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Taxation Law Committee

Post Implementation Review of Division 7A of Part III of the Income Tax Assessment Act 1936: Second Discussion Paper March 2014

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The Board of Taxation
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NSW Young Lawyers

NSW Young Lawyers, a division of the Law Society of NSW is made up of legal practitioners, who are under the age of 36 or in their first five years of practice, and law students. It is the largest body of young lawyers and law students in Australia, with a membership comprising some 13,000 members.

NSW Young Lawyers supports practitioners in their career development in numerous ways, including encouraging involvement in its 16 separate committees, each dedicated to a particular area of practice.

The members of the NSW Young Lawyers Taxation Law Committee ("the Committee") are young practitioners from NSW who share an interest in and passion for taxation law. The Committee represents a group of emerging legal practitioners who will be at the forefront of tax planning advice and tax disputes over the coming years, and who will assist taxpayers to meet their obligations under any revised Division 7A regime.

This submission has also been prepared in consultation with the Business Law Committee of NSW Young Lawyers.

Inquiries may be directed to Thomas Spohr, President of NSWYL, at president@younglawyers.com.au or on 0435 325 065, or to Nathan Weinberger, Chair of Taxation Law Committee, at taxlaw.chair@younglawyers.com.au or on 0403 956 708.

Summary of issues raised in this submission

The Committee's position in response to the "*Post Implementation Review of Division 7A of Part III of the Income Tax Assessment Act 1936: Second Discussion Paper (March 2014)*" (**Discussion Paper**) can be summarised as follows:

a) priority should be given to the Board's goal of maximising simplicity when evaluating the design of the policy framework and the merits of the alternative models;

b) the Statutory Interest Model is preferred, even if this results in a cost to revenue (assuming such costs are not unreasonable); and

c) any amendments affecting trusts should be considered together with the ongoing Treasury review of the taxation of trusts.

The Committee's responses to the specific questions raised in the Discussion Paper are set out in more detail below. Unless otherwise specified, a reference to a section or division is a reference to the *Income Tax Assessment Act 1936* (Cth).

Chapter 4: A Coherent Policy Framework for Guiding Reform

Question 4.1

The Board seeks stakeholders' comments on whether taxing business accumulations at a 'company tax' rate, irrespective of the structure chosen, is an issue that should be considered as part of a wider tax reform process.

Any change to the taxation of trusts is significant from a tax policy perspective. This was acknowledged by the federal government in November 2011 when it invited submissions to the consultation paper proposing that Division 6 be re-written[1]. Excluded from the scope of that discussion paper was taxing trusts at the company rate.

To ensure there is a systematic and comprehensive review of the relevant issues, the Committee is of the view that any proposed 'uniform business tax rate' be considered together with the re-write of Division 6 and not only as part of a review of Division 7A.

We note that in chapter 3 of the Discussion Paper the Board recognises that trusts, rather than companies, have become a 'vehicle of choice' for reasons including asset protection, succession and tax planning.

The Committee submits that our members have observed that there has been a decline in use of companies by small businesses to hold commercial property due to the attractiveness of the general Division 115 discount available for trusts and SMSFs. In addition, many small businesses do not fit within the eligibility criteria of the small business CGT concessions under Division 152.

For these reasons, the proposal to tax business accumulations at a company tax rate **irrespective of the structure** (emphasis added) must be considered as part of a wider tax reform. Presently, accumulations of income in discretionary trusts and unit trusts are taxed at the highest marginal tax rate of 46.5% whereas business-related accumulations for SMSFs (for example, returns on business premises) are taxed at 15% in accumulation phase and 0% in pension phase.

The Committee does not endorse a "one size fits all" approach for taxation of business accumulations without regard to a wider review. Any such review should consider the policy intent of other areas of law (including, for example, the *Superannuation Industry (Supervision) Act 1993*, trust law and the ongoing review of taxation of trust and small business CGT provisions). Consideration should also be given to the non-tax implications for small and medium businesses.

