



Australian Government

The Board of Taxation

POST IMPLEMENTATION REVIEW OF DIVISION 7A OF PART III OF THE INCOME TAX ASSESSMENT ACT 1936

Second Discussion Paper

the **board** of **taxation**
www.taxboard.gov.au

The Board of Taxation
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the **board** of **taxation**

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FOREWORD

On 18 May 2012, the then Assistant Treasurer and Minister Assisting for Deregulation announced the Board of Taxation would undertake a post-implementation review of Division 7A of Part III of the *Income Tax Assessment Act 1936*.

Division 7A was introduced in 1998 to ensure that private companies would no longer be able to make tax-free distributions of profits to shareholders (and their associates) in the form of payments or loans.

The Board welcomes the opportunity to conduct a post-implementation review of Division 7A. The Board's intention in undertaking this post-implementation review is to focus on whether the Division 7A legislation is operating as intended, in light of feedback received from relevant stakeholders, and whether its operation can be improved.

In undertaking the review, the Board has found that Division 7A interacts with other areas of the tax law, including the trust provisions, in a way that suggests that greater simplification, policy coherency and integrity could only be achieved by an examination of the broader tax framework in which Division 7A operates.

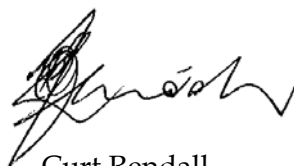
Accordingly the Board requested, and on 8 November 2013 the Government agreed to, extended terms of reference for this review.

This discussion paper is intended to facilitate public consultation and the preparation of written submissions to the Board on the broader taxation framework in which Division 7A operates, including its interaction with other areas of the tax law.

The Board expresses its gratitude to those that have provided submissions and participated in consultations and looks forward to the further involvement of stakeholders in this review.



Teresa Dyson
Chair of the Board of Taxation



Curt Rendall
Chair of the Working Group

EXECUTIVE SUMMARY

As requested by the extended terms of reference for this review, the Board has made some preliminary observations about the current policy framework in which Division 7A operates, including its interactions with other areas of the tax law.

The Board's main observation is that, in its current form, Division 7A fails in achieving its policy objectives. Moreover, the Board has found that Division 7A can be a significant source of compliance costs for businesses, even for those that operate in accordance with the policy intent of the provisions.

The Board considers that protecting the progressivity of the tax system should not be at the expense of impeding the ability of businesses to reinvest their income as working capital. Facilitating this reinvestment supports improved productivity and entrepreneurial growth. By contrast, the private use of business income serves a different purpose, namely, the enjoyment and accumulation of private wealth, in which case the progressivity of the personal income tax system needs to be preserved.

Having regard to these considerations, and consistent with the high level tax policy aims of efficiency, simplicity and equity, the Board has developed a policy framework relevant to private business that is designed to provide an appropriate balance between these competing aims. It is designed to assist in evaluating the existing regime and in developing and evaluating possible reform models.

The Board considers that the high level tax policy aims of efficiency, simplicity and equity will be served by adopting a policy framework for private businesses that supports the progressivity of the personal tax system 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.
- 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.

Consistent with the above goals, this second discussion paper outlines five reforms to improve the operation of Division 7A.

These reforms are intended to support growth and jobs by making the system simpler, reducing compliance costs and make it easier for small businesses to reinvest business income as working capital.

The five proposed reforms outlined in this discussion paper are:

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

From:

- A complex, unpredictable system that lacks a coherent set of guiding principles and leads to inconsistent treatment of cash-based transactions (loans, payments, debt forgiveness) and transactions involving the use of company assets.

To:

- A single set of common principles for dealing with loans, payments, debt forgiveness and use of company assets.

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

From:

- A system in which the rules for calculating company profits (or distributable surplus) are complex and costly (requiring regular revaluations of assets, formally or informally, where informal valuations may lead to disputes about the values) and can lead to either double taxation or an inappropriate failure to tax certain transactions.
 - Under the current rules, distributable surplus is based on the values of assets. Valuing assets formally can involve significant costs to small businesses while informal valuations provide less certainty.

To:

- A simpler system in which:
 - asset revaluations will not be required and unrealised profits will not be taken to be distributed because company assets have been used, and
 - company profits will be tested each year to appropriately tax all transactions.

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

From:

- A system that is inflexible because it requires the principal on the loan to be repaid in equal annual instalments over the life of the loan.
- A system that requires loan terms that are either too restrictive (that is, 7-year terms for unsecured loans) or too generous (25-year terms for loans secured by real property).

To:

- A single 10-year loan period with more flexible requirements for the repayment of principal.

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

From:

- A system that imposes significant complexity where trusts retain funds distributed to companies as working capital (including adhering to ATO 'safe harbour' arrangements).

To:

- A 'tick the box' regime that will provide trading trusts with a simple option to retain funds that have been taxed at the corporate rate, providing important working capital. As a trade-off, trading trusts that make this election will be denied the CGT discount (like companies) except in relation to goodwill.
- A system that removes the uncertainty on the treatment of UPEs more generally by clarifying that all UPEs are loans for Division 7A purposes.

5. A self-correcting mechanism

From:

- A complex area of the tax law system that brings substantial compliance and administrative costs and where there is no ability for taxpayers to self-correct mistakes and omissions and which require the exercise of the Commissioner's discretion in order to avoid a deemed dividend.

To:

- A self-correction mechanism which would enable taxpayers to put in place complying loan agreements, reduce compliance and administrative costs and substantially reduce the number of cases that would require a decision by the Commissioner.

The Board proposes to undertake consultation on these reforms along with the other matters covered in this Discussion Paper.

CHAPTER 1: INTRODUCTION

BACKGROUND

1.1 On 18 May 2012, the then Assistant Treasurer and Minister Assisting for Deregulation, the Hon David Bradbury MP, announced that he had commissioned the Board of Taxation to undertake a post-implementation review of Division 7A of Part III of the *Income Tax Assessment Act 1936* (Division 7A).¹

1.2 Division 7A was introduced into the tax law in 1998. The Division applies to amounts paid or lent by a private company to a shareholder (or a shareholder's associate) and to debts owed by a shareholder (or a shareholder's associate) to a private company that are forgiven. Amounts to which Division 7A applies are treated as unfranked dividends and assessable to the shareholder or to the shareholder's associates, unless the loan, payment or forgiven debt comes within specified exclusions.

1.3 The rules were introduced as integrity provisions to prevent shareholders of private companies (or their associates) from inappropriately accessing the profits of those companies.

1.4 Division 7A is a set of rules that focuses on private (rather than public) companies.

1.5 As the Board found that much of the complexity and difficulty in relation to Division 7A related to its interaction with other areas of tax law, including the trust provisions, the Board considered that the scope of the review needed to be broadened and requested an adjustment to the terms of reference and an extended reporting date.

1.6 On 8 November 2013, the Assistant Treasurer, Senator Arthur Sinodinos AO, announced that the Board of Taxation will extend its review of Division 7A to include the broader tax framework in which private business operates and provide its report to the Government by 31 October 2014.

1 Unless stated otherwise, any legislative reference in this discussion paper is to the *Income Tax Assessment Act 1936* (ITAA 1936) and any reference to a Division is a reference to a Division of Part III of that Act.

EXTENDED TERMS OF REFERENCE

1.7 The extended terms of reference acknowledge that Division 7A is part of a broader tax framework in which private business structures operate. The extended terms of reference now allow the Board to examine this broader framework. The Board is also no longer restricted to a 'revenue neutral' or 'near revenue neutral' outcome. However it should take into account the revenue implications of various options and, where appropriate, suggest approaches that minimise any revenue cost.

1.8 The extended terms of reference are set out below:

The Board of Taxation is currently undertaking a post-implementation review of Division 7A of Part III of the *Income Tax Assessment Act 1936* (Division 7A).

Division 7A contains integrity provisions designed to prevent shareholders (or their associates) of private companies from inappropriately accessing the profits of those companies in the form of payments, loans or debt forgiveness transactions.

Division 7A is part of a broader tax framework in which private business structures operate. Within this context the Board should:

- examine the broader taxation framework in which Division 7A operates including its interaction with other areas of the tax law;
- examine whether there are any problems with the current operation of Division 7A that are producing unintended outcomes or disproportionate compliance and administration costs; and
- to the extent that there are problems, recommend options for resolving them so that, having regard to the policy intent of Division 7A and potential compliance and administration costs, the tax law operates effectively.

The Board's report should take account of the revenue implications of various options and, where appropriate, suggest approaches that minimise any revenue cost.

In undertaking this review the Board should seek public submissions and consult widely.

The Board should report to the Government by 31 October 2014.

THE REVIEW TEAM

1.9 The Board appointed a Working Group of its members comprising Curt Rendall (Chair of the Working Group), Keith James and Elizabeth Jameson to oversee the review and Mark West (Partner, McCullough Robertson), a member of its Advisory Panel. The Working Group is being assisted by members of the Board's Secretariat, the Treasury and the Australian Taxation Office (ATO).

1.10 The Board has also received assistance in the development of this discussion paper from Mark Molesworth (Tax Partner, BDO) and from Alexis Kokkinos (Partner, Pitcher Partners).

1.11 The position and affiliations of the Board's members are listed on the Board's website.

STRUCTURE OF THIS DISCUSSION PAPER

1.12 This second Discussion Paper has been structured in response to the extended terms of reference given to the Board. It supplements the earlier December 2012 Discussion Paper.

1.13 In response to the December 2012 Discussion Paper, the Board received 19 submissions of which three were confidential. A list of the non-confidential submissions received is provided in Appendix A.²

1.14 Chapter 2 of this discussion paper provides an historical overview of the policy framework for Division 7A in the context of the broader system within which it operates, as required by the extended terms of reference.

1.15 Chapter 3 then discusses how business practice has responded to the current policy environment and includes some practical examples.

1.16 In Chapter 4 the Board advances its preliminary thinking on the deficiencies of the current provisions and suggests a more coherent policy framework, based on four key principles, for guiding future reform.

1.17 As part of this proposed policy framework, Chapter 4 outlines two key elements of a new model that could replace the existing provisions: common rules for the treatment of loans and the private use of assets, and a new method for calculating distributable surplus.

1.18 In Chapter 5 the Board provides its preliminary views on the three models that were canvassed in the December 2012 discussion paper: the *Division 7A Adjustment Model*, the *Statutory Interest Model* and the *Distribution Model*. An initial assessment of these models against the proposed policy principles is also contained in this chapter.

1.19 Appendix C of this discussion paper adds to the provision-by-provision analysis of Division 7A as contained in Chapter 4 of the December 2012 discussion paper. It includes problems identified since that discussion Paper was issued in December 2012.

2 Submissions are provided in full on the Board's website (*see* www.taxboard.gov.au).

1.20 In Chapter 6 the Board builds further on the new framework outlined in Chapter 4 and proposes three further components of a new model to replace the existing provisions: a new, simplified regime for complying loans; a limited exclusion for the application of Division 7A to UPEs owed by trusts that ‘tick the box’ and forgo access to the capital gains tax (CGT) discount on the disposal of assets; and the availability of a self-correcting mechanism.

CONSULTATIONS

Making Submissions

1.21 The purpose of this second discussion paper is to give stakeholders an opportunity to address the wider terms of reference as set out in paragraph 1.8 and the issues and questions outlined in this discussion paper (a full list of questions is at Appendix B). It is not expected that each submission will necessarily address all of the questions raised in the discussion paper.

1.22 The closing date for submissions is Friday 9 May 2014. Submissions can be sent by:

Mail to: The Board of Taxation
 c/ The Treasury
 Langton Crescent
 CANBERRA ACT 2600

Fax to: 02 6263 2617

Email to: taxboard@treasury.gov.au

1.23 Stakeholders making submissions should note that Board members, the review team, and those assisting it, will have access to all submissions including confidential submissions. All information (including name and contact details) contained in submissions may be made available to the public on the Board’s website unless it is indicated that all or part of the submission is to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like only part of their submission to remain in confidence should provide this information marked as such in a separate attachment. A request for a submission to be made available under the *Freedom of Information Act 1982* (Commonwealth) that is marked ‘confidential’ will be determined in accordance with that Act.

The Board’s report

1.24 The Board will consider the issues raised by stakeholders in their submissions and in consultation meetings. However, the Board’s report and its recommendations will reflect the Board’s independent judgment.

1.25 The Board has been requested to provide its report to the Government by 31 October 2014.

CHAPTER 2: POLICY FRAMEWORK FOR DIVISION 7A

2.1 To understand Division 7A it is important to understand both the Division itself and the income tax framework in which the provisions are found.

2.2 This chapter has two sections. The first section, Historical/policy context of Division 7A, highlights the key changes in tax policy and practice over several decades that have led to the emergence of a preferred structure for private companies to achieve tax effectiveness for their owners. While these structures vary considerably, at their core they often have a trust earning income and then distributing to a company, rather than directly to an individual.

2.3 The most notable changes in policy that have brought this about have been:

- the introduction of dividend imputation;
- the removal of the sufficient distribution regime;
- the emergence of a gap between personal and corporate tax rates;
- the introduction, and amendment over time, of the small business CGT concessions;
- changes to CGT that were made in 1999;
- the increasing acceptance of carrying on a business in a trust and the commercial and tax effectiveness of this compared to a company; and
- changes to dividend imputation in 2000 to make franking credits refundable.

2.4 The second section, Overview of Division 7A, discusses the history and policy of Division 7A and examines some of its important effects and interactions. The interaction between Division 7A and the trust taxation provisions, in particular the use of unpaid present entitlements, is discussed at some length.

HISTORICAL/POLICY CONTEXT OF DIVISION 7A

2.5 A detailed discussion on the historical overview of the policy framework for Division 7A is contained in the Board's December 2012 discussion paper.³ However, a brief summary is provided below.

2.6 From 1934 to 1986, Australia maintained a classical company taxation system, under which corporate profits were taxed at the corporate level, and dividends were taxed in the hands of the shareholders without any credit allowed for the corporate tax. The corporate tax rate was significantly lower than the top marginal personal tax rate, which encouraged the accumulation of profits in private companies.

2.7 To discourage the accumulation of profits in private companies, a sufficient distribution regime was introduced in the form of Division 7 in 1938. It provided for different types of income to be distributed to shareholders in different percentages. Income not distributed in accordance with the requirements was subject to an 'undistributed profits tax' at the rate of 50 per cent, a rate higher than the then company tax rate. Division 7 sought to deter the accumulation of excessive profits in private companies so as to avoid tax which shareholders would otherwise pay if such profits had been distributed to them.

2.8 Division 7 acknowledged that businesses needed to retain funds for working capital purposes. And over the years the percentage of active business income that could be retained without attracting undistributed profits tax moved from 33.33 per cent to 80 per cent. By contrast, only 10 per cent of passive income – including public company dividends, rent, interest and trust distributions – could be so retained.

2.9 Thus, until 1987, the additional tax prescribed in the legislation created a clear disincentive for private companies to retain funds for working capital over and above the acceptable retention percentages.

2.10 Division 7 also included another provision, section 108, that was designed to ensure that the profits able to be retained by the company without being subject to the undistributed profits tax could not be distributed to shareholders or their associates in a tax-free form.

2.11 Section 108 provided that an amount paid or the value of assets distributed by a private company by way of advances or loans to its shareholders, or payments on behalf of or for the individual benefit of any of its shareholders, would be treated as a dividend if, in the opinion of the Commissioner of Taxation (Commissioner), they

3 The Discussion Paper can be accessed from the Board's website at http://www.taxboard.gov.au/content/content.aspx?doc=reviews_and_consultations/division_7A/default.htm&pageid=007.

represented a distribution of profits. It sought to prevent the avoidance of tax by the use of disguised dividend distributions.

2.12 The classical system of company taxation was replaced on 1 July 1986 by the imputation system. Imputation gives resident shareholders a credit for tax paid at the company level, effectively removing any double taxation for them. Where the resident shareholder's marginal rate is below the company tax rate, the excessive credit can be used to offset other taxes.

2.13 The introduction of the imputation system was accompanied by the alignment of the company tax rate and the top marginal tax rate for individuals at 49 per cent. This removed the potential for tax deferral benefits that might have been achieved by accumulating amounts in a private company (rather than distributing to individuals). There was no longer any practical consequence arising from the undistributed profits tax and it was repealed (subject to transitional arrangements).

2.14 Section 108 was retained to deal with profits that had been accumulated under the pre-imputation arrangements and with disguised distributions of profits that otherwise would have been paid out as unfranked dividends. About the same time, section 108 was also strengthened so that certain loans or advances, or credits to associated persons, could be assessed as dividends.⁴

2.15 It is important to note that prior to 1990 it was not common practice in Australia for trusts to distribute profits to companies. As noted, under Australia's classical tax system, trust distributions were regarded as passive income and subject to undistributed profits tax for a corporate beneficiary. After the repeal of the sufficient distribution regime, the alignment of the company tax rate and top personal marginal tax rate largely preserved the disincentive for trusts distributing income to companies.

2.16 However the company tax rate and the top marginal tax rate were only briefly aligned. The company tax rate was cut to 39 per cent with effect from 1 July 1988 and, since that time, has generally declined to its current rate of 30 per cent. This decline reflects a government policy of ensuring that the corporate tax system is internationally competitive, thereby enhancing the ability of Australian business to access international capital markets.

2.17 In comparison, in the period since 1980, the top marginal rate of tax has fluctuated from a high of 60 per cent (before the Medicare levy was introduced) to its current level of 46.5 per cent (including Medicare levy).

