KOUSTAS+CO
CHARTERED ACCOUNTANTS

Koustas & Co Pty Ltd
ABN 91 139 889 037
Level 9, 636 St Kilda Road, Melbourne Victoria 3004
PO Box 6750, St Kilda Road Central, Victoria, 3004
T: +613 8530 1600 F: +613 8530 1616
E: enquiry@koustas.com.au
www.koustas.com.au

9 May 2014

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

Dear Sir/Madam,

POST IMPLEMENTATION REVIEW OF DIVISION 7A

We appreciate the opportunity to provide comment in relation to the "Post Implementation Review of Division 7A of Part III of the Income Tax Assessment Act 1936" – Second Discussion Paper, and also the broader framework within which this division operates.

BACKGROUND

Koustas & Co is a chartered accounting and business advisory firm committed to helping privately-held businesses and their owners maximise business performance and value. We provide a broad range of accounting and consulting services to family businesses, SME's and mid-market companies which provides us with significant exposure to the practical effects that Division 7A has upon private business. This includes the impact of compliance, the costs of which are borne by the taxpayer, even though in many cases, there isn't any actual tax malfeasance. Due to our deep and ongoing engagement with this segment of the economy, the practical implementation and management of Division 7A and Unpaid Present Entitlements is both a constant consideration and of utmost importance to our firm.

PREAMBLE

We welcome and strongly encourage any attempt to both rewrite the Division 7A provisions in a more simplistic form and review the broader environment within which private businesses operate. We firmly believe the five proposed reforms outlined in the discussion paper would significantly improve the operation of Division 7A and assist both taxpayers and advisors alike.

A unified set of rules dealing with the private use of business profits and simple and flexible complying loan rules would certainly assist in achieving the stated tax policy aim of simplicity. Similarly, providing trusts with an option to retain profits taxed at the company rate would address the tax policy aim of equity. These rules are an important consideration for SME taxpayers, especially in recent years (due to the release of Taxation Ruling TR 2010/3 and Practice Statement PS LA 2010/4) Clarification and simplification would eliminate inadvertent omissions, reduce administration cost and improve overall compliance in this area by returning the focus to the intended integrity measures.

The transitional rules will require careful planning so as to avoid replacing the existing complexity with further complexity.

All of the proposed reforms serve the aim of efficiency, and this aim would be particularly satisfied by the introduction of a self-correcting mechanism. We also believe that a self-correcting mechanism should be part of the transitional rules in some way, to assist in correcting some inequity that arose due to the interpretation of complex Division 7A provisions.

RESPONSE

We now address a number of specific questions raised in the second discussion paper.

QUESTION 4.1 – TAXING BUSINESS ACCUMULATIONS AT A COMPANY TAX RATE

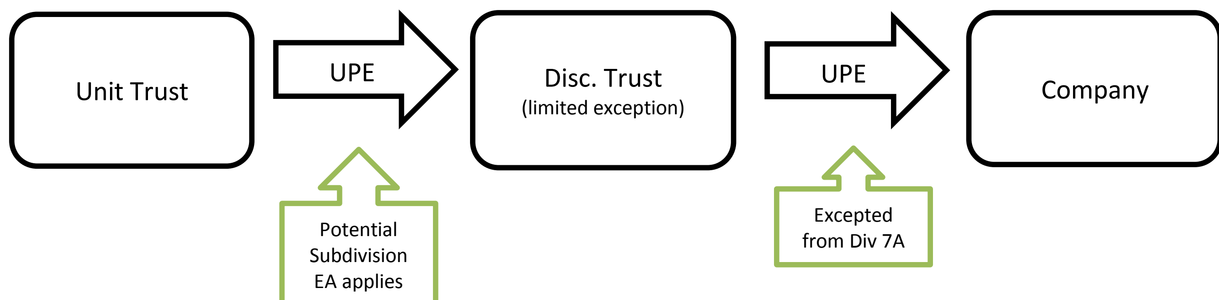
We believe that taxpayers should not be disadvantaged as a result of the structure they have chosen to operate their business from. The current practical issue arising from the Commissioner's interpretation of Division 7A in Taxation Ruling TR 2010/3, is that trading trusts are greatly disadvantaged, as they cannot effectively retain profits for working capital purposes.

