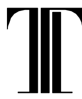

THE TAX INSTITUTE

27 March 2013

Mr Curt Rendall
Chairman of the Division 7A Working Group
The Board of Taxation
c/ The Treasury
Langton Crescent
PARKES ACT 2600

Email: taxboard@treasury.gov.au

Dear Curt

Discussion Paper: Post-implementation review of Division 7A of Part III of the Income Tax Assessment Act 1936

The Tax Institute thanks you for the opportunity to provide this submission in response to the Board of Taxation's Discussion Paper entitled "Post-implementation review of Division 7A of Part III of the *Income Tax Assessment Act 1936*" (the "**Discussion Paper**").

As noted in our previous correspondence with the Board of Taxation (the "**Board**") dated 10 July 2012, Division 7A has resulted in significant implementation difficulties for taxpayers and the Australian Taxation Office ("**ATO**") alike since its introduction in 1997. As a result, The Tax Institute welcomed the announcement and commencement of this Board review. We look forward to the Board's reform recommendations and the Government's response.

Aspects of the submission that relate to specific questions in the Discussion Paper have been identified as such.

Policy rationale

As noted in the Discussion Paper, the terms of reference of the Board's review state that Division 7A contains integrity provisions to prevent shareholders and associates of private companies from "inappropriately accessing the profits of those companies" via payments, loans or debt forgiveness transactions. These forms of transfers of value would otherwise constitute an un-taxed or concessionally taxed transfer of value from the company to the shareholder.

In the context of our current taxation system, The Tax Institute acknowledges the need to implement this stated policy intent owing largely to the significant differential in marginal rates potentially applicable to individual shareholders in comparison to private companies (as defined).

While we recognise the need to maintain the integrity of the taxation system in this manner, our members report that many of the implementation problems with the current Division 7A stem from the wide ambit of the Division's potential application combined

Level 10, 175 Pitt Street Tel: 02 8223 0000 info@taxinstitute.com.au
Sydney NSW 2000 Fax: 02 8223 0077 taxinstitute.com.au
ABN 45 008 392 372

with its self-executing nature. As such, we recommend that Division 7A be revised to target only that conduct which undermines the integrity of the tax system.

Private companies typically operate in a vastly different environment in comparison to widely listed companies. Such companies typically operate small to medium enterprises which depend heavily on prior year earnings or debt funding for working capital due to a lack of access to equity markets.

As such, the manner in which “inappropriate use of funds” is defined needs to be considered in this context.

It is our view that only profits that are paid, loaned or in relation to which a debt is forgiven that are used for private purposes should be caught within the ambit of a punitive integrity measure such as Division 7A. [Question 2.2]

The use of such funds to facilitate investment (whether active or passive) should not be treated punitively, as occurs under the current Division 7A. While we recognise the need to ensure that the return on such funding is taxed at the correct rate, it is our view that a narrower mechanism (such as the statutory interest model or the distribution model set out in section 5 of the Discussion Paper) would target such integrity concerns more appropriately without resulting in the difficulties and punitive results caused by the current Division 7A.

Such a narrower mechanism would recognise the limited funding options available to private companies and tax such intra-group funding mechanisms appropriately without causing unnecessary implementation and compliance difficulties.

In a self-assessment environment, we are broadly supportive of the self-executing nature of the Division, tempered by an appropriately administered discretion bestowed on the Commissioner.

Models for reform

As noted above, the ambit of the current Division 7A is unnecessarily wide.

Taxpayers and the ATO would undoubtedly benefit from a rewriting and clarification of aspects of the current Division 7A as would result on application of the Division 7A adjustment model in Chapter 4. As such, we recommended that this model constitute a minimum recommendation for reform. Further comments on this model are set out below.

Nonetheless, the Board should harness this unique opportunity to recommend a more significant rewrite of Division 7A that restricts the application of the integrity measure to the necessary and appropriate extent, and otherwise treats intra-group lending arrangements fairly (rather than punitively).

Regardless of the model for reform adopted, we recommend that the treatment of unpaid present entitlements and the operation of the Commissioner’s discretion be examined with respect to the policy rationale underpinning Division 7A. Our recommendations in this regard are also set out further below.

Statutory interest model

[Question 5.5] For the sake of clarification, we have set out below our understanding of the manner in which the statutory interest model is intended to function. Should our understanding differ, we would be pleased to discuss.