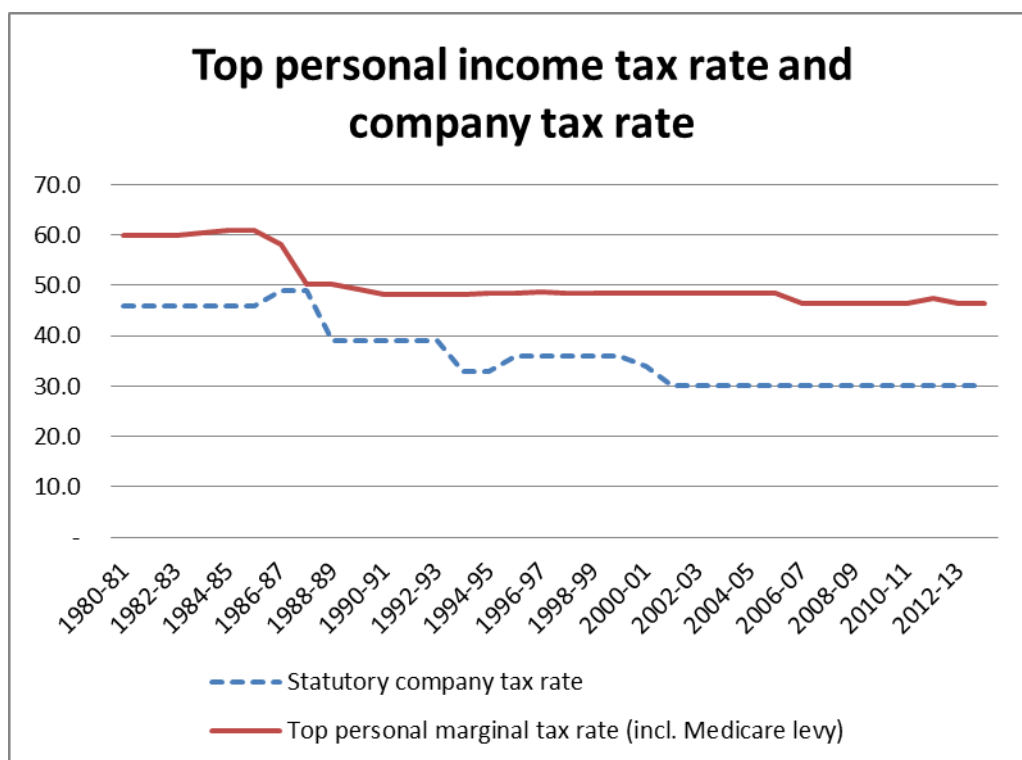
2.18 The successive fall in the rate of company tax meant that the withholding function of company tax became less effective in terms of income tax progressivity. The

4 The provision was amended in June 1987 by the *Taxation Laws Amendment Act (No.3) 1987*.

greater the gap between the rate of company tax and higher marginal tax rates, the greater the incentives are to accumulate profits in private companies rather than distributing them to shareholders. The effect of the accumulation is to postpone the levying of the appropriate 'top-up' tax (that is, the difference between the individual shareholder's marginal tax rate and the corporate rate). The Board observes that, currently, after tax profits can be retained within companies and be reinvested without being subject to the personal tax system.

2.19 The widening gap between the company tax rate and the top marginal rate, coupled with the lack of a sufficient distribution regime, represents a challenge for the progressivity of the tax system. In theory, progressivity is restored when, on distribution of a company's profits, individual shareholders on high marginal rates pay the appropriate 'top-up' tax. However, such distributions can be postponed indefinitely, giving shareholders the deferral advantage of a 'capped' tax rate.

2.20 The incentives associated with the gap between the company tax rate and the top marginal rate are illustrated in the following chart. It shows the difference between the company rate and the top marginal rate from 1981 to the present.



2.21 Successive government reviews of the tax system have recommended reducing the corporate tax rate in Australia. The 1999 *Review of Business Taxation* recommended a phased reduction of the company tax rate to 30 per cent. That review considered that a 30 per cent rate offered structural advantages by aligning the company tax rate with

the 30 per cent marginal tax rate applicable to most individual taxpayers and making the headline rate of corporate tax internationally competitive.⁵

2.22 In 2009, *Australia's Future Tax System* recommended that the company income tax rate be reduced to 25 per cent over the short to medium term, suggesting that this would ensure Australia would remain an attractive place to invest.⁶ This policy is consistent with global company tax rate trends.

2.23 In 2012, the Government's Business Tax Working Group noted that Australia's company tax rate is already higher than that of most OECD countries and that many of those countries are actively pursuing further rate reductions.⁷

2.24 In a global environment where company tax rates are falling, an increasing gap between corporate and personal rates of tax heightens the need to consider how the progressivity of the tax system is protected.

Capital gains tax

2.25 A second important factor that has a major impact on how private businesses choose to structure themselves is the current policy settings around capital gains tax CGT.

2.26 The CGT rules were introduced in 1985 and applied to realised gains and losses on certain assets acquired after 19 September 1985. From 1985 to 1999, an indexation system applied, so that only real, and not nominal, gains were taxed. An averaging system was also in place to reduce the impact of progressive income tax on realised gains over a period of years. In 1999, the system of indexation and averaging was effectively replaced by a broad-based CGT discount for individuals, complying superannuation entities and trusts.⁸ These changes were implemented in response to the recommendations of the *Review of Business Taxation*.

2.27 The CGT discount allows individuals and trusts to exclude 50 per cent of capital gains made on assets held for at least 12 months, while complying superannuation funds are able to exclude one third of such capital gains. Companies, however, do not benefit from this CGT discount treatment.⁹

5 Review of Business Taxation, *A Tax System Redesigned, More Certain, Equitable, and Durable*, 1999, 424-425.

6 *Australia's Future Tax System*, Part One Overview, Report December 2009, 40.

7 The Australian Government, the Business Tax Working Group, Draft Final Report (October 2012), 3.

8 Division 115 of the ITAA 1997. Under the changes, indexation was preserved for entities that did not qualify for, or preferred to forgo, the CGT discount. However, indexation was 'frozen' as at 20 September 1999.

9 Review of Business Taxation, *A Tax System Redesigned, More Certain, Equitable and Durable*, Report (July 1999), 595-607.

2.28 While capital gains derived by a trust can be initially discounted by 50 per cent, special rules apply so that the CGT discount is traced through to the ultimate beneficiaries that receive the capital gains. This mechanism allows the appropriate CGT discount percentage to be applied by the ultimate individuals (50 per cent) or superannuation funds (33.33 per cent) that receive the capital gain. Corporate beneficiaries that receive capital gains through trusts are required to reverse the CGT discount amount.

2.29 The rules governing the availability of the CGT discount have contributed to a practice in which discretionary trusts are settled with both corporate and individual beneficiaries. Distributions can be made to individuals to take advantage of low personal marginal rates and to preserve the CGT discount and to companies to 'cap' the tax at the corporate rate.

2.30 Prior to 1999, a significant benefit (from a tax perspective) of operating a business in a trust was the ability to vary distributions between beneficiaries to achieve tax-effective outcomes. The CGT changes introduced additional incentives to do so.

2.31 It should be noted that the Review of Business Taxation's recommendations which led to these changes were made in the context of the then Government proposal to tax most trusts like companies. Accordingly, it was not envisioned at that time that trusts would be able to pass the benefit of the CGT discount on to beneficiaries. Under the proposal, flow-through taxation (and access to the discount) would only be preserved for a narrow class of 'excluded trusts', that is, trusts created to satisfy a practical or legal obligation such that the option of using a non trust structure was unavailable.

2.32 It was noted in the Review that 'an individual taxation treatment benchmark for excluded trusts is appropriate to reflect the nature of excluded trusts, including the limited potential for such trusts to be used for commercial activities and for the interests in such trusts to be sold'.¹⁰

Refundable franking credits

2.33 Another policy change that has acted to further increase the incentive to accumulate profits in private companies rather than distributing them to shareholders was the decision in 2000 to allow franking credits to be refunded. This was adopted on the recommendation of the Review of Business Taxation and was designed to ensure that taxpayers are taxed at their appropriate marginal rates of tax on assessment.¹¹

10 Review of Business Taxation, *A Tax System Redesigned, More Certain, Equitable and Durable*, Report (July 1999), 546.

11 Review of Business Taxation, *A Tax System Redesigned, More Certain, Equitable and Durable*, Report (July 1999), 421.

2.34 Effectively this increased the incentives for corporate profits to be banked in private companies and paid out to shareholders when it is tax-effective to do so. That is, franking credits can be accumulated during years where the shareholders' income is high and paid out when the shareholders' personal marginal rates have dropped below the company tax rate. The benefits of this strategy generally outweigh the reduction in value of the franking credits over time because of inflation and the risk of franking credits being 'trapped' if the company becomes insolvent and is unable to pay a dividend.

OVERVIEW OF DIVISION 7A

2.35 Division 7A of Part III of the ITAA 1936 was introduced with effect from 4 December 1997, effectively replacing section 108.¹² Division 7A replicated the main elements of section 108 and had broadly the same legislative purpose.¹³ However, unlike that provision, the main operative provisions of Division 7A apply automatically without the need for a determination by the Commissioner. It was considered that the requirement for a determination made section 108 difficult to administer and that many loans that should have been taxed as dividends were not being so taxed. Division 7A was designed to overcome this limitation by being self-executing.¹⁴

2.36 As noted above, Australia has a progressive system of taxing personal income and its current features, to differing degrees and in different ways, seek to support this progressivity without the explicit method found in the sufficient distribution rule under the former Division 7.

2.37 The trust tax provisions are one example of the measures introduced to protect progressivity. These include section 99A, and Divisions 6AA and 6A.

2.38 Division 7A supports progressive taxation, albeit in a different way to the trust provisions, by ensuring that private company profits that are enjoyed privately by shareholders are taxed at their personal marginal rates of tax.

2.39 Consistent with section 108, Division 7A supports progressivity by treating certain non-commercial loans as dividends. Loans accepted as being on a commercial footing (because they are either repaid or meet minimum interest rate, maximum term

12 The commencement of some of the operative provisions was postponed. This included section 109UB (certain trust amounts treated as loans) which commenced on 27 March 1998.

13 Section 108 was not repealed when Division 7A was enacted although it only had residual operation, effectively having been replaced by Division 7A with regard to transactions occurring on or after December 1997. It was subsequently repealed (by Act No 79 of 2007) with application to assessments for the income year in which 1 July 2006 occurred and in later years.

14 Explanatory Memorandum to Taxation Laws Amendment Act (No. 3) 1998, paragraph 9.10.

and minimum yearly repayment requirements by the relevant lodgment day) are excluded from being treated as dividends.

2.40 Unlike Division 7, Division 7A does not explicitly seek to deter accumulation of income by companies. However, in practice Division 7A, like Division 7, encourages companies to distribute their profits in cases where shareholders or associates have accessed such profits. This is because the repayments required under Division 7A complying loans are often, of necessity, financed by the payment of dividends to the individual borrower. However, this indirect 'sufficient distribution' incentive only applies to profits that are enjoyed by shareholders or their associates and not to amounts accumulated in the company.

2.41 Trusts, unlike companies, are taxed on a flow-through basis. Section 99A imposes a flat rate of tax equal to the highest personal marginal tax rate (currently 46.5 per cent¹⁵ including the Medicare levy) where there is net income of the trust estate not assessed to a beneficiary.

2.42 The Board observes that many private group structures operate so that, in accordance with the rules in Division 6, beneficiaries are made presently entitled to all of the income of the trust, with the result that section 99A does not apply. In this regard, it is common practice for the trustee to resolve that a corporate beneficiary (a 'bucket company') will become presently entitled to any residual income to which the individual beneficiaries are not presently entitled.

2.43 These structures have the effect, initially at least, of ensuring that tax on such income is at the 30 per cent corporate rate rather than, potentially, the highest personal marginal tax rate. However, the present entitlement created in the bucket company is often not fully paid and is retained in the trust for use as working capital in a business carried on by the trustee or for other purposes such as investment in passive assets.

2.44 An unpaid (or uncalled) distribution made by a trust is referred to as an unpaid present entitlement or UPE.¹⁶ In the context of this Paper, the term UPE is used to denote UPEs of companies (as distinct from non-corporate beneficiaries).

15 Increasing to 47 per cent from 1 July 2014 as a consequence of a 0.5 per cent increase in the Medicare levy.

16 It is important to note that the amount to which a beneficiary, including a corporate beneficiary, of a discretionary trust is presently entitled is often incapable of payment at the time of the relevant resolution, for example because at that time the amount is uncertain. Payment may occur at a later time once the trusts accounts are finalised and the trustee notifies the beneficiary of their entitlement to trust income; this often occurs around lodgment of the trust tax return.

Unpaid Present Entitlements

2.45 The treatment of UPEs is, and has been, a contentious area. From 2009, the Commissioner of Taxation has taken the view, as outlined in Taxation Ruling TR 2010/3, that a UPE is capable of amounting to the provision of financial accommodation by the private company beneficiary in favour of the trust and may be a loan for Division 7A purposes.

2.46 Under this view, a subsisting UPE (which means a UPE that has not been paid to the entitled beneficiary) is a loan under the extended definition of that term in Division 7A if it is the provision of financial accommodation or an in-substance loan. An example where a company may provide financial accommodation or an in-substance loan is where it knows that the funds representing its present entitlement remain intermingled with other funds of the trust estate, or are otherwise able to be used for 'trust purposes'.

2.47 The ATO accepts that, if funds representing the UPE are used only for the private company's sole benefit, the private company does not provide financial accommodation in respect of that UPE because the trust receives no pecuniary aid or favour from the private company. Therefore, there is no loan for Division 7A purposes.

2.48 Administrative guidance and safe harbours on the evidentiary requirements for UPEs that are used solely for the private company's benefit can be found in ATO Law Administration Practice Statement PS LA 2010/4. The Commissioner accepts in this practice statement that no loan will arise where the funds are placed on sub-trust for the sole benefit of the private company beneficiary and the trustee adopts one of the investment options set out in the practice statement. These options include investing the funds in a 7 or 10-year interest only loan or in a specific income-producing asset or investment.

2.49 In comparison to the complying loan requirements of Division 7A, there are significant cash flow advantages that arise from the fact that the principal under the 7 and 10-year loan options in the practice statement do not have to be repaid until the end of the investment term. By contrast, a complying Division 7A loan arrangement requires minimum yearly repayments of principal and interest.

2.50 Where UPEs continue to remain unpaid they effectively enable trusts to be financed out of profits taxed at the corporate tax rate. Accordingly, trusts that carry on business can finance themselves out of profits taxed at this rate rather than, potentially, the 46.5 per cent tax rate. However, UPEs also effectively allow income taxed at the corporate rate to be used by the trust to acquire assets that are eligible for the CGT discount on later disposal.

2.51 The application of TR 2010/3 and the accompanying practice statement has been a source of controversy, with some stakeholders considering that the view set out by the Commissioner is not a technically correct interpretation of the current law and expressing dissatisfaction with the ATO's departure, albeit prospectively, from its longstanding administrative practice in relation to these circumstances.

2.52 The safe harbours contained in the practice statement provide a practical solution for trusts with active business operations that need to fund working capital through previously taxed profits (that is, UPEs).

2.53 However, as the safe harbour terms are arguably significantly more generous than the 'complying loan' terms, the practice statement preserves the incentive for using UPEs for purposes other than to fund active business operations. The use of UPEs for these other purposes is inconsistent with progressive taxation.

2.54 At the same time, the safe harbours impose additional compliance costs when compared to the Commissioner's prior administrative practice, including for those trusts that use UPEs solely as a source of working capital.

2.55 Large, well-advised businesses are often able to take advantage of, or structure around, the provisions while smaller taxpayers and small business generally continue to suffer the uncertainties and traps of Division 7A.

2.56 In certain situations, trust activities can also be financed by a company within a private group without the use of UPEs. Alternative methods of financing the activities – albeit typically of an active nature – include the company acquiring and leasing plant and equipment, providing trading stock (on a consignment basis) and factoring receivables. These financing techniques are not generally available to smaller businesses because of prohibitive set-up costs.

CHAPTER 3: TYPICAL BUSINESS STRUCTURES

3.1 Having regard to the tax and regulatory landscape in which small business operates, it is clear that small business owners, in making choices between the different structures that are available, must weigh up a wide range of factors. These include the need to ensure the viability of the business, including its ability to access finance on competitive terms as well as private considerations such as personal wealth accumulation and succession planning. While tax considerations are important drivers of business structuring, other factors often have to be considered as well.

3.2 The current framework of tax rules (including those outlined in the previous chapter), and other non tax considerations, create an incentive for private groups to use a combination of entities and employ particular distribution policies to suit their circumstances. As noted in the Treasury's Architecture of Australia's tax and transfer system paper:

In practice, both small and large businesses will often own assets and operate businesses using a combination of entities for both tax and non-tax reasons, and will choose distribution and asset disposal strategies that best suit the particular entity or entities used.¹⁷

3.3 The paper went on to say:

For example, a business may operate through a partnership to allow for outside investment, business succession, and losses to flow through to partner level. Partnership interests may be held by non-fixed trusts (such as discretionary trusts) to allow for income splitting, with a company among the trust beneficiaries to allow income to be retained in a company when advantageous. Another non-fixed trust may own the partnership business assets to protect them from business risks and maximise access to CGT concessions. In addition, trustees may themselves be companies to limit the trustee's liability.¹⁸

3.4 A choice to include a private company in a structure requires weighing the complexity and compliance costs associated with the structure against the tax and other benefits that the structure offers. That is, a decision must be made on whether the compliance costs dealing with the tax and governance arrangements that apply to

17 The Treasury, Architecture of Australia's tax and transfer system (2008), 257.

18 Ibid., 258.

companies are sufficiently offset by the tax deferral and other benefits (such as separate legal identity) that may be available to a company.

STRUCTURING CONSIDERATIONS

3.5 A decision to operate a business using a particular structure or entity is generally driven by a range of considerations. Personal, family or commercial considerations relating to the need to provide for asset protection, privacy, or to limit personal liability may be important.

3.6 Business life cycle considerations are also important. For example, the need for flexibility, particularly at the start-up stage, may be highly valued, while key staff transition into a business. The ability to retain working capital to reinvest in and grow an operating business may also be desired.

3.7 Ease of entry and exit are also important considerations. For example, the company generally has been the favoured structuring vehicle for the ease of entry and exit of investors where the shares in the company can be expected to be readily able to be sold. In those circumstances, new or existing shareholders are able to acquire or dispose of their interest in a company with no CGT impact on continuing shareholders.¹⁹

3.8 In practice, however, there is often no ready market for shares in a company carrying on a small business. Prospective buyers of a small business are generally reluctant to assume the risks associated with purchasing the company, and prefer instead to purchase the business assets (including goodwill) directly. The effect of a direct asset sale by a company is that the shareholders forgo the significant benefit of the 50 per cent CGT concession. Small business operators therefore have an incentive to operate through a trust, to ensure that this concession is preserved when business assets are sold.

3.9 As discussed above, a key factor in structuring decisions is the differential between the corporate tax rate (currently 30 per cent) and the marginal tax rates for individuals (the highest marginal tax rate is currently 46.5 per cent, including the basic Medicare levy).

3.10 As also discussed above, another key tax factor relevant to the consideration of a business structure arises out of the fact that the tax treatment of capital gains differs depending on the type of entity and size of the business group. Where there is a potential for deriving capital gains, a trust would be the preferred structure of choice, principally for CGT and asset protection purposes

¹⁹ Subject to the potential operation of integrity rules including the general value shifting regime (GVSR).

3.11 Since the ‘Simpler Super’ changes in 2007, the use of self-managed superannuation funds (SMSFs) as another type of investment vehicle, is also a key consideration in small business structuring, with particularly attractive taxation advantages.

