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Dear Sirs

Post Implementation Review of Division 7A
Second Discussion Paper
Family Business Australia and KPMG response

Family Business Australia ("FBA") and KPMG Private Enterprise are pleased to provide our response to the Board of Taxation ("BoT") Second Discussion Paper "Post implementation review of Division 7A of Part III of the Income Tax Assessment Act 1936 ("Discussion Paper") March 2014.

KPMG's Private Enterprise practice has been working with family businesses for more than 100 years, helping them to navigate their challenges and determine a balance that suits their own unique family business model. Our client base includes a broad cross-section of some of the most successful and dynamic family businesses in Australia providing a significant contribution to the Australian economy via their output, tax contribution and employment.

Family Business Australia ("FBA") is the peak body committed to contributing to Australia's future through a dynamic and sustainable family business community. The strength and success of the family business sector is vital to the future of Australia's economy, community and culture.

KPMG has a long and established relationship with FBA. KPMG has sponsored eight national Family Business Surveys dating from 2005 to 2013. We are delighted to provide a joint response to this Discussion Paper on such an important issue for family businesses.

We have focussed our response to the discussion paper on the specific needs of family business groups in relation to Division 7A and the impact on typical family group structures.

We believe change is important to ensure family businesses are not adversely and inappropriately impacted by Division 7A. Hence, we value the progress being made in trying to solve and manage the complexities and unintended impacts associated with this Division.

We have provided our response in Appendix 1 and specifically focussed our comments to questions raised in Sections 4 and 6.

We would be delighted to discuss any aspect of this submission with the BoT. Please contact either of us on the numbers above.

Yours faithfully

Simon Le Maistre
KPMG
Partner

Yours faithfully

Robin Buckham
Family Business Australia
Chief Executive Officer

Appendix 1

Response to Discussion Paper

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

1. Introduction

We will focus our response to this Discussion Paper with respect to the impact of the proposed modification to the current Division 7A for family businesses.

Family businesses are most commonly defined as comprising of two or more members of the same family involved in the business with one or more related members having a controlling interest, and are not necessarily limited to a small and medium-size enterprise[1]. The family business sector accounts for around 70% of all Australian business with an average turnover of $12million per annum. The entire sector is estimated to be worth $4.3 trillion. Accordingly, this sector is very important for the growth in the Australian economy.[2]

Family trusts are an important vehicle in the structure of family groups. It is a cost effective way to manage asset protection and to conduct family trading businesses.

Funding is difficult to obtain for family businesses, and in many instances they rely on retained profits and family group monies to fund their operations and growth.

Accordingly, the key issue for family business and the impact of Division 7A is the ability to retain funds within the family group, specifically a family trust, without causing an unintentional tax burden.

The policy intent of Division 7A is to prevent shareholders (and their associates) of private companies from inappropriately accessing the profits of the company in the form of payments, loans or debt forgiveness. Since its introduction, other tax measures have been enacted, which we believe has resulted in Division 7A as an integrity measure diverging from its original policy intent. Importantly even when money is retained in business operations, these provisions can apply.

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[1] Mr David Smorgon, Generation Investments Pty Ltd, Committee Hansard, 14 November 2012, p.2.
[2] FBA website: http://fambiz.org.au

2. Important of Trusts to Family Business

Family trusts are a well-established vehicle for family group structures.

Trusts provide significant advantages for:
- asset protection;
- managing succession planning; and
- providing a mechanism for control of the business within the family group.

Family businesses often use trusts for conducting a commercial enterprise, as well as passive investment vehicles. For the larger family groups, a trust structure has been used as the financier for the whole group. For the 2012 income year, of the 753,000 trust returns lodged with the ATO, 40% were discretionary investment trust whereas a significant 32% were discretionary trading trusts.[3]

3. Businesses in Trusts for Family Businesses

Division 7A can apply where funds are utilised in a trust yet have only suffered tax at a corporate tax rate.

As an integrity measure, Division 7A primarily acts to protect the progressive tax base - the arbitrage between corporate tax rate of 30% and the individual highest margin tax rate of 46.5%. With changes in the business and tax landscape since the introduction of Division 7A, amendments such as Subdivision EA have been required to be introduced, going beyond, we believe the intent of the originally enacted Division 7A policy.

Subdivision EA is designed to ensure that amounts cannot be sheltered at a company tax rate by creating an amount of net income that is "presently entitled" to a company without actually paying it, and accordingly treats this amount as a deemed dividend to the ultimate shareholder. This aspect of Division 7A causes compliance and complexities for family businesses, and can trigger a taxing point that would not occur within companies.