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[1] Commonwealth Treasury, *Modernising the taxation of trust income – options for reform*, Consultation Paper, November 2011

Question 4.2

The Board seeks stakeholders' comments on whether the high level tax policy aims of efficiency, simplicity and equity would be served by adopting a policy framework for private businesses that supports the progressivity of the personal tax system by striking an appropriate balance between the following four goals:

(a) **It should ensure that the private use of company profits attracts tax at the user's progressive personal income tax rate.**

(b) **It should remove impediments to the reinvestment of business income as working capital.**

(c) **It should maximise simplicity by reducing the compliance burden on business and the administrative burden on the Commissioner and other stakeholders.**

(d) **It should not advantage the accumulation of passive investments over the reinvestment of business profits in active business activities.**

The Committee agrees that the high level tax policy aims would be served by a policy framework which balances the above listed four goals.

However, the third goal (paragraph (c) above) should be given more weight and should be the most important factor in the policy design.

This is especially so in the context of the broad policy intent of 'cutting red tape' for small businesses and encouraging Australian innovation and start-up businesses.

Accordingly, the interaction of Division 7A with other provisions of the tax legislation (such as the ongoing review of employee share schemes for start-ups and current employee share scheme provisions within Division 83A) must be considered to encourage innovation.

Specifically, the provisions of Division 7A do not apply to certain employee share schemes under Division 83A. However, employee share schemes that fall outside of Division 83A, for example, loan funded share plans at market value, continue to be subject to Division 7A.

The Committee submits that commercial loans from a private company or unlisted overseas company on arm's length terms to incentivise employees should be carved out of the provisions of Division 7A to encourage innovation and start-up businesses.

In addition, the importance of the third goal should permit a policy design that results in an overall cost to the revenue (i.e. by a less-than-perfect achievement of the first goal (paragraph (a)), though this cost should be limited as far as possible.

It is also suggested that the fourth goal (paragraph (d)), though important, can only be achieved to a limited extent by the framework of Division 7A, especially given that the incentives of the general 50% CGT discount and negative gearing deductions will continue to exist.

Compared to the current law, a policy framework that is slightly more concessional (which is required to achieve simplicity) would remove disincentives for entrepreneurs and small business to operate through companies.

Question 4.3

The Board seeks stakeholders' comments on how, if the suggested framework were to be implemented, the proposed rules regarding asset usage could be designed without introducing undue complexity.

The Committee prefers the Statutory Interest Model.

It is acknowledged that the Statutory Interest Model will require a separate asset usage policy framework.

The Committee has no specific comments on the design of the asset usage policy except that simplicity must be a paramount consideration.

The Committee supports comments by ICAA[2] about simplified alternative valuation methods for asset usage.

Question 4.4

The Board seeks stakeholders' comments on:

(a) whether excluding unrealised gains from the distributable surplus would assist in simplifying compliance with the provisions and address the potential for double taxation;

(b) whether there would be integrity concerns or likely cost to revenue if the proposed approach to distributable surplus were to be adopted; and

(c) whether, as an alternative to the proposed approach, unrealised gains and losses should be included in the basic calculation of distributable surplus, but then be subtracted when dealing with temporary transfers of value.

The Committee considers that the proposed changes to the distributable surplus calculation accord more closely with the underlying economic reality of a business (reflecting actual realised gains the business has derived).

However this approach would not necessarily simplify compliance. It would add an additional layer of complexity in ascertaining a Division 7A liability – requiring annual review of the company's position to determine whether a liability will arise for that year, taking into account all Division 7A loans from previous years, even where no Division 7A advances were made during that year.

If this approach was adopted, the education campaign for the new regime would need to focus on awareness of the annual test and its application to all prior year loans. In order to improve taxpayer compliance, a new schedule to the company tax return for private companies (not necessarily to be provided to the ATO) should require a listing of all current and prior year loans and a calculation of the realised profit for the year, enabling distributable surplus to be easily calculated.

It is noted that additional complexity could arise if this proposed distributable surplus calculation was implemented together with the Statutory Interest Model. This is discussed in further detail below.

The Committee does not see any additional benefit of the proposed 'subtraction' calculation method in Question 4.4(c).

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[2] Submission by the Institute of Chartered Accountants Australia dated 22 February 2013 to the first Board of Tax discussion paper

Question 4.5

The Board seeks stakeholders' comments on whether the distributable surplus rules should be adjusted to be:

(a) tested at year end for permanent transfers of value, as well as for temporary and ongoing transfers of value (for example loans, asset usage) at each year end; and

(b) based on the amount of available realised profits of the company as reflected in its accounts (net assets), but with appropriate adjustments to address situations:

i. of possible double counting; and

ii. where value which has not been reflected as realised in the accounts has been transferred to shareholders/associates.

