23 April 2010

The Secretary
Senate Economics Legislation Committee
PO Box 6100
Parliament House
CANBERRA ACT 2600

Dear Sir/Madam

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

Thank you for your invitation to assist in the Senate Committee's inquiry into Taxation Laws Amendment (2010 Measures No. 2) Bill 2010 (the Bill).

The primary issues that affect the integrity of the income tax system relate to proposed changes that:

1. Improve the fairness and integrity in the tax system: distributions to entities connected with a Private Company contained in Schedule 1 of the Bill;

2. Extend the tax file number withholding arrangements to closely held trusts, including family trust contained in Schedule 2 of the Bill; and

3. Repeal certain unlimited periods for amending assessments contained in Schedule 6 of the Bill.

In relation to the amendments proposed in Schedules 3, 4 and 5 of the Bill, we do not consider that they have as significant an impact on the integrity of the taxation system.

We make the following observations in relation Bill.

Schedule 1 – Distributions to entities connected with a Private Company

Section 109XH and section 109XI - Overview of submissions

Both sections potentially create an "Incontestable Tax" and are arguably outside the Commonwealth Parliament's power to enact laws in relation to taxation contained in section 51 of the Constitution.

Notwithstanding, we are concerned that subsection 109XH(1) and subsection 109XI(4) provides the Commissioner with the ability to impose tax on "the amount (if any) determined by the Commissioner".

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Under a self assessment system, taxpayers ought to be entitled to look to the Income Tax Assessment Act 1997 to define how much they will be taxed on. In the case of section 109XH and 109XI, a taxpayer cannot determine the amount of income they will be taxed on at all.

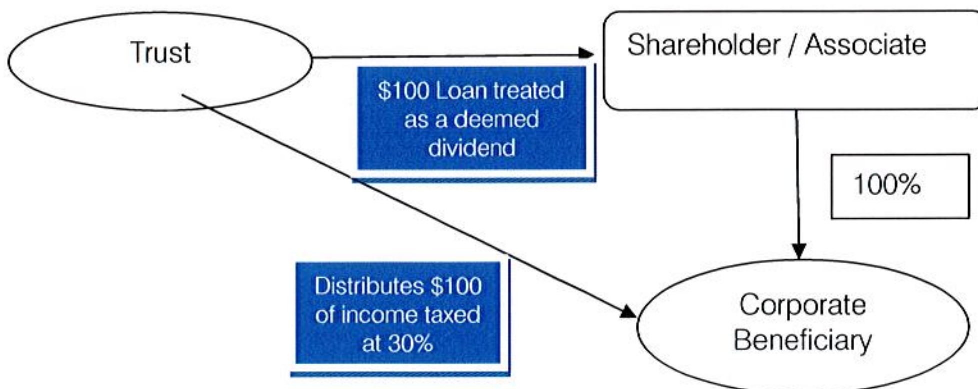
The determination of that amount is left to the Commissioner. We submit that section 109XH and section 109XI do not provide the Commissioner with sufficient objective criteria that a taxpayer could apply to arrive at a definite, certain sum they will be taxed on. We consider that the policy of the Government can be defined in the Bill with a significantly greater level of precision than the proposed section 109XH and section 109XI.

Detailed analysis in support of our submission

Subsection 109XA(2) in the Income Tax Assessment Act 1936 (the 1936 Act) defines when a loan by a trust to a shareholder (or their associate) of a corporate beneficiary of the trust will be treated as a deemed dividend from a company.

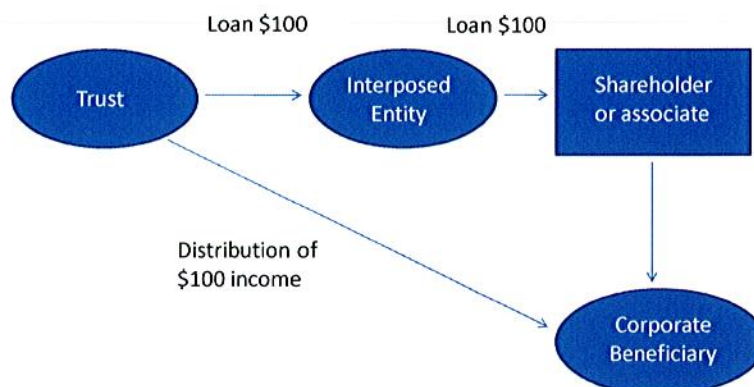
Subsection 109XA(2) applies where a trust distributes its income to a Corporate Beneficiary but does not pay that amount for an indefinite period of time. The amount of money or property that is represented by the income distribution to the company is lent to a shareholder or an associate of a shareholder of the corporate beneficiary.

Diagrammatically, section 109XA(2) applies:



In broad terms, section 109XG extends the concepts in section 109XA(2) of when a trust makes a loan to a shareholder (or associate) of a corporate beneficiary to include entities interposed between the trust and the shareholder (or associate).

Hence:



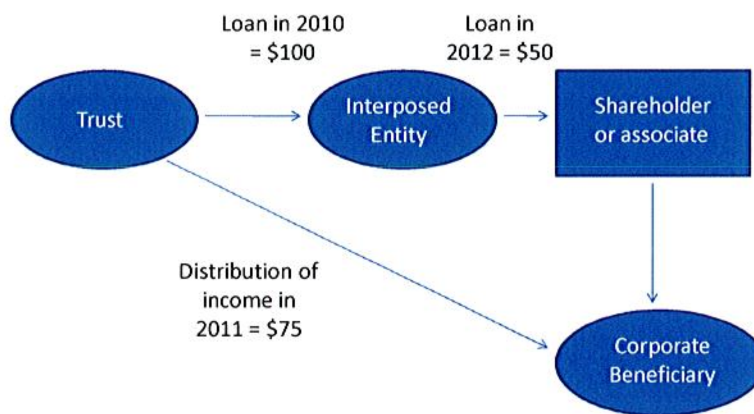
In the above example the Trust distributes $100 of income to a Corporate Beneficiary. Before of after that distribution of income, the trust lends the $100 ostensibly represented by that income to an interposed entity that on lends that $100 amount to the shareholder or associated of the shareholder of the corporate beneficiary.

Paragraph 109XG(2) will treat the loans from the Trust to the interposed entity as a loan caught by section 109XA(2) if a reasonable person would conclude that the trustee made the loan to the interposed entity "solely or mainly as part of an arrangement involving a loan to the target entity".

The next issue is how much of that loan will be treated as a deemed dividend under Division 7A? In the above example, where the loans between the trust and the interposed entity and ultimately the shareholder are of the same amount, the inference is that $100 ought to be treated as a deemed dividend. Also implicit in that example is that the loans all occur at or about the same time.

