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

By email: taxboard@treasury.gov.au

Post Implementation Review of Division 7A
Ernst & Young submission

Dear Sirs

Ernst & Young is pleased to respond to the Board of Taxation (the Board) discussion paper 'Post-Implementation Review of Division 7A of Part III of the Income Tax Assessment Act 1936 (the discussion paper) of 19 December 2012.

We welcome the review and the potential for these highly complex provisions to be improved. The recommendations of the review should aim to:

- Simplify the rules where possible
- Increase taxpayer certainty
- Reduce costs of compliance
- Ensure fair and equitable outcomes

The terms of reference include a requirement that any 'broader reforms' need to maintain the integrity of the tax law and have revenue neutral or near revenue neutral outcomes. In this respect the correct calibration of the policy of the regime and an understanding of the current revenue raised by the rules will be necessary. However this revenue neutral requirement will restrict the extent that the review may recommend changes to achieve the above aims.

The policy of the rules is that they are to prevent shareholders and their associates from inappropriately accessing the profits of companies as "disguised dividends". However the purpose of the rules is often described, including by the ATO, as to prevent the private use of company funds, which has lead to some taxpayer misconceptions. The rules have never had a sufficient distribution policy nor should such a policy be introduced at this time.

While the 'Division 7A adjustment model' has significant merit and is on balance our preferred approach, we are concerned at how long the legislative process might take, in particular in light of new Treasury resource constraints. It will therefore be necessary to accelerate some interim amendments for the most pressing issues including to address:

- Unpaid present entitlements
- Loans where the interest would be otherwise deductible to the shareholder/associate
- Mechanisms for relief in appropriate cases where the requirements of the provisions are not met

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Exceptions for small business taxpayers should be considered, applying the definitions in Division 328 of the Income Tax Assessment Act 1997 (ITAA 1997).

We have identified in the Appendix some additional issues with the rules which should be addressed as part of the broader update of the provisions.

The main attraction of the proposed 'statutory interest rate' model would be to remove the significant complexity and resulting uncertainty of the range of interposed entity and other integrity measures and to remove the current multiple specific exemptions. However the mandatory charging of interest, at likely significantly higher interest rates than under the current benchmark interest rate rules, may cause commercial problems and is unlikely to be a sufficient trade off for taxpayers with simple structures and those with currently excluded arrangements. On balance, we therefore do not support this model at this time.

We do not recommend the 'distribution model' as outlined in the discussion paper, nor do we think that such a model is relevant to the policy of Division 7A. Such a model would introduce potential significant complexity and result in inequitable outcomes for small business taxpayers.

Further details of our submission are included in the Appendix.

Although not raised in the discussion paper, the related section 109 of the Income Tax Assessment Act 1936 excess payments to shareholders, directors and associates rules should be repealed. The provisions are outdated and are not necessary in a regime of progressive personal income tax rates.

Should you have any queries or would like to discuss this submission further please do not hesitate to contact in the first instance either Ian Burgess on (07) 3243 3711 or Tony Stolarek on (03) 8650 7654.

Yours sincerely

Ernst & Young

Appendix

Responses to discussion paper

All legislative references are to the Income Tax Assessment Act 1936 (ITAA 1936) unless otherwise specified.

1. Policy of Division 7A

[Question 2.2]

The policy that Division 7A is designed to prevent shareholders (or their associates) of private companies from inappropriately accessing the profits of those companies in the form of payments, loans or debt forgiveness transactions means inappropriately **accessing** profits as "disguised dividends". This is in accordance with section 108 which the Division replaced.

We agree with the discussion paper's analysis in respect of the policy that led to the introduction of Division 7A into the ITAA 1936 and the conclusion at paragraphs 2.49 and 2.50 that Division 7A does not have the sufficient distribution role held by the previous Division 7. Retention of profits in private companies is allowed in the same way that profits may be retained by public companies.

To suggest that private companies should be subject to a sufficient distribution regime is inappropriate and may lead to inequitable and unfair outcomes. A sufficient distribution regime that protects businesses while leading to fairer outcomes would likely involve significant complexity and resulting increased costs of compliance. However retention of profits in any company is legitimate whether for business or investment purposes. This has been a clearly understood feature of the tax law for the last two decades.

In addition, as identified in the discussion paper, the Australian business and tax landscape has changed significantly since Division 7 was repealed, including for example in respect of the use of trusts. It is not possible to overlay those rules, developed in a classical system, on the current tax regime without significant complexity as discussed below.

The likely adverse impact of any such sufficient distribution measures on small business taxpayers and subsequent flow on effects on the economy should be considered when analysing the revenue impact of this proposal.

