



4 February 2013

The Board of Taxation  
c/- The Treasury  
Langton Crescent  
CANBERRA ACT 2600

By email: [taxboard@treasury.gov.au](mailto:taxboard@treasury.gov.au)

Dear Sir / Madam

## Discussion paper – Post-implementation review of Division 7A

Thank you for the opportunity to provide comments on the discussion paper released in December 2012 relating to the review of Division 7A of Part III of the Income Tax Assessment Act 1936.

The Hayes Knight group of accounting firms provide a significant amount of taxation advice to small and medium business taxpayers throughout Australia and we also provide advice to a large number of other accounting firms through the support service we operate. The application of the rules contained in Division 7A is a significant consideration for this market segment.

Without seeking to comment on all the issues raised in the discussion paper, we would like to address a number of specific items relating to the application of Division 7A in practice.

Unless otherwise stated, references are to the *Income Tax Assessment Act 1936* ('ITAA 1936') or the *Income Tax Assessment Act 1997* ('ITAA 1997').

### **Question 2.1 – other aspects of the tax framework that should be taken into account**

The discussion paper notes that the Board of Taxation will ensure that the recommendations contained in the report to the Government will take account of trust reform options being considered by the Government. We agree that it is vital that these areas are considered in conjunction with each other given the fact that many private groups use a combination of companies and trusts for business and investment purposes.

#### **Question 4.1 – assist small business owners to understand Division 7A**

In our experience, many small business owners who use companies within their private group rely heavily on their accountants and tax agents to assist them to comply with the requirements of the tax system, including the provisions of Division 7A. Therefore, any communication strategies employed by the Government or Australian Taxation Office to improve general awareness and understanding of Division 7A should also be directed to accountants and tax agents.

Amending or replacing the legislative provisions of Division 7A is unlikely to directly improve the understanding of the rules by small business owners. However, given the broad nature of this review and the likelihood that a number of changes will be made to the provisions, this may present an ideal opportunity to rewrite the provisions into the ITAA 1997.

Even if no significant changes are made to the underlying substance of Division 7A, rewriting the provisions to conform to the drafting approach used in the ITAA 1997 should improve the ability of accountants and tax agents to understand the provisions and apply them to real life client scenarios. This should result in improved compliance with the rules by small business owners and assist in eliminating some of the honest mistakes and inadvertent errors that may occur from time to time.

The use of a top-down structure, aids to navigation, non-operative guide material and additional examples could all improve the 'readability' of the rules. For example, in our experience the rewriting of the commercial debt forgiveness provisions into the ITAA 1997 has improved the ability of taxpayers and practitioners to understand the provisions. Similar benefits could be obtained by undertaking this approach to Division 7A.

#### **Question 4.2 – Family Court orders**

Following on from comments made in the discussion paper, we are aware of instances where the potential application of Division 7A has not initially been taken into account in Family Court orders. In some cases, unintended and significant tax liabilities have been narrowly averted by late changes to the terms of a property settlement order, particularly where the Family Court order involves an in specie distribution by a private company.

Regardless of whether this issue is ultimately resolved by allowing some form of relief from the tax consequences of a deemed dividend being triggered, in the short term there would be great value in the Government and / or ATO undertaking some form of communication strategy to ensure that courts, legal advisers and taxpayers are made aware of this issue.

#### **Question 4.3 – unpaid present entitlements**

Without seeking to comment on the correctness of the ATO's practice of treating unpaid present entitlements owing to corporate beneficiaries as loans for Division 7A purposes, there would be great value in clarifying the position through legislative amendment to provide certainty to small business owners and practitioners.

At the moment business owners and practitioners have to either take the risk of challenging the ATO's technical position through the courts or take the commercial risk of accepting the ATO's technical position and put procedures in place that may turn out to be unnecessary if the ATO's view is later found to be incorrect (eg, putting loan agreements in place with specified interest rates).

Many small business owners have found that complying with the ATO's revised interpretation on this issue is causing cash flow and working capital pressure. Given the significant impact this is having on many small businesses the Government should provide certainty on this issue through legislative amendment.

#### **Question 4.4 – problems with Division 7A**

We broadly agree with the problems that have been raised in the discussion paper around the application of Division 7A. In addition to these problems, we also believe the following issues should be considered in the review.

