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Dear Teresa

BOARD OF TAXATION'S POST-IMPLEMENTATION REVIEW OF DIVISION 7A

Please see the attached submission to the Board of Taxation on the Board's Discussion Paper on the "Post-Implementation Review of Division 7A of Part III of the Income Tax Assessment Act 1936" issued in December 2012.

Yours sincerely

Mark Leibler AC
Senior Partner

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SUBMISSION ON THE BOARD OF TAXATION'S DISCUSSION PAPER ON THE POST-IMPLEMENTATION REVIEW OF DIVISION 7A OF PART III OF THE INCOME TAX ASSESSMENT ACT 1936 ("Discussion Paper")

1 This submission will not deal with all, but only some aspects, of the terms of reference, issues and questions set out in the Discussion Paper. Our view of the approach which should be adopted to reforming Division 7A is set out in our letter dated 10 August 2012 to the Chair of the Division 7A Working Group of the Board of Taxation. It is annexed to and forms part of this submission.

2 We have given very careful consideration to all of the issues and questions outlined in the Discussion Paper and remain of the view that the proposals set out in our letter of 10 August 2012 are the best approach to resolving the difficulties and problems associated with Division 7A.

3 Question 2.2 seeks views "on what inappropriate accessing of profits means" in the context of the issues raised in Chapter 2 of the Discussion Paper. In our view, the most appropriate response to that question is provided by the Board of Taxation itself in paragraph 4.56 of the Discussion Paper which, in part, states as follows:

> "Section 109CA (provision of an asset payment) includes an otherwise deductible rule. It has been argued that this approach should not be limited to the use of company assets but should apply to all other payments and loans. For example, if the loan recipient could otherwise claim a deduction for interest incurred if in fact interest were charged, the argument is that Division 7A should have no application."

4 We strongly support Option 2 set out in paragraph 5.2 of the Discussion Paper. As stated in that paragraph:

> "An alternative approach is to largely replace Division 7A with a requirement that loans to related entities carry a

> statutory rate of interest, but with no requirement that principal be repaid prior to termination of the loan."

As the Discussion Paper goes on to point out in paragraph 5.5:

> "A view has been expressed that a commercial loan - from a private company to a trust within the private group - that does not comply with Division 7A, but in respect of which the loan funds do not permanently leave the group for private use or consumption and are used as working capital or for investment in the business (rather than for passive investment), should be the subject of an exclusion from Division 7A."

We agree with that view save and except that we see no justification for excepting from the "exclusion" a use of the loan funds for "passive investment". Our reasoning is explained on pages 2 and 3 of our letter to the Board of Taxation dated 10 August 2012.

5 Paragraph 5.21 of the Discussion Paper states as follows:

> "On the other hand, it is clear that Division 7A was always intended to deter private companies from entering into arrangements that trigger deemed dividend treatment. Without an effective deterrence, private companies could seek to test the limits of the integrity provision knowing that the only outcome of mischaracterisation of payments would be an appropriate characterisation. This would provide an incentive to undertake such activity, potentially leading to increased disputes between taxpayers and the ATO."

6 We take issue with the above observation by the Board of Taxation. Imposing a penalty is one thing. Imposing double taxation is another thing altogether and simply cannot be justified. The suggestion by the Board of Taxation that "the only outcome of mischaracterisation of payments would be an appropriate characterisation" is entirely misconceived. In addition to "an appropriate characterisation", there would be additional primary tax on the

differential between tax at the corporate rate and tax at the taxpayer's marginal rate, interest on the additional tax at a rate in excess of the commercial rate, potential penalties of either 25% or 50% of any additional primary tax, depending on whether the taxpayer has acted with reasonable care, adopted a reasonably arguable position or has been reckless, and, finally, the prospect of further penalties should it transpire, in a particular case, that Part IVA of the Income Tax Assessment Act 1936 is applicable. To suggest that these potential consequences would not amount to an "effective deterrence" is simply wrong. Indeed, there are countless other potential tax mischiefs which could occur as a result of taxpayer misbehaviour where the only effective deterrents are as outlined above.

7 We agree with the observations in paragraph 5.23 of the Discussion Paper that there would be a need to deal with forgiveness of debt and payments which are not loans.

8 The observations set out in paragraphs 5.28 and 5.29 are consistent with the proposals set out in our letter of 10 August 2012.

9 With regard to Question 5.5, it is apparent from this submission and, in particular, from the proposals set out in our letter of 10 August 2012, that we strongly support the statutory interest model which, for the reasons set out in our letter (see page 2) is consistent with the policy intent of the tax framework of which Division 7A is a part.

10 Question 5.7 raises the issue of whether there are better ways to improve on the current legislative design of Division 7A. In our view the use of so-called "principle-based drafting" to express the changes to Division 7A we advocate in this submission will not be necessary. Indeed, if other instances of "principle-based drafting" are anything to go by (notably the consolidation provisions), then the outcome for a "principle-based" re-draft of Division 7A is likely to be far less clarity and simplicity. As to the use of regulations to provide an appropriate level of guidance, there is merit in the proposal that would justify it being explored further.

11 With regard to Appendix D of the Discussion Paper, we are strongly of the view that only one interest rate should be specified and that it should be a commercial rate of interest. For reasons set out in our letter of 10 August 2012, we believe that Division 7A should only require the payment of interest (either actually or notionally) and, accordingly, we don't favour the imposition of a higher rate of interest to "provide an incentive to place the loan on a seven year repayment option as compared to an interest only option where the loan is used for private purposes". We don't agree that there is any need to "ensure that companies are not prone to providing interest only loans as compared to interest and principal loans to shareholders." (See page 78 of the Discussion Paper).

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