THE TAX INSTITUTE

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21 May 2014

Mr Curt Rendall
Chair of the Division 7A Working Group
The Board of Taxation
c/- The Treasury
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By email: taxboard@treasury.gov.au

Dear Curt,

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

The Tax Institute welcomes the opportunity to make a submission to the Board of Taxation (**Board**) in relation to the Second Discussion Paper on the *Post Implementation Review of Division 7A of Part III of the Income Tax Assessment Act 1936* (**Discussion Paper**).

Following the post-implementation review of Division 7A begun by the Board in late 2012, with the recent change of government, the Board requested and the current government agreed to extended terms for the post-implementation review of Division 7A. These extended terms are set out in the Discussion Paper[1] and centre around examining the broader taxation framework in which Division 7A operates, identifying problems with the current Division 7A rules and finding solutions for these problems.

The Tax Institute thanks the Board's Division 7A Working Group members for providing the opportunity to meet with them on 16 April 2014 to discuss the Board's proposals in the Discussion Paper.

Summary

The Tax Institute is broadly supportive of the policy principles that the Board has stated Division 7A should achieve by ensuring that the private use of private company funds is appropriately taxed at the user's marginal tax rate. The Board has developed 4

[1] At page 2

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alternate models which each offer opportunities for improvement to the current Division 7A framework.

In considering what these models have to offer and the issues raised in the Discussion Paper, our submission below addresses two broad areas, namely:

- The statutory interest model, together with an 'otherwise deductible' rule, being the preferred option to pursue to simplify the Division 7A framework; and
- Though not without merit, the transfer of value model is problematic and may not be a straightforward solution to resolving the problems with the current Division 7A framework.

Discussion

The Tax Institute previously made a detailed submission to the Board in relation to the post-implementation review of Division 7A. Accordingly, we refer the Board to our submission dated 27 March 2013 (**Submission**).

1. Policy objective of Division 7A

The Board has noted that in its current form, Division 7A does not meet its policy objective, which is to be an integrity measure to prevent shareholders (and their associates) of private companies from inappropriately accessing the profits of the company[2]. In its 16 year history, the rules have been amended and expanded and as a result have become ever more complex and difficult to apply, particularly with regard to their interaction with other areas of the tax law.

The Board notes that Division 7A is mainly concerned with inappropriate access to wealth that has been accrued in a corporate tax environment (ie a company) and regards the operation of Division 7A as an intermediary between the business and personal tax systems[3]. Division 7A has a primary role to support the progressive nature of the personal tax system. However, the Board has found that Division 7A fails to provide a coherent framework for taxing the private use and enjoyment of wealth that has been accumulated in a corporate tax environment.

The Board has proffered 4 principles for how (a revised) Division 7A should operate, namely:

[2] See page 1 of the Discussion Paper. The detailed policy objective of Division 7A is set out at paragraph 9.119 of the Explanatory Memorandum to *Taxation Laws Amendment Act (No. 3) 1998* (Cth)
[3] See page 27 of the Discussion Paper at paragraph 4.4.

- It should ensure that the private use of company profits attracts tax at the user's progressive personal income tax rate;
- It should remove impediments to the reinvestment of business income as working capital;
- It should maximise simplicity by reducing the compliance burden on business and the administrative burden on the Commissioner and other stakeholders; and
- It should not advantage the accumulation of passive investments over the reinvestment of business profits in active business activities[4].

Bearing in mind the original policy objective of Division 7A and the 4 principles set out by the Board, we consider two of the models proposed by the Board.

2. Statutory Interest Model

The Tax Institute supported the statutory interest model as set out in the Board's first discussion paper[5]. The new statutory interest model would employ an 'otherwise deductible' rule with a residual arm's length interest rate rule only for loans on which the interest would not otherwise be deductible.

We preferred this model due to the simplicity. Though not without its own issues, it provides an opportunity for the simplification of Division 7A by providing a targeted integrity measure that imposes a disincentive for the private use of the economic value accumulated in a private company by denying a deduction for the interest if funds loaned from a private company are used for private purposes.

The Board analysed this model against the four principles and noted that in its view the model did not give effect to the fourth principle of not advantaging the accumulation of passive investments over the reinvestment of business profits in 'active business activities'.

The Board has also indicated that there would be a substantial cost to revenue from implementing this model, but we question the extent of the cost to revenue. We doubt that it would be as great as the Board thinks it to be. We would like to see some initial modelling to gain an indication of the likely cost to revenue from adopting this model.

We envisage that an 'otherwise deductible' rule would only apply to loans which were used wholly for deductible purposes, avoiding the need to calculate and pay interest on such loans. Since a part of the compliance obligations imposed by Division 7A is the calculation of interest on the daily balance of a loan, taxpayers' compliance costs would be reduced by removing this requirement.

[4] See page 30 of the Discussion Paper
[5] Issued in December 2012

We understand that the Board is concerned that the statutory interest model (particularly in combination with an ‘otherwise deductible’ rule) might unduly advantage the use of economic value in a company for passive investment purposes. If that is the case, we suggest that that concern could be overcome if an ‘otherwise deductible’ rule only applied to the requirement to charge and pay interest – principal reductions in line with the schedule described at paragraph 6.19 of the Discussion Paper (or over a period of time matching the maximum loan term under the Division) could still be required rather than being open-ended.

Removing the requirement to charge and pay interest would also address the Board’s concern described in paragraph 5.34 of the Discussion Paper.

However, subject to the detailed comments in our previous Submission, The Tax Institute is still of the view that the statutory interest model is the preferred model that should be explored for the purpose of revising and simplifying Division 7A.

3. Transfer of Value Model

At first blush, the new transfer of value model proffered by the Board in the current Discussion Paper appears to be a favourable solution. However, on closer examination, there seem to be associated complexities with this model and in fact this model does not offer the same level of simplification to the Division 7A framework as the statutory interest model.

