Grant Thornton
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# Targeted amendments to the Division 7A integrity rules

Response to The Treasury's Consultation Paper
November 2018

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**Grant Thornton Australia Limited**
King George Central
Level 18
145 Ann Street
Brisbane QLD 4000

T +61 7 3222 0200

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

Via email

22 November 2018

Dear Sir/Madam

# Submission – Targeted amendments to the Division 7A integrity rules

Grant Thornton Australia Limited (Grant Thornton Australia) appreciates the opportunity to provide comments to Treasury on the Consultation Paper "Targeted amendments to the Division 7A integrity rules" dated 22 October 2018. The submission is made today as agreed with your Mr G Derlacz on Tuesday 20 November 2018.

Grant Thornton's response reflects our position as leading advisers to mid-size family groups, privately held companies and businesses as well as to smaller firms assisting that sector.

Our submission comprises our overarching comments below together with responses to the specific questions posed in the Consultation Paper.

The impact of Division 7A is increasing due to the widening gap between the top marginal tax rate and the corporate tax rate, especially for companies having turnover of less than $50m. However, irrespective of this gap, reform of the current rules is overdue as they are complex and impose an unreasonable compliance burden.

This is particularly the case for groups involving trusts having unpaid present entitlements (UPEs) owing to associated trusts and private companies. Applying the existing law, associated rulings and practice statements in these relatively common situations is simply too challenging for many taxpayers and their advisers.

Too often people get it wrong, or otherwise incur significant compliance costs. And the latter is then exacerbated by the current requirement to obtain the Commissioner's relief pursuant to section 109RB.

We promote and support effective reform to these rules. We believe that the desired system integrity can be achieved with a focus on **simplicity** as well as reducing the **compliance** burden. And if reforms may affect existing arrangements, transitional rules should respect decisions made pursuant to current and prior laws so that **fairness** and **economic efficiency** is ensured.

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To this end, a number of proposed reforms are welcome, including:

- The standardised 10 year loan term
- Treating all UPEs as loans
- The new self-correction mechanism

Given the proposed UPE reforms, Division 7A will apply to each interface between a private company and a shareholder or their associate, which will include associated trusts. As such, Subdivisions EA and EB and associated provisions will become redundant and should be repealed.

Matters requiring further attention include:

- Consideration that the conduct of the parties should be sufficient evidence of a loan, instead of a watered down version of current rules
- Whether the complexity of the current distributable surplus rules is outweighed by the unintended consequences of the proposed reform to remove them
- That the so-called “simplified” repayment calculation method is not simple in many situations and imposes an unreasonable burden on business, especially small business
- The latter situation is exacerbated by the interest computation method and that the proposed increased interest rate which, based on the past 10 years, will be approximately 300 basis points higher than the current benchmark (see Appendix 1, Table 1)
- The proposed 14 year amendment window is ill conceived, especially in light of the proposed amendment to subsection 109G(3) to only exclude forgiven debts as deemed dividends if the original loan was a deemed dividend that actually assessed to tax

The proposed transitional arrangements also need reconsideration as more respect should be paid to efforts made to comply with current and previous rules. To approach this otherwise would lead to the proposal being retrospective in nature, which is unwelcome and not justified. Moreover, for many taxpayers, the large increased burden will be either significantly disruptive or unaffordable. The combination of a number of factors gives rise to this:

- Bringing more funding arrangements into Division 7A that were previously outside the scope of the rules
- Introducing principal repayments or otherwise increasing principal repayment obligations
- Applying a higher benchmark interest rate
- For those meeting minimum repayments by drawing further assessable income, the significant burden imposed by the consequential tax on that income

We would welcome the opportunity to discuss our submission or provide further information at your request.

Should you have any queries in relations to these matters please contact me at paul.banister@au.gt.com or on 07 3222 0202.

Yours sincerely
GRANT THORNTON AUSTRALIA LIMITED

Paul M Banister
Partner - Tax

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# About Grant Thornton

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Grant Thornton Australia has more than 1,160 people working in offices in Adelaide, Brisbane, Cairns, Melbourne, Perth and Sydney. We combine service breadth, depth of expertise and industry insight with an approachable “client first” mindset and a broad commercial perspective.

More than 50,000 Grant Thornton people, across over 135 countries, are focused on making a difference to clients, colleagues and the communities in which we live and work. Through this membership, we access global resources and methodologies that enable us to deliver consistently high quality outcomes for our clients.

# Response to Consultation Questions

## Discussion Question 1:

### Proposed loan model

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

The proposed loan model involves the following key features:

- Time given to repay the loan, or apply it against assessable income, by the tax return lodgement day as with the current system
- Written or electronic evidence required that parties intended that a loan be in place
- A standardised 10 year loan term rather than the existing 7 year unsecured or 25 year secured current arrangements
- Interest applied using the Small Business Variable Overdraft rate as a benchmark rather than the Standard Owner-occupied Home Loan rate
- Minimum repayment required by 30 June each year is the total of the minimum principal amount and the interest
- Minimum principal payment is one-tenth of loan amount. There is no clarity about what happens if a year's payment exceeds the minimum
- Interest is calculated on the opening balance each year rather than the daily balance
- Shortfall of minimum repayment to be deemed to be a dividend, subject to the proposed self-correction mechanism (discussed below)

We consider that the approach should be refined, as explained in the following paragraphs.

#### Loan Evidence

There should be no requirement for written or electronic evidence to be in place by the lodgement day in the year of the loan. The current evidentiary requirements are onerous but clear. To merely soften those rather than remove them altogether will create uncertainty. Given the significant gap between the top marginal tax rate and the corporate tax rate, this may potentially motivate non-compliance.

We consider that conduct of the parties in treating the loan as such (eg whether that is in written or electronic evidence by lodgement day or by later charging interest and making repayments by the end of the first year) should be sufficient evidence of the loan and will remove uncertainty for taxpayers.

#### Minimum Repayment Method

In our experience, whatever the computation method, errors will occur in calculating minimum repayments and interest. As such, there is no need to alter the current repayment method except as proposed in relation to the principal component of a previously deemed dividend(s) under section 109E (as outlined in our response at Discussion Question 6b).

The current method is based on the *credit foncier* approach, which is most common in a commercial setting when calculating repayments and interest for term loans. As such, there are many tools freely available to calculate repayments and interest including calculators already provided on the Australian Taxation Office website. We see no justification to move to the uncommon "equal principal repayment" method.

If the "equal principal repayment" method was adopted, clarity would be needed about how the benefit of greater-than-minimum repayments is applied – eg a reduction in the opening balance of the next year and apply the remaining loan term to reduce the year's repayment, or alternatively a reduction to later

repayments to absorb the excess payment. Clarity would also be required as to whether the excess can be offset against interest and principal obligations or principal obligations only.

The fact that repaying more than the minimum leads to so many aspects that require further clarity highlights that the "equal principal repayment" method will not provide the desired reduction in complexity at all.

### Interest Computation Method

The minimum interest each year should be calculated based on the reducing balance – ie earlier repayment during part of a loan period should attain the benefit of a reduction in interest expense.

This approach is adopted in any commercial setting and should apply in tax law and practice to ensure economic efficiency.

We have no objection if the proposed interest computation method is available as a safe harbour.

### Interest Rate Benchmark

Looking firstly from a practical perspective, the compliance and related tax burden appears unreasonably high when the proposed higher interest rate benchmark is applied. In this regard, we have analysed the impact if the proposed benchmark had applied for the 10 years leading up to 30 June 2019 and compared this to two alternative situations:

- Using the Current Rate Benchmark; and
- Using an Alternative Rate Benchmark being the *Small Business; Variable; Residential-secured; Term* rate

Tables 2a and 2b at Appendix 1 compare the annual loan repayments required under (a) the Consultation Paper computation method and (b) the current computation method.

Both tables illustrate that annual repayments increase by an average of approximately 14% if the proposed benchmark is used. But if the alternative benchmark is used, the average repayment increase would only be approximately 5% each year.

It is highlighted that the starkest comparison arises between Tables 3a and 3b at Appendix 1. These tables are relevant to the many taxpayers that apply franked dividends (in this case assuming the company is not a Base Rate Entity such that franking credits are at a 30% rate) to meet their minimum loan repayment obligations and the corresponding tax arising on those dividends. Once the tax to afford the loan repayment is accounted for, as well as the corporate and deferred shareholder tax on company interest income, the overall tax payable increases by 32%.

There is no doubt that this will be a significant burden on business entities and their owners. Such a Government revenue increase will be a surprise to those who understand that the reforms are meant to be limited to an improvement in the structural integrity of this part of the tax system. Given the large extent of the increase, this must be an unintended consequence, one that will bite particularly hard where associated funds are locked up in existing business ventures and assets.

So what rationale ought to apply to determine the appropriate interest rate benchmark? As indicated, the Consultation Paper proposes that the annual benchmark interest rate will be the "*Small business; Variable; Other; Overdraft – Indicator*" lending rate. No explanation or justification is provided as to why the current benchmark (*Housing loans; Banks; Variable; Standard; Owner-occupier*) should not be retained.

