CLEARY HOARE
SOLICITORS

clearlaw@clearyhoare.com.au
www.clearyhoare.com.au

BRISBANE
Level 1
1 Breakfast Creek Road
(cnr Longland Street)
Newstead QLD 4006

PO Box 2684
Fortitude Valley BC
QLD 4006

T 07 3230 5222
F 07 3252 1355

SYDNEY

PERTH

Our Ref: BMH:AMB:BAI7756

21 November 2018

Gregory Derlacz
Senior Adviser
Small Business Entities and Industries Concessions Unit
The Treasury
Langton Crescent
PARKES ACT 2600

By Email: DIV7A@treasury.gov.au

Dear Mr Derlacz

Targeted Amendments to the Division 7A integrity rules

Cleary Hoare Solicitors welcomes the opportunity to provide submissions on the consultation paper "Targeted amendments to the Division 7A integrity rules".

Cleary Hoare Solicitors works exclusively with private businesses throughout Australia, many of whom will be adversely impacted by some of the proposed amendments contained within the consultation paper.

Transitional Rules – 7 year and 25 year loans

1. It is noted that under the proposed transitional rules:

   1.1 For existing 7 year loans, the term will remain the same however the interest rate will climb to the higher Small business; Variable; Other; Overdraft indicator lending rate for the remainder of the term;

   1.2 For existing 25 year loans:

      1.2.1 From 1 July 2019 until 30 June 2021 the interest rate will climb to the higher Small business; Variable; Other; Overdraft indicator lending rate for the remainder of the term; and

      1.2.2 From 30 June 2021 the loans will be in effect converted to a ten year loan.

2. Considering that the current Division 7A interest rate is 5.2% and the new rate currently is 8.3% this will lead to significant further interest cost (an increase of almost 60%) for these clients who have transitional loans.

3. This has real practical ramifications for these clients in that:

3.1 They will be required to find significant extra cash in order to repay the extra interest;

3.2 Existing loan arrangements for shareholders or related entities to acquire assets may no longer be viable due to the extra costs and drain on cash flow, resulting in the potential of forced sale of assets.

3.3 This could potentially result in either extra cost and tax on realisation of those assets, or in some circumstances actual losses suffered by the client.

3.4 By way of example, consider the below real life example (with client details changed):

3.4.1 Jane Smith works in the Pilbara in WA as a Fly In Fly Out Worker.

3.4.2 Using a loan from a private company that she controls, Jane acquired a property for investment purposes in Port Hedland to rent.

3.4.3 As she held sufficient equity in her main residence, she was able to implement the loan from her company on complying Division 7A terms under a 25 year loan agreement.

3.4.4 Since the mining downturn, the following has occurred:

3.4.4.1 Jane has seen a reduction in her income from her job of around 50%;

3.4.4.2 The value of the property has dropped by 60%;

3.4.4.3 Rental return on the property has been reduced to a quarter and there are long periods where the property is not rented.

3.4.5 If the interest rate on the Division 7A loan was increased as recommended and then the period shortened after 2 years grace period, Jane would have no capacity to service the principal and interest payments.

3.4.6 In fact the matter is worse, if Jane sells the property at a loss she will not be able to repay the company the Division 7A loan unless she sells her main residence. If she fails to do that, a deemed dividend will arise in relation to the shortfall.

3.5 Of course the reverse is also possible in some client circumstances, in that the property is sold as a profit and the taxpayer is subjected to CGT on something they would not otherwise have sold.

3.6 We also note that regardless, it is likely that extra dividends will be required to be taken by clients in order to fund the extra interest cost, resulting in extra taxation on those dividends in most circumstances.

3.7 As a final note on this point, we also request Treasury to consider the impact of the extra interest on circumstances where Division 7A compliant loans have been made to entities such as superannuation funds, and the effect on those superannuation funds of now having to pay extra interest. There is no doubt that this will result in some of those arrangements having to be unwound, and potentially result in losses to those superannuation funds.