3.12 The various advantages and disadvantages of a particular entity make it attractive to combine structures, utilising advantages offered by more than one structure (for example, for **companies**: taxation at the 30 per cent corporate tax rate and limited liability; for **trusts**: access to discount capital gains, asset protection and flexibility; and for **superannuation funds**: taxation at the 15 per cent tax rate and access to the CGT discount and refundable franking credits).

3.13 The use of different structures in closely-held businesses is particularly relevant to the design and ongoing operation of Division 7A. In particular, a family-owned business may use a combination of discretionary trusts and private companies. As noted in the previous chapter, a common form of structuring is the so-called ‘bucket company’ structure, which is the use of a private company beneficiary to cap tax at the 30 per cent corporate rate.

3.14 Given the CGT advantages of trusts, their flexibility as to distributions, and the availability (subject to meeting safe harbour requirements) of bucket company arrangements, it is not surprising that trusts have become a vehicle of choice in structuring.

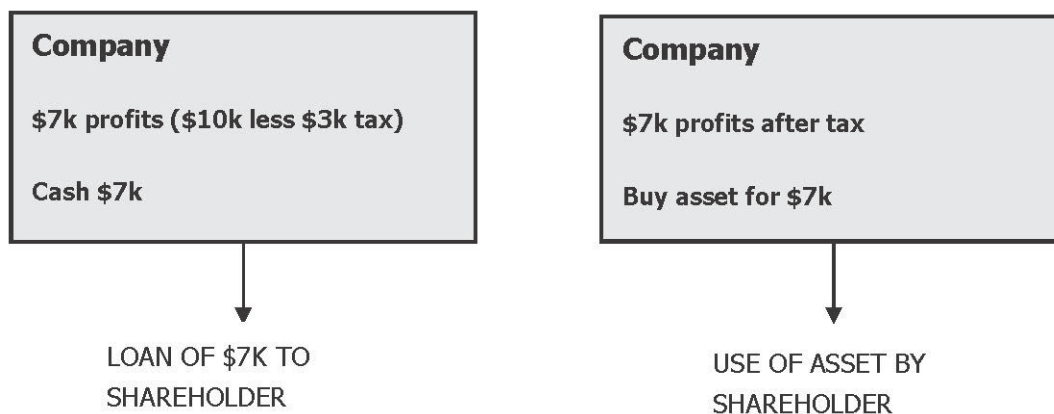
3.15 However, the prevalence of bucket company arrangements in the small business sector should not be overstated. According to ATO statistics, of the 788,983 companies that lodged tax returns in the 2011 year of income, only 59,209 reported receiving distributions from trusts. That said, the amount distributed to corporate beneficiaries is significant – \$28 billion in 2011 – and the Board understands that bucket company arrangements are a vehicle of choice for higher value small and medium enterprises.²⁰ Under the tax regime as it operated prior to 1990, it is likely that the amounts distributed to corporate beneficiaries would have been negligible.

Operation of Division 7A: Examples of its effect on common situations and business structures

3.16 The following section contains three stylised examples of how Division 7A operates. These will be followed by two further, more complex examples that are intended to serve as practical illustrations of how Division 7A and other tax considerations might influence business structuring decisions. Each example assumes that the private company has available profits (and sufficient ‘distributable surplus’ within the meaning of the current Division 7A).

²⁰ ATO, Taxation Statistics 2010-11 (2013).

1. Temporary access to company profits



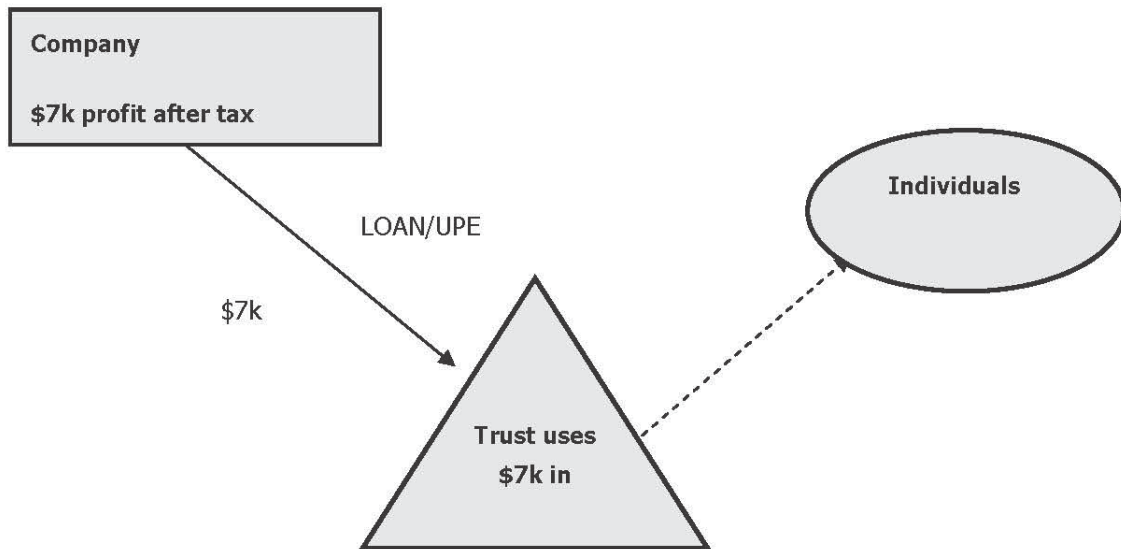
3.17 The diagram above is a simplified example of how Division 7A operates in accordance with its policy objective, to ensure that corporate profits are not accessed by shareholders (or their associates) without being subject to the appropriate rate of tax.

3.18 In this example, a private company makes a loan to a shareholder during the year. If the loan is not fully repaid before the lodgment day for the current year, the private company will be deemed to have paid the shareholder a dividend, unless the loan arrangement is formalised with a complying loan agreement before the lodgment date for that year of income. A complying loan is one that includes a minimum statutory interest rate, a maximum term and minimum yearly repayment requirements (principal and interest).

3.19 Where a private company purchases an asset for use by a shareholder or associate it will also attract the application of Division 7A. Subject to certain exclusions, all payments made by a private company to, on behalf of or for the benefit of, a shareholder (or their associate) result in the private company being deemed to have paid a dividend to the recipient of the payment.

3.20 For the purposes of Division 7A the definition of 'payment' has been extended to include the provision of an asset for use (other than transfer of property) by an entity. In the example above, with effect from 1 July 2009, under the extended definition of payment the company will be deemed to have paid a dividend through the provision of an asset for personal use by the shareholder.

2. Business operated in trust — extension of company business



3.21 The second diagram is an example of how Division 7A extends to structuring arrangements involving companies and trusts. It involves a trust that earns income to which it makes a corporate beneficiary presently entitled.

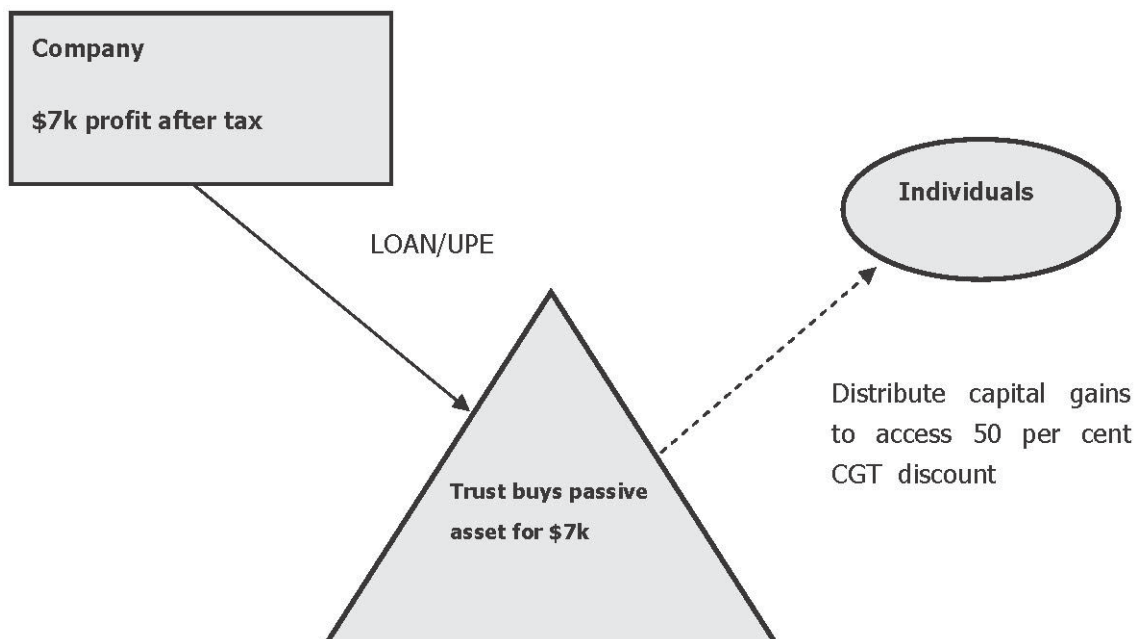
3.22 To the extent that the cash to which the company has been made presently entitled is retained in the trust to be used for trust purposes and not for the benefit of the private company beneficiary (in this example, \$7,000 after tax), the UPE may be treated as financial accommodation and therefore a loan for Division 7A purposes.²¹

3.23 A UPE that is treated as a loan will give rise to a deemed dividend from the private company to the trust unless it is placed under a complying Division 7A loan agreement.

3.24 The trustee can avoid the UPE being treated as a loan (and therefore avoid the UPE itself being deemed to be a dividend) by using the funds for the sole benefit of the private company. The Commissioner accepts this requirement is met where the funds are placed on sub-trust for the sole benefit of the private company beneficiary and the trustee adopts one of the three investment options set out in PS LA 2010/4. These include investing the funds in a seven or 10-year interest-only loan or in a specific income-producing asset or investment.

21 In these cases, the Commissioner would not also seek to apply Division 7A to the payment made from the trust to the individuals. This is the case despite the absence of specific anti-overlap rules to deal with this in Division 7A itself: see paragraph 182 of TR 2010/3 and TD 2011/16.

3. Passive assets held in trust



3.25 As outlined above, it is still possible for trusts to continue to use the funds retained through UPE arrangements for active business purposes and avoid the operation of TR2010/3, if funds are held in a sub-trust. The trustee may then invest the sub-trusts funds back into the main trust on commercial terms, providing the main trust with access to those funds for working capital.

3.26 There is no restriction on how the funds can be used, once reinvested in the main trust. However, if the funds are not used by the main trust for business or other income-producing purposes, the interest paid to the sub-trust is not deductible to the main trust.

3.27 The safe harbours available in PS LA 2010/4 have somewhat contributed to preserving the incentives associated with retaining funds in the trust through UPE arrangements.

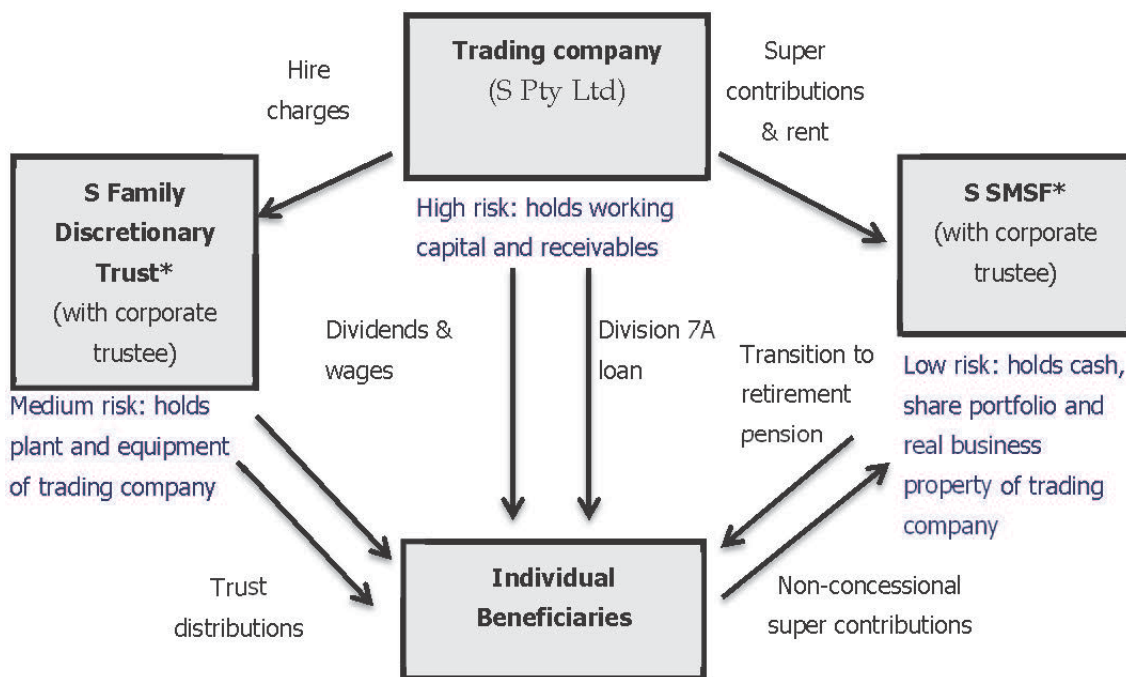
3.28 The investment options set out in the practice statement operate to treat UPEs more favourably than distributions in the form of loans, payments or debt forgiveness caught by the operation of Division 7A, which are placed under a complying Division 7A loan arrangement. Of note are the potential cash flow advantages that arise from the fact that the seven and 10-year loan options do not require repayment of principal until the end of the loan term.

3.29 Furthermore, where the trust acquires a personal asset using the UPE, beneficiaries can use that asset in almost all cases without attracting the extended

operation of the ‘payment rules’.²² Accordingly, where the passive asset is also a personal asset, the UPE can be used for personal purposes without attracting the further application of Division 7A.

3.30 Where the funds are applied for passive investment purposes, for example used to invest in land or equity (see the diagram above), the safe harbours are equally applicable. For example, the 10-year loan option presents significant advantages, where the prospect of replacement arm’s length finance exists at the end of the 10-year period. Furthermore, as the investment activity is conducted through the trust, the flexibility to access the general 50 per cent CGT discount is maintained, while capping income at the corporate tax rate.

4. Practical illustration — business carried on through a company



3.31 The diagram above is an illustration of the fictional S Family Group, a manufacturing business. It has three different entity structures, each performing a specific and identified activity.

3.32 The day to day business activities are operated through S Pty Ltd (the trading company). Mr S is the sole shareholder, director and secretary of S Pty Ltd. S Pty Ltd holds the working capital and receivables of the business and pays the dividends and wages. As the business (the high risk entity) is operated within the corporate structure, Mr S is offered protection from any liabilities incurred by the company. Mrs S holds all personal assets offering additional protection against creditors.

²² This is because subsection 109XA(1) is limited to ‘unrealised reserves’.

3.33 Under the corporate structure the business obtains the benefit of limiting tax at the corporate rate without having to distribute profits out of the entity. If the business were operated through the discretionary trust, it would only be possible to achieve the cap of the corporate tax rate by distributing the profits to a corporate beneficiary at the point where the tax on distributions to individuals would exceed the corporate rate. However, caution would have to be taken not to attract Division 7A or, if it does apply, to comply with its requirements.

3.34 The plant and equipment used in the business operations are held in the S Family discretionary trust (the medium risk entity). The discretionary trust hires out the plant and equipment to S Pty Ltd on commercial charge-out rates, effectively separating the assets from the trading company. This provides added protection, by reducing the businesses assets at risk.

3.35 To further minimise the business risk to Mr and Mrs S, the discretionary trust operates through a corporate trustee, STP Pty Ltd, of which Mrs S is sole director and shareholder. The income generated by the discretionary trust is distributed to the individual beneficiaries – Mr and Mrs S and their four children, Charlie (29 years), David (23 years), Ella (17 years) and Felix (15 years) – ensuring that total income for significant individuals remains below the top marginal tax rate for individuals.

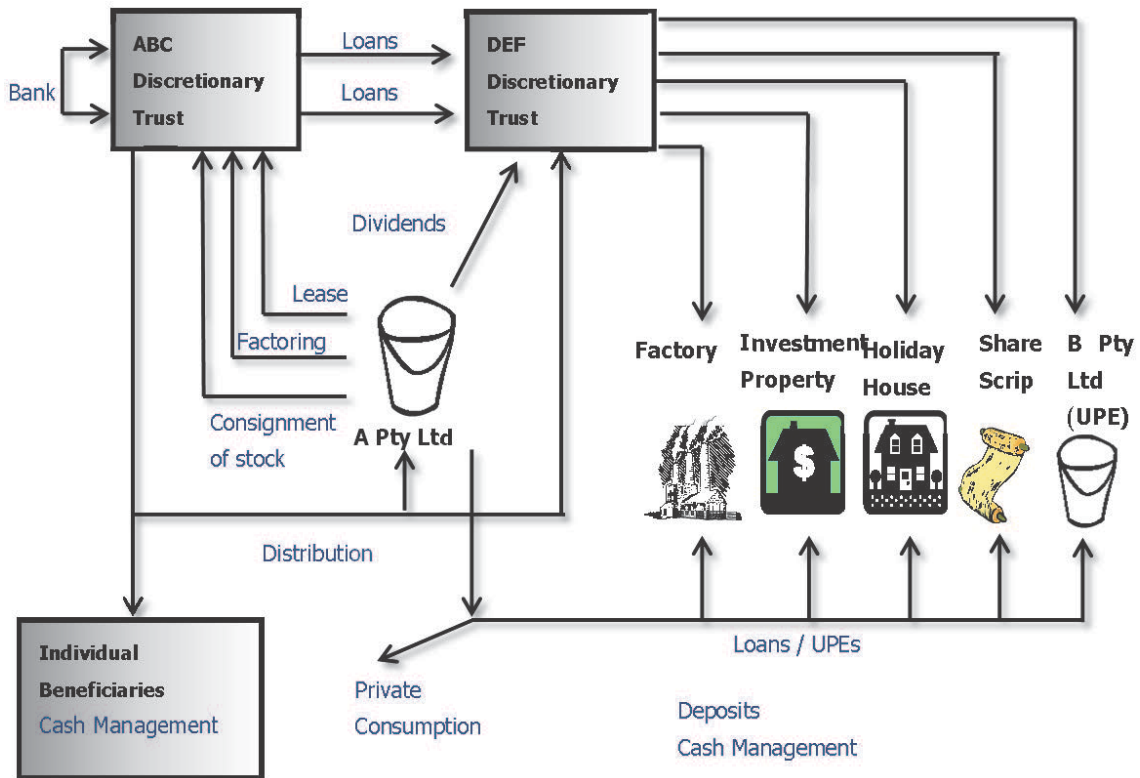
3.36 Where trust profits are distributed to minor beneficiaries caution must be taken to ensure that distributions do not exceed the tax-free threshold for ‘unearned income’ of minors. Otherwise, the distribution will attract the top marginal tax rate under Division 6AA of the ITAA 1936.

