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

PARKES ACT 2600

By email: Div7A@treasury.gov.au

Dear Sir/ Madam

SUBJECT: Targeted amendments to the Division 7A integrity rules

CPA Australia represents the diverse interests of more than 163,000 members working in 125 countries and regions around the world. We make this submission on behalf of our members and in the broader public interest. The submission is not made in-confidence and may be released.

Division 7A is an important longstanding issue for many SMEs. Based on the most recently publicly available ATO data, nearly one million companies lodge tax returns, of which 80,000 reported loans to shareholders and their associates in 2015-16.

CPA Australia is of the view that some of what is proposed in the consultation paper - if implemented – will be to the detriment of SME growth and profitability.

For example, the proposed ten-year loan model - alleged to be 'more closely aligned to commercial practice for principal and interest loans' may have negative impacts on small business cash flow at the very time our engagement with the sector indicates that access to finance is becoming more difficult.

Members have also advised that it is disingenuous for the Treasury consultation paper to suggest this loan model is preferred '…as annual payment encourages proactive cash flow management by businesses'.

The proposed ten-year loan model runs counter to this objective – stymying cash flows at a critical time in the life of a business, and impacting both current and future business growth and therefore jobs growth.

It also is counter to the Australian government's recent comments that 'enhancing small business access to funding is part of the Coalition Government's plan for a stronger economy.' [1]

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[1] http://jaf.ministers.treasury.gov.au/media-release/051-2018/

Similarly, members also expressed concern that the proposal to bring unpaid present entitlements into Division 7A, especially those arising prior to 16 December 2009 will have negative impacts on cash flow and working capital of small business. For these reasons and to encourage compliance it would be beneficial if UPEs were brought in under separate transitional rules.

Members have raised numerous points of clarification on the consultation paper with us. Some of these relate to how the ATO may administer the proposed law. We therefore suggest that the ATO establish a limited life working party that works alongside Treasury's consultation process to identify administrative issues with the proposed law in need of clarification. The objective should be to release draft Law Companion Rulings and Practical Compliance Guidelines at the same time that draft law is released.

We recognise that the Division 7A provisions are anti-avoidance provisions, and are supportive of the overall policy intent. But it is essential that after many years of legislative change, reviews and uncertainty, that Australian businesses get the right policy outcome this time.

Our specific comments on the consultation paper are enclosed in the **Attachment.**

If you have any queries on this submission, please contact Gavan Ord, Manager - Business and Investment Policy on gavan.ord@cpaaustralia.com.au or 03 9606 9695.

Yours sincerely

Craig Laughton
Executive General Manager Policy, Advocacy & Public Practice
CPA Australia Ltd

Cc. Stuart Robert
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Attachment

Discussion Question	CPA Australia response
Discussion Question 1	
Proposed loan model a. Is there an aspect of the proposed loan model that could be refined?	The consultation paper notes amongst other things that '… although an interest only model is simple in operation, it is not consistent with the policy intent behind Division 7A which requires repayment of principal over time. This is because there is an expectation that amounts borrowed from private companies will be returned over time to shareholders as dividends and taxed at the shareholders' marginal tax rates.' This is not disputed. However, it is recommended that for reasons outlined in our letter the proposed loan model should be refined to enable interest only repayments in the initial years of a business to better support cash flow, which in turn may improve business survival rates and help foster business growth. Members have also advised that the simplistic loan interest calculation – based on the opening loan balance -is uncommercial and therefore inappropriate as it will not take into account loan repayments made during the year. Some members have advised a more complex but commercial formula (possibly based on the daily loan balance) is appropriate and that online calculators could be made available to simplify such calculations; alternatively, the existing interest rate basis could be retained Also, members have raised the prospect of having an ATO pro-forma loan arrangement developed that sets out the complying loan terms that could be used in the absence of a formal loan agreement. Such a pro-forma agreement could be included in a PCG. Further, members raised the issue of how the proposal is in conflict with 25 year loan arrangements that have been formalised/ are in place. While members have informed us that 25-year loan agreements are uncommon, should existing 25 loan agreements be left to run to maturity? The proposal would therefore only apply to new loans from 1 July 2019 or the release date of the consultation paper?

