Taxpayers Australia Ltd T/A
Tax & Super Australia
ABN: 96 075 950 284

26 November 2018

Attention: Gregory Derlacz

Senior Advisor
Small Business Entities &
Industry, Concessions Unit.
The Treasury – Langton
Crescent,
PARKES ACT, 2600.

Subject: Submission regarding targeted amendments to the Division 7A integrity rules.

Taxpayers Australia Limited, trading as Tax & Super Australia (TSA) welcomes the opportunity to lodge its submission on behalf of its members to the Treasury concerning its views on the Government's proposed implementation of the amendments to Division 7A of the Income Tax Assessment Act 1936. We appreciate Treasury granting us an extension of time for our submission.

TSA is a not-for-profit organisation that has assisted accountants, tax and superannuation professionals for nearly a century. A summary of our organisation is contained in Appendix 1 for your reference.

Our members, who are mostly registered tax agents, have been voicing their concern for some time regarding the difficulties of correctly interpreting and applying certain extremely complex tax legislation that applies to Division 7A.

Our submission has been driven by the priorities and concerns of our members, while being premised on an overarching objective of achieving a suitable balance of fairness, efficiency and simplicity in the administration of the taxation system.

We trust that the views contained in our submission are of value and that it will assist Treasury in its consultation process on the design of new division 7A rules.

On behalf of our members, we would be pleased to assist if any future opportunities arise for us to consult on this issue.

Level 13, 303 Collins Street, Melbourne, Victoria 3000
PO Box 226, Flinders Lane, Victoria 8009
t: (03) 8851 4555
e: info@taxandsuperaustralia.com.au
w: taxandsuperaustralia.com.au

Should you have any further questions or require any clarification, please contact:

Mr Michael McCarthy
Senior Tax Specialist
Tel: (03) 8851 4555
Email: mmccarthy@taxandsuperaustralia.com.au

Yours Sincerely,

Moti Kshirsagar
Chief Executive Officer
Tax & Super Australia

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Discussion Question 1:

Proposed loan model

a. Is there an aspect of the proposed loan model that could be refined?

Whilst the Government's proposed loan model provides a degree of simplicity, it doesn't have the flexibility of the Board of Taxation's proposed model included in their recommendation 6. The Board's model uses "milestone" periods as a test to whether minimum repayments are met. This would assist businesses where cash flow fluctuates from year to year and the repaying of the loan is dependent on that cash flow.

The rate proposed of the "small business, variable, other, overdraft indicator" lending rate most recently published by the Reserve Bank of Australia prior to the start of each income year, is a substantial increase from the benchmark interest rate currently applicable. At 1 July 2018 this rate was 8.3%, as compared to the 5.2% benchmark interest rate at that time.

Recommendation: Incorporate the Board of Taxation's prescribed maximum loan balances during the term of the loan, with deemed dividend consequences only after end of years three, five, eight and ten, per their recommendation.

Defer the introduction of the increased interest for at least three years (for loans less than 10 years), to provide businesses with adequate time to review their existing div 7A loan arrangements. For loans greater than 10 years, please refer to transitional rules (b) below.

Transitional rules

b. Do the proposed transitional rules result in any unintended outcomes?

Currently there are complying 25-year loans in existence. Whilst, under the Government proposal, exemption will apply to the majority of changes until 30 June 2021, the proposals seem to be harsh, particularly for say those with a current term significantly more than 10 years.

The proposed transitional rules could result in serious cash flow issues for those refinancing a 25-year loan. The question could be asked why these business entities can't lend funds at a commercial interest rate based on a 25 year term, fully secured by a registered mortgage over real property, where the market value of the property at the time the loan is made is at least 110% of the loan amount, and where the Tax Office has currently indicated that it is ok?

Recommendation: Retain the existing two term loan categories. i.e., amending the current 7 and 25-year loans (where the latter are fully secured by a registered mortgage over real property and the market value of the property at the time the loan is made is at least 110% of the loan amount) to say the 10 years as proposed, and say a 20-year model for those loans with the required security. Alternatively, as a minimum, we consider the Board of Taxation's recommendation regarding grandfathering the terms of complying 25-year loans, should be implemented.

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Application to non-resident private companies

c. In what circumstances (if any) is the application of Division 7A to non-resident private companies unclear?

Mentioning the requirement to refer to the relevant double tax treaty may be useful as an inclusion in sec. 109BC of ITAA 1936. (The DTA requirements can be easily overlooked by Tax Practitioners).

d. Would the application of Division 7A to non-resident private companies benefit from additional public guidance material?