The Australian Government has previously considered these problems with Division 7A for family businesses. In March 2013, the Parliamentary Joint Committee on Corporations and Financial Services published their review entitled "Family Business in Australia – different and significant: why they shouldn't be overlooked". The Committee recommended[4] that as part of the Division 7A inquiry, the BoT should review evidence on the impact of Division 7A on the family business sector. The Committee further recommended that the BoT should consider the

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[3] ATO tax trust return statistics
[4] Recommendation 12

measures require to support Australian family business and by extension the economy while giving due regard to appropriate tax obligations.

4. Funding difficulties for Family Businesses

An important challenge faced by family business groups is the difficulty in attracting affordable funding to operate and grow their business. Family business options for funds include lending from banks as commercial loans or bank overdrafts, raising capital and source funding partners.

There is a lack of competition in the banking sector with the Big 4 banks[5] offering little diversification in their product offering. Over 90% of family businesses bank with Big 4 banks[6], and after the lessons learnt from the GFC, banks are cautious and there are limits on amount of commercial loans and overdrafts available to family businesses from their primary banker. Hence, there is often a requirement for family businesses to gain funds from other non-traditional sources.

Family businesses are resistant to raising capital as this may dilute their control of their family business and open it up to non-family members. Furthermore, family businesses are very risk adverse and adopt a patient approach to any decisions in relation to capital injections with consideration of the impact on future generations.

Private equity is another funding source available to be considered for family business. Generally, private equity is more focussed on larger more mature businesses. The typical investment for private equity is in the $10-$20 million range and expected returns are three times the investment within a 3-5 year time frame. Such capital investment and growth horizons are not an appropriate strategic fit for a conservative, risk adverse family business. The KPMG and FBA Survey[7] identified that family businesses were not embracing of Private Equity funding due to the fundamental requirement to preserve the business for future generations.

Accordingly, family businesses usually rely on the use of cash flow and retained profits as sources of funds, supplemented with family loans. Division 7A can have an impact on retaining these funds within commonly adopted family business structures.

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[5] CBA, NAB, Westpac and ANZ

[6] MGI Survey, 2010

[7] KPMG and FBA Survey of Family Businesses 2009

5. Response to Discussion Paper

5.1 A coherent policy framework for guiding reform

5.1.1 Implications of temporary and permanent transfers and distributable surplus

Questions 4.3 and 4.4

We agree that with appropriate planning, temporary use of assets should be able to be managed without any complex calculations, otherwise they should be converted to permanent assets (4.39), and treated accordingly.

We suggest that the temporary transfer of income producing assets where associated expenses are "otherwise deductible", should not be subject to these new Division 7A provisions. This would be consistent with the treatment of loans to employees for FBT purposes and recent s109CA. This will greatly assist family business where the business operation may be funding an investment vehicle beneficially owned by the same family group.

We agree with the simplicity of approach by excluding unreleased gains from the calculation of distributable surplus. In the past, the requirement to include unrealised gains has caused undue complexity based on the need to source valuations – an expense and time requirement normally unnecessary except for the purposes of Division 7A.

Question 4.4 (c)

We consider the temporary transfer / removal of unrealised gain calculation approach would be more unduly complex than the current recommendation to calculate the distributable surplus and should not be adopted. In addition it would perpetuate the unnecessary cost and time associated with obtaining a valuation previously referred to.

Question 4.5

We strongly disagree that the distributable surplus should be tested at the end of **each** year. We consider that this will add unnecessary complexity beyond the current provisions, since all prior arrangements would be required to be annually examined. The outcome would seem inappropriate given that a Division 7A exposure may be triggered by future events that did not exist, and may not be anticipated at the time that the arrangement was originally entered into. This would be impossible to plan and budget for, and accordingly may have adverse cash flow impacts on the family business. Such an outcome seems contrary to the goals of this framework.

5.1.2 Deemed dividends and frankability

Questions 4.6

We agree that deemed dividends should be frankable.

We consider the prior treatment is contrary to the policy intent of Division 7A to protect the progressive tax systems. The inability to frank deemed dividends has introduced a penalty

instead of correcting the arbitrage between the company and highest individual marginal tax rate.

5.2 The transfer of value model

5.2.1 Complying loans

We acknowledge and welcome the simplicity of the proposed new methodology for complying loans. We believe that this simplified approach is a benefit to family businesses. However, loan attributes should still be consistent with any arm's length financial arrangements with third party lenders such as Authorised deposit-taking Institutes ("ADI's").