The Committee agrees with the proposed changes to the distributable surplus calculations, subject to the implementation of a clear method statement and an education campaign informing taxpayers how to calculate the distributable surplus under the new rules.

Question 4.6

The Board seeks stakeholders' comments on:

(a) the proposed general rules for determining when deemed dividends should arise; and

(b) whether, and in what circumstances, deemed dividends should be frankable.

The Committee agrees with the proposed general rules for deemed dividends, including the annual test for distributable surplus. This is subject to our view that the Statutory Interest Model is preferred.

The Committee submits that as a broad approach, a deemed dividend should be frankable where the company and/or the shareholder identify the deemed dividend and either self-assess in the current year return or initiate an amendment to a prior year return to include the deemed dividend. Where the Commissioner reviews and amends an assessment, the dividend would be unfrankable as per the current regime. This would retain a disincentive for non-compliance and incentivise self-correction.

Chapter 5: Analysis of Previously Proposed Models

Question 5.1

The Board seeks stakeholders' comments on whether the potential benefits of the Statutory Interest Model (particularly the simplification benefits) are justifiable having regard to the policy framework set out at paragraph 4.25 above.

The Committee submits that the Statutory Interest Model is preferred. The simplicity of this model and the resulting reduction in compliance costs for business outweigh the disadvantage of any perceived incentive to accumulate passive income and any cost to the revenue base.

As a specific example, under the current regime, the cost of having Division 7A loan agreements drafted and implemented can be significant for small businesses, especially where multiple entities are involved in a complex private group structure. In addition, the Committee's members have provided anecdotal evidence of a number of instances where Division 7A agreements are technically invalid due to defects in the form of the agreement or the timing of the signing of the agreement (e.g. where the company's tax return is lodged before the due date).

The proposed simplification of the loan agreement requirements as per Question 6.1 would be welcomed. However the Statutory Interest Model would alleviate the need for these agreements altogether. The Discussion Paper notes at paragraph 5.22 that a number of submissions to the first discussion paper put forward that the Statutory Interest Model was the preferred model.

The main concern noted by the Board is that the pure Statutory Interest Model would result in a detriment to the revenue. The Committee submits that these concerns (noted as bullet points in paragraph 5.32 of the model) could be addressed as follows:

a) The arbitrage between the company and personal marginal rates should be addressed by an 'otherwise deductible' rule, as suggested by, among others, the Tax Institute[3]. Under this model, statutory deemed interest on the loan would only apply if the loan funds are not used by the borrower for a deductible purpose. To the extent that the funds are used by the borrower for a deductible purpose, no statutory interest would apply. There would never be an actual deduction available to the borrower.

b) The disincentive for companies to pay a dividend to fund repayments could be addressed by a higher statutory interest rate – noting the concerns about arbitrage are dealt with above. In addition, the statutory interest rate could increase over the life of the loan, to effectively compensate the revenue impact for the lack of principal repayments. For example, the statutory interest base rate could apply for the first 5 years of the loan, then be raised by a fixed percentage each subsequent year. The rising interest rate would encourage repayment of the loans. The Committee would encourage the Board to model the revenue impact of such a model.

c) The fact that the borrowed funds could be used to finance the purchase of assets for which the 50% CGT discount is available on sale should not be considered to cause a significant detriment to the revenue base. It is always possible for a company to use funds taxed at the corporate rate to acquire assets (whether active business or passive investment assets) whose increase in value remains unrealised. Then, if the shares in the company are sold by the shareholder (rather than the company selling the assets), the 50% discount is effectively

[3] Submission by The Tax Institute dated 27 March 2013 to the first Board of Tax discussion paper

available to the shareholder on the increased value of those assets. In addition, a rising statutory interest rate as discussed above would indirectly compensate the revenue impact, by making long-term private use borrowings less tax effective.

d) Finally, as an alternative, it might be possible to create a distinction between business and other deductible purposes under the Statutory Interest Model. That is, a "three-tier system" could operate as follows:

   i. The otherwise deductible could rule be limited to cases where the borrower carries on a business and uses the borrowed funds in the business.

   ii. A lower, one-side statutory interest rate (assessable to the company, not deductible to the borrower) could apply where the funds are used by the borrower for an income producing purpose that falls short of it being a business.

   iii. The full statutory interest rate would apply where the funds are used for private purposes.

