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Mr Curt Rendall
Chair
Division 7A Working Group
The Board of Taxation
Treasury Building
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Dear Mr Rendall

BOARD OF TAXATION'S POST-IMPLEMENTATION REVIEW OF DIVISION 7A

Thank you for your letter of 10 July 2012 and the invitation to participate in the very constructive consultation meeting which took place on 2 August 2012.

I am attaching to this letter a summary of the presentation which I made to the Tax Forum on 4 October 2011. I stand by everything that I said at the time. Indeed, in the months since the Tax Forum, the practical difficulties associated with Division 7A have become even more obvious and pronounced.

As indicated during the course of the consultation on 2 August, I believe that Division 7A should be repealed and replaced by a simple set of rules which will minimize the current compliance burden without any significant adverse impact on government revenues.

What follows is a framework comprising the principal elements of what I propose be incorporated in a new Division 7A:

1. Unpaid present entitlements should be treated as loans.

2. No loan repayments will be required and re-borrowings will be permitted, since the revenue will be adequately protected (see 5 below).

3. Division 7A loans to related entities (other than inter-company loans) must be interest bearing. There will be one interest rate fixed from time to time by regulation.

4. It follows from 3 above that, if the funds in question are ultimately lent to an individual or entity which does not use the borrowed funds for the purpose of deriving assessable income, any interest incurred by that individual or entity will not be tax deductible.

5. The revenue will be protected because, on the one hand, the end user of the borrowed funds will have to pay interest which will not be tax deductible if the loan is used for private purposes whereas, on the other hand, the interest received will be subject to tax in the hands of the recipient entity.

6. Any debts forgiven or payments made which are not loans (subject to the otherwise deductible rule) - other than payments made to discharge genuine indebtedness or obligations - will be treated as dividends and taxed accordingly (see 7 below).

7. Currently, when Division 7A applies, it eliminates the flow through franking credits and thereby, in effect, imposes double taxation. There is no justification for this draconian approach. The new Division 7A should allow franking credits to attach to any deemed dividend, with the consequence that only top up tax would be payable. The usual penalties will still be applicable for false and misleading statements, lack of reasonable care, adopting a position which is not reasonably arguable, etc.

8. Within the framework of the new Division 7A there will no longer be any need for a discretion to be vested in the Commissioner of Taxation to relieve for non-compliance.

In my view, the framework described above clearly gives effect to the policy underpinning Division 7A. That policy, as articulated in the Terms of Reference of the Review, is "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."

Division 7A was introduced in 1997. In 1999 provisions relating to discount capital gains were enacted. It has been suggested that the elimination of the requirement for minimum loan repayments (see 2 and 5 above) could impact adversely on the revenue by enabling taxpayers to use the borrowed funds for the purpose of accessing discount capital gains via other entities, such as trusts, without first extracting those funds from the relevant companies in the form of dividends and incurring a liability to top up tax. In my view, this argument is misconceived for the following reasons:

(a) Even under the current Division 7A, funds can be borrowed for up to seven years or, where real estate security is provided, for up to twenty-five years. Indeed, under the current applicable Practice Statement, the establishment of a subtrust can, in effect, facilitate the setting up of an interest only loan for up to ten years.

(b) The difference between the corporate tax rate of 30% and the discount capital gains tax rate plus medicare levy (at the top marginal rate) is only some 7 percentage points.

(c) In many cases, the capital gains discount may not be available and the profit on sale of the relevant assets will be treated on revenue account. If that occurs, in many cases more tax will be generated than if the relevant assets had been held and sold by a company.

The fundamental policy underpinning our tax system is that taxpayers should be free to choose which entity should acquire and derive any capital gain from the disposition of an asset. The policy considerations underlying Division 7A do not mandate that this division be used as an instrument for the purpose of influencing a taxpayer's choice of entity for the purpose of acquiring an asset and ultimately realising any gain on that asset.

Finally, in my view it is possible - indeed, desirable - to adopt the framework outlined in this letter quite independently of any update and/or rewrite of the trust income tax provisions, whether in relation to unpaid present entitlements or otherwise.

I would be very pleased to further clarify any of the matters referred to above.

Yours sincerely

Mark Leibler AC
Senior Partner

Enc

cc. Keith James, Board of Taxation Deputy Chairman
Mathew Umina, Assistant Commissioner, Australian Taxation Office

MARK LEIBLER

SUMMARY OF PRESENTATION TO TAX FORUM

4 OCTOBER 2011

* The concerns which I propose to raise in relation to Division 7A impact on hundreds of thousands of privately owned businesses - large, medium sized and small - which rely on private companies and trusts as vehicles for their business and investment activities.

* The Division 7A provisions are complex beyond imagination, produce unintended consequences, obstruct legitimate business and commercial activities and apply in a variety of contexts where it is clear that there is no avoidance of tax.

* The few accounting firms which actually appreciate the implications of Division 7A find it difficult - sometimes well nigh impossible - to provide sensible and reliable advice to their clients. The costs of compliance are enormous and many accounting firms simply haven't grasped the potential reach of Division 7A. Furthermore, the Tax Office has issued rulings which are no more comprehensible than the legislation itself.

* I have no problem with the policy which underpins - or, at least, which should underpin - Division 7A, namely, that top up tax should be paid if funds are extracted from companies for private purposes, for private consumption. However, Division 7A, as currently framed, applies in a variety of cases where funds are moved between entities - but nevertheless remain invested in the relevant business activities and are not applied for private purposes.

* This nightmare, this horrendous and unnecessary compliance burden, affects hundreds of thousands of businesses. The Government can fix it all by repealing Division 7A and inserting a new Division which is limited to ensuring that the anti avoidance provisions only apply where funds are directly or indirectly extracted from private companies and then applied for private consumption.

* The impact of such a legislative change on minimizing compliance costs for hundreds of thousands of Australians would be hugely positive. Moreover, there would be no significant adverse impact on Government revenues. I urge the Government to accord top priority to changing the law along the lines I have described.