2. Problems identified in the operation of Division 7A

[Question 4.4]

We commend the Board on its summary of the provisions and list of issues which it has compiled in chapter 4.

We have only a limited number of additional issues to raise.

Breadth of the associate rules and unit trusts

The discussion paper notes the issues raised concerning how the broad definition of associate results in Division 7A extending beyond what was intended (para 4.154).

We highlight that this broad definition may result in commercial issues where unit trusts are owned by companies. We note that our observations below extend equally to unit holders that are trusts with direct or indirect UPEs to companies.

Companies that make loans to unit trusts in which they only have a minority interest may be at a commercial disadvantage to other entities whose loan terms are not so regulated, in particular in start up cases where it is initially difficult for the trust to make repayments.

Where unit trusts are owned by multiple unrelated entities they may still be associates of each private company with interests in it and will be subject to the rules.

Where a company has units in a unit trust (or fixed interests in a fixed trust) the trust should only be an associate where there is greater than 50% ownership (together with associates) by a company of the unit/fixed trust. This would recognise that many groups structure business arrangements at arm's length using companies and unit trusts and it is inappropriate that such arrangements are subject to the confines of Division 7A.

2.1 Loan documentation requirements

The strict legislative requirements for the form of loans needed in order to meet the s109N excluded loan provision are unnecessarily onerous and should be simplified.

There should be no requirement that the excluded loans be made under an agreement in writing specifying all the current requirements of the section. This results in unnecessary costs of compliance including those incurred in obtaining legal services for such agreements.

That a loan has been entered into between the company and its shareholder or associate should be able to be evidenced by other means including for example by an exchange of letters or other correspondence (eg emails) and minutes of meetings. These documents could state that the loan is subject to either the 7 year Division 7A loan requirements without the need to have a loan agreement further spell out the specific terms. Alternatively, any subsequent minimum loan repayments would also be evidence of the loan. To the extent the minimum loan repayments are not met and interest not charged, this could then be a deemed dividend in accordance with section 109E.

2.2 Financial hardship discretion section 109Q does not apply to section 109D loans

As noted in the discussion paper, the Commissioner has a discretion to disregard a deemed dividend in certain hardship cases. Section 109Q provides this discretion only in respect of section 109E amalgamated loans.

However an issue arises where the requirements of section 109N are not met, including where a loan is not made within the required time for it to be an amalgamated loan. The "loan" (or payment that is to be converted into a loan) cannot be granted relief in accordance section 109Q and the taxpayer must attempt to be granted relief from the operation of Division 7A under section 109RB.

For example, a private company that is in financial distress or other hardship circumstances may, as a result of outstanding prior year income tax returns, have an earlier lodgment date of 31 October for a year rather than the usually expected 15 May in the following year lodgment date. As a function of the practical difficulties of such taxpayers in these circumstances they are likely not to have met the section 109N loan requirements by 31 October.

It would appear to be a simple amendment to extend the operation of section 109Q to section 109D loans, noting that the relief remains subject to the exercise of a discretion by the Commissioner.

2.3 References to 'lodgment day'

The various references in the Division to 'lodgment day' can create uncertainty because a company's due date can vary from year to year in accordance with the lodgement program. Further, an entity may prepare loan agreements and have them ready to be signed by the expected due date but fall foul of the rules because the return is lodged earlier than its due date.

A suggested alternative could be to have a reference to "the 15th day of the 11th month following the end of the income year" to improve certainty and to simplify the rules. This equates with the current latest time for lodgement for small companies and trusts on a tax agent's lodgment program.

2.4 Compliance costs – suggested limited carve out for small business

The costs of compliance to consider and apply Division 7A are significant.

The introduction of a limited carve out from some provisions of Division 7A for simple business structures that use private companies should be considered.

Division 7A was designed with extensive integrity rules which have grown significantly over time to include complex interposed entity and UPE provisions. These provisions have the potential to add significant costs of compliance which we expect contributes to many taxpayers not appropriately considering their application and therefore to not considering Division 7A as a whole. While such taxpayer groups might not be subject to these integrity rules when they are examined, the need to examine them increases costs and may be a disincentive to seeking appropriate advice on the rules.

A limited carve out might improve the accessibility of Division 7A if simple businesses were not required to consider or apply these integrity provisions. Such entities would still be subject to the Part IVA general anti-avoidance rules if for example they took steps to come within the carve out where it would not otherwise have applied.

We recommend that such an exclusion could be based on the company meeting the small business entity requirements of Division 328 of the ITAA 1997. This applies to taxpayers where they, together with certain associates ('connected' and 'affiliate' entities), have an annual turnover of less than $2million.

3. Division 7A reform approaches

3.1 Division 7A adjustment model

The proposed 'Division 7A adjustment model' approach to address the individual issues and problems in Division 7A has some attraction.