3.37 The S SMSF holds the cash, share portfolio and real business property of the trading entity, S Pty Ltd. The low risk nature of the SMSF makes it an attractive vehicle for investment in this family business context, with particularly attractive taxation advantages for the S Family Group.

3.38 In this particular situation, the SMSF offers Mr and Mrs S the added benefit of increased control over their investments, the access to concessional tax rates of 15 per cent which applies to the SMSF (and 10 per cent for capital gains on assets that have been held for at least 12 months), CGT and stamp duty concessions, and access to their superannuation prior to retirement in the form of a tax-free income stream from the transition to retirement pension.

3.39 As can be seen from the structure above the business risk has been quarantined in the company, while the inclusion of the discretionary trust and SMSF offered the advantages of greater asset protection and tax minimisation while maintaining the flexibility to access the CGT concessions.

5. Practical illustration — business carried on through trust



3.40 The following is an example of another structure which offers the benefits of asset protection, tax minimisation, the ability to maximise the business CGT concessions, the ability to income split and Division 7A planning. It can be observed that much of the structuring is based around the application of Division 7A and the use of a corporate beneficiary.

3.41 In this example the business operates its activities through a discretionary trust (The ABC Discretionary Trust). The trustee distributes some of the trust income to individual beneficiaries, having regard to their marginal rates of tax. The majority of its income is distributed to a corporate beneficiary, A Pty Ltd. This allows the tax on income to be capped at the corporate rate.

3.42 As with the previous example, the assets are not acquired or held by the principal operating entity. The assets used in the business are owned by A Pty Ltd and leased to the trust. Division 7A is not triggered where the lease is on commercial terms. A Pty Ltd also supports the active business activities of the trust through a factoring and consignment type arrangement as can be seen in the diagram above.

3.43 The shares in A Pty Ltd are, in turn, owned by a second discretionary trust, the DEF Discretionary Trust. The DEF Discretionary Trust receives fully-franked dividends from A Pty Ltd, which it distributes to a corporate beneficiary, B Pty Ltd. As the dividends are fully franked no additional tax is payable on the distribution. Again, this allows the tax on the income to be capped at the corporate rate.

3.44 In the example, distributions to the corporate beneficiary, B Pty Ltd, are not immediately paid, but are retained in the trust resulting in a UPE. The funds represented by the UPE can then be used as a source of financing to acquire capital assets within the trust (in the diagram above: factory, investment property, holiday house and share scrip).

3.45 However, it is necessary to ensure that the UPE does not attract a Division 7A deemed dividend. To avoid Division 7A treating the UPE as a deemed dividend, the UPE can be structured as a complying loan with annual repayments over seven years (for a loan that is unsecured) or 25 years (for a loan that is secured against real estate). Alternatively, the trustee can avoid the operation of Division 7A by complying with the practice statement.

3.46 This particular structure also provides the benefits of the general 50 per cent CGT discount as the capital assets are purchased through the DEF Discretionary Trust rather than through the corporate structure.

CHAPTER 4: A COHERENT POLICY FRAMEWORK FOR GUIDING REFORM

4.1 The first part of this Chapter will discuss the operation of Division 7A in the context of the broader tax system, make some observations about the coherency of the current policy framework, and suggest broader approaches to reform.

4.2 It will then suggest a policy framework for guiding the development of future Division 7A reform and propose a set of general principles that will give effect to that framework. In the context of that discussion, it will also put forward an alternative approach to the treatment of distributable surplus, a core element of the provisions.

4.3 The policy framework suggested in this Chapter will form the basis for the Board's evaluation of the previously proposed models in Chapter 5 and for the discussion of a new model – the Transfer of Value Model – detailed in Chapter 6.

COHERENCY OF DIVISION 7A

Achieving its policy objectives

4.4 Division 7A is mainly concerned with the inappropriate access to wealth that has been accrued in the corporate tax environment. As such, Division 7A operates at the interface between the personal and the business tax systems and must balance the sometimes competing aims of those systems.

4.5 The Board recognises that a principal role of Division 7A is to support the progressivity of the personal tax system. However, having reflected on the policy settings for Division 7A in the context of the broader tax system (Chapter 2) and observing the system in operation (Chapter 3), the Board considers that the current provisions fail to provide a coherent policy framework for taxing the private use or enjoyment of corporate funds.

4.6 Firstly, it is questionable whether Division 7A succeeded in its explicit policy aim of supplanting an unwieldy, determination-based system with a simple, self-executing system. There is general agreement that Division 7A, largely because of its complexity, is unduly difficult for businesses to comply with and for the Commissioner to administer.

4.7 Moreover, while Division 7A is self-executing in the first instance, it has a number of exclusions and discretions designed to mitigate harsh or inappropriate applications. These provisions are necessary and appropriate but have the effect of merely postponing the administrative complexity of a determination-based system to a later stage of the process. The general relieving provision in section 109RB was

identified in the December 2012 Discussion Paper as a source of particular administrative complexity.

4.8 Secondly, while acknowledging that transactions between private companies and shareholders should be held to a benchmark of commerciality, the current framework – centred on the concept of the ‘complying loan’ – is inflexible.

4.9 Thirdly, Division 7A in its current form has failed to provide a coherent framework for distinguishing between activities that involve private use or consumption of company wealth from those that merely involve the application of income in growing an active business.

4.10 Finally, it is noted that Division 7A sometimes operates to impose a significant compliance burden even on those businesses that operate in accordance with its intended policy.

Division 7A and its interaction with various structures

4.11 The Board considers that Division 7A provides an inadequate response to the different ways private businesses are structured and fails to acknowledge the many tax *and non-tax* considerations that dictate those structures.

4.12 In particular, the use of trusts as active trading entities, while controversial, is currently an embedded feature of the Australian small business landscape. Accordingly, the Board believes that the interaction with trusts must be factored into any approach to reforming the current system.

4.13 It has also been noted that business structures that combine companies and trusts – such as ‘bucket company’ arrangements – have emerged as a means of overcoming the limitations of each type of entity. However, the current provisions of Division 7A do not provide a coherent framework as to when such interactions are acceptable or not acceptable from a policy perspective.

4.14 The use of bucket companies is now a source of significant complexity and uncertainty. Safe harbour arrangements implemented by the ATO have gone some way to addressing the uncertainty and the working capital concerns of small businesses that operate through trusts.

4.15 However, the safe harbour arrangements, particularly the interest-only options, are unfocussed and largely preserve the incentives for using bucket companies for private wealth accumulation that existed prior to 2009. This is particularly the case for the larger, more sophisticated segment of the private business sector. Accordingly, the Board is of the view that the operation of Division 7A with respect to these arrangements is not coherent from a policy perspective.

Potential broader approach to reform

4.16 It was noted in the Report on Australia's Future Tax System that competitive company tax rates encourage innovation and entrepreneurial activity and boost the productivity of Australian businesses. This raises a larger question about whether there should be access to a capped, competitive tax rate for business accumulations generally, not one that is confined to companies.

4.17 One issue for consideration is whether a case can be made for taxing business accumulations at a 'company tax' rate, irrespective of the structure chosen. 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 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.

4.18 In light of the interactions between Division 7A and the trust taxation provisions, it is noted that in 2011 the Board advised the then Government on current issues with the trust taxation provisions. One of those issues concerned problems associated with the misalignment between two central concepts in those provisions, namely 'income of the trust estate' and 'net income of the trust estate'.

4.19 Following the Board's advice, the then Government announced in March 2011 that it had decided to amend the law to better align those concepts in order to reduce anomalous outcomes and opportunities to manipulate tax liabilities.²³ A review was subsequently initiated by the Treasury. One aspect of that review was the consideration of the tax rate that is applicable to trustees under section 99A.

4.20 The Board considers that while there is value in examining the issues outlined at paragraphs 4.16 to 4.19, they are outside the scope of the current review. Moreover, they are but one aspect of the interface between the personal and business tax systems. The Government's proposed White Paper on the tax system may be an appropriate forum for examining such issues.

Q 4.1 Issues / Questions

The Board seeks stakeholders' comments on whether taxing business accumulations at a 'company tax' rate, irrespective of the structure chosen, is an issue that should be considered as part of a wider tax reform process.

23 Australian Government, Improving the taxation of trust income: Discussion Paper (March 2011), 1.

4.21 While a capped tax rate for business accumulations is outside the scope of this review, the Board believes there is scope under the Terms of Reference to consider whether there is a case for providing active trading trusts with increased access to the corporate tax rate for profits used to finance their operations.

4.22 As discussed in Chapter 3, under the current system, trusts that comply with the ATO's safe harbour arrangements are able to access the corporate tax rate by creating UPEs in favour of corporate beneficiaries.

4.23 The Board considers, however, that in light of the current policy settings it would be difficult to justify extending access to the corporate tax rate for private use of business income. It further notes that while providing business with improved access to working capital supports improved productivity and entrepreneurial growth, the private use of business income serves a different purpose, namely, the enjoyment and accumulation of private wealth.

4.24 Having regard to these considerations, and consistent with the high level tax policy aims of efficiency, simplicity and equity, the Board has developed for consideration a policy framework relevant to private business that is designed to provide an appropriate balance between these competing aims. It is designed to assist in evaluating the existing regime and in developing and evaluating possible reform models.

4.25 The Board's proposed policy framework contains four goals or principles for a reformed Division 7A:

- 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.
- 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.

Q 4.2 Issues/Questions

The Board seeks stakeholders' comments on whether the high level tax policy aims of efficiency, simplicity and equity would be served by adopting a policy framework for private businesses that supports the progressivity of the personal tax system by striking an appropriate balance between the following four goals:

- a. It should ensure that the private use of company profits attracts tax at the user's progressive personal income tax rate.
- b. It should remove impediments to the reinvestment of business income as working capital.
- c. It should maximise simplicity by reducing the compliance burden on business and the administrative burden on the Commissioner and other stakeholders.
- d. It should not advantage the accumulation of passive investments over the reinvestment of business profits in active business activities.

CONCEPTUAL FRAMEWORK

4.26 A conceptual framework that provides a more coherent and clear starting point for addressing the sort of issues that should be the subject of Division 7A is required. A proposal in this respect is outlined in this section.

Introduction

4.27 There is a common view that the policy of Division 7A is to assess 'disguised dividends' from companies.

4.28 More clearly, the policy can be set out as an integrity measure to prevent profits subject to lower tax rates (typically the company tax rate of 30 per cent) in a company from being accessed by shareholders and their associates outside of the company in a non-dividend form.

4.29 Such access or 'transfer of value' allows those profits or gains to escape being subject to the progressive tax rates for individuals. Preventing this access (without taxation) reflects the first, and most important, goal stated in paragraph 4.25 above, of taxing the private use of company profit or gains at the user's progressive personal income tax rate.

General principles

Transfers of value by cash and other assets

4.30 Within this context of Division 7A being directed to prevent access to profits or gains of a company, transfer of value to individual shareholders or shareholders' associates may occur by way of access to cash or to other assets.

Accounting perspective — cash or asset cost

4.31 In accounting terms, this access to profits or gains can be seen as being achieved by access to the debits on a company's balance sheet, where the relevant source profits or gains are the credits on that balance sheet.

4.32 This perspective draws attention to the fact that it is usually the cash held by the company, or cash applied to buy an asset (the asset cost), that represents the relevant profits or gains to which access can be gained, and which is to be prevented or taxed.

4.33 This way of looking at the access to profits or gains can be useful in arriving at common rules — across cash and other assets — for limiting or taxing such access.

4.34 Such common rules include the distributable surplus rules and the rules for setting loan repayment or asset usage payments to be made by shareholders or associates as complying arrangements, if deemed dividends are to be avoided.

4.35 It also assists with the consideration of issues arising over access to realised or unrealised profits or gains, as discussed later. The limits of this accounting perspective are also recognised — for example, not all profits may be recognised in the accounts — and are addressed further in the considerations about calculating distributable surplus.

Temporary and permanent transfers of value

4.36 It is useful to categorise the ways that those profits or gains may be accessed between:

- temporary transfers of value — loans of cash, use of assets; and
- permanent transfers of value — payments, loans forgiven, assets transferred.

4.37 The distinction between temporary and permanent transfers of value is not always clear and is one of the matters to be properly managed by Division 7A as an integrity measure — but it is a useful distinction in guiding how Division 7A can efficiently achieve its intended objective, while not causing unintended consequences.

4.38 To achieve the Division 7A objective, permanent transfers of value — representing a company's profits or gains — must be taxed appropriately.

4.39 Temporary transfers of value must be repaid or paid for, or they will be considered permanent transfers.

4.40 Achieving the policy intent requires appropriate payments to be made to a company, on some basis, for the 'use' of temporary transfers of value. Otherwise the temporary transfers become a way to constantly circumvent the rules about permanent transfers of value.

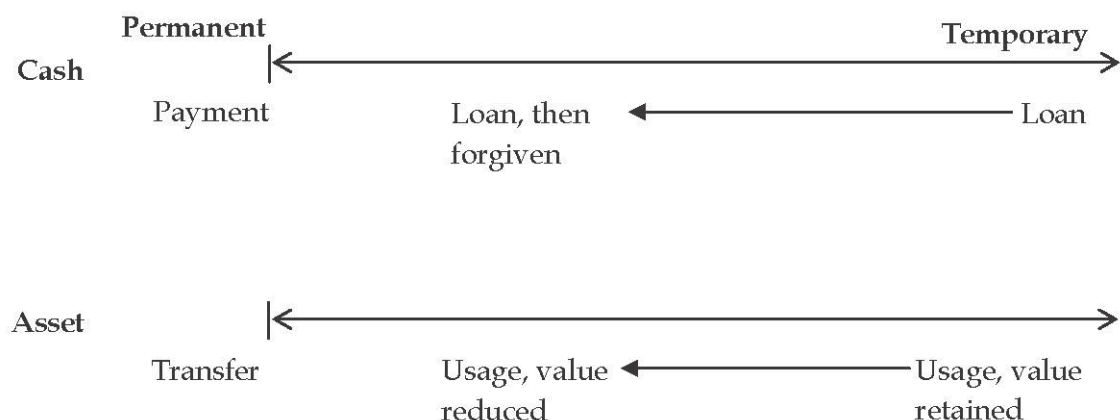
4.41 For example, whether the benefit of **cash** accessed by a shareholder or associate is temporary (a loan), as opposed to permanent (a payment or forgiveness), depends on:

- the initial access to the cash being able to be confirmed as a genuine loan – currently Division 7A requires formal loan agreements to confirm this;
- there being some cost for the temporary use of the cash – the interest required to be paid, such as under the current minimum repayment rules in Division 7A;
- the loan continuing to be repayable – versus there ceasing to be an intention to repay by way of a forgiveness, formal or informal; and
- the loan principal actually being repaid on some reasonable basis – which must occur for the access to continue to be temporary, such as under the current minimum repayment rules in Division 7A. Access to cash without actual repayment (even if no formal or informal forgiveness) is equivalent to a permanent transfer of value.

4.42 In respect of assets, whether the benefit of an **asset** accessed by a shareholder or associate is temporary (usage), as opposed to permanent (a transfer), depends on:

- ownership of the asset remaining with the company – which differs from cash in that, for both permanent and temporary access to cash, the cash asset is transferred to the shareholder or associate;
- even where ownership of the asset remains with the company, there being some cost for the temporary use of the cash applied to the cost of the asset – equivalent to the interest on a loan (or interest component of a finance lease); and
- again, even where ownership of the asset remains with the company, whether the asset cost is actually 'used up' (loses its value) during the period of usage – which would represent a permanent transfer of value as the asset is 'used up', unless appropriate asset usage payments for this asset cost are made.

4.43 Diagrammatically:



Unrealised gains in assets transferred permanently

4.44 Because, unlike cash, there can be unrealised gains on assets, there is an additional aspect to a permanent transfer of value occurring by an asset transfer. The transfer itself provides (realises) the unrealised gains inherent in the asset.

4.45 In this regard, the ‘debits on the balance sheet’ analysis, suggested as useful above, must be adjusted for such asset transfers – to recognise this additional transfer of value. This has implications for the distributable surplus rules.

Temporary transfers of value — common principles for complying arrangements

4.46 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.

4.47 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.

4.48 A loan will continue to exist for its stated term unless it is forgiven. By contrast, the value of a depreciating asset will be ‘used up’ over a period of time. Accordingly, the appropriate time period for a usage fee will need to reflect the period over which the asset depreciates.

4.49 Therefore, exactly common rules, in terms of the standard loan term versus asset usage term, may not be possible. However, an asset usage term of the lesser of an asset’s depreciation period or the standard loan term could apply with reasonable simplicity.

4.50 In accordance with the above, the payments required for the use of assets by shareholders will mirror the payments required for loans as closely as possible, but

with allowance for a shorter repayment period where the asset depreciates more quickly than the standard loan term.

4.51 Whether an asset is owned by the company or by its shareholders or associates, adopting such common rules would provide simplicity by equating the effects of lending money with those of lending the relevant asset cost from the company.

4.52 However, because of the difference between a cash loan and the use of an asset – that title to the asset remains with the company – certain extra matters would need to be addressed in respect of asset usage, including:

- what amounts to the ‘use’ of an asset – with the concept applying effectively to arrangements where assets of a company (especially depreciating assets) are available for the use of shareholders;
- that (like finance leases) all of the asset usage fee would be assessable to the company;
- the company would still depreciate the asset under the usual rules;
- whether the asset usage fee should be the basis of tax deductibility (again, like a finance lease) to the shareholder or associate user – where the level of usage fee may ‘run ahead’ of the relevant asset’s actual depreciation;
- inclusion in the asset cost, on which the asset usage fee is calculated, of maintenance and holding costs (for example, interest costs) paid by the company, as these are further applications of company profits;
- rules about partial use of the asset – where the asset usage fee may be reduced for partial use only, but would be payable until all the asset cost has been paid for; and
- rules about use of an asset starting years after the asset was originally acquired by the company – specifically, addressing questions of when to test distributable surplus and whether to still use asset cost for the value transferred.

4.53 Particular issues may require consideration in respect of long-term assets, building and land.

Q 4.3 Issues/Questions

The Board seeks stakeholders’ comments on how, if the suggested framework were to be implemented, the proposed rules regarding asset usage could be designed without introducing undue complexity.

