph (a) meant that once the amount was an unpaid present entitlement, it would always be regarded as one. Accordingly, the view that an unpaid present entitlement could (by acquiescence) become a loan would not be possible in our view under section 109UB.

Secondly, we highlight that the conditions, as contained in section 109UB, specifically cover the fact pattern demonstrated in Example A. That is, in Example A, Aco is presently entitled to $100, which has not been paid to Aco by the year end. Trust A then makes a loan to Mr Smith, being a shareholder of Aco. Accordingly, the conditions of section 109UB would be satisfied.

ATO administration

From the date of its introduction, tax practitioners and taxpayers alike applied Division 7A (generally) and section 109UB on the basis that if there was no loan to a shareholder or associate of the corporate beneficiary, then Division 7A and section 109UB did not apply. However, many tax practitioners were concerned by the harshness of section 109UB. That is, unlike section 109D, which only applied if the loan from the private company to the shareholder (or associate) was not fully repaid by the end of the year of income in which the loan was made, section 109UB applied regardless of whether the loan was repaid by year end or not.

Board of Taxation review of section 109UB

On 12 December 2002, the then Treasurer, Peter Costello issued a press release advising that the Government would legislate to introduce new provisions in place of section 109UB. The announcement made by the then Treasurer was based on recommendations by the Board of Taxation (the Board) in its report which was released on the same day entitled *Taxation of Discretionary Trusts*. In examining this issue, the Board report discussed the general application of Division 7A to unpaid entitlements as follows:

> 72 The ambit of the deemed dividend rules is extended to trusts by section 109UB of the ITAA 1936, which applies to a private company that is a beneficiary of a trust estate. A trustee can make a company presently entitled to trust income without distributing cash to the company. This allows a trust to effectively accumulate income that has been taxed only at the company tax rate. Section 109UB deals with the case in which a trustee:
>
> - makes a company presently entitled to trust income (so as to access the company tax rate), and
> - then distributes the underlying cash to individual beneficiaries through loans (so that the beneficiaries avoid paying any 'top-up' tax that would be imposed on a distribution if the beneficiaries have a higher marginal tax rate).
>
> 73 Section 109UB deems the loan to have been made by the company, thus attracting the operation of the deemed dividend rules.
>
> Cases in which section 109UB is ineffective
>
> 74 Section 109UB, however, does not cover a case in which:
>
> - the trustee makes a private company presently entitled to trust income, but does not pay the income to the company; and
> - the trustee then distributes the underlying cash to trust beneficiaries, but not as a loan.
>
> 75 In such circumstances, the individuals are able to access, without further tax liability, trust income that has been taxed only at the company tax rate". [emphasis added]

The observation of the Board clearly highlights the practice and ability to 'accumulate income' in the trust, without triggering the operation of Division 7A. That is, the Board's example in paragraph 72 is exactly the same as that contained in Example A of this submission, where the Board indicates that a trust is allowed to accumulate income in the trust that has been taxed only at the company rate. That is, in Example A, the Board's review of section 109UB means that $95 would not be taxed as a deemed dividend under Division 7A, as it has been accumulated in the trust.

Further, the reference to the distribution of the "underlying cash" and the description of the transaction by the Board indicates that the Board believed that Division 7A should only apply when there was a loan of the underlying cash (i.e. the $5 in Example A) to a shareholder or associate of the shareholder. The conclusion that only the "corporate tax rate" would apply is a clear indication that the Board concluded that Division 7A did not apply to the example covered in paragraph 74 of their report. This view is in stark contrast to that in the Draft Ruling, which would deem the whole of the unpaid present entitlement to be a loan.

Further, the recommendation made by the Board in relation to Division 7A (i.e. Recommendation 3) indicates that the Government should consider options for amending the tax law to improve the effectiveness and fairness of "provisions intended to prevent individuals who are trust beneficiaries with high marginal tax rates accessing, without further tax liability, funds that have been taxed only at the company tax rate".

