The Board of Taxation
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9 May 2014

Dear Sirs

Post Implementation Review of Division 7A : Second Discussion Paper

We refer to the Second Discussion paper released on 25 March 2014 by the Board of Taxation (Board) in relation to the post-implementation review of Division 7A of the *Income Tax Assessment Act* (ITAA 1936).

Division 7A is about the use of company assets by shareholders (and their associates). If a permanent gain is obtained by a shareholder (or their associate) from the use of these assets we support the need for a penalty tax regime. However, we consider that such a regime should not be drafted in a way that creates a quasi 'profits first' rule where the temporary use of assets (e.g. loans) is involved.

The *Fringe Benefits Tax Act 1986* was introduced to deal with the use of company assets by employees and overcome the associated valuation issues. It is disappointing that the Board has not taken a similar approach to that adopted by the Fringe Benefits Tax (FBT) regime such that if a shareholder (or associate) uses company assets in a temporary manner there is a prescribed way that this can be done which does not seek to penalise commercial lending practices.

Currently, we are in the perplexing situation where it is easier for employees to borrow from a private company then it is for the company's shareholders. There is also a mismatch between loans made to the employees (which are subject to FBT) and loans to shareholders (which are subject to Division 7A). In the case of FBT, only the arm's length interest charge is subject to tax, whilst under Division 7A, the whole amount of the loan is potentially subject to tax.

We would therefore urge the Board to consider a model which brings the treatment of shareholder loans in line with the treatment currently afforded to employee loans under the FBT regime. This would seemingly fix the uncertainty surrounding the valuation of company assets used by shareholders but at the same time allow them to borrow under more commercial terms whilst protecting the revenue base from abuse by taxpayers arbitrating corporate rates as compared to marginal rates.

Specific comments on Second Discussion paper

We comment on the following proposed reforms recommended by the Board.

1. *A unified set of rules based on the principle of transfers of value*

We are supportive of the Board's recommendation to introduce a single set of common principles for dealing with loans, payments, debt forgiveness and use of company assets based on the principle of transfers of value.

However, care will need to be taken to ensure that the technical complexities of the existing Division 7A regime are not replaced with a new regime which is difficult to understand and cumbersome to apply in practice. We consider that the existing FBT rules should provide a useful reference point when designing these new rules.

2. *A better targeted framework for calculating a company's profits*

We are supportive of the approach taken by the Board in relation to the calculation of a company's Distributable Surplus.

3. *A simpler, more flexible and better targeted system of 'complying loans'*

We support the introduction of a new, simplified regime to replace the existing provisions in Division 7A relating to complying loans as well as the requirements in the Commissioner's PS LA 2010/4.

We agree that flexibility should be provided for the payment of principal and interest as due to the nature of the business or investment activity undertaken by the loan recipient; it may not be possible to make annual payments of interest and principal.

As noted in our previous submission dated 15 February 2013:

> *"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."*

However, we consider the approach taken in relation to the minimum loan balances required at key milestone periods does not go far enough to relieve private businesses of the pressures to repay principal prior to the end of the current loan term and does not provide them with any refinancing options in the event that payments cannot be made.

Practically, loan recipients will need to derive an annual yield from their borrowed funds well in excess of 10% (the quoted small business variable (other) overdraft rate) if they are to have any chance of meeting the interest and principal repayment requirements. Loan recipients may often only have sufficient funds available once assets have been divested which may not occur until the end of the loan period. Earlier divestments may not be commercially practical. In many cases private companies will be forced to pay out dividends to enable loan recipients to meet their repayment requirements.

We consider that private businesses should only be required to repay the principal at the end of the loan period, a practice in keeping with current commercial lending practices.

To enforce the repayment of principal over the term of the loan (albeit at staggered intervals) is effectively introducing a quasi 'profits first' rule for private companies and is putting private businesses at a competitive disadvantage.

