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The Board of Taxation
c/- The Treasury
Langton Crescent
CANBERRA ACT 2600

Email: taxboard@treasury.gov.au

Dear Sir or Madam

**SUBJECT: SUBMISSION ON THE BOARD OF TAXATION POST- IMPLEMENTATION REVIEW OF DIVISION 7A – SECOND DISCUSSSION PAPER**

CPA Australia represents the diverse interests of more than 150,000 finance, accounting and business professionals in 121 countries. Our vision is to make CPA Australia the global accountancy designation for strategic business leaders.

Against this background we provide this submission concerning the Second Discussion Paper issued by the Board of Taxation on 25 March 2014 in relation to its post-implementation review of Division 7A of Part III of the Income Tax Assessment Act 1936 (‘the ITAA 1936).

If you have any questions regarding the above, please contact Mark Morris, Senior Tax Counsel, on (03) 9606 9860 or via email at mark.morris@cpaaustralia.com.au.

Yours faithfully

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# APPENDIX A - SPECIFIC RESPONSES TO QUESTIONS CANVASSED IN DISCUSSION PAPER

We provide the following specific comments in respect of each of the specific issues and questions raised in chapters 4, 5 and 6 of the Discussion Paper:

## CHAPTER 4:

**Q 4.1 Issues/Questions**

**The Board seeks stakeholders' comments on whether taxing business accumulations at a 'company tax' rate, irrespective of the structure chosen, is an issue that should be considered as part of a wider tax reform process.**

CPA Australia recognises that there are significant productivity benefits to be realised by allowing different business structures to fund their working capital needs from their own accumulated after-tax income rather than borrow equivalent interest bearing debt from third party financiers.

It is for this reason that we proposed that a non-fixed trust carrying on a business activity be provided with an irrevocable option to have its taxable income assessed to the trustee of the trust at a business tax rate (e.g. 30 per cent) in our submission to Treasury dated 10 February 2012 in respect of its reform option paper entitled 'Modernising the taxation of trust income'. A copy of this submission is enclosed.[1]

As a corollary this submission provided that any business non-fixed trust making such an election would be taxed as a company for all purposes of the income tax law, and that a non-fixed trust carrying on investment activities would conversely be treated as a trust for income tax purposes thereby ensuring that the progressive nature of the personal tax system would not be eroded regarding the derivation of passive investment income.

Given our longstanding view on this matter we therefore welcome the proposal that a trading trust be provided with the option to 'tick the box' and be treated as a company in respect of any future unpaid present entitlement owed to a private company beneficiary as it will ensure that such a trust can effectively reinvest the funds representing the unpaid distribution as working capital without being subject to top-up tax.

Hence, as we believe that Treasury and other stakeholders should revisit the above optional accumulation model for non-fixed trusts, we would also welcome the terms of reference of the Tax Reform White Paper enabling consideration of whether the business income of any entity be able to be taxed at the company tax rate and that the after-tax balance be accumulated and used to fund working capital.

However, we also note that it is not readily apparent how this concept could be expanded to apply to a fixed trust carrying on a business, or to any trust which carries on a mix of investment and trading activities.

Accordingly, we believe that any consideration of the issue as to whether business accumulations derived by any entity should be taxed at the corporate tax rate be deferred until the White Paper tax reform process commences, and that the option of trading trusts being allowed to retain an unpaid present entitlement for working capital purposes be separately and urgently progressed.

