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The Board of Taxation
C/ The Treasury
Langton Crescent
PARKES ACT 2600

By email: taxboard@treasury.gov.au

Submission on second discussion paper "Post-Implementation Review of Division 7A".

The IPA welcomes the opportunity to provide a submission on the abovementioned discussion paper. The IPA has advocated in its pre-budget submissions for a review of Division 7A for some time and supports the review wholeheartedly.

The IPA is a professional organisation for accountants recognised for their practical, hands-on skills and a broad understanding of the total business environment. The IPA represents more than 26,000 members and students nationally and in more than 51 countries. IPA members work in industry, commerce, government, academia and private practice. Over two-thirds of our members work in or with small business and SMEs and are recognised as the trusted advisers to these sectors. Through representation on special interest groups, the IPA ensures views of its members are voiced with government and key industry sectors and makes representations to Government including the Australian Taxation Office (ATO), Australian Securities and Investments Commission (ASIC), Australian Competition and Consumer Commission (ACCC) and the Australian Prudential Regulation Authority (APRA) on issues affecting the profession and industry.

The IPA welcomes the broader terms of reference for this review which takes into account the interactions of Division 7A with other areas of tax law, in particular the trust provisions. The interactions with trusts must be factored into any review of Division 7A.This acknowledges the common business structure of having a trust

which earns the income that is then distributed to a company rather than directly to an individual. The use of this bucket company arrangement is now a source of significant complexity and uncertainty for many small businesses. According to ATO statistics for the 2011 year of income, there are 52,209 companies reported as receiving distributions from trusts.

We are pleased with the removal of the revenue neutral outcome which places unrealistic conditions on the various reform options under consideration. These conditions hamstrung the previous review and have given the Board of Tax the opportunity to propose a new model without the constraint of the revenue neutral requirement that was stipulated in the first discussion paper's terms of reference.

The high compliance and administrative costs associated with Division 7A warrant a review of its provisions. It is pleasing that the Board has acknowledged that Division 7A can be a significant source of compliance costs for small businesses, even for those that comply with its provisions.

Division 7A was introduced in 1998 as an integrity provision designed to ensure that private companies would no longer be able to make tax-free distributions of profits to shareholders and their associates in the form of payments, loans and forgiveness of debt. If triggered, these amounts are treated as unfranked dividends assessable to the shareholder unless the loan, payment or debt forgiveness comes within specified exclusions. Division 7A was always intended to protect and enhance tax system integrity rather than raise revenue. It however represents one of the more commonly encountered problem areas for practitioners dealing with small businesses.

Since its introduction, there have been number of amendments which have turned Division 7A into a highly complex body of law that many practitioners fail to fully comprehend. Bringing Unpaid Present Entitlements (UPEs) to corporate beneficiaries into the Division 7A net has also significantly increased compliance costs for small businesses using trust structures. We concur that Division 7A,

largely because of its complexity, is unduly difficult for businesses to comply with, and for the ATO to administer.

It is reassuring that the second discussion paper takes the view that the protecting the progressivity of the tax system should not be at the expense of impeding the ability of businesses to reinvest their income as working capital. Facilitating reinvestment supports productivity and entrepreneurial growth. We welcome the removal of impediments to the reinvestment of business income as working capital. It is encouraging to see that the discussion paper includes this as one of the four key policy objectives to guide future reforms of Division 7A.

We acknowledge the analysis done of the previous proposed models under the revenue neutral constraint. The IPA was supportive of the Statutory Interest Model as it would greatly reduce complexity and compliance. We however appreciate that it can fail to disincentivise the accumulation of passive income for private purposes which offend the progressivity principle of our tax system.

Our detailed comments on the second discussion paper are set out below.

- **Complying loans**
  - We support the proposed flexibility around repayments acknowledging that it is not always commercially realistic to make annual payments of interest and principal in the early years;
  - We support the removal of the need for a formal loan agreement to be executed. We agree that a written or electronic record to support the making of the loan detailing the terms and conditions will be sufficient;
  - We support the preservation of the exclusion for loans that are repaid by the due date for lodgement of the tax return;
  - We support one maximum term for loans of ten years to simplify the existing seven year unsecured and 25 year secured loans;

- Setting the interest rate at the start of the loan and leaving it fixed over the term of the loan provides for more simplicity and certainty
- The prescribed maximum loan balances as outlined in the discussion paper provide for a reasonable flexible repayment schedule in contrast to the existing requirement to make minimum yearly repayments of principal and interest.