- Loans to related parties will bear interest at a rate specified by law;
- The payment of interest is permissible but not necessary;
- Loans may be "rolled-over" i.e. re-borrowings of principal are permitted;
- Loans may be "rolled-over" indefinitely;
- Interest will be assessable/deductible regardless of whether it is paid; and
- The statutory interest model would apply to loans to individuals as well as to companies and other trusts in circumstances where Division 7A is applicable;

In addition to the above, we note that the model as described in the Discussion Paper does not address the consequences of all deemed dividends under Division 7A. As noted in paragraph 5.29 of the Discussion Paper, the treatment of debt forgiveness and payments will need to be resolved if this model is adopted.

We consider the 'statutory interest model' worthy of consideration and further development. The adoption of such a model would allow Division 7A to target the underlying integrity concern via the denial of a deduction for the relevant interest expense where the loan was utilised for private expenses, but allow a deduction for a rate of interest (that presumably will approximate an arm's length rate) where the loan funds have been put to income generating purposes.

Otherwise deductible rule

The most preferred method by which to apply this rationale would be the inclusion of an "otherwise deductible rule" with respect to the loan, with a residual arm's length interest rate rule for loans on which the interest would not be otherwise deductible (as set out below and also at paragraph 4.56 of the Discussion Paper).

Such a provision would limit the operation of Division 7A to only those types of loans that are intended to be caught. Furthermore, such a solution would significantly simplify the current system of repayments, loan agreements and fixed loan periods. This is because there would no longer be any requirement to consider any factors other than the purpose to which the loan is put in determining consequences under Division 7A.

In our view, an otherwise deductible rule should apply regardless of whether interest is actually payable or paid. This is because where the otherwise deductible rule would apply, there should be no integrity concern in allowing funds to be loaned without the payment of interest and without the application of Division 7A. This is especially so because an otherwise deductible rule will not, on average, result in a leakage of revenue in comparison to the taxation and deduction of paid or payable interest. This is because our members report that the marginal tax rate that would otherwise apply to the deduction will typically exceed the marginal tax rate at which the interest would be taxed.

We do not anticipate that an otherwise deductible rule would affect the revenue adversely as:

- <u>If the otherwise deductible rule applies:</u> We also do not anticipate that such a system would create capacity for inappropriate manipulation. Many of the perceived benefits bestowed by such a model are already intended to be

accessible under current laws (as noted in paragraph 5.36 of the Discussion Paper).

- If the otherwise deductible rule does not apply: The interest rate that would be required to be applied would approximate the interest rate at which the recipient would have been able to borrow from another source, and the interest charged would be returned by the company as assessable income.

Because of this anticipated differential in marginal tax rates, an otherwise deductible rule would also address the potential integrity concern that may arise from taxing the interest on the relevant loan at the corporate tax rate, and allowing loan funds to be used to purchase assets in respect of the subsequent sale of which capital gains tax concessions may be available.

That is, without an otherwise deductible rule, the statutory interest model may allow the financing (at the corporate tax rate) of the acquisition of capital gains tax assets used in a business conducted by the company, while simultaneously allowing access to capital gains tax discounts in respect of the asset/s which would have been otherwise unavailable to the company.

Setting the interest rate

While the adoption of a statutory interest model may require the imposition of a higher rate of interest than the current benchmark interest rate, we are broadly of the view that the simplicity benefits of this model may nevertheless outweigh the potential costs. In this regard we acknowledge the concerns set out in paragraph 5.26 of the Discussion Paper.

Alternatively, the relevant interest rate should be required to be set as the arm's length rate, with the statutory rate constituting a "safe harbour" via an expansion of the current section 109M to excuse loans made at an arm's length rate from the operation of Division 7A, regardless of whether the loan is made in the ordinary course of the company's business and without regard to the terms on which the loan is made (other than the interest rate).

In this regard, we note ongoing confusion in relation to what the term "in the ordinary course of the private company's business" means in this section, but that in our view, there is no need to limit such an exemption to companies that engage in the business of lending funds.

Potential difficulties

Where the otherwise deductible rule does not apply, we foresee potential difficulties in application in relation to the recoverability of the underlying debt or taxpayer understanding of the need to pay top-up tax on any dividends paid to offset this liability in relation to the principal amount at the end of the loan period. In this regard, we recommend an education campaign in relation to the management of cash flows and obligations under the new regime, especially in the first few years after commencement.

Whether or not the payment of interest will be permitted even where the otherwise deductible rule would apply will also need to be carefully considered. In such a situation, questions would arise as to whether the actual interest paid/payable should be deductible/assessable. If this question is answered in the affirmative, taxpayers are likely to take cash-flow considerations as well as differing marginal tax rates into account in determining whether interest should actually be paid/payable on the loan.

