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Dear Sir or Madam

Submission in relation to Post Implementation Review of Division 7A

Thank you for the opportunity to provide comments in relation to Division 7A. The comments in this submission are largely from a high level perspective. The various technical issues are dealt with at length in the Board's Paper and will, no doubt, be dealt with in other submissions.

Background on Greenoak Advisory

Greenoak Advisory is a specialist tax practice established by Ray Cummings. The practice focuses on tax consulting advice for private businesses and their owners. Ray Cummings has over 30 year's tax experience including 15 years as a tax partner at Pitcher Partners in Melbourne and has advised many clients on both Division 7A and section 108 issues.

Overview

The key issues in relation to Division 7A outlined in this submission are as follows:

- complexity
- compliance costs
- understanding the policy objectives
- the penalising nature of the provisions
- various technical and interpretive issues

The key comments on each of these areas are detailed below. In our view, any review of Division 7A needs to be folded in to the broader review of the taxation of trusts.

Key Issues

1. Complexity

   This arises for a number of reasons including:

   a) the provisions have been changed, amended and expanded many times over many years
   b) the language of the provisions is approaching the incomprehensible
   c) many of the concepts at which the provisions are directed are exceedingly complex

   Given all of these issues, it is hardly surprising that provisions are a mystery to most tax payers and indeed many professionals. Any amendments which make the provisions easier to understand, easier to apply and less onerous would be more than welcomed by advisors and business owners alike.

2. Compliance costs

   Tax payers need to pay their advisers, often significant sums of money, to analyse loan balances, arrange loan agreements, principal and interest repayments and the like and generally explain the operations Division 7A. This can often more than double the cost of their annual compliance. It adds nothing to business and quite often nothing to the Revenue. This cost is compounded by the almost constant changes to the provisions and changes in the ATO approach to interpretation and application of provisions.

3. Understanding the policy of the provisions

   At the highest level, tax payers do understand that if they draw money out of a private company and use those funds for private purposes, the provisions should come into operation. However, where the funds are applied for investment or business purposes, they mistakenly have a view that there should not be a problem. In their view there is no "tax mischief".

   The tax policy of the provisions has become obscured over the years as it has been progressively amended. Quite often it is more than a little difficult to work out whether a particular transaction or event is meant to fall within the provisions. This is made even more difficult by frequent obtuse language in the legislation. Likewise, it is often easy to inadvertently fall foul of the provisions on particular transactions which, on their face, appear innocuous.

   The Paper highlights the terms of reference stating that the purpose of Division 7A is to prevent taxpayers" inappropriately" accessing company profit. The Board asks for comments on what might be "inappropriate". This actually begs the policy question. One needs to go back to the policy behind the introduction of Division 7A. On a reading of the Explanatory Memorandum, it appears Division 7A was introduced as a self executing provision to replace the deficiencies in section 108 rather than dealing with "inappropriateness". There does not appear to be any reference to "inappropriateness' in that material. If this analysis is correct, an examination of degrees of "inappropriate" would seem to be irrelevant for current purposes. This would then take the analysis back to the section 108 purpose which was, broadly, to tax "disguised" distributions of profit.

A fairly straightforward example highlighting the issues of policy, mischief and operation of the existing provisions is as follows:

> *Company XYZ has a property purchased exclusively from bank borrowings. The company has no retained profits. The property has increased in value and the bank is prepared to advance additional amounts to the company with the property as security. The shares in Company XYZ are owned by the XYZ family trust. Company XYZ makes a loan to the XYZ family trust.*

The existing provisions would lead to a conclusion that Company XYZ has a distributable surplus being the increase in value of the property. The loan made to the XYZ family trust clearly falls within the terms of Division 7A.

It is difficult to see the mischief underlying the transaction. On one view, the company would have revalued the property and paid a dividend. This which would not be able to franked as the company has no franking balance in this example. Such an outcome would be the same as the Division 7A deemed dividend outcome.