Businesses trading through a company structure have ready access to working capital as a result of a flat company tax rate of 30%.

The same business operating out of a trust structure would be subject to the top marginal tax rate if it retained business profits, under section 99 of the ITAA 1936. A common scenario is for trusts to appoint income to a private company, creating an Unpaid Present Entitlement ("UPE"), and retain funds within the trust for working capital requirements. This requires a complying loan agreement or a sub-trust arrangement, with administrative complications and unnecessary cost for business.

Even in the event that the proposed limited exception and "tick the box option" outlined in Chapter 6 is implemented, a potential complication can be demonstrated by way of the following example involving a chain of trusts: -

- A fixed unit trust ("UT") is a trading entity;
- The units are owned by a discretionary trust ("DT");
- UT retain profits for working capital requirements;
- UT appoints income distributions in accordance with the trust deed to the DT;
- DT subsequently appoints income distributions to a private company;
- This creates a UPE between the UT and the DT, <u>and</u> a UPE between the DT and the private company;
- The UT would not be in a position to elect to apply the limited exception since there are no loans between the UT and the company;
- If the DT makes this election, there is a potential that Subdivision EA could apply, as the DT has a debit loan (UPE) with the UT (an associate). Refer illustration below.



It would seem that the only option to ensure compliance in the above example would be to put a complying loan agreement in place between the UT and the DTs. Removing the application of Subdivision EA <u>would not</u> be prudent, as that could lead to abuse of the limited exception in the way that another trust or related individual could access funds from the DT.

The above example highlights the inequality between trusts and companies, in direct conflict with two of the goals of the Board of Taxation's proposed policy framework, namely: removing impediments to the reinvestment of business income and maximising simplicity.

Many businesses have operated through trust structures for decades. These businesses are currently left with no choice but to adopt the Commissioner's guidelines in PSLA 2010/4, despite the Taxation Ruling upon which it is based having been widely and publically criticized in the legal fraternity as a complete contradiction of the underlying legislative purpose of the Division 7A provisions, "…supported by legally flawed arguments..."

Many taxpayers have decided to restructure their affairs to overcome the uncertainty surrounding the Commissioner's views, unnecessarily adding to the administration and professional costs in doing so.

We fully support the taxation of business accumulations at a company tax rate - irrespective of the structure chosen. Taxing retained profits in trusts at the company tax rate would remove complexity and administration of the UPE management process, and the need to appoint a trust's income to a private company simply to satisfy the form (as the physical cash is needed within the business). This would further simplify the way private businesses operate and would no doubt reduce their associated compliance costs.

Using the above illustration, the implications would be as follows:

1. There would be no distribution or appointment of income by the unit trust;
2. Income would instead be accumulated in the unit trust;
3. A flat 30% tax rate is applied to the amount accumulated;
4. There would be no UPE between the unit trust and discretionary trust and therefore no loan;
5. Subdivision EA would not be applicable

We recognise that treating trusts as companies in a wider sense would be complex and involve broader taxation matters outside the scope of the current review. Integrity measures and access to the franking system would be among the key challenges to overcome. Clearly Division 7A should still apply if retained profits are accessed by related parties for private purposes, consistent with the treatment in a company structure. Nevertheless, we feel that the option for business trusts to be taxed at the company tax rate should be explored.

Similar to the proposed "tick the box" reform, it would be important that trusts be required to make an election and those that elected to adopt this treatment would retain access to the general CGT discount on business goodwill.

Extension

We realise that the following might be outside of the scope of this review, however, it is relevant to the broader tax framework in which private business structures operate. Based on our experience, the most likely reason for a business choosing to trade through a trust structure is the ability to access the 50% general CGT discount under Division 115 of the ITAA 1997.

