Tel: +61 7 3237 5999
Fax: +61 7 3221 9227
www.bdo.com.au

Level 10, 12 Creek St
Brisbane QLD 4000
GPO Box 457 Brisbane QLD 4001
Australia

By email: taxboard@treasury.gov.au

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

9 May 2014

Dear Sir/Madam

POST IMPLEMENTATION REVIEW OF DIVISION 7A OF PART III OF THE INCOME TAX ASSESSMENT 1936 - SECOND DISCUSSION PAPER

BDO welcomes the opportunity to provide a submission in respect of the Board of Taxation's Second Discussion Paper (Discussion Paper) released as part of its post-implementation review of the provisions of Division 7A of Part III (Division 7A) of the Income Tax Assessment Act 1936 (ITAA 1936). All references to statutory provisions are to the provisions of the ITAA 1936 unless otherwise indicated. References to the ITAA 1997 are to the *Income Tax Assessment Act 1997*.

We make the submissions set out below in respect of the matters addressed in the Discussion Paper.

Business profits that are reinvested in a business should be taxed at the corporate rate for all types of business structures

There is considerable merit in the suggestion that business profits that are reinvested in a business should be taxed at a uniform corporate rate in all circumstances. Under the current system profits of companies' which are retained for reinvestment are taxed at the corporate rate, leaving at least 70 cents in each dollar of profit for reinvestment in the applicable business. It is inequitable and offends against principles of neutrality that similar profits reinvested in the business of a trust estate will be taxed at the marginal rate of beneficiaries, often leading lesser amounts available for reinvestment.

However, we note that consideration of whether some of the corporate specific tax rules would then need to apply to such trusts. These would include the imputation system for subsequent distributions of 30% taxed profits and Division 7A for beneficiary loans or use of trust assets that were funded from 30% taxed profits.

Distributable surplus not be calculated by reference to unrealised profits

The current system, whereby the distributable surplus from which dividends can be deemed to have been paid includes unrealised profits, can lead to considerable difficulties and compliance costs for affected taxpayers. The solution to this problem suggested in the Discussion Paper of having regard only to realised profits and retesting on an annual basis has considerable merit and we submit that this recommendation should be adopted.

Testing of distributable surplus at end of each year

The testing of distributable surplus at the end of each year, instead of only at the end of the year the loan is made, appears to be an appropriate proposed change. However, clarification is required on when the 10 year period of the loan would start in situations where there is no distributable surplus in the year of loan but there is a distributable surplus in a subsequent year.

In this situation would the 10 year period start from the year after the loan is made or the year after the year in which there is a distributable surplus? If it is the year after the loan is made, what happens if the first year there is a distributable surplus is after the year 3 requirement for partial repayment?

Retention of a lower rate of interest and longer term for loans secured over real property

The suggestion of standardising on a ten year term and providing greater flexibility in respect of interest and principal repayments has some merit. We submit, however that shareholders should continue to be able to borrow money from a private company where the repayment of such indebtedness is secured by means of a mortgage over real property. In those circumstances the applicable interest rate should be that for mortgage secured indebtedness (rather than the recommended higher rate of the Reserve Bank of Australia's indicator lending rate for small business variable (other) overdraft rate).

Similarly, where indebtedness is secured over real property, the current 25 year term is more in keeping with market practice rather than the proposed mandated 10 year term.

Interest rate should not be fixed at the commencement of the term of the loan.

The Board recommends at paragraph 6.19 of the Discussion Paper that the applicable statutory interest rate for shareholder loans would be set at the start of the loan and fixed over the term of the loan. In a market where prevailing interest rates can vary very significantly over a ten year period, we submit that fixing the interest rate for such a period is undesirable. A better system would be to set the interest rate by reference to the applicable indicator rate on an annual basis.

Asset Usage

The Discussion Paper proposes a single set of common principles for dealing with loans, payments, debt forgiveness and use of company assets. We submit that, while the apparent simplicity of such an approach is attractive, the various ways that a company's assets can be used could make it difficult to implement such a uniform approach for all asset usage cases.

