Tax Laws Amendment (2010 Measures No.1) Bill 2010:

Non-Commercial Loans

Submission

1. Executive Summary

Our submission sets out our comments in relation to the amendments to the Non-Commercial Loss Rules as contained in the *Tax Laws Amendment (2010 Measures No.1) Bill 2010.*

Our submission focuses on the following the technical application of the rules and its potential impact on taxpayers.

In the main, Taxpayers Australia, agrees with the policy intent of the various integrity measures introduced to prevent the application of Division 7A from being bypassed.

However, we have made comments, in some respect to the application of the proposed amendments in terms of fairness to taxpayers and ease of interpretation and clarity.

These mainly focus on:

- the application of the minor benefits exception in determining whether the use of an asset by a shareholder falls within the meaning of "payment" for Division 7A purposes;

- use of assets which are deemed "payments" but are not subject to FBT;

- the use of a dwelling exception and the 10% use of area condition;

- clarity on the interaction of the new interposed entity rules under Subdivision EA and the use of asset by the shareholder in that entity;

- clarity on the application date.

To the extent that the exposure draft is amended as a result of subsequent feedback, we welcome the opportunity to comment on any future drafts of these provisions.

2. Specific comments

2.1 Comments in relation to proposed amendments

(i) Minor benefit exception

Under the proposed section 109C(3B) ITAA36, to reduce compliance costs, the use of a private asset would not be deemed to be a payment under Division 7A to the extent that the provision of that benefit satisfies the meaning of a minor benefit under section 58P of the *Fringe Benefits Tax Assessment Act 1986 (FBTAAA86)*.

In our view, section 58P FBTAAA86, in its current form, is difficult to interpret given the number of conditions and the subjectivity in determining whether the provision of a benefit constitutes a "minor benefit" for FBT purposes.

The difficulty in interpretation and therefore, the difficulty for taxpayers and their advisers is demonstrated in *Taxation Ruling: TR 2007/12: Minor Benefits*.

In that Ruling, it is explained that a minor benefit is an exempt benefit to the extent that:

- The notional value of the minor benefit is less than $300; and
- it would be concluded that it would be unreasonable, having regard to the specified criteria in paragraph 58P(1)(f), to treat the minor benefit as a fringe benefit.

Amongst others, these criteria include whether the benefit provided is infrequent and irregular, and whether it is part of an "associated benefit".

Based on the Ruling, depending on the relevant facts, it may be possible for an employee to receive multiple benefits which individually have a notional value of less than $300, but is considered (either associated or in isolation) to be minor and/or infrequent. Therefore, collectively, the monetary value of the benefits that are received by the employee may be substantial (refer Example 3 in TR 2007/12 at para. 43-51).

Notwithstanding that there is a body of case law (such as *National Australia Bank v Commissioner of Taxation (1993) 46 FCR 252; 93 ATC 4914; (1993) 26ATR 503* and *Case 2/96 (1995) 32 ATR 1099,96 ATC 131)* which considers whether the provision of a certain benefit is deemed to be infrequent or irregular, there is still a level of subjectivity based on the nature of the asset being put to use.

Further, there may also be difficulty in determining whether certain benefits provided to shareholders collectively would constitute an "associated benefit" or "other associated benefits" as contemplated under section 58P(1)(f)(iii) FBTAA86. The example of an "associated benefit" as provided in Example 16 in TR 2007/12 at para. 228-231 does not provide clarity to those relying on the provision.

Taking into account the criteria to be considered, the application of the minor benefit rule does not necessarily make it easier or provide certainty to taxpayers.

Taxpayers Australia Comment

Taxpayers Australia has reservations about the use of the minor benefit rule under the FBT provisions to determine whether an exemption would apply from the use of an asset in a private company.

Whilst, we understand that the use of the minor benefits rule as an exception under section 109C(3B) is to allow consistency between how shareholders and employees are treated with respect to benefits provided by a company, we consider that the subjectivity involved under the minor benefits rule does not provide certainty to taxpayers.