[1] The submission can also be downloaded from: http://www.cpaaustralia.com.au/~/media/Corporate/AllFiles/Document/professional-resources/taxation/Submission-on-moderning-the-taxation-of-trust-income.pdf

**Q 4.2 Issues/Questions**

**The Board seeks stakeholders' comments on whether the high level tax policy aims of efficiency, simplicity and equity would be served by adopting a policy framework for private businesses that supports the progressivity of the personal tax system by striking an appropriate balance between the following four goals:**

- **It should ensure that the private use of company profits attracts tax at the user's progressive personal income tax rate.**
- **It should remove impediments to the reinvestment of business income as working capital.**
- **It should maximise simplicity by reducing the compliance burden on business and the administrative burden on the Commissioner and other stakeholders.**
- **It should not advantage the accumulation of passive investments over the reinvestment of business profits in active business activities.**

We believe that the above four principles appropriately summarises the objectives of the reformed Division 7A set out in the Discussion Paper which strikes a commendable balance between protecting the revenue by ensuring that the private use of business income is subject to progressive rates of tax whilst ensuring that business groups are more readily able to reinvest business income as working capital especially in respect of unpaid distributions owed by trading trusts to private company beneficiaries.

Accordingly, there is considerable merit in including the above four principles as an 'objects clause' in any redrafted version of Division 7A which is incorporated into the Income Tax Assessment Act 1997 (the ITAA1997).

However, we believe that care needs to be taken to ensure the robustness of any finalised recalibrated version of Division 7A as the raft of amendments made to Division 7A in the 2004, 2007 and 2010 calendar years has detracted from its efficacy and caused considerable confusion and, inevitably some non-compliance. Thus, whilst it is preferable to maximise simplicity wherever possible it is particularly desirable that any new version of Division 7A be well structured and comprehensive so that it ultimately represents a stable and robust set of tax provisions.

**Q 4.3 Issues/Questions**

**The Board seeks stakeholders' comments on how, if the suggested framework were to be implemented, the proposed rules regarding asset usage could be designed without introducing undue complexity.**

We note that a pivotal part of the proposed framework for the revised Division 7A is that there be a single set of rules based on common principles concerning transfers of value that would apply to temporary transfers of value such as loans and asset usage and permanent transfers of value such as payments and debt forgiveness.

The paper sets out a strong conceptual argument as to why this principle of transfer of value would be beneficial especially given the use of these principles would potentially simplify the calculation of a company's distributable surplus by ensuring that temporary transfers would not result in a deemed dividend where the distributable surplus solely comprises unrealised profits.

However, we are concerned that in practice the application of the principle could cause significant confusion and additional compliance for private company groups, and that these costs would outweigh some of the perceived benefits of the suggested framework. This view is discussed further below in our commentary on issues 4.5 and 4.6.

Moreover, the existing legislative principles associated with payments and debt forgiveness are reasonably well understood by taxpayers, and in our view the major focus of reform should be on loans and the use of private company assets by shareholders and associates. We believe the proposed simpler and more flexible regime of complying loans discussed in section 6.1 below will significantly reduce compliance. Accordingly, the focus of the following discussion is on possible simplification on the rules associated with the use of private company assets. Broadly, we contend that the existing rules concerning the right to use of a private company asset by an entity be retained as this will ensure that a deemed dividend arises wherever the shareholder or an associate has the right to use the asset to the exclusion of the private company.

We also believe that that the value of any right to use a private company's assets should continue to be reduced to nil where the use of that private company asset would have been otherwise deductible.
We also believe that a minor benefits rule should also be retained as a potential exclusion from these provisions to reduce compliance but that the minor benefits exclusion threshold should be raised to a more commercially realistic level of, say, $3,000 rather than the $300 threshold that currently applies.

Where the asset usage does not meet either of the above exemptions we contend that the start point in determining the valuation of asset usage by shareholders and associates should continue to be the arm's length value of that asset usage by the shareholder or an associate.

This is because in many cases such an arm's length value may be readily available. For example, an arm's length value will be easily obtainable where a rental property is leased by the private company at a commercial rate for most of the year to third parties, and is then made available to a shareholder or associate for part of the tax year who will be attributed their pro rata share of the commercially determined rent for their period of use of the property.

In practice, where such a market valuation is not readily available we believe that a relatively simple default position is to allow the valuation to be determined as a lease rental which will vary depending on whether the assets used are depreciating or appreciating assets.