Distributable surplus — realised versus unrealised gains

4.54 Even where there is a permanent or temporary transfer of value from a company to shareholders or associates, Division 7A generally only needs to cause a deemed dividend to arise when there has been access to realised profits that have been subject to no Australian income tax or lower Australian income tax rates (typically the company income tax rate of 30 per cent).

4.55 The rules for determining a distributable surplus are the mechanism used to identify whether those profits exist and have been accessed.

4.56 Returning to an accounting perspective, the distributable surplus rules are directed to identifying the credits which are the source of value accessed from the company. Those rules must work in tandem with the rules identifying the extent of any permanent or temporary transfer of value — being the debits accessed.

4.57 There is early and (eventually) double taxation when unrealised gains are counted in a distributable surplus and those unrealised gains are **not truly and permanently distributed**. This can occur where the assets have only been accessed temporarily and their value remains in the company.

4.58 Loans, by their nature, cannot be made from such unrealised gains. However, the unrealised gains may be counted to support deemed dividends in respect of loans which are funded by company borrowings (and where there is no distribution of the gains).

4.59 There **is** a realisation and a transfer of otherwise unrealised gains, when the asset itself, on which such unrealised gains have accrued, is permanently transferred.

4.60 Accordingly, the distributable surplus rules need to be properly directed to **exclude** unrealised gains for (most) circumstances in which such gains are not permanently transferred out of the company, but must be able to **include** such gains when they are realised and transferred with asset transfers.

4.61 The Board's preliminary view is that it would provide increased fairness to exclude unrealised gains from the calculation of distributable surplus, except where those gains are the subject of a permanent transfer of value (for example, by asset transfer).

4.62 As an alternative to the above proposal, the unrealised gains and losses could be included in the basic calculation of distributable surplus, but then be subtracted when dealing with temporary transfers of value.

4.63 The Board acknowledges that the proposal to exclude unrealised gains may come at a cost to the revenue and open up planning opportunities. To address these issues, this proposal could be considered in conjunction with a change to the timing of when distributable surplus is tested. This is discussed below.

Q 4.4 Issues/Questions

The Board seeks stakeholders' comments on:

- a. whether excluding unrealised gains from the distributable surplus would assist in simplifying compliance with the provisions and address the potential for double taxation;
- b. whether there would be integrity concerns or likely cost to revenue if the proposed approach to distributable surplus were to be adopted; and
- c. whether, as an alternative to the proposed approach, unrealised gains and losses should be included in the basic calculation of distributable surplus, but then be subtracted when dealing with temporary transfers of value.

Distributable surplus — timing issues, changes in funding

4.64 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. In accounting terms, the transfer of value is a debit and the realisation of the surplus is a credit.

4.65 Analysed from an accounting perspective, it becomes apparent that the source of the funding for transfers of value may change over time. Transfers of value which are not originally sourced from a 'realised' distributable surplus may become so later.

4.66 Earlier loans into a company can be used to provide transfers of value to shareholders or associates at a time when there is no distributable surplus.

4.67 When those earlier loans into the company are repaid out of later realised profits, the effect is the same as if the later realised distributable surplus had been provided to shareholders/associates in the first instance.

4.68 However, under the current provision, 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, there was no distributable surplus and the relevant transfer was funded by the loan into the company, no deemed dividend could arise, *even when the source of the funding is effectively transferred to the later realised profits.*

4.69 Division 7A should manage this timing effect to deal with this possible 'advantage'.

4.70 Temporary transfers of value may be ongoing over periods when it could be expected that profits will be earned to repay the earlier transfers. But temporary transfers of value that become permanent (through debt forgiveness or asset transfer) should give rise to deemed dividends.

4.71 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 **each year end** – without the need for tracking of individual liabilities that have funded particular earlier transfers of value to shareholders or associates.

4.72 Assessing distributable surplus at each year end (a ‘global’ net asset approach) would be simple, and would likely be effective because the earlier company liabilities could only be repaid from the later realised profits.

Example — Distributable surplus

4.73 The following is an example of proposed changes to distributable surplus rules. (Company tax payments and required repayments of loans have been ignored for simplicity.)

Year 1 – Company Z has \$100,000 share capital applied to buy land at a cost of \$100,000

Year 2 – The land has increased in value to \$200,000 and Company Z borrows \$100,000 to make a loan to its shareholder of \$100,000.

Under the existing distributable surplus rules –

Division 7A will apply to the \$100,000 shareholder loan as there is a distributable surplus represented by the \$100,000 unrealised gain on the land.

Under the proposed distributable surplus rules –

There is no distributable surplus (the unrealised gain is excluded) and the shareholder loan is not subject to Division 7A.

Year 3 – Company Z starts a business of providing consulting services and makes \$100,000 realised profits from invoicing services provided in its business. It uses those profits to repay the \$100,000 it borrowed in Year 2.

Under the existing distributable surplus rules –

No change. Division 7A continues to apply to the \$100,000 shareholder loan based on the testing of the distributable surplus in Year 2 when the loan was first made.

Under the proposed distributable surplus rules –

The distributable surplus must be tested each year for the shareholder loan. As there is now a distributable surplus, the \$100,000 realised

profits, the shareholder loan becomes subject to Division 7A – as it is now funded by those realised profits.

Year 4 – The land increases in value to \$400,000 and Company Z transfers the land to its shareholder.

Under the existing distributable surplus rules –

There is a deemed dividend of \$300,000 arising from the land transfer as a ‘payment’ to the shareholder, based on a distributable surplus of \$300,000 (the now realised increased land value of \$300,000 plus the realised profits of \$100,000 less the prior deemed dividend in Year 2).

Under the proposed distributable surplus rules –

There is a deemed dividend of \$300,000 arising from the land transfer as a permanent transfer of value to the shareholder, based on a distributable surplus of \$300,000 (the now realised increased land value of \$300,000 plus the realised profits of \$100,000 less the prior deemed dividend in Year 3).

DISTRIBUTABLE SURPLUS — SUMMARY

4.74 Reflecting the comments already made above, the distributable surplus rules could be adjusted to be:

- tested at year end for permanent transfers of value, as well as for temporary and ongoing transfers of value (for example loans, asset usage) at **each** year end; and
- based on the **amount** of available realised profits of the company as reflected in its accounts (net assets), but with appropriate adjustments to address situations:
 - of possible double counting (for example, prior deemed dividends still shown as loans in the accounts); and
 - where value which has not been reflected as realised in the accounts has been transferred to shareholders/associates (for example, gains realised and paid out as asset transfers during the year; asset transfers at below market value the gains on which have not been recorded as offsetting prior accounting losses).

4.75 This testing of distributable surplus would address the timing issues identified above. More extreme planning could be left to be addressed under the general anti-avoidance rules. This ‘more extreme planning’ refers to the possibility of early loans being used to make early permanent transfers of value – with the loans later repaid by later profits.

4.76 These changes to the distributable surplus rules are seen as consistent with the first goal set out at paragraph 4.25 above, because they would better target the operation of Division 7A:

- to not apply where unrealised profits have not, in substance and reality, been made available for private use by shareholders or shareholders' associates; and
- to apply where transfers of value to shareholders or shareholders' associates for private use have become funded by realised profits, even if that private use was originally funded by other means (for example, company borrowings).

Q 4.5 Issues/Questions

The Board seeks stakeholders' comments on whether the distributable surplus rules should be adjusted to be:

- a. tested at year end for permanent transfers of value, as well as for temporary and ongoing transfers of value (for example loans, asset usage) at **each** year end; and
- b. based on the **amount** of available realised profits of the company as reflected in its accounts (net assets), but with appropriate adjustments to address situations:
 - of possible double counting; and
 - where value which has not been reflected as realised in the accounts has been transferred to shareholders/associates.

DEEMED DIVIDENDS — GENERAL RULES

4.77 Based on the conceptual framework outlined above, the Board suggests that deemed dividends under Division 7A should arise where:

- there is a permanent or temporary transfer of value; and
- the permanent or temporary transfer of value does not fall within a safe harbour or specific exemption provision (for example for temporary transfers, a complying loan or complying payments made for asset usage);

4.78 The taxable amount of the deemed dividend should be determined by reference to the distributable surplus:

- tested at each year end for transfers of value; and
- based on the **amount** of available realised profits of the company as reflected in its accounts (net assets) with appropriate adjustments.

4.79 A further issue for consideration is whether, and in what circumstances, deemed dividends should be frankable. Under the current rules, dividends arising under Division 7A are taken to be unfranked. Relaxing this requirement may ensure that the Division applies in a more proportionate manner by ensuring that tax already paid at the company level is taken into account in determining the shareholder's tax shortfall (and associated penalties). However, it may also remove an important disincentive on private companies that might seek to make disguised transfers of value to associates. The Board is interested in exploring this issue further.

Q 4.6 Issues/Questions

The Board seeks stakeholders' comments on:

- a. the proposed general rules for determining when deemed dividends should arise; and
- b. whether, and in what circumstances, deemed dividends should be frankable.

CHAPTER 5: ANALYSIS OF PREVIOUSLY PROPOSED MODELS

5.1 To reduce the complexities and difficulties in the operation of Division 7A, the Board developed three reform models or approaches, which were set out in the 2012 Discussion Paper.

5.2 The models are not mutually exclusive and would address the problems to differing degrees. The models are:

- *Distribution Model*: Allows active income retained in a company or trust to be taxed at the company tax rate while requiring other income to be distributed to avoid a higher tax rate.
- *Statutory Interest Model*: Requires Division 7A loans to related entities to be interest-bearing (at a rate higher than the current Division 7A rate to compensate for there being no requirement to make principal repayments). If the funds in question are ultimately lent to an individual or entity which does not use the borrowed funds for the purpose of deriving assessable income, any interest thereon will not be tax deductible.
- *Division 7A Adjustment Model*: Retain the existing Division 7A provisions with improvements to specific aspects of those provisions.

DISTRIBUTION MODEL

5.3 The *Distribution Model* outlined in the Board's 2012 Discussion Paper – which may more appropriately be referred to as a 'retention model' – allows the retention of profits within the private group where they are used for permitted purposes and to treat any profits not so used, and not distributed, as deemed dividends (which would be able to be franked). Profits able to be retained in this way would be taxed at the company tax rate, and deemed dividends would be taxed at the personal tax rate of the relevant shareholders.

5.4 Permitted purposes would centre on the use of profits for working capital and other active business purposes of the private company or related entity (for example, another trust or company in the group). Use of the profits for passive investment purposes would not be permitted, although the acquisition of assets used in an active business would be.

5.5 A key advantage of this model would be the ability to effectively retain, via private companies, income applied for active business purposes in trusts while being subject to tax only at the corporate tax rate. This would support the financing of business, particularly small business. Under this model, loans from companies to trusts would meet the requirements of Division 7A even if no principal or interest were payable as long as the loan funds are used for permitted purposes.

5.6 The automatic frankability of deemed dividends would also remove a concern held by taxpayers in relation to the operation of Division 7A.

5.7 The focus on how private company profits are used would arguably constitute a more comprehensive and direct approach to dealing with inappropriate accessing of private company profits. That is, this approach would recognise the fact that many Australian small businesses carry on business through a trust and effectively retain, through UPE arrangements, income taxed at the company tax rate and applied for active business purposes. At the same time, it would ensure that passive income earned through trusts is taxed at personal marginal tax rates.

Views in submissions

5.8 Submissions received from various stakeholders in response to the 2012 Discussion Paper viewed this model as the least preferred of the three models for addressing Division 7A reform.

5.9 The Law Council of Australia did state that this model may be appealing from a theoretical perspective. However, the Council went on to say there were real practical difficulties with it:

The model would require continuous and specific accounting processes to be undertaken in order to ascertain active versus passive activity. Further, a tracing of funds would be required. Not only can this be a very difficult exercise (especially if not attended to constantly throughout the income year), but the administrative cost associated with such an exercise is invariably prohibitive for small to medium (and even large family group) taxpayers and may be disproportionate in relation to the mischief to which Division 7A is directed.

5.10 PricewaterhouseCoopers was also concerned with the practical difficulties and stated:

Whilst the tax law does make a distinction between active and passive income in the context of other provisions, there is complexity where a group is involved in both active and investment activities. The concept of working capital would need to be defined which disadvantage certain industry groups given the concept of working capital may differ amongst industry groups.

5.11 A number of submissions commented that the model extended beyond the policy intent of Division 7A. CPA Australia stated:

... the policy underlying the Distribution Model to treat distributions of 'passive' profits which are retained in the company as deemed dividends also extends beyond the original policy intent of Division 7A which was to treat distributions of profits in a tax-free form to shareholders and associates as deemed dividends.

Board's consideration

5.12 Judged against the Board's proposed policy framework set out in paragraph 4.25, the *Distribution Model* appears to satisfy three of the four principles:

- it satisfies the **first principle** by targeting only the private consumption of company funds;
- it satisfies the **second principle** by providing businesses (including those with trusts in the business structure) with considerably more flexibility as to the reinvestment of active business income; and
- it satisfies the **fourth principle** by ensuring there will be an additional tax impost on accumulated passive income that is not redirected to an active business.

5.13 However, the Board considers that the *Distribution Model* fails to give effect to the **third principle**, namely, simplicity.

5.14 The major impediment to simplicity arises from the need to distinguish active income from passive income. Although some areas of tax law do distinguish between active and passive income,²⁴ the Board acknowledges that this distinction will be difficult to apply consistently across all types of business.

5.15 The Board also acknowledges that, in some cases, complex tracing rules may be required meaning that the *Distribution Model* does not obviate the need for Division 7A type rules in respect of income able to be retained. In particular, they would be needed to deal with non-loan payments. However, the Board considers that such tracing rules may be required for a small minority of businesses and would not apply to those businesses with relatively simple structures and activities.

5.16 The Board is of the view that this model offers the prospect of facilitating the financing of business, particularly small business, while maintaining revenue integrity.

24 See for example Division 152 of the ITAA 1997 which provides CGT relief for small business for certain active assets. See also the controlled foreign corporation (CFC) rules in Part X of the ITAA 1936 which seek to tax passive income – which includes rent, royalties, 'tainted interest' and dividends – of CFCs as it is earned unless it is taxed offshore in a comparably taxed jurisdiction or the income is derived almost exclusively across all types of businesses.

However, the policy outcomes of the *Distribution Model* pertain more to maintaining the progressivity of the income tax system as a whole rather than to addressing the specific policy objective of Division 7A, that is, preventing shareholders of private companies (or their associates) from inappropriately accessing the profits of those companies in the form of payments, loans or debt forgiveness transactions.

5.17 Accordingly, the Board is of the opinion that this model should only be pursued as part of a broader review of the small business tax system that includes an examination of the progressivity of the income tax system as a whole. The Government's proposed White Paper on the tax system may be an appropriate forum for undertaking this examination.

STATUTORY INTEREST MODEL

5.18 The *Statutory Interest Model* would largely replace that aspect of Division 7A concerned with loans with a requirement that loans to related entities bear interest at a rate specified by law from time to time. Progressive loan repayments would not be necessary and re-borrowings (of principal) would be permitted.

5.19 While many parts of Division 7A would be unnecessary, there would be a continued need to deal with forgiveness of debt and payments which are not loans.

5.20 An advantage of this model is that it may address the use of private company loans for private purposes without complicated rules. This would occur by way of interest on such loans not being deductible. Such an approach has the potential to make the law relating to loan arrangements (as opposed to debt forgiveness and non-loan payments) between private companies and related entities more understandable to taxpayers.

5.21 However, to minimise revenue impacts and to ensure shareholders do not receive a benefit where the loan is used for private purposes, this model would require the interest rate on the loan to be considerably higher than the current Division 7A rate to compensate for an interest-only loan with no principal repayments being made.

Views in submissions

5.22 Submissions indicated that the *Statutory Interest Model* was the most preferred model as it would greatly reduce complexity and compliance costs.

5.23 Arnold Bloch Leibler stated that they are strongly supportive of the *Statutory Interest Model*, but only on the condition that a single interest rate should be specified and that it should be a commercial rate of interest.

5.24 Greenoak Advisory Pty Ltd stated:

This model would be welcomed by most taxpayers and advisors as it would greatly reduce complexity and compliance costs. It would also provide certainty and comparative simplicity of operation.

5.25 Moore Stephens also expressed a strong preference for this model. They stated:

In our view, this model provides the most efficient, equitable result and aligns with the overall policy objectives of Division 7A, in that through the mandatory interest requirement, it will continue to provide an effective deterrence for the tax-free use of business profits. Importantly, it is our view that if this model is implemented appropriately, it will provide a significantly simplified outcome, thereby reducing the administrative burden on taxpayers ...

5.26 Pitcher Partners stated:

We support the use of a statutory interest model as being the basis for rewriting Division 7A as an integrity measure to deal with 'disguised distributions' to shareholders (or associates of shareholders) of private companies.

... we believe that the statutory interest model deals with the significantly complex aspects of Division 7A, being: the interposed entity rules; the treatment of UPEs; the minimum loan repayment rules; and simplifying the Commissioner's discretion. We believe that all this can be achieved whilst maintaining the integrity and policy intent of Division 7A.

5.27 However, a number of submissions were concerned with the need to charge interest at a rate higher than the current Division 7A rate. Ernst & Young stated:

The main attraction of the proposed 'statutory interest rate' model would be to remove the significant complexity and resulting uncertainty of the range of interposed entity and other integrity measures and to remove the current multiple specific exemptions. However, the mandatory charging of interest, at likely significantly higher rates than under the current benchmark interest rate rules, may cause commercial problems and is unlikely to be a sufficient trade-off for taxpayers with simple structures and those with currently excluded arrangements. On balance, we therefore do not support this model at this time.

5.28 A number of submissions also suggested an 'otherwise deductible rule' for loans, with a residual arm's length interest rate rule only for loans on which the interest would not be otherwise deductible. The Tax Institute supported this rule and stated:

Such a provision would limit the operation of Division 7A to only those types of loans that are intended to be caught. Furthermore, such a solution would significantly simplify the current system of repayments, loan agreements and fixed loan periods. This is

because there would no longer be any requirement to consider any factors other than the purpose to which the loan is put in determining consequences under Division 7A.

Board's consideration

5.29 The *Statutory Interest Model* meets three of the four principles set out in the Board's proposed policy framework:

- it would satisfy the **first principle** by preserving the function of Division 7A for private use of company assets;
- it would satisfy the **second principle** by facilitating the retention of income for active business purposes; and
- it would satisfy the **third principle** by reducing complexity and thereby lowering the cost of compliance and administration.

5.30 However, the *Statutory Interest Model* fails to give effect to the **fourth principle**. It would fail to remove, and may even increase, incentives for the accumulation of passive income. This means that the Model, in addition to having adverse revenue implications, might not appropriately serve the progressivity of the tax system.