##### ***a) Associate rules – application to partnerships***

One of the concepts that is fundamental to the operation of Division 7A is the term 'associate' as defined in section 318 ITAA 1936. However, there is some uncertainty in relation to the application of the associate rules to partnerships. In particular, it is not entirely clear whether a loan from a company to a partnership of trusts would be subject to Division 7A in certain situations.

For example, assume Mr Smith is the only shareholder of a private company. Also assume that Mr Smith is a beneficiary of the Smith Family Trust which carries on business in partnership with an unrelated trust.

If a loan was made by the company to the partnership of trusts, we would need to determine whether the loan was made to either a shareholder of the company or an associate of a shareholder. In this case the partnership is not a shareholder of the company. When it comes to determining the associates of Mr Smith, it is not clear whether this could include the partnership that has received the loan from the company. It could be argued that Division 7A would not apply because:

- The partnership is not a 'relative' of Mr Smith so subparagraph 318(1)(a) should not apply;
- Mr Smith is not a partner in the partnership so subparagraphs 318(1)(b) and 318(1)(c) should not apply;
- The partnership is not the trustee of a trust so subparagraph 318(1)(d) should not apply; and
- The partnership is not a company so subparagraph 318(1)(e) should not apply.

The only way Division 7A could apply to this arrangement is if the loan is treated as having been made to the Smith Family Trust rather than to the partnership.

This issue should be clarified to provide certainty when dealing with these situations.

***b) Inconsistency between rules on use of company assets and other areas of Division 7A***

Since 1 July 2009 section 109CA has ensured that the term ‘payment’ includes the provision of an asset for use by a shareholder of a private company (or an associate of a shareholder). These rules contain a number of exceptions which broadly match some concessions contained within the *Fringe Benefits Tax Assessment Act 1986*, such as a ‘minor benefits’ exemption and an ‘otherwise deductible’ concession.

The Explanatory Memorandum to *Tax Laws Amendment (2010 Measures No. 2) Bill 2010* notes that the minor benefit exception will reduce compliance costs for taxpayers. Consideration should be given to whether similar exceptions should be provided in other areas of Division 7A to reduce compliance costs for taxpayers (eg, when private companies make loans to shareholders or their associates).

***c) Distributable surplus***

Consideration should be given to amending the calculation of a company’s distributable surplus in section 109Y to align the concept of ‘net assets’ with the calculation of net assets that is required to be undertaken under section 254T of the *Corporations Act 2001* when a company is seeking to pay a dividend. This would arguably reduce compliance costs as small business owners and their accountants would only need to undertake one calculation of net assets rather than undertaking two separate calculations.

The comments above are based on the assumption that the proposed changes to section 254T in relation to the calculation of assets and liabilities for non-reporting entities become law (refer to the Exposure Draft of *Corporations Legislation Amendment (Remuneration Disclosures and Other Measures) Bill 2012*).

While we agree that it is appropriate for section 109Y to contain adjustments to the net assets of the company when calculating its distributable surplus for Division 7A, we consider that the starting point should be the same as the net assets determined in accordance with section 254T.

In addition, we note that section 109Y provides the Commissioner with the ability to substitute values if the Commissioner considers that either:

- The company’s assets are significantly undervalued or overvalued; or
- The company’s provisions are undervalued or overvalued.

It is not clear what is meant by the term ‘significantly undervalue or overvalue’ and this can cause confusion and uncertainty for small business owners and practitioners. While Taxation Determination TD 2009/5 provides the Commissioner’s guidance on when it is appropriate for values to be substituted, there is still significant uncertainty in practice surrounding the meaning of the terms used in section 109Y.

The Commissioner notes in TD 2009/5 that the Commissioner will generally substitute values where it is plain that the company, its shareholders and directors have acted in a way that treats the real and higher value of assets as their true value, regardless of their value shown in the accounting records. However, the position is rarely this clear in real life and further clarity and guidance on this matter would reduce uncertainty. The use of de minimis thresholds may assist in this regard.

While the matter is addressed briefly in TD 2009/5, there is also considerable uncertainty around the values to be attributed to internally generated goodwill and purchased goodwill. The process of undertaking a valuation of a company's goodwill is often not straight forward and would typically involve a significant cost to the private company involved. The ATO has reasonably high expectations when it comes to undertaking valuations for the purpose of applying the tax laws and this may be an area where the cost to small business may outweigh the 'mischief' that is targeted by Division 7A.

