THE TAX INSTITUTE

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By email: DIV7A@treasury.gov.au

Dear Mr Derlacz

Treasury – Targeted amendments to Division 7A

The Tax Institute welcomes the invitation to make a submission to Treasury in relation to the targeted amendments to the Division 7A integrity rules as outlined in the Consultation Paper dated October 2018 (**Consultation Paper**).

Summary

In our opinion, the Government's approach in the Consultation Paper reflects an attempt to only selectively adopt some of the recommendations of the Board of Taxation Post-Implementation Review of Division 7A dated November 2014 (**Board's Division 7A Report**).

The Board's Division 7A Report made wide ranging recommendations precisely because one of the criticisms of the evolution of Division 7A was the constant 'band-aiding' of the Division. The Board therefore specifically rejected this as an approach and recommended a package of measures that could be adopted as a replacement to Division 7A.

The Board of Taxation's recommendations were made after extensive consultation and engagement with practitioners, the ATO, Treasury officials and taxpayers. In our opinion, the Consultation Paper should clearly outline why recommendations have not been adopted.

In our opinion, the measures in the Consultation Paper represent another band-aid fix to Division 7A. The Government needs to reconsider this approach and revisit the recommendations made by the Board of Taxation. We would strongly encourage the government not to continue the errors of the past by, once again, applying band-aid fixes to the Division.

Distributable surplus

The Tax Institute considers that the proposal to remove the concept of “distributable surplus” should not proceed.

Division 7A was originally introduced effective from 4 December 1997. Prior to this date any disguised distribution of private company profits was potentially treated as a deemed unfranked dividend under the former section 108 of the *Income Tax Assessment Act 1936* (**ITAA 1936**).

Broadly, the former section 108(1) of the ITAA 1936 provided that where a private company paid or credited an amount (including a loan) to a shareholder or an associate, the company would be deemed to have paid a dividend to that person if the Commissioner of Taxation formed the opinion that the amount paid or credited represented a distribution of profits.

It ultimately transpired that section 108 was a difficult provision for the Commissioner to invoke and accordingly it was, over time, replaced by Division 7A. While Division 7A was introduced to overcome the limitations of section 108, fundamentally, like section 108, it is still aimed at preventing private company owners and their associates from avoiding dividend taxation by trying to access company profits in another form besides dividends. The Board of Taxation accepted this in their “Second Discussion Paper” released in March 2014.

Section 109Y of the ITAA 1936 introduced a statutory concept of 'distributable surplus' to replace the less precise notion of 'profit' in section 44 of the ITAA 1936 (section 108 operated through the mechanism of section 44). Notwithstanding this, the term 'distributable surplus' is to be understood in that context, namely, the realised and unrealised profits in the company available for distribution.

This is supported by the Commissioner’s comments in TD 2009/5 at paragraph 18:

> *“In section 109Y a statutory conception of 'distributable surplus' is introduced to replace the looser notion of 'profit' in section 44.[9] It reflects the approach taken in Spanish Prospecting in that it is based on a comparison of the value of assets at two dates. This conception has two evident purposes, one is to bring greater certainty to the amount of the surplus and the other is to reduce scope for manipulation of that amount by taxpayers (as might be expected in a provision which is primarily an anti-avoidance provision). The broader purpose of 'profit' is retained by the use of the conception 'to prevent taxation of a return of capital', that is, of something which was not a gain to the company.”*

By removing the concept of distributable surplus, Division 7A arguably becomes broader in its application than originally intended.

The Consultation Paper says that the limitation of the amount of deemed dividend will be removed. Removing the distributable surplus means that loans not funded from company profits (eg, from share capital or loans) can be treated as unfranked dividends. This can result in double or triple taxation, especially where franking credits are denied.

Further, removing the concept of distributable surplus will lead to anomalous results in circumstances where a taxpayer is taxed on a loan made from:

- money previously subject to the progressive marginal rates of tax. For example, a loan made by a private company from share capital or debt capital advanced by an individual taxpayer from 'owned' funds; or
- money borrowed from arm's length parties. For example, a loan made by a private company from debt capital borrowed from an ADI. Group finance companies for private groups will often be in this situation.

In our opinion, imposing double taxation (which may occur in the situations above) should be avoided except in extreme circumstances.