However Appendix A of that Paper repeats the Board of Taxation's Recommendations without comment. Recommendation 6 suggests the higher rate.

The average additional interest rate arising from the Small Business Overdraft rate over the past 10 years is approximately 300 basis points, as noted at Appendix 1, Table 1 of this submission.

The Board of Taxation's Final Report from its "Post-Implementation Review of Division 7A of Part III of the Income Tax Assessment Act 1936", completed in 2014, is comprehensive. However, there is no analysis of the efficacy and relevance of various interest rate benchmarks. In this regard, paragraph 6.21 of that report merely comments that the proposed benchmark "is a benchmark reference rate that taxpayers already have some familiarity with" due to its current use as the rate applied to 10-year interest only sub-trust arrangements as outlined in PS LA 2010/4.

We do not agree with this premise. Even where sub-trust arrangements are utilised, the 10-year interest only option is rarely used in our experience, mainly due to the significantly higher interest rate. Instead, if the sub-trust approach is adopted, the 7-year option invariably applies. As such, most taxpayers only have familiarity with the current benchmark rate, which is based on the standard home loan variable rate.

When Division 7A was first introduced as part of *Taxation Laws Amendment Bill (No.7) 1997*, there appears to have been little consideration of the appropriate interest rate benchmark – rather it appears that the FBT benchmark rate was simply adopted (which refers to the current benchmark) without considered analysis.

So what further factors should be considered? We acknowledge that some may contend that an unsecured loan benchmark rate may be appropriate as the proposed new system does not require loan security and, further, that a third party financier would be likely to charge an unsecured loan interest rate on an unsecured loan. However, we do not consider that these are the only relevant considerations.

The main driver of the interest rate margin applying beyond the risk-free rate is the risk inherent in the loan. In this regard, presumptions are made where a loan is secured (ie that capital should be available in the event of default). As an example for owner-occupied home loans, the presumption is that the risk is at the lower end of the scale as owner-occupiers would be expected to protect their own assets, especially their home.

Applying these principles to a typical Division 7A setting, an associated borrower would normally be very determined to meet their loan obligations, often due to meeting family expectations but especially as the consequences of not doing so involves paying tax on unfranked dividends at marginal tax rates. As such, the credit risk should be at the lower end of the scale.

And in some situations, this risk will be further reduced as the lending entity will require real estate security (eg where the interests of other family members need to be protected).

Accordingly, we consider that there is no compelling reason to change from the current interest rate benchmark. This is supported by the adverse tax impact of the proposed change that will divert funds that would otherwise be available to support business needs to the payment of tax. Where a change is deemed warranted, the proposed benchmark rate is inappropriate to the typical risk profile of these related party loans.

Where the Government intends to amend the applicable interest rate, which we do not support, we consider that either the "*Lending rates; Personal loans; Revolving credit; Home equity loans*" or the "*Lending rates; Small business; Variable; Residential-secured; Term*" should be used for the purposes of calculating the interest payable for the remaining term of the loan.

Finally, even if the proposed interest rate benchmark were to be adopted, it should not apply to any amount that is subject to the transitional rules. The current benchmark rate should apply in those situations.

### Standard Loan Term

While we generally welcome and support the standardised 10 year loan term, some lenders will still require security, even when lending to associated parties.

In such circumstances, we consider it would represent good policy for a longer loan term (eg 25 years) to be available. This is particularly the case to reduce the repayments required if the proposed higher benchmark rate was adopted, which we do not support, especially for a secured loan.

## Transitional rules

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

Treasury has asked for consideration of any unintended outcomes of the transitional rules in relation to the following loans:

i. 7 year loans

ii. 25 year loans

iii. Pre-1997 loans

In this regard, Grant Thornton provides commentary in respect of the transitional measures proposed for each category of loan.

In accordance with the principles of an appropriate and fair tax system, retrospective amendments, as well as the application of amended legislation to previous transactions, should be restricted to situations where the legislation did not operate as previously intended. It is our position that the transitional measures should be implemented in this context, and Treasury should give consideration to 'grandfathering' existing arrangements in full unless Taxpayers make an election to operate under the new rules.

### Worked Example – impact of transitional rules

To illustrate the impact of how the rules may affect taxpayers applying the transitional rules, we have prepared a Worked Example where the hypothetical taxpayer has the following attributes:

- Pre 4 Dec 97 Loan: $ 500,000
- Post 4 Dec 97 Loan (unsecured): $1,000,000
- Post 4 Dec 97 Loan (secured): $1,000,000
- Pre 16 Dec 2009 UPE: $1,200,000
- Post 16 Dec 2009 UPE: $ 700,000

The year to year results (starting from 2017 and utilising the assumed future interest rates used by Treasury in the Consultation Paper) are depicted in the table at Appendix 1, Table 4. The outcomes for Minimum Repayments and Overall Tax Payable are also presented as graphs following Table 4.

Using the current tax year (ie 2019) as a base year, the obligations to make minimum repayments increase significantly over the next 5 years – in some years by more than double the current level. Concurrently, the tax obligations increase dramatically, assuming that repayments are funded by franked dividends.

This is simply too harsh and will not be affordable for many taxpayers, as the funds involved will have been fully invested and/or deployed as working capital in business entities. As such, transitional rules should be cognisant of this. Some recommendations are provided below.

### 7 year loans

#### Recommendation – retain all 7 year loan agreements entered into on or before 30 June 2019 on the basis of the current legislation

In considering Treasury's proposed transitional measures in relation to existing 7 year loans Grant Thornton agrees with Treasury's proposal that the retention of the existing loan term is appropriate. However, the calculation of the minimum repayments each year should continue on the basis of the current legislation. In addition the current 'ATO Benchmark Rates' (being the "*Lending Rates; Housing loans; Banks; Variable; Standard; Owner-occupier*") should be retained until the end of the existing loan term.

The current law in relation to a 7 year loan term operates as intended such that a change to these arrangements is unnecessary.

Taxpayers complying with the terms of existing loan agreements should not be subject to an interest rate that is approximately on average 300 basis points higher than the current 'ATO Benchmark Rate' given that they made economic decisions to enter into the relevant loan agreements on the understanding that a substantially lower interest rate would apply to the repayment of those loans.

### 25 year loans

Grant Thornton considers that the transitional measures for 25 year secured loans entered into on or before 30 June 2019 are inadequate, inappropriate and unfair. These loans are currently secured in accordance with the requirements of subsection 109N(3)(a) requiring 100 per cent of the loan to be secured by a mortgage over real property with a market value, at the time of the loan, of at least 110 per cent that is registered in accordance with a law of a State or Territory.

Taxpayers with 25 year loans demonstrate a strong willingness to comply with the law and provide practical examples of the intent underlying current laws. They have committed costs engaging advisors and meeting regulatory requirements to secure the loans in accordance with the existing rules and should be entitled to maintain these arrangements, both in terms of retaining the current interest rate benchmark and loan term.

Further, it is considered that there may be unintended consequences for some taxpayers due to the combined effect of the reduction of the loan term, increased repayments and changes to the interest rate used. For example, where these loans have been validly entered into between a private company and a self-managed superannuation fund in accordance with the limited recourse borrowing arrangements, the higher loan repayment requirements and interest cost will render some of those arrangements as being unworkable. Further, the interest rate applied at the benchmark proposed by Treasury may not be an appropriate market rate as required by the SIS Act and Regulations leading to further unintended consequences.

#### Recommendation 1 – existing arrangements should be allowed to continue until the conclusion of the arrangement

In considering the proposed transitional measures Grant Thornton considers that 25 year secured loans entered into prior to 30 June 2019 by Taxpayers should be 'grandfathered' such that they maintain the existing terms of those agreements until expiry. Alternatively, they may voluntarily elect to adopt the new "single 10 year loan model". It is our position that the current legislation in relation to 25 years operates as intended and there is no compelling reason why these existing arrangements should be disturbed.

Taxpayers that have taken the appropriate steps to secure a mortgage over real property in accordance with the existing rules have done so on the basis of the current operation of the legislation. The costs associated with obtaining legal advice and registering mortgages in accordance with the relevant State

or Territory laws are sunk costs that cannot be recouped. Our mid-sized business clients committed to these costs and the associated burden of securing real property assets on the basis of the extended term and this example of responsible tax compliance must be respected.

### Recommendation 2 – the transitional interest rate applied should continue to be based on the "*Lending Rates; Housing loans; Banks; Variable; Standard; Owner-occupier*" rather than the proposed "*Lending Rates; Small business; Variable; Other; Overdraft – Indicator*"

In line with our position that the term of existing loans should not be disturbed we consider that an interest rate applied to a secured loan based on the *Lending Rates; Small business; Variable; Other; Overdraft – Indicator* is inappropriate as it will be based on an overdraft facility when 100 per cent of the loan is secured by real property of the taxpayer. The proposal to adopt a punitive interest rate is both unnecessary and unwarranted.

