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20 November 2018

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Small Business Entities and Industries Concessions Unit
The Treasury
Langton Crescent
PARKES ACT 2600

Email: DIV7A@treasury.gov.au

RE: Consultation paper: Targeted amendments to the Division 7A integrity rules

Dear Sir,

The National Tax and Accountants' Association Ltd ('NTAA') welcomes the opportunity to provide feedback in relation to a number of select consultation questions that form part of the *Targeted amendments to the Division 7A integrity rules consultation paper* (dated October 2018).

By way of background, the NTAA is a national not-for-profit association, which currently represents the interests of approximately 10,000 member firms, including tax agent practices and taxation accountants. It is our unique engagement with our members who are at the 'coal face' that allows us to identify problematic issues associated with proposed changes to tax law.

From the outset, it is important to note that the NTAA accepts that Division 7A of the ITAA 1936 ('Division 7A') is an anti-avoidance provision that has been designed to ensure that distributions of profits that are made by private companies to its shareholders (or associates of shareholders) are taxed to the recipient. As such, our feedback is predicated on the understanding that Division 7A is an integrity provision that has been introduced to safeguard against arrangements whereby profits are effectively transferred out of a company without a taxing point arising (whether that be to a shareholder or an associate thereof). Division 7A achieves this outcome by imposing a number of strict requirements that must be satisfied before a payment, loan or distribution from a private company to a shareholder (or associate thereof) avoids the application of the deemed dividend rules in Division 7A.

The NTAA has some concerns in relation to the complexity of Division 7A and the compliance costs it has have created for small business taxpayers. As such, the NTAA is overwhelmingly supportive of the Government's attempts to streamline/simplify the administrative requirements associated with this provision with certain amendments proposed in the consultation paper.

However, we do have a number of concerns in relation to certain aspects of the proposed simplification of this area of the law, which we believe may create inequities. These are outlined below:

Discussion Question 1 – Transitional rules: ***Do the proposed transitional rules result in any unintended outcomes?***

(a) Transitional rules for 25-year loans in existence as at 30 June 2019

Based on the consultation paper, it has been proposed that complying 25-year loans will be exempt from the bulk of the proposed Division 7A changes until 30 June 2021. At this time (being 30 June 2021), the outstanding value of the loan will give rise to a deemed dividend unless a 'complying loan agreement' is entered into prior to the lodgment day of the company tax return (for that year).

Practically, this means that company taxpayers that entered into a complying 25-year loan expecting to repay the principal over a 25-year period will potentially now be required to repay the principal over a substantially shorter time frame of 10 years.

Our primary concern in relation to this proposal is that this will have adverse implications for certain taxpayers that entered into a 25-year Division 7A loan agreement in good faith under the existing law.

One of the biggest challenges that confront taxpayers who entered into a 25-year loan under the original Division 7A rules (in good faith) is that they may now face additional cash flow pressure as a result of the shorter repayment term (being reduced from 25 years to 10 years). In some cases, where the 25-year loan was entered into in more recent times, the period of repayment could be over a substantially shorter period than was anticipated by the relevant parties at the time the original loan agreement was made.

Anecdotal evidence collected from our members suggests that 25-year loans were more common amongst primary producer clients. As such, imposing this provision to existing 25-year loans (albeit from 1 July 2021) is likely to impose tremendous cash flow challenges for an industry that is already facing difficult times because of the drought.

In addition, many taxpayers who entered into 25-year secured loans under the current provisions incurred substantial implementation costs. These implementation costs included arranging for a written loan agreement to be prepared, ensuring that appropriate security was provided with respect to the loan, and the cost of tax/accounting advice in relation to the agreement. If the proposed changes are enacted as proposed, not only would affected taxpayers be unable to fully benefit from costs already incurred in this regard, but they would also incur additional costs in ensuring compliance with the new law (including the cost of professional advice to determine the consequences of refinancing the 25-year loan agreement, as well as ensuring compliance with the new law).

As a result, the NTAA believes that existing 25-year loans should be fully grandfathered under the transitional rules, particularly given that affected taxpayers will have entered into financial commitments on the understanding that the 25-year term would continue to apply.

In essence, introducing the 10-year loan period for existing 25-year Division 7A loan agreements (albeit from 1 July 2021) represents a retrospective application of these changes.