Yes. If not already available, a Tax Ruling would assist. Where the guidance issued is binding on the Tax Office, this assists Tax Practitioners with ensuring certainty with its application.

e. Are legislative amendments required to clarify the application of Division 7A to non-resident private companies?

Yes. Refer c) above.

Distributable Surplus

f. Does the removal of the concept of distributable surplus result in any unintended outcomes?

Yes. Take the scenario of a small business owner who contributes funds into the Company from the outset. If the funds are contributed by way of equity, and part of the funds are subsequently withdrawn prior to any profits being derived by the Company, removing the distributable surplus test will result in a deemed dividend. If those same funds invested into the Company were accounted for as a loan to the Shareholder, and were similarly withdrawn, there would be no deemed dividend.

The Board of Taxation recommended retaining the rules regarding the calculation of distributable surplus. We acknowledge Treasury's proposal of aligning the treatment of dividends with section 254T of the Corporations Act 2001, which allows dividends to be paid out of both profits and capital. However, the concept of "accounting" and "tax" rules do not always need to align. (e.g., Depreciation for "accounting" purposes can differ from "tax" purposes etc.), and we consider that in the case of the distributable surplus rules, it would be an assistance to businesses if these rules were retained.

Recommendation: Retain the rules regarding the calculation of distributable surplus.

g. If this concept is removed, are there any interactions with other provisions of Division 7A that might become relevant?

Recommendation: Retain the rules regarding the calculation of distributable surplus.

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Discussion Question 2:

Unpaid present entitlements

a. Are transitional rules required for UPEs arising on, or after, 16 December 2009 and on or before, 30 June 2019 where the funds are invested in the main trust using one of the investment options in PSLA 2010/4 and therefore the UPE is considered to be held for the sole benefit of the private company beneficiary? If so, what kind of transitional rules might be required?

Yes. Transitional rules should be required in such cases. These situations are currently covered by guidance in PSLA 2010/4 and PCG 2017/13.

One further thought on this is that from a Government revenue perspective, past UPEs' have generally been taxed at Company tax rates of 30% (or 27.5% if applicable) on this profit.

We note that there is already in existence sec. 100A ITAA 1936 and sec. 109T (which we note you are amending 109T (1) with a reasonable person test).

Recommendation: A grandfathering provision from the proposed new rules for arrangements that have applied the safe harbour options in place as at 30th June 2019, that are compliant with PSLA 2010/4 and PCG 2017/13. The proposed new rules can then apply to these arrangements upon the first expiry date of the safe harbour provisions after 30 June 2019.

b. Should UPEs arising prior to 16 December 2009 be brought within Division 7A?

No. Generally, the Company has paid company tax on these UPEs', so we would not consider there is significant revenue loss for the Treasury on this issue, although we acknowledge the reference to PSLA 2010/4 at para 104, which states "For the avoidance of doubt, the ATO may, in appropriate cases, apply Subdivision EA in respect of UPEs in existence before 16 December 2009.

Also, in ATO fact sheet ref. QC 24445 "A UPE may be subject to Division 7A", it states "As the Commissioner first expressed his view on 16 December 2009, we will only apply this view to UPEs which come into existence on or after this date".

Obviously, the exception is where fraud or evasion is involved, or the Tax Office considers part IVA is applicable.

Discussion Question 3:

Self-Correction Mechanism

a. Are the eligibility criteria clear and concise?

The breach needs to be "inadvertent" to qualify for "self-correction". Does this mean any breach that is not fraud or evasion, i.e., recklessness an inadvertent breach?

b. **Are additional objective factors necessary to include in determining a taxpayers' eligibility?**

Ideally yes. Legislation seems to be increasingly factoring in "bright line" tests.

c. What guidance should be provided to assist taxpayers in using the self-correction mechanism?

Recommendation: When guidance is produced for this (as "inadvertent" could be open to interpretation), it provides examples that they consider are as close as possible to the "line", to assist in the self-assessment process. (Difficulty arises where the examples provided range from one extreme to the other).

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A series of questions could be put forward, where a 'yes' answer reasonably concludes an "inadvertent" breach has occurred. A certain number of questions answered favourably could provide the Taxpayer with a safe harbour that they are not at risk of an unfavourable audit outcome in the future.

Period of Review

d. Will the period of review cause any unintended outcomes?

It definitely could for the Taxpayer. Generally, two and four-year amendment periods, provide some form of certainty for Taxpayers where there is no fraud or evasion involved. 14-year amendment periods where a breach may have been considered in good faith to be inadvertent, which is later considered in an audit not to be, could result in adverse tax consequences for the Taxpayer.

e. Are there any alternative options to a 14-year review period that would ensure the integrity of the revised Division 7A?