Division 7A is familiar to many practitioners and taxpayers and such an approach would build on their knowledge and experience rather than requiring a new regime to be learnt and implemented. As acknowledged in the discussion paper, many issues with Division 7A have already been dealt with so this would be a logical project to complete the reforms.

However we are concerned that this approach would require the significant resources of Treasury and would therefore likely be a lengthy process. We understand that there are many current tax reform projects with Treasury that have been progressing slowly because of resourcing constraints and more

recently Treasury has been impacted by new budget constraints that have pushed the expected development of other tax reforms back further.

We therefore recommend that this model would need to be implemented in at least two tranches in order to fast track the most pressing concerns within say the next year. The remaining less urgent reforms could then be completed at some stage after that.

We propose that the following issues should be included for these "interim amendments":

- Unpaid present entitlements (UPEs)
- Loans where the interest would be otherwise deductible to the shareholder/associate
- Mechanisms for relief in appropriate cases where the requirements of the provisions are not met including improving the application of the honest mistake concessions

3.1.1 UPEs

The treatment of UPEs and the interaction of the ATO's views and the specific Division 7A UPE rules and interposed entity rules should be addressed as a priority. The treatment of UPEs is a more recent and complex issue following the ATO's publication of its views in 2010 (with prospective application).

The key concern is that under the ATO's revised approach to UPEs, effectively two sets of rules need to be complied with (e.g. PSLA 2010/4 for the UPE with a company and Subdivision EA for loans made by a trust with a UPE to a company). Clearly only one set of rules should apply.

We consider the simplest approach is to legislatively clarify that UPEs do not constitute financial accommodation and therefore Division 7A does not apply to a UPE per se. Subdivisions EA/EB would remain to ensure any subsequent loans/payments by a trust with a UPE to a company are brought within Division 7A.

If the ATO view that a UPE is financial accommodation is preferred, then the legislation should clarify that subdivisions EA/EB do not apply in respect of those UPEs. If this approach was adopted, we submit there is still a case for concessional rules relating to the UPE. For example, the loan requirements of these "UPE loans" could mirror the requirements in PSLA 2010/4. This would allow for the continued funding of the trust by the retained funds representing the UPEs at a cost reflecting the use of those funds without the burden of continued principle repayments over the life of the loan.

Potential inconsistencies between dates for placing amounts on a sub-trust or loan could be resolved in the law (sub-trust required by 'main trust's' lodgment day (PSLA 2010/4) and section 109N loan required by company's lodgment day). As discussed above there should also be simpler rules for when and how "UPE loans" and excluded loans are required to be made (for example by making the date for all documentation to be "the 15th day of the 11th month following the end of the income year").

UPEs of prior years including pre-16 December 2009 UPEs should be grandfathered. Further, and only at the election of the taxpayer, these UPEs could be transitioned into the new rules over an extended period at the option of the taxpayer. For example a UPE currently being dealt with as a sub trust in accordance with TR 2010/3 and PSLA 2010/4 could be converted to a "UPE loan" prior to it becoming repayable in accordance with ATO practice (but without extending the original principal repayment term).

3.1.2 Loans where the interest would be otherwise deductible to the shareholder/associate

There are a series of circumstances where Division 7A may apply to arrangements in groups of associated entities that may not be expected nor anticipated by taxpayers, as they are not done for private purposes.

This includes in particular where funds are lent between entities to fund income producing activities.

It would assist simplicity if such arrangements were not subject to Division 7A and we believe this is consistent with the approach taken for loans to employees for FBT purposes.

An exclusion for loans between associated entities for otherwise deductible purposes should apply equally to business and investment purposes. This would also avoid unnecessary work and uncertainty where there are both business and investment activities in an entity, which is common.

If an exclusion was deemed not appropriate for loans with otherwise deductible purposes, then flexibility in loan arrangements, including in respect of the term of a loan and repayment requirements (i.e. interest only loans), would also promote simplicity and decrease costs to business.

Such an approach would also be simpler than amending the other exceptions including for example the section 109M exception for loans made in the ordinary course of business on arm's length terms. This provision is difficult for a private company group to come within in accordance with ATO views, even where the company acts as the group's in-house finance company and on-lends third party debt.

3.1.3 Relief in appropriate cases where the requirements of the provisions are not met

We agree that the reform of the approach of the section 109RB commissioner's discretion for an "honest mistake" or "inadvertent omission" should be a priority.

The operation of the provisions, following the ATO's publication of its views on the gateway terms to the relief, is not as broad as was expected in the consultation on the development of this relief. The nature of the relief being by a discretion and the absence of transparency by the ATO of when it has and has not exercised the discretion has also contributed to uncertainty and to a general reluctance to apply for the relief, notwithstanding the ATO's ruling and practice statement (however limited those views are).