However, is unlikely to be the commercial outcome. Faced with the prospect of an unfranked dividend, the XYZ family trust could approach the bank to carry out the transaction in a different way. Given the increasing value of the property, the shares held by the XYZ family trust would also have increased in value. The bank could take a lien against the shares and lend the money directly to the XYZ family trust. If this were to occur there would be no Division 7A issue.

Commercially, the outcome is essentially the same for all parties but, from a tax perspective, they are very different.

In the context of this example, it is difficult to determine what behaviour is appropriate and what behaviour is inappropriate.

4. Penalty nature of the provisions

The above issues are compounded by the fact that failure to comply with Division 7A gives rise to an unfranked dividend. This means taxpayers can face a tax impost of around 63 cents for every dollar earned by the company (before penalties and interest). This was clearly a policy decision but seems excessive particularly in relation to events which are often inadvertent. Faced with that prospect, taxpayers every time would choose to pay out the dividend so the effective rate was only what it should be at 46.5%. Once Div 7A applies to deem a dividend, they no longer have that choice. This issue is often raised as a big stick in a broader audit context to convince taxpayer to settle on other issues.

The Board at paragraphs 5.20 and 5.21 indicates that this policy treatment is appropriate as it prevents certain types of behaviour. However, in our view, the position should be no different from any other tax position. If an amount is advanced and turns out to be a dividend and is able to be franked, the taxpayer is then exposed to potential top up tax, penalties for not having a reasonably arguable position and also shortfall or general interest charges. This would be no different from a tax payer taking a stand on any other tax issue which was subsequently overturned by the ATO. The taxpayer is penalised for their “inappropriate” behaviour.

5. Technical and interpretive issues

   As stated above, these issues have been comprehensively documented in the Board’s Paper and elsewhere so are not covered in this submission.

   Taxpayers and advisors would welcome any changes which alleviate all or some of above. Advisors often bear the brunt of provisions and apart from headaches often have a financial loss as taxpayers are not prepared to the pay full amount for “fixing up” Div 7A issues. The fees spent on Division 7A compliance often mean clients economise on fees they would otherwise pay for other services. These may be services that may be more beneficial to their business and to the community in general.

Reform Alternatives

1. Division 7A adjustment model

   As outlined above and at length in the full paper, there are many deficiencies with the existing Division 7A. In our view, the adjustment model would be inadequate to address all of these. In fact, it would only compound the issues because unless conducted very carefully, it could represent a patchwork over the existing provisions. The existing provisions need to be scrapped and re-written.

2. Statutory Interest model

   This model would be welcomed by most taxpayers and advisors as it would greatly reduce complexity and compliance costs. It would also provide certainty and comparative simplicity of operation.

   Taxpayers certainly see no difference between passive and active assets. To the extent that funds are drawn for private purposes, the interest will be non-deductible, thereby providing a commercial disincentive for taxpayers to draw money such purposes or pay the price if they do.

   Having said that, there is a question mark over the policy outcome and whether or not this alternative would achieve that outcome.

3. Distribution model

   This model, on its face, would appear fraught with difficulty and complexity. In the first place, defining “permitted purposes'” is likely to be a difficult process. It will potentially be both prescriptive and limiting in nature.

   The other issue is the intention that acquisition of passive assets would not fall within permitted purpose. In our view, there should be no distinction between passive assets and active assets as the tax issues are the same. The Board’s Paper seems to indicate that retention of profits for use within an active business, particularly in a trust context ,should be permitted whereas acquisition of passive assets should not because the ”top up” tax will emerge in the former case but not in the latter. As a matter of logic and as a matter of practice, there is no distinction between the funds used for an active asset or for a passive asset. In some cases, the top up tax will emerge and in others, it will not.

Concluding remarks

While it may be possible to deal with Division 7A reform in isolation, given the complexities outlined in the Board’s paper, it would appear that solving one problem may create another. Any amendments of substance to Division 7A would need to be considered in light of not just the “vanilla” company loan situation but also the broader issues relating to taxation of trusts.

We would be pleased to discuss these issues in more detail if required and can be contacted via e-mail or on 0417 537 141.

Yours sincerely

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