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TARGETED AMENDMENTS TO DIVISION 7A

BDO welcomes the opportunity to provide feedback in response to the Treasury Consultation paper on targeted amendments to Division 7A released on 22 October 2018 (Consultation Paper). We provide the detailed BDO comments on the discussion questions in the Consultation Paper are in the attached appendix. All legislative references in this submission refer to the Income Tax Assessment Act 1936 unless otherwise indicated.

The main issues identified in the BDO submission are summarised as below:

- Widen the exclusion of commercial loans under section 109M so that Division 7A does not apply to loans on a commercial arm's length basis made to shareholders or associates for business or other income production reasons.
- Keep the existing benchmark interest rate for 25 year secured loans until 30 June 2021.
- Clarify the Division 7A treatment of shareholders and associates of foreign companies, in relation to the source rules, double tax agreements and section 47A.
- The concept of distributable surplus should not be removed but changed to clarify Division 7A does not apply if the only funds in the company are share capital or borrowed funds.
- Pre 16 December 2009 UPEs should not be brought into Division 7A but if they are, generous transitional arrangement should be provided recognising the difficulty there may be in reorganising these arrangements.
- There is no need for the 14 year review period. The ATO can already extend the review period where there is tax evasion.
- The Board of Taxation's recommendations that the taxation of business income should be at the concessional corporate rate, regardless of entity, should be reconsidered at least in relation to trusts as outlined in the Board's recommendations.

Should you wish to discuss any of our comments, please feel free to contact me on +61 2 9240 9736, or via email: Lance.Cunningham@bdo.com.au.

Kind regards,

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APPENDIX

Discussion Question 1(a) - Is there an aspect of the proposed loan model that could be refined?

Extend the exemption for commercial loans

The aspect of Division 7A that causes the most problems for many private companies and their shareholders, particularly groups of private companies and trusts, is the requirement to fit into the restrictive requirements of Division 7A for loans from the private company being used for working capital or other business or income producing activities.

BDO suggests that Division 7A should not apply where companies lend to their shareholders and associates on commercial terms for use in their business or other income producing activities (i.e. on arm's length terms obtainable from a bank or other arm's length financier).

There is currently a limited concession in section 109M that partially deals with the above but it requires the loan be made by the company in the ordinary course of the company's business and on terms it provides for similar loans it makes on an arm's length basis. BDO suggests amending section 109M to remove the requirement that the loan be made in the ordinary course of business and on terms it makes to arm's length borrowers and the requirement be widened to include loans provided on arm's length terms that the shareholder or associate could obtain from an arm's length financier for loans used in carrying on their business or other income producing activities.

However, we note one of the proposals in the Consultation Paper is a suggestion to amend section 109M to restrict its operation by making it clear that the loan has to be made by the company in the ordinary course of a "business of money lending" (see under 'Minor Technical Amendments' on pages 15 &16). BDO considers this proposed restrictive amendment should not be made; and instead section 109M should be amended to widen its scope as described in the previous paragraph.

Keep the 25 year secured loan option

If the above suggestion to extend the exemption for commercial loans is not accepted, BDO suggests that the 25 year secured loan option be retained in Division 7A. This option at least provides a degree of flexibility in the repayment period for such loans.

Discussion Question 1(b) - Do the proposed transitional rules result in any unintended outcomes

Existing 7 year loans

The requirement that the loans in existence as at 30 June 2019 retain their current term reduces the simplicity of the provisions. BDO suggests that the Board of Taxation proposal for legislated requirements for loan repayments should be adopted. The Board's approach would allow these loans to have their terms extended to the full 10 years.

Existing 25 year loans

Complying 25 year loans that are in existence as at 30 June 2019 will be exempt from the majority of changes until 30 June 2021 but, at that date, the outstanding value of the loan will give rise to a deemed dividend unless a loan agreement complying with the new rules is put in place prior to the lodgement day of the 2020-21 company tax return. BDO suggests that many borrowers that have taken out 25 year loans will find it difficult to rearrange their affairs to repay the loan over 10 years. As an alternative they may look to refinance with a secured loan from an external financier, however, with the current restrictions on bank lending, many borrowers may find it difficult to refinance with an arm's length lender.

The consultation paper does not provide sufficient details on how the 25 year loan is to be converted to a 10 year loan. It is assumed the requirement to have a complying loan agreement means that the 25 year loan agreement has to be renegotiated to convert it to a 10 year loan, but it is not clear when this 10 year term has to start. Would the 10 year term start from 1 July 2021 irrespective of the remaining term of the 25 year loan? For example, would an existing 25 year loans that has less than 10 years to run as at 1 July 2021 be able to be converted into a 10 year loan term from 1 July 2021?

