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Ms Louise Lucas
Board of Taxation Secretariat
The Board of Taxation
C/- The Treasury
Langton Crescent
PARKES ACT 2600

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Dear Louise,

REVIEW OF DIVISION 7A OF PART III OF THE INCOME TAX ASSESSMENT ACT 1936

We refer to the Discussion Paper released on 20 December 2012 (the '**Paper**') by the Board of Taxation (the '**Board**') on the post-implementation review of Division 7A of Part III of the *Income Tax Assessment Act 1936* ('**Division 7A**').

By way of background, Moore Stephens Australia ('**Moore Stephens'**) is a leading mid-tier network of accounting firms. Moore Stephens has significant involvement in the high wealth individual and private group space and, as such, we have substantial practical experience with relation to Division 7A.

Moore Stephens welcomes the opportunity to comment on the Discussion Paper on the review of Division 7A.

Moore Stephens' view is that the progressive evolution of Division 7A has resulted in an extremely high level of legislative and practical complexity, making it very difficult for advisors and taxpayers to ensure that the compliance requirements of the provisions are satisfied. Whilst we appreciate and understand the need to maintain the integrity of the provisions, we have identified significant increases in compliance costs for entities and groups affected by Division 7A.

We further note that the significant shift in the views of the Australian Taxation Office ('**ATO**') on the treatment of unpaid present entitlements contained in Taxation Ruling TR 2010/3 has significantly widened the ambit of Division 7A. This factor, coupled with the increasing complexities of and numerous pitfalls entrenched in the legislation, has meant that Division 7A has become a major tax compliance issue for private groups.

In our view, the complexities and pitfalls presented by Division 7A in its current form, and the way that it is currently interpreted by the ATO, have outstripped the underlying policy intentions of the provisions. Accordingly, we are pleased that the Government has taken this opportunity to review these provisions and provide further clarity and certainty on the application of Division 7A.

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Moore Stephens supports a comprehensive review and re-write of the current Division 7A. In relation to the current Division 7A reform considerations presented by the Board in the Paper, it is our belief that a model aligned with the Statutory Interest Model highlighted in the Discussion Paper would provide the most efficient outcomes for loans, whilst maintaining the underlying integrity and policy intent of the regime. However, we note that such a move to a new taxing model (whether the Statutory Interest Model or another model) will require careful consideration to transitional measures to ensure that existing arrangements are appropriately dealt with. There would also be a need for Division 7A styled provisions to have residual application to non-loan transactions, such as payments and debt forgiveness.

To the extent that Division 7A remains (whether by way of residual application or otherwise), it is imperative that clarification and amendments to certain provisions and practices be made. In particular, the treatment of unpaid trust distributions to private company beneficiaries requires legislative clarification. We have detailed in our submission a number of other items that we believe require further consideration by the Government.

For completeness, we note our view that the Distribution Model is likely to be the least preferred alternative of the three that are outlined in Chapter 5 of the Paper.

We have outlined our specific issues in relation to the Division 7A reform considerations in the attached submission.

If you have any queries please contact Ian Kearney on 03 8635 1914.

Yours faithfully

Ian Kearney
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Submission on the post-implementation review of Division 7A
Division 7A Reform Considerations

Proposed Models

The Board of Taxation has raised for consideration three models for the reform of Division 7A. We comment briefly on each of these in turn.

Statutory Interest Model

Of the three models proposed, Moore Stephens has a strong preference for the Statutory Interest Model to replace the existing Division 7A measures relating to loans. In our view, this model provides the most efficient, equitable result and aligns with the overall policy objectives of Division 7A, in that through the mandatory interest requirement, it will continue to provide an effective deterrence for the tax-free use of business profits. Importantly, it is our view that if this model is implemented appropriately, it will provide a significantly simplified outcome, thereby reducing the administrative burden on taxpayers.