This is the most "vanilla" situation that is contemplated by the legislation and is relatively straightforward to establish the link between the various loans and the distribution to the corporate beneficiary.

Nevertheless, the "vanilla" example does not always present itself in practice. What if the sequence of events is as follows?



In the above example the loan to the interposed entity is $100 and occurs one year before the distribution of income of $75. A year after the distribution the loan from the interposed entity to the corporate beneficiary is $50.

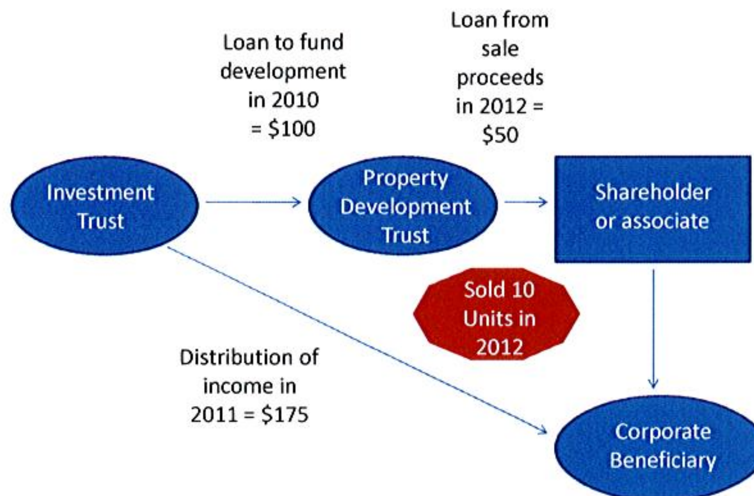
Looking to paragraph 109XG(1)(b), could a reasonable person conclude that the trustee made the $100 loan to the interposed entity in 2010 solely or mainly as part of an arrangement involving a loan to the shareholder in 2012 of $50?

What does paragraph 109XG(1)(b) mean? Paragraphs 1.38 to 1.45 do not elaborate on *what* the "reasonable person" is meant to conclude nor do they say *when* he is meant to form that conclusion. Does it mean that there is an expectation that the loan $100 loan in 2010 will at some stage be on lent to a shareholder of the corporate beneficiary at a future but not yet determined time? Is that conclusion to be formed in 2010 or in 2012 or somewhere in between?

How realistic is this example? We advise that the above transactions or substantially the same transactions occur regularly in established property development groups. Taking the facts and applying them to a property development group, the sequences of events are:

The Investment Trust loaned in 2010 to the Property Development Trust $100. During 2011 the Investment Trust distributed its income from other sources to a corporate beneficiary. During 2012 the Unit are sold off the plan. The Property Trust receives a deposits applies some of the original loan funds (say $50 as an advance to the controller of the group who is the shareholder of the corporate beneficiary.

That loan is to be offset against project management fees the shareholder would charge the property development Trust when all of the 10 Units have settled. Alternatively, the right to invoice could occur as specified milestones in the property development. As the milestone has not arisen the shareholder may not have the contractual right to invoice and as such seeks an advance. The purpose of the loan is to help fund costs of the development incurred by the shareholder or associate.



We consider that it is important to point out that if all the loans were from an arm's length financial institution, then the interest would be deductible. Further, the shareholder could be another trust, a company, an individual or partnership. Alternatively some entity related to a shareholder could have borrowed the funds.

At all times there was clearly some intention to pay an amount to the shareholder of the Corporate Beneficiary. This is because the shareholder is undertaking project management services and will often need some form of advance to pay for costs.

Under paragraph 109XG(1)(g) at the time the Investment trust made the loan to the property trust, property development was contemplated. Part of the property development involved engaging a related party as the project manager. As it is reasonably foreseeable that the project manager may be advanced funds to assist in paying costs the property development As such a reasonable person could conclude that the trustee made the loan to the interposed entity (ie the property trust) "solely or mainly as part of an arrangement involving a loan to the target entity (the shareholder).

Nevertheless, how does the reasonable man make the determination in 2010 in the absence of the amount actually being loaned to the target entity?

The current test lacks a concept of when the Reasonable person is meant to form their determination

The loan from the Investment Trust to the Property Trust occurred in 2010 whilst the subsequent loan between the Property Trust and the shareholder occurred in 2012. How can a reasonable person foresee that the 2012 loan is somehow linked to the 2010 loan and a distribution in 2011? There is no sense of time in the provision and again, the "reasonable person" test which is meant to be an objective standard struggles in analysis of transactions that span several years.

Subsection 109XG(4) is intended to provide some guidance on the topic. Under subsection 109XG(4), the loan is taken to occur at the time the interposed entity makes the loan. However, even then, the time period is awkward for the "reasonable person". In 2012, the reasonable person is meant to conclude that the loan made to the shareholder is linked to a loan that occurred some 2 years earlier from the Investment Trust to the Property Trust? As the taxpayer has the burden of proof, how would a taxpayer prove that the loans are not linked other than by pointing to the period of time the transactions took place.

Taxpayers are meant to self assess and apply these concepts. We consider that the legislation does not provide sufficient guidance to enable that self assessment to be undertaken. In preparing a return, how far back is the legislation asking a taxpayer to stand in the shoes of the reasonable person? In our example, the first loan occurred in 2010 the loan to the target occurred in 2012. In theory, the first loan could have occurred in 2005 and if there is a link between the funds lent to the Property trust with a subsequent loan in 2012, section 109XG could apply.

The Commissioner's Determination

The next element is determining the amount that is taken by the Investment Trust to have been loaned to the Shareholder (ie the Target entity). Under section 109XH that determination is left to the Commissioner. Query then what will be the Commissioner's determination?

The only guidance given to the Commissioner is in subsection 109XH(2). The Commissioner must take into account the amount the Property Trust lent the shareholder and the extent to which that loan was arm's length consideration for something provided by the Shareholder to the Property Trust or investment trust.

The loan itself was not consideration for anything provided by the Shareholder. It was an advance to assist the Shareholder to provide project management services. It will ultimately be offset against future invoices. As such, is the Commissioner required to take that factor into account?

We consider that it is a required element that the Commissioner must take into account but it is a matter that reasonable minds may differ on. Subsection 109XH(2) does not make that point clear in respect of advances that will be offset in the future against an invoice. Rather the provision is more focussed on payments under section 109XF in exchange for goods and services provided by the target entity.

Section 109XH also does not contain a provision to exclude amounts that have previously been subject to taxation under Division 7A other than subsection 109XG(3). Subsection 109XG(3) limits the Commissioner determination to an amount that does not to exceed the unpaid present entitlement in subsection 109XA(4).