Although the 25 year loans will be exempt from the majority of the proposed changes until 30 June 2021, the main exception is the rate of interest on the loan for the period up to 30 June 2021. The Consultation paper says the interest rate payable during this period must equal or exceed the new benchmark interest rate. This does not appear to be appropriate as the new benchmark interest rate is based on the unsecured overdraft rate but the 25 year loan will generally continue to be secured over real estate for the period up to 30 June 2021. It is suggested that in such cases the existing Division 7A benchmark rate be allowed to be used until the loan is required to come under the new rules on 1 July 2021.

Discussion Questions 1(c)(d)(e) - Application to non-resident private companies

The current Division 7A has no territorial restrictions in relation to the private companies and section 109BC appropriately includes clarifying rules that deal with differing tax and accounting periods in foreign countries etc. Therefore, it appears clear that Division 7A applies to both Australian and foreign companies. However, there is still uncertainty on how the Division 7A rules operate in relation to the shareholders of foreign companies

In relation to non-resident shareholders of foreign companies, they are only assessable on income that is from an Australian source. The case law on the source of dividend income generally holds that it is based on the source of the profits made by the company out of which the dividends were paid. There are practical implications of identifying the source of a foreign company's dividends paid to a non-resident shareholder but this is largely overcome where the foreign company is resident in a country with a double tax agreement with Australia because section 18 of the International Tax Agreements Act 1953 provides that such a dividend shall be deemed to be derived from a source in the company's country of residence. However, it is not clear how the case law source rules; section 18 of the International Tax Agreements Act 1953; and the various double tax agreements apply to a deemed dividend under Division 7A.

In relation to resident shareholders and associates of a foreign company there is a question on the interaction between the Division 7A rules and the section 47A rules for distribution benefits from CFCs. It appears that both these provisions have potential of operating in relation to a foreign private company making loans, payments or debt forgiveness in relation to its Australian resident shareholders or their associates. It appears that section 47A will take precedence over Division 7A because of the operation of section 109L, which provides that a deemed divided will not arise under Division 7A where the amount is assessable under another provision of the Tax Act. However, it is suggested the ATO could give some more guidance on the interaction between these two provisions.

Discussion Questions 1(f)(g) - Removal of the concept of distributable surplus

BDO submits that the total removal of the concept of 'distributable surplus' from section 109Y of Division 7A should be reconsidered. The concept of distributable surplus is one of the essential numeric components to calculate a Division 7A deemed dividend. Broadly, the distributable surplus is the realised and unrealised profits in the company. If there is no distributable surplus at the end of the company's year of income there would be no deemed dividend, or the deemed dividend amount would be limited by the amount of distributable surplus.

The result of removing the concept of distributable surplus means a deemed dividend can arise where there are no realised or unrealised profits in the company e.g. where the only source of the funds is from share capital or borrowed funds. The Consultation Paper justifies this on the basis that the corporations law no longer requires dividends to be paid out of profits (as per section 254T of the Corporations Act 2001).

BDO submits that, while the corporations law no longer requires dividends to be paid out of profits, this is not the appropriate basis for removing the concept of distributable surplus from the Division 7A calculations. It is more appropriate to consider what would be the treatment of the payment, loan or debt forgiveness under the Tax Acts if instead it was paid as a dividend. In this context the definitions of 'dividend' in section 6-1 and 'frankable distribution' in section 202-40 of the Income Tax Assessment Act 1997 (ITAA 1997) should be considered. Generally, both these provisions do not include distributions out of share capital (with limited exceptions).

In relation to funds borrowed by the company and on lent to shareholders or associates there may be inappropriate outcomes of removing the concept of distributable surplus. This could be a particular problem for group finance companies in a private group. For example, where the group finance company borrows funds from a bank and then on lend to non-corporate members of the group. In most cases such group finance companies do not have a distributable surplus and therefore, under the current Division 7A rules, they can operate as the group finance company without the danger of Division 7A applying to the on-lent loans. This would not be possible under the proposal to eliminate the concept of distributable surplus.

Although a company can borrow to pay a dividend, this is not generally the purpose of a group finance company when borrowing to on-lend to the rest of the group.

BDO submits that the concept of distributable surplus in section 109Y should not be removed but rather it should be amended so that it is clear that Division 7A would not apply if the only funds available in the company are either share capital or borrowed funds.

Alternatively, if the above suggestion is not accepted then there should be an exclusion for group finance companies as described above.