Question 6.1 (a)

We agree that reducing the documentation required for complying loans will be advantageous to family businesses. Often inadvertent non-compliance with such requirements can create a Division 7A exposure contrary to the intention of the taxpayer. We suggest that administrative guidance should be provided to taxpayers on the acceptable evidence that should exist for complying loans and such evidence should be general to avoid a replication of the current scenario. Hence, we consider that journal entries, financial statements, minutes of meetings etc. should be appropriate evidence.

Question 6.1 (b)

We acknowledge maintaining the interest rate throughout the life of the loan will assist with the simplicity of the calculation compared with the current principal and interest repayment model.

However, we do not consider a fixed interest rate to be consistent with commercial practice. A standard commercial loan would be permitted to be refinanced or moved to a variable rate. It would be highly unlikely that an arm's length commercial borrower would be locked into a fixed interest rate without any ability to renegotiate – particularly when looking at a 10 year period.

We suggest that to maintain the simplicity of implementation, but allow for economic interest rate fluctuations, the interest rate percentage could be revisited at each milestone as detailed in 6.19 dot point 5 i.e. three, five and eight years, and adjusted to reflect the new rate at this time point (both up or down).

Question 6.1 (c)

We acknowledge that the statutory interest rate suggested has been determined using commercial lending data. The use of this data should ensure a commercially competitive rate for the loan.

However, we note that the proposed interest rate is based on the "small business variable (other) overdraft" rate and the **higher** interest rate listed in the RBA's commercial lending data[8]. A

[8] www.rba.gov.au/statistics/tables/xls/f05hist.xls

review of the marketing collateral from the Big 4 banks indicate that these loans are unsecured, designed for emergency cash flow and repaid on variable and flexible arrangements. This is contrary to the framework around the Division 7A loans. We suggest a more appropriate interest rate based on the conditions of the Division 7A would be the "small business variable (other) term interest rate"[9].

We are aware that the risk of default of commercial loans can be mitigated by security over the loan and this nominally results in a reduction in the applicable interest rate. The adoption of the statutory interest rate does not distinguish between secured and unsecured loans and the statutory interest rate suggested is based on an unsecured loan. We believe that this may be again inconsistent with normal commercial terms. We suggest that if a loan is able to be secured, a reduced interest rate should be available. This interest rate reduction is supported by the RBA's indicator interest rates data already referenced by this framework.

Question 6.1 (d)

We acknowledge that the maximum term suggest of 10 years is a reasonable compromise between the existing 7 year (unsecured) and 25 year (secured) loan periods.

Question 6.1 (e)

We acknowledge the simplicity of the four milestones for repayments of a loan.

However, we note that the timing of the loan repayment may be detrimental to certain family business operations.

We agree that the milestone time points are appropriate for a standard family trading business operating through a trading trust.

However, for certain family business such as those undertaking property developments, returns may not start flowing within three years, once approval, building and sales timelines are taken into consideration. We have observed in property development businesses that commercial loan agreements are structured with final payment of interest and principal at the completion of the project with no interim payments. We would suggest that one way to cater for such an eventuality would be to have any repayments dependent on profit arising within the borrowing entity and not be able to exceed such an amount. We would propose that profit would be determined in accordance with accounting standards. This is similar to the concept of distributable surplus for Division 7A loans. Any deficiency and hence any potential deemed dividend would be capped at the level of profit not paid out.

Question 6.1 (f & g)

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[9] ibid

We support the suggestion of no specific annual principal payments and the accumulation of interest. We believe such flexibility mirrors the normal commercial terms of bank loans and supports businesses through changing economic times.

<u>Question 6.1 (h & i)</u>

We support the last two suggestions in relation to the shortfall payment and the timing of the payment linked to lodgement of the tax return.

<u>Transition arrangements</u>

We consider that transition arrangements should be put in place for current 7-year and 25-year loan arrangements. We suggest that these loans should be grandfathered. There may be very real difficulties in refinancing 25 year loans in certain instances. Furthermore, there would also be compliance costs and complexity in dealing with these pre-existing arrangements.

5.2.2 UPEs

<u>Question 6.2</u>

We acknowledge that the policy intent has been managed for the simplicity of implementation by treating all UPEs as loans compared with the existing s109 EA and s109 XI.

We support the need to maintain the current s109T in relation to interposed structures and multiple excluded trusts. We acknowledge that this measure will add to the complexity compared with the policy intention of this paper, however, this detail will be required to avoid the risk of potential abuse. This requirement does not seem to be any more complex than the current requirements.