This proposal will place unnecessary additional cash flow and taxation burdens on taxpayers that have complied with laws that have operated as intended in relation to the existing loan. Whilst a simplification of the provisions of Division 7A is welcomed by Grant Thornton we do not believe that this should be at the expense of fairness and economic efficiency of particular taxpayers.

We consider that the current "ATO Benchmark Rate", based on the *Lending Rates; Housing loans; Banks; Variable; Standard; Owner-occupier*, applied to 25 year loans is appropriate and should be retained for all loans entered into on or before 30 June 2019.

Where Treasury intends to amend the applicable interest rate, which we do not support, we consider that either the "*Lending rates; Personal loans; Revolving credit; Home equity loans*" or the "*Lending rates; Small business; Variable; Residential-secured; Term*" should be used for the purposes of calculating the interest payable for the remaining term of the loan.

The current "ATO Benchmark Rate" is commercially appropriate for a loan secured by real property such that no change is warranted or necessary.

### Recommendation 3 – No requirement for a new complying loan evidence

Grant Thornton considers that it is unnecessary for a new loan agreement or other evidence to be put in place for an existing 25 year loan that is already subject to a complying agreement under the existing rules. This is an unnecessary administrative requirement and appears at odds with the "single 10 year loan model" that will be based on the fact that a formal written loan agreement is not required.

If the 25 year loan is required to be altered for tax purposes, taxpayers should only be required to adjust their loan repayments to ensure that the existing loan is repaid 10 years after the transitional period expires (if this occurs), where Treasury ultimately considers that 'grandfathering' of these loans is inappropriate.

Where a taxpayer fails to meet the required minimum repayment a deemed dividend should apply to the extent of the repayment required for that year only, to the extent that it cannot be rectified pursuant to the proposed self-correction mechanism.

## Pre-4 December 1997 loans

### Recommendation 1 – pre-Dec 1997 loans should remain outside Division 7A

As highlighted above, Grant Thornton has a fundamental issue with retrospective application of legislation to circumstances where the legislation operated as intended. When Division 7A was introduced from 4 December 1997 the Government at the time made a decision that loans prior to the implementation date would not be subject to the provisions unless there was a fundamental change to the terms of the loan and/or the amount was forgiven after 4 December 1997.

There appears to be no compelling reason provided for a change to occur in relation to these loans. The assertion by Treasury that an amendment to include pre-Dec 1997 loans "…will provide certainty for taxpayers and protect them from exposure to Division 7A if the Commissioner were to consider that there was no longer a commercial loan in existence and deemed it to be forgiven" does not appear to be a valid reason for taxpayers to be subjected to an interest bearing loan or a deemed dividend in relation to a loan that was specifically excluded from being within the ambit of Division 7A when it was originally enacted.

Further, some of the pre-Dec 1997 loans may also have been precluded from the application of Division 7A pursuant to the rules relating to distributable surplus. This suggests that loans made post 4 December 1997 that were disregarded due to a private company's lack of distributable surplus could be disregarded and forgiven. However, loans that were originally outside the scope of Division 7A will now be subject to the rules with no regard given to how the legislation has applied for the past 20 years to these loans.

It is our position that removing the 'grandfathering' of these loans under the guise of simplicity is unwarranted, particularly when the simplest option is to maintain the current status quo and retain the position via 'grandfathering'.

### Recommendation 2 – taxpayers be provided with a 10 year interest free period to repay pre-Dec 1997 loans

In the event that Treasury does not accept the recommendation to maintain the 'grandfathering' of pre-Dec 1997 loans, Grant Thornton considers that the transitional 10 year repayment period proposed to apply from 30 June 2021 (i.e. when the loan is deemed to be financial accommodation) should be interest free.

Under this proposal, taxpayers would be granted a 2 year period to undertake their own investigations to confirm whether the loans are statute barred in the relevant State or Territory jurisdiction, such that the loan has effectively already been deemed to be forgiven. In this regard it will be the responsibility of the taxpayer, pursuant to Australia's self-assessment tax system, to determine whether a debt forgiveness has already occurred that is subject to any of the relevant tax provisions (including Division 7A), and whether the forgiveness occurred within a relevant amendment period.

Comments in relation to so-called statute barred loans in the Consultation Paper appear to be based on the notion that such rules ought to have caused most pre-Dec 97 loans to cease to exist (ie deemed forgiven). In our experience, this does not accurately represent the law. Further, if good commercial practices were adopted each year, it is likely that most pre-Dec 97 loans are still on foot.

Given that the Commissioner's statement in PSLA 2006/2 (GA) states that "… as a matter of practical compliance and sensible administration, the Commissioner has decided to take no active compliance action on private company and trustee loans made prior to the enactment of Division 7A of the ITAA 1936 deemed to be forgiven in consequence of the operation of subsection 109F(3) of the ITAA 1936, merely because the period within which the creditor is entitled to sue for recovery of the debt ends by the operation of the statute of limitations" we can see no reason why this issue is now of such importance to justify treating these loans as the provision of financial accommodation some 20 or more years after they were provided to the shareholder or associate.

Further, we cannot reconcile with a Federal tax system that provides any advantage to taxpayers on the basis of differing State or Territory laws where the application of Federal law can be circumvented based on where you are located. This is of particular relevance in relation to these loans as the means by which a loan is treated as statute barred is different across the States and Territories.

In order to maintain fairness and equality in the system we consider that taxpayers should be provided with the option to incur their own costs to determine whether a loan is legally statute barred (and

deemed forgiven) or be provided with the simple option of adopting the 'single 10 year loan model' (or suitable alternative) from 30 June 2021 on an interest free basis.

Where a taxpayer does not adopt either of the proposed options we accept Treasury's position that the amount will be a deemed dividend for the year ended 30 June 2021.

### Recommendation 3 – the commencement date for the proposed rules applying to pre-Dec 1997 loans to be deferred

Following on from Recommendation 2, we consider that, if the 'grandfathering' of pre-Dec 1997 loans is not to be maintained, the proposed transitional 10 year repayment period should not apply from 30 June 2021. Instead a later date should apply, say 30 June 2029.

This is due to the significant impact of needing to make principal repayments on various loans or deemed loan arrangements that are currently not subject to Division 7A. The Worked Example above highlights that many taxpayers will face significant challenges affording the transition. Taking a realistic approach to pre-Dec 97 loans will help to manage this.

### Recommendation 4 – Existing Post-Dec 1997 loans not previously subject to Division 7A

We note that the Consultation Paper provides no guidance on the treatment of post December 1997 loans that were not subject to Division 7A (eg where the private company did not have sufficient distributable surplus for the loan to be deemed as a dividend (in full or in part)). In this regard we recommend the same treatment as the transitional measures proposed above for pre-Dec 1997 loans.

Our preferred option is that the loans be permanently 'grandfathered' and not subject to Division 7A unless the loan is subsequently forgiven.

However, where Treasury considers that these loans should be refreshed from a Division 7A perspective then taxpayers should have a two year period to assess their options in relation to the loan, after which the loan can be placed on a 10 year interest free loan term in compliance with Division 7A or treated as a deemed dividend for the year ended 30 June 2021 (or later date based on Recommendation 3 above).

## Application to non-resident private companies

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

Section 109BC Income Tax Assessment Act 1936 was originally enacted to remove uncertainty as to whether Division 7A could apply to a foreign resident company with no Australian source income. The introduction of this measure is purported to have removed the uncertainty in this regard.

### Application of Source Rules in Relation to Deemed Dividends

Based on the simplified outline of the Division, provided pursuant to section 109B, it is understood that where Division 7A applies to deem a dividend the relevant dividend is made assessable pursuant to section 44. As indicated section 109BC ensures that Division 7A is not avoided where a non-resident company makes payments, loans or forgives a debt to shareholders or associates of the company simply due to the residency of that company.

The issue that is relevant is the extent to which a deemed dividend applies in relation to non-resident company where the recipient shareholder or associate is a non-resident. Subsection 44(1)(b) provides:

> *The assessable income of a shareholder in a company (whether the company is a resident or a non-resident) includes:*

*If the shareholder is a non-resident:*

*(i) dividends (other than non-share dividends) paid to the shareholder by the company to the extent to which they are paid out of profits derived by it from sources in Australia; and*

*(ii) non-share dividends paid to the shareholder of the company to the extent to which they are derived from sources in Australia*

Applying the decision in *Nathan v FCT* (1918) 25 CLR 183 the deemed dividend for a non-resident shareholder or associate pursuant to Division 7A should be limited to dividends deemed to be paid out of profits with the requisite Australian source.

Confirmation on the practical application of Division 7A to non-resident shareholders and associates would be beneficial and welcomed. This is of particular importance for providing clarity for non-residents in relation to their potential Australian income tax obligations where a dividend is deemed pursuant to Division 7A in respect of Australian sourced profits.