This model would involve the statutory interest being a one-sided impost, deeming assessable income to arise for the company without allowing a corresponding deduction for the borrower, and never requiring that interest actually be paid.

The Committee submits that this three-tier approach would remove impediments to the reinvestment of business income as working capital, enable passive investment (but not advantage it relative to reinvestment in active business activities) and still capture the use of business profits for private purposes.

The distinction between active business activities and other income producing activities already exists in a number of areas of the income tax law. The Committee submits that there is no reason this distinction could not also apply to Division 7A loans.

In addition, the statutory interest income could be deemed to be derived by the company regardless of whether or not it is actually paid and received. Issues of excess franking credits arising in the company would need to be managed.

The Committee acknowledges that in seeking to perfect the Statutory Interest Model, some of the benefits of its simplicity may be lost, for example under the rising interest rate model or the three-tier system as proposed above. However, the Committee submits that a modified Statutory Interest Model, in some form, is best able to strike the balance between the goal of simplicity and the other goals.

Question 5.2

The Board seeks stakeholders' comments on:

(a) whether a number of administrative issues and the high compliance and administrative costs associated with Division 7A are due to the prescriptive and, in some cases, form-based provisions within the Division;

(b) whether pursuing the *Division 7A Adjustment Model* alone would have only limited impact in moving the system in the direction of the Board's preferred policy framework as discussed in Chapter 4; and

(c) if the new model suggested in Chapters 4 and 6 (and summarised in the Executive Summary) were to be adopted, what remaining aspects of the *Division 7A Adjustment Model* (if any) should be progressed, any in what priority.

The Committee agrees that the high compliance and administrative burden is due to the form-based provisions in the current Division 7A. The Committee does not endorse the adjustment model approach to deal with the problems in applying Division 7A as it may result in additional complexity and compliance costs for taxpayers. The adjustment model would not achieve the objectives of the reform to simplify the provisions and application of Division 7A in practice.

The Committee does not support the Division 7A adjustment model alone, but acknowledges that the preferred approach of the Statutory Interest Model needs to be supplemented with rules to deal with permanent transfers of value and asset usage.

Chapter 6: New Model – The Transfer of Value Model

Question 6.1

The Board seeks stakeholders' comments on whether it would simplify compliance if legislation were enacted prescribing the terms and conditions for Division 7A loans as outlined below and, if not, how the proposed rules could be modified to improve simplicity:

- **(a) There would be no requirement for a formal written agreement between the parties. However, written or electronic evidence that a loan was entered into must be exist by lodgment day for the income year in which the loan was made.**
- **(b) The statutory interest rate would be set at the start of the loan and fixed over the term of the loan.**
- **(c) The statutory interest rate for a particular year would be set at be the Reserve Bank of Australia's indicator lending rate for small business variable (other) overdraft for the month of May immediately before the start of that income year.**
- **(d) The maximum loan term would be 10 years.**
- **(e) The prescribed maximum loan balances during the term of the loan (including any accumulated interest) would be as follows:**
  - **i. 75 per cent of the original loan by the end of year three;**
  - **ii. 55 per cent of the original loan by the end of year five;**
  - **iii. 25 per cent of the original loan by the end of year eight; and**
  - **iv. 0 per cent of the original loan (that is, fully repaid) by the end of year ten.**
- **(f) Subject to meeting the minimum loan balances, there would be no specified annual principal repayments.**
- **(g) Interest would be able to be accrued but would have to be paid by the end of each milestone period — ends of years three, five, eight and ten.**
- **(h) Failure to make the repayments by the end of the milestone periods would result in the private company being taken to have paid a dividend to the entity based on the amount of the shortfall in the payment required.**
- **(i) The Commissioner's period of review would commence to run from the date of lodgment for the income year in which each milestone payment is required (or would have been required, had a complying loan agreement been entered into).**

The Committee agrees that these rules for complying loans are simpler and should be preferred to the current rules. However, a modified Statutory Interest Model as per above is the most preferred model.