5.31 The Board's financial analysis indicates that the model is effective where the funds borrowed by the shareholder from the company are used for a private purpose (and are therefore non-deductible). In this situation, provided a sufficiently high interest rate is imposed, the model would provide both simplification and integrity. An appropriate interest rate to ensure this outcome would need to be in the order of nine per cent per annum.

5.32 However, where the funds are not used for private purposes, the analysis indicates a significant cost to revenue. This cost can be magnified where gearing (negative or otherwise) is used. The reasons for the revenue costs are threefold:

- there is an arbitrage between the company and personal tax rates—when the retained funds are used to fund a negatively geared investment, the individual borrower will be entitled to excess deductions that may shelter income that would otherwise be taxed at a rate as high as 46.5 per cent while the interest income in the hands of the company is only taxable at 30 per cent;
- the absence of a requirement for regular payments of principal removes a key incentive for the company to declare an annual dividend each year to fund this repayment, leaving the borrower in a better position to avoid the payment of top-up tax; and
- the model allows funds that have been taxed at the corporate rate to be directed towards investments that, on realisation, would be eligible for the CGT discount.

5.33 Further financial analysis has been undertaken to determine whether this issue can be addressed by requiring an increase in the statutory interest rate to be used to assess the lender to tax. As noted above, under the model, the interest rate must be set at a rate that is sufficiently high to discourage the private use of company funds.

5.34 However, the increased statutory interest rate does not resolve, and indeed exacerbates, the second reason for a cost to revenue, namely that the individual borrower is able to deduct the higher interest expense on the loan at their marginal tax rate, while the company only pays tax on the higher interest income at 30 per cent.

5.35 Currently there may not be significant use of negative gearing of property investment through Division 7A loans as such arrangements are curtailed by the requirement to make annual repayments. However, as annual repayments of principal are not required under a statutory interest model, it could be expected that the above changes would lead to their use expanding considerably.

5.36 The Board has undertaken additional financial analysis to determine whether a 46 per cent company tax rate on the Division 7A interest received by the company would restore revenue neutrality. The results indicated that although this reduced the revenue cost it did not fully do so. This approach would also increase complexity.

5.37 The Board notes that these revenue costs, at least in part, are due to the existing differential between the corporate tax rate and the highest personal marginal tax rate.

5.38 Having regard to the extended terms of reference for this review, the Board considers that there is scope to consider whether the potential benefits of the *Statutory Interest Model* (particularly the simplification benefits) outweigh the additional cost to revenue. The Board also welcomes stakeholder input on ways to minimise the cost of this model or of offsetting its cost with changes that are beneficial to the revenue.

5.39 As alluded to above, it is also to be borne in mind that in dealing only with loans, this is not a complete model, and if the *Statutory Interest Model* were to be adopted, other aspects of Division 7A reform would also be required. In this regard, aspects of the *Division 7A Adjustment Model*, alone or together with aspects of the *Transfer of Value Model* discussed in Chapter 6, would still need to be pursued under this Model.

Q 5.1 Issues/Questions

The Board seeks stakeholders' comments on whether the potential benefits of the Statutory Interest Model (particularly the simplification benefits) are justifiable having regard to the policy framework set out at paragraph 4.25 above.

DIVISION 7A ADJUSTMENT MODEL

5.40 The *Division 7A Adjustment Model* would encompass retaining the existing Division 7A provisions while addressing specific issues, problems or uncertainty in those provisions.

5.41 The advantage of this approach is that it could deal with known issues within the context of provisions already familiar to practitioners and the ATO. However, it has the potential to be a piecemeal solution and would be unlikely to significantly simplify or clarify the law. It should be noted that significant amendments have already been made in the years 2004, 2005, 2007 and 2010 to the operation of Division 7A.

Views in submissions

5.42 Submissions indicated that this was not the preferred model.

5.43 The taxation committee of the Business Law Section of the Law Council of Australia (Committee) did not recommend the use of the *Division 7A Adjustment Model* and it stated:

... in the Committee's view Division 7A is currently unnecessarily complex. It is difficult to understand and implement for both taxpayers and tax agents and advisors. Amending Division 7A will not rectify this problem and the continuation of the past approach of legislating to remedy harsh and unjust consequences on an ad hoc basis as they emerge should not be the preferred policy approach.

Further, Division 7A does not give rise to commercially appropriate outcomes for taxpayers in many instances. To rectify these issues would require a substantial overhaul of the Division which a piecemeal approach to amending the Division would not solve. Such a piecemeal approach has been undertaken to date and has resulted in provisions that are extremely difficult to read and apply in practice.

5.44 Greenoak Advisory Pty Ltd further stated that the *Division 7A Adjustment Model* would be inadequate to address all of the deficiencies with the existing Division 7A. It stated:

In fact, it would only compound the issues because unless conducted very carefully, it could represent a patchwork over the existing provisions. The existing provisions need to be scrapped and re-written.

5.45 However, the Institute of Chartered Accountants supported the adjustment model and stated:

In view of the issues identified in the above two models, at this point in time, the Division 7A adjustment model seems to be the simplest model for taxpayers and their advisors to comply with in view of the volume of guidance provided over the years by the ATO.

5.46 Ernst & Young also supported this model and stated:

The proposed 'Division 7A adjustment model' approach to address the individual issues and problems in Division 7A has some attraction.

Division 7A is familiar to many practitioners and taxpayers and such an approach would build on their knowledge and experience rather than requiring a new regime to be learnt and implemented.

Board's consideration

5.47 The Board considers that the current system emphasises the importance of progressivity at the expense of other legitimate policy goals. As the *Division 7A adjustment model* preserves the basic architecture of the existing provisions, it would have limited impact in moving the system in the direction of the Board's preferred policy framework as discussed in Chapter 4.

5.48 It is important to note, however, that even if more systematic reform is undertaken, care should be taken to ensure that the issues and problems with the current system are not replicated. The Board has welcomed the assistance of stakeholders in identifying these issues.

5.49 The Board notes that Division 7A has been described by some tax advisers outside of the big four accounting firms as the most commonly encountered problem area for them. The complexity of some of the provisions makes it difficult to comply with Division 7A.

5.50 The Board also understands that the requirements of Division 7A are often misunderstood, particularly by small business owners, resulting in frequent and unintended breaches of the provisions. Concerns have been expressed by both the ATO and tax advisers about a number of administrative issues and the high compliance and administrative costs associated with Division 7A.

5.51 The Board finds that a number of the difficulties are due to the prescriptive and, in some cases, form-based provisions within the Division. Some requirements are not framed in a sufficiently flexible or commercial manner.

5.52 The Board also considers that this model does not address the impact of the size and sophistication of a private business to finance their business operations from business profits. In Chapter 2 of this Paper, we observed that larger private businesses are able to structure around Division 7A by utilising certain leasing, factoring and consignment arrangements. This gives rise to two areas of concern. Firstly, these methods are generally not available to smaller businesses, putting them at a competitive disadvantage in terms of their ability to access working capital. Secondly, the Board is concerned about the adoption of these structuring arrangements in relation to passive investment activities.

5.53 The Board also acknowledges that submissions indicated that this was not the preferred model. Nonetheless, to the extent to which other models are silent on aspects of Division 7A, parts of the *Division 7A Adjustment Model* may still be utilised - see as reference Appendix C.

Q 5.2 Issues/Questions

The Board seeks stakeholders' comments on:

- a. whether a number of administrative issues and the high compliance and administrative costs associated with Division 7A are due to the prescriptive and, in some cases, form-based provisions within the Division;
- b. whether pursuing the *Division 7A Adjustment Model* alone would have only limited impact in moving the system in the direction of the Board's preferred policy framework as discussed in Chapter 4; and
- c. if the new model suggested in Chapters 4 and 6 (and summarised in the Executive Summary) were to be adopted, what remaining aspects of the *Division 7A Adjustment Model* (if any) should be progressed, any in what priority.

CHAPTER 6: NEW MODEL: THE TRANSFER OF VALUE MODEL

6.1 The review to date has illustrated the prescriptive and, at times, inflexible, non-commercial and somewhat form-based rules in Division 7A.

6.2 The extended terms of reference allow the Board to examine the broader tax framework in which Division 7A operates including its interaction with other areas of the tax law. In light of this, the Board has given consideration to the development of a more principle or substance-based framework, from which appropriate 'deemed dividend' rules could be developed.

6.3 In Chapter 4 the Board suggested a new policy framework that included four key policy objectives that should guide future reform. These are:

- To ensure that the private use of company profits attracts tax at the user's progressive personal income tax rate.
- To remove impediments to the reinvestment of business income as working capital.
- To maximise simplicity by reducing the compliance burden on business and the administrative burden on the Commissioner and other stakeholders.
- To not advantage the accumulation of passive investments over the reinvestment of business profits in active business activities.

6.4 Chapter 4 then proposed a set of guiding principles to give effect to the proposed framework that centres on the key concepts of permanent and temporary transfers of value. Drawing on these principles, it then proposed **two key elements** for a new model to replace the existing provisions:

- a set of common rules that would, as far as possible, equate the private use of assets by shareholders and their associates to the treatment of loans; and
- a new method for the calculation of distributable surplus that would assist in simplifying compliance and address issues of double taxation.

6.5 This Chapter will build on Chapter 4 and outline **three further components** of the new model:

- a new, simplified regime to replace the existing provisions relating to complying loans;

- a limited exclusion from the application of Division 7A to UPEs owed by trusts that nominate to 'tick the box' and forgo access to the CGT discount on disposal of assets; and
- a mechanism to allow taxpayers to self-correct mistakes or omissions without having to apply to the Commissioner for the exercise of his discretion.

6.6 Following feedback provided to the Board on the December 2012 Discussion Paper (including on the previously proposed models), the Board has formulated the proposed new model with a view to significantly simplifying compliance with Division 7A for those businesses that retain funds in a trust in order to finance their working capital needs.

6.7 The proposed new model is also designed to simplify compliance for those taxpayers who access company funds for private use. This is achieved by providing a simpler set of rules for complying loans. Compliance is also intended to be simplified by the common set of rules aligning the treatment of loans and the use of company assets.

6.8 The Board has aimed, in the design of the model, to propose reforms that would relieve a significant proportion of small businesses from the burden of complying with Division 7A. Trusts that elect not to tick the box in order to preserve access to the CGT discount will remain subject to Division 7A, but will be assisted by the simpler rules for non-complying loans.

6.9 Finally, the Board notes that the new model will preserve integrity rules and their associated compliance costs for those trusts that seek to make disguised distributions by way of non-commercial loans or making assets available for private use.

SAFE HARBOUR AND SPECIFIC PROVISIONS RELATING TO TEMPORARY TRANSFERS

6.10 The Board has developed what it considers to be a set of appropriate requirements for determining when a temporary transfer of cash (that is, a loan) will not be taken to be a dividend under a reformed Division 7A. They are set out below.

6.11 The purpose of such a set of requirements would be to replace what constitutes a complying loan under the current Division 7A as well as the requirements in the Commissioner's PS LA 2010/4.

Complying loans

6.12 The Board considers that there is a need for the legislation to set out broad terms and conditions that enable a broader range of loans to fall within the exclusion for complying loans. There are a number of features of the current provisions and

administrative arrangements that are either unduly restrictive and inflexible, or provide overly generous terms that do not serve the policy intent of Division 7A.

6.13 The problems with the current rules include:

- A maximum term of seven years for some unsecured loans may not be sufficient and a maximum term of 25 years for secured loans provides, in a general sense, preferential treatment for investing in real property (via a 25-year loan) over financing working capital for business (via a seven-year loan).
- The requirements for repayments of principal are inflexible.
- The safe harbour rules in PS LA 2010/4 for UPEs held on a sub-trust that provide for seven-year and 10-year interest-only loans are overly generous as no principal repayments are required. These rules are not consistent with the complying terms for Division 7A loans.
- The Benchmark interest rate based on the Indicator Lending Rates – Bank variable housing loans interest rate last published by the Reserve Bank of Australia before the start of the income year is too low as it does not reflect the unsecured nature of the loan and the non-arm’s length relationship of the parties. It provides an incentive for shareholders to borrow funds from their company to purchase non-deductible acquisitions, rather than receiving a dividend with which they can make the purchase.²⁵

6.14 To address the above shortcomings, the Board considers that there is value in considering a number of possible amendments to the provisions:

- Some flexibility should be provided for the payment of principal and interest recognising that, due to the nature of the business or investment activity undertaken by the loan recipient, it may not be possible to make annual payments of interest and principal.
- Rather than having to determine for each year of the term of the loan a minimum yearly repayment, the interest rate and repayment milestones or timeframes should be set out at the start of the loan.
- There should be written or electronic evidence to support the making of the loan and detailing the terms and conditions but no requirement for a formal loan agreement to be executed.

²⁵ A similar incentive was observed in the proposed Statutory Interest Model discussed at paragraph 5.31. For that model, it was observed that the interest rate should be set at a sufficiently high rate to deter private use of company funds.

6.15 The exclusion from the operation of Division 7A for loans that are repaid by the due date for lodgment of the tax return for the income year following the year in which the loans are made should be preserved.

6.16 The Board considers that having the one maximum 10-year loan term would greatly simplify Division 7A and make it easier to comply with. This 10-year maximum loan term would replace the existing seven-year unsecured and 25-year secured loans and the ATO's safe harbours for UPE arrangements. Accordingly, there would be no need to distinguish between secured and unsecured loans or to adjust for refinancing from unsecured to secured and secured to unsecured. In addition, there would be no need to calculate an annual minimum yearly repayment which overcomes many of current problems.

6.17 This would also remove the preferential treatment for investing in real property (via a 25-year loan) over financing working capital for business (via a seven-year loan).

6.18 Taxpayers would also have certainty as to the interest rate for the period of the loan, payments required and the potential for improved cash flow as the rate would be set upfront and there would be no requirement to make annual payments of principal and interest.

Requirements of a complying loan

6.19 Taking the above into consideration, the Board's preliminary view is that all Division 7A complying loans should be based on the following terms:

- There should be no requirement for a formal written agreement between the parties. However, written or electronic evidence showing that a loan was entered into must exist by lodgment 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 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.²⁶ For example, the rate for the year ending 30 June 2013 is 10.0 per cent.
- The maximum loan term would be 10 years.

²⁶ These rates can be found at Table F5 on the Reserve Bank of Australia website (*see* <http://www.rba.gov.au/statistics/tables/index.html>).

- 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; and
 - 0 per cent of the original loan (that is, fully repaid) by the end of year 10.²⁷
- 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 – the ends of years three, five, eight and ten.
- The deductibility of interest would be governed by existing income tax rules.

6.20 Failure to make the repayments by the end of the milestone period 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.

6.21 As the Commissioner has limited periods of review in which to amend assessments, there is a risk that for a 10-year loan the Commissioner would not be able to amend assessments to include omitted deemed dividends. This is particularly a risk where, due to a technicality, an arrangement would ordinarily result in a deemed dividend in year one, rather than year 10.

6.22 One way of overcoming this problem would be to ensure that the Commissioner's period of review commences to run from the date of lodgment for the income year in which each milestone payment is required (or would have been required, had a complying loan agreement been entered into). This rule would not provide the Commissioner with an unlimited amendment period.

6.23 In accordance with the above, the relevant distributable surplus would be the distributable surplus at the end of the year of income in which the Division 7A breach occurred and not the distributable surplus at the end of the year when the Commissioner became aware of the breach.

27 This replicates the rate at which principal is reduced under the 'Rule of 78', an arithmetic progression that is commonly used in commercial lending. See the discussion in Taxation Ruling TR 93/16.

Q 6.1 Issues/Questions

The Board seeks stakeholders' comments on whether it would simplify compliance if legislation were enacted prescribing the terms and conditions for Division 7A loans as outlined below and, if not, how the proposed rules could be modified to improve simplicity:

- a. 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 lodgment day for the income year in which the loan was made.
- b. The statutory interest rate would be set at the start of the loan and fixed over the term of the loan.
- c. The statutory interest rate for a particular year would be set at be 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.
- d. The maximum loan term would be 10 years.
- e. 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; and
 - 0 per cent of the original loan (that is, fully repaid) by the end of year ten.
- f. Subject to meeting the minimum loan balances, there would be no specified annual principal repayments.
- g. Interest would be able to be accrued but would have to be paid by the end of each milestone period – ends of years three, five, eight and ten.
- h. 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.
- i. The Commissioner's period of review would commence to run from the date of lodgment for the income year in which each milestone payment is required (or would have been required, had a complying loan agreement been entered into).

Treatment of UPEs — problems with the current rules

6.24 The Board considers that, regarding the treatment of UPEs, what constitutes financial accommodation for the purposes of Division 7A should be legislatively clarified. Legislative clarification is particularly important given that on this key threshold issue the Commissioner's position under the current law has been controversial.

6.25 The Board's preliminary opinion is that the Commissioner's view, set out in TR 2010/3, that a UPE can amount to financial accommodation is broadly consistent with what ought to be the policy outcome in terms of the substance of the UPE arrangements. However, the scope of the Commissioner's ruling, which is restricted by technical aspects of trust and income tax law, is too narrow to fully address the policy issues on what constitutes financial accommodation and to enable interaction issues to be dealt with on a sound basis.

6.26 The limitations of the ruling (and accompanying PS LA 2010/4) mean that well-advised taxpayers are able to attain unintended benefits. They can, for example, place a UPE on a sub-trust within the evidentiary safe harbours set out in PS LA 2010/4 (including seven and 10-year interest-only loans) which is then used to fund the acquisition of investment assets such as real property.

6.27 At the end of the interest-only loan permitted by PS LA 2010/4, and assuming the property has increased in value sufficiently, it can be refinanced through a bank without the top-up tax on the loan ever being paid.

6.28 The Board notes that in certain situations, the UPE provisions may be avoided entirely by certain leasing, factoring and consignment arrangements. These arrangements are the cause of much complexity for taxpayers notwithstanding that, in a situation where a trust is carrying on a business, the financing of the trust by the company enables the business of the trust to expand.

6.29 The Board believes that greater simplification, certainty and policy coherency could be gained from 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. This would give effect to the principle that temporary transfers of value, if they are not repaid or paid for, will be considered to be permanent transfers.

6.30 The treatment of all UPEs as loans for Division 7A purposes as at 30 June in the year of the relevant distribution should not result in a deemed dividend if the obligation to meet the entitlement is repaid by the time the trust tax return is due to be lodged in the income year following that in which the entitlement arises. This treatment would be consistent with shareholder loans not being covered by

Division 7A if they are repaid by that time. Consistency in treatment of UPEs and shareholder loans from a timing perspective will significantly reduce compliance costs.