14-year amendment period

On 16 December 2004 the Treasurer announced, in response to the *Report on Aspects of Income Tax Self-Assessment (August 2004, Treasury)*, that the Government would commit to improving certainty for taxpayers by 'reducing the periods allowed for the Tax Office to increase a taxpayer's liability in a wide range of situations'.

Improving taxpayer certainty is a key goal for tax administration. The length of time that elapses before assessments can no longer be amended represents an aspect of risk and uncertainty for taxpayers. Unlimited amendment periods represent an extreme case of uncertainty, as the time to amend extends indefinitely.

While short amendment periods provide greater certainty for taxpayers, it is acknowledged that setting periods too short may jeopardise the capacity of the Commissioner to detect non-compliance. A balance needs to be reached between the two competing objectives. For this reason, the Report on Aspects of Income Tax Self-Assessment concluded that, in order to promote optimal certainty, the period permitted for an amendment should approach the minimum required for the Tax Office to identify the majority of incorrect assessments and take action to correct them. This suggests that unlimited amendment periods should only exist in rare or exceptional circumstances.

Treasury refers to the CGT provisions as an example of other areas of the law in which there is an extended period of review. The CGT provisions inherently entail a degree of complexity, given the range of assets, events and exemptions that can apply. Also, assets may be held for long timeframes before capital gains tax is triggered by a CGT event, such as disposal. As the liability for CGT can often only be determined following a contingent event — usually the CGT event — it is accepted that a period of four years may not be sufficient in certain circumstances. It is difficult to understand how Division 7A can be compared in this context.

Unobjectionably, if there is sufficient time for the Commissioner to examine the claim and make any necessary amendments to the relevant assessment and there is no continuing compelling reason for having a special amendment period, then such a special period should not exist. In the context of the newly proposed Division 7A provisions as they apply to loans, if the repayment actually made in the income year is less than the required minimum yearly repayment, a deemed dividend will arise for the amount of the shortfall. In this context it is not clear why the Commissioner requires an extraordinary period of review to uncover this detail.

Treasury does not provide any justification as to why 14 years is the ideal period for reviewing Division 7A transactions apart from stating that such approach is consistent with other areas of the law in which there are an extended period of review, including capital gains tax and loss recoupment rules.

The 14-year review period is not the review period of any area of the tax law. By law the Commissioner is allowed a 4-year period review, except in cases of fraud or evasion, where the Commissioner has unlimited time to review tax assessments. In our opinion, a Division 7A specific extended review period is not necessary

Treasury's proposal imposes an onerous financial and administrative burden on taxpayers who will be subject to a 14-year review period without any reasonable explanation. Further matters need to be clarified. For example, if the trigger for Division 7A is a payment or a forgiveness of a debt, will that be a 14-year amendment period as well or just 4 years? Further,

- In the case of real property, those assets may have been in the company well before Division 7A was introduced. Will there be a 14-year amendment period applied to what is essentially an annual cost?
- What happens once the loan becomes unenforceable? Do you have to prove that it has been unenforceable for another 14-years or just the 4 years from the date the loan becomes unenforceable?

The Tax Institute considers that the 4-year review period should be maintained in the new regime, which is consistent with every other area in the tax law. Further, the Commissioner should be required to fulfil his statutory obligation to administer the tax laws within the existing time limits.

Simplified Loan Rules

The intention to 'better align with calculations for the repayment of principal and interest loans in commercial transactions' is welcomed. However, in our opinion, this objective will not be achieved with the recommendations in the Consultation Paper.

In our opinion, the claim in the Consultation Paper that requiring annual payments encourages proactive cash flow management by businesses misses the point in the Board's recommendations. In particular, the Board's recommendation for the amortisation model (using a maximum balance at four points in time) was in response to feedback about pro-active cash flow management by businesses. It was proposed that less frequent measurement points mean that businesses have the capacity to plan their cash flows more flexibly and more closely represents the negotiated position that would be reached in arm's length arrangements.

In relation to the proposed simplified loan rules, we also note that:

- The indicator rate is substantially higher than the currently applied rate. This will need to be clearly communicated, particularly in the transitional period.
- The lack of requirement for a formal written loan agreement is a good step. However, the requirement for some form of record including the loan term still imposes an arguably unnecessary compliance step on taxpayers. In the Board's Division 7A Report, the Board suggested that all that would be required is evidence that the moneys were lent (as opposed to 'paid'). Division 7A would then set out the requirements for repayment of the loans. Failure to meet those legislated requirements would lead to a deemed dividend.
- It is of concern that the provision would require interest on the opening balance to be paid as if the loan were outstanding for the whole year, even if it is fully repaid at any time during the year. This is clearly not consistent with commercial transactions.
- No detail is given as to how Division 7A would interact with the TOFA provisions for those taxpayers subject to them.