The allowance of re-borrowings of principal will need to be carefully considered – the unconstrained ability to roll-over the loan may result in a perpetual loan instrument that may be the cause of integrity concerns and yield unintended consequences.

With respect to the concern noted in the Discussion Paper in respect of this model allowing a more favourable tax treatment if the income was earned in a company, we note that retention of income in a company (whether passive or otherwise) after being subject to taxation at the corporate tax rate has always been permissible on the presumption that any resulting increase in the value of the company will be captured by the tax system if the shareholder disposes of his/her interest in the company. This outcome seems appropriate in light of the broader context – Division 7A was only intended to target inappropriate access to private company profits, not the mere retention of those profits.

As set out above and in the Discussion Paper, a number of issues will need to be resolved before this model is capable of application. As such, we recommend that detailed modelling and testing be undertaken to determine the likely outcomes and effect of application, as well as the likely compliance cost impost prior to a decision being made on the best model for reform.

Distribution model

[Question 5.6] It is our view that this model will be difficult to legislate and implement due to the uncertainty that is likely to be caused in the definition of "permitted purposes" and also of the family group. This model will also put too much stress on the passive/active asset definitions. Furthermore, our members report significant difficulties in the application of the sufficient distribution rules in the former Division 7 (which, as the Discussion Paper notes, the distribution model is similar to).

As such, we do not recommend further exploration of this model for reform. Should this model be considered worthy of development, we recommend detailed modelling and testing to determine the likely outcomes and effect of application as well as the likely compliance cost impost prior to a decision being made on the best model for reform.

Division 7A adjustment model

[Question 4.4] As noted above, in our view the Division 7A adjustment model should constitute a minimum recommendation for reform.

Many of the problems identified in the Discussion Paper require urgent resolution. Of particular concern are the interposed entity rules which have been very difficult to deal with in practice and have generated significant compliance difficulties. Furthermore, these provisions are not in some respects self-executing, and are thus contrary to the intended structure of operation of Division 7A.

Our specific comments on the Division 7A adjustment model are as follows:

- The Discussion Paper highlights a multitude of interpretational and application-related issues with the current form of Division 7A in Chapter 4. These issues include the inconsistent use of poorly defined terms through to inconsistencies within the same provision.

- We broadly agree with the Board's identification and definition of such problems with the current Division 7A, and as such are of the view that the rectification of

these issues should constitute a minimum model for reform. In this regard we acknowledge the extensive work undertaken by the Board in identifying these issues and as such do not seek to replicate these efforts here.

- We are also of the view that Division 7A should be rewritten with a greater focus on the principles underlying the legislation in order overcome the problems caused by the current overly-prescriptive nature of the provisions. [Question 5.7]

- A broader clean-up of the provisions as suggested in Chapter 4 should occur regardless of whether either the statutory interest model or the distribution model is also adopted.

- Should either of the alternate models set out in Chapter 5 be adopted, a broad-scale review of many of the problems listed in Chapter 4 would still be required once the policy intention of Division 7A has been clarified.

- However, in our view such a review would be best conducted as a two-stage process in order to ensure coherence between policy intention and letter of the law. In this context, we note that many of the problems identified in Chapter 4 would need to be reconsidered in light of the narrower application/focus of the revised Division 7A.

- We would be pleased to provide further thoughts on this model for reform, should it be helpful to the Board.

Unpaid present entitlements

The Discussion Paper aptly summarises the problems caused by the ATO's current view of the treatment of unpaid present entitlements ("**UPEs**") in the context of Division 7A.

The joint professional bodies (including The Tax Institute) made a submission to the ATO in respect of then draft TR 2009/D8 in relation to the ATO's position on this issue. We also sent this submission to the then Assistant Treasurer, Senator Nick Sherry. This letter of 18 June 2010 (and earlier submission) is attached at Appendix A for your ease of reference.

In accordance with the views set out in that submission, it remains our view that a UPE does not constitute a loan under the current provisions or according to the policy intention of the current Division 7A. As such, the ATO's ruling and PSLA are incorrect at law.

Should it be the Government's policy intention that UPEs constitute loans for this purpose, this intention should be clarified via legislative amendment. [Question 5.1(a)]

Following on from the above, should it be Parliament's intention that UPEs should constitute loans for the purposes of Division 7A, Subdivisions EA and EB of the Act should be rewritten in line with this policy intention. [Question 5.1(b)].

Should an unpaid present entitlement be treated as a "loan"?

The allowing of a present entitlement to remain unpaid for a significant period of time constitutes the provision of a benefit from the company to the trust. The nature of this benefit is undefined, but broadly constitutes the trust's capacity to utilise funds without

bearing a market value cost for the use of those funds. This benefit could be akin to an injection of capital, or a loan, depending on the circumstances.