Where a depreciating asset is used a charge could be calculated based on the depreciation of the asset (based on the Commissioner's prevailing estimate of the effective life of depreciating assets) as well as an imputed interest charge (being a statutory interest rate to the opening adjustable value of the asset). To this extent the value of the benefit associated with the use of the asset would be broadly congruent with the calculation of a car benefit under the operating cost method in respect of a car owned by an employer as applied under section 10 of the Fringe Benefits Tax Assessment Act (1986). By contrast where the asset is an appreciating asset (being principally land) a statutory interest charge could be levied on a suitable proxy for the market valuation being, say, land valuations disclosed on council rates notices.

We would also be receptive to other benchmark market valuations that could reasonably be applied as we believe it essential that any valuation methodologies developed be readily ascertainable at low cost.

**Q 4.4 Issues/Questions**

**The Board seeks stakeholders' comments on:**

- **whether excluding unrealised gains from the distributable surplus would assist in simplifying compliance with the provisions and address the potential for double taxation;**
- **whether there would be integrity concerns or likely cost to revenue if the proposed approach to distributable surplus were to be adopted; and**
- **whether, as an alternative to the proposed approach, unrealised gains and losses should be included in the basic calculation of distributable surplus, but then be subtracted when dealing with temporary transfers of value.**

CPA Australia does not support the proposed changes to the distributable surplus calculation methodology which would apply different criteria depending on whether there was a temporary or permanent transfer of value as unrealised profits will only be taken into account where there has been a permanent transfer of value.

We acknowledge that the proposed framework has some attraction from a theoretical perspective.

However, we believe that it may be practically difficult in some cases for accrual taxpayers to distinguish between realised and unrealised profits. Moreover, we believe that most companies will have retained earnings and that it will seldom be the case that a company would only have unrealised profits in the form of an asset revaluation reserve. Thus, the potential benefit of the proposed changes would appear to be quite narrow.

We are also concerned that the exclusion of unrealised gains for temporary transfers of value may trigger avoidance activity.

Accordingly, to preserve the integrity of the Division 7A regime and to contain compliance costs we suggest that the current definition of distributable surplus be retained in any rewritten version of Division 7A which is incorporated into the ITAA 1997.

**4.5 Issues/Questions**

**The Board seeks stakeholders' comments on whether the distributable surplus rules should be adjusted to be:**

- **tested at year end for permanent transfers of value, as well as for temporary and ongoing transfers of value (for example loans, asset usage) at each year end; and**
- **based on the amount of available realised profits of the company as reflected in its accounts (net assets), but with appropriate adjustments to address situations:**
    - **of possible double counting; and**
    - **where value which has not been reflected as realised in the accounts has been transferred to shareholders/associates.**

As discussed, CPA Australia does not support the changes to the calculation of a company's distributable surplus as set out in subchapter 4.4. As a corollary we do not support the annual testing of a company's distributable surplus which would appear necessary if the above changes to the distributable surplus calculation are introduced. In our view such a measure would impose a considerable compliance burden on private and closely held groups. Accordingly, compliance with the distributable surplus rules should only be tested in respect of the year in which the provisions of Division 7A are triggered. In our view if any group deliberately engineers their activities so there is no distributable surplus in the year in which Division 7A is triggered, (and this position reverses in subsequent years), the general anti avoidance provisions of Part IVA of the ITAA 1936 should be available to the Commissioner to deter such avoidant behaviour.

**Q 4.6 Issues/Questions**

**The Board seeks stakeholders' comments on:**

- **the proposed general rules for determining when deemed dividends should arise; and**
- **whether, and in what circumstances, deemed dividends should be frankable.**

As set out in our comments on issue 4.3, we believe that the current rules associated with payments, loans, debt forgiveness and use of private company assets should be retained under any rewrite of Division 7A in the ITAA 1997.

We have long taken the view that the most problematic aspects of Division 7A were the rules associated with section 109N complying loans and unpaid present entitlements owed by private company beneficiaries. We believe that the suggested reforms to these aspects of Division 7A as set out under Chapter 6 of the Discussion Paper have the potential to considerably reduce much of the complexity and compliance burden arising under the current provisions of Division 7A.