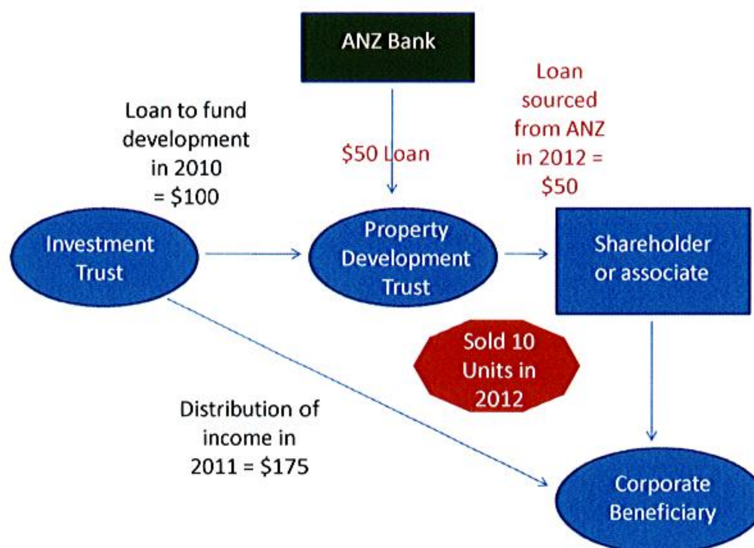
In our example, the loan from the Investment Trust to the Property Trust is potentially within subsection 109XA(2).

The Commissioner's determination does not have to link or trace the application of the distribution to the Corporate Beneficiary to any loan made to the interposed entity and to the target entity.

In the exercise of the Commissioner's determination, the Commissioner could tax the group on an amount up $175 under section 109XH. However, the loan from the Property Development Trust to the Shareholder is not sourced from any amount unpaid to the company. It is from the Property Development Trust's funds. Hence, although $100 was loaned from the Investment Trust to the Property Development Trust, if the Property Development trust on lends $50 of that original $100, the Commissioner can still determine that the $50 is assessable as a deemed dividend to the Shareholder.

The result is that economically, only $100 was loaned out of the unpaid distribution from the Company but the Commissioner can assess $150. The power is vested in the Commissioner is limited only by the amount of the unpaid present entitlement to the company (ie $175) and not by the amount loaned through the interposed entity to the target entity. In our example, the Commissioner could determine to include $50 loan to the shareholder from the Property Trust as an assessable dividend in addition to a $100 that is potentially deemed to be a dividend under section 109XA and 109XB being the loan from the Investment Trust to the Property Trust.

The same result would apply if the Property Development Trust borrowed the $50 from an arm's length bank, eg ANZ, Commonwealth Bank to make the loan. Specifically:-



In practice, as the Property Development trust would be the land holding entity, it may be the only entity in the group that could raise sufficient funds from a Bank to actually make the loan to the Shareholder. In that case, the Commissioner can still treat the $50 loan to the shareholder even though the funds were not sourced from the amounts distributed to the Corporate Beneficiary in 2011. We consider that any such outcome that treats as a deemed dividend the funds borrowed from an arm's length financier as part of a wider business transaction under Division 7A generally and specifically under section 109XH is unfair and unreasonable.

This outcome arises is because there is no requirement for the Commissioner to trace the source of the funds that resulted in the making of the loan to the shareholder. Without the relevant tracing of the funds, the Commissioner can severely limit a group's ability to fund property developments.

As such, there is a potential for double taxation.

Ability to Challenge the Commissioner's determination

Further, how is a taxpayer able to appeal or seek a review of the decision by the Commissioner to make his determination? In our example, the Commissioner could choose any amount between $0 and $150 as the amount to be included in the taxpayer's assessable income.

Further, what protection does the taxpayer have that the determination will be an economically reasonable and fair manner? What would be an appropriate tax shortfall penalty in anything other than a "vanilla" case?

The legislation does not contain any specific detail of the factors the Commissioner should take into account. This makes the operation of the provision uncertain and costly to challenge. Our view is that a self assessment system of taxation should not have such a significant level of uncertainty for taxpayer's to navigate. The makes it almost mandatory for taxpayers to seek specialised advice and even with the benefit of such advice, the outcome for the taxpayer is still contains a high level of risk where the taxpayer carries on business through a group of trusts.

The Commissioner also has the benefit of hindsight in making his determination. Taxpayer's are meant to self assess whether the provision applies or not and if so, the amount they have to address as being caught by Division 7A at the time they lodge their income tax return. The provision as drafted is, we submit, incapable of providing that level of precision. This is especially the case if it involves analysing 3 years to determine if there is a risk and forming a view as to the extent the provision applies.

Constitutional Validity

For the above reasons we query whether it is Constitutional for Parliament to delegate such a power to the Commissioner under paragraph 51(ii) of the Constitution. We raise the concern that the deemed dividend that results from the delegation of such a power results in section 109XG being an incontestable tax.

The Full High Court in *MacCormack v FCT* (1984) 158 CLR 622 at paragraph 32 of the joint decision of Gibbs C.J., Wilson, Deane and Dawson JJ considered that:

> *"For an impost to satisfy the description of a tax it must be possible to differentiate it from an arbitrary exaction and this can only be done by reference to the criteria by which liability to pay the tax is imposed. Not only must it be possible to point to the criteria themselves, but it must be possible to show that the way in which they are applied does not involve the imposition of liability in an arbitrary or capricious manner. In Giris Pty.Ltd. v. Federal Commissioner of Taxation [1969] HCA 5; (1969) 119 CLR 365, at pp 378-379, Kitto J. pointed out that the expression " incontestable tax " in the sense in which it is used in Hankin and Brown "refers to a tax provided for by a law which, while making the taxpayer's liability depend upon specified criteria, purports to deny him all right to resist an assessment by proving in the courts that the criteria of liability were not satisfied in his case." The purported tax is thereby converted to an impost which is made payable regardless of whether the circumstances of the case satisfy the criteria relied upon for characterization of the impost as a tax and for characterization of the law which imposes it as a law with respect to taxation. Such an incontestable impost is not a tax in the constitutional sense and a law imposing such an impost is not a law with respect to taxation within s.51(ii). It is in this sense that an incontestable tax is invalid."*

As the example demonstrates, the determination of the Commissioner can be arbitrary and capricious. Further, we do not consider that there are sufficient objective criteria specified in section 109XH upon which the taxpayer can resist an assessment by proving that the criteria of liability were not satisfied. As such, we submit that the provision is reasonably open to challenge on Constitutional grounds.

We make the same submission in relation to section 109XI.

Our view is that no amount ought to be within Division 7A at all. This is on the basis that the amounts have been put to income producing uses and the interest on the loans is otherwise deductible. In the case of loans, there is no otherwise deductible exclusion. If all the entities were companies, then there would be no requirement under Division 7A to charge interest at all. As the entities are groups of trusts, Division 7A operates in a manner where there is a potential for double taxation.