Without delving into a deeper discussion point regarding the rationale behind the concessional taxation of capital profits in the first place, and the ineligibility of corporate structures for this general CGT discount, we believe that providing a mechanism for companies to access a 50% CGT discount on goodwill only would shift the preference for SMEs to adopt trusts back to company trading structures.

The benefit of the CGT discount should be able to be passed on to the shareholders - similar to the operation of the 15-year small business CGT exemption.

The revenue impact and tax outcome of this proposal would not be significantly different to the outcome of the "tick the box" option proposed in this paper, but it would certainly simplify structuring requirements and the compliance impost for privately-held businesses.

QUESTION 4.2 – PROPOSED POLICY FRAMEWORK

Attempting to clarify the policy framework relevant to private businesses could assist in the future development of policies more consistent with the overarching tax objectives. It would also assist in the evaluation of proposed changes and current deficiencies.

We have commented below on each of proposed goals with reference to the stated tax policy aims of:

(i) efficiency;
(ii) simplicity; and
(iii) equity.

GOAL 1

Ensure that the private use of company profits attracts tax at the user's progressive personal income tax rate.

The original intention for the introduction of Division 7A is still highly relevant. Integrity measures are important to ensure equity outcomes for taxpayers. If company profits are accessed and enjoyed by shareholders, the equity aim will only be satisfied if they are ultimately taxed in their own right. Private use of business income doesn't support the efficiency aim, as instead of supporting entrepreneurial growth, it merely supports the accumulation of private wealth.

GOAL 2

Remove impediments to the reinvestment of business income as working capital.

We support taxing business accumulations at a company tax rate, irrespective of the business structure chosen. This goal supports the equity of the tax system. Improved access to working capital also supports business growth, satisfying the efficiency aim.

GOAL 3

Maximise simplicity by reducing the compliance burden on business and the administrative burden on the Commissioner and other stakeholders.

The many amendments and changes in the interpretation of Division 7A over the years have contributed to an expensive administrative and compliance burden being foisted upon taxpayers clearly not contemplated by the original legislators. Many taxpayers do not understand the associated tax implications that can arise as a result of routine business decisions undertaken for commercial reasons. In our experience, some practitioners are struggling to stay abreast of the changes, tax implications and compliance measures required to address them. Simplifying legislative provisions and their operation would clearly serve both the simplicity and efficiency aims.

GOAL 4

Provide no advantage to the accumulation of passive investments over the reinvestment of business profits in active business activities.

This goal adequately serves the efficiency aim. Currently, it seems that some safe-harbour options for dealing with UPEs via sub-trust arrangements, set out in PS LA 2010/4, support passive investments, such as real property.

Due to the inability of trusts to retain profits in a tax efficient manner, business profits could inadvertently be "trapped" in UPEs to corporate beneficiaries under these safe-harbour options. Providing legislative clarification in this area and greater simplification of the rules would serve this goal.

QUESTION 6.1 – THE TERMS AND CONDITIONS FOR DIVISION 7A LOANS

a. Removal of the requirement for a formal written loan agreement would simplify compliance and reduce costs to taxpayers, as the construct of a complying loan agreement generally requires a solicitor's involvement. We believe that a loan amortisation schedule specifying the term of the loan, interest and repayments would be sufficient evidence of the existence of the loan.

b. Setting the fixed statutory interest rate at the beginning of the loan would simplify ongoing calculations. However, it has the potential of becoming very unfavourable for a taxpayer in the event market rates decrease significantly over time (as it has since 2008). With that in mind, there should be a mechanism allowing "refinancing" of Division 7A loans, as required by the taxpayer.

c. We strongly believe that the statutory interest rate should reflect the commercial interest rate available in the market. The question that taxpayers might (reasonably) ask is: Why borrow from a bank when an associated entity has the funds to lend to me? The potential issue can arise when there is security which could be offered, which would normally reduce the applicable interest rate. However, due to the nature of the proposed reforms and the simplicity aim, this secured option would not be available any more.