With respect to the specific design features of this model, we propose the following framework:

Loans

- All loans made by private companies and trusts to shareholders and their associates (related entities) to be subject to a fixed interest rate, in order to be complying and thus avoid a deemed dividend outcome (assuming that a distributable surplus existed in the lender).

- The suggested interest rate to be applied is a rate that is higher than the current benchmark rate. The rate that is suggested is the RBA indicator lending rate for small business variable (other) overdraft rate (along the lines suggested in Option 2 in PS LA 2010/4).

- Such interest would be required to be paid on an annual basis in order for the loans to comply with the new provisions.

- No mandated principal payments or fixed term provisions would be required, but complying terms would be required to be documented. Because of the higher interest rates applicable to such loans, where loans were not being applied to income earning pursuits there would be an obvious inbuilt encouragement for such loans to be repaid as soon as possible to minimise the tax leakage on the interest.

- The definition of loans should be extended in a statue to provide clarification as to the status of unpaid present entitlements ('**UPEs**'). The definition of loan should be extended to specifically cover UPEs, subject to similar timing considerations as those reflected in the ATO Ruling TR 2010/3 (i.e. an UPE converts to a loan essentially in the income year following the year in which the UPE arises). However, transitional measures in relation to existing UPEs, particularly those that came into existence prior to 16 December 2009 would require careful consideration (see below).

- The current concession for company to company loans in section 109K of the ITAA 1936 could be scrapped. The purpose of this suggestion is twofold: (a) on the basis that the objective is to ensure that application of company funds for private use on non-income earning pursuits is to be penalised, there is no reason to distinguish between company borrowers and other forms of entities; and (b) it is considered that treating corporate borrowers from private companies in the same way as other forms of borrowers would permit significant simplification – that is, the interposed entity rules to the extent that they relate to loan transactions may not be required.

- To the extent that loan terms or actual events (e.g. failure to make interest payments) relating to such loans did not comply with Division 7A a deemed dividend would arise. The proposal is that any shortfall in payment of required interest amounts should be treated as a deemed unfranked dividend.

Payments and debt forgiveness

- There would be a residual application of Division 7A to adequately deal with payments and debt forgiveness.

- This residual application of Division 7A could be a significantly stripped down version of the current rules, with the existing provisions relating to loans removed and replaced with the statutory interest framework referred to above. A number of simplifications to these provisions are much needed, in our view, including a simplification of the interposed entity provisions. We are strongly of the view that these provisions require urgent amendment to ensure that where any payment is made by a private company on commercial terms to an interposed entity (eg a repayment of existing debt, or arm's length consideration for another transaction) that this should remove any subsequent transaction from an interposed entity to a target entity from Division 7A. This issue (and other problems with the existing provisions in Division 7A that require attention) is explained in more detail below.

We believe that the above framework would adequately maintain the intention underpinning the provisions of Division 7A, namely "to prevent shareholders (or their associates) of private companies from inappropriately accessing the profits of those companies in the form of payments, loans or debt forgiveness transactions". It would do so in a way that is expected to be considerably simply than the complex labyrinth of rules that is the current Division 7A. The higher interest rate proposed above will serve as a considerable deterrent to borrowers that apply funds sourced from company profits to non-income earning pursuits and will encourage early repayment of loans. The new framework will mean that many of the existing complex provisions are likely to become redundant and able to be repealed.

Transitional measures under a statutory interest approach

If the statutory interest model was to be adopted, we note the need for careful consideration of transitional measures to be included to adequately cover existing Division 7A loans as well as unpaid trust distributions currently held on sub-trust. These existing arrangements, under the current Division 7A measures, can be in place for as long as 25 years[1]. In a perfect world, given that reduction in complexity is a key goal of the reforms, it would be desirable if the new regime could apply to both existing and new arrangements. It is possible that the framework outlined above would be sufficiently simple and accepted by taxpayers that such an outcome would be possible. Another alternative is to effectively exclude all existing arrangements from the new regime (leaving Division 7A in its existing form to apply), save for an "opt in" feature in relation to the new measures. We note the inherent complexities within this suggestion, in that taxpayers (and the ATO) will effectively be required to deal with two separate regimes.