It should be noted that paragraph 1.87 of the explanatory memorandum to *Tax Laws Amendment (2010 Measures No.2) Bill 2010* that introduced section 109BC provided that "there has been some conjecture as to whether Division 7A applies in circumstances where a shareholder of a private company (or their associate) is an **Australian resident** (emphasis added) and the private company involved in the arrangement is a foreign resident".

The introduction of section 109BC was introduced to remove this "conjecture". On this basis it is questionable whether the scope of this amendment was also intended to extend to non-resident shareholders and associates where the deemed dividend is notionally deemed to be paid out of Australian sourced profits.

### Lodgement Day of a Non-Resident Company

Consistent with our overall submission supporting Treasury's objective of simplifying compliance with the requirements of Division 7A Grant Thornton considers that section 109BC requires clarification in relation to the lodgement day of a non-resident company, particularly as it relates to a company that is a resident of an unlisted country.

Subsection 109BC(1)(b) outlines the following in relation to the lodgement day of a non-resident company:

*(b) references in this Division to the lodgement day for the year of income were references to the due date for lodgement of the company's return of income for the tax accounting period under that tax law*

***Tax accounting period*** is defined in section 317 as being "in relation to an entity, in relation to a foreign tax imposed by a tax law of a **listed country**, means the accounting period used by the entity for the purposes of determining the tax base under that law".

Clarification is welcomed on how the lodgement day is applied in relation to a non-resident company of an unlisted country.

Further, where a country does not have an applicable tax year, the lodgement day could be based on a tax year end of 30 June for the non-resident private company.

### Interaction between Division 7A and Section 47A

With the introduction of section 109BC with effect from 1 July 2009 there is substantial overlap with the provisions of Division 7A and section 47A that often provides taxation outcomes that are materially different depending on which provision has application.

It is worth highlighting that when the CFC provisions were introduced there were over 60 countries that were categorised as 'listed countries'. As such the application of section 47A was far narrower than the current application on the basis that there are now only 7 listed countries for the purposes of the CFC rules. When this is combined with increased globalisation section 47A has a far wider application than policy makers likely anticipated when the legislation was originally enacted.

From a policy perspective it our understanding that Division 7A is intended to be the primary provision in the legislation designed to tax the distribution of disguised distributions of profits from private companies. Where a private company that is a non-resident in an unlisted country makes a loan to an Australian resident (and potentially a non-resident in certain circumstances) the private company has the option to place the loan on complying loan terms and repay the loan in accordance with Division 7A.

However, where the loan is provided by a non-resident company that is a CFC of an unlisted country the loan is also required to be considered pursuant to section 47A without the ability to place the loan on complying terms after the loan has been made despite the fact that it is subsequently eligible to be placed on a complying loan term in accordance with Division 7A.

The result in this regard is that a loan from the private company may satisfy the requirements of Division 7A but still be treated as a dividend pursuant to section 47A as a distribution benefit by the CFC. In these circumstances it would appear that the taxpayer would then be on a complying agreement that would not be required to be repaid and would also not trigger a deemed dividend under Division 7A as a result of the application of section 109L.

Difficulties also arise in relation to a forgiveness of the loan as this is a separate distribution benefit under section 47A that will be taxed where the CFC has profits at the forgiveness time. Further, in these circumstances the forgiveness of the loan is unlikely to be disregarded under section 109G(3) as a deemed dividend did not arise under either section 109D or s.109E such that the forgiveness may be taxed as a deemed dividend pursuant to both section 47A and section 109F (although the latter provisions sensibly provide the Commissioner with the power to not treat the forgiveness as giving rise to a dividend. This is provided pursuant to section 109G(4) where appropriate; corresponding relief that is not provided by section 47A).

Clarification on the interaction between these two provisions is necessary to ensure that these anomalous results do not continue to occur.

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

In this regard it is our position that Treasury's focus should be on ensuring that the legislation in relation to non-resident private companies operates as intended. Additional public guidance material should be limited to situations where the underlying legislation contains subjective context that requires clarification of the policy intent and/or the Commissioner's interpretation and application of the legislation.

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

Grant Thornton considers that legislative amendment is required to ensure that Division 7A (and related legislation) operates in accordance with its designed policy intent. We propose that Treasury give consideration to the following amendments as they apply to non-resident companies:

#### Lodgement day

In relation to Discussion Question 6b, we have provided an alternative definition of 'lodgement day' to be considered by Treasury that is the earlier of the actual lodgement date of the private company's

return and the day that is 1 year after the end of the private company's tax year in which the loan, payment or debt forgiveness occurred.

The simplified definition could be applied indiscriminately to resident and non-resident companies. Where a non-resident private company does not have a tax year the default position could be based on a 30 June year end unless the Taxpayer applies to the Commissioner for a substituted period.

### Amendment of Section 47A

In considering the policy intent that Division 7A is the primary provision for taxing disguised distributions of private company profits to shareholders and their associates we recommend that section 47A be amended to include an exemption where the distribution benefit is also covered pursuant to Division 7A.

It is important that this exemption is not provided on the basis that a dividend is deemed pursuant to Division 7A, but rather that the distribution benefit pursuant to section 47A that is covered by the provisions of Division 7A more broadly is not treated as a dividend for the purposes of section 47A.

An amendment in this regard would create the necessary clarity for taxpayers and ensure that the tax system operates as intended.

## Distributable Surplus

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

The removal of the concept of distributable surplus is unnecessary and highly problematic.

Commentary in the Consultation Paper that the amount that is taxable from the amount "distributed" is arbitrarily limited is erroneous. The limitation is deliberate, specific and appropriate.

The original intent of Division 7A was to tax profits extracted from private companies without tax being paid at the recipient's marginal tax rate. The removal of the concept of distributable surplus goes beyond this intent and may also result in dividends that, if paid, would contravene the provisions of the *Corporations Act 2001*. Rather than align with section 254T of the *Corporations Act 2001*, removal of the distributable surplus concept as proposed would contradict that provision.

While the amendments to the *Corporations Act 2001* referred to in the discussion paper allow dividends to be paid out of capital, there are no provisions allowing dividends to be paid when capital is insufficient and there are no realised or unrealised profits. Deeming dividends beyond share capital where there are no realised or unrealised gains or profits is contrary to the *Corporations Act* and the intent of the amendments. That is, the proposal may cause a deemed dividend to arise when an actual dividend is prohibited from being paid.

Further, dividends paid out of capital are dealt with as adjustments to cost base and/or as a capital gain when cost base is completely eroded. Treatment of a deemed dividend from capital as an unfranked dividend is contrary to the intention of the amendments to the *Corporations Act* and inconsistent with the taxation treatment of such dividends in the ordinary course. Any deemed dividend from capital should therefore at least be treated as a return of capital and taxed under Capital Gains Tax provisions where the recipient of the deemed dividend is the owner of the shares. However, it is common for the recipient of a deemed dividend not to be the direct shareholder of the company making the loan or payment. Where the recipient is not the owner of the shares, the capital gains tax provisions are generally unlikely to be operative as there would be no disposal event.

Many private companies have only minor share capital amounts (in many cases $2). The concept of deeming dividends out of capital in these cases is immaterial and irrelevant. Amounts lent by private

companies beyond what is currently considered the distributable surplus and share capital are generally not amounts which a company can return to shareholders as dividends.

Taxing amounts where there is no distributable surplus as unfranked dividends is incompatible with the intent of the Division 7A rules, the provisions of section 254T of the *Corporations Act* and in many cases the capacity for any loan amounts to be repaid.

Companies lacking a distributable surplus are often companies in a loss position. To expect shareholders to pay tax on loans without the capacity to draw on funds from the company will only place more pressure on businesses and owners under financial stress.

In order to repay many Division 7A loans, many shareholders require a dividend to be paid via credit to their loan account. This is clearly problematic when the company does not have a distributable surplus, particularly with the private company sector is predominantly thinly capitalised. The implications for tax debt driven liquidation of businesses and owners warrants significant consideration.

On a practical level, many taxpayer groups utilise a single group finance company that is the single borrowing party from a third party financier, with the former then on-lending throughout a group of entities as required. Often the company is only a $2 company and the assets of associated taxpayers are used to secure the external loan. Removal of the distributable surplus concept will now give rise to needless and unwarranted Division 7A implications for this relatively common situation.

The real compliance issue, however, in respect of the distributable surplus concept is based on the determination or assessment of the distributable surplus. This is particularly so where the assets of a company include unrealised gains which may be subjective in value or of a nature that cannot be recognised in the financial statements (e.g. internally generated goodwill). There may be an education and enforcement consideration but that does not warrant legislative change to remove the otherwise sound concept of distributable surplus.

The Commissioner has discretion to disregard accounting records for the purpose of calculating a company's distributable surplus (subsection 109Y(2)). Refer also to TD 2009/5 in regards to the circumstances of deliberate, significant understatement of the value of a company's assets in totality. It may be relevant to reconsider the operation of subsection 109Y(2), or the construction thereof, to provide clarity and more certainty as to that value of a company's assets in circumstances where relevant loan(s) have been made and the financial statements indicate that there is no distributable surplus but assets are undervalued, particularly where the assets in question may be assets that are not required to be valued at market value or indeed cannot be recognised in the financial statements.

