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

By email: taxboard@treasury.gov.au

Dear Sir/ Madam

SUBJECT: SUBMISSION ON THE BOARD OF TAXATION DIVISION 7A POST- IMPLEMENTATION REVIEW

CPA Australia represents the diverse interests of more than 144,000 finance, accounting and business professionals in 127 countries Our vision is to make CPA Australia the global accountancy designation for strategic business leaders.

Against this background we provide this submission concerning the Discussion Paper issued on 20 December 2012 in respect of the Board of Taxation's 'Post-Implementation Review of Division 7A of Part III of the Income Tax Assessment Act (1936)'.

We acknowledge at the outset that Division 7A is an anti-avoidance measure, and any changes must ensure that these provisions effectively achieve their original stated purpose of ensuring that private companies cannot make disguised distributions of profits tax-free to their shareholders or associates by way of payment, loan or debt forgiveness transactions.

Notwithstanding the above, CPA Australia believes it imperative that any future reform of the provisions of Division 7A must focus on significantly reducing its complexity to ensure that the productivity of hundreds of thousands or privately held Australian groups can be substantially improved.

Such an outcome is crucial to the on-going commercial viability and international competitiveness of small to medium sized enterprises (SMEs) who have to currently grapple with inordinately convoluted rules which often lead to inadvertent tax consequences, dysfunctional commercial behaviour and/ or disproportionately costly tax advice.

In our view any reform implemented must therefore result in more understandable legislative concepts, clearer language, rational business outcomes and reduced compliance costs.

Given these policy settings, we strongly advocate that the conceptual principles underpinning the application of Division 7A to loans be based on a model which is broadly aligned with the 'Statutory Interest Model' canvassed as the second reform option in the Discussion Paper.

In these circumstances interest would be assessable to the lender in all circumstances and deductible to the borrower other than where the loan funds borrowed are first applied by a member of the group for private purposes.

Such an approach would be generally accepted by tax practitioners servicing their clients within the business community as the principles underpinning the deductibility of interest on borrowed funds applied for business and private purposes are widely understood.

As a corollary the introduction of such a reform would considerably slash the compliance burden of SMEs as most of the complicated provisions under Division 7A associated with excluded loans, amalgamated loans, minimum yearly repayments, loan guarantees and loan repayments would become redundant or at the very least become less intrusive. However, we recommend that the current loan exemptions should be retained to the extent that they would still be potentially applicable following the implementation of the above model.

Furthermore, by extending the above principle to treat any future unpaid present entitlement (UPE) owed by a trust to a private company beneficiary as a loan under the proposed model, the excessive compliance burden and commercial uncertainty imposed on privately owned companies with associated trusts under Taxation Ruling TR2010/3 and Practice Statement PSLA 2010/4 could be removed.

We also concur with the view expressed in the Discussion Paper that any implementation of the Statutory Interest Model must be accompanied by the enactment of revised albeit simplified rules under the 'Division 7A Adjustment Model' to ensure that payments and debt forgiveness transactions which constitute tax free distributions of profits continue to be assessed as unfranked deemed dividends.

Taken in their totality these changes provide an opportunity to achieve real and meaningful tax reform without creating significant risk to the revenue.

By contrast we are of the view that the implementation of any reform model based on the 'Distribution Model' set out in the Discussion Paper is fraught with difficulty, and would extend beyond the original policy intent of Division 7A to include any distributions of profits which were not business related and not just disguised distributions of profits.

Finally we note that if any reform of Division 7A is to proceed that it must be accompanied by appropriate transitional measures which are both equitable and preserve the integrity of the tax regime. This is especially crucial in respect of transactions involving amalgamated loans, pre 4 December 1997 quarantined loans and UPEs held on a sub-trust in accordance with Practice Statement PSLA 2010/4 whether they arose before or from 16 December 2009. One approach may be to give taxpayers the option of either subjecting existing arrangements to the proposed amendments or to ensure that any revised framework is only generally applied to transactions after the amending legislation has been enacted.

Further details on our views are set out in the Attachment to this letter.

If you have any questions regarding the above, please contact Mark Morris, Senior Tax Counsel, on (03) 9606 9860 or via email at mark.morris@cpaaustralia.com.au.

Yours faithfully

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Attachment

CPA Australia: Specific comments in relation to the Board of Taxation's 'Post-Implementation Review of Division 7A of Part III of the Income Tax Assessment Act (1936)'.

We provide the following specific comments in respect of our preferred model for reform based on the three reform options canvassed in the Discussion Paper:

1. Statutory interest model

As discussed, CPA Australia recommend that the principles set out in the Statutory Interest Model in the Discussion Paper be applied to develop a new taxing regime in respect of loans made between entities of a privately held group in lieu of the plethora of rules currently applicable to loans under Division 7A.