Given the nature and potential impact of any such reform relating to Division 7A we suggest that further consultation would be desirable to consider potential transitional measures.

Division 7A Adjustment Model

Whilst our strong preference is for a Statutory Interest Model framework as described above, we have also outlined brief comments on the main reforms we see as being necessary if the Division 7A Adjustment Model is chosen. Under this option the framework of Division 7A is retained with specific modifications and clarifications.

We highlight below the major issues within the current regime that we consider require urgent reform:

[1] Where the Division 7A loan is secured by registered mortgage over real property

1. *Treatment of unpaid present entitlements ('UPE') and sub-trust arrangements*

   One of the most controversial aspects of Division 7A in its current form is the treatment of UPUs. The Commissioner of Taxation (the '**Commissioner**') has expressed his views on the provisions of financial accommodation with respect to UPEs in Taxation Ruling *TR 2010/3* and the Practice Statement *PS LA 2010/4.* Legislative clarity is urgently required in relation to this complex issue. We consider the need for certainty on this issue to be of the critical importance given the significant impact on private groups and companies. To this end, we recommend that UPEs are specifically included in the definition of loan under Division 7A thereby aligning the legislative provisions with the current practices. One particularly troubling aspect of the status quo is the Commissioner's "subtrust" concept, as set out in PS LA 2010/4. Whilst this concept is ostensibly a construction that is in taxpayer's favour, it is a concept that is without any legislative backing or support even to the extent that it is not even binding on the Commissioner (being a concept defined in a Practice Statement only). Many taxpayers are relying on this concept and are potentially exposed if a dispute proceeds to Court or in the event that the Commissioner simply changes his mind. This situation is unacceptable.

2. *Definition of associate*

   In our view, the use of the section 318 (ITAA 1936) definition of "associate" for Division 7A purposes is too broad. In our view, a circumstance where a shareholder or associate holds a miniscule interest (say, 0.001%) in a unit trust or partnership should not be sufficient to expose the parties to a Division 7A outcome, yet that is the position under Division 7A as it stands. We therefore recommend that the definition of associate be reviewed. One possibility may be to align the associate concept with the definition of 'connected entity' under section 328-125 of *Income Tax Assessment Act 1997* ('**ITAA 1997'**) used for the purposes of both taxation of financial arrangements provisions[2] and small business relief provisions[3].

3. *Exemption for loans to purchase shares under employee share schemes ('ESS')*

   Section 109NB of ITAA 1936 only provides limited exemption for particular genuine categories ESS[4]. Whilst it may be legislatively convenient to align the preconditions of this section with the conditions in Subdivision 83A-B/83A-C of ITAA 1997, our view is that this significantly limits the exemption without justification. A significant number of legitimate employee share arrangements will not factually satisfy these conditions[5] and will be denied the Division 7A concession. We do not believe that there is any rationale policy reason for confining the exemption to such a limited range of ESSs and submit that the exemption for loans under ESS be broadened to include other genuine ESS categories.

4. *Interposed entity rules*

   Our view is that these provisions are in urgent need of amendment. These rules can operate in a manner that is absurdly harsh for taxpayers and clearly contrary to the underlying policy intention of Division 7A. As noted above, we believe that the key reform necessary for these

[2] Division 230 of *Income Tax Assessment Act 1997*
[3] Division 152 of *Income Tax Assessment Act 1997*
[4] Exemption only applies to loan under employee share schemes to which Subdivision 83A-B and Subsections 83A-35(3) to (9) of that Act apply, or Subdivision 83A-C of that Act applies.
[5] For example, because the arrangement does not satisfy the "non-discriminatory" condition in subsection 83A-35(6) or the "no forfeiture" condition in subsection 83A-35(7).

rules is to ensure that where the first transaction from the private company source is a commercial transaction, the interposed entity rules should have no application. For example, where a private company pays a dividend, or repays an existing liability or engages in another transaction that involves the passing of arm's length consideration, the interposed entity rules should have no further operation so far as any transaction that occurs between an interposed entity and the target entity. It is completely inadequate where the legislation is such that taxpayers are forced to rely on the sort of reasoning that (thankfully) the Commissioner has adopted in Taxation Determination TD 2011/16 to give a commonsense outcome.