d. We agree that there should be a set maximum loan term and a period of 10 years would appear to be reasonable, however arbitrary.

e. We also agree that there should be some prescribed milestones regarding outstanding loan balances during the term of the loan, and it makes sense to use the "Rule of 78" amortisation schedule.

f. We recognise that some taxpayers, when offered the option to effectively defer repayments, would do so in order to preserve their cash-flow, but could easily end up in a situation where they then can't make the required cumulative repayment in the prescribed year if they subsequently have financial difficulties. With that in mind, maybe the minimum annual principal repayments requirement should be retained.

g. In connection with (e) and (f) above, the interest should be able to be accrued, but a physical payment should be required only if the prescribed loan balances are exceeded.

h. We agree that a failure to make required repayments by the end of milestone periods should result in a deemed dividend being declared to the extent of shortfall. However, there should also be a self-correction option available in the instances where the failure to comply with loan requirements was the result of a genuine mistake or oversight.

i. The rules regarding the Commissioner's period of review should take into consideration the interaction with the self-correction mechanism.

QUESTION 6.2 – LEGISLATIVE AMENDMENT TO CLARIFY ALL UPES ARE LOANS

In most circumstances, there would be no tax implications for taxpayers, favourable or unfavourable, as the reclassification of a UPE as a loan would not change the tax outcome. However, the important distinction is a UPE between a trading trust and a corporate beneficiary, where the cash is retained in the trust for working capital purposes.

The complexity and inequality created by the view that UPEs are loans for Division 7A purposes can be seen over the last few years since draft Taxation Ruling TR 2009/D8 and TR 2010/3 were issued.

If this issue is resolved as proposed in the paper, we believe that there would be no impediment to legislative clarification that all UPEs be treated and considered as loans. Greater certainty and simplification would certainly be achieved. Furthermore, this would also allow Subdivision EA to operate again as intended, which supports tax policy coherency.

QUESTION 6.3 – LIMITED EXCEPTION FOR LOANS MADE TO TRUSTS

a. The issues associated with retaining working capital in a trust can be successfully addressed with the "limited exception" option. However, recognising that there are structures where discretionary trusts hold units in a trading unit trust, it becomes important to achieve equivalent treatment of goodwill under these circumstances. As proposed in paragraph 6.38, there should be a "look through" mechanism.

b. We believe that this limited exception should be available to all trusts that have loans with private companies, as it is unlikely that any investment trust (except as described in the above comment) would elect this option - due to the loss of the CGT discount - which serves the equity aim of the tax policy (i.e. no advantage to the accumulation of passive investments).

c. The proposed limited exception would certainly reduce compliance costs for trading trusts. However, there would still be a requirement to appoint income to a corporate beneficiary, and manage the resultant UPE balance thereafter. Nonetheless, it would simplify structuring requirements but could possibly result in an increased compliance burden and cost for those taxpayers who don't have access to quality tax advisors.

d. The focus of the consequential rules required if a limited exception were to be applied is predominantly around integrity measures. For example, it should be ensured that Subdivision EA still applies as intended to prevent distribution of underlying cash (retained as working capital at the prevailing company tax rate) to the company shareholders or associates.

   Furthermore, it should be ensured that interposed entity provisions - designed to prevent Division 7A rules from being circumvented - <u>do not negatively impact upon the proposed limited exception</u>. We refer to our example in Question 4.1 above.

e. Any transitional rules that would be required should a limited exception be applied would have to serve the simplicity aim of the tax policy. Having to deal with two sets of rules for potentially another 10 years (under current sub-trust arrangements) would certainly not serve this aim.

f. Merits of transitional rules:

   - A transitional rule that deems that any loans in place prior to a trust making an election would continue to be subject to the existing arrangements seems to be common sense. However, this would create an environment where two sets of rules would apply for up to 10 years. This could cause unintended complexity and further administration and compliance cost to taxpayers.

