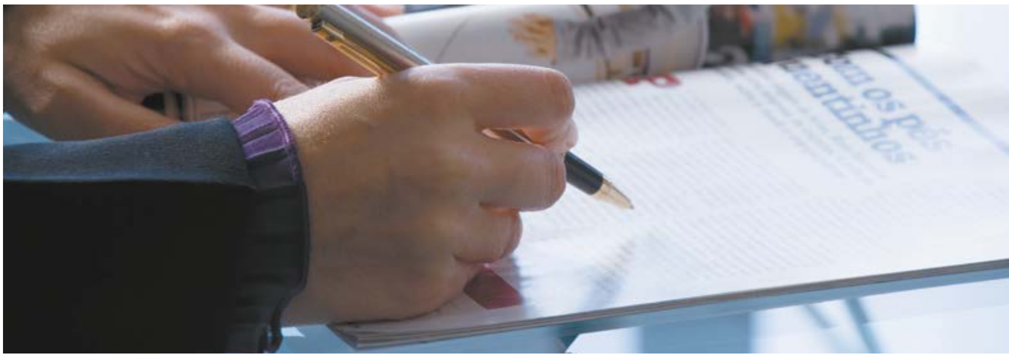

TECHNICAL UPDATE

DEEMED DIVIDENDS FROM PRIVATE COMPANIES – BOARD OF TAXATION RELEASES SECOND DISCUSSION PAPER AS PART OF ITS REVIEW OF DIVISION 7A

AS PART OF ITS POST-IMPLEMENTATION REVIEW OF THE DEEMED DIVIDEND TAXATION PROVISIONS IN DIVISION 7A OF PART III OF THE INCOME TAX ASSESSMENT ACT 1936 (DIVISION 7A) THE BOARD OF TAXATION HAS RELEASED A SECOND DISCUSSION PAPER. THE DISCUSSION PAPER CANVASSES PROPOSALS FOR MATERIAL CHANGES TO THE OPERATIVE PROVISIONS OF DIVISION 7A.

The Board of Tax has asked for submissions on the Discussion Paper by 9 May 2014. The Board will provide its report to the Government by 31 October 2014. The Government has not at this stage indicated whether it will implement any of the suggestions in the Discussion Paper.

As discussed below, in the Discussion Paper the Board puts forward a number of significant proposals for the reform of Division 7A and related areas of income tax, including the following:

- Business profits that are reinvested in the business be taxed at the corporate rate for all types of business structures
- The use of private company assets be treated in a similar manner to loans, by treating the right to use the asset as akin to a finance lease i.e. payment of cost and interest over a set period
- Distributable surplus be tested each year instead of the current testing only at the end of the year the loan was made
- A simpler and more flexible system for complying loans with a fixed rate of interest and more flexible principal repayment requirements
- All unpaid present entitlements (UPE) from trusts be treated as loans for Division 7A purposes, thus eliminating the need for sub-trusts (subject to next dot point).
- Trusts be able to elect for loans and UPE's to be excluded from Division 7A, but would then forgo the CGT discount on capital gains (except on goodwill)
- A self correction mechanism that allows taxpayers to correct mistakes except where it could be inferred that the Division 7A rules have been deliberately ignored.

In the Discussion Paper the Board records its view that, in relation to Division 7A, the high level tax policy aims of efficiency, simplicity and equity will be served by striking an appropriate balance between the following four goals:

- It should ensure that the private use of company profits attracts tax at the user's progressive personal income tax rate.
- It should remove impediments to the reinvestment of business income as working capital.

SECTOR

Tax

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- It should maximise simplicity by reducing the compliance burden on business and the administrative burden on the Commissioner and other stakeholders.
- It should not advantage the accumulation of passive investments over the reinvestment of business profits in active business activities.

Below is a more detailed discussion of the Discussion Paper proposals.

1. **Business accumulations be taxed at the corporate tax rate regardless of the business structure chosen**

   While conceding that this proposal is outside the scope of its current review, the Board suggested that a reform of this nature would go some way towards achieving significant simplicity and would, arguably, create an incentive for entrepreneurial risk-taking. However, it conceded that it may also create some consequential complexity, (for example, requiring detailed rules to deal with any subsequent access by associated individuals to business profits) and come at a cost to the revenue.

2. **A unified set of rules based on the principle of transfers of value**

   The Board suggests that viewing temporary transfers of value — whether of cash or asset usage — as both involving access to company cash, either as cash (loans) or as cash applied to buy assets (assets usage), suggests that common principles could be used for the repayments or payments required in respect of those temporary transfers of value. To this end, the Board suggests that if loans require repayment of the loan principal and agreed interest over a set period of time, a usage fee for assets could also be required over an appropriate time period and reflecting the payment of cost and interest, akin to a finance lease.