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

Removal of the concept of distributable surplus will lead to problems with some other provisions rather than Division 7A itself. However, with respect to Division 7A, there may be more undue hardship applications pursuant to section 109Q.

For provisions outside of Division 7A, arguably Division 7A would be performing the role that section 45B performs. Given that the former is self-executory and the latter is subject to Commissioner's discretion, this may be problematic. Consideration may be given to exclude the application of section 45B to private companies.

As noted above, there are also interactions with the CGT provisions (eg CGT Event G1) that may lead to unintended consequences, especially as the anti-overlap rule will not operate to the extent that the deemed dividend simply absorbs the cost base rather than giving rise to assessable income.

# 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?**

The Commissioner expressed his opinion in relation to the application of Division 7A to UPEs arising from a trust on or after 16 December 2009 in TR 2010/3 and subsequently provided guidance to taxpayers in PSLA 2010/4 on the options available to manage a taxpayer's exposure to Division 7A.

Taxpayers which have sought to act in accordance with the Commissioner's views, as expressed in PSLA 2010/4, and have entered into (and complied with) arrangements in accordance with the Commissioner's views.

In these situations, taxpayers should benefit from transitional rules that 'grandfather' arrangements applying for UPEs that arose on or before 30 June 2018.

We do not consider that UPEs that arise in relation to 30 June 2019 should be subject to the transitional measures as long as taxpayers' decisions can be made on the basis of enacted legislation by the time that trustees are required to pass trust resolutions in relation to the income of the trust for the financial year ended 30 June 2019. However, where a trustee is required to pass a trust resolution between 1 July 2018 and the date of the enacted legislation the options available pursuant to PSLA 2010/4 should be afforded to taxpayers under the transitional rules.

The proposed transitional approach of allowing taxpayers to continue to utilise the current options for dealing with UPEs from a Division 7A perspective is based on the premise that taxpayers should be entitled to make decisions as to their financial and taxation affairs on the basis of the regulatory environment at the time. Subsequently "shifting the goal posts" on taxpayers who have genuinely attempted to manage their tax affairs in accordance with the rules as they applied at the time does not inspire confidence in the integrity of the tax system or allow for taxpayers to make economically efficient decisions in relation to their affairs.

In summary we recommend the following transitional rules:

- Existing arrangements that comply with TR 2010/3 and PSLA 2010/4 should be quarantined from the changes and allowed to mature as documented. This would include any arrangements entered into in relation to UPEs arising between 1 July 2017 to 30 June 2018
- UPEs arising between 1 July 2018 and enacted legislation should also be entitled to the transitional measures
- At the conclusion of these arrangements taxpayers will have the option to have the UPE treated in accordance with the amended legislation

Currently Division 7A requires loans and payments to be documented on or before the due date (or lodgement if earlier) of the company's tax return.

We recommend that for simplicity, and aligned with our recommendation surrounding the requirement of loan evidence, that this date to be changed to the last day of the company's following financial year. For example, for a company with a 30 June year end, in relation to a UPE that arises on 30 June 2020, the evidence or parties' conduct would need to illustrate that the UPE was placed on complying loan terms by 30 June 2021.

Having a consistent, pre-determined date, would simplify the compliance obligations and would provide the taxpayer with sufficient time once the value of the UPE has been quantified to either take steps to repay the UPE (in part or full) or put the balance outstanding on complying loan terms.

In many cases, taxpayers may not be able to accurately quantify the UPE that has been created and be able to take steps to manage the potential tax outcomes. This provides the taxpayer with a longer period of time to make an informed decision as to how to best manage their tax affairs. We note that the first minimum repayment pursuant to a complying loan would still be due at the same time.

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

We strongly object to any proposal that seeks to include pre December 2009 UPEs within Division 7A as this will have a significant commercial impact on taxpayers that have reinvested the relevant UPE in capital assets within the trust.

Where these UPEs are brought within Division 7A the trustees of the applicable trusts would, in many cases, be forced to unnecessarily liquidate or transfer the assets to the private company with significant income tax or duty (depending on the laws of the relevant State of Territory) implications.

There is no justification for including these entitlements within Division 7A without a substantial transitional period to afford taxpayers the opportunity to reorganise their affairs in a commercially acceptable manner.

Grant Thornton could only support a proposal for including pre December 2009 UPEs where the underlying policy intent is to simplify Division 7A in relation to the Subdivisions EA and EB. Where the policy intent supported the repeal of Subdivision EA and Subdivision EB, we would be open to considering a proposal by Treasury in this regard.

In the event that a suitable proposal could be developed to remove the complexity associated with the interaction between Division 7A and Trusts we would accept a recommendation to bring pre December 2009 UPEs within Division 7A provided that the UPEs were not treated as financial accommodation for a period of at least 10 years and at the expiry of the 10 year period taxpayers could place the UPE on a 10 year interest free complying loan arrangement or recognise a deemed dividend pursuant to Division 7A for the amount of the UPE.

Once it is legislated that all UPEs constitute financial accommodation, and are deemed to be a loan, for the purposes of section 109D we consider that Subdivision EA and EB can be repealed as they will have no practical application. This position is premised on the fact that all shareholder or associate interactions with a private company will be strictly governed by Division 7A. Where any taxpayer seeks to work around this by interposing trust beneficiaries, Subdivision E and other existing anti-avoidance provisions outside Division 7A would apply.

# Discussion Question 3:

## Self-Correction Mechanism

**a Are the eligibility criteria clear and concise?**

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

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

We welcome the introduction of a statutory self-correction mechanism. The current arrangements pursuant to section 109RB involve much uncertainty and are usually very costly to comply with.

Our comments address these three issues together. The proposals state that, to qualify for self-correction, the taxpayer will need to meet eligibility criteria in relation to the benefit that gave rise to the breach. The eligibility criteria will require that:

- On the basis of objective factors, the breach of Division 7A was an inadvertent breach
- Appropriate steps have been taken as soon as practicable (and no later than six months after identifying the error unless the Commissioner allows more time) to ensure that affected parties are placed in the position they would have been in had they complied with their obligations
- The taxpayer has taken, or is taking, reasonable steps to identify and address any other breaches of Division 7A

Grant Thornton's submissions:

- We agree that the proposed self-correction mechanism should replace the Commissioner's current discretion per section 109RB. In our experience advising small and medium enterprises, there is generally a genuine desire to comply with the tax laws and any inadvertence that could be self-corrected would save both the taxpayer and the Commissioner time and costs in applying for and administering the discretion
- We support the further proposal that reasonable circumstances should be set out by the ATO in its public advice and guidance products. Included in this ATO guidance should be examples of the "objective factors", "appropriate steps" and "reasonable steps". This guideline would provide more certainty to taxpayers and their advisers when interpreting these broad terms
- The ATO's guidelines should make clear that a taxpayer's self-correction which is undertaken unprompted by and/or outside the course of an ATO review or audit should be prima facie evidence of the entitlement to self-correction. That is, the ATO should not require the taxpayer to provide further evidence of inadvertence if the ATO were to identify that self-correction has occurred for a breach on review/audit
- If a breach has not yet been self-corrected when identified under an ATO review or audit, the taxpayer should be given the opportunity to self-correct without penalty if the breach can be shown to be inadvertent by reference to the ATO's public guidance on the issue. This opportunity to self-correct should also extend to include breaches caused by hardship for example, accident, illness, death, natural disaster etc
- The taxpayer's ability to self-correct by amending tax returns should be matched in the legislation with the proposed period of review for Division 7A transactions. It would be unfair if a taxpayer would be prevented from self-correcting due to the expiry of the general tax return amendment time limits but still be open to adverse ATO action under the proposed Division 7A review time limits

The proposed legislation should clarify whether the self-correcting mechanism only applies to Division 7A transactions occurring on or after 1 July 2019 or if self-corrective action could be undertaken from 1 July 2019 for pre 1 July 2019 Division 7A breaches as well.

## Period of Review

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

Grant Thornton does not consider that a 14 year amendment period is an appropriate or acceptable amendment. The notion of keeping assessments open for so long cannot be justified in any situation, absent the existing safeguards for fraud or evasion.

A 14 year amendment period will create an unnecessary administrative burden on taxpayers and is completely unwarranted.

The 14 year amendment period for one particular type of income, eg a deemed dividend pursuant to Division 7A, over another, eg a trust distribution, creates inequity between taxpayers. Based on the 14 year amendment period proposal a taxpayer could receive a loan, payment or benefit from a debt forgiveness 14 years earlier and be subject to tax under Treasury's proposal compared with a taxpayer that fails to include a trust distribution from a family trust in the same financial year but the Commissioner will be out of time to amend the taxpayer's return. This inequity is not acceptable for an appropriate and effective taxation system.

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

In considering an alternative to the proposed 14 year amendment period we consider that the existing amendment periods of 2 and 4 years are appropriate for the purposes of administering Division 7A.