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Transitional rules	
b. Do the proposed transitional rules result in any unintended outcomes?	Some members have suggested it would be more appropriate if taxpayers with existing seven-year loan agreements as at 30 June 2019 be given the option of extending the term to 10 years, or otherwise be left to run to maturity.
Application to non-resident private companies c. In what circumstances (if any) is the application of Division 7A to non-resident private companies unclear? d. Would the application of Division 7A to non-resident private companies benefit from additional public guidance material? e. Are legislative amendments required to clarify the application of Division 7A to non-resident private companies?	No comments provided.
Distributable Surplus f. Does the removal of the concept of distributable surplus result in any unintended outcomes?	f. Members have queried, and in some cases expressed strong concerns over the implications of the removal of the concept of distributable surplus and how that would impact on a return of capital to a shareholder. Others think the possible simplification is welcome. If there are no retained earnings in the company is there a 'benefit' and would Div. 7A apply? CPA Australia's view is that the implications of the removal of the distributable surplus have not been fully thought through in the development of the consultation paper. For example, it makes little sense for a corporate financing entity that is borrowing at arms-length from a bank to be compelled to enter into a separate loan agreement with a related trading entity at 8.3 per cent annual interest plus principal payments over ten years only for the purposes of complying with Div. 7A. The compliance costs amongst other things will be high, and it passes on a loan obligation to a trading entity that may be cash poor until the end of a particular long-term project. It is therefore recommended that the distributable surplus concept be retained. For the record other members have suggested If the

g. If this concept is removed, are there any interactions with other provisions of Division 7A that might become relevant?	government decides to remove the concept, consideration should be given to making it prospective by quarantining or grandfathering existing distributable surpluses. g. The return of capital scenario mentioned at the beginning of (f.) above also raises the question of how Div.7A interacts with the capital gains (CGT) provisions. It has been suggested that CGT Event A1 would apply in this situation – but this will need to be clarified if the distributable surplus rule is abolished.
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 in the sub-trust 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? b. Should UPEs arising prior to 16 December 2009 be brought within Division 7A?	Members have suggested that should the government decide to bring UPEs arising prior to 16 December 2009 into Div. 7A, it should give a 10-year interest-free period commencing 1 July 2021 to repay the UPE. This could involve the UPE being repaid in a series of annual instalments from that date. This would reduce cash flow pressure on such businesses of this proposal.
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?	It is unclear whether self-correction mechanism would apply to breaches or corrective action taken only from 1 July 2019, or action taken from that date but in respect of certain breaches before that date. We suggest that the law be flexible in this respect. In relation to the criterion that the taxpayer takes corrective action no later than six months after identifying the error (unless the Commissioner allows more time), members consider this period of time to be insufficient. Members noted that after identifying an error, taxpayers will most likely seek professional advice, or their tax agent may

	need to seek expert advice, both of which can take time. Members note that as third parties may be involved in the corrective action, this may add time. A more reasonable period of time would be 12 months. Another issue identified by members in relation to the self-correction mechanism is whether it allows a taxpayer to frank the deemed dividend. This also needs to be clarified.
Period of Review a. Will the period of review cause any unintended outcomes? b. Are there any alternative options to a 14-year review period that would ensure the integrity of the revised Division 7A?	Some members have queried the 14-year period of review. It would seem this is the current four-year review period plus the proposed ten-year loan period. However, what is not clear is whether the 14-year period of review commences and builds to 14 years by 2033, or whether it applies retrospectively i.e. back to 2005.
Discussion Question 4	
Safe Harbours – Provision of assets for use a. Is there an alternative formula which could be used? 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? c. Is a 5 per cent uplift interest rate as part of the usage charge appropriate? Or should another rate (e.g. the benchmark interest rate) be used? d. Should there be a 'reasonableness' test included in the statutory formula or alternatively, are multiple formulas needed?	Members expressed concern over the five per cent uplift in addition to the benchmark interest rate.
Discussion Question 5	
Minor Technical Amendments a. Are any changes required to the interposed entity rules, apart from section 109T? For example, should	No comments provided.

section 109V and 109W be amended? 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? 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?	
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? b. Are there any other issues relevant to the amendments canvassed in this paper that have not been considered?	a. CPA Australia is supportive of an objects clause. b. Additional questions/ matters requiring clarification/ guidance are as follows: • Would s. 109R apply to the refinance of a 7-year loan into a 10-year loan to take advantage of the longer loan term? • The terms of existing 25-year loans should be quarantined. The proposed model provides windfall gains for loans that were entered into more than 15 years before 1 July 2021, and shortens the term of those loans which were entered into less than 15 years before 1 July 2021. This will have significant implications for recently made loans. • How will ‘non-commercial loans’ referred to in the third component of the formula in s. 109Y that are still on the company’s balance sheet be treated from 1 July 2019?

	• Existing sub-trust arrangements should be quarantined for the duration of their term. At conclusion, if the principal remains unpaid it should be able to be refinanced as a new 10-year loan in accordance with the current treatment in PCG 2017/13.

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