Accordingly, we believe that the current rules applied to determine the amount of a deemed dividend arising from a payment, use of company asset or forgiveness of debt be retained subject to our earlier comments that less onerous rules be introduced in determining the value of any asset usage by a shareholder or an associate where the market value of the right to use a private company asset is not readily obtainable.

We also note that the amount of any consideration provided by a shareholder or an associate in respect of any payment by a private company on their behalf should be allowed to reduce any amount which is paid or credited to them on their behalf. Such a rule would be consistent with other provisions of Division 7A where the amount of any deemed dividend arising from a transfer of property, a right to use property or a debt forgiveness can all be potentially reduced by the amount of any contribution made by the shareholder or an associate.

In addition, a shareholder or associate should be able to make such a contribution to reduce the amount of any deemed dividend provided such compensation is received by the company before the lodgment day of the company's income tax return for the year in which the relevant Division 7A benefit was received.

Finally, we believe that any deemed dividend arising under Division 7A should be franked as any such deemed dividend will be potentially subject to penalties if determined on a review or audit by the Australian Taxation Office (ATO) as well as general interest charge which collectively should be a sufficient deterrent.

# CHAPTER 5

### Q 5.1 Issues/Questions

**The Board seeks stakeholders' comments on whether the potential benefits of the Statutory Interest Model (particularly the simplification benefits) are justifiable having regard to the policy framework set out at paragraph 4.25 above.**

CPA Australia's advocated the introduction of the statutory interest model in our submission dated 22 February 2013 on the Board of Taxation's first discussion paper on its post-implementation review of Division 7A.

However, following our review of the second discussion paper we recognise that the adoption of the statutory interest model would potentially be a significant cost to the revenue.

Moreover, it would replicate some of the practical issues associated with unpaid present entitlements which are put on a sub-trust under Options 1 and 2 under Practice Statement PSLA 2010/4 as there would be no requirement for the shareholder or associate to make principal repayments. As set out under paragraph 5.32 of the second discussion paper the absence of a requirement to make principal repayments will reduce the need to make dividend payments to fund the payment of top-up tax by shareholders which is problematic where the loan funds are applied to fund the purchase of passive investments.

In any event we believe that the proposed changes to complying loans and unpaid present entitlements set out under Chapter 6 of the second Discussion Paper significantly ameliorate much of the complexity and adverse commercial issues arising from the current operation of Division 7A.

**Q 5.2 Issues/Questions**

**The Board seeks stakeholders' comments on:**

- **whether a number of administrative issues and the high compliance and administrative costs associated with Division 7A are due to the prescriptive and, in some cases, form-based provisions within the Division;**
- **whether pursuing the *Division 7A Adjustment Model* alone would have only limited impact in moving the system in the direction of the Board's preferred policy framework as discussed in Chapter 4; and**
- **if the new model suggested in Chapters 4 and 6 (and summarised in the Executive Summary) were to be adopted, what remaining aspects of the *Division 7A Adjustment Model* (if any) should be progressed, any in what priority.**

In our view the high compliance costs associated with the operation of Division 7A stem from the often impenetrable nature of the provisions which are simply too hard to read, understand or apply. Furthermore, the more complicated the structure of the private group the more difficult the task becomes to ensure that the provisions are appropriately complied with.

We have therefore taken the view that there needs to be some form of major structural reform to the provisions of Division 7A especially in respect of complying loans and unpaid present entitlements is necessary in order for there to be some meaningful simplification of Division 7A.

Hence, we do not believe that by merely applying the Division 7A Adjustment Model as set out in the first discussion paper that we will get the required simplification of Division 7A.

However, should the changes in Chapter 6 of the second discussion paper proceed, we recognise that there may be residual elements of the Division 7A Adjustment Model listed in the first and second discussion papers which could be adopted and incorporated into any rewrite of Division 7A to improve its efficacy.