Recommendations

We recommend the following changes:

1. Limit the exercise of the Commissioner's determination to the amount that is distributed to the target entity reduced by any amount previously within Division 7A. As such, an equivalent to subsection 109XI(3) should be included in 109XH;

2. Limit the period the Commissioner is entitled to look at to a period of no more than 2 years between the distribution from the first trust, in our example the Investment Trust and the Target entity. If not 2 years then no more than 4 years which is the maximum period the Commissioner can amend an assessment.

3. Include a presumption that if the interest in the loan is otherwise deductible by the borrowing entity, then section 109XG should not apply at all.

4. Amend subsection 109XH(4) to make any determination by the Commissioner prospective from the period the determination is made rather than the year which the loan by the interposed entity is made rather than make it a provision that the taxpayer must "self assess each year" Alternatively if the loans from the first entity (the Investment Trust) to the Interposed Entity the Property Trust and the Shareholder/associate are greater than 2 income years apart (ie the current income year and the previous one), then make the effect of Commissioner's determination prospective. Otherwise the Commissioner can make his determination effective from the year the interposed entity made the loan to the target entity. On that basis, we consider that the compliance burden imposed on taxpayer becomes less onerous.

5. Amend the "consideration" factor in subsection 109XH(2) to include advances made that are subsequently offset by an arm's length contractual obligation to pay for goods or services provided by the target entity to the interposed entity.

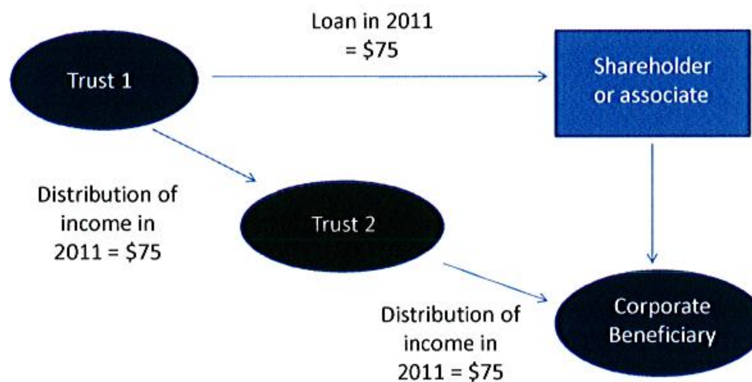
6. Due to the broad nature of the provision and the possibility that it can be applied in an oppressive or unjust manner, prevent the Commissioner from obtaining Mareva injunctions, applying Garnishee notices or seeking security for tax to enforce an amended assessment where the arrangement under section 109XH or 109XI alleged by the Commissioner spans more than 2 years. As the provisions are currently drafted, the potential for an unjust determination by the Commissioner is significant. The ability of the taxpayer to resist an unjust determination is limited. The Commissioner should not be permitted to freeze a taxpayer's assets in the case where the taxpayer has a limited potential to challenge the Commissioner factually. We consider this to be such a case and as such, we consider our recommendation is appropriate.

Section 109XI

Section 109XI is drafted in a similar manner to section 109XH. As such all of the comments made in relation to section 109XH may have similar application to section 109XI. The different roles between the provisions can be summarised as follows.

Section 109XH defines how much a taxpayer is treated as having received a deemed dividend. Section 109XI determines quantifies the amount of the unpaid present entitlement which has been used to fund the deemed dividend.

The "vanilla" situation that appears to be intended to be within the ambit of section 109XI may be summarised in the diagram below.

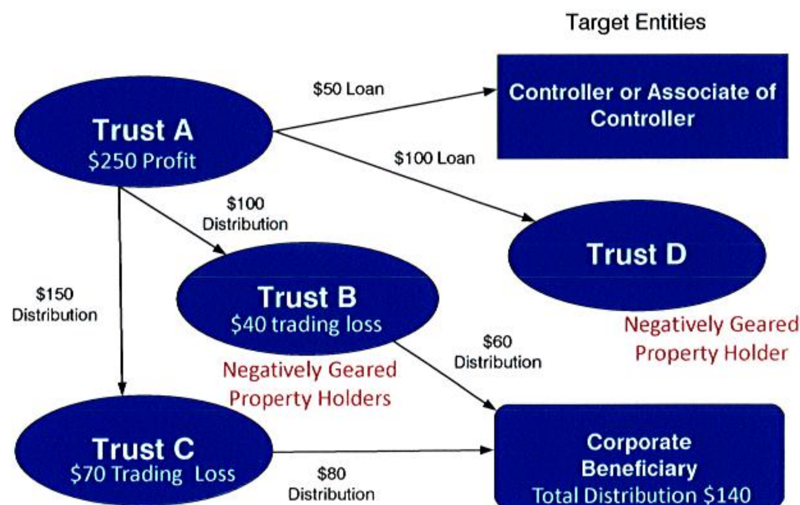


This is a vanilla case where all the distributions are loans are made in the same tax year and if there were nothing else, on it face, the Commissioner could make a determination that the distribution from Trust 1 through Trust 2 to the Corporate beneficiary could be taken as an entitlement by the Corporate Beneficiary of $75 of the net income of Trust 1.

In consequence of that determination under subsection 109XI(4), then applying section 109XA the Commission could treat the loan of $75 to the Shareholder as a deemed dividend from the Corporate Beneficiary.

The perceived shortcoming in section 109XA was that the loan from Trust 1 to the shareholder was not caught by Division 7A on the basis that at the time the loan was made, there was no unpaid present entitlement owing by Trust 1 to a corporate beneficiary. Section 109XI is intended to allow the Commissioner to look through the distribution to Trust 2 and effectively treat the distribution as being directly from Trust 1 to the Corporate Beneficiary.

Property developers are the most typical example where section 109XI can become onerous. This is a common example within established property development groups. The example is the same one we prepared in the making of our submission concerning the equivalent provision in the Exposure Draft legislation. We do not consider the Bill has advanced considerably since the provisions were originally drafted in the Exposure Draft legislation. Nevertheless we consider that the concepts can be refined further to assist taxpayers interpret the provisions.



This is a common structure because for land tax purposes (especially in Victoria) holding properties in separate trusts often limits the extent to which the value of the properties are grouped for land tax purposes. Hence, property developers and investors frequently hold each separate property in a separate trust. For the purpose of the example all of the trusts hold a separate property that is held for land development.

The difficulty with applying section 109XI in this example arises because all the amounts are dissimilar.

Further, the trusts may not necessarily be discretionary trusts and could be unit trusts. The reason they could be unit trusts is because of different individuals investing in different properties in different proportions. Hence, there could be several arms length individuals that are unit holders of each individual trust in different proportions.

Nevertheless, one or more of those individuals could be considered to be a controller of the trust.