No grandfathering of 25-year loans

In the Board's Division 7A Report, 25-year loans were 'grandfathered' from the new rules. The Treasury now proposes that existing 25-years loans unpaid as at 30 June 2021 be placed on a 10-year term from 1 July 2021. Current 25-year loans are secured by real property and so to place the loan on 10-year terms would involve significant expense in terms of documentation and discharging the mortgage.

The proposal to replace 25-year loans with a 10-year complying loan agreement will have a retrospective effect on existing transactions by ignoring those currently operating under legally binding agreements. The Tax Institute considers that this is not consistent with the rule of law and as a matter of general policy, tax measures should apply prospectively.

Current 25-year loans may be secured by real property. To place the loan on 10-year terms would involve significant expense in terms of documentation and discharging the mortgage. For loans that currently have a 25-year loan term, this assumes taxpayers can simply amend agreements to a 10-year term. In our opinion, this assumption is incorrect. In our opinion, 25-year loans entered into before Budget announcement should be grandfathered to prevent those taxpayers that have complied with the current regime from being subjected to unintended costs.

Further, the Consultation Paper does not clarify how costs involved in converting 25-year loans into 10-year loans will be treated for tax purposes. Clarification is needed in relation to:

- Will costs become immediately deductible?
- How will the costs of unwinding the loan be treated?
- If the lender is subject to the TOFA provisions, they will trigger a taxing event as the financial arrangement will come to an end and be substituted for a shorter period (or longer period if the 25-year loan had less than 10 years to run)?

Treasury's proposal has the result of providing different loan terms to taxpayers who have existing 25-year loans. For example, if a 25-year loan that was entered into in 2001 is converted into a 10-year loan on 1 July 2021, by 2021 the loan will have been in place for 20 years, giving a total term of 30 years. Conversely, if the loan began in 2016, the combined term of the original 25-year loan that is replaced by a 10-year loan in 2021 will be 15 years.

7-year loans

In the Board's Division 7A Report, 7-year loans could transition to the new 10-year loan regime. The Treasury now proposes to restrict the existing 7-year loans to keep their maturity date at a higher interest rate. As well as the financial cost of the higher interest (see below), this would require amending loan agreements to reflect the new interest rate (and any other changes).

Taxpayers who decided to enter into a loan of 7 years did not anticipate such a significant increase in interest rate and should be given the choice to either maintain their maturity date or convert the loan balance into a compliant 10-year loan from 1 July 2019 (less the expired term much like a refinancing under the current 109R(6)).

In our opinion, the Board's recommendation is preferred on the basis of simplicity.

Pre-1997 loans and pre-December 2009 UPEs

Treasury proposes that both pre-4 December 1997 loans and unpaid present entitlements (**UPEs**) arising on or after 16 December 2009 must be either repaid or placed on 10-year complying loan terms from 1 July 2019.

Pre-1997 loans have been quarantined for over 20 years. The new legislation intends to give a mere 2-year grace period for taxpayers to organise payment of a substantial amount of money under Division 7A terms. As a result, taxpayers may need to realise assets, and some may end up facing potential financial hardship in order to be able to convert the outstanding amount into a compliant loan.

The Tax Institute considers that pre-1997 loans should remain quarantined in order to protect taxpayers from any adverse application of the law.

We also consider that Treasury should maintain its position to not apply the new regime to pre-2009 UPEs, as under the same principle that no change of law should apply adversely to someone's existing rights. The Consultation Paper is unclear on what the arrangements will be for pre-2009 UPEs.

In relation to all UPEs arising after 16 December 2009, we propose that, similar to 25-year loans and pre-4 December 1997 loans, a two-year transition period is allowed and then the UPE must be converted to a 10 year loan. If our preferred approach as outline above is not accepted, a similar approach could be used for pre-16 December 2009 UPEs.