The key design features of such a regime would be as follows:

- All loans made by private companies and trusts to their associates within a group would be subject to interest at an appropriate commercial rate
- Any revised definition of loan should be expressly amended to make it clear that a UPE owed by a trust to a private company beneficiary will be regarded as a loan for the purposes of the new regime in the income year following the year in which the UPE arose. Accordingly, the definition of loan under the revised model should include the extended definition of a loan as it currently applies under section 109D(3)
- The interest received on a loan would be assessable to the lender in all circumstances and deductible to the borrower when paid other than where the loan funds borrowed are first applied by a member of the group for private purposes. Such an approach would ensure that revenue integrity concerns were appropriately addressed
- No principal repayments would be mandatorily required to be made on such a loan but a loan agreement would need to be documented in accordance with the terms of any amending legislation to evidence the existence of a legally enforceable debt and asset. Furthermore, principal lent under such a loan could be repaid and re-borrowed without triggering any adverse tax consequences provided the re-borrowed loan funds are applied for income producing purposes
- Where the loan funds are applied for income producing purposes we suggest that the interest rate that should be charged and paid on such funds be set at an arm's length commercial rate such as, say, the Reserve Bank of Australia's indicator lending rate for small business variable overdrafts that applies to 'interest only' loans with a 10 year term under Option 2 of Practice Statement PSLA 2010/4
- Conversely, where the loan funds are applied by the borrower for a private purpose there would be a more punitive interest rate to deter the making of such loans which could include a base penalty resulting in a rate akin to, say, the general interest charge
- Interest must be paid on a loan annually as we believe it would be detrimental to allow interest to be indefinitely capitalised on a loan as the size of such capitalised loans over time may ultimately create debt exposures which are unsustainable
- It will be necessary to apply the above rules on each borrowing along a chain of entities within a multi-tiered closely held group to determine the purpose for which the funds on lent have been applied. Interest payable on funds will be treated as non-deductible when first applied for private purposes. Thus, in respect of each loan made within the group it will merely be necessary to determine if the loan funds borrowed have been applied for private or income producing purposes. Accordingly, the complex interposed entity rules in Subdivisions E and Subdivision EB will no longer be required which should increase certainty as it will no longer be necessary to apply a reasonableness test as to whether those provisions should apply
- Any loan made by an entity within a privately held group should only be treated as a deemed unfranked dividend under any revised regime to the extent that interest is not paid on the loan at the appropriate commercial rate, and

- The current loan exemptions in Subdivision D should be retained to the extent that they would continue to have an application following the replacement of the excluded loan and amalgamated loan provisions with the proposed model.

Commentary included in the Discussion Paper suggests that the statutory interest model could enable funds to be retained indefinitely within the group to acquire passive investments as opposed to active business assets, and that income arising from such passive assets may receive more favourable treatment because it was originally earned in a company under the proposed regime rather than another type of tax entity. Whilst not expressly stated in the commentary on the statutory interest model it appears that such passive income could include discounted capital gains from the disposal of assets by associated trusts.

We do not believe that any application of the statutory interest model should differentiate between income arising from the acquisition of passive or business assets in determining whether the funds were put to an income producing purposes for the following reasons:

- Such an approach would re-introduce complexity into the tax regime applicable to privately held groups especially in respect of 'non-vanilla' cases where it may be highly difficult to trace how composite funds from multiple sources were allocated between the acquisition of passive and business assets

- Funds can currently be lent by a private company at arm's length interest rates under excluded loans subject to section 109N or by the making of UPEs held on a sub-trust pursuant to Practice Statement PSLA 2010/4 which may be used to acquire passive investments, and

- Capital gains will not in any event be available be eligible for the CGT Discount by a trust where the relevant asset had not been held for more than 12 months, or is treated as being ordinary income on revenue account under section 6-5 of the Income Tax Assessment Act (1997) (the ITAA (1997)).

As discussed, we recognise that the implementation of the above statutory interest model must be accompanied by measures which ensure that payments and debt forgiveness by a member of a closely held group to a shareholder or an associate continue to be treated as deemed unfranked dividends.

However, in doing so we believe that some of the concepts set out in the existing applicable Division 7A provisions need to be refined in certain respects to ensure that they operate efficiently and equitably. These changes are discussed below in our comments on the Division 7A Adjustment Model.

