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Changes to Division 7A – A Wealth Tax By Stealth

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On Monday, 4 January 2010, the Assistant Treasurer, Senator the Hon. Nick Sherry, issued a Press Release (No.2 of 2010) under the Orwellian title, "Tax Clarity for Rural Communities and Small Business Operators a Step Closer". The Press Release concerns amendments to Division 7A of Part III (***Division 7A***) of the *Income Tax Assessment Act 1936* (the ***1936 Act***) originally announced in the last Budget. The Press Release directs you to the Treasury website where an Exposure Draft of the changes to Division 7A and a draft Explanatory Memorandum (the ***draft EM***) can be found.

It is well understood that Division 7A is necessary to ensure that profits of private companies are not distributed in a tax free way and no one can quibble with the underlying principle that profits of a company should be taxed if individual shareholders or their associates benefit from those profits through interest free or low interest loans or payments made on behalf of a shareholder.

"Grant of a Lease, Licence of Right to Use"

Amongst the many proposed changes to Division 7A, is the addition of a paragraph (d) to subsection 109C(3) of the 1936 Act so that ***a grant of a lease, or a licence or other right to use an asset*** becomes a payment and an assessable deemed dividend if there is a "distributable surplus" and the recipient is either a shareholder or an associate of a shareholder (or in some cases a former shareholder or associate of that former shareholder) and the recipient does not either (i) pay an arm's length amount for the lease, licence or right to use or (ii) benefit from one of the proposed carve-outs.

Briefly, the carve-outs are as follows:

1. Proposed subsection 109C(3B), which concerns "minor benefits".
2. Proposed subsection 109C(3C), which concerns the "once-only deduction" rule (similar to section 21A of the 1936 Act and the carve-out from taxation of some non-cash business benefits).
3. Proposed subsection 109C(3D), which essentially concerns certain farms and other places where a business is carried on and the dwelling is below a 10% threshold in terms of area.

The phrase, "a grant of" would suggest that the company, acting through its directors, is involved in something that is active as distinct from passive so that the phrase would not necessarily cover a situation where the company tolerated a shareholder using an asset of the company in circumstances where the individual had not acquired a right. However, in the Exposure Draft there is an Example involving a yacht, and the wording used is *the private company allows one of its shareholders to use the yacht on weekends* which indicates that the intended meaning of "a grant of" extends to something that involves no actual creation of a legal right and involves no more than the tolerance of a situation.

The position evidenced by the Example is consistent with the broad interpretation given to the concept of granting a right to use in cases such as *Tourapark Pty Limited v FCT* (1982) 149 CLR 176; (1982) 12 ATR 842, *AAT Case 4894* 20 ATR 3304 and *W A Hughes Pty Ltd v FCT* (1981) 11 ATR 900. Consequently, it will be very easy to trigger a deemed dividend because of proposed paragraph (d) to subsection 109C(3).

Equity and Simplicity

The test of any change is whether it is equitable and does not add complexity and cost.

Unfortunately, the change and the proposed carve-outs have not been carefully thought through and the result will be inequity, complexity and cost.

In effect, an additional tax, akin to a wealth tax, as well as a significant compliance burden will be imposed on those who have made the mistake of holding personal assets through a private company rather than directly or through a trust.

Whilst there are genuine examples of untaxed benefits being obtained by individuals who acquire assets through companies, especially if the assets have been acquired out of profits that have been untaxed or suffered a lower rate of tax than the individuals would have borne, the change fails to discriminate between those who genuinely benefit and those who have either historically held such assets through a company (acquired before trusts became fashionable and tax effective!) or have acquired them through a company to minimise liability issues, where the acquisition was funded out of after tax income of the individuals.

One simple example of where the new rule, if applicable, may result in an inequitable outcome is in relation to company title apartments. If the rights acquired by a purchaser of shares in a company title apartment involve a grant of a lease, licence or right to use the apartment (as they would appear to) and the company has distributable profits (as defined in section 109Y of the 1936 Act), a shareholder may be subject to tax periodically on what may be his home.

To further illustrate the inequity, we need only compare the following very simple situations involving a farm (although the asset could just as easily be a boat, a car, a tractor, a horse or any other asset):

1 A buys a farm in his name.

2 B buys a farm through a family trust.

3 C buys a farm through a private company wholly owned by C funded by the private company from its after tax earnings.

4 D buys a farm through a private company wholly owned by D funded by D from his after tax earnings.

The farm is not run as a business.

Any use of the farm by A or B is not taxable. However, under the proposed rule any use by C or D or any of their relatives of the farm is almost certainly taxable if there is a distributable surplus.

So, if the farm has increased in value, then a deemed dividend under section 109C can arise because there is a “distributable surplus”, albeit the profits are unrealised.

In the case of C, there is an argument that the benefit should be taxed to C, but the tax should truly only be by reference to the tax saved on the profits taxed to the private company.

However, it is not clear what policy or how equity is served by discriminating against D, especially when one realises that under the current law, a sale of the farm will almost certainly mean that D will be taxed at a higher rate than A or B will be on the capital gain.

One might say, why not use a trust to hold the farm. Going forward that is a possible solution for the next acquisition, but it is one fraught with a number of issues, not the least of which is the ticking CGT time bomb that arises out of the intersection between CGT event E5 and the rule against perpetuities that mandates that a trust must vest within a specified period (these days usually 80 years, except, of course, in South Australia where the rule has been abolished).