In our view, the discussion paper therefore supports the view that both Parliament (who commissioned the Board to perform this review) and the Board did not consider that an unpaid present entitlement was a loan for Division 7A purposes. We highlight that Treasury and ATO were represented on the Board's panel at the time of the review.

Introduction of Subdivision EA

In order to address the integrity concerns highlighted above, the Board put forward two options that could be used to more effectively prevent beneficiaries accessing trust income that had borne tax only at the company tax rate.

The first option was a replacement provision. This option was chosen by the Government and is in the form of Subdivision EA today. However, the second option suggested that "section 109UB could be repealed, and replaced with a section setting out the consequences where a trustee makes a company presently entitled to the income of a trust, but does not pay the funds to the company within a reasonable period. The consequences could be either that the trustee would be assessed on the amount of the income as if there had been no distribution, or that the company would have to pay a top-up tax (which could create franking credits in the company)".

It is noted that the second option is similar to the view provided by the ATO in their Draft Ruling. That is, the unpaid present entitlement would effectively be treated as a deemed dividend and thus top-up tax would be paid on the unpaid present entitlement by the trust. Furthermore, it is noted that neither option one or two would have been necessary if the unpaid present entitlement were treated as a loan under Division 7A, making the recommendations unnecessary if the ATO view in the Draft Ruling were correct.

In our view, the Board's review, the Board recommendations, and the Government's ultimate decision on amending section 109UB (through option one) makes it clear that an unpaid present entitlement (even when not paid in a reasonable period) did not trigger and was not intended to trigger the operation of section 109D. Again, we reiterate that this conclusion stands in stark contrast with the Draft Ruling released by the ATO.

1.8 Institute's view of Division 7A and unpaid present entitlements

The history to Subdivision EA and the significant amount of time that has been invested by both Treasury and the Board of Taxation in reviewing the application of the former section 109UB and the current Subdivision EA makes it clear that the provisions contained within the Subdivision are an important part of Division 7A. That is, in our view, there is a clear indication that these provisions have a significant role to play in relation to a very common transaction in trust structures. However, the ATO's interpretation of the provisions as set out in the Draft Ruling would result in Subdivision EA and therefore proposed Subdivision EB, being both unnecessary and effectively inoperative.

The ATO believes that Subdivision EA would have application going forward in very limited circumstances contained in Example 6 of the Draft Ruling which seems to reconcile the operation of the law. However, as outlined in Section 1.5 of this submission above, such an example in our view does not occur in common practice and was not the reason for introducing section 109UB or Subdivision EA into Division 7A. Accordingly, we believe that the ATO view provided in the Draft Ruling (if finalised) would render Subdivision EA as having no practical effect. In turn, this would render proposed Subdivision EB as also having no practical effect.

1.9 Providing purpose and certainty

We believe that the ATO view would be at odds with the way legislation should be interpreted. In the case of *AMP Inc v Utilur Pty Ltd* [1972] RPC 103 at 1094, Lord Reid stated that:

> "it being improbable that the framers of legislation could have intended to insert a provision which <u>has virtually no practical effect</u>, one should look to see whether any other meaning produces a more reasonable result".

We believe that rendering Subdivision EA and the proposed Subdivision EB effectively inoperative, cannot be the intention of Parliament. While we believe that a Court would sensibly interpret section 109D to exclude unpaid present entitlements, such a process may take a significant amount of time to provide clarity. Until that time, we believe that there will be significant ambiguity in the law, resulting in mass confusion and unintentional non-compliance with the provisions.

Accordingly, we urge the SEC recommend the amendment proposed in Section 1.10 below. This minor amendment will ensure that taxpayers have clarity in relation to the way that the law operates in respect of unpaid present entitlements and Division 7A.

1.10 Recommended solution to issue

We believe it is critical for clarification to be provided on the treatment of unpaid present entitlements under Division 7A. It is our view that the SEC should recommend a provision that states that a loan for the purposes of Division 7A excludes an unpaid present entitlement in a trust estate. We would recommend that this change be made to section 109D. For example, as proposed below, a new subsection 109D(3A) could be introduced to clarify the operation of the provisions.