Question 6.2

The Board seeks stakeholders' comments on whether greater simplification, certainty and policy coherency would be gained from a legislative amendment to clarify that all UPEs are loans for Division 7A purposes.

The Committee agrees that legislative clarification that UPEs are loans is essential and beneficial to all parties.

Whilst there is uncertainty in relation to the interaction of the current Division 7A rules and the general law concepts of equity and trusts, there is no policy reason that UPEs should not be treated as loans.

The Statutory Interest Model and otherwise deductible rule would provide a regime that would not affect UPEs that are retained for use in the business of a trust.

Question 6.3

The Board seeks stakeholders' comments on:

- **(a) whether the issues associated with retaining working capital for the carrying on of a business in a trust can be addressed with the use of a limited exception;**
- **(b) whether the limited exception (provided through legislation) should be that all loans to trusts (including UPEs) can be excluded from the operation of Division 7A, where the trust makes a once and for all election to forgo access to the CGT discount on its capital gains arising from assets held within the trust;**
- **(c) whether the proposed limited exception would reduce compliance costs in instances where a business is carried on in a trust;**
- **(d) the nature of the consequential rules that would be required if such a limited exception were to be applied;**
- **(e) the nature of any transitional rules that would be required if such a limited exception were to be applied; and**
- **(f) the merits of a transitional rule that provides that:**
    - **i. any loans in place prior to a trust making an election would continue to be subject to the existing requirements; and**

While the opportunity for trusts to make this election simplifies the difficulties surrounding UPEs and Division 7A, care would need to be taken in drafting legislation that excludes these trusts from applying the CGT discount.

The amendments imposing the election would necessarily be quite complex and would also alter the principles of 'streaming' capital gains to individuals and the inclusion of trust capital gains in the income of the beneficiaries. These changes would need to be considered in the context of the broader reform of the taxation of trusts and not in isolation as part of a review of Division 7A.

In addition, the apportionment of the trust's proceeds of sale between goodwill and other assets (especially where the sale involves shares in companies which themselves have goodwill) would have greatly increased significance and could result in valuation disputes and administrative uncertainty.

It is again noted that the Statutory Interest Model combined with the otherwise deductible rule would remove the need for this approach altogether.

Finally, if the tick-the-box exception were to be adopted, some clarity concerning the interaction of this carve out from Division 7A and the anti-avoidance provisions of section 100A would be required. This is especially important in light of the Commissioner of Taxation's suggestion that section 100A could apply adversely in certain circumstances where UPEs are owed to a company beneficiary. Where section 100A applies, the trustee is adversely taxed on the trust income the subject of the UPE under section 99A.

If the tick-the-box model were to be adopted, it would need to be confirmed that any UPEs owed by the trust to a private company cannot be subject to section 100A, which could otherwise operate to defeat the purpose of this exception.

Question 6.4

The Board seeks stakeholders' comments on:

- **(a) whether a legislative self-correction exception should be available to taxpayers to correct mistakes or omissions;**
- **(b) the nature of any eligibility requirements for the exception;**
- **(c) the nature of any conditions that should be satisfied to qualify for the exception;**
- **(d) appropriate record-keeping and evidentiary requirements that must be met to qualify for the exception; and**
- **(e) any impediments to the practical administration of the exception.**

The Committee would welcome the introduction of a self-correction mechanism for taxpayers. The self-correction mechanism would enable taxpayers to put in place complying loans, reduce compliance, administrative costs and substantially reduce the number of cases that require the Commissioner's discretion.

It is our members' belief that taxpayers who did not take the opportunity to utilise the amnesty provisions for Division 7A or had incorrect advice from previous advisers should be given the opportunity to self-correct under safe harbour provision without penalties or general interest charges provided the amendment is made within the amendment periods and the relevant corrective action is taken.

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The Committee thanks the Board for the opportunity to comment on the Discussion Paper and would be very pleased to provide further information or submissions as required.

Sincerely,

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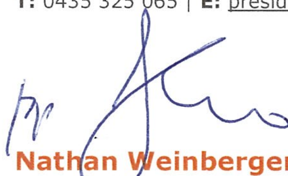

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