The Board of Taxation
c/- The Treasury
Langton Crescent
CANBERRA ACT 2600
Via email: **taxboard@treasury.gov.au**

13 May 2014

Dear Board Members,

Post-Implementation Review of Division 7A of Part III of the Income Tax Assessment Act 1936 (Review)

The Taxation Committee of the Business Law Section of the Law Council of Australia (**Committee**) appreciates the opportunity to provide this submission to the Board of Taxation in relation to the Review.

The Committee commends the Board for putting forward for public consultation a document containing carefully-considered and analysed options for a structural review of Division 7A. The Committee also commends the Government for extending the Board's terms of reference to include the broader tax framework in which private business structures operate and for the Board not to be restricted to a "revenue neutral" or "near revenue neutral" outcome. In the Committee's view, this is an essential requirement to resolving some of the complexities emerging from the Review.

Executive Summary

The Committee's views are summarised as follows:

1. The present provisions of Division 7A need to be replaced by a model which does not perpetuate the complexities and compliance issues that the current and previous regimes have contained.

2. The Committee does not consider that the adoption of the Transfer of Value Model (**TVM)** will achieve that objective. Indeed, the Committee is concerned that the adoption of that model may lead to further and different aspects of complexity by addressing issues which are better addressed within the context of a broader review of the taxation of SME structures.
   In particular, the Committee recommends *against* attempting to resolve issues relating specifically to UPEs, passive investments and the taxation of amounts attributable to working capital of SME enterprises within the operation of Division 7A.

3. It is apparent that no single model considered to date will address all major issues satisfactorily. The emphasis of the review should turn to identifying the suggestions within models which can provide workable outcomes in respect of specific issues.

4. Within that context, the broader legislative objective of maintaining the progressivity of the income tax system as a whole should not prevent the adoption of a model or mechanism which achieves the specific policy objective of Division 7A: namely, preventing the shareholders of private companies and their associates from permanently and inappropriately accessing the profits of companies other than by way of dividends.

5. Having regard to the need to focus on simplicity and usability, the Statutory Interest Model (**SIM**) is an effective model to address the issues posed by temporary transfers of private company profits, such as loans and UPEs. Under that model, where interest is payable at a specified rate tied to a market measure, the specific policy objective of Division 7A is achieved.

6. Addressing temporary transfers involving the use of company assets and permanent transfers involving payments and forgiveness of debts will require separate consideration and resolution. In this regard, the Board's recommendations of self-correction may be adapted readily to the concepts of the SIM as if they were loans.
   To the extent that earlier versions of the SIM have been deficient in appropriately dealing with temporary or permanent transfers of company profits, the Committee believes that the design elements of the SIM can be made to address such concerns.

7. In the absence of a single model, the Commissioner's discretion to correct honest mistakes and inadvertent omissions under section 109RB should be retained, but with consideration to be given to lowering the threshold that presently governs the exercise of the Commissioner's discretion. Presently, there generally needs to be evidence of an honest mistake or an inadvertent omission before the Commissioner can exercise his discretion. This requirement should be relaxed, making self-correction easier.
   Importantly, any dispute about the exercise of the Commissioner's discretion should be made subject to review by the Administrative Appeals Tribunal.

8. The Board should take the view that an increase in simplicity and a reduction in compliance costs in any Division 7A model are critical.

Submission

Compliance concerns with Division 7A

The Review acknowledges and accepts that compliance problems and uncertainties arising out of the operation of Division 7A and its interaction with other provisions of the tax legislation have resulted in a present regime that is too complex, uncertain in its operation and costly to comply with.

The additional problems identified since the December 2012 review document and listed in Appendix C of the Review underscore the fact that anomalies and unfair outcomes are likely to continue to emerge under the provisions as they presently apply.

Further examples that can be cited in support of this proposition include:

- the calculation of minimum annual repayments for each income year in relation to the relevant amalgamated loan;

- the rules that apply for private company, liquidations where where debts are forgiven;

- the rules that apply for family law driven transfers;
- the rules that potentially apply for executors of deceased estates; and
- the subdivision EB rules affecting transactions between trusts with UPE's and other entities, including trusts.

The TVM will continue to suffer from complexity and compliance cost

In many respects the TVM appears to be a similar concept to Division 7A, but with some different design elements. In particular, there is still a requirement to evidence the making of loans and the repayment of loans, and the prescribed maximum loan balances still require compliance costs to be incurred in order to comply with the rules, as well as the calculation of the relevant distributable surplus.

In addition however, a considerable part of the Review analysis is directed to the issue of applying Division 7A to limit the ability of trusts to access private company funds for investment in "passive" investments which may qualify for the 50% CGT discount.

In effect, the TVM proposes that by implementing a "tick the box" option, trusts will be permitted to access private company funds (either by UPE or loan) if that access is effectively limited to working capital funds and increasing business goodwill. This leads to a consideration of "passive" investments of shares in companies which may represent goodwill in other operating companies. There is an inherent additional layer of complexity as a result of the TVM being adopted.