> **Section 109D(3) What is a loan?** In this Division, loan includes:
> (a) an advance of money; and
> (b) a provision of credit or any other form of financial accommodation; and
> (c) a payment of an amount for, on account of, on behalf of or at the request of, and entity, if there is an express or implied obligation to repay the amount; and
> (d) a transaction (whatever its terms or form) which in substance effects a loan of money.
>
> <u>**Section 109D(3A) Unpaid present entitlement.** To avoid doubt, where a company becomes presently entitled to an amount from the net income of a trust estate, and the whole of that amount has not been repaid at that time, any of the amount that remains unpaid is not to be treated as a loan for the purpose of applying this Division at that time.</u>

We believe that this change is the only way to provide certainty on the operation of Subdivision EA and thus the operation of the proposed Subdivision EB. Where Treasury does not clarify this issue by way of legislative change, we highlight that the introduction of the provisions contained in Schedule 1, Item 25, will result in significant ambiguity. Such ambiguity in our view will result in mass non-compliance by those small business taxpayers operating their businesses through trust structures.

2. Proposed Subdivision EB

2.1 Application of use of asset rule to pre-1 July 2009 assets is inappropriate

The amendments in item 13 provides that the new payment provisions can operate in either of two circumstances, where:

- there is an 'actual use' of the asset; or
- the asset is 'available for use' in circumstances where the company does not have a right to use that asset or to provide the asset for use by another shareholder or associate of the company.

The proposed definition is very broad and includes not only the use of an asset, but having an asset 'available for use' (even if it is not used).

In many circumstances the application of the new payment rule will apply to assets that were purchased in the company structure prior to 1 July 2009. This is confirmed in Example 1.1 of the EM. However, assets held in a company may have been purchased for legitimate reasons non-tax driven reasons (such as asset protection). In many cases, such assets may be held in non-operating companies that do not generate profits or taxable income. While we understand the integrity concern targeted by Item 13, we highlight that it is often difficult (if not impossible) to move such assets out of a company without the incurrence of significant tax and other administrative costs. Accordingly, small business taxpayers will now be required to incur an additional annual tax liability and compliance costs in applying these measures, without being given an opportunity to avail themselves from the operation of the provisions.

The current definition of 'payment', as contained in section 109C of Division 7A, already applies to assets that are used by shareholders or associates. This view is contained in the ATO fact sheet, at question 21, which states:

> **21. Can a 'right to use' property be treated as a payment for Division 7A purposes?**
>
> Yes. A 'right to use' property can be a payment for Division 7A purposes where that right involves a transfer of property. Where the right does not involve a transfer of property, it is not treated as a payment.
>
> Example 1: a right to use real property that is made by way of a lease involves a transfer of property to the lessee and is a payment for Division 7A purposes.
> Example 2: the granting of a licence which does nothing more than provide a mere permission to enter onto and use real property is not a transfer of property and hence not a payment for Division 7A purposes.

Item 13 seeks to extend the current operation of the definition of payment to 'right to use' assets which do not constitute a transfer of property. This extension is confirmed in the EM at paragraph 1.18. This extended definition is quite significant and could apply to almost all assets that are available for use by the shareholder or associate.

Accordingly, from 1 July 2009, such assets will be subject to the onerous rules and additional costs of compliance under Item 13 of the Bill, including the requirement for valuations (as discussed below). We believe that the application of the measures to those assets is not appropriate where small business taxpayers are not provided an opportunity to avail themselves of these measures (i.e. are not provided with an ability to restructure such assets without an upfront tax cost).

In particular, the application of the amendments from 1 July 2009 to assets of a company that are not 'actually used', but are 'available for use', will be problematic for many taxpayers. The types of assets that may fall within this provision include holiday type accommodation, cars and boats. Such assets may not be used by the taxpayer, but may be considered 'available for use' because of the way the asset is held or stored by (or on behalf) of the company.

For example, a collection (coins, memorabilia) held at a shareholder's residence for safe keeping would likely be caught under this 'available for use' rule. The shareholder may be taxed in respect of the value of this 'use' (if a value can be found, see further below) although they have done nothing since 1 July 2009 other than care for the asset for the company, which they may have been doing for many years.