Our members broadly report that UPEs arise in the context of private companies and discretionary trusts that are typically operated in respect of the same business, which is in turn typically owned by the same family group.

As such, the capacity for broader integrity concerns (such as for example, inappropriate *de facto* streaming of dividends, transfer of losses etc.) are not likely to be significant in this context and should not drive policy decisions in respect of the taxation treatment of UPEs.

The taxation of UPEs should be as follows:

- The company should be permitted to allow the UPE to be held on sub-trust, if this circumstance best reflects the substance of the relationship between the parties.

- The company should be permitted to convert the UPE into a loan, if this circumstance best reflects the substance of the relationship between the parties. Such loans should be subject to an otherwise deductible rule (as set out above). Conversely, where the UPE has been used to facilitate the acquisition of a private asset, an arm's length amount of interest should be required to be paid (as set out above).

Such a treatment would be in line with our comments above in relation to the policy rationale that should underpin Division 7A i.e. only profits that are paid, loaned or in relation to which a debt is forgiven that are used for private purposes should be caught within the ambit of a punitive integrity measure such as Division 7A.

In this regard we note relevantly that the concept of an "unpaid present entitlement" stems from trust law rather than tax law, and that as such is likely to survive the rewrite of Division 6 that is currently being managed by Treasury. However, the appropriate taxation treatment of UPEs will ultimately depend on both Division 7A and the taxation of trusts regime (as recognised in the terms of reference of this review). We would be pleased to discuss this likely interaction with the Board once the Government has announced the preferred model for trusts taxation reform.

Franking credits

Deemed dividends that arise under Division 7A should either be permitted to be franked or a corresponding franking debit should not arise in the company's franking account [Question 5.3].

Division 7A will still deter taxpayers from seeking to disguise dividends by recharacterising transactions where appropriate. A further penalty via double taxation is unnecessary to ensure such deterrence and represents the imposition of a disproportionate penalty.

Integrity provisions should only seek to restore the correct application of the laws to the substance of the transaction. Such an outcome would be achieved by either allowing deemed dividends to be franked or preventing a commensurate franking debit from arising in the company's franking account.

To the extent that inappropriate taxpayer behaviour is considered worthy of punishment, the penalty provisions in the *Taxation Administration Act 1953* are best suited to achieve this purpose.

Commissioner's general relieving discretion

[Question 5,2] The appropriateness of discretions in the Income Tax Assessment Acts in the context of a self-assessment system has always been contentious.

It is our view that laws should be drafted with the greatest clarity possible in order to allow taxpayers an appropriate level of certainty in relation to their tax affairs. As such, discretions within the Acts should generally only alleviate otherwise inappropriate consequences for taxpayers, and should not operate to increase tax liability. Such a limited operation for discretions ensures that taxpayers at least have a base level of certainty in relation to their tax liability.

In order to maximise taxpayer certainty, we recommend that the scope for such a discretion to apply should be limited via paring back of the scope and consequences of the application of Division 7A (by, for example, introducing a "statutory interest model" subject to an otherwise deductible rule and allowing deemed dividends to be franked).

Nevertheless, in the context of integrity provisions such as Division 7A, a general relieving discretion should be afforded to the Commissioner to alleviate the consequences of application in inappropriate circumstances. This is because the likely scope of application of Division 7A in all circumstances is unlikely to have been foreseen as at the time of drafting, and the consequences of application are punitive in nature and consequence.

Our members report that the Commissioner's current approach to the general relieving discretion in Division 7A is excessively rigid and focussed on applying strict definitions rather than taking a reasonable approach to the facts. While the current PSLA governing the application of this discretion is reasonably clear, our members report that extraneous factors are often considered by the relevant ATO officer, or undue reliance is placed on relatively insignificant aspects of the situation when considering the application for exercise of the discretion.

In order to minimise the scope for arbitrary application, the general relieving discretion should be clear in application, via legislative definition.

For example, a discretion which contains the following elements would be preferable:

- Terms used in the discretion provision should be clearly defined;
- Rights of review for a decision made by the Commissioner when applying his discretion should be clearly defined; and
- If conditions are to be imposed by the Commissioner and met by the taxpayer, the conditions should be required to be met by the end of the taxpayer's relevant period of review.

* * * * *

Should you wish to discuss any of the above, please do not hesitate to contact either me or Tax Counsel, Deepti Paton on 02 8223 0044.

Yours sincerely

Steve Westaway
President