As a result, it may not reduce the level of compliance costs as envisaged particularly in circumstances, where multiple benefits are being provided to a shareholder over the course of a year or where the benefits are "associated".

Notwithstanding that this would be inconsistent with the minor benefits rule for FBT purposes, to assist in the compliance, we suggest that a fixed annual cap for benefits provided to shareholders of $1,500 per shareholder be allowed (instead of the $300 notional value for potentially multiple and associated benefits as considered under the minor benefits rule). This cap will apply to each shareholder for each income year.

We believe that in having a fixed monetary cap that this will provide certainty and reduce any associated compliance costs.

(ii) Use of assets which are exempt from FBT

As noted by the exception provided under the proposed section 109C(3B) ITAA36 for minor benefits, as a general observation, it appears that the aim of that particular provision is to align the treatment of employees receiving minor benefits with shareholders in similar situations without the triggering of some form of tax liability. Therefore, the receipt of the benefit whether by an employee or shareholder is not distinguished.

However, it is noted that in other instances, the use of a company's asset by a shareholder, which would ordinarily be exempt under FBT to an employee, would be a deemed dividend to the shareholder under the amended rules.

The following example illustrates a particular scenario which highlights this point:

Example.

John is a shareholder of X Co (but is not an employee). X Co owns premises in which it conducts its business. On those premises, there is a tennis court which is available to employees. As a shareholder, John is also allowed the right to use the tennis court. The annual costs if dealing at arm's length would be $900 and therefore, the minor benefit exemption would not apply.

None of the other exemptions under s109C(4) apply and therefore, prima facie, the right to use the tennis courts would be deemed to be a "payment" for Division 7A purposes.

Therefore, an unfranked dividend of $900 would be assessable in the hands of John as a shareholder.

For employees of X Co, no FBT liability would arise as the provision of a recreational facility to employees which is on business premises is exempt from FBT under section 47 FBTAAA86.

Taxpayers Australia comment

Taxpayers Australia suggests that consideration be given to whether it is the intended purpose of the new amendments that the use of certain assets, which would ordinarily be exempt to the company if provided to an employee, should be exempt if the same benefit was provided to a shareholder of the company instead.

We note that the same distortion occurs also where a car parking fringe benefit is provided and that the benefit satisfies the small business exemption pursuant to section 58GA of the FBTAAA86, whereby one of the conditions is that the turnover of that employer is less than $10 million for the prior income year.

(iii) Dwelling owned by a private company exception

After public consultation, the Assistant Treasurer, in Media Release No. 51 of 1 September 2009, made a statement that the use of a residence by rural communities and small business shareholders would not be affected by the proposed "use of company asset" rules under Division 7A.

In particular, the Media Release stated the following:

> "*We have received submissions that genuine farming businesses and those small businesses that include a residence located at the business itself may have been unintentionally impacted – so we've listened to those concerns and acted decisively to provide certainty and clarity....*
>
> *The non-commercial loans measure will now include:...*
>
> *... a "residence exemption" for certain payments – any residence that is an integral part of the business of real property and is owned by a private company but is lived in under a right-to-use or a license as part of the carrying on a business is disregarded.*"

Under the proposed section 109C(3)(d), the use of a dwelling by a shareholder of a private company would not be considered to be a payment and therefore, a deemed dividend, provided that the dwelling is used for business purposes and that less than 10% of the area of the land, water or building is used.

Example 1.6 in the Explanatory Memorandum details a scenario where Rebecca (a shareholder) runs a surgery in a house which is also used to live in. In this case, 40% of the house is used as a surgery and the remaining 60% used as a dwelling.

The use of the house is considered to be a payment for Division 7A purposes, as the areas used as the dwelling is greater than 10% of the area of the house.

Taxpayers Australia comment

We believe that the arbitrary figure of 10% is low for the scenario noted above, or those which are similar (ie. home practices).

Notwithstanding that a distinction has been identified in the Explanatory Memorandum between the use of farm land and a home practice, we consider this to be unfair to the taxpayer in the former situation given that there may be particular commercial reasons for the company owning the house (as opposed to the shareholder).