The breadth of the provision will require taxpayers to closely consider each and every asset held by a company to determine whether the payment rule may be breached. To avoid this compliance cost and the possible punitive operation of these rules, assets would need to be moved out of the company structure with the potential for significant stamp duty and income tax consequences on disposal.

Given that the current definition of payment would otherwise cover the 'use of assets' where there is a transfer of property, we believe that an application to pre-existing assets (where the asset cannot be moved without significant tax implications) is effectively akin to a retrospective application of these provisions. In our view, a retrospective application of these measures is not equitable for small business taxpayers and is therefore inappropriate. We therefore support the amendments contained in Item 13, provided that they are applied to new assets acquired after a 'transitional date' as discussed below.

Recommendations

We submit that the proposed 'available for use' payment provision, contained in paragraph 109CA(2)(b), should not apply to assets acquired before 1 July 2009 (or alternatively before 12 May 2009 being the date of 2009-10 federal budget night announcement of the changes). Assets acquired during this period would be regarded as being acquired during the transitional period.

We also submit that the actual use of assets rule, contained in paragraph 109CA(2)(a), should not apply in respect of any assets acquired by the company prior to 4 December 1997 (being the date of application of the original Division 7A provisions). Assets acquired during this period would be regarded as being acquired during the transitional period.

Accordingly, any assets acquired during the 'transitional period' would be subject to the existing definition of payment as contained in section 109C prior to the amendments contained at Item 13. Where the use of such an asset constitutes a 'transfer of property' under the existing definition of payment, the use would be regarded as a deemed dividend under Division 7A (as is the case currently).

Alternatively, if the SEC does not agree with the above, we would strongly request the SEC to consider recommending a restructuring provision to allow small business taxpayers to move such assets outside of the company without the incurrence of a significant upfront tax cost. For integrity purposes, such a measure could be limited to assets that would otherwise fall within the extended definition of payment, as proposed by Item 13, where the asset was acquired before 1 July 2009.

2.2 Optional safe harbour rule for valuing payments

It is proposed that the amount of the payment for the use of the asset is the amount that would have been paid for the provision of the asset by parties dealing at arm's length less any consideration paid for that use by the shareholder or associate.

The law therefore introduces new costs of compliance for taxpayers to require them to find an arm's length rate for the use of assets. Although it might be reasonably straight forward to obtain such values for some common assets, including for example rental properties, there will be many circumstances where the requirement to find an arm's length value will be difficult to meet where an asset does not have a readily available market, such as for the use of antiques etc..

Recommendation

We submit that an optional safe harbour valuation method should be included in the amendments to allow taxpayers to determine the amount of payment for the use of assets where it is not practicable to determine an arm's length value. Such a method might be based on applying the Division 7A interest rate to the original cost of the asset, however the safe harbour would need to be developed in consultation with Treasury.

Schedule 2 – Extending the tax file number withholding arrangements to closely held trusts, including family trusts

Background

On 5 February 2010, the Assistant Treasurer released for consultation the exposure draft and explanatory material for this 2009-10 Budget measure to extend current Tax File Number ("TFN") withholding arrangements to closely held trusts, including family trusts. This followed initial consultation on the proposed measures during October and November 2009 which was facilitated by a Treasury discussion paper.

The Institute lodged a submission on the exposure draft on 23 February 2010 and was pleased to see a number of improvements in the Bill such as alignment of the annual reporting obligation for trust distributions with the timing of lodgement of the trust's tax return.

Whilst the Institute generally supports the objectives of the measures – i.e. to facilitate data matching and enhance compliance - it still has concerns about the additional compliance burdens/workloads that will be placed on tax agents who handle the affairs of closely held trusts ("CHTs") if the measures proposed in the Bill are passed into law in their current form.

Summary of submission

The Institute considers that the current rules dealing with withholding by trustees, in addition to this proposed measure, are more complex than they need to be. The Institute's preferred approach is that these should be streamlined rather than continuing to introduce new provisions that overlap each other in certain areas. This is set out in Part A below.

