IPA INSTITUTE OF PUBLIC ACCOUNTANTS

18 February 2013

The Board of Taxation
c/ The Treasury
Langton Crescent
PARKES ACT 2600

By email: taxboard@treasury.gov.au

Submission on discussion paper "Post-Implementation Review of Division 7A".

The Institute of Public Accountants (IPA) is one of the three professional accounting bodies in Australia, representing over 25,000 accountants, business advisors, academics and students throughout Australia and internationally. The IPA prides itself in not only representing the interests of accountants, but also small businesses and their advisors.

The IPA welcomes the opportunity to provide a submission on the abovementioned discussion paper. Division 7A was always intended to protect and enhance tax system integrity rather than raise revenue. It however represents one of the more commonly encountered problem areas for practitioners dealing with small businesses. The high compliance and administrative costs associated with Division 7A warrant a review of its provisions. Business owners grapple with trying to understand the implications of Division 7A, and the lack of understanding results in frequent and unintended breaches despite the best efforts of practitioners trying to explain its impacts. Exacerbating the situation is the difficulty practitioners themselves have in understanding the provisions and their reach. Since its introduction, there have been number of amendments which have turned Division 7A into a highly complex body of law that many practitioners fail to fully comprehend. Bringing Unpaid Present Entitlements (UPE's) to corporate beneficiaries into the Division 7A net has also significantly increased compliance costs for small businesses using trust structures.

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Division 7A was introduced in 1998 as an integrity provision designed to ensure that private companies would no longer be able to make tax-free distributions of profits to shareholders and their associates in the form of payments, loans and forgiveness of debt. If Division 7A provisions are triggered these amounts are treated as unfranked dividends assessable to the shareholder unless the loan, payment or debt forgiveness comes within specified exclusions.

Our detailed comments on the discussion paper are set out below. The IPA has advocated in its pre-budget submissions for a review of Division 7A for some time and supports the review wholeheartedly.

In relation to issues raised in the discussion paper, we provide the following submission summary.

In broad terms, the main points can be summarised as follows:

- Division 7A provisions should be rewritten into 1997 ITAA in a clearer and simpler manner to minimize the compliance burden. The policy intent of ensuring that companies do not make tax free distributions to shareholders can still be maintained whilst the provisions are cleansed of technical/interpretative difficulties and uncertainties.

- As a matter of policy, address the uncertainty surrounding whether UPE's in favour of corporate beneficiaries should be considered loans for Division 7A purposes. This is particularly important since the release of *Taxation Ruling TR 2010/3* which sets out the Commissioner's view on when a private company with an unpaid entitlement from an associated trust is considered to have made a loan for Division 7A purposes. This ruling effectively brings UPEs to corporate beneficiaries into the Division 7A net and turns them into deemed dividends unless corrective action is taken. This is achieved by extending the definition of a loan to include financial accommodation. Trusts

have been a long standing and legitimate structure chosen by many families and businesses, principally for asset protection and flexibility.

UPEs have been in existence for many years and the overwhelming view (and policy objective) was that UPEs were not loans so long as the money stays within the trust for commercial purposes. The long standing view has been not to treat these UPEs as loans unless the trust lends the money to a shareholder or their associate in which case Subdivisions EA and EB of Division 7A would apply in the manner in which they were originally intended.

IPA's preferred policy position is that the retention of funds within a group should not be subject to Division 7A. Our view is that a loan from a private company to a trust within the private group, where the funds do not permanently leave the group for private use or consumption and are used as working capital or for investment in the business (excluding passive investment) should be an exclusion from Division 7A. The issue of whether UPE's should be treated as financial accommodation for the purposes of Division 7A needs to be clarified as a matter of policy. Once this is clarified, a redraft of the EA and EB subdivisions to address the inappropriate accessing of profits of private companies can occur to restate what these provisions attempt to address.

The Institute believes the Government should remove uncertainty by determining whether it will adopt the ATO's revised position and make the requisite legislative amendments to Division 7A as a matter of policy. If the Government's policy intent is to extend Division 7A to UPE's, it needs to consider more commercially acceptable options with respect to repayment of loans than are currently available under ATO guidance. The current ATO administrative practices contained in PS LA 2010/4 provide three investment options; with the majority of taxpayers choosing option 1 or 2. Both these options require repayment of the principal at the end of 7 or 10 year terms respectively.

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- In the event that UPE's in favour of corporate beneficiaries are to be considered loans for Division 7A purposes, there should be no obligation for loan repayments. Ideally we would prefer that such loans not incur interest obligations unless the UPE funds are not used entirely for income producing purposes by applying an otherwise deductibility rule. Alternatively loans with no repayments can be interest bearing with interest to be charged at a rate which is fixed from time to time by regulation (similar basis as Division 7A compliant loans). The entity borrowing the funds will be subject to the ordinary interest deductibility rules. This ensures that funds retained in the family group for working capital purposes are able to claim interest deduction for any interest incurred.

  If the funds are used wholly or partially for private purposes, then deductibility will be denied or apportioned accordingly. If such funds leave the group, then Division 7A would apply in accordance with its policy intent (currently Subdivision EA and EB would catch such amounts as deemed dividends).

- In the event that Division 7A is triggered and amounts are treated as deemed dividends, there appears no reason why such amounts should not be allowed to carry franking credits. The automatic franking of deemed dividends would ensure that such distributions would only be subject to top up tax. This would alleviate the need to apply for the Commissioner's discretion to treat such amounts as frankable distributions (Commissioner has a relieving discretion for honest or inadvertent omission). The existing penalty regime would still apply to act as a deterrent for false and misleading statements and/or not exercising reasonable care. The Commissioner's discretion is complex to administer and relies on interpretations which lead to disagreements between various parties when they apply for the discretion.

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Reform Options in discussion paper

With respect to the three reform options put forward in the discussion paper, the Statutory Interest Model appeals most. This model allows for funds to be retained internally within private groups without the need to re-pay principle at any point in time.

The IPA has a small business focus and the cost of complying with the provisions contained in Division 7A is of a major concern to our members servicing small business clients.

The IPA welcomes the opportunity to discuss further any of the matters we have put forward in our submission. Please address all further enquires to myself (tony.greco@publicaccountants.org.au or 0419 369 038).

Yours sincerely

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Institute of Public Accountants