As is typically the case with property developers, not every development makes a profit. Often, a profit making trust will be required to support another trust that has only just commenced the development and has not reach the stage where sufficient sales have been generated to cover the cost of the development. Typically, there will be loans and inter entity distributions between one trust and another.

The above diagram indicates trust A with an annual profit of $250 distributes its profit to Trust B and Trust C. Trust B and C could be associated property holding entities that have negatively geared their investments. As a result of the negative gearing, part of the distribution is absorbed by the negative gearing losses leaving net income in trust B of $60 and net income in trust C of $80. Both those trusts distribute their net income to a corporate beneficiary.

Trust D is commonly another property holding entity at the start of its development phase and needs financial support from Trust A

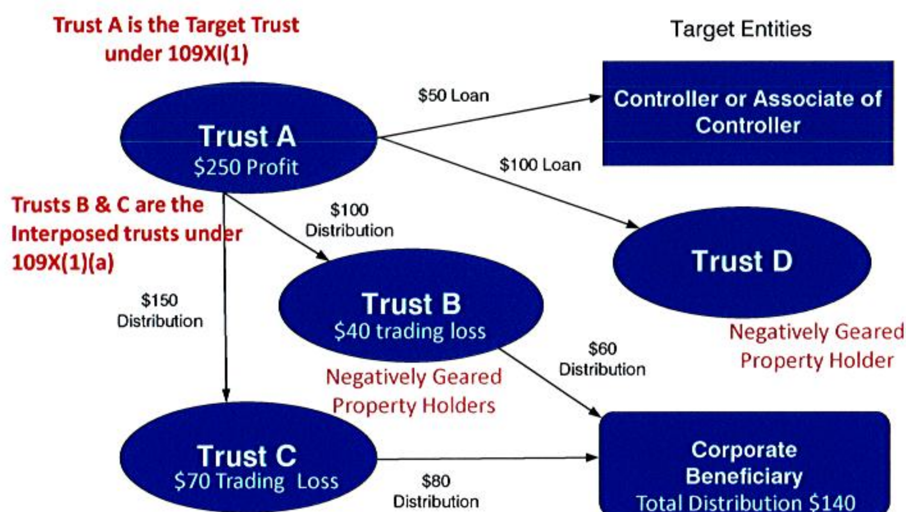
To add to the example we have assumed that one of the controllers of the group, which is a shareholder of the corporate beneficiary or an associate of corporate beneficiary shareholder, has borrowed $50.

There are specific reasons for this type of structure. First, each property liability exposure for each trust can be separated from the assets in the other trusts. Second, land tax grouping is limited to some extent if the properties are held in different trust. Different arm's length parties could be involved in each different property development in each trust. Nevertheless there may be a single entity or individual that has a majority of control in each entity.

Applying section 109XI how much of the distribution from Trust A can the Commissioner treated as being an effective distribution of the net income of Trust A to the Corporate Beneficiary?

(a) $140 representing the distribution from trust B and trust C to the corporate beneficiary?
(b) Any amount up to $250 being the original profit made trust A?
(c) $0?

Analysing the operation of subsection 109XI(1) Trust A is the Target Trust. Trusts B&C are the Interposed Trusts. Under paragraph 109XI(1)(b), a reasonable person would have to conclude that the Corporate beneficiary became presently entitled to a distribution from Trust B & Trust C solely or mainly as part of an arrangement involving an entitlement to an amount from the Target Trust. Diagrammatically:-



For the Reasonable person to form the view required by paragraph 109XI(1)(b), the conclusion that the reasonable person would have to draw is that Trust A would have otherwise have distributed to the Corporate Beneficiary if the distribution was not made to Trust B & Trust C.

In the above example, the Trust Distributions made by Trust B & Trust C are in the control of the trustees of Trust B & Trust C and not the Trustee of Trust A. Unless there is a common level of control between the 3 trusts, we do not consider that the reasonable person could form such a conclusion. Trust A's motivation for making the distribution to Trust B & Trust C is to financially support Trust B & Trust C as part of their property development activities.

Returning to our original proposition, was it the intention of the trustee of Trust A that the balance of the distribution not otherwise applied to pay the debts of Trust B & Trust C should be distributed to the Corporate Beneficiary? In any respect could it influence the actions of Trust B & Trust C? This relevant to a property development group because, as highlighted earlier,

Trusts A, B, C & D may all be unit trusts with different ownership proportions and different unit holders. Then on the other hand they may be controlled by the same family group.

The Time that the reasonable person must form the 109XI(1)(b) conclusion.

Section 109XI does not state when the reasonable person must form their conclusion. Subsection 109XI(2) specifies that the provision could apply if the distributions are made in different income years.

In our example, Trust A could distribute to Trust B in 2010 and Trust B could make the distribution to the Corporate beneficiary in 2011. When does the reasonable person form the conclusion as to whether the Distribution by Trust A to Trust B was made as part of an arrangement to make a distribution to the Corporate Beneficiary? In 2010 when the distribution between Trust A to Trust B in 2010 or in 2011 when Trust B distributions to the Corporate Beneficiary?

Our view is that the provision requires there to be a link between the distribution from Trust A to the Corporate Beneficiary via the interposed entity Trust B. As such the conclusion should be formed in 2010. We could not image a reasonable person in 2011 could form the view that the reason why Trust A made a distribution to Trust B a year earlier was so that Trust B could distribute to the Corporate Beneficiary. We consider the analysis becomes non sensical if the time the conclusion is formed is any year other than 2010.

Swapping the years around results in a similar non sensical outcome. Assume Trust B made the Distribution to the Corporate Beneficiary in 2010 a year prior to receiving a distribution from Trust A. Can a reasonable person in 2010 make the conclusion that Trust B makes a distribution to a corporate beneficiary in anticipation of a distribution from Trust A in the following year?

That said, the reasonable person could conclude that the reason why Trust A made a distribution to Trust B was due to the fact that Trust B had an unpaid trust distribution owed to a Corporate Beneficiary, eg for the purpose of funding that distribution or using losses Trust B may have had in 2011.

Hence our view is to include a requirement that the reasonable person form their conclusion at the time the Target Trust made the Trust Distribution.

Subsection 109XI(5) is near incomprehensible

We cannot determine what function subsection 109XI(5) is meant to perform. No reference is made to it in the Explanatory Memorandum and to us appears to be a mistake.

Whatever the intention is behind subsection 109XI(5) we request that it be reworded to be more comprehensible to understand. We make those comments in the context of a self assessment system and that legislation should at least be drafted in plain English. We do not consider that on any view that subsection 109XI(5) could be considered to be drafted in plain English.