We agree that the requirement for a formal loan agreement should be removed. However, clear guidance would need to be provided to taxpayers and tax practitioners with regards to what written or electronic evidence would be considered sufficient.

As with the proposed Statutory Interest Rate model (refer to our previous submission dated 15 February 2013 which is attached), we consider it important that the proposed statutory rate must be no more onerous than what could reasonably be expected under a commercial lending institute for a similar amount and under similar terms and conditions.

In the ordinary course, third party lenders would require some form of security from the borrower, typically resulting in a rate of interest lower than the unsecured RBA's indicator lending rate for small business variable (other) overdraft rate. Therefore, under this model there should be the ability for loans to be secured and for loan recipients to take a commercial interest rate. Consequently, loan recipients should be able to select either a secured or unsecured arrangement.

We agree that fixing the statutory interest rate at the start of the loan would provide certainty for loan recipients in terms of their future cash flow requirements. However, applying a fixed rate of interest to the loan may lead private businesses to borrow from banks where variable interest rates may be available.

We consider that loan recipients should instead be given the choice to either fix the interest rate at the start of the loan period or adopt a variable rate of interest throughout the life of the loan. It would therefore be up to the loan recipient to decide how complex they make their own lending arrangements.

4. *Greater flexibility for trusts that reinvest unpaid present entitlements (UPEs) as working capital*

We welcome a legislative fix to align the treatment of unpaid present entitlements (UPEs) with other Division 7A loans. Although not critical of the concessions which are currently in place for UPEs, the existing UPE rules are complex and cumbersome and bring with them an increased compliance cost.

We support in principle the suggested 'tick the box' approach for trusts which will operate to exclude any loans to trusts (including UPEs) from the operation of Division 7A. In our experience, the profits first nature of Division 7A coupled with its onerous compliance requirements has left many clients regretting their decision to hold assets in trusts. The ability to elect out of the operation of the Division 7A rules (even partially) is therefore particularly welcomed.

That said we find it disappointing that the Board has decided to focus on the ability of trusts to utilise the CGT discount together with the marginal tax rate that may apply to that gain as a reason to adjust Division 7A. The ability to claim the CGT discount was not a policy consideration when Division 7A was originally introduced.

Under the ‘tick the box’ approach, a trust that makes an election would forgo the CGT discount on capital gains arising from assets (other than goodwill) held within the trust. The rationale for this is provided at paragraph 6.36:

> *“… The denial of the CGT discount in these circumstances is consistent with allowing use of the loan (including UPE) funds as if they were still in a company environment – where companies cannot access the CGT discount.”*

We agree that if a private company were to sell its underlying business that it would not be able to access the CGT discount. However, shareholders have the option to sell shares in the private company itself, in which case the CGT discount would ordinarily be available to individual shareholders who may be taxed at the top marginal tax rate.

As shareholders have the ability to manage their affairs to take advantage of the CGT discount, to disallow the CGT discount under the ‘tick the box’ approach as ‘companies cannot access the CGT discount’ appears unduly restrictive as trusts do not have an option other than to sell their assets.

If the ‘tick the box’ option is pursued we would need clarity around which trusts could make this election. Is it intended to apply only to trusts which have UPEs, or would it also apply to a trust which has previously borrowed from companies and is now finding it unmanageable to monitor its Division 7A compliance obligations?

We consider that any trust (regardless of what activities it undertakes and the origin of the loan involved) should be allowed to forgo the CGT discount and select the ‘tick the box’ option so that they are no longer required to comply with Division 7A in respect of all their loans.

5. A self-correcting mechanism

We are supportive of the introduction of a self-correction mechanism which would enable taxpayers to put in place complying loan agreements, reduce compliance and administrative costs.

We consider it important that this mechanism is auto-enacting such that taxpayers no longer need to rely on the exercise of the Commissioner’s discretion in order to amend prior-year returns where mistakes or omissions have been made.

If you have any queries in relation to the above please contact me on (02) 8266 1600.

Yours sincerely

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