Yes. Currently the review period is two years for small business taxpayers and four years for Taxpayers with more complex tax affairs. There is currently no time limit for underpayment of tax due to fraud or evasion. There is also part IVA of the ITAA 1936 available, that can be utilized when required. We consider these time limits are sufficient and no alteration is required. If the Tax Office discover fraud or evasion in relation to Division 7A then there is no time limit. With our complex tax system, Taxpayers deserve reasonable time limits for amendments so that they are not penalised for inadvertent and honest errors. We appreciate that other areas of tax law have extended periods of review however the concern is that these exceptions gradually become the norm for each specific piece of tax legislation.

Discussion Question 4:

Safe Harbours – Provision of assets for use

a. Is there an alternative formula which could be used?

The Board of Taxation's recommendation 4 includes designing safe harbour rules distinguishing between depreciating assets and appreciable assets.

The proposed formula could substitute "A" for the tax written down value of an asset where a depreciating asset is concerned.

b. Should Taxpayers have the option to elect between the statutory formula and providing their own arm's length usage charge or should the statutory formula be the only option?

If Taxpayers support a reasonable arms-length usage charge, we support this option to be made available.

c. Is a 5 per cent uplift interest rate as part of the usage charge appropriate? Or should another rate (e.g. the benchmark interest rate) be used?

We support the benchmark interest rate.

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d. Should there be a ‘reasonableness’ test included in the statutory formula or alternatively, are multiple formulas needed?

We consider there should be a “reasonableness” test. We understand there may be substantial private use of high cost assets i.e., private jets, luxury yachts etc. The example given in the consultation paper was a yacht valued at $1,200,00. These types of figures warrant say a formal valuation every five years. There are substantial other assets which could fall into the carve out made available for motor vehicles, which do not warrant a formal valuation every five years. In these instances, and in order to simplify compliance, tax written down values could be used, rather than the value of asset.

A further suggestion could be a “de minimus” rule. i.e., exclusions for assets with a cost of say less than $20,000?

Discussion Question 5:

Minor Technical Amendments

a. Are any changes required to the interposed entity rules, apart from section 109T? For example, should section 109V and 109W be amended?

Insufficient time for a well thought out response, however we have been referred to TD 2018/13, which may assist.

b. For the purposes of applying section 109M, is it necessary to have objective criteria to determine whether a loan is made in the ordinary course of a business of lending money? If so, what should be included in the criteria?

Not applicable to our constituency.

c. Do similar changes need to be made to other paragraphs of the definition of ‘fringe benefit’ in subsection 136(1) of the *Fringe Benefits Assessment Act 1986* to clarify the interaction of FBT and Division 7A?

Insufficient time for a well thought out response.

Discussion Question 6:

Other issues

a. Would the insertion of an objects clause in the legislation, consistent with the ‘Policy intent’ outlined on page 2 of this paper, be useful in clarifying the intent of the provisions?

Insufficient time for a well thought out response.

b. Are there any other issues relevant to the amendments canvassed in this paper that have not been considered?

Yes. We couldn’t locate any reference in the discussion questions regarding feedback on the treatment of pre-1997 loans. In the consultation on page 7, it referred to the proposed transitional treatment. These loans were originally “grandfathered” as they pre-dated the introduction of Div. 7A. In effect the proposal reverses this “grandfathering” which has been acted on in good faith by the affected Taxpayers’ and the Tax Office.

Recommendation: Retain “grandfathering” rules for pre-1997 loans.

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APPENDIX 1:

About Tax & Super Australia

Taxpayers Australia Limited trading as Tax & Super Australia is a not-for-profit organisation committed to a fairer and more transparent taxation system for every Australian taxpayer.

Our aim is to provide taxation practitioners, superannuation professionals, small businesses and individuals with up-to-date, informative and above all understandable information about Australian taxation.

As a community benefit organisation, Tax & Super Australia is independent and unaffiliated with any political or commercial groups, advertising or sponsoring organisations. We are a member-based organisation, and our loyalty is dedicated to our members.

Tax & Super Australia has been a trusted source of tax knowledge and expertise since 1919 - we are one of the original, if not the first, of such associations in the world.

Our membership and subscriber base comprise tax and superannuation professionals as well as individuals and small businesses. Our plain English approach means that information is not obscured by confusing jargon or heavy technical and overly academic language, while still ensuring that tax issues are comprehensively clarified.

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