   - A transitional rule that deems that any CGT assets acquired by the trust prior to making an election would continue to be eligible for the CGT discount on disposal seems the only fair and equitable option. Taxpayers that structured their affairs in a particular way that would be affected with the above proposal (e.g. trading from trusts which hold other capital assets) should not be "penalised" when the rules change, as they could not have foreseen this change. They would still need access to working capital, which this proposed transitional rule would provide, thereby achieving both simplicity and integrity.

g. An alternative transitional rule would be to enable the new rules to be applied to existing arrangements with a view of simplifying them and equalising the treatment. This would require a "tick the box" exclusion to operate on a retrospective basis as well. Furthermore, the self-correction mechanism could be available retrospectively.

Even more simple, practical and realistic is to contemplate an alternative which would essentially provide a safe-harbour option that could be provided to existing arrangements, effectively quarantining the existing outstanding UPEs, excluding them from the definition of a loan for Division 7A purposes.

This is similar to what occurred in December 2009, when the Commissioner's views regarding UPEs changed. Subject to certain evidentiary requirements, UPEs outstanding upon the introduction of new provisions could be made exempt from the application of TR 2010/3, as was the case in December 2009, in relation to loans pre and post this time, and also earlier in 1997.

Notwithstanding the possible alternatives available, any formulated transitional rules should only contemplate the repayment of the UPE's within a prescribed time frame – but with no interest required to be charged.

QUESTION 6.4 – SELF-CORRECTION MECHANISM

a. In our experience, the large majority of taxpayers have a genuine intention to comply with the tax rules. Very often the non-compliance with Division 7A provisions arises as a result of small business owners' having limited access to quality tax advice, or inadvertent omissions - such as miscalculations of interest or repayment amounts. When we as tax advisors are faced with this issue, we can easily devise a corrective action, taking up "catch-up" adjustments and payments. However, there is no ability to implement this corrective action without requesting the Commissioner's discretion adding further complexity and cost to the exercise.

   A legislative self-correction exception, similar to the Commissioner's administrative practice adopted in PS LA 2007/20 for the 2002-2007 income years, should most definitely be available to taxpayers and their advisors to correct mistakes and omissions. This would improve the efficiency of the tax system within the environment that private businesses operate in.

b. This exception should be subject to eligibility requirements to prevent abuse. The nature of these requirements could be linked to the taxpayer's lodgement history, reasons for the mistake or omission, and details of any previously taken corrective actions. This would likely require a disclosure in the company's tax return that corrective action has been taken in a given year.

c. The main condition that should be satisfied to qualify for the exception would be to ensure that the parties are placed in the same position as if the Division 7A rules had been applied from the inception of the relevant loan or payment. Interest should be accrued from the beginning of the loan; the required documentation put in place; and future minimum repayment schedule adhered to.

d. Taxpayers and their advisors should be required to maintain all relevant records, including interest calculations, loan schedules, accounting journal entries and analysis of the reasons that led to non-compliance with the Division 7A provisions, to ensure taxpayers who deliberately ignored or circumvented the provisions are not inadvertently rewarded with a self-correcting exception.

e. We acknowledge that our last point potentially presents a practical implementation problem, as it involves a degree of objectivity. However, guidelines could be communicated to tax advisors to adopt to assist in achieving the goals of efficiency and equity.

   We also believe that a self-correcting mechanism should in some way form part of the transitional rules, to assist in simplifying existing arrangements and correcting inequities that arose post-December 2009 in respect of the interpretation of complex Division 7A provisions. This would also encourage taxpayers to address past breaches.

We thank you for considering our submission and would welcome the opportunity to discuss any aspect of this submission with the Board.

Yours sincerely,
KOUSTAS & CO PTY LTD

HERC KOUSTAS
DIRECTOR

DAMIEN BURKE
DIRECTOR

SANYIN GELJIC
TAXATION MANAGER