Recommendations to assist in the Application of 109XI(1)(b)

The answer to each of the above issues naturally depends on the facts. The point that we make is that paragraph 109XI(1)(b) should not be left as an *open ended* provision but include in the relevant factors that a reasonable person must consider in forming the conclusion. Specifically, we make the following recommendations:

1. The degree of common control between the Target Trust, the first interposed trust and any other trust interposed between the first interposed Trust and the Corporate Beneficiary. Our view that there must be common control of the trustees before a reasonable person could form any conclusion under section 109XI.

2. The extent to which the distribution made to the first interposed trust and any other interposed trust is paid or applied to provide financial assistance to those trusts; and

3. The pattern of distributions made by Target Trust, the first interposed trust and any other interposed trust in prior years.

4. Include an example similar to the one included in our submission as an aid to the interpretation of section 109XI

5. Redraft or remove subsection 109XI(5) as we consider that the provision is too vague and overly difficult to interpret. It appears to have poor sentence structure and the concepts in it are confused.

6. Include a concept of when the reasonable person is meant to form the conclusion. Our view is that the conclusion must be formed at the time Trust A makes the distribution to Trust B & Trust C. Otherwise, the provision may have a non sensical operation.

7. Limit the time differential between the distribution by the Target Trust to the interposed trust and the distribution from the interposed trust to the corporate beneficiary to be 2 years (ie the current year Target Trust made the distribution and either the prior year or subsequent year for the distribution by the Interposed Trust to the Corporate Beneficiary. Otherwise, applying the provision becomes too onerous in practice.

We consider that the above factors would assist in compliance with the provision and in the interpretation of the legislation and thereby reducing the compliance costs of the taxpayers generally.

We also point out that subsection 109XI(4) is drafted in similar terms to section 109XH(1). The amount that is taken to be an entitlement to net income distributed to a corporate beneficiary is the amount determined by the Commissioner. Without elaborating on the factors that would be relevant to making the determination makes it difficult for any determination of the Commissioner to be challenged or reviewed by Taxpayers.

In theory, the Commissioner could apply the provision of in our example Trust A made the distribution in 2010 to Trust B and Trust B made the distribution to the corporate beneficiary in 2020. As with section 109XH, the potential for an unjust and unfair result is significant if the application is left to the Commissioner to tax taxpayers on such amount he determines without at least Parliament specifying what the Commissioner should take into account.

As with section 109XH, we also consider that with such open ended discretions, the Commissioner should not have the power to stifle the legitimate business operations of taxpayers by issuing assessments based on the exercise of an open ended discretion and being able to freeze taxpayer's assets (via a Mareva Injunction, securing the tax payable on the taxpayers' assets or garnishee Taxpayer's receipts). Such a power, in our view, would be inconsistent with Article 17 of the United Nations Universal Declaration of Human Rights specifically:

1. *Everyone has the right to own property alone as well as in association with others;*
2. *No one shall be arbitrarily deprived of his property*

The potential for an arbitrary depravation of taxpayer's property is, in our view, possible with both section 109XH and 109XI. We submit that a tax that can be arbitrarily applied without the scope of reasonable challenge is inconsistent with Article 17 and on balance of probabilities, unconstitutional as an incontestable tax.

Although the United Nations Universal Declaration of Human Rights is not part of the Laws of Australia, we consider that it should be used as a benchmark in the review of all taxation legislation and in particular anti avoidance provisions such as Division 7A.

We consider that the relevant interpretive factors recommended above are consistent with the policy of the provision and make its operation more efficient.

Commencement Date

We refer to the original Press Release of The Honourable Treasurer dated 12 May 2009 announcing the proposed amendments to Division 7A (Press Release No 067 of 2009).

The attachment to that Press Release makes specific reference to the use of assets of a company and the strengthening of the Division 7A Rules by including corporate limited partnerships within the ambit of Division 7A. In the attachment to the Press Release, The Treasurer also announced that "other technical amendments to Division 7A will also be made to strengthen its [Division 7A's] operations. The Government will consult on the form of the intended changes".

Item 35 of Schedule 1 of the Bill provides that the amendments made in relation to payments made, loans made and debts forgiven on or after 1 July 2009.

The proposed changes contained in the Exposure Draft Legislation go beyond the use of company assets or the extension of Division 7A to corporate limited partnerships and could not, in our view, be considered to be "technical amendments". The proposed changes significantly increase the ambit of Division 7A.

We submit that the commencement date of the following amendments be no earlier than the public release date of the Exposure Draft Legislation or 1 July 2010:

(i) The changes extending Division 7A to non resident companies.
(ii) The amendments to subdivision EA of Division 7A that address payments and loans through interposed entities.
(iii) The operation of the proposed Subdivision EB of Division 7A
(iii) The amendments to Section 109Y that alter the definition of *non commercial loans* and Division 7A amounts as part of the formula for determining the distributable surplus of a company.

We consider that the above amendments incorporated in the Bill are a fundamental change in the way Division 7A operates and were never part of the original "intended" operation of Division 7A. We recommend a start date for these measures to be no earlier than I July 2010. At the very least, the date of the introduction of the Bill into Parliament.

Proposed Section 109BC

The following comments were made in our submission to the exposure draft legislation. We consider that the comments are equally applicable to the Bill:

> We note that the proposed Section 109BC is intended to extend the operation of Division 7A to non Australian Resident Private Companies.
>
> We point out that the amendment is "simplistic" in its operation. Non Australian Resident Companies that are controlled by Australian residents are potentially subject to attribution under the Controlled Foreign Company Rules.

If the distributable surplus under Section 109Y includes profit or part of a profit that has been subject to attribution under the Controlled Foreign Company Rules or the Foreign Investment Fund Rules, then the loan is potentially subject to taxation twice. The first, when the profit was originally attributed to the Australian Controller and the second, when the loan is actually made out of that attributable profit to a shareholder or associate of the shareholder.

Amendments of the kind considered by Section 109BC required detailed and complex consequential amendment provisions to ensure double taxation does not apply.

The consequential amendments should consider the application of the Controlled Foreign Company Rules as well as the Foreign Investment Fund Rules (which address investments in foreign companies that are not controlled by Australian residents under the Controlled Foreign Company Rules).

As such, until the detailed Consequential Amendments and Integrity Provisions that are required to support Section 109BC are written, we do not consider that Section 109BC ought to be included in the proposed Bill introduced into Parliament as its effect is potentially unfair.

Further, as the Controlled Foreign Company Rules and the Foreign Investment Fund Rules are currently being rewritten, we consider that Section 109BC is properly addressed as the part of the rewrite to those Rules rather than within Division 7A.

However, if the Government intends to proceeds with Section 109BC, then we recommend an amendment to Section 109BC to exclude payments, loans and debt forgiveness out of profits that have been attributed under the Controlled Foreign Company Rules, or amounts that are included in the attribution account under the Foreign Investment Fund Rules.

Similar amendments should be made to the Distributable surplus in Section 109Y to exclude profits attributed under the Controlled Foreign Company Rules and amounts included in the Attribution Account of the Foreign Investment Fund Rules.