6.31 While the Board believes there is merit in clarifying that UPEs are loans for Division 7A purposes, it considers it undesirable to adopt this simplification or clarification without at the same time addressing the use of UPE funds from a company as working capital for the carrying on of a business in a trust.

6.32 In the next section of this Paper, the Board outlines a proposal under which a limited exclusion from the Division is provided for trusts that use UPEs to fund active business activities.

Q 6.2 Issues/Questions

The Board seeks stakeholders' comments on whether greater simplification, certainty and policy coherency would be gained from a legislative amendment to clarify that all UPEs are loans for Division 7A purposes.

EXCLUSION — LOANS MADE TO TRUSTS (TICK THE BOX OPTION)

6.33 The Board considers that the issue of retaining working capital for the carrying on of a business in a trust can be addressed with the use of a limited exception. Given the relatively common use of trusts by small business in particular, there is a need to address this working capital issue to achieve the second and fourth goals stated in paragraph 4.25 above of removing impediments to reinvestment in businesses and not advantaging private use of business income over business reinvestment.

6.34 The Board aims to address this problem in a way that will relieve those businesses that retain UPE funds solely to meet their working capital funding needs from the compliance burdens associated with Division 7A.

6.35 This proposal aims to allow trading trusts to opt in to a key feature of the company tax system (the company tax rate) but requires, by way of trade-off, that the trust forgoes an important concession not available to companies (the CGT discount).

6.36 The proposed exclusion has two components:

- 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 an election (an excluded trust) would forgo the CGT discount on capital gains arising from assets (other than goodwill) held within the trust. The denial of the CGT discount in these circumstances is consistent with allowing

use of the loan (including UPE) funds as if they were still in a company environment – where companies cannot access the CGT discount.

6.37 The CGT discount will, however, still be applicable to any goodwill arising from the sale of a business. This is on the basis that goodwill is, by its nature, an asset solely connected with the use of funds in a business – and so allowing continued access to the CGT discount for goodwill arising from business activities would be consistent with the goals identified at paragraph 4.25 above. This treatment is also aligned with the characterisation of goodwill under the CGT small business relief provisions as an asset ‘inherently connected’ with a business.²⁸

6.38 To achieve equivalent treatment, where the excluded trust holds shares in a business with goodwill, this goodwill treatment should apply to the part of the share value representing goodwill.

6.39 The proposed exclusion will put loans from companies to trusts that make the election on an equal footing with inter-company loans. It does this by, in effect, replicating the exception in section 109K that currently applies to inter-company loans. The section provides, inter alia, that a loan made by a company to another company (other than a company acting in the capacity of a trustee) does not result in the private company being taken to have paid a dividend.

6.40 The proposed exclusion would be limited to loans (including UPEs) owed by the excluded trust. For simplicity, it would not extend to temporary transfers of value by way of asset usage by the trust. It would also not extend to permanent transfers of value – debt forgiveness, asset transfers – to the trust.

6.41 There is no intention to treat the trust as a company in any wider sense than necessary for Division 7A purposes. To do so would be both complex and involve wider matters outside of the scope of the current review of Division 7A.

6.42 As with the rules applicable to inter-company loans, any temporary transfers of value by way of private asset use or loans out of the receiving entity (in this case the excluded trust) would not be subject to the exception. The proposed complying loan requirements or asset usage fees would apply to those transactions, as if the transaction had been entered into by the company to which the excluded loans are owed.

6.43 Similarly, permanent transfers of value – debt forgiveness, asset transfers – made by the excluded trust will not be within the exception.

6.44 There will remain a clear obligation for the excluded loan (including UPE) amounts to ultimately be repaid to the company.

28 Note 3 to section 152-40 of the ITAA 1997.

6.45 There will also be a need for section 109T, the interposed entity rule, to be strengthened to ensure it adequately deals with any concerns regarding these excluded trusts. For example, amounts lent through multiple excluded trusts before being used to purchase assets allowed to be used by shareholders or associates will need to be subject to the same safe harbour asset usage rules, as if the company itself had owned the asset and allowed its use.

6.46 Rules will also need to apply to allow amounts to be paid out by an excluded trust in satisfaction of UPEs directly owed to shareholders or associates of shareholders as beneficiaries of the trust, but preventing such UPEs being used to circumvent Division 7A, such as by creating those UPEs over unrealised gains.

6.47 Consequential rules may be needed to deal with assets that leave the excluded trust without triggering a realisation for CGT purposes (for example, because of a rollover). As a general principle, the CGT discount should be not available in the hands of the new owner on a capital gain to the extent that it is attributable to value that accrued in the excluded trust.

Examples — UPEs retained by trusts under the tick the box option

Example A

- The G Business Trust has made G Pty Ltd presently entitled to \$100,000 and that amount remains owing as a UPE.
- Funds representing the UPE are used as working capital to fund debtors in the G Business Trust (as confirmed by there not being any loans to individuals or use of assets out of the trust).
- If the G Business Trust makes the election — the \$100,000 UPE owed by the G Business Trust to G Pty Ltd would be excluded from Division 7A as akin to an inter-company loan.

Example B

- The H Family Trust has made H Pty Ltd presently entitled to \$500,000 and that amount remains owing as a UPE.
- Funds representing the UPE are used:
 - \$100,000 as working capital to fund debtors in the H Family Trust business; and
 - \$400,000 to buy a residential investment property.
- If the H Family Trust makes the election, the \$500,000 UPE owed to H Pty Ltd would be excluded from Division 7A as akin to an inter-company loan **but** the

50 per cent CGT discount will not apply to any capital gain on the residential investment property.

Example C

- The J Family Trust has made J Pty Ltd presently entitled to \$500,000 and that amount remains owing as a UPE to J Pty Ltd.
- Funds representing the UPE are used by the J Family Trust to buy a yacht, which the family uses.
- If the J Family Trust makes the election:
 - the \$500,000 UPE owed to J Pty Ltd would be excluded from Division 7A as akin to an inter-company loan **but** the use of the yacht will be treated as if J Pty Ltd provided the yacht;
 - there may be deemed dividends if the safe harbour asset usage payments are not made to the J Family Trust for the use of the yacht; and
 - the \$500,000 UPE will remain owing to the J Family Trust and will be a deemed dividend if it is forgiven, for example, because the yacht loses significant value.

Example D

- The K Family Trust has made K Pty Ltd presently entitled to \$800,00 of which it pays \$500,000 to K Pty Ltd and retains the other \$300,000 as UPE used as working capital to fund debtors and plant in the K Family Trust business.
- K Pty Ltd uses the \$500,000 to buy a yacht and allows the K Family Trust to use the yacht by providing it to beneficiaries as the trustee directs.
- If the K Family Trust makes the election:
 - the \$300,000 UPE owed by K Family Trust to K Pty Ltd will be excluded from Division 7A as akin to an inter-company loan but the use of the yacht is not similarly excluded; and
 - there may be deemed dividends if the safe harbour asset usage payments are not made to K Pty Ltd for the use of the yacht.

6.48 If a private company makes a loan to a trust and the exception has no application (that is, the trust has not made an election), it is proposed that the UPE can be paid by the next lodgment date, or the private company and trustee can enter into a complying loan to avoid a deemed dividend arising in respect of that UPE.

6.49 Loans (including UPEs) subject to the exception should be excluded from fringe benefits tax (FBT) in the same way that safe harbour Division 7A loans would be excluded.

Transitional rules

6.50 Transitional rules will be required for existing assets held within the excluded trust, in respect of the denial of the CGT discount.

6.51 Consistently with the suggested policy framework, the transitional rules should be designed having regard to the main objectives of maximising simplicity and minimising the cost of compliance.

6.52 To give effect to these objectives, one option would be for the tick the box exclusion to operate on a purely prospective basis under which:

- Any loans (including UPEs owing to a company) in place prior to a trust making an election would continue to be subject to the existing requirements.
- Any CGT assets acquired by the trust prior to the making of an election would continue to be eligible for the CGT discount on disposal.

Q 6.3 Issues/Questions

The Board seeks stakeholders' comments on:

- a. whether the issues associated with retaining working capital for the carrying on of a business in a trust can be addressed with the use of a limited exception;
- b. whether the limited exception (provided through legislation) should be that all loans to trusts (including UPEs) can be excluded from the operation of Division 7A, where the trust makes a once and for all election to forgo access to the CGT discount on its capital gains arising from assets held within the trust;
- c. whether the proposed limited exception would reduce compliance costs in instances where a business is carried on in a trust;
- d. the nature of the consequential rules that would be required if such a limited exception were to be applied;
- e. the nature of any transitional rules that would be required if such a limited exception were to be applied; and
- f. the merits of a transitional rule that provides that:
 - any loans in place prior to a trust making an election would continue to be subject to the existing requirements; and

- any CGT assets acquired by the trust prior to the making of an election would continue to be eligible for the CGT discount on disposal; or
- g. alternative suggestions for a transitional rule that maintain integrity, provide simplicity and reduce compliance costs.

SELF-CORRECTION MECHANISM

6.53 Division 7A is seen as a complex area of tax law and notwithstanding amendments made to simplify the operation of 7A mistakes will occur. Under the current law there is no ability to self-correct mistakes or omissions and taxpayers are required to request the exercise of the Commissioner of Taxation's general discretion in order to avoid a deemed dividend.

6.54 The requirement to request the exercise of the discretion is seen as an unnecessary cost of compliance for taxpayers and the discretion is difficult for the Commissioner to administer.

6.55 If a private company is taken to have paid a dividend because the loan is not considered to be a complying loan or repayments have not been made as required, it has been argued that taxpayers should have the ability to correct any mistakes or omissions.

6.56 The Board seeks feedback on whether a legislated self-correction mechanism could 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.

6.57 As with the current discretionary provision, a self-correction 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.

6.58 A 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.

6.59 The existence of eligibility requirements and conditions would mean that taxpayers would need to meet appropriate record-keeping and other evidentiary requirements.

6.60 In terms of the practical administration of a self-correction mechanism, the Board notes that for the 2002 until the 2007 years of income, the Commissioner adopted an

administrative practice in which taxpayers who met prescribed eligibility requirements were given the benefit of the general discretion without making a formal application.²⁹ The features of this administrative practice may be a useful point of reference in the design and administration of a legislative exception.

6.61 Subject to the issues outlined above, the Board considers that the ability to self-correct is likely to increase certainty and encourage taxpayers to address past Division 7A breaches plus reduce the costs of compliance. It may also substantially reduce the number of cases that require a decision to be made by the Commissioner.

Q 6.4 Issues/Questions

The Board seeks stakeholders' comments on:

- a. whether a legislative self-correction exception should be available to taxpayers to correct mistakes or omissions;
- b. the nature of any eligibility requirements for the exception;
- c. the nature of any conditions that should be satisfied to qualify for the exception;
- d. appropriate record-keeping and evidentiary requirements that must be met to qualify for the exception; and
- e. any impediments to the practical administration of the exception.

²⁹ Practice Statement Law Administration, PS LA 2007/20.

APPENDIX A — LIST OF SUBMISSIONS

The following is a list of submissions, excluding confidential submissions, made to the Board in response to its December 2012 Discussion Paper on its post-implementation review of Division 7A of Part III of the *Income Tax Assessment Act 1936*.

Submission can be viewed in full on the Board's website at www.taxboard.gov.au.

Table A.1: List of organisations and persons providing public submissions

Entity
Adrian Abbott
Arnold Bloch Leibler
BDO Australia Ltd
CPA Australia Ltd
Ernst & Young
Greenoak Advisory Pty Ltd
Hayes Knight (NSW) Pty Ltd
Institute of Chartered Accountants Australia Part 1
Institute of Chartered Accountants Australia Part 2
Institute of Public Accountants
Law Council of Australia Business Law Section
Law Council of Australia Family Law Section
Moore Stephens
Pitcher Partners
PricewaterhouseCoopers
The Tax Institute

APPENDIX B — QUESTIONS

CHAPTER 4:

Q 4.1 Issues/Questions

The Board seeks stakeholders' comments on whether taxing business accumulations at a 'company tax' rate, irrespective of the structure chosen, is an issue that should be considered as part of a wider tax reform process.

Q 4.2 Issues/Questions

The Board seeks stakeholders' comments on whether the high level tax policy aims of efficiency, simplicity and equity would be served by adopting a policy framework for private businesses that supports the progressivity of the personal tax system by striking an appropriate balance between the following four goals:

- (a) It should ensure that the private use of company profits attracts tax at the user's progressive personal income tax rate.
- (b) It should remove impediments to the reinvestment of business income as working capital.
- (c) It should maximise simplicity by reducing the compliance burden on business and the administrative burden on the Commissioner and other stakeholders.
- (d) It should not advantage the accumulation of passive investments over the reinvestment of business profits in active business activities.

Q 4.3 Issues/Questions

The Board seeks stakeholders' comments on how, if the suggested framework were to be implemented, the proposed rules regarding asset usage could be designed without introducing undue complexity.

Q 4.4 Issues/Questions

The Board seeks stakeholders' comments on:

- (a) whether excluding unrealised gains from the distributable surplus would assist in simplifying compliance with the provisions and address the potential for double taxation;
- (b) whether there would be integrity concerns or likely cost to revenue if the proposed approach to distributable surplus were to be adopted; and
- (c) whether, as an alternative to the proposed approach, unrealised gains and losses should be included in the basic calculation of distributable surplus, but then be subtracted when dealing with temporary transfers of value.

Q 4.5 Issues/Questions

The Board seeks stakeholders' comments on whether the distributable surplus rules should be adjusted to be:

- (a) tested at year end for permanent transfers of value, as well as for temporary and ongoing transfers of value (for example loans, asset usage) at **each** year end; and
- (b) based on the **amount** of available realised profits of the company as reflected in its accounts (net assets), but with appropriate adjustments to address situations:
 - of possible double counting; and
 - where value which has not been reflected as realised in the accounts has been transferred to shareholders/associates.

Q 4.6 Issues/Questions

The Board seeks stakeholders' comments on:

- (c) the proposed general rules for determining when deemed dividends should arise; and
- (d) whether, and in what circumstances, deemed dividends should be frankable.

CHAPTER 5:

Q 5.1 Issues/Questions

The Board seeks stakeholders' comments on whether the potential benefits of the Statutory Interest Model (particularly the simplification benefits) are justifiable having regard to the policy framework set out at paragraph 4.25 above.

Q 5.2 Issues/Questions

The Board seeks stakeholders' comments on:

- (a) whether a number of administrative issues and the high compliance and administrative costs associated with Division 7A are due to the prescriptive and, in some cases, form-based provisions within the Division;
- (b) whether pursuing the *Division 7A Adjustment Model* alone would have only limited impact in moving the system in the direction of the Board's preferred policy framework as discussed in Chapter 4; and
- (c) if the new model suggested in Chapters 4 and 6 (and summarised in the Executive Summary) were to be adopted, what remaining aspects of the *Division 7A Adjustment Model* (if any) should be progressed, any in what priority.

CHAPTER 6:

Q 6.1 Issues/Questions

The Board seeks stakeholders' comments on whether it would simplify compliance if legislation were enacted prescribing the terms and conditions for Division 7A loans as outlined below and, if not, how the proposed rules could be modified to improve simplicity:

- (a) 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 lodgment day for the income year in which the loan was made.
- (b) The statutory interest rate would be set at the start of the loan and fixed over the term of the loan.
- (c) The statutory interest rate for a particular year would be set at be 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.
- (d) The maximum loan term would be 10 years.
- (e) 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; and
 - 0 per cent of the original loan (that is, fully repaid) by the end of year ten.
- (f) Subject to meeting the minimum loan balances, there would be no specified annual principal repayments.
- (g) Interest would be able to be accrued but would have to be paid by the end of each milestone period – ends of years three, five, eight and ten.
- (h) 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.
- (i) The Commissioner's period of review would commence to run from the date of lodgment for the income year in which each milestone payment is required (or would have been required, had a complying loan agreement been entered into).

Q 6.2 Issues/Questions

The Board seeks stakeholders' comments on whether greater simplification, certainty and policy coherency would be gained from a legislative amendment to clarify that all UPEs are loans for Division 7A purposes.

Q 6.3 Issues/Questions

The Board seeks stakeholders' comments on:

- (a) whether the issues associated with retaining working capital for the carrying on of a business in a trust can be addressed with the use of a limited exception;
- (b) whether the limited exception (provided through legislation) should be that all loans to trusts (including UPEs) can be excluded from the operation of Division 7A, where the trust makes a once and for all election to forgo access to the CGT discount on its capital gains arising from assets held within the trust;
- (c) whether the proposed limited exception would reduce compliance costs in instances where a business is carried on in a trust;
- (d) the nature of the consequential rules that would be required if such a limited exception were to be applied;
- (e) the nature of any transitional rules that would be required if such a limited exception were to be applied; and
- (f) the merits of a transitional rule that provides that:
 - any loans in place prior to a trust making an election would continue to be subject to the existing requirements; and
 - any CGT assets acquired by the trust prior to the making of an election would continue to be eligible for the CGT discount on disposal; or
- (g) alternative suggestions for a transitional rule that maintain integrity, provide simplicity and reduce compliance costs.

Q 6.4 Issues/Questions

The Board seeks stakeholders' comments on:

- (a) whether a legislative self-correction exception should be available to taxpayers to correct mistakes or omissions;
- (b) the nature of any eligibility requirements for the exception;

- (c) the nature of any conditions that should be satisfied to qualify for the exception;
- (d) appropriate record-keeping and evidentiary requirements that must be met to qualify for the exception; and
- (e) any impediments to the practical administration of the exception.

APPENDIX C — ADDITIONAL PROBLEMS IDENTIFIED IN THE OPERATION OF THE DIVISION 7A PROVISIONS

The terms of reference asked the Board to examine whether there are any problems with the current operation of Division 7A, including its interaction with other areas of the tax law, that are producing unintended outcomes or disproportionate compliance and administration costs.

Chapter 4 of the December 2012 Discussion Paper set out the provisions of Division 7A and problems identified in their operation. The chapter sought to highlight the depth and breadth of a number of those difficulties and issues.

The format of Chapter 4 was to follow the Division 7A framework (the Subdivisions) and progressively work through the provisions in the order in which they appear in the legislation. They were not set out in order of priority. Based on the views in the submissions, some of the issues were regarded as high priority, others medium priority and the balance were minor technical or administrative issues.

The high priority issues were considered to be:

- The use of assets provisions.
- In-house provisions of finance and trading.
- Treatment of unpaid present entitlements.
- Distributable surplus.
- Interposed entity provisions.
- Commissioner's general discretion.
- The interaction of Division 7A with other areas of tax law.
- Current definitions of payment, loan and debt forgiveness are inadequate to describe the varied ways by which private company profits can be accessed.
- The operation of section 109R – disregarding of temporary loan repayments.