In addition, we note that the initial intention to exempt small business, as noted by the Assistant Treasurer's Media Release has been overlooked and that the proposed amendment only favours rural land owners.

Further, in practice, we consider a number of shareholders may have arrangements whereby a house is owned by their company, in which they conduct their business. To require a market value rent be imposed on the use of the residence to avoid the application of Division 7A, places the shareholder under additional burden and is inconsistent with the announcement by the Assistant Treasurer.

In addition, in holding the house under the company's name, there are no available CGT concessions (such as a partial main residence exemption or CGT 50% discount) if the house was held under the shareholder's name.

Based on the foregoing, Taxpayers Australia recommends that consideration be given to:

- providing a different percentage for use of a dwelling compared with a block of land by a shareholder. We suggest an arbitrary figure of 50% would be a representative value of the maximum area in which a house is used before it should be subject to some form of market value rental; and

- exempting homes which are owned by the private company which conducts the business, provided the home is inextricably "linked" to the business (as would be the case with a farmhouse).

(iv) Interaction of private-use asset rules with look-through for interposed entities

Under the proposed amendments, where a corporate beneficiary has a present entitlement to an amount from the net income of the trust estate and the whole the amount has not been paid, and an entity is interposed between the company and the shareholder (ie. the target entity), the trust is deemed to have directly paid or loaned the amount to the shareholder.

Taxpayers Australia comment

Given the proposed amendments to deem use of assets in a private company as a "payment" for Division 7A purposes, there is uncertainty as to a situation where there is an unpaid present entitlement from a trust to a corporate beneficiary, and the use of the asset is held in an interposed entity instead of by the company.

The proposed section 109XF(1)(c)(i) or (ii) ITAA36 states that either the payment or loan is made by the interposed entity (ie. a trust or company) or another interposed entity.

Therefore, prima facie, it appears that the provision of a right to use an asset by an interposed entity would be deemed to be a payment under the proposed section 109C(3)(d) ITAA36.

However, having regard to section 109XF(1)(b) ITAA36, a reasonable person would need to conclude that trustee made the payment as part of an arrangement involving a payment to the target entity (ie. the shareholder).

Therefore, there are two matters which require consideration:

- Firstly, whether it is the intention of the provisions, that the use of an asset in an interposed entity may be deemed to be a payment and therefore, be subject to Division 7A; and

- Secondly, the difficulty in the reasonable person determining whether there is a relationship between the provision of the use of an asset held by an interposed entity to the shareholder and any loans or payments made by the trustee to that interposed entity.

On this basis, Taxpayers Australia suggest that further guidance be provided on the interaction between the use of the private asset and the provision of such use by an interposed entity which is subjection to subdivision-EA ITAA36.

(v) Application date

According to para. 1.71 of the Explanatory Memorandum, it is anticipated that the amendments will apply from the 2009-10 and later years. It is unclear as to whether the amendments apply for companies which have a substituted accounting periods.

Taxpayers Australia comment

Based on the foregoing, Taxpayers Australia suggests that clarity be provided as to whether the application date applies to companies which have a substituted accounting period (say, an early balance date of 1 January 2009).

In such situations, the use of a private asset may have occurred from a point in time, without the taxpayer knowing the intended application of these amendments.

In other words, individual shareholders may be inadvertently taxed on deemed dividends, treated as payments, from use of company assets for use of assets before these changes were announced in the May 2009-10 Budget.

Therefore, Taxpayers Australia recommends that clarity in terms of application date also be provided for such circumstances.

2.2 General comments

Re-write of Division 7A in the Income Tax Assessment Act 1997

We note that certain provisions in the *Income Tax Assessment Act 1936* have been re-written in the *Income Tax Assessment Act 1997*. This has been demonstrated recently by the *Tax Laws Amendment (Transfer of Provisions) Bill 2009*.

Notwithstanding the need to have integrity measures to ensure that the application in certain instances under Division 7A is not circumvented, Taxpayers Australia recommends that the rewrite of the Division 7A provisions be undertaken in the 1997 Act to ensure that the provisions are easy to interpret and are in line with modern drafting techniques.