The other more subtle, but equally serious, problem with the interposed entity rules, as they are currently drafted, is their interaction with section 109R of ITAA 1936. There would seem to be a technical risk that the application of the interposed entity rules could mean that a a taxable dividend assessable to a taxpayer at top marginal rates and applied in repayment of a loan could be disregarded for Division 7A purposes, when such rules are applied in conjunction with section 109R. Consider the following situation – Private company A Pty Ltd has loaned money to the Trustee of The A Family Trust, which is an associate of a shareholder of Private Company A. The sole shareholder of A Pty Ltd is Mr A. In order for the loan to be repaid, A Pty Ltd declares a fully franked dividend to Mr A, which is paid, Mr A loans the sum of money to the Trustee of the A Family Trust which then uses the funds to repay the debt owing to A Pty Ltd. Despite the fact that the dividend is fully assessable to Mr A, under the interposed entity rules, the dividend to Mr A would technically constitute a payment and the subsequent loan from Mr A to the Trustee of the A Family Trust would potentially give rise to a deemed loan from A Pty Ltd to the Trustee of the A Family Trust (by virtue of sections 109T and 109W). As a result, it would seem open to the Commissioner to disregard the repayment of the loan owing to A Pty Ltd, under the operation of section 109R. This would clearly be a ludicrous outcome and hopefully one that the Commissioner would not pursue in the circumstances. Rectifying the interposed entity rules to ensure that this outcome cannot arise should be an urgent priority.

5. *Undue hardship rules*

Under the current law, the Commissioner has the discretion to disregard a debt forgiveness where he is satisfied that the reason for the forgiveness was that the payment would have caused the entity undue hardship and the entity has lost the ability to pay the debt in the foreseeable future (see subsection 109G(4) of the ITAA 1936). We consider that a similar reciprocal discretion should be extended to loans where the borrower has lost the ability to make minimum yearly repayments in the foreseeable future.

6. *Definition of "real propert*y"

There is a need to clarify that real property for the purposes of paragraph 109N(3) of ITAA 1936 includes leasehold interests in land. Whilst we believe that this is clearly the intention underpinning the use of the term real property (otherwise certain landholders, such as those with landholdings in Australian Capital Territory where the land ownership system is leasehold based would be severely disadvantaged), we believe that it is important that this be made clear in the statute.

Distribution Model

For completeness, it is appropriate to briefly explain why we believe that the distribution model outlined in Chapter 5 of the Paper is the least preferred of the alternatives outlined:

(a) The Distribution Model would be a drastic change to the basis on which private companies are taxed and we are fearful that the level of complexity and uncertainty that it would introduce would be contrary to the objectives of the reform process. By contrast, we believe that the Statutory Interest Model would be much simpler and easier for both taxpayers and ATO to deal with.

(b) The outline of the proposed Distribution Model draws a distinction between passive and business activities. The consequences of this distinction are quite material. In our view, the distinction between “business” and “passive” activities is not so great as to justify the very different treatment proposed for taxable income from such activities, from a policy perspective. In our view, the more meaningful distinction is between income earning activities and non-income earning (private activities), a distinction that the Statutory Interest Model framework proposed above would handle well. In our view, it is the private use of funds that should be penalised from a Division 7A perspective, not passive income generating activities. The other issue that is relevant to note in this context is that the distinction between business and passive activities can be quite blurry in practice (depending on a range of factual matters, such as intent, scale, degree, etc) whereas the distinction between income and non-income generating activities is reasonably well understood in practice.