3. **A better targeted framework for calculating a company's profits**

   The Board observed that all of the possible permanent or temporary transfers of value — that is, payments, loan forgiveness, loans, and assets purchased and provided for use — can be viewed as different applications of a 'realised' distributable surplus.

   It noted, however, that under the current provisions, the testing of distributable surplus only occurs at the end of the year of income in which the loan was originally provided. As at that time, if there was no distributable surplus and the relevant transfer was funded by a loan into the company, no deemed dividend could arise, even when the source of the funding is effectively transferred to later realised profits.

   To this end, the Board concluded that the intended Division 7A objectives would be achieved if the general distributable surplus definition is of realised profits (subject to the extra market value adjustment for asset transfers) and the testing is done at each year end.

4. **Consideration should be directed toward whether, and in what circumstances, deemed dividends should be franked.**

5. **A simpler, more flexible and better targeted system of 'complying loans'**

   The Board proposed that it would simplify compliance if legislation were enacted prescribing the terms and conditions for Division 7A loans as follows:

   - There would be no requirement for a formal written agreement between the parties. However, written or electronic evidence that a loan was entered into must exist by lodgement day for the income year in which the loan was made.
   - The statutory interest rate would be set at the start of the loan and fixed over the term of the loan.
   - The statutory interest rate for a particular year would be set at the Reserve Bank of Australia's indicator lending rate for small business variable (other) overdraft for the month of May immediately before the start of that income year.
   - The maximum loan term would be 10 years.
   - The prescribed maximum loan balances during the term of the loan (including any accumulated interest) would be as follows:
     - 75 per cent of the original loan by the end of year three
     - 55 per cent of the original loan by the end of year five
     - 25 per cent of the original loan by the end of year eight
     - 0 per cent of the original loan (that is, fully repaid) by the end of year ten.
   - Subject to meeting the minimum loan balances, there would be no specified annual principal repayments.
   - Interest would be able to be accrued but would have to be paid by the end of each milestone period — end of years three, five, eight and ten.
   - Failure to make the repayments by the end of the milestone periods would result in the private company being taken to have paid a dividend to the entity based on the amount of the shortfall in the payment required.
   - The Commissioner's period of review would commence to run from the date of lodgement for the income year in which each milestone payment is required (or would have been required, had a complying loan agreement been entered into).

6. **Greater flexibility for trusts that reinvest unpaid present entitlements (UPEs) as working capital**

   The Board expressed the view that there should be a legislative amendment to clarify that all UPEs are loans for Division 7A purposes, thereby eliminating the need to create sub-trusts and comply with the conditions outlined in PS LA 2010/4.

   Further, the Board proposed that:

   - Trusts would be eligible to make a once and for all election for loans from companies (including UPEs owing to companies) to be excluded from the operation of Division 7A (the 'tick the box' option).
   - A trust that makes such an election (an excluded trust) would forgo the CGT discount on capital gains arising from assets (other than goodwill) held within the trust.

7. A self-correction mechanism

The Board proposed that a legislated self-correction mechanism should be made available to taxpayers. Such a mechanism might operate as an ex post facto exception that operates to 'undo' the prior deeming of a dividend.

As with the current discretionary provision, it is proposed such an exception to Division 7A should be subject to eligibility requirements. At a minimum, it should not be available in circumstances where, on the basis of objective factors, it can be inferred that taxpayers have deliberately ignored, or attempted to circumvent, the provisions.

It is proposed that the self-correction exception should also be subject to meeting required standards of corrective action. The corrective action required would be broadly designed to ensure that the parties are placed in the same position as if Division 7A had been complied with from the outset. Typically, this would involve putting complying loan agreements in place and making 'catch-up' payments of interest and principal for the period starting when the dividend would, but for the exception, have arisen.

BDO comment

Overall, the Board of Taxation's Discussion Paper represents a reasonable attempt to impose order on the currently chaotic deemed dividend provisions. Such advantages are not without costs, however, particularly by reference to:

- The maximum term of shareholder loans being limited to 10 years (rather than the currently available 25 years where the borrowing is secured over real property)
- The inability to avoid a UPE deemed dividend through establishing a sub-trust in favour of the affected private company
- The higher statutory interest rate implicit in the prescribed 'Reserve Bank of Australia's indicator lending rate for small business variable (other) overdraft', (e.g., the rate for the year ending 30 June 2013 is 10 per cent).

BDO will be making a submission to the Board of Taxation in respect of the matters raised in the Discussion Paper. Please contact your BDO tax adviser if you wish to have any issues addressed in that submission

National expertise

The BDO Tax team is one of the largest and most dynamic tax practices in Australia, with 27 partners and more than 150 specialists located in each major city across the country.

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