This is reinforced when combined with the proposal to amend section 109G(3) to ensure that the debt forgiveness exemption only applies in situations where the taxpayer was previously assessed for income tax on a deemed dividend in relation to the forgiven loan. Where the loan was subject to Division 7A but was excluded from assessment on the basis that the amount was outside the amendment period the loan will still be subject to Division 7A at the forgiveness time.

This should be an appropriate safeguard to address concerns about taxpayers benefiting from the current section 109G(3).

Further, where a taxpayer enters into a complying loan agreement and intentionally fails to meet minimum repayments and does not include a deemed dividend in their income, the Commissioner has the power to treat these omissions as being fraud or evasion which is then not subject to the ordinary amendment periods.

# Discussion Question 4:

## Safe Harbours – Provision of assets for use

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

It is often difficult to determine the value of usage rights for many assets, especially on a short term basis. As such, we support the introduction of a safe harbour alternative.

We support the formula proposed as a mechanism to provide a return to the company for the investment in the assets being used. We question whether using the Division 7A benchmark interest rate plus 5% will equate to an arm's length amount given the many asset classes owned and used. Setting the benchmark rate at too high a level will discourage use of the safe harbour leading to continued uncertainty and higher compliance costs in many situation.

Using the Division 7A benchmark rate should be sufficient as taxpayers are able to borrow from the company or from a third party lender at this rate and hold the assets personally.

### 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?

There are various classes of assets that may be owned through a company and used by its shareholder or associates (eg motor vehicles, real estate, boats, aircraft, collectibles, plant and equipment). Some will appreciate in value while others depreciate. The rate of return required or current arm's length charge possible in the market place will vary between asset classes (eg residential property yields are 3% to 4% which is well under the interest rate proposed in the formula).

If a safe harbour for the provision of assets is to be provided it should be determined and offered separately for each asset and asset class to reflect that each asset could be utilised differently.

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

The 5% uplift to the proposed increase in the Division 7A benchmark rate (which exceeds 8%) is too high and will discourage use of the safe harbour mechanism. If our recommendation of retaining the current Division 7A benchmark is accepted, the 5% uplift would be starting to appear more realistic.

However, even with that, the safe harbour adopts a 'one size fits all' approach. It may be more appropriate where the asset class is unique eg luxury motor vehicles (noting that vehicles are excluded) and boats and aircraft but not for, say, residential property or other lower yielding assets.

Consideration should be given to using the Division 7A benchmark rate instead if a single rate is to be adopted.

Where taxpayers incurring usage charges (eg use of farm assets) have losses quarantined via non-commercial loss rules, an adjustment should be permitted to relieve the resulting hardship.

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

The current rules are difficult to comply with, involve excessive costs to comply and lead to uncertainty. To overlay a welcome safe harbour rule with a reasonableness test would denude its effectiveness.

We see a role for multiple formulas as it will encourage taxpayers to utilise the safe harbour rules for particular groups of asset classes. However, we would limit the number of formulas to help provide certainty and simplification.

# 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?**

Grant Thornton supports the policy intent of Subdivision E and agrees with Treasury that the subdivision is difficult for the Commissioner to apply in a practical sense. This has the compounding effect of creating greater uncertainty for taxpayers and their advisors in relation to the respective compliance obligations of the taxpayer.

It is our recommendation that amendments to the operation of Subdivision E should be made so that the Subdivision operates as a self-assessment provision, where possible. This will provide greater alignment with the majority of the other requirements of Division 7A. However, the difficulty in this regard is that Subdivision E is effectively an anti-avoidance measure whereby the Commissioner has the power to treat a loan as being subject to Division 7A where a taxpayer seeks to circumvent Division 7A by interposing an entity(s) between the private company and the target shareholder or associate. It appears that where a taxpayer engages in activities of this nature that self-assessment to include the amount as a deemed dividend will be unlikely.

Based on the proposal by Treasury to repeal section 109Y (ie relating to distributable surplus) it would appear that Subdivision E will have limited application except in situations where the interposed entity is neither a shareholder nor associate of the private company. In this situation where a private company makes a loan the taxpayer should be in a position to self-assess whether a loan, payment or other benefit is an indirect benefit captured by Subdivision E. Where there is uncertainty section 109T should be amended to provide the Commissioner with the power to exercise discretion on the basis that a reasonable person would not treat the receipt as an indirect benefit on the basis of transactions undertaken by the private company, that is, Subdivision E should be predominantly self-executing.

As outlined elsewhere in this submission we do not consider that the limitation provided by the distributable surplus mechanism should be removed. However, we consider that, where an indirect benefit is obtained by the shareholder or associate in accordance with the proposed amended application of Subdivision E, that outcome will ultimately be the same except that the deemed dividend will be limited to the distributable surplus (or suitable alternative) of the private company for the year in which the indirect benefit is provided to the target shareholder or associate.

**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?**

The proposed amendment to section 109M appears to miss the crux of the issue we encounter in practice. There are 2 parts to this.

Firstly, as it is currently drafted, in most cases section 109M is practically limited to "loans arising in the ordinary course of a business". In this regard, there is uncertainty as to the situations where loans arise in the ordinary course of business, other than a business of lending money. Many take the view that it is uncommon for a private company to make a loan to parties at arms' length unless the private company is in the business of lending money. In taking this position, the exceptions (for example, vendor financing on the sale of a business) are sufficiently rare as to render the possibility of a loan to a related party being on "the usual terms" low.

Secondly, and more importantly, it misses the opportunity to clarify the major area of uncertainty with the provision. There are two phrases that create this uncertainty: ‘usual terms’ and ‘similar loans’.

There is limited useful guidance on these phrases. For example, in ATO Interpretative Decision ATO ID 2003/588, the Commissioner stated that "a comparison of the terms of loans must be made". In Taxation Determination TD 2008/1 the Commissioner indicates that the requirements of section 109M are satisfied if the private company applies the same processes and procedures to arm's length and related party loans. This appears to be the case even if such processes and procedures are not specifically incorporated into or referred to in the loan agreement itself.

In addition, our experience in dealing with the ATO on this very issue suggests confusion within the ATO as to how to interpret these phrases. For example, in one instance, we were firstly advised that the ATO would only consider the terms as written into the loan agreements themselves. However, on the same matter, we were subsequently advised that reference would also be had to the factors taken into account and the processes and procedures by which the private company would determine whether or not to make a loan to any given party (whether related or not).

Therefore, we submit that the application of section 109M would be better clarified by requiring a decision by reference to an exhaustive set of objective factors applied on balance. Such factors might include:

- Purpose of loan
- Interest rate
- Repayment terms (eg. throughout loan, at end)
- Actions on default
- Loan and credit assessment process
- Loan security (eg. type, nature and extent)

### 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?

If a benefit is exempt from FBT under the provision of the FBTAA, then it is not a ‘fringe benefit’ as defined in subsection 136(1) of the FBTAA – in accordance with paragraph (g) of that definition. The proposed subsection 109ZB(3) exception is drafted to apply to fringe benefits, so would therefore not apply to exempt benefits. Therefore, even though a benefit might be exempt from FBT, Division 7A could still apply to tax the benefit as a deemed dividend. We suggest that this is not appropriate and that if an FBT exemption would be available, similarly, Division 7A should not apply. Our suggestion would therefore be that subsection 109ZB(3) should apply where there is either a fringe benefit or an exempt benefit provided.

In relation to whether Division 7A or FBT should take precedence, our view is that the law should dictate this. We consider FBT should take precedence and that this can be achieved by way of Division 7A stating that it is not applicable to benefits that constitute either a fringe benefit or an exempt benefit. Then arguably, paragraph (r) of the definition of a ‘fringe benefit’ would not be necessary, FBT would take precedence and if a benefit were not a fringe benefit or an exempt benefit, then Division 7A could apply.

For instance, if an employee/shareholder were to be provided with a laptop computer by the company, primarily for use in the employer’s business, then section 58X of the FBTAA would exempt this from FBT. The proposals outlined above, would then ensure that Division 7A could not then apply to tax the provision of the laptop as a deemed dividend.

# 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?**

Grant Thornton considers that an objects clause consistent with the policy intent of Division 7A would be appropriate for clarifying the intent of the provisions.

We highlight again the policy intent as outlined in the Consultation Paper that Division 7A "is an integrity rule that is intended to protect the operation of the progressive personal income tax system and ensure taxpayers cannot access funds that have not been taxed at their applicable marginal tax rates for the year".

It follows too that the legislation, including proposed amendments, should be based on this intent. As outlined in our submission we consider that some of the targeted amendments to Division 7A fall outside the relevant policy intent. The main example of this is the proposed removal of the distributable surplus limit for the purposes of determining a deemed dividend.

The proposal to repeal section 109Y and treat all payments, loans or debt forgiveness as subject to Division 7A may give rise to situations where the deemed dividend is not sourced from company profits but will still be subject to individual marginal rates. This means that the provisions would be operating above and beyond the intended policy intent.

