Institute of
Chartered Accountants
Australia

28 February 2013

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

By email: taxboard@treasury.gov.au

Dear Sir / Madam,

Post-implementation review of Division 7A discussion paper – Unpaid present entitlements

The Institute of Chartered Accountants in Australia (the Institute) is pleased to lodge a further submission on the discussion paper entitled *Post-Implementation Review of Division 7A of Part III of the Income Tax Assessment Act 1936* (the Paper). This submission sets out the Institute's views on the preferred Division 7A treatment in relation to unpaid present entitlements (UPEs) from a trust to a corporate beneficiary and follows on from our submission lodged on 22 February 2013 on the Division 7A reform models in the Paper. The Institute has prepared a separate submission on UPEs because we recognise the issue of whether a UPE is a loan for Division 7A purposes is a difficult and controversial issue for our members. Accordingly, the Institute wanted more time to consult with members in respect of the appropriate Division 7A treatment of UPEs.

The Institute's main focus in relation to the post-implementation review of Division 7A is the need for a significant simplification of the current structure of Division 7A.

The Institute is currently examining Australia's level of complexity in its tax system and has sponsored a three-year, multi-university tax research project, *Assessing and addressing tax system complexity in Australia.* The first report released as part of this project, *A comparative analysis of tax compliance costs and the role of special concessions and regimes for small businesses in Australia, Canada, South Africa and the United Kingdom*[1] reveals that on average, it costs Australian small businesses US$34,209 per year to comply with its tax obligations. The report also reveals that in Australia the compliance costs expressed in relation to A$1,000 turnover show a clearly regressive pattern over the range of different size of businesses. Put simply, this means the smaller the business, the higher the tax compliance costs relative to turnover.

Given the preliminary results of this research, the Institute believes that focusing on simplifying the Division 7A treatment of UPEs would yield efficiency benefits resulting from reduced tax compliance costs.

Uncertainty and complexity around unpaid present entitlements

Prior to the legislative and administrative developments in 2009 and 2010 concerning the treatment of unpaid present entitlements (UPEs) from a trust to a corporate beneficiary, our members found that complying with Subdivision EA, the main provisions dealing with UPEs, was complex but manageable. However, with the introduction of Subdivision EB and the development of the Australian Taxation Office

[1] The report, *A comparative analysis of tax compliance costs and the role of special concessions and regimes for small businesses in Australia, Canada, South Africa and the United Kingdom* (Hasseldine et. al, 2012), is authored by tax academics from across the globe. The Australian part of the research was conducted by Professor Chris Evans (The University of New South Wales) and Dr Philip Lignier (University of Tasmania).

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(ATO)'s views in TR 2010/3 *Income Tax: Division 7A: trust entitlements,* the application of Subdivisions E, EA and EB to family group structures with UPEs from a trust to a corporate beneficiary, has become incredibly complex and uncertain for taxpayers and their advisors.

The difference in views between the ATO and the tax practitioner community on whether a UPE is a loan under section 109D of the ITAA 1936 has resulted in uncertainty. As a result, our members have informed us, taxpayers and advisors currently either take the risk of challenging the ATO's view in TR 2010/3 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.

Moreover, the ATO's view in TR 2010/3 has resulted in Subdivisions EA and EB becoming less relevant in relation to dealing with UPEs. Subdivisions EA and EB only come into play when a UPE is not treated as a loan under TR 2010/3. The ATO has set out its administrative guidance on when a UPE would not be treated as a Division 7A loan in PS LA 2010/4 *Division 7A: trust entitlements.*

Although PS LA 2010/4 has been helpful in providing some certainty for taxpayers and their advisors where ATO compliance activity is concerned, the interaction of TR 2010/3 and PS LA 2010/4 with Subdivisions EA and EB has exacerbated the uncertainty and added a further layer of complexity to Division 7A.

On page 53 of the Paper (Question 4.3), the Board seeks stakeholder comment on whether Subdivisions EA and EB could be more appropriately replaced with another rule and refers, as an example, to either a rule treating a private company's UPE as a loan or a rule that excludes all UPEs from being loans but increases the scope of Subdivisions EA and EB to other forms of benefits for shareholders or associates.

In light of the complexity involved in relation to UPEs, the Institute believes that to achieve simplicity and certainty, UPEs should be treated as loans under Division 7A by way of legislative amendment. By treating UPEs as loans under Division 7A, Subdivisions EA and EB could be removed from Division 7A thereby removing some of the most complex provisions in Division 7A.

This conclusion does not mean that the Institute supports the ATO's view in TR 2010/3 but in the interest of simplicity and certainty for taxpayers and advisors, we believe this is the best way forward in achieving these goals in respect of UPEs.

We recognise our view on the preferred Division 7A treatment of UPEs is controversial as it is in line with the ATO's technical position on UPEs. Furthermore, in the past, we have made numerous submissions to the ATO and Government that, technically, UPEs are not loans for Division 7A purposes. That said, attempting to turn back time to achieve the situation as it was prior to the ATO's change in view on UPEs, is not likely to be achievable from a policy perspective.

Also, we do not know at this time, the outcome of Treasury's consultation on its reform on taxing trust income. The practice of trustees using private company UPEs to retain working capital is a function of the different tax rates between companies and trusts. Accordingly, the Institute's view on its preferred treatment of UPEs for Division 7A is subject to change depending on the outcome of Treasury's consultation on trusts.

What is inappropriately accessing the profits of private companies in the context of UPEs?

As mentioned above, the use of private company UPEs is a function of the differential tax rates between companies and trusts.

Whether allowing a trust to retain profits taxed at the lower corporate tax rate should be considered as ‘inappropriately accessing the profits of a private company’ is not an easy question to answer. This question needs to be considered in light of the Australian tax system as a whole. We have made some observations below in this regard.