# CHAPTER 6

**Q 6.1 Issues/Questions**

**The Board seeks stakeholders' comments on whether it would simplify compliance if legislation were enacted prescribing the terms and conditions for Division 7A loans as outlined below and, if not, how the proposed rules could be modified to improve simplicity:**

- **There would be no requirement for a formal written agreement between the parties. However, written or electronic evidence that a loan was entered into must be exist by lodgment day for the income year in which the loan was made.**
- **The statutory interest rate would be set at the start of the loan and fixed over the term of the loan.**
- **The statutory interest rate for a particular year would be set at be the Reserve Bank of Australia's indicator lending rate for small business variable (other) overdraft for the month of May immediately before the start of that income year.**
- **The maximum loan term would be 10 years.**
- **The prescribed maximum loan balances during the term of the loan (including any accumulated interest) would be as follows:**
    - **75 per cent of the original loan by the end of year three;**
    - **55 per cent of the original loan by the end of year five;**
    - **25 per cent of the original loan by the end of year eight; and**
    - **0 per cent of the original loan (that is, fully repaid) by the end of year ten.**
- **Subject to meeting the minimum loan balances, there would be no specified annual principal repayments.**
- **Interest would be able to be accrued but would have to be paid by the end of each milestone period — ends of years three, five, eight and ten.**
- **Failure to make the repayments by the end of the milestone periods would result in the private company being taken to have paid a dividend to the entity based on the amount of the shortfall in the payment required.**
- **The Commissioner's period of review would commence to run from the date of lodgment for the income year in which each milestone payment is required (or would have been required, had a complying loan agreement been entered into).**

CPA Australia supports the proposed design features of the single 10 year complying loan exemption as detailed in Chapter 6 of the Discussion Paper. As a corollary much of the complexity associated with the current differential rules regarding secured or unsecured loans will no longer be required.

This measure would also strike an appropriate balance between ensuring that shareholders or associates repay private company loans over a reasonable period (regardless of whether the loans are secured or not) at an appropriate arm's length interest rate whilst providing some flexibility for interest and principal repayments over the loan term.

We also submit that any simplification in respect to documentation should extend beyond the initial loan arrangements and also cover subsequent loan repayment arrangements. Per the board's two discussion papers, it is recognised that Division 7A loan repayments are often facilitated by internal dividends. Consultation with our members has shown that such dividend funding will in practice entail a formal declaration followed by an agreement by the parties to satisfy the loan repayment by way of an offset of the dividend entitlement against the loan repayment obligation. The extent of documentation for such repayments will be a dividend minute, journal entries and the final signed accounts. Members have expressed concern that such actions will not be accepted as sufficient evidence by the Australian Taxation Office. A simplification policy in respect to written documentation concerning loan arrangements would be the ideal context in which to introduce measures recognising such actions as sufficient evidence of loan repayments.

**Q 6.2 Issues/Questions**

**The Board seeks stakeholders' comments on whether greater simplification, certainty and policy coherency would be gained from a legislative amendment to clarify that all UPEs are loans for Division 7A purposes.**

We believe that considerable certainty could be achieved if the definition of a loan for Division 7A purposes was expressly amended to include an unpaid present entitlement by a related trust to a private company beneficiary.

However, such a change must be accompanied by the proposal to allow a trading trust a tick the box election so that it is irrevocably treated as a company for the purposes of making an unpaid present entitlement to a private company beneficiary.

This will ensure that no adverse tax implications will arise for such trusts under Division 7A in respect of such unpaid present entitlements.