Where the policy intent has changed we would expect a clear statement from the Government on this shift with appropriate reasoning to support the requirement to increase the scope of Division 7A. Where this is the case the objects clause should be amended to reflect the change in policy.

We do not, however, consider that any such policy change has been suggested by the Government meaning that the targeted amendments should be limited to the current scope of that intent.

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

We provide the following additional recommendations that would assist in achieving Treasury's objective of simplifying the application of Division 7A by taxpayers that have not already been canvassed in the consultation paper.

### Amendment to the Definition of Lodgement Day

Practical adherence to the requirements of Division 7A as they interact with the lodgement day, as defined in subsection 109D(6), for a private company's year of income continues to cause confusion for taxpayers and advisors. This is particularly so for private mid-sized businesses that are subject to changes in their lodgement obligations on an annual basis, depending on their relevant size for tax purposes.

In order to simplify the application of Division 7A we consider that a universal definition of lodgement day should be adopted for the purposes of Division 7A. This would provide greater certainty for taxpayers and ensure less inadvertent breaches of the requirements as a result of failing to ensure compliance by an arbitrary lodgement day.

We recommend that subsection 109D(6) be amended to provide for a lodgement day that is the earlier of the actual lodgement date of the private company's return and the day that is 1 year after the end of the private company's tax year in which the loan, payment or debt forgiveness occurred.

It is our position that this amendment will create greater certainty for taxpayers, increase compliance with Division 7A and will be easier for taxpayers to comply with, thus achieving Treasury's objectives in relation to the application of Division 7A post amendment.

In addition the proposed amendment will also allow for the lodgement day to be more easily applied to non-resident companies that are subject to Division 7A pursuant to section 109BC as the lodgement day would be based on their applicable tax year in their country of residence.

Where a country does not have an applicable tax year the lodgement day could be based on a tax year end of 30 June.

It is noted that, as a general rule, we would prefer that the lodgement day to be the actual date of lodging the company's tax return for a particular year. However, for tax system integrity, a maximum period of one year post-year end is considered appropriate.

### Amendment to Legislate the Lodgement Day of a Private Subsidiary Company of an Income Tax Consolidated Group

The Commissioner outlined the ATO's interpretation of lodgement day of a private company that is a subsidiary member of an income tax consolidated group for the purposes of subsection 109D(6) in Tax Determination TD 2015/18.

We consider that if the Commissioner's position that the lodgement day of a subsidiary member of a tax consolidated group is in fact the lodgement day of the head company of that income tax consolidated group then this should be reflected within the legislative provisions of Division 7A.

### Financial Accommodation in relation to a UPE owing to a private company beneficiary

Another important consideration in relation to the lodgement day requirement relates to the proposal to treat a UPE as financial accommodation arising pursuant to section 109D in the year of the present entitlement rather than the year after the present entitlement. It is common for taxpayers to determine the quantum of the present entitlement close to the lodgement due date of a trust's tax return. Under the proposed amendments taxpayers will only be afforded minimal time to transfer the funds required to settle the present entitlement or otherwise to address this.

From a practical perspective it is difficult to understand how a private company can provide financial accommodation in relation to a UPE until the directors know the full quantum of the entitlement and the amount that they can call on for payment.

The current treatment by the Commissioner acknowledges this and accepts that financial accommodation cannot be provided until the quantum of the present entitlement is known. As such we recommend that the current approach adopted be reflected in the legislative amendments in relation to the 'financial accommodation' provided by a private company in relation to a UPE.

### Law to be amended to exclude the principal component of a previously deemed dividend pursuant to s.109E

The Consultation Paper is silent on how section 109E is to apply in relation to the proposed 'single 10 year loan model'. As such we assume that Treasury intends for this section to operate as it is currently drafted.

Our interpretation of the current law is that the principal component of a complying loan is not reduced where a taxpayer fails to meet the minimum repayment in one year for the purposes of calculating the minimum repayment in subsequent years.

We consider that in the interests of simplicity and fairness that the principal component previously assessed pursuant to section 109E should be notionally forgiven for the purpose of calculating the applicable minimum repayment in subsequent years without a requirement to formally forgive the loan or apply section 109ZC.

An amendment in this regard creates fairness and certainty for taxpayers and ensures that the same portion of the loan balances is not taxed more than once.

### Impact on shareholders arising due to Base Rate Entity rules

With the purpose of Division 7A being to protect the personal tax base by governing the interaction between private companies and its shareholders and their associates, proposed Division 7A reforms need to be considered in the appropriate context.

Many private companies now benefit from a lower corporate tax rate as their turnover is less than $50m. A consequence is that the company cannot provide as franking credits the full corporate tax that was paid in earlier years – generally, the franking credits are restricted to the corporate tax rate applying to the company during the dividend payment year.

As a result, shareholders of private companies now face an increased effective rate of “top-up tax”. Based on a 47% top marginal tax rate, the top-up tax rate increases from 24.3% (with dividends franked at a 30% rate) to 29.3% (once the corporate rate of 25% applies).

This increased tax burden will limit the ability to meet any increased burden arising due to the proposed Division 7A changes. As such, this impact should be factored in to any reform, especially regarding how the transitional arrangements should apply.

### Limited refinancing options

Private groups have a strong history of adapting to any tax reform. Accordingly, they will do what they can to adapt to whatever reforms are made to Division 7A.

Many will look to refinance obligations with external financiers to relieve the burdens imposed by Division 7A. However, there is currently a tight lending market and this may not be resolved quickly, especially with banking practices under a greater spotlight due to the ongoing Banking Royal Commission.

This potentially difficulty should also be considered when determining appropriate transitional arrangements.

# Appendix 1

**Table 1: Comparison Between Existing Rate & New Indicator**

| Year | Proposed Indicator | Current Indicator | Difference |
|---|---|---|---|
| 2010 | 8.80% | 5.75% | 3.05% |
| 2011 | 10.30% | 7.40% | 2.90% |
| 2012 | 10.65% | 7.80% | 2.85% |
| 2013 | 10.00% | 7.05% | 2.95% |
| 2014 | 9.20% | 6.20% | 3.00% |
| 2015 | 8.95% | 5.95% | 3.00% |
| 2016 | 8.45% | 5.45% | 3.00% |
| 2017 | 8.35% | 5.40% | 2.95% |
| 2018 | 8.30% | 5.30% | 3.00% |
| 2019 | 8.30% | 5.20% | 3.10% |
| Average | 9.13% | 6.15% | 2.98% |

Refer to Discussion Question 1a.

**Table 2a: Comparison of Loan Repayments Using 3 Rates & Consultation Paper Computation Method**

| | Annual Minimum Repayment | | |
|---|---|---|---|
| | Treasury Proposed Rate | Current Rate | Alternate Rate |
| 2010 | 188,000 | 157,500 | 171,000 |
| 2011 | 192,700 | 166,600 | 177,400 |
| 2012 | 185,200 | 162,400 | 172,000 |
| 2013 | 170,000 | 149,350 | 156,000 |
| 2014 | 155,200 | 137,200 | 144,100 |
| 2015 | 144,750 | 129,750 | 135,500 |
| 2016 | 133,800 | 121,800 | 126,400 |
| 2017 | 125,050 | 116,200 | 119,500 |
| 2018 | 116,600 | 110,600 | 112,900 |
| 2019 | 108,300 | 105,200 | 106,450 |
| Total | 1,519,600 | 1,356,600 | 1,421,250 |

**Table 2b: Comparison of Loan Repayments Using 3 Rates & Current Computation Method (10 Years)**

| | Annual Minimum Repayment | | |
|---|---|---|---|
| | Treasury Proposed Rate | Current Rate | Alternate Rate |
| 2010 | 154,451 | 134,263 | 143,036 |
| 2011 | 164,040 | 144,125 | 152,275 |
| 2012 | 166,123 | 146,348 | 154,566 |
| 2013 | 162,627 | 142,601 | 149,417 |
| 2014 | 158,833 | 138,884 | 146,483 |
| 2015 | 157,807 | 137,944 | 145,510 |
| 2016 | 156,077 | 136,367 | 143,873 |
| 2017 | 155,797 | 136,240 | 143,609 |
| 2018 | 155,691 | 136,048 | 143,509 |
| 2019 | 155,691 | 135,918 | 143,509 |
| Total | 1,587,137 | 1,388,738 | 1,465,787 |

Refer to Discussion Question 1a.