Discussion Question 2(a) - Are transitional rules required for UPEs arising between 16 December 2009 and 30 June 2019?

In relation to all UPEs arising after 16 December 2009, we recognise that having all forms of financial accommodation under one system will have simplicity benefits. However, in order to give private companies and their shareholders and associates time to reorganise their affairs we propose that, similar to 25 year loans and pre-4 December 1997 loans, a two year transition period be allowed before requiring the UPE to be converted to a 10 year loan i.e. the new rules do not apply to them until 1 July 2021.

It is not entirely clear in the Consultation paper whether pre 30 June 2019 UPE sub trusts that are put under a complying loan agreement will have a further 10 years to fully pay out the UPE or just the remaining term of the sub-trust arrangement. This should be clarified.

Discussion Question 2(b) - Should UPEs arising prior to 16 December 2009 be brought within Division 7A?

Pre 16 December 2009 UPEs were administratively excluded by from being dealt with under Division 7A and on this basis it is BDO's opinion that they should not retrospectively brought into Division 7A. However, if they are to subject to Division 7A they should be provided with a generous transitional approach to account for the fact that the relevant companies and trusts may have financial arrangements that did not envisage having to deal with Division 7A and these arrangements may be difficult to unwind. We suggest these entities have a transitional period until at least 30 June 2021 and with the ability to obtain an extension of this transitional arrangement for situations where the rearranging of the financial arrangements is difficult.

Discussion Questions 3(a)(b)(c) – Self correction mechanism

There should be consideration of how the TOFA provisions will interact with this proposal, in particular in relation to the catch up principle and interest payments paid or received by entities that are subject to TOFA.

Discussion Questions 3(d)(e) 14 year Period of Review

BDO Submits that the proposed 14 year review period is not required. It is assumed that the reason for proposing the 14 year review period is to counter situations where some taxpayer attempt to avoid their Division 7A responsibilities by waiting until after the relevant 2 or 4 year assessment review period before identifying breaches of the Division 7A requirements. However, we do not consider the 14 year review period is necessary to deal with this situation. The ATO already has the ability to extend the review period where the taxpayer has been involved in tax evasion, which would include situations where taxpayers are aware of the Division 7A breach but do not take any action before the review period has past.

It is suggested that as an alternative the ATO should publish material that makes it clear that it considers such behaviour as tax evasion and as such there is an unlimited review period for the relevant assessments.

Discussion Question 4 – Safe Harbours – provision of assets for use

The Safe harbour proposal excludes motor vehicles on the basis that motor vehicle rental may be readily ascertainable by other means, however it should be made clear whether it is long term leasing or short term hire that is intended to be used for motor vehicles. We also question whether the exclusions for motor vehicles is appropriate on the basis that creating an exception to a rule does not promote simplicity.

Discussion Question 5 - Minor Technical Amendments

Section 109M

As discussed above at Question 1(a), BDO submits that section 109M should be widened rather than restricted. Refer to comments under Question 1(a) above.

Interaction with FBT

Section 109ZB(3) currently excludes from the operation of Division 7A payment that are made by a company to a shareholder or associate in their capacity as an employee as defined in section 136 of the Fringe Benefits Assessment Act 1986 (FBTAA). The Consultation Paper suggests that this exclusion from Division 7A for payments should only apply where the payment to a shareholder constitutes a fringe benefit (ignoring the exclusion in para (r) of the FBTAA definition). This would mean the payment would have to fit the definition of 'fringe benefit' under section 136 FBTAA (disregarding para (r)). However, this would mean a large number of payments to employees that are exclued from the definition of 'fringe benefit' (such as for superannuation contributions, personal injury payments etc.) would then potentially become subject to Division 7A. There does not appear to be any good policy considerations that would justify these types or employment related payments be subjected to Division 7A.

BDO Suggests that the proposed amendment be reconsidered and if is decided that an amendment is required then, along with ignoring of paragraph (r) in the definition of fringe benefit, the other exclusions in the definition of 'fringe benefit i.e. (f) through to (s) should also be considered whether they should also be ignored for the purposes of Section 109ZB(3).

Discussion Question 6 - Other Issues

The consultation paper does not address many of the Board of Taxation's recommendations. One that we particularly want to stress is the treatment of business income derived by trusts and taxed to corporate beneficiaries. It appeared to the Board, and it appears to us, that the better policy setting is to allow the taxation of business income at the concessional corporate rate, regardless of entity. While the structure of the Australian tax system cannot currently easily accommodate this for businesses operated by individuals (alone or in partnership), it is possible to achieve this for trusts as outlined in the Board's recommendations.