- **Unpaid Present Entitlements** (UPEs)
  - We wholeheartly agree that legislative clarification of whether UPEs constitutes financial accommodation for the purposes of Division 7A is essential. This will remove any uncertainty under the current law. The IPA has been advocating for this since 2009 when the ATO changed its interpretative position on UPEs. The administrative practice statement developed by the ATO (PS LA 2010/4) would then not be required, eliminating the need to create sub-trusts and comply with the conditions outlined in these administrative practices. Greater simplification, certainty and policy coherency would result from legislative clarification which is long overdue;
  - UPEs should be afforded the same treatment as loans if they are repaid by the time the trust tax return is due to are lodged. There is no reason UPEs should be treated any differently from a policy perspective;
  - The limited exception rule to deal with trading trusts that retain UPE funds solely to meet their working capital funding, represents a good way to overcome existing impediments to reinvestment in the business and is to be commended. The IPA's preferred policy position has been that the retention of funds within a group should not be subject to Div 7A unless there are transfers of value by way of asset usage or debt forgiveness in favour of the trust.The opt in or 'tick the box' option is a sensible trade-off to exclude UPEs from Division 7A. Trusts which use the 'tick the box' option will have loans including UPEs excluded from the operation of Division 7A on the

proviso that the trust forgoes the CGT discount on capital gains arising from assets other than goodwill held within the trust. If applied purely on a prospective basis, we support this trade-off as a reasonable compromise of dealing with UPEs. From a policy perspective it makes sense, in that if the funds were in the company there would be no access to CGT discounts. We understand that there would need to be some integrity rules to ensure that the exception operates as intended but in the main should result in a more streamlined approach for entities using UPEs for working capital purposes. This exception allows for funds to be retained internally within private groups without the need to re-pay principal at any point in time. This is a more commercially acceptable option with respect to repayment of loans than is currently available under ATO guidance. The current ATO administrative practices contained in PS LA 2010/4 provide three investment options; with the majority of taxpayers choosing option 1 or 2. Both these options are interest only, requiring repayment of the principal at the end of 7 or 10 year terms respectively. The removal of the obligation to make repayments will eradicate existing impediments to the reinvestment of income as working capital. Facilitating reinvestment will better support productivity and entrepreneurial growth of small businesses.

- Deemed dividends frankable
  - In the advent that Division 7A is triggered and amounts are treated as deemed dividends, there appears no reason why such amounts should not be allowed to carry franking credits. The automatic franking of deemed dividends would ensure that such distributions would only be subject to top up tax. This would alleviate the need to apply for the Commissioner's discretion to treat such amounts as frankable distributions (Commissioner has a relieving discretion for honest or inadvertent omission). The existing penalty regime would still apply to act as deterrent for false and misleading statements

and/or not exercising reasonable care to ensure that there remains a disincentive for companies that seek to make disguised transfers of value to associates.

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- Self-correction mechanism
    - We support a legislated self-correction mechanism to enable practitioners to correct any genuine mistakes or omissions without having to request the Commissioner of Taxation to exercise general discretion in order to avoid a deemed dividend. This will avoid an unnecessary cost of compliance in cases where taxpayers have not deliberately ignored or attempted to circumvent the rules. The ATO administrative practice in which taxpayers who met prescribed eligibility requirements were given the benefit of general discretion without the need to seek the Commissioners discretion is a good starting point for the design and administration of a legislated self-corrective provision. A self correction mechanism would reduce compliance costs and allow taxpayers to put in place complying loan agreements.

- Transitional Issues
    - Big issue for our members would be how to take advantage of not having to repay existing UPEs that comply with PS LA 2010/4. This administrative ruling requires repayment of principle in year 7 or year 10. The repayment of these UPE loans will cause cash flow issues for small business.

- Rewrite of Division 7A
    - Once a coherent policy framework has been established, the Division 7A provisions should be rewritten into 1997 ITAA in a clearer and simpler manner to minimise the compliance burden whilst helping to protect the integrity of the tax system. The policy intent of ensuring that companies do not make tax free distributions to shareholders

can still be maintained whilst the provisions are cleansed of complex technical/interpretative difficulties and uncertainties.

The IPA has a small business focus and the cost of complying with the provisions contained in Division 7A is of a major concern to our members servicing small business clients.

In broad terms, there are a lot of positives that can be drawn from the second discussion paper. A move away from the existing prescriptive and at times inflexible, non commercial based rules is a welcomed step forward.

As stated in the discussion paper, these reforms are intended to support growth and jobs by making the system simpler, reducing compliance costs and making it easier for small businesses to reinvest business income as working capital.

The IPA welcomes the opportunity to discuss further, any of the matters we have put forward in our submission. Please address all further enquires to me. (tony.greco@publicaccountants.org.au or 0419 369 038).

Yours sincerely

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