Proposed subsection 109CA

Compliance Costs & Documentation

We consider that the compliance costs any private company that operates a business to comply with section 109CA will now become prohibitive.

Two different FBT regimes. One for employees and another for Shareholders

The best example is motor vehicles and car fringe benefits. A company will now have one set of valuation rules in the Fringe Benefits Tax legislation in relation to motor vehicles provided to arm's length employees, another being an estimate of the arm's length value of the "notional rental" of the motor vehicle provided to the shareholder or associate of the shareholder. Add to that the different tax treatment for the cost of fuel and repairs associated with the provision of that motor vehicle.

Under the statutory fraction the running cost of the car in included in the valuation of the fringe benefit. Under section 109CA each one will have to be accounted for as a deemed dividend.

The example becomes more absurd with the typical corporate office occupied by the shareholder in their capacity as director of the company. In the office there is office equipment that includes lap top computers, desk top computers, a safe or secure document storage cabinet, stationary, photocopies, telephone etc.

Assuming section 109ZB(3) does not apply, how will the company establish that the "private use" of the office assets situated on the business premises of the company falls within the minor benefit exemption or is otherwise deductible? Assume that the individual uses the office safe to store the title to his principal residence and other personal documents. What value is placed on that usage?

Similarly private internet usage of a computer? Is that something that is provided to a shareholder in their capacity as employee? The exclusion is subsection 109ZB(3) did not contemplate the breadth of operation that it now has to perform and appears to be to narrow for the function that it has to perform. What will be the requirements to establish that is a minor benefit?

As the laptop computer is not exempt from Division 7A, what records establish that the business and personal use of the computer fits within either the minor benefit or otherwise deductible exemption? What is the arm's length rental of a computer used part of the time for business and part of the time for personal use?

Under the Fringe Benefits Tax legislation, there are appropriate exclusions that address the above issues and either exclude them from the Fringe Benefits Tax net or impose a deemed value on the benefit.

We do not consider that this as the intended consequence of the Treasurer that there ought to be two different regimes for valuing benefits provided to shareholders in their capacity as shareholders and benefits provided to employees (or shareholders in their capacity of employees).

As such recommend an adoption of the fringe benefit tax valuation provisions where appropriate for benefits provided to shareholders that are payments that are not excluded by section 109ZB.

Interest Deduction and Investment Allowance Deduction for Assets whose use is within Section 109CA

The following points were made in relation to the Exposure Draft Legislation. We point out that the issues have not been addressed in the Bill.

> *If a company incurs an interest deduction or would otherwise be eligible to claim the investment allowance in respect of an asset the company holds that is used by a shareholder or an associate of a shareholder, will the interest deduction and investment allowance deduction continue to apply?*
>
> *Generally, a company can only claim a tax deduction for interest where the asset is used in an income producing activity. If the asset is used by a shareholder that results in a deemed Division 7A dividend, does the income producing use of the asset change?*
>
> *Generally, the interest deductibility for borrowings to pay dividends is unclear and contentious. If for example the company purchased a car under a hire purchase arrangement which is used by a shareholder, will it still be able to claim an interest deduction if the use of the car constitutes a deemed dividend paid by the company to the shareholder?*
>
> *As shareholders already made their decisions to acquire assets prior to the announcement of the changes to Division 7A in the May 2009 Budget, we consider that denying the company a tax deduction for interest would be unfair and beyond what would otherwise be an accepted use of "retrospective" legislation.*

Investment Allowance

Similarly, if the asset, such as the car, were acquired for the principal purpose of providing that car to an employee in the course of operating the company's business, the investment allowance would otherwise apply. In the FBT context, it didn't matter that motor vehicle was used for private purposes as the company acquired the vehicle primarily and principally to provide remuneration for an employee of the company.

If the employee also was a shareholder or an associate of a shareholder, a deemed dividend under Division 7A would follow from the use of that asset. Query therefore whether the company can argue that the motor vehicle was acquired primarily and principally as remuneration for an employee if the legislation deems the provision of the car to be a deemed dividend paid to the shareholder.

The other typical assets that are inadvertently caught would include the office furniture of the controller's office, motor vehicles, desktop computers, desks, chairs, professional libraries, photocopiers, printers, and other "work related" assets.

We do not consider that the Government intended that consequence. Given the gravity of the position concerning the Investment Allowance and the number of companies acquiring assets relying on the Investment allowance, then we recommend this issue be given the highest of priority.

Proposed Amendments Contained in Schedule 2 of the Bill
Tax File Number withholding arrangements including Family Trusts

We make the following observations in relation to amendments contained in Schedule 2 of the Bill.

Section 202DP of the Income Tax Assessment Act 1936

Under section 202DP, the trustee must report to the Commissioner the beneficiary's tax file number (TFN) in the approved form within one month of the end of the quarter the TFN is quoted or such further time as the Commissioner allows.

As part of the Trust Return lodgement process, the Commissioner has already collected TFN information for beneficiaries in the Distribution Statements that are lodged with the Trust Income Tax Return. From a practical perspective, Trustees of Trusts should not have to lodge a further report where the Commissioner has already been provided the TFN information in prior years.

Mechanically, the Commissioner could identify the TFN information of beneficiaries of the Trust on the ATO Portal and allow the Tax Agent to confirm that the information the ATO has is correct.

As such, we recommend that the Commissioner confirm that the provision of the existing information on the Tax Agent Portal is technically feasible. Further, the legislation should exclude Trusts from having to provide the report where a tax return has been lodged prior to the date of the introduction of the legislation that has already quoted the TFN. In addition we recommend that the lodgement of the Distribution Statement in the Trust Tax return with the TFN information should be sufficient for reporting purposes for all future years.

Section 12-175 Trustee distributions income of closely held trust

Under that provision, the Trustee must withhold tax if the beneficiary did not quote their TFN before the distribution time of Trust. Typically, the trustee of the trust resolves to distribute the income of the trust at or prior to 30 June of each year. Generally, this is requirement of the Trust Deed.

A beneficiary of a closely held trust often does not know:

a. They are a beneficiary of a discretionary trust; and
b. They are entitled to a distribution of income from the trust until after the distribution is actually made or paid to them.

An individual or entity that is a beneficiary does not consciously choose to become a beneficiary of a discretionary trust. In contrast, an individual chooses to open a bank account, acquire listed company shares or buy units in a publicly listed trust.

The process of establishing a discretionary trust involves the Settlor of the Trust making a gift of property to the Trustee for them to manage in accordance with the wishes of the Settlor. Those wishes are embodied in the terms of the Trust Deed which includes a description of the beneficiaries of the trust. A discretionary trust is an instrument to provide gifts to the beneficiary. The Beneficiary doesn't know if they will receive a gift of income or capital from the trust until the gift is actually made.