In our view, it seems appropriate (and more consistent with the Government's objective of simplifying this area of the law) to abolish 25-year Division 7A loans on a prospective basis only, unless a taxpayer choses to refinance to an unsecured loan (in which case, compliance with the proposed new loan model should be required).

(b) Transitional rules for 'pre-1997 loans'

Based on the consultation paper, it appears that a pre-1997 loan will only become subject to Division 7A under the proposed new rules if the loan has not already been forgiven (e.g., because it has become statute-barred under the relevant *Limitations Act*) *and* it continues to be reported in tax returns as at 30 June 2021. On this basis, if a pre-1997 loan is either statute-barred and/or it has previously been written-off, such that the loan no longer appears in the taxpayer's financial statements, the loan will not be subject to Division 7A under the proposed changes.

Fortunately, following the release of PS LA 2006/2 (GA), many taxpayers will have already determined that a pre-1997 loan is statute-barred, and, of those taxpayers, many will have removed the loan from the company's balance sheet.

We understand that the Commissioner released PS LA 2006/2 (GA) for the purpose of advising taxpayers that statute-barred loans made prior to 4 December 1997 would not be treated by the ATO as giving rise to a deemed dividend under Division 7A (notwithstanding such a loan is technically taken to be forgiven at the time it becomes statute-barred for the purposes of S.109F of the ITAA 1936). Furthermore, we understand that, on one view, a previously statute-barred loan can be written off the balance sheet without triggering subsequent adverse Division 7A implications (i.e., as Division 7A can only apply to the first forgiveness and, therefore, even if the loan is subsequently written-off, it will not trigger Division 7A). Refer to S.109F(8) of the ITAA 1936.

As a result of the above, the NTAA believes that many pre-1997 loans will not be caught under the proposed changes to Division 7A (and, thus, will not be required to be repaid over 10 years under the new proposed loan model).

However, the NTAA still has concerns that some taxpayers have continued to record pre-1997 loans in their private company's balance sheet (and the relevant income tax return) and may not have determined whether or not a pre-1997 loan is statute-barred. In fact, in some cases, taxpayers may have continued to acknowledge the existence of a pre-1997 loan for the purpose of ensuring the loan is *not* statute-barred. This course of action may have been adopted based on advice from a professional adviser and/or because of a desire to take a cautious approach to the potential application of Division 7A.

For the following reasons, the NTAA is of the view that Division 7A should **not** apply to any pre-1997 loan (i.e., a pre-1997 loan should be excluded from the application of Division 7A):

- Legislating to ensure that all pre-1997 loans are excluded from the operation of Division 7A will remove the obligation for affected taxpayers to obtain legal advice confirming the status of the loan (as being statute-barred or otherwise). This seems like a reasonable approach given the complexity of the law in this regard (i.e., the *Limitations Act* differs between State/Territories, and that advice relating to the application of these laws can even differ from one legal professional to the next in the same State or Territory).

  This suggested approach would reduce compliance costs for impacted businesses and provide certainty.

- Additionally, it seems quite arbitrary to apply Division 7A to a pre-1997 loan simply because a taxpayer took a prudent approach in relation to this issue by continuing to acknowledge the existence of the loan (and record it in the financial statements) based on the legal uncertainty that has existed with respect to these loans.

- In our view, the NTAA's suggested approach seems more consistent with the Government's objective of simplifying this area of the law given that, in most cases, these loans will be statute-barred and not subject to Division 7A (meaning that, relatively speaking, there is little to be gained in pursuing this type of loan from a revenue perspective on the basis that it is likely that only a small number of pre-1997 loans would ultimately be caught under these changes).
- Additionally, the current proposal outlined in the consultation paper (i.e., to 'bring in' pre-1997 loans under Division 7A) would clearly have a retrospective application to transactions entered into over 20 years prior to the proposed reforms (which had been originally grandfathered). Additionally, this appears inconsistent with the approach previously taken by the ATO in PS LA 2006/2 (discussed above). Importantly, such retrospective application would impose significant cash flow difficulties on impacted taxpayers whose business and/or investment projections would not have contemplated the need to repay these loans at interest on 10-year complying terms.

Once again, we thank you for the opportunity to comment on the *Targeted amendments to the Division 7A integrity rules consultation paper* (October 2018). Should you have any queries in relation to the comments above, please contact Rebecca Morgan on (03) 9209 9999.

Kind regards,

Geoff Boxer
Chief Executive Officer
National Tax and Accountants' Association