The Tax Institute considers that introduction of the transfer of value model may simply result in the replacement of one set of complex rules with another.

Analysis

Having carefully reviewed this model, we regard it as problematic and set out some of the problems we have identified below:

a) Employing new terms like “temporary transfers” and “permanent transfers” and whether the definitions are intended to refer to “legal form” of the transfer of value or the economic substance of it.

b) Use of the ‘tick the box’ concept – this will require a complex anti-avoidance regime to be put in place to ensure that the CGT benefits are not exploited. Division 7A would need to apply to ‘tick the box’ trusts as if they were companies; otherwise, what prevents a tick the box’ trust from making loans or acquiring property for use by private company shareholders? This adds a layer of complexity and inequity where funds flow through chains of trusts rather than offering a simple solution.

c) There is a trade-off between some of the benefits offered by this model and the loss of access to the CGT concessions if the “tick the box” option is chosen by a trust even though the benefit is retained for goodwill.

d) The Board is seeking feedback on whether a self-correction mechanism should be included in Division 7A. A ‘correction’ mechanism is already contained in section 109RB of Division 7A, though this requires the Commissioner to exercise his discretion rather than permitting a taxpayer to make amendments.

It would be more useful if taxpayers could self-correct errors and not have to rely on the exercise of the Commissioner’s discretion. A process similar to that which applied for the 2001-02 to 2006-07 income years pursuant to Practice Statement PSLA 2007/20[6] should be considered. Though, this will need to be weighed up against the other obligations of the taxpayers and their advisers.

e) There is no definition of the “trigger point” in the transfer of value model to assist a Court to apply Division 7A when the wealth of a private company has either been accessed directly (eg by way of loan or payment) or indirectly (by way of an unpaid present entitlement). It would be useful if there were some clearly stated exceptions to the application of Division 7A to ensure transactions that should not be subject to Division 7A do not otherwise become subject to Division 7A.

f) This model produces a potential inequity between operating a business through a discretionary trust as compared to a company. A company is able to accumulate funds that have been subject to the (lower) company tax rate of 30% whereas, broadly, a discretionary trust would accumulate income that has been subject to the (higher) top marginal rate (unless the income has been appointed to beneficiaries).

g) Drawing the distinction between passive assets and working capital assets as opposed to a distinction between “active” assets and non-active assets or business vs private assets. The current passive/working capital distinction discriminates against investment in infrastructure.

[6] PSLA 2007/20 Exercise of the Commissioner’s discretion under section 109RB of Division 7A of Part III of the *Income Tax Assessment Act 1936* to disregard a deemed dividend in respect of the 2001-02 to 2006-07 income years.

In light of the above, one possible option may be to permit a loan with characteristics similar to an overdraft under which the loan continues indefinitely but repayments are required from time to time.

4. Answers to specific questions in the Discussion Paper

a) Question 4.2 - The Tax Institute broadly agrees with the proposed policy framework set out at paragraph 4.25 of the Discussion Paper.

b) Question 4.3 – To ensure there is no undue complexity arising from the introduction of proposed rules regarding asset usage, we suggest that the amount ‘charged’ for the use of the asset be equal to the total of the costs of holding and maintaining the asset (that is, all expenses incurred in relation to the asset along with depreciation, if relevant). An appropriate test to determine which costs associated with holding and maintaining the asset should be used to quantify the ‘charge’ could be all of the expenses that are deductible to the company *because of* the company’s derivation of assessable income from the use of the asset. The company would ‘break even’ with respect to the cost of holding and using the asset (that is, it would recoup all of its outgoings) and the ‘cost’ of the asset would be passed on to the user.

   Should these rules be adopted, we recommend that the ‘otherwise deductible’ rule that currently exists in relation to the use of assets continue to be available. This would result in non-deductible expenses (to the user) as a result of the private use of assets and would confer the desired protection to the revenue.

c) Question 4.4(a) – Our members are divided as to whether the proposal to exclude unrealised gains from the distributable surplus of a company would assist in simplifying compliance with the provisions and address the potential for double taxation. Some are of the view that this proposal would simplify compliance upfront. Other members are concerned that there may be an additional compliance burden in later income years because the distributable surplus (if any) would need to be determined annually.

d) Question 5.2 – We refer the Board to our comments in our previous submission dated 27 March 2013 where we noted our concerns with the Division 7A adjustment model.

e) Question 6.1 - The proposed simplification of loan arrangements outlined in the Discussion Paper is favourable, especially the removal of the requirement to have a written loan agreement. The Tax Institute would welcome the proposals in paragraphs (a) to (i) of Question 6.1 provided that an ‘otherwise deductible’ rule was also available and applied to interest obligations.

f) Question 6.2 – The legislative clarification proposed at paragraph 6.31 of the Discussion Paper would be welcomed provided that it was sufficiently clear and certain.

   In relation to the statement made by the Board at paragraph 6.27 that (paraphrasing) when an interest-only loan permitted under PSLA 2010/4 ends, the investment assets that were purchased via such a loan can be refinanced “without the top-up tax on the loan ever being paid”, we note that company accumulated profits are only ever a timing difference. These profits will inevitably be extracted from the company at a future point in time (for example when the company is wound up).

g) Question 6.4 – As noted above, a self-correction mechanism should be available to taxpayers under these rules to ensure that taxpayers are able to make corrections where they have incorrectly treated certain distributions as subject to Division 7A without the need to apply for the Commissioner’s discretion.

If you would like to discuss any of the above, please contact either me or Tax Counsel, Stephanie Caredes, on 02 8223 0059.

Yours sincerely

M. Fly

Michael Flynn
President