The relief provided where the section applies should be able to be self assessed. That is, a taxpayer that identifies that they have not complied with Division 7A should be able to take action to place the payment or loan on appropriate Division 7A loan terms and to make a catch up payment as allowed by the ATO in its practice statement PSLA 2007/10. The current "honest mistake" and "inadvertent mistake" requirements should be replaced with a simpler integrity rule that would deny the use of the provision only in cases of deliberate manipulation of the availability of the relief.

The self correction would include the payment of assessable interest, on an accruals basis. This would help compensate the revenue for the non application of otherwise taxable Division 7A consequences. Self correction would also encourage taxpayers to address past Division 7A breaches and to come within the law.

Any remaining discretion should only apply where a taxpayer does not comply with the requirements of self assessing corrective action.

3.2 Statutory interest rate model

The main attraction of the proposed 'statutory interest rate' model would be to remove the significant complexity and resulting uncertainty of the range of interposed entity, other integrity measures and the current multiple specific exemptions.

The model would be more flexible than the current exclusion for excepted loans including section 109N complying loans, and should allow taxpayers to choose the terms of the loan and the resulting level of interest. As discussed above, onerous requirements for formal loan agreements should not be required.

Allowing interest only loans and the accruing of interest would also address some issues raised with the funding of minimum loan repayments under the current excluded loan rules.

UPEs could be dealt with by specifically including them as a loan from the company and allowing them to be put on terms similar to those allowed in PSLA 2010/4.

However, the mandatory charging of interest, at likely significantly higher interest rates than under the current benchmark interest rate rules, may cause commercial problems and is unlikely to be a sufficient trade off for taxpayers with simple structures. The rule would appear to impose Division 7A interest obligations in circumstances where a loan is not currently subject to Division 7A, including for example company to company loans. This will result in increased costs of compliance and potential inefficiencies.

For example, the interest charged by a business entity while deductible to that entity might contribute to the creation of non-groupable losses in that shareholder/associate. In some cases the charging of interest (deemed or actual) might create solvency issues. In other cases bank covenants might prevent the charging of interest.

The rule could be introduced with an otherwise deductible rule similar to that discussed above. A deemed dividend would not arise and interest would not be taxed to the company provided the associate is not an individual and is carrying on a business or using the funds for income producing investment purposes. However the strict tracing for the use of funds rules should not be required if this is limited to the funding of businesses. Rather a predominant use test should be used.

The 'distributable surplus' rules should be retained under this model for all loans, debt forgiveness and payments. Notwithstanding this, the complex interposed entity rules should be removed, to be replaced by the potential application of the Part IVA general anti-avoidance rules.

As noted in the discussion paper, the proposal does not address issues with the forgiveness of debt or payments (which are not loans) rules. Presumably this means that a 'Division 7A adjustment model' approach to address issues with those rules will still be required.

3.3 Distribution model

We do not recommend the 'distribution model' nor do we think that such a model is relevant to the policy of Division 7A.

Such a model would introduce potential significant complexity and result in inequitable outcomes for small business and other taxpayers.

The requirement to trace the use of funds would be very difficult other than in the most simple single business cases. Interpretation issues would include how excess "business funds" that earn interest and

other similar "passive" returns are categorised in particular where such income is earned for an extended period.

We question how wide the extension of permitted purposes to the active business purpose of a related entity would be and how other entities would qualify for grouping. If the current Division 7A approach of looking at associates is followed then this could be very wide, subject however to difficulties with being able to confirm such permitted use in the associate where the entities are not controlled by the same persons (a difficulty under the current rules highlighted above). At the other end of the scale a commonly controlled "group" limitation may not accommodate legitimate structuring by families.

We do not agree that retention of profits for passive investment should not be allowed in a private company. This will create great inequity compared to the unencumbered ability of public companies to retain funds for any purpose for the benefit of their investors.

The proposed model will need to develop its own concept of profits, which might be different to the Division 7A distributable surplus approach.

We do not agree that small business taxpayers and tax professionals should have to implement another new regime. This will introduce new unnecessary costs on business and the community. It will start a lengthy cycle of education and new uncertainty that will need to be dealt with by taxpayers, tax professionals and the ATO. Education and resolving uncertainty have been identified as a significant issue with the now mature Division 7A.

The proposal also only potentially addresses loans. We are uncertain from the discussion paper how payments and debt forgiveness will be treated however it seems likely that Division 7A would either continue to have residual application or each current payment and debt forgives circumstance would need to be specifically addressed, including the private use of assets.