**Q 6.3 Issues/Questions**

**The Board seeks stakeholders' comments on:**

- **whether the issues associated with retaining working capital for the carrying on of a business in a trust can be addressed with the use of a limited exception;**
- **whether the limited exception (provided through legislation) should be that all loans to trusts (including UPEs) can be excluded from the operation of Division 7A, where the trust makes a once and for all election to forgo access to the CGT discount on its capital gains arising from assets held within the trust;**
- **whether the proposed limited exception would reduce compliance costs in instances where a business is carried on in a trust;**
- **the nature of the consequential rules that would be required if such a limited exception were to be applied;**
- **the nature of any transitional rules that would be required if such a limited exception were to be applied; and**
- **the merits of a transitional rule that provides that:**
    - **any loans in place prior to a trust making an election would continue to be subject to the existing requirements; and**
    - **any CGT assets acquired by the trust prior to the making of an election would continue to be eligible for the CGT discount on disposal; or**
    - **alternative suggestions for a transitional rule that maintain integrity, provide simplicity and reduce compliance costs.**

We fully support the introduction of an irrevocable tick the box election which will allow all loans to a trading trust (including unpaid present entitlements) to be excluded from the scope of Division 7A, and that it is appropriate to fund the cost of this initiative by such a trust foregoing its entitlement to claim the 50% CGT Discount in respect of any CGT assets (other than goodwill) from the time the election is made.

Such an initiative will significantly reduce compliance costs such as those associated with satisfying the requirements of Practice Statement PSLA 2010/4. More importantly, it will ensure that the funding of the trust's working capital is secured which is not the case given the current requirement for such trusts to repay principal at the end of the loan term in respect of unpaid entitlements which are subject to Options 1 and 2 of Practice Statement PSLA 2010/4.

It is also congruent with many of the features of the accumulations model we canvassed in our submission on the Treasury option paper entitled 'Modernising the taxation of trust income'.

Given that the amount of such contingent principal repayments on unpaid present entitlements held on a sub-trust under Options 1 and 2 of Practice Statement PSLA 2010/4 has often progressively grown each year since the issue of the Practice Statement it is also imperative that some meaningful transitional rules be introduced to address this growing tax exposure.

In our view the most appropriate transitional relief would be for a trading trust to be provided with an irrevocable option that it can elect to be treated as a company in respect to any past, current and future loans (including unpaid present entitlements) in return for permanently foregoing its entitlement to any 50% CGT Discount on any of its CGT assets (other than goodwill) regardless of when that post CGT asset was acquired.

As a corollary any part of the consideration attributable to goodwill which is received on a sale of shares or unit should similarly be potentially eligible for the 50% CGT Discount to ensure that there is parity between an equity or asset sale of a business.

**Q 6.4 Issues/Questions**

**The Board seeks stakeholders' comments on:**

- **whether a legislative self-correction exception should be available to taxpayers to correct mistakes or omissions;**
- **the nature of any eligibility requirements for the exception;**
- **the nature of any conditions that should be satisfied to qualify for the exception;**
- **appropriate record-keeping and evidentiary requirements that must be met to qualify for the exception; and**
- **any impediments to the practical administration of the exception.**

CPA Australia believes that a legislative self-correction exception be included in any rewrite of the Division 7A provisions which will allow taxpayers and their advisers to take appropriate corrective action so that the parties are in the same position that they would have been had Division 7A been fully complied with when the original Division 7A trigger event occurred.

Such a mechanism will allow taxpayers to become fully compliant with Division 7A and allow tax agents who take on new clients to identify any Division 7A breaches and take the appropriate remedial action.

However, we share the Board's concerns that the self corrective mechanism should not be accessed by taxpayers who deliberately ignore Division 7A or attempt to circumvent its provisions.

That said, we also note that the current gateway to the exercise of the Commissioner's discretion to rectify prior year amendments due to honest mistakes or inadvertent omissions under section 109RB has been so restrictively applied by the ATO in Taxation Ruling TR20010/8 that the discretion is of only limited utility in allowing corrective action to take place.

Accordingly, it may be necessary to provide more definitive guidance on what would constitute an honest mistake or inadvertent omission. Where this requirement is met a moderate penalty of, say, 5 per cent could be imposed in respect of any tax shortfall arising from a prior year failure to correctly apply Division 7A to deter any attempts to merely ignore or circumvent Division 7A.