We suggest that the timing of the repayment of the UPE to **not** result in a deemed dividend as per 6.30 should be considered by the time that the **company** tax return is due for lodgement. This should be the point in time where the exposure to a deemed dividend is actually triggered and not at the time of the trust return. This would also reduce complexity and risk of inadvertently missing the time point and creating a deemed dividend.

We acknowledge that the new arrangements may create three categories of UPE's:

- pre 2009 quarantined UPEs;
- current UPE; and
- new UPE to loan arrangements.

We consider that requiring pre-2009 UPE's to convert to the new arrangements, may have an adverse impact on cash flows for some family businesses. We suggest that pre-2009 UPE are instead grandfathered, and should not be required to convert to the new arrangements.

We also suggest that the administrative treatment of the ATO should be reflected in legislation[10].

We consider that any current sub-trust arrangements should continue to be subject to the existing requirements, and that the approach receive legislative backing.

5.2.3 Exclusion – Loans made to trusts (Tick the box option)

Question 6.3

As outlined, trust structures may have issues with funding of operations and growth initiatives. We agree that allowing UPE's to be retained by trusts without any tax disadvantages would assist with this funding issue and **strongly** support such an approach.

We have observed this need is not limited to trading trusts, but also other trust vehicles. One example would be a trust that acts as the financier for the family group.

We suggest that this "tick a box option" be available to all trusts that are willing and able to meet the required exclusion requirements.

The proposal aims to treat the excluded trust as a company by applying the company tax rate and forgoing the CGT discount as stated in 6.35. We agree that this seems a reasonable compromise between retaining funds for business purposes and a tax rate of 30%.

We suggest that the definition of goodwill be clearly stated to ensure no ambiguity. We have recently experienced the goodwill debate during the introduction of the "rights to future income" legislation. The BoT agreed that customer relationships, know-how, and customer contracts subject to renewal are in the nature of goodwill[11]. For accounting purposes, goodwill is required to be split into a range of separately identifiable assets. We strongly suggest that a definition of goodwill is legislated.

We acknowledge that goodwill will remain subject to the 50% discount due to value that this asset represents to the business of the trust. We suggest that this concept should not be limited to goodwill and include other business assets that provide enhanced value through the trading business.

We support the need to maintain the current s109T in relation to interposed structures and multiple excluded trusts. We acknowledge that this measure will add to the complexity compared with the policy intention of this paper, however, this detail will be required to avoid the risk of potential abuse. This requirement does not seem to any more complex than the current requirements.

Question 6.3 (e)

We support the concepts outlined in the transitional rules.

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[10] PS LA 2010/4

[11] Review of the consolidation rights to future income and residual tax cost setting rules. A report to the Assistant Treasurer, BoT, May 2011

Furthermore, we suggest that transitional provisions should be considered for trusts containing both business assets and "lifestyle" (non-business/non income producing) assets. We propose that the taxpayers should be permitted to set up a separate trust to allow separation of "lifestyle" assets from business assets without any adverse tax consequences on transfer (i.e. through provision of a specific rollover relief for a transitional period). This will allow the taxpayer to treat each trust separately and not taint the trading trust with "lifestyle" assets. We anticipate that the compliance costs for the trading trust would be reduced, if the lifestyle assets could be quarantined in this manner.

5.2.4 Self-correction mechanism

Question 6.4

We agree with the overarching concept that there should be a self-correction mechanism for any mistakes or omissions in the application of the Division 7A based on the complexity of the implementation this legislation. Such a mechanism should undo the deeming of a dividend.

We suggest that eligibility requirements for self-correction should be fair and equitable to **all** taxpayers. We believe that there should be an objective standard on taxpayers that may be omitted from the self-correction mechanism and not a subjective threshold as outlined in 6.57.

The current s109RB and PSLA 2007/20 view have proved to be difficult to apply in practice.

We suggest that the corrective action could instead include bringing all tax affairs up to date, such as lodgement of outstanding returns and payment of shortfall amounts and associated interest charges prior to such action. This can then objectively demonstrate that the taxpayer is seeking to be compliant with all obligations.

In relation to outstanding Division 7A exposures, the corrective action should also include that for all current complying loans, the principal and interest payments should be completely up to date.

We consider that if the taxpayer is prepared to undertake prescribed corrective action within a specific period of time, such as three to six months, then the self-correction should be available. We feel this is a reasonable outcome. We believe such an approach will also encourage ongoing compliance with Division 7A even when historical oversights or errors have inadvertently occurred.

This methodology would be more prescriptive than the existing s109B and allow for a more objective interpretation of the eligibility criteria to adopt the self-correction regime.

We suggest that any self-correction would be limited to the current amendment period of four years.