Business income election

The Board of Tax Report proposed a once-and-for-all election to exclude loans from companies (including UPEs owing to companies) from the operation of Division 7A (the 'business income election') which is not included in the Discussion Paper. The business income election would have significantly reduced compliance costs for family groups. No reason was given for the Consultation Paper not including the election.

The business income election should be reinstated as per the recommendations in the Board of Tax Report.

Loan documentation requirements

The strict legislative requirements for the form of loans needed in order to meet the s 109N excluded loan provision can be onerous and result in unnecessary costs of compliance. The removal of the requirement to document a loan in writing is, therefore, welcome.

However, while the Consultation Paper proposes no requirement for a formal written loan agreement this may lead to uncertainty in relation to substantiation requirements. Therefore, we consider that these issues need further clarification. For example:

- if the loan is not documented how do you prove that a payment is a loan or just a plain dividend?
- how do you prove that it is not a loan if the Commissioner says it is a loan?
- what do you have to do to substantiate the transaction? For example, will the mere disclosure of the loan in the accounts as a loan be adequate to discharge the loan documentation requirements.

It may be the case that the requirements in the Consultation Paper, and the likely ATO compliance requirements to satisfy the onus of proof, mean that the proposed requirements are more onerous than the existing requirements. We, therefore, recommend that default loan terms be incorporated into the legislation.

Default loan terms

In order to simplify compliance, we recommend that Treasury consider incorporating into Division 7A a mechanism whereby all loans and UPEs that are subject to the Division *by default* have complying 10-year terms applied to them. These terms could readily be set out in the legislation. We note that a similar arrangement is available under the Companies Act for the adoption of standard company constitution terms. Taxpayers could opt out of this default treatment if they wanted a shorter loan term.

This proposal would remove the current need to document complying Division 7A loans (the vast majority of which all get put on the same terms anyway), thereby reducing the work involved in preparing loan agreements) or otherwise creating documents evidencing the terms of Division 7A loans.

This is also consistent with the Board of Taxation's recommendations.

Self-correction mechanism

It appears that the self-correction mechanism does not deal with errors relating to UPEs. If this is the case, we consider that it should be rectified or clarified.

The concept of an 'inadvertent breach' will introduce more uncertainty into the tax system. Similarly, uncertainty will also arise in relation to the "objective factors" that will be taken into account. The "objective factors" to be taken into account should be the subject of consultation.

In our opinion the self-correction mechanism needs to be drafted more comprehensively and with less uncertainty.

Further, a statement on how the TOFA provisions will interact with this proposal for affected taxpayers should be made.

Other comments

We support the general proposal in relation to the safe harbours for the provision and use of assets. However, we disagree with creating an exception to the general rule for motor vehicles because creating an exception to a rule does not promote simplicity.

If such an exception is to be proceeded with, we note that more clarity will be required in relation to whether it is long term leasing arrangements or short-term hire that is intended to represent market value.

Further, the safe harbour rule for the use of assets on a days used basis will create significant uncertainty as to when assets are used and when they are not. In the example given to occasionally use a $1.2m yacht for $5,326 a year does not appear realistic.

In relation to the Minor Technical Amendments outlined in the Consultation Paper we note that the first dot point on page 17 suggests that the exclusion from Division 7A only applies where the payment to a shareholder constitutes a fringe benefit (ignoring the exclusion in para (r) of the FBTAA definition). However, this leaves a large number of exclusions (such as for superannuation contributions, personal injury payments etc) which are not fringe benefits but which policy considerations suggest should not be subject to Division 7A. We consider that this amendment needs to be reconsidered.

In relation to the proposed section 109T amendment, we are concerned that the changes will not achieve any greater level of certainty. If there is no change in application of section 109T then it should not be amended. If the amendment is proposed to change the application of the section this should be outlined in detail.

Lastly, the Consultation Paper does not address many of the recommendations in the Board's Division 7A Report. One recommendation that we consider to be particularly important is the treatment of business income derived by trusts and taxed to corporate beneficiaries. In line with the Board's comments, we consider that the better policy setting is to allow the taxation of business income at the concessional corporate rate, regardless of the entity type. While the structure of the Australian tax system cannot currently easily accommodate this for businesses operated by individuals (alone or in partnership), it is possible to achieve this for trusts as outlined in the Board's recommendations.

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If you would like to discuss, please contact either me or Tax Counsel, Angie Ananda, on 02 8223 0011.

Yours sincerely

Tracey Rens

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President