However, if the Parliament is to pursue the approach in the Bill, the Institute considers that it is crucial that refinements are made to reduce the compliance burden on trustees and tax agents. These are detailed in Part B.

Detail of submission

Part A – Preferred approach is to streamline the withholding measures for trusts

The current rules dealing with trustee withholding, in addition to the proposed new measures in the Bill, seem overly complex for trustees and their tax agents. The proposed measures introduce the following new sections:

- Division 4B – quotation of tax file numbers in connection with certain closely held trusts
- Schedule 1, subdivision 12, *Taxation Administration Act 1953* ("TAA") – payment in respect of entitlement to trust income where TFN not quoted
- Schedule 1, subdivision 16, TAA – providing information to Commissioner and recipient of withholding payment.

These proposed requirements are in addition to the existing disclosure requirements under the family trust rules and the trustee beneficiary rules.

The Institute considers that the current rules dealing with withholding by trustees, in addition to this proposed measure, are more complex than they need to be. There are already a number of other existing provisions that require trustees to withhold tax. The Institute's position is that these should be streamlined rather than continuing to introduce new provisions that overlap each other in certain areas. The trustee beneficiary disclosure rules and this proposed measure are an obvious example.

We accept that there are circumstances where more than one set of rules are necessary. However, there seems no point to keeping the trustee beneficiary disclosure rules found in Division 6D of the ITAA 1936,

when the proposed TFN measure could cover any assessable distributions where the TFN is not provided (i.e. not just distributions to a trustee).
In our view only one set of rules is needed to achieve virtually the same outcome. Having two or more sets of rules that are essentially aimed at the same mischief, no doubt, results in increased complexity. In other words, the more sets of rules that need to be understood by trustees and/or their advisers obviously results in greater compliance costs and a greater likelihood of errors being made.

Part B – Refinements needed if proposed approach is pursued

If the Parliament is to pursue the approach in the Bill for extending TFN withholding to CHTs, rather than streamlining the provisions as recommended in Part A above, the Institute considers that it is crucial that refinements are made to the measures in the Bill to reduce the compliance burden on trustees and tax agents by:

- Seeking to minimise reporting requirements
- Removing duplication in reporting the same information
- Providing more realistic time frames, particularly in the initial year of operation of the measures and bearing in mind the tax agents' lodgement program
- Facilitating a smoother transition to the new requirements.

To minimise (unnecessary) reporting obligations, the Institute considers that the legislation must state that:

- o the information in the trust's tax return will be sufficient for the purposes of the annual reporting of trust distributions
- o the fact that TFNs have been provided to a trustee in previous years - i.e. to enable prior year trust tax returns to be completed - means that the relevant beneficiaries have already quoted their TFNs in an approved form
- o a trustee does not need to register for PAYG withholding if it is only making payments to beneficiaries who have provided their TFNs, and
- o a beneficiary can provide their TFN at any time until the lodgement date/due date for lodgement (whichever is the earlier) of a trust's tax return.

Further details on these points and other concerns are set out below.

1. Registering for, and the reporting of, withholding amounts

1.1 No need to register for PAYG withholding if all TFNs provided

The Institute submits that the legislation and/or the Explanatory Memorandum ("EM") needs to clearly state that a trustee <u>does not</u> need to register for PAYG withholding if it is only making payments to beneficiaries who have provided their TFNs.

The current wording of the EM (see paragraphs 2.56 to 2.60 and, in particular, paragraph 2.86) is not clear as to whether the above result is achieved.

1.2 Extension to lodge annual report for withholding amounts

The annual report for withholding amounts is due 3 months after the trusts' income year (s16-152(2)(a) of Schedule 1 to the TAA which will place an additional requirement on tax agents. However, the trustee can request an extension of time (s16-152(2)(b) of Sch 1 to TAA) from the Commissioner of Taxation to lodge the annual report.

The Institute submits that the legislation should permit that such a request could be made at any time up until the lodgement date of the trusts' tax return for the first year - the 2010 income year - because many trustees will be unaware of their obligation or will not have quantified the relevant amount until they take their information to their tax agents.

