Law Council
OF AUSTRALIA
Business Law Section

Our ref:

11 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 of Part III of the Income Tax Assessment Act 1936

1. The taxation committee of the Business Law Section of the Law Council of Australia (**Committee**) appreciates the opportunity to participate in the Board of Taxation's process of reviewing Division 7A (**Division 7A**) of Part III of *the Income Tax Assessment Act 1936* (**Tax Act**)[1].

2. The Committee welcomes the Treasurer's decision to commission the Board of Taxation to undertake a post-implementation review of Division 7A. In the Committee's experience, the rules contained in Division 7A are routinely considered and applied by a large proportion of tax professionals, as they apply to

[1] In this submission, references to sections are to the *Income Tax Assessment Act 1936*, unless otherwise indicated.

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small and SME clients. Those clients collectively represent a very large proportion of tax practitioners' clients. However, time and again examples of inadvertent non-compliance with Division 7A are cited. It is no doubt the case that this is due in part to the complexity of the rules themselves. Although the underlying, core intention of the legislation is relatively straightforward, the number of complex provisions, together with the use of statutory fictions, leads to a complex piece of legislation. The Committee hopes that through the post-implementation process a clearer, more effective and fairer set of rules emerges.

3. Set out below are the Committee's submissions in relation to the post-implementation review discussion paper (**Paper**).

Summary of submissions

4. In summary the Committee's submissions are as follows.

   (1) Division 7A should be re-drafted and replaced with rules that are more commercial in nature, are easier to understand and apply and have less compliance costs associated with them.

   (2) While the original objective of Division 7A continues to be relevant, the manner in which Division 7A has evolved and now reads is unnecessarily complex. Owners of private companies and many tax agents and advisors have difficulty applying the Division 7A rules. It is submitted that the complexity of Division 7A and the high compliance costs associated with Division 7A, are not warranted.

   (3) The Committee supports the introduction of a new set of rules to replace Division 7A, and, with some modifications, supports the Statutory Interest Model as set out in the Paper. If drafted well, this model will simplify the rules in this area and be easier to understand and apply for taxpayers and advisors, which in turn should reduce compliance costs for both taxpayers and the ATO (in relation to audit activities).

(4) The Committee does not recommend the introduction of the Distribution model.

(5) The Commissioner should have a broad based relieving discretion to exclude taxpayers from the operation of the “deemed dividend” rule in certain circumstances, irrespective of which model is ultimately adopted. Further, the Administrative Appeals Tribunal (**AAT**) should have clear jurisdiction to review the exercise of the Commissioner’s discretion.

5. Set out below are the Committee’s:

(1) submission on the Statutory Interest Model and how this should be applied; and

(2) comments on specific questions and other issues raised in the Paper in the event the Board chooses to support the Adjustment Model set out in the Paper.

Statutory Interest Model

Loans

6. In principle the Committee supports the introduction of the Statutory Interest Model to replace Division 7A. As set out in the Paper, the Statutory Interest Model should operate to deem loans made by private companies to related entities to be interest-bearing.

7. The policy intention of these rules should be to treat loans as being commercial in nature, and if they are not, to put the parties on similar terms as if the loan was a loan made in the course of carrying on a business. The Committee view is that this regime would address the mischief that Division 7A is seeking to address but in a simplified manner.

8. The Committee agrees that a commercial interest rate should be imposed on the borrowing.

9. The Committee agrees that where the rules apply that the:

   (1) lender should be taxed on the statutory interest rate, whether or not the interest is actually paid, and that this approach is preferable and simpler than the current deemed dividend rules; and

   (2) Commissioner should have a broad based relieving discretion to exclude taxpayers from the operation of this rule in certain instances.. Further, the exercise of the Commissioner's discretion should be subject to full merits review by the AAT.

10. There should not be any requirement to repay the loan within a set timeframe or to make a minimum repayment of principal.

11. The rules should not apply to loans from a company as lender to a company as borrower.

Debt forgiveness

12. Subject to the operation of the commercial debt forgiveness rules, the Committee's view is that any forgiveness of a loan to which the new rules apply should give rise to assessable income for the borrower, with the Commissioner having a relieving discretion to not apply this provision in certain instances. Rather than retaining the complex deemed dividend rules, it is submitted that there should be a specific rule making such a forgiven amount assessable income.

13. This rule would not apply if the commercial debt forgiveness rules applied (i.e. the commercial debt forgiveness rules take precedence over these rules).

Other payments

14. In relation to other payments (as set out in the Paper) made to shareholders which are not loans, the Committee submits that these should be treated as either dividends or assessable income of the recipient.

Unpaid present entitlements

15. For the sake of simplicity, unpaid present entitlements should be treated as loans.

Effect of a deemed dividend – franking credits

16. Notwithstanding that interest will be assessable income as described in paragraph 2.4 above, if a dividend is deemed for whatever reason to have been paid to the entity that has received the benefit of the loan, the Committee is of the view that such dividend should be frankable. Not allowing franking credits to attach to such dividends is in effect a penalty, a harsh and draconian penalty. Having regard to the fact that penalties under Schedule 1 of the *Taxation Administration Act 1953* and general interest charge will usually apply, it should be sufficient that an assessable dividend is included in the taxpayer's income.