As noted in the Paper, ‘Australia has a progressive system of taxing personal income. The current features of the income tax system, including those found in company tax system and the trust tax system, seek to support this progressivity’.

In supporting the progressivity of the personal income tax system, we understand that, historically, the integrity concern with the taxation of private companies was the accumulation of excessive profits in the private company. Because of the difference in the maximum individual tax rate and the corporate tax rate, accumulation of profits in the private company was seen as effectively a deferral of tax by the shareholders. Nevertheless, there was a policy concession acknowledging that businesses needed to retain funds for working capital purposes.

We understand that Division 7A seeks to support progressive taxation, as well as acknowledging the working capital policy concession, by ensuring that private company profits *that are enjoyed* by shareholders (and their associates) are included in their assessable income and taxed at their personal marginal rates of tax.

Division 7A seemed to support progressive taxation well when businesses were mainly conducted through private companies. However, the business environment has evolved over the years and the use of trusts in the business context has become increasingly common for asset protection purposes and succession planning.

Due to the difference in tax rates for trusts and companies, it could be argued that Division 7A’s support of progressive taxation is weaker if trusts are effectively allowed to retain profits subject to the lower 30 per cent corporate tax rate, without having to pay any top up tax. Nevertheless, given the prevalence of the use of trusts in the modern business environment, it could be argued that in view of the working capital policy concession, trusts which conduct businesses as should be allowed to retain profits at the corporate tax rate. It is the Institute’s view that the underlying policy issue is with the appropriateness of the tax rates applicable to trusts.

Where trusts are used for private purposes, the policy of applying the highest marginal individual tax rate to the profits retained by the trustee seems appropriate in supporting Australia’s progressive system of taxing personal income. However, where a trust is used for conducting business and is deriving business income, the profits retained by the trust are not personal income and thus, it seems there is no necessity to applying the highest marginal individual tax rate to those profits. Of course where a trust has mixed purposes, there is no simple answer.

The Institute acknowledges that the appropriateness of the tax rate for trusts is a matter for Treasury and its reform for taxing trust income. However, we encourage the Board to liaise with Treasury in relation to this issue.

Another development which may affect the tax treatment of trusts is the Senate Committee, Parliamentary Joint Committee on Corporations and Financial Services, inquiry into family business in Australia (the Senate Committee inquiry). One of the terms of reference for the inquiry is the role of family trusts in facilitating family business. The committee is due to release its report on this inquiry on 12 March 2013. The Institute recommends that the Board takes the Senate Committee inquiry into account in liaising with Treasury and reaching its deliberations on UPEs.

If there is a legislative amendment to treat UPEs as loans

If Division 7A is to be amended to treat a UPE from a trust to a corporate beneficiary under a family group structure[2] as a loan for Division 7A purposes, the Institute recommends that certain features should be included to:

- minimise the impact of change in the practices of taxpayers and their advisors in dealing with UPEs where they have been complying with the ATO's administration of UPEs; and
- recognise that the funds representing the UPEs are inherently, when stripping away the 'cloaks and mirrors', not 'financial accommodation' from the private company.

We propose the following features be incorporated in the new rules dealing with UPEs:

- *Timing of the loan* - A UPE arising during or at the end of an income year would become a loan for Division 7A purposes at the end of the following income year to the extent it remains unpaid. Using the end of the following income year is simpler and provides greater clarity than the trust tax return lodgment day (i.e. 15th day of the 11th month following the year end) which is used in PS LA 2010/4. We note that there is only a month and half difference between the dates.
- *When to take action to avoid deemed dividend treatment* - Where a UPE has become a Division 7A loan at the end of an income year, the corporate beneficiary and trust would have until the lodgment day of the company's income tax return for that income year to either pay out the UPE or put it under Division 7A compliant loan terms.
- *Division 7A compliant loan terms*:
    - Division 7A compliant loan terms could be along the lines of what has been proposed under the statutory interest model. That is, an interest rate on the UPE loan would be required but no progressive loan repayments. The interest only loan concept is also similar to the options available to avoid deemed dividend treatment under PS LA 2010/4.
    - To keep things simple, while the current structure of Division 7A is still applicable, we suggest the benchmark interest rate under section 109N be the minimum interest rate required for the UPE loan to be Division 7A compliant.
- *Timing of deemed dividend* - If the UPE loan is not put on Division 7A compliant loan terms by the lodgment day of the company's income tax return for the income year the UPE becomes a loan, then the company is treated as having paid a dividend to the trustee at the end of that income year.

Transitional treatment

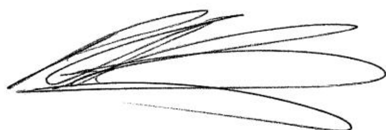
Our members have informed us that the ATO's view on UPEs has caused cash flow and working capital pressure for many small businesses. Given the significant impact on small businesses, if UPEs are treated as loans for Division 7A purposes, we submit that flexibility be given during the transitional period in allowing taxpayers to transition into the new treatment.

To avoid too much change for taxpayers and their advisors, UPEs which arose pre-16 December 2009 should be grandfathered from the new rules. For UPEs arising during the period 16 December 2009 and before the enactment of the new rules, taxpayers could be given the option to elect into the new rules or continue complying with the ATO's administrative practice under TR 2010/3 and PS LA 2010/4.

[2] Note that the reference to a family group structure is a reference to a group of related entities including or comprising a private company and a trust, where the same entities or persons have the practical ability to, or capacity to, control the group.

If you have any queries regarding the content of this submission, please do not hesitate to contact me on 02 9290 5609 or Karen Liew 02 9290 5750.

Yours sincerely



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