Requiring a beneficiary to give their TFN to the Trustee without having any knowledge of whether a gift will be made to them is, in our view, unreasonable and has the potential to promote identity theft.

To quote from the Taxation Institute of Australia's submission on the Exposure Draft legislation:

> *Identity Theft*
>
> *A person's Tax File Number is a key piece of identification that ought not to be given out without some caution. As a beneficiary may be unaware of their entitlements from a Trust until some time after year end, Section 202DO and Section 202DP appear to require that a beneficiary to identify each possible Trust that exists where they might have some connection with and quote their Tax File Number. How does the beneficiary determine whether they have quoted their TFN to the correct trust?*
>
> *Further, if the beneficiary held a mistaken belief that they are a beneficiary of the trust, they would be giving their identity away unnecessarily and exposing them to a greater risk of identity theft or fraud.*
>
> *To take our example earlier concerning a Trust that is established where all the Members of Parliament are beneficiaries, would it be reasonable to expect the Members of Parliament to seek out all such Trusts to quote their Tax File Number in the hope that they might receive a distribution from that Trust?*
>
> *The Institute does not consider that the Tax File Number Withholding Model that applies to third parties as being appropriate or workable for a closely held group.*
>
> *Naturally, closely held groups and close families would be able provide this information in a timely manner. However, if families are not "close" and do not interact for prolonged periods of time, this places an unreasonable burden on the beneficiary to find family related Trusts.*
>
> *Further, the legislation provides potential "rogues" with a method of obtaining key identifying information from potential beneficiaries. Trusts set up by "rogue" operators could write to all the potential beneficiaries advising them that they are a beneficiary of a Trust citing this legislation support for a request for them to provide their Tax File Number.*
>
> *A beneficiary, fearful that they may lose out on part of their entitlement because of the withholding obligations imposed by this legislation may quote their TFN to the rogue operator who could use that key identity related information for potentially fraudulent purposes.*

In short, this model exposes beneficiaries to potential fraud which the Institute considers unacceptable. As such, the current system where the Tax File Numbers are gathered in the Trust's Tax Return appears to be the preferred option of dealing with closely held groups rather than considering Family Trusts as akin to third party investments or employer / employee relationships

We reinforce those comments by adding that just because the trust is a closely held family trust does not mean that identity fraud cannot be promoted by family members and estranged spouses.

Recommendation

Our recommendation is that the requirement to quote the TFN should only arise at the earlier of payment of the trust distribution or within 3 months of the beneficiary being notified of their entitlement. Further, the requirement to notify the beneficiary of their entitlement should arise at or prior to the due date for the lodgement of the Trust's income tax return.

Further, to fully understand the practical significance of our recommendation please consider our comments to section 12-180.

Section 12-180 of the Taxation Administration

In light of the recent High Court decision in Bamford v FCT, we consider that the withholding should be based on their legal entitlement to the income and capital of the trust for trust law purposes rather than being based on their share of the net income of the trust.

Under Division 6 of the Income Tax Assessment Act 1936, and broadly under section 97, a beneficiary that is presently entitled to a share of the income of the trust (ie Trust law income) is taxed on their share of the net income (ie Taxable Income as defined under section 4-15 of the Income Tax Assessment Act 1997).

Our point is that the amount the beneficiary can call to be paid from the Trust may have no reflection of the amount of tax they have to pay. To take blatant example:

> Trust A has two beneficiaries, Mrs Armstrong and Mr Armstrong. Mr Armstrong and Mrs Armstrong are separated. Under the Family Law Settlement, Mrs Armstrong effectively controls Trust A as the sole shareholder and director of the Trustee Company of Trust A.
>
> Neither Mr Armstrong nor Mrs Armstrong have quoted their tax file number to the Trustee of Trust A prior to 30 June.

For the year ended 30 June 2011 Trust A had derived $100,000 of income and made a $1,000,000 net taxable capital gain. The capital gain is not included in the income of the Trust under the Trust Deed for Trust A. The Taxable income of the Trust is $100,000 plus the net capital gain of $1,000,000 ie $1,100,000.

Mrs Armstrong resolves to distribute the $100,000 of income to Mr Armstrong and the Capital gain to herself.

Following the High Court decision in Bamford's Case Mr Armstrong is presently entitled to 100% of the income of the Trust (ie the $100,000). As such, under section 97 Mr Armstrong is assessed on 100% of the Taxable Income of the Trust (ie $1,100,000). Mrs Armstrong is required to withhold tax on $1,100,000 at the 46.5% rate which is $511,500 yet Mr Armstrong can only call for $100,000 to be paid to him. In theory, Mrs Armstrong could attempt to recover the $411,500 difference from Mr Armstrong.

Mrs Armstrong who is legally entitled to call for the $1,000,000 to be paid to her does not have to withhold TFN withholding on her distribution. Further, the Trustee entity would not have the funds to pay the $1,000,000 to her because of the TFN withholding liability placed on the distribution to Mr Armstrong.

In addition, what amount of tax does Mr Armstrong claim back as a TFN withholding credit? Is it $511,500?

Recommendation

1. We consider that the anomalies can be addressed by linking the TFN withholding to the legal entitlement to Trust law income and capital that a beneficiary could legally call to be paid to them rather than basing the withholding on Taxable Income.

2. To recap, in the example, would Mr Armstrong be willing to provide his tax file number to Mrs Armstrong in the case of a marital separation? Further, when would Mr Armstrong be notified by his estranged spouse of his distribution entitlement, if at all? We would speculate that Mr Armstrong would not be notified prior to 30 June.

   In such circumstances where the relationship between the beneficiary and the Trustee is acrimonious, we also recommend that provision be made in the legislation to allow a beneficiary to make a direct notification of their TFN to the Commissioner rather than to the Trustee of the Trust. If the Commissioner receives such a notification, the Commissioner can write to the Trustee of the Trust advising the Trustee that no TFN withholding be required in relation to distributions to the beneficiary.

Schedule 3-5

We have no comments to add to the amendments proposed in Schedules 3-5

Schedule 6 Repeal of certain unlimited periods for amending assessments

We agree with the removal of the unlimited period of review for certain provisions contained in the Income Tax Assessment Act.

As a general proposition, we consider that there should be a limited period of review for all tax provisions other than for fraud or evasion. As such, we can recommend that other provisions that have an unlimited amendment periods provisions be included in the amendment.

However, we take the view that Government has made the decision that it will only remove those specific provisions. We accept the Government's position and as such, we do not intend to provide any further comment on the topic.

We are happy to make any further recommendations on the matter if requested.

We are happy to discuss any aspect of our submission in further detail. Please contact Mr Noel Beharis of our office on 03 9607 6850.

Yours Faithfully

Noel Beharis
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