Distribution Model

17. While the Distribution Model may be appealing from a theoretical perspective, as alluded to in the Paper, the Committee sees real practical difficulties with it. The model would require continuous and specific accounting processes to be undertaken in order to ascertain active versus passive activity. Further, a tracing of funds would be required. Not only can this be a very difficult exercise (especially if not attended to constantly throughout the income year), but the administrative cost associated with such an exercise is invariably prohibitive for small to medium (and even large family group) taxpayers and may be disproportionate in relation to the mischief to which Division 7A is directed.

Adjustment Model

18. The Committee does not recommend the use of the Adjustment Model. As set out above, in the Committee's view Division 7A is currently unnecessarily complex. It is difficult to understand and implement for both taxpayers and tax agents and advisors. Amending Division 7A will not rectify this problem and the continuation of the past approach of legislating to remedy harsh and unjust consequences on an *ad hoc* basis as they emerge should not be the preferred policy approach.

19. Further, Division 7A does not give rise to commercially appropriate outcomes for taxpayers in many instances. To rectify these issues would require a substantial overhaul of the Division which a piecemeal approach to amending the Division would not solve. Such a piecemeal approach has been undertaken to date and has resulted in provisions that are extremely difficult to read and apply in practice.

20. In the event the Board chooses to support this approach the Committee has made some comments set out below regarding specific issues with Division 7A.

Adjustment Model - specific comments in relation to Division 7A

21. The Committee agrees with the problems that are identified in Chapters 4 and 5 of the Paper and makes the following further comments and submissions.

Section 109E – amalgamated loans

22. Section 109E which deals with amalgamated loans requires amending. There is no apparent justification for making a loan, on which the borrower would be entitled to an interest deduction, subject to the annual minimum repayment amount set in section 109E. This provision may apply to certain commercial transactions, and there is no apparent sound policy justification for such a minimum repayment obligation.

The definition of associate in section 318 of the Tax Act and its interface with Division 7A

23. The Committee considers it necessary to identify in greater detail some of the issues flowing from the problem indentified in paragraph 4.154 of the Discussion paper, which deals with the definition of *associate* in section 318 and its interaction with Division 7A.

24. The breadth of the definition of *associate* has the potential to cause unforeseen and serious adverse consequences in some structures where there is no risk to the Revenue of the type to which Division 7A is directed.

25. In particular, the case of *Di Lorenzo Ceramics v Commissioner of Taxation* [2007] FCA 1006 illustrated the fact that a company which holds interests in an

associated unit trust may effectively be taxed twice on a single amount of income. In the Committee's view this anomaly should be rectified.

Section 109RB

26. The Committee agrees with the issues of concern identified in the Paper regarding the Commissioner's ameliorating discretion in section 109RB and would go further.

27. In the Committee's view section 109RB should be replaced. It is poorly drafted and lacks clarity as to the circumstances in which relief is available.

28. In particular, there is an inherent uncertainty in granting relief for "honest mistakes" and "inadvertent omissions", particularly where many of the problems which arise result from misunderstandings of the law. This uncertainty is borne out by the convolutions of language and examples in TR 2010/8.

29. In the Committee's view, if the Division 7A Adjustment Model is to be adopted, there should be inserted in the place of section 109RB a broad-based discretion granted to the Commissioner to provide relief against harsh, unjust or anomalous consequences including in circumstances where there has been no effective distribution of company profits to shareholders or their associates. An exercise of that discretion unfavourably to the taxpayer (or the failure to exercise it) should be able to be referred by the taxpayer for full merits review by the AAT.

30. Alternatively, if section 109RB were to be retained substantially in its present form, the Committee's view is that there should be a statutory right of review to the AAT for exercises of the discretion which are unfavourable to the taxpayer (or failure to exercise it), including any conditions which attach to a favourable exercise of the discretion. There is presently uncertainty as to whether proceedings under Part IVC of the *Taxation Administration Act 1953* are available to taxpayers who have sought the exercise of the discretion and are dissatisfied with the Commissioner's decision.[2]

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[2] The Committee notes the recent decision in *Building Company Owner and Commissioner of Taxation [2012] AATA 755 (1 November 2012).* Although the Tribunal appears to have implicitly accepted that it had jurisdiction to hear the matter, it appears that neither the parties to the matter, nor the Tribunal itself,

Family Law Obligations

31. To the extent that “errors of the Family Court and/or Family Law practitioners” may be said to arise, most probably they arise because the provisions of Division 7A differ conceptually from the more straight-forward operation of the capital gains tax provisions and are counter-intuitive to practitioners who are not taxation specialists.

32. It is apparent that neither section 109J nor section 109RC adequately addresses the problems identified in the Paper, although both appear to go some of the way. The Committee considers that those problems may best be remedied by broadening section 109J to include the discharge by a private company of any obligation which arises pursuant to a family law obligation (as defined in section 109ZD) between spouses. That would avoid the problems identified in ID 2004/462 and would bring property distributions into line with cash distributions.

Further contact

33. If you have any questions regarding the contents of this advice, please do not hesitate to contact the Committee Chair Mark Friezer on 02 9353 4227.

Yours faithfully

Frank O’Loughlin
BLS Chairman

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considered the Tribunal’s jurisdiction to be an issue in the proceedings. Notwithstanding the decision, in the LCA’s view the law is still sufficiently unclear in relation to the Tribunal’s jurisdiction to hear such matters and that clarification, by way of legislative amendment, is warranted.