The Review further proposes that the TVM apply a revised method for calculating the *distributable surplus* of private companies based on transfers of value, rather than on the year-end values of company assets, with consideration being given to realised and non-realised gains on temporary and permanent transfers of value within each tax year.

The Committee is of the opinion that these issues will perpetuate the aura of complexity which currently surrounds the Division and are likely to lead to further and different aspects of complexity.

With regard to the question of UPEs and working capital, the Committee commends the Board raising the question (in paragraph 4.16) as to whether there should be a capped, competitive rate for business accumulations generally, rather than one that is confined to companies. It is noted however that further consideration of that issue was outside the scope of the Review.

It is submitted that addressing the issue of working capital in respect of trusts and companies within the context of Division 7A without regard to similar issues affecting other SME entities seeking access to working capital (i.e. sole practitioners and partnerships) is not an appropriate consideration for resolution within the operation of Division 7A. It is the Committee's view that this is an issue which requires root and branch reform and detailed separate consideration.

No single model will achieve the desired outcome

It is apparent that no single model considered to date will address all major issues satisfactorily. The concentration should therefore turn to identifying the suggestions being particular models or within particular models which can provide workable outcomes in respect of specific issues

In this regard, the Committee considers that the Statutory Interest Model (**SIM**) will deal appropriately with loans and ETPs and that payments and debt forgiveness should be addressed separately, including having regard to some issues arising under the TVM.

***The* SIM is to be preferred in relation to temporary transfers such as loans and UPEs**.

This model is stated by the Review as satisfying all but one of the four principles set out in the Board's policy framework.

The principle considered not to be satisfied was that the SIM may increase incentives for accumulation of passive income and therefore contravene the principle of serving progressivity in the tax system.

Indeed, the Review expresses a concern that the SIM may even be said to incentivise the accumulation of passive investment as a result of the prospect of negative gearing.

The Committee is of the opinion that the SIM provides a simple and effective basis on which to deal with loans and UPEs between private companies, the shareholders and their associates, to ensure that the taxed company funds cannot be accessed inappropriately.

As such this model goes directly to the specific policy objective of Division 7A and should take precedence over any concerns regarding the broader issue of maintaining progressivity of the tax system.

In this regard, it is noted that in dismissing the *Distribution Model* as an acceptable model, the Board commented that it was unsuitable for application because "the policy outcomes of the *Distribution Model"* pertain more to maintaining the progressivity of the income tax system as a whole rather than to addressing the specific policy objective of Division 7A…" (paragraph 5.16). The Committee is of the view that this argument commends the adoption of the SIM with similar force.

The SIM, if appropriately legislated, will be readily comprehensible to tax agents and their clients in the SME sector. As such it should reduce costs and increase compliance. The Committee is of the view that the SIM should adopt a market level measure of interest, and that interest should be deductible (or not) according to the use of the funds in the normal way. There would be no requirement for repayment of principal.

On the issue of concerns about negative gearing, the Committee further considers that a focus upon the use of the funds by the shareholder results in a distortion in the basic principle underlying Division 7A.

Division 7A is concerned with arrangements for accessing taxed profits by shareholders and their associates. If appropriate commercial consideration is payable by the shareholder or associate at the point of extraction, that should be the end of the matter as far as the provisions of Division 7A are concerned.

Accordingly, the Committee submits that it is the provision of the benefit to which any reform of Division 7A should apply, and not to the subsequent use of the benefit so received. The Committee is of the view that if there is an intention to favour one type of investment over another that is a concern which should be dealt with elsewhere in the legislation.

Payments and forgiveness of debts and the Commissioner's relieving discretion

As indicated above, the Committee notes that if the SIM is adopted, permanent transfers such as payments and forgiveness of debts should be dealt with separately.

In this regard, the Review's suggestion of self-correcting mechanisms for such matters as inadvertent payments which are subsequently discovered may be treated as loans and correcting payments made where necessary.

However in the absence of a comprehensive model which can be said with confidence to address the uncertainties and inequities which arise under Division 7A, it will be essential to retain and perhaps strengthen the Commissioner's discretion under section 109RB to provide relief to taxpayers. The present relief may be granted in the case of honest mistakes and inadvertent omissions.

Consideration may need to be given to broader relief in respect of unfair outcomes, having regard to the circumstances in which liabilities may arise, and it is for this reason that any dispute about the exercise of the Commissioner's discretion should be made subject to review by the Administrative Appeals Tribunal under Part IVC of the *Taxation Administration Act 1953*.

Whatever further steps may be taken in this regard, the Committee is of the view that the Commissioner's exercise of that discretion should be made subject to review by the Administrative Appeals Tribunal. At present, appeals are most likely limited to appeals to the Federal Court under ADJR legislation or the *Judiciary Act 1903*. This can be prohibitively expensive for the vast majority of taxpayers.

Should the Board have any questions, please direct them to the Committee Chair, Mark Friezer, of Clayton Utz on (02) 9353 4227.

Yours sincerely,

John Keeves
Chairman, Business Law Section