2. Division 7A Adjustment Model

Based on the premise that the statutory interest model is adopted along the lines proposed above, we believe that the existing provisions of Division 7A applicable to payment and debt forgiveness transactions need to be amended as follows:

- We believe that the amount of any deemed dividend arising under section 109C should be amended to the extent that the payment made would have been otherwise deductible to the shareholder or associate as a once-only deduction had they made that payment themselves. This is especially important in respect of amounts which have been credited to such persons. Moreover, the introduction of such a rule would ensure that section 109C was more aligned with section 109CA which provides such an otherwise deductible exemption in respect of the extended definition of payment relating to the use of private company assets under section 109CA(5)

- The amount of any deemed dividend arising in respect of a payment under section 109C in a form other than a transfer of property should be capable of being reduced by any consideration provided by the shareholder or associate to the private company in respect of such a payment under any amended rewrite of section 109C. This approach may also be necessary under our proposed model as payments may no longer be capable of being converted into excluded loans

- Clarification should be provided as to where there is a credit of an amount to an entity, on behalf of the entity or for the benefit of an entity for section 109C(3)(b) purposes. There are currently no cases or public rulings which specifically consider the meaning of the term 'credit' as it is used in section 109C(3)(b)

- Pursuant to section 109CA(4) the provision of an asset by a private company to an entity will not be regarded as a payment where it would have been regarded as a minor benefit under section 58P of the Fringe Benefits Tax Assessment Act (1986) if it had been provided in respect of the employment of an employee of a company. We have long been concerned that the $300 de minimis exemption under the

minor benefits exemption is too low as companies practically do not have systems in place to monitor the frequency and value of benefits provided to shareholders to the same extent as systems they maintain to track the provision of benefits to employees whose numbers typically exceed shareholders in closely held groups. We therefore recommend the introduction of a threshold that is sufficiently high to remove the need for companies to monitor the provision of benefits which are of a relatively immaterial value. For example, a $3,000 annual threshold could be applied under section 109CA(4) to exempt the private use of company assets by a particular shareholder or associate in an income year

- Clarity should be provided as to the intended operation of section 109J which broadly provides that a private company is not taken to have paid a dividend under section 109C to the extent that a payment discharges an obligation to pay money to an entity. Firstly, the exemption only applies where the obligation is discharged by a payment of money even though a transfer of property would similarly be regarded as a payment as defined under section 109C. Prima facie there does not appear to be any rationale for this distinction. Secondly, in practice an order may be made for family law purposes which imposes an obligation on a shareholder to transfer ownership of property (e.g. commercial premises) owned by a private company to another shareholder or associate as part of a matrimonial settlement. We believe that the exemption under section 109J should extend to the discharge of such an obligation which would also be congruent with the outcome arising from the operation of the capital gains tax same asset rollover available on a marriage or relationship breakdown under Subdivision 126-A of the ITAA (1997)

- We concur with the views expressed in the commentary to Chapter 4 that it is unclear how the debt forgiveness rules under section 109F apply where the amount forgiven is caught under the extended definition of loan under section 109D as it appears that a debt subject to section 109F may not included the provision of financial accommodation as the definition of debt under section 109F takes its meaning from the more limited definition of debt under the commercial debt forgiveness provisions of Subdivisions 245 of the ITAA (1997), and

- We suggest that the Commissioner's general discretion under section 109RB be retained. Although we believe that the incidence of disputes will diminish if a statutory interest framework is adopted we believe that inadvertent errors could still arise such as, say, on the valuation of the use of private company assets under section 109CA. Whilst the honest mistake and inadvertent omission threshold requirement to the availability of the discretion under section 109RB is too onerous under the prevailing Division 7A regime, we believe that it would be an acceptable gateway test if our suggested model concerning the reform of Division 7A was fully implemented as proposed.

3. Distribution model

CPA Australia wishes to reiterate its significant concerns regarding any possible reform of Division 7A based on the 'Distribution Model' being the third reform option outlined under Chapter 5 of the Discussion Paper.

From a policy perspective the principles underpinning the Distribution Model are so vaguely enunciated that their introduction would cause significant confusion for both business owners and tax advisers as to when profits could be retained for 'permitted purposes' and when profits retained for 'non-permitted purposes' would be treated as deemed dividends.

We believe that it will be necessary to introduce a new prescriptive definition as to what will constitute 'permitted purposes' for the model to be effective which will be regarded as a far more complicated and less comprehensible concept to practitioners than applying the familiar interest deductibility test applicable under the statutory interest method.

Furthermore, the compliance difficulties associated in potentially complying with this model would be significant as illustrated by the practical problems often encountered in practice in distinguishing between active and passive assets under the small business CGT concessions. This complication would only become more acute if practitioners and their small to medium sized clients were required to separately identify and track active, passive and personal CGT assets.

As discussed, the policy underlying the Distribution Model to treat distributions of 'passive' profits which are retained in the company as deemed dividends also extends beyond the original policy intent of Division 7A which was to treat distributions of profits in a tax free form to shareholders and associates as deemed dividends.

We believe that any reform of Division 7A should be restricted to the original policy intent of those provisions which was to prevent disguised distributions of profits.

From a practical perspective it will also be extremely difficult for most closely held groups who typically receive finance from multiple sources which are then commonly pooled to trace the flow of funds to identify where they have been applied to respectively acquire passive or active assets.

Such an outcome would also be contrary to our view that any reform to Division 7A should cut complexity, reduce compliance costs and be based on clearer language.

Accordingly, we would not support the introduction of a Distribution Model.