The Discussion Paper proposes a finance lease approach for asset usage. This may be appropriate for situations where a particular shareholder or associate has exclusive use of a particular asset but it may not be appropriate for situations where an asset is being used sporadically by one or more shareholders or associates.

The discussion paper does not provide a detailed discussion of any perceived problems with the current treatment of use of company assets. We suggest that before there is a change to the current treatment of the use of company assets, there should be a discussion of what the perceived problems of the current system are and how any proposed new system would be an improvement.

All unpaid present entitlements (UPE) to be deemed loans subject to choice to ignore loans and UPEs owed by trust estates to private companies.

Subject to a significant proviso, we support the recommendation to treat all UPE of companies' in respect of trusts as loans for Division 7A purposes. However, the timing of when the UPE is to be treated as a loan needs to be clarified. Under the current administrative treatment by the Australian Taxation Office the UPE is taken to be treated as a "financial accommodation" (and therefore a deemed loan) at the main trust's lodgement day for the income year in which the UPE came into existence (see paragraph 46 of PS LA 2010/4). Consideration should be given to whether this is the appropriate day for the UPE to be treated as a loan. There may be situations where it is appropriate for the timing of a UPE as a loan be a later time than under the current administrative treatment.

The proviso referred to above is that the other recommendation of the Board is adopted whereby loans and UPE owed by trusts to private companies can be ignored for Division 7A purposes where the applicable trust elects to forgo the CGT discount except in respect of goodwill.

In addition, as the motivation for denying the discount in these circumstances is to prevent affected trusts from accumulating passive assets which would benefit from the CGT discount when they were disposed of by the trustee, consideration should be given to preserving the availability of the discount in respect of other active assets, in addition to goodwill. Some guidance on what could be classified as active assets, for these purposes, might be provided by the small business capital gains tax provisions in Division 152 of the ITAA 1997.

The definition of 'associate' for the purposes of Division 7A is too broad.

Division 7A adopts the definition of 'associate' in s318, from the controlled foreign company provisions. We submit that this definition, in its breadth of operation, is inappropriate for the purposes of Division 7A. One example of this is, by reference to s318(3)(a) and s318(6)(a), that a person capable of benefiting as a member of a class of discretionary objects under the terms of a trust would be an associate of the trustee, as would any partner or relative of such a person (see s318(3)(b) and ss318(1)(a) and 318(1)(b)).

Self-correction mechanism and franking of resulting deemed dividend.

We strongly support the recommendation by the Board in paragraphs 6.53 and following of the Discussion Paper that a self-correction mechanism be adopted to address circumstances where a Division 7A deemed dividend inadvertently arises. This is highly appropriate in a self-assessment environment.

We submit an addition to this proposal, that would be appropriate in light of this being a remedy only available to those who inadvertently fall within the provisions, would be to allow affected taxpayers to frank the resulting deemed dividends for the purposes of Part 3-6 of the ITAA 1997.

Forgiveness of UPE deemed to be a loan

The Discussion Paper does not look at the treatment of the 'forgiveness' of a UPE that is to be treated as a loan under the proposed new rules. Should the 'forgiveness' of such a deemed loan be affected by the forgiven debt rules under section 109F and/or the commercial debt forgiveness rules in Division 245 of ITAA 1997?

Transitional measures

Many taxpayers have loan and other arrangements "on foot" which comply with the current permitted loan provisions in Division 7A or the safe harbours in respect of UPEs provided by the Australian Taxation Office under Law Administration Practice Statement PS LA 2010/4. Transitional provisions should allow taxpayers to choose to continue with such arrangements for their duration

* * * * * * *

Should you have any questions, or wish to discuss any of the comments made in the above submissions, please do not hesitate to contact Lance Cunningham on 02 9240 9736 or lance.cunningham@bdo.com.au or Matthew Wallace on 02 9240 9760 or matthew.wallace@bdo.com.au.

Yours sincerely

Lance Cunningham

BDO National Tax Director

Matthew Wallace

BDO National Tax Counsel