**Table 3a: Overall Tax Position with Repayment Funding Mechanism Based Upon Consultation Paper Method**

| | Repayments: Franked dividends from Non Base Rate Entity | | | |
|---|---|---|---|---|
| | Tax to Afford Repayment | Corp Tax on Interest | Deferred Tax Total | Total |
| 2010 | 60,302 | 26,400 | 14,960 | 101,662 |
| 2011 | 61,809 | 27,810 | 15,759 | 105,378 |
| 2012 | 59,404 | 25,560 | 14,484 | 99,448 |
| 2013 | 54,528 | 21,000 | 11,900 | 87,428 |
| 2014 | 49,781 | 16,560 | 9,384 | 75,725 |
| 2015 | 46,429 | 13,425 | 7,608 | 67,462 |
| 2016 | 42,917 | 10,140 | 5,746 | 58,803 |
| 2017 | 40,110 | 7,515 | 4,259 | 51,884 |
| 2018 | 37,400 | 4,980 | 2,822 | 45,202 |
| 2019 | 26,301 | 2,490 | 1,411 | 30,202 |
| Total | 478,983 | 155,880 | 88,332 | 723,195 |

**Table 3b: Overall Tax Position with Repayment Funding Mechanism Based Upon Current Legislation**

| | Repayments: Franked dividends from Non Base Rate Entity | | | |
|---|---|---|---|---|
| | Tax to Afford Repayment | Corp Tax on Interest | Deferred Tax Total | Total |
| 2010 | 56,949 | 17,250 | 9,775 | 83,974 |
| 2011 | 59,948 | 19,535 | 11,070 | 90,553 |
| 2012 | 60,587 | 17,741 | 10,053 | 88,382 |
| 2013 | 59,576 | 13,291 | 7,532 | 80,399 |
| 2014 | 58,654 | 9,058 | 5,133 | 72,845 |
| 2015 | 58,449 | 5,968 | 3,382 | 67,798 |
| 2016 | 58,173 | 2,812 | 1,593 | 62,578 |
| 2017 | - | - | - | - |
| 2018 | - | - | - | - |
| 2019 | - | - | - | - |
| Total | 412,336 | 85,655 | 48,538 | 546,528 |

Refer to Discussion Question 1a.

**Table 4: Overall Position assuming new system adopted as announced (including transitional rules)**

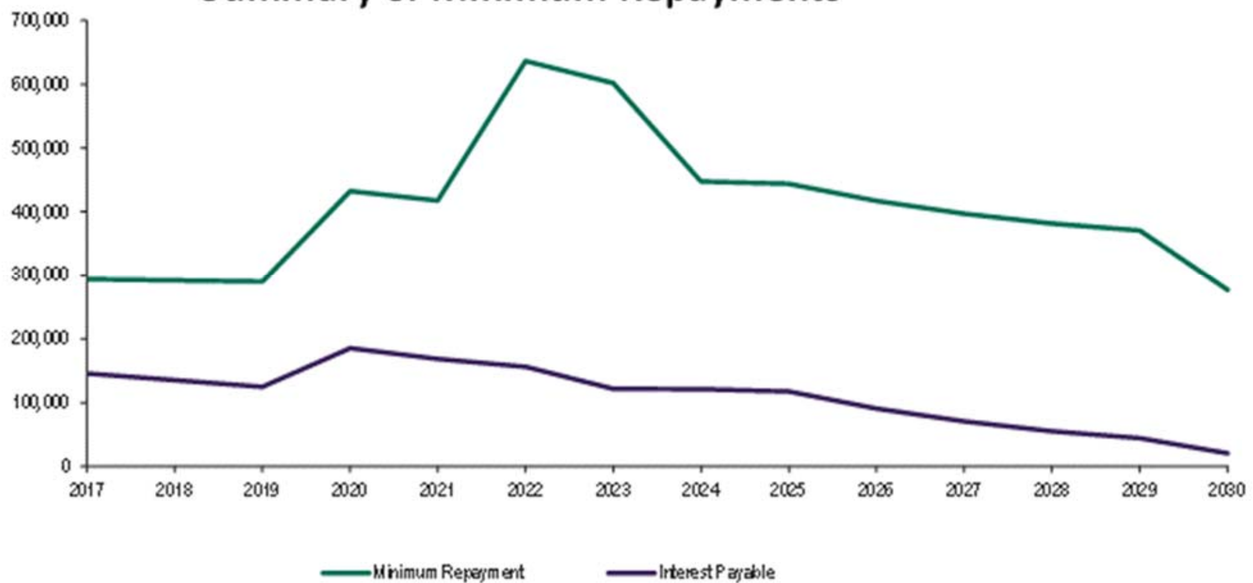
| Year | Minimum Repayment | % increase in Min Repmt vs 2019 | Interest Payable | % higher Int Payable vs 2019 | Personal Tax to afford pmt via franked div & tax thereon | % higher Tax Payable vs 2019 Base | Overall Tax exposure incl corp & deferred tax on Interest | % higher overall Tax vs 2019 Base | Closing Balance |
|---|---|---|---|---|---|---|---|---|---|
| 2017 | 293,899 | 1.29% | 145,800 | 17.06% | 109,492 | 2.57% | 185,891 | 10.99% | 4,251,901 |
| 2018 | 291,971 | 0.63% | 135,251 | 8.59% | 108,773 | 1.89% | 179,645 | 7.26% | 4,095,181 |
| 2019 | 290,147 | 0.00% | 124,549 | 0.00% | 106,752 | 0.00% | 167,491 | 0.00% | 3,929,584 |
| 2020 | 432,565 | 49.08% | 185,055 | 48.58% | 159,151 | 49.08% | 249,397 | 48.90% | 3,682,075 |
| 2021 | 417,490 | 43.89% | 168,476 | 35.27% | 165,421 | 54.96% | 245,795 | 46.75% | 3,433,061 |
| 2022 | 636,658 | 119.43% | 156,314 | 25.50% | 264,273 | 147.56% | 337,741 | 101.65% | 2,952,718 |
| 2023 | 602,070 | 107.51% | 121,727 | -2.27% | 249,916 | 134.11% | 307,127 | 83.37% | 2,472,374 |
| 2024 | 447,537 | 54.24% | 120,990 | -2.86% | 185,770 | 74.02% | 242,635 | 44.86% | 2,145,828 |
| 2025 | 444,071 | 53.05% | 117,524 | -5.64% | 184,331 | 72.67% | 239,568 | 43.03% | 1,819,281 |
| 2026 | 417,237 | 43.80% | 90,691 | -27.18% | 173,193 | 62.24% | 215,818 | 28.85% | 1,492,734 |
| 2027 | 397,073 | 36.85% | 70,526 | -43.38% | 164,823 | 54.40% | 197,970 | 18.20% | 1,166,187 |
| 2028 | 381,442 | 31.47% | 54,895 | -55.93% | 158,334 | 48.32% | 184,135 | 9.94% | 839,640 |
| 2029 | 370,674 | 27.75% | 44,127 | -64.57% | 153,865 | 44.13% | 174,604 | 4.25% | 513,094 |
| 2030 | 277,029 | -4.52% | 20,482 | -83.56% | 114,993 | 7.72% | 124,620 | -25.60% | 256,547 |
| Totals | 5,699,861 | | 1,556,408 | | 2,299,087 | | 3,052,436 | | |

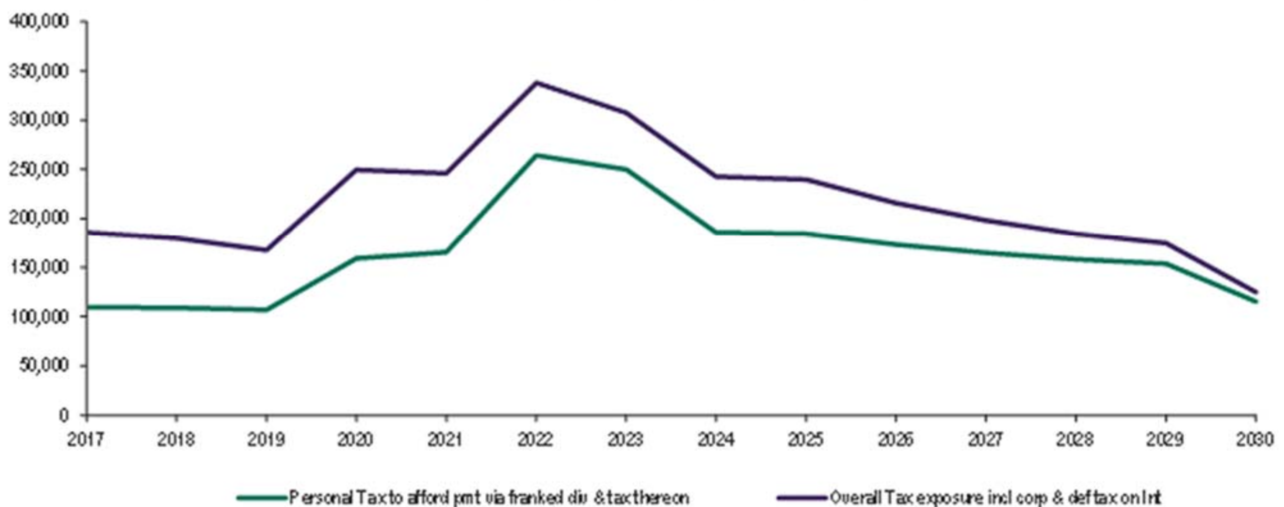
Refer to Discussion Question 1b

.

### Graphs for Table 4

Refer above & to Discussion Question 1b



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