Distributable Surplus

4. The proposed removal of the concept of a distributable surplus fails to recognise what Treasury themselves in the Consultation paper recognise as a purpose of Division 7A, in that it relates to taxed amounts so as to ensure that where access is made by shareholders or associates it is taxed at their marginal tax rate.

5. The removal of a requirement to have a distributable surplus will result in some circumstances of amounts that are not profits or gains being subject to taxation. This is a substantial departure from income tax law in Australia and fails to recognise the purpose of the distributable surplus calculation.

6. It will result in inequity and hardship to some clients. We can think of a number of circumstances where it will lead to "taxation by default" in circumstances where there has been no benefit obtained.

Period of Review

7. This proposed amendment to allow for a 14 year amendment period is the one that causes us the most concern for clients and will unduly increase compliance costs for these clients, not reduce them, which is one the stated purpose of the amendments and certainly the purpose of the Board of Taxation report on which they have been drawn.

8. The reason for this is simple, Division 7A operates in relation to private companies. Private companies by their nature are generally owned by private business persons. If the amendment period is extended to 14 years:

8.1 Clients and their advisors will have to keep their records for at least 14 years. *No other taxpayer has this obligation*.

8.2 This will add to compliance costs due to the requirement to keep these records.

8.3 We pose the question whether Treasury had considered the storage and archival costs of 14 years of records, and whether they can locate their own personal records from 14 years ago. This cost will not just be to the clients, but to their advisors who will also be required to keep those records.

8.4 A suggestion may be that the client store those record electronically to avoid those costs. In terms of that suggestion, the short-sightedness of it can be shown by asking whether Treasury is still using the same computer system, storage software, document management software from 14 years ago so that you can retrieve those records. The writer can think of four separate documents systems used by our firm over the last 14 years, two of which are no longer accessible.

8.5 This will result in uncertainty where a client is entering into a transaction to acquire an interest in a private company or unit trust which is extremely unlikely to have held those records for 14 years. They will have no certainty that their investment may be subjected to tax risk due to Division 7A matters that arose some period before their investment.

9. These are practical issues that will add enormous cost and compliance issues to private business clients.

10. On a technical analysis of the need for such a lengthy amendment period, there simply is none:

    10.1 As Division 7A currently operates and will continue to do so, the liability to assessment arises when there is non-compliance by a taxpayer.

    10.2 This is judged on an annual basis, i.e. it is not something that is judged at the end of the proposed 10 year loan for example.

    10.3 The Commissioner has 2 or 4 years to amend returns in these matters currently and identify any non-compliance. *This is to give taxpayers certainty of their affairs.*

    10.4 In the absence of fraud or evasion, there is no need for the Commissioner to be able to amend assessments for Division 7A from 14 years ago as they should be able to identify non-compliance within the current review periods.

    10.5 If there is fraud or evasion, the Commissioner has sufficient powers currently to deal with the matter under the current provisions.

11. We consider this to be the thin edge of the wedge in terms of protecting taxpayers from unnecessary and costly review by the Commissioner, and have concerns that:

    11.1 If examining a taxpayers affairs over a fourteen year period, we have no doubt that as part of that review under the auspices of Division 7A the Commissioner will use it to review other aspects of the clients they would not normally be able to look at;

    11.2 As we operate under a reverse onus for taxation litigation matters, it will be unfair to taxpayers that for these sorts of matters there is a 14 year review period where they have to provide evidence that the Commissioner is wrong, as in many cases that evidence will not be able to be produced.

12. This amendment should not be made.

Amendment to 109G(3)

13. The proposed amendment to 109G(3) is not required and will lead to complication and inequity for clients. It is proposed that 109G(3) will only operate where the amount has been taken into account in the income tax assessment of an entity or entities, as opposed to the current drafting of it where it requires there only to be a deemed dividend due to the operation of the provisions.

14. As a trustee does not receive a notice of assessment, this will mean that this exception could never apply if amended in this fashion where there had previously been a deemed dividend from a company to a related trustee.

15. Clearly that is not the purpose of 109G(3) and it should remain as currently drafted.

We would be happy to discuss any of the above points with Treasury further in person or by other means.

Yours faithfully

Brett Hart
Cleary Hoare Solicitors