To transfer the farm into a trust may involve significant tax and stamp duty being paid, so restructuring will in many cases not be an option.

The proposed change also fails the test of simplicity. There is complexity because of the difficulties associated with the carve-outs (discussed below).

Finally, cost is also an issue because it will become necessary for just about every private company to value its assets regularly and to comparatively price the cost of providing rights to use assets such as vehicles, boats, horses, etc. if one is to be compliant, as we all must be.

The Carve-outs

Minor Benefits - Subsection 109C(3B)

Just how mean-spirited the changes are can be seen by the way the minor benefits carve-out works.

Broadly, the carve-out allows a benefit worth <u>less than $300</u> to escape taxation but only if the other requirements of section 58P of the *Fringe Benefits Tax Assessment Act 1986* are satisfied (aside from an associate or shareholder being an employee as that is taken to be satisfied).

One of the conditions is that the benefit must be infrequent and irregular. So, if C's or D's relatives use the farm periodically, they may well be required to pay tax on a deemed dividend unless they pay an arm's length fee for use.

A relative includes a child so if D's daughter regularly rides a horse owned by the company, be it a nag or a son of Octagonal, then she may be faced with paying tax on a deemed dividend if she does not pay an arm's length fee for the right to use the company's asset (or can we say that the horse is a liability and not an asset as a horse costs a lot more than it is often worth to maintain?).

No doubt C and D will get used to the sight of the Tax Office auditors standing at the farm gate checking who comes to stay, who uses the horses and timing trail bike rides.

The Once-Only Deduction - Subsection 109C(3C)

This carve-out is of very limited utility. It reflects the principle that a benefit is not assessable if the cost of paying for it would be deductible but only as a once-off deduction so that if one could amortise the cost of the benefit over a period the carve-out cannot apply.

This carve-out cannot apply to lifestyle assets and is only relevant to business assets used as part of a business.

Surprisingly, the draft EM (in Example 1.4) tells us that this carve-out does not apply to a lease of real property at a less than market value rent for business purposes even though proposed paragraph (d) of section 109C refers specifically to a "lease" and the carve-out should literally apply (if the rent is otherwise deductible).

Apparently, a lease of real property is a transfer of property for the purposes of paragraph (c) of section 109C and the carve-out does not apply to paragraph (c). However, if a lease is covered by paragraph (c), why refer to it in proposed paragraph (d)? If paragraph (d) is the specific provision, why will paragraph (c), the general provision, apply?

The Dwelling - Subsection 109C(3D)

This exception is specific to those who carry on business on land owned by the company and also live on the land (or apparently a house boat).

Unfortunately, the carve-out is oddly worded and not easy to satisfy.

For example, if the company owns a warehouse that includes a flat, a licence to a shareholder who carries on business at the warehouse to use the warehouse and the flat is an excluded benefit provided that the licence to use the flat is granted for the purpose of enabling the shareholder to utilise the licence of the warehouse and the flat is less than 10% of the area of the whole.

The wording of the exception also requires that separate rights are granted in respect of the land on which the business is conducted and in respect of the dwelling. This is illustrated by the example used in the draft EM which is as follows:

Example 1.5

> Farm Pty Ltd owns a farm. During the 2009-10 income year, the shareholders of Farm Pty Ltd (Aaron and Liz), run a farming business on the land owned by Farm Pty Ltd under a licence arrangement (Aaron and Liz do not have exclusive possession of the farmland). Due to the remote location of the farm, Aaron and Liz would not be able to utilise the farm to run their business without accommodation on the farm. In addition to the licence to use the farmland, Farm Pty Ltd therefore provides Aaron and Liz with the right to use a farmhouse that is situated on the farmland.
>
> Aaron and Liz do not make payments to Farm Pty Ltd for either the use of the farmland or the farmhouse.
>
> The use of the farmland by Aaron and Liz is not a payment for the purposes of paragraph 109C(3)(d). This is because if they had made a payment during the income year for the use of the farmland an once-only deduction would have been allowable. However, the use of the farmhouse by Aaron and Liz is of a private nature and hence does not come within the exception provided for in subsection 109C(3C).

As Aaron and Liz are carrying on a business on the land on which the farmhouse is situated, the right to use the farmhouse was granted to enable them to utilise their licence to use the farmland and the farmhouse is less than 10% of the area of the farmland, their use of the farmhouse is disregarded for the purposes of paragraph 109C(3)(d).

The carve-out is likely to have limited application and clearly discriminates in favour of farmers as against artists and artisans who are unlikely to satisfy the 10% limitation in area. So, if the baker who provides Aaron and Liz with their bread runs his business through a private company and lives on the premises, he is unlikely to avoid being taxed on the use of the dwelling.

Retrospectivity

Just to be clear, these rules are to be retrospective as they apply to lease, licences and rights to use granted since 1 July 2009. One should not assume that because the company has been around for many years that new rights are not being granted.

Conclusion

The change to subsection 109C(3), if enacted, will have many unintended and inequitable outcomes. Ideally, the proposed change should not be enacted without being substantially revised and narrowed in its scope so that the outcomes are equitable and not based on false premises.

One can only hope that the Henry Review advocates and the Government accepts changes that render Division 7A irrelevant.