



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

15 February 2013

Dear Sir

Subject: Post Implementation Review of Division 7A

We refer to the discussion paper released by the Board of Taxation on 20 December 2012 in respect of the post implementation review of Division 7A of Income Tax Assessment Act 1936.

We comment on the 3 approaches proposed by the Board.

Statutory Interest Rate Model

We are of the opinion that this model could achieve the policy intent of Division 7A.

A statutory interest rate model could replace the current provisions in section 109N. The current provisions are onerous and require repayments of principal irrespective of any consideration of current economic conditions. Private businesses may genuinely be struggling to meet repayments. Ordinarily, third party lenders provide an ability to refinance loans which is precluded in the current provisions of Division 7A.

Private businesses should not be placed at a competitive disadvantage if there is an ability to utilise funds within the private group environment. Therefore the proposed statutory rate must be no more onerous than what could reasonably be expected under a commercial lending institution for a similar amount and under similar terms and conditions.

We agree with the suggestion that the proposed statutory interest rate model should permit re-borrowings. However, loan repayments of principal should only be required to be repaid at the end of the term of the loan rather than progressively throughout the term of the loan. This would be in alignment with the current approach for Investment Agreements.

We agree with the Board's comment that forgiveness of debts and payments (other than for commercial purposes) would need to be separately addressed within Division 7A.

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Distribution Model

This approach allows the retention of profits within private groups for permitted purposes and any profits not used for permitted purposes, and not distributed, is deemed to be a dividend which could be frankable.

This approach forces private companies to repatriate profits to shareholders if profits are not used for working capital. Public companies are not subject to the restraints of Division 7A and this model places private companies at a competitive disadvantage. Private companies would be forced to repatriate profits if not retained for working capital whilst public companies are not required to do so.

A private company would not be able to utilise company profits for passive investments under this approach. Ordinarily a portion of company profits would be invested by companies to diversify their portfolio and for wealth management. Private companies would not be allowed to retain profits for passive investment purposes or to lend to an investment structure under this approach.

Whilst the tax law does make a distinction between active and passive income in the context of other provisions, there is complexity where a group is involved in both active and investment activities. The concept of working capital would need to be defined which may disadvantage certain industry groups given the concept of working capital may differ amongst industry groups.

Adjustment Model

Other areas for consideration

Otherwise Deductible

An alternative approach could be to adopt an otherwise deductible test, similar to that which is adopted in the Fringe Benefits Tax Act 1986. Where the shareholder would have been entitled to a deduction for the interest expense on the loan, then the loan from the private company should be treated as commercial and not subject to the provisions of Division 7A.

This approach would be revenue neutral for the government with interest deductions that should be available to the individual and interest income assessable to the private company. As such, there is no requirement to charge an interest (either commercial or a statutory rate).

If the loan is not otherwise deductible, a deemed dividend should arise equivalent to the arms length servicing cost of the loan. There is currently a mismatch between loans made to employees (which are subject to Fringe Benefits Tax) and loans made to shareholders (which are subject to Division 7A). In the case of FBT, only the arms length interest charge is subject to tax, whilst under Division 7A, the amount of the loan is subject to tax.

Self Correcting Mechanism

We are of the opinion that there should be a self correcting mechanism for taxpayers who were previously unaware the application of Division 7A and its application has been brought to their attention.



Taxpayers should be able to amend tax returns, subject to the relevant amendment period, and self correct.

As a general statement, tax practitioners are concerned with public liability in taking on such clients who may have historic Division 7A issues.

Private use of assets

The extended definition of a payment for Division 7A purposes includes the provision of an asset. This extended definition should be limited to actual use of an asset rather than the provision of an asset that is available for use.

If you have any queries, please contact me on (02) 8266 1600.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Kel Fitzalan', written over a light blue horizontal line.

Kel Fitzalan
Partner