#### ***d) Family law obligations and franking of deemed dividends***

Section 109RC allows a deemed dividend to be franked if it is taken to be paid because of a family law obligation. This provides a concession in situations when transfers of assets from a company may be non-voluntary.

Firstly, the discussion paper notes that a dividend may only be franked in the same circumstances that CGT roll-over relief applies in relation to the marriage breakdown (similar comments are made in the Explanatory Memorandum to *Tax Laws Amendment (2007 Measures No. 3) Bill 2007*). However, the definition of 'family law obligation' in section 109ZD ITAA 1936 does not include all of the events that can potentially qualify for CGT roll-over relief in Subdivision 126-A ITAA 1997. Consideration should be given to expand the definition of 'family law obligation' in section 109ZD to also include an agreement mentioned in paragraph 126-5(1)(da).

Also, the operation of the concession contained in section 109RC is reasonably inflexible as it only allows the dividend to be franked if:

- The dividend is franked at the company's benchmark franking percentage for the period in which the dividend is deemed to be paid; or
- If the company does not have a benchmark franking percentage for the period, the dividend is franked at 100%.

This can cause problems in cases where a company does not have a benchmark franking percentage for the year in question and also does not have sufficient franking credits to frank the deemed dividend at 100%. In this case the choices available are as follows:

- Do not attach any franking credits to the deemed dividend, with the shareholder or associate being taxed on the deemed dividend in full; or
- Frank the dividend at 100% and potentially trigger a franking deficit tax liability in the company at the end of the income year.

Given the circumstances in which the deemed dividend is triggered, our view is that the company should be able to choose to frank the dividend at any percentage, particularly in situations where the company does not already have a benchmark franking percentage for the year in question.

### **Question 5.1 – treatment of UPEs**

As noted above in response to Question 4.3, there would be great value for small business owners and their advisers in clarifying the position with respect to the treatment of unpaid present entitlements as loans through legislative amendment. Depending on the approach taken to the treatment of UPEs as Division 7A loans it may also be necessary to amend Subdivisions EA and EB to ensure that Division 7A as a whole operates effectively and consistently.

One of the problems with the Commissioner's approach in Taxation Ruling TR 2010/3 and Practice Statement PS LA 2010/4 is the arbitrary nature of the timing rules for treating a UPE as a loan for Division 7A purposes.

In paragraph 46 of PS LA 2010/4 the Commissioner states that a UPE owing from a trust to a related company will become a Division 7A loan from the trust's lodgement day for the income year in which the UPE arose (unless a complying sub-trust arrangement is put in place). However, there does not appear to be any sound basis for using the trust's lodgement day as the starting point for treating the unpaid amount as a loan.

Regardless of the approach to UPEs favoured by the Government, this issue needs legislative amendment to clarify the position and provide certainty for small business owners and their advisers.

### **Question 5.6 – Distribution model**

While we can see the merits of applying a distribution model which would enable small businesses to retain funds in trusts to finance active business operations, our main concern with this model is the potential complexity of determining or tracing the use of the company's profits.

While determining the use of company profits (whether within the company or a related entity) may be relatively straight forward in some circumstances, this would not always be the case and we would envisage the need for complex and robust tracing rules.

For example, a common situation would involve the appointment of trust income to a corporate beneficiary with the company allowing the funds to remain within the trust. Presumably the application of the rules would depend on the use of these funds by the trust. That is, it would be necessary to determine whether the funds have been reinvested in the trust's active business activities rather than being used for passive investment or other purposes.

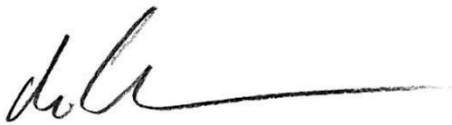
As well as putting rules in place to trace the use of the company's profits it would also be necessary for the rules to specify the point in time when the use of the profits should be determined.

The rules would need to be robust and sophisticated enough to maintain the integrity of the tax system without being overly complex to apply to real life scenarios. It may be difficult to achieve a reasonable balance between these objectives.

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Thank you for your consideration of this submission. Should you have any queries then please do not hesitate to contact me at [Michael.Carruthers@hayesknight.com.au](mailto:Michael.Carruthers@hayesknight.com.au).

Yours faithfully

A handwritten signature in black ink, appearing to read 'Michael Carruthers', with a long horizontal flourish extending to the right.

**Michael Carruthers**  
**Director – Hayes Knight (NSW) Pty Ltd**  
**On behalf of the Hayes Knight Group**