2. Reporting to the Commissioner of amounts withheld and amounts distributed

As stated in the EM:

> 2.76 These amendments also require the trustee of a closely held trust to lodge two different annual reports with the Commissioner. The first report (annual report for withholding amounts) is an annual report which is designed to detail the amounts withheld by the trustee under this measure. The second report (annual report for amounts distributed) is also an annual report and is designed to detail the amounts distributed to beneficiaries, even though the trustee was not required to withhold from those distributions.

The Institute considers that the legislation should state that the information in the trust's tax return will be sufficient for the purposes of the annual reporting of trust distributions. If not, then the trust tax return will show the TFNs of beneficiaries and then a separate report/form will show exactly the same information. This would seem an unnecessary duplication of effort.

3. Quoting and reporting TFNs

3.1 TFNs reported in previous years

To prevent unnecessary duplication it needs to be made clear in the Bill and/or the EM that where TFNs have been provided to a trustee in previous years - i.e. to enable prior year trust tax returns to be completed and lodged with the ATO - this automatically means that the relevant beneficiaries have already quoted their TFNs in an approved form. If not, then (similarly to the point we made above) the previously lodged trust tax return will show the TFNs of beneficiaries and then a separate report/form will show exactly the same information - this seems to be an unnecessary duplication of effort.

3.2 Quarterly reporting is not necessary

The Institute sees no reason why the trustee should be required to report any (new) TFNs quoted by their beneficiaries on a quarterly basis under the proposed rules (s202DP of the ITAA 1936). Rather, the Institute submits that it should be sufficient to report such TFNs by lodgement of the trust's income tax return.

Quarterly reporting is unnecessary as the ATO cannot do any data matching before both the trust's and the beneficiaries' income tax returns are lodged. Typically the lodgement date for trusts and the beneficiaries is May or June following the relevant income year. Even if a beneficiary lodges earlier than that, there is no point doing a data match until the trust's income tax return is finalised and the beneficiary's share of the net income of the trust is known with certainty.

All the trustee can give to the ATO at an earlier point in time is the amount of a beneficiary's present entitlement to income of the trust. This amount is not necessarily the same amount as the amount included in a beneficiary's assessable income. The amount included in the beneficiary's assessable income is their share of the net income, not their share of the trust's income.

If the ATO is concerned about the accuracy of a TFN then a better solution would be for it to amend its software so that the beneficiaries' TFNs are validated when the trust's income tax return is lodged electronically. That is what the system does for the trust's TFN. If the trustee lodges a paper income tax return, there is a contact name and number supplied on the income tax return so that the ATO can follow up with the trustee directly in the rare event that a TFN turns out to be incorrect.

If incorrect TFNs are a common occurrence, the Institute is of the view that the ATO should provide evidence of this to the Senate inquiry.

4. Proposed start date of 1 July 2010

The Institute considers that the proposed start date of the new requirements of 1 July 2010 may lead to problems for the ATO, trustees and tax agents to disseminate information on the new TFN withholding obligations (if passed by the Parliament) to affected taxpayers so that they (and clients/trustees) can be made as ready as possible for the changes. This is crucial for instance in seeking the TFNs of potential beneficiaries of affected trusts.

As most trustees of CHTs are not currently required to withhold tax on assessable distributions (i.e. only a minority of CHTs would have withholding tax obligations for non-resident beneficiaries etc), any amendment would need to allow for an extensive education program for trustees and tax agents prior to the implementation date.

The situation is exacerbated by the fact that the soonest the legislation could be passed by the Senate is after the Committee reports on 11 May 2010. In our view, it follows that without the changes above, a smooth transition to meeting the additional requirements will be jeopardized.

The other option would be delay implementation of the measures until the following year (2011/12) to allow sufficient time for trustees, tax agents and beneficiaries to familiarise themselves with the requirements, collect/provide/report the TFNs and put procedures in place to meet the onerous requirements proposed in Schedule 2 of the Bill.