Since the issue of the December 2012 Discussion Paper, additional problems have been brought to the attention of the Board including by way of the submissions made. They are set out below, again in the order in which they appear in the legislation.

SUBDIVISIONS A AND AA — OVERVIEW OF DIVISION AND APPLICATION OF DIVISION

Scope of application — private companies

To clarify its scope of application, Division 7A needs to set out how it applies to:

- (a) all entities that are companies or taxed as if they were companies, but not private companies; and
- (b) private companies that are treated as partnerships for tax law purposes.

The December 2012 Discussion Paper stated at paragraph 4.14 that the ‘extent of the application of Division 7A is unclear in some circumstances and may not be broad enough to capture some arrangements that should fall within the measure’.

The December 2012 Discussion Paper highlighted that since the scope of the application of Division 7A was extended to closely-held corporate limited partnerships (section 109BB), other entities such as companies limited by guarantee and public trading trusts are being used in corporate structures and arrangements to circumvent the operation of the Division.

Division 7A does not set out how the Division applies to private companies that are treated as partnerships for tax law purposes. As an example of such company, in the ITAA 1997, Division 830 was introduced to enable certain entities formed outside Australia (called foreign hybrids) that are treated as fiscally transparent for the purposes of foreign income tax (but as companies for Australian income tax law purposes) to be treated as partnerships under Australian income tax law.

SUBDIVISION B — PRIVATE COMPANY PAYMENTS, LOANS AND DEBT FORGIVENESS ARE TREATED AS DIVIDENDS

General

Subdivision B of Division 7A broadly provides that certain payments, loans, amalgamated loans and forgiven loans are to be treated as unfranked dividends. Additional issues raised include:

- (c) A number of the provisions require the entity taken to have been paid the dividend at the end of the year of income to be the entity to which the payment or loan was made. Division 7A may not operate as intended where that is not the case.

For example, there is an issue surrounding the application of Division 7A following the death of a shareholder (or their associate). Section 109D (loans) and section 109E (amalgamated loans) require the entity taken to be paid the

dividend at the end of the year of income to be the entity to which the loan was made. Section 109F (debt forgiven) on the other hand only requires all or part of a debt the entity owes the company to be forgiven in that year. As a result there is a view that a dividend may arise as appropriate under section 109F in respect of a shareholder or associate who died during the relevant year, but not under sections 109D and 109E. However, it is arguable that the provisions may operate consistently if the term 'entity' is capable of being interpreted to include a deceased person and his or her personal legal representative.

- (d) Deemed dividends that arise under Division 7A should be permitted to be franked. While Division 7A is an integrity provision, it is not clear why a taxpayer who receives a dividend (as opposed to one who is deemed to have received a dividend) should be treated any differently under the tax laws. By not allowing the flow through of franking credits Division 7A, in effect, imposes double taxation.
- (e) The various references in the Division to 'lodgment day' can create uncertainty because a company's due date can vary from year to year in accordance with the lodgment program. Further, an entity may prepare loan agreements and have them ready to be signed by the expected due date but still trigger a deemed dividend because the return is lodged earlier than its due date. A suggested alternative could be to have a reference to 'the 15th day of the 11th month following the end of the income year' to improve certainty and to simplify the rules. This equates with the current latest time for lodgment for small companies and trusts on a tax agent's lodgment program.

Payments — section 109C

Payment is broadly defined in subsection 109C(3). Additional issues raised in relation to section 109C include:

Definition

- (a) Clarification should be provided as to when there is a credit of an amount to an entity, on behalf of the entity or for the benefit of the entity for paragraph 109C(3)(b) purposes.

Right to use payments

- (b) The extended definition for provision of an asset for use should be limited to actual use of an asset rather than the provision of an asset that is available for use.
- (c) A provision of an asset by a private company to an entity will not be regarded as a payment where it would have been regarded as a minor benefit under section 58P of the *Fringe Benefits Assessment Act 1986* if it

had been provided in respect of the employment of an employee. The \$300 *de minimus* exemption under the minor benefits exemption is too low as companies practically do not have systems in place to monitor the frequency and the value of benefits provided to shareholders to the same extent as systems they maintain to track the provision of benefits to employees.

- (d) For taxpayers who are required to apply section 109CA it is unfortunate that they were not provided with an opportunity to restructure their affairs to 'divest' or 'demerge' the assets out of the private companies to the ultimate non-corporate shareholders.
- (e) Division 7A potentially applies in circumstances where family members have simply used a private company as a vehicle to hold a property (for example, beach house) and not to carry on any business or investment activities.

Other

- (f) In cases where private companies have issued shares for no consideration it is argued that the issue of shares is not a transfer of property for Division 7A purposes.
- (g) The use of promissory notes. Transactions involving the circular use of non-arm's length promissory notes have been used as part of a series of transactions attempting to avoid the potential operation of Division 7A. The arrangement involves the creation of value somewhere in the group (generally by way of asset revaluation) and the transfer of that value to a shareholder who then uses that value to notionally repay the Division 7A loan. It is argued that the notional repayment prevents a deemed dividend from arising even though it involves no actual movement in funds.
- (h) In some circumstances a private company may be used to carry on what otherwise would be an individual's hobby or recreational pursuit. For example, the private company may own and race thoroughbred horses. In these circumstances there is no right to use payment made to the shareholder (or their associate).

Loans — section 109D

Loan is broadly defined in subsection 109D(3). There is an additional issue concerning whether undrawn partnership profits should amount to a loan within its extended meaning for Division 7A purposes.

Where a private company has partnership profits that remain unpaid, there is a risk that the funds relating to those profits could be advanced by the partnership to a shareholder (or their associate) of the company without attracting Division 7A.

Loans — section 109E

The Discussion Paper set out a number of problems with the operation of section 109E. The additional issue raised does not focus on the actual operation of the provision but rather on what loans should be covered by the provision.

The issue raised was the lack of justification for making a loan, on which the borrower would be entitled to an interest deduction, subject to the annual minimum repayment amount set out in section 109E.

SUBDIVISION D — PAYMENTS AND LOANS THAT ARE NOT TREATED AS DIVIDENDS

General

Subdivision D sets out the rules about payments and loans that are not treated as dividends. That is, Subdivision D includes the exceptions and exclusions. One of the issues with Subdivision D is the currency of its exclusions in the present-day commercial world. This is reflected in the following additional issues raised:

- (a) The problem with the current Division 7A loan requirements is its inflexibility to deal with real commercial arrangements of a private company and its relationship with other entities in the group. The current seven-year principal and interest option does not cater for most business to business loan arrangements. Any legislatively prescribed terms should be more commercially flexible, similar to those options contained in PS LA 2010/4 for UPEs.
- (b) Loans from a private company to a trust within a private group but in respect of which the loan funds do not permanently leave the group for private use or consumption and are used for working capital or for investment should be subject to an exclusion from Division 7A.
- (c) An 'otherwise deductible' rule would limit the operation of Division 7A to only those types of loans that are intended to be caught. The rule should apply regardless of whether interest is actually payable or paid. There should be no integrity concern in allowing funds to be loaned without payment of interest and without the application of Division 7A as the marginal tax rate that would otherwise apply to the deduction will typically exceed the marginal tax rate at which the interest would be taxed.

Section 109K Inter-company payments and loans not treated as dividends

It was suggested that the exclusion should extend to payments or loans made to partnerships where all the partners are companies.

Section 109M Loans made in the ordinary course of business on arm's length terms not treated as dividends

One of the issues raised in the Discussion Paper highlighted that section 109M has no application in circumstances where the private company only transacts with related parties. The submissions received generally agreed that the exclusion in section 109M was too narrow.

The additional issue raised concerns on the application of section 109R and how it may impact on loans made. It was stated that entities in a private group regularly borrow from an in-house finance company, so there is always a danger that the arrangement will offend section 109R (temporary loan repayments) and therefore any repayments could be disregarded.

Section 109N Loans meeting criteria for minimum interest rate and maximum term not treated as dividends

The Discussion Paper did not directly raise any issues with section 109N. For loans that were excluded by section 109N, the loan issues concerned the application of section 109E to the loans (amalgamated). A number of section 109N issues have been raised. They include:

Loan agreements

- (a) There should be no need for legally binding written loan agreements and the relevant terms and conditions set out in the legislation could apply in default. The current rules are onerous and result in unnecessary compliance costs.

Interest rate

- (b) Paragraph 109N(1)(b) requires the rate of interest payable on a loan to equal or exceed the benchmark interest rate over the life of the loan. If the loan agreement specifies an actual interest rate, it is not possible to establish whether the rate will exceed the benchmark interest rate over the life of the loan.
- (c) The interest rate used for Division 7A loans should be the FBT rate.
- (d) To simplify the operation of Division 7A and the calculations for minimum yearly repayments the interest rates should remain fixed for the

period of the loan, with the rate tied to the year in which the loan was originally made.

- (e) The provision should clarify how interest is to be calculated as it is currently not clear as to whether it is calculated on a daily basis, based on the opening, closing or average loan balance or in fact some other method.

Term of loans

- (f) The current seven year period to repay unsecured loans does not reflect the reality of today's commercial funding obligations and 10 years would be more appropriate. A 10 year period also accords with the ATO's own Option Two methodology in PS LA 2010/4.

Secured loans

- (g) The 'maximum term' condition in subparagraph 109N(3)(a)(ii) requires that when a loan secured by real property is first made, the market value of that real property (less the amounts of any other liabilities secured over that property in priority to the loan) be at least 110 per cent of the amount of the loan. This gives rise to two issues. Firstly, any reduction in the value of the security provided in later years would have no impact unless there were to be new loan. Secondly, where a loan is later refinanced from being unsecured to secured, the relevant market value will be the market value when the loan is first made and not the market value at the time of refinancing.
- (h) There is a need to clarify that real property for the purposes of subsection 109N(3) includes leasehold interests in land.

Section 109NB Loans to purchase shares under employee share schemes (ESS) not treated as dividends

It was submitted that while linking the exclusion to the ESS share schemes may be legislatively convenient, it results in a significant number of legitimate employee share arrangements being denied the Division 7A concession. An example was put forward of companies in the SME market being unable to take advantage of section 109NB by issuing shares as an incentive to key personnel but being unable to afford to do so on a non-discriminatory basis.

Section 109Q Commissioner may allow amalgamated loan not to be treated as dividend

Section 109Q gives the Commissioner a discretion to disregard the failure to make a minimum yearly repayment if the failure was caused by circumstances beyond the

control of the loan recipient and the inclusion of the deemed dividend in assessable income would result in the recipient suffering undue hardship.

It has been argued that the section 109Q discretion should also apply in circumstances where section 109D applies and results in a deemed dividend rather than the discretion being limited to section 109E amalgamated loans.

Section 109RB Commissioner may disregard operation of Division or allow dividend to be franked

A number of submissions raised concerns about the drafting of this provision and suggested a self-correcting mechanism so that taxpayers would not be required to request the Commissioner to exercise his discretion in all circumstances.

Section 109RC Dividend may be franked if taken to be paid because of family law obligation

A 'family law obligation' is defined in section 109ZD to mean an order, agreement or award mentioned in paragraphs 126-5(1)(a), (b), (d), (e) or (f) of *the Income Tax Assessment Act 1997*.

The dividend may only be franked in the same circumstances that CGT roll-over relief applies in relation to marriage breakdown. The Discussion Paper highlighted that for some taxpayers the relief provided may not be enough, and there are also some inappropriate interactions with the CGT regime.

Two additional issues have been raised:

- (a) The definition of family law obligation does not include an agreement mentioned in paragraph 126-5(1)(da). Paragraph 126-5(1)(da), effective 1 March 2009, extends the CGT marriage breakdown roll-over to transfers of assets under an agreement made between parties to a de facto relationship.
- (b) The operation of the concession is inflexible as it only allows the dividend to be franked if the dividend is franked at the company's benchmark franking percentage for the period in which the dividend is deemed to be paid. If the company does not have a benchmark franking percentage for the period, the dividend is franked at 100 per cent. This can cause problems in cases where the company does not have a benchmark franking percentage for the year in question and also does not have sufficient franking credits to frank the deemed dividend at 100 per cent.

SUBDIVISION E — PAYMENTS AND LOANS THROUGH INTERPOSED ENTITIES

Section 109T Payments and loans through interposed entities

Before the interposed entity provisions can apply the conditions in subsection 109T(1) must be satisfied. Most of the issues raised in the Discussion Paper concerned the conditions in subsection 109T(1) such as the scope of the reasonable person test in paragraph 109T(1)(b) and the operation of the provision in circumstances where there are a number of transactions involving multiple private companies and multiple target entities.

The interposed entity provisions have no application if the actual payment or loan made by the private company to the first interposed entity results in the private company being taken to have paid a dividend (deemed dividend) to the interposed entity (subsection 109T(3)).

Returning to the scope of subsection 109T(3), paragraph 4.105 of the Discussion Paper stated:

The scope of the reasonable person test in (b) has caused confusion as to when section 109T will apply. On one reading of the legislation, the test would appear to be satisfied in all cases involving a flow of traceable funds through an interposed entity to a target entity. However, it has been argued that the policy of section 109T demands that the provision be given a more restrictive application. Although there may be the case for clarifying the proper scope of section 109T, it should be noted that the reasonable person test is only relevant to determining whether a private company is taken to have made a deemed payment or notional payment to the target entity. This is only the first stage in calculating the amount of any deemed dividend.

The provision could be given a more prescriptive application by extending the exceptions and exclusions to the operation of the interposed entity provisions.

Submissions suggested that section 109T (and the interposed entity provisions) should not apply in circumstances where:

- (a) the first transaction from the private company source is a commercial transaction, or
- (b) the first leg of the arrangement is a Division 7A-compliant loan under section 109N.

The point was also made that taxpayers should not have to rely on the reasonable person test or the Commissioner determining that the amount of a deemed payment or notional loan is \$nil in circumstances where the first transaction falls into (a) or (b) above.

SUBDIVISIONS EA AND EB — UNPAID PRESENT ENTITLEMENTS

The Discussion Paper contained a range of issues and problems with the operation of Subdivisions EA and EB. Additional issues raised included the following:

- (a) A right to use an asset of a trust is not a payment covered by Subdivision EA because payments caught by Subdivision EA are limited to payments that discharge or reduce a present entitlement that is wholly or partly attributable to an amount that is an unrealised gain.
- (b) Section 109XB does not appear to allow for the modified application of section 109E (minimum yearly repayments) as section 109XB refers to dividends being included at the end of the year of income in which the actual transaction took place. Actual transaction is defined in subsection 109XA(2) for loans to be the loan.

SUBDIVISION F — GENERAL RULES APPLYING TO ALL AMOUNTS TREATED AS DIVIDENDS

General

Since Division 7A was inserted in 1998, there have been many changes in other areas of tax law (for example, in the CGT provisions) and new measures (such as the consolidation provisions) have been introduced. Subdivision F provides little or no guidance or rules on how Division 7A interacts with these amended or new areas of tax law.

Interaction with Consolidations

There is view that where a subsidiary member or head company of a consolidated group makes a payment or a loan, or forgives a debt to a shareholder or associate of a shareholder, the single entity rule does not apply to the calculation of the distributable surplus. This means that the distributable surplus is based on the entity making the loan, payment or debt forgiveness on a stand-alone basis.

It is therefore possible for companies within a consolidated group that transact with entities outside the group to circumvent Division 7A by transferring assets or forgiving debts to other members of the consolidated group and thereby reducing the distributable surplus. Transferring assets or forgiving debts are a common occurrence in a consolidated group environment.

Limiting the calculation of distributable surplus to the entity making the payment, loan or debt forgiveness may not appropriately serve the policy intent of either the consolidation regime or Division 7A.

Interaction with Taxation of Financial Arrangements (TOFA)

There is a view that there is an interaction issue between Division 7A and TOFA such that Division 7A, including Subdivision EA, may not apply to tax the principal amount of loans made to shareholders (or their associates) due to the anti-overlap provision in the TOFA legislation.

Distributable surplus formula — subsection 109Y(2)

The Discussion Paper listed a number of issues and problems with the distributable surplus formula. The following legislative changes were put forward as a way of reducing the compliance burden on taxpayers:

- Amending the calculation of the company's distributable surplus in section 109Y to align the concept of 'net assets' with the calculation of net assets that is required to be undertaken under section 254T of the *Corporations Act 2001* when the company is seeking to pay a dividend.
- Defining 'net assets' according to how they are stated in the company's financial statements where they are prepared in accordance with the generally accepted accounting principles and/or relevant accounting standards.

Later dividend rules — section 109ZC

One submission noted that section 109ZC needs to be improved to deal with franked dividends. A franked dividend that is paid after a deemed dividend should be capable of being a 'later dividend' as defined (and thus offset against the prior dividend). In such a case, the dividend should be non-assessable — however, the franking credit gross-up should be assessable and the franking credit should also be available as a credit.

SUBDIVISION G — DEFINED TERMS

Associate

'Associate' is defined in Division 7A to have the meaning given by section 318. This definition is very broad. For example, the associate of a trustee includes any entity that benefits under the trust. To benefit under a trust all that is required is that the taxpayer is capable of benefiting under the trust either directly or through any interposed companies, partnerships or trusts. It also includes associate of entities that benefit under the trust.

The submissions noted the following issues concerning the term 'associate':

- (a) The breadth of the definition of 'associate' has the potential to cause unforeseen and serious adverse consequences in some structures where there is no risk to revenue. A company which holds interests in an associated unit trust may effectively be taxed twice on a single amount of income.

- (b) Where a shareholder or associate holds a minute interest (say 0.001 per cent) in a unit trust or partnership, this should not be sufficient to expose the parties to a Division 7A outcome. However, Division 7A operates in the same way as if the company makes a loan to the trust or partnership.
- (c) The definition in subsection 318(3) of 'associates' of a trustee may not be broad enough to include a partnership, per se, where one or more of the partners is an associate of the trustee. Therefore, if a trustee is a shareholder of a private company, and the private company makes a loan to the partnership (which includes an associate of the trustee as a partner), section 109D may arguably have no application because the loan is not made to an associate of a shareholder. It has been stated that Division 7A will only apply to this arrangement if the loan is treated as having been made to the associate of the trustee rather than to the partnership.

Entity

'Entity' is defined in Division 7A to have the meaning given by section 960-100 of the Income Tax Assessment Act 1997. Subsection 960-100(1) lists a range of entities included in the definition (for example a partnership, a trust, any other unincorporated association or body of persons). The note to the subsection states that it covers all kinds of legal persons and groups of legal persons, and other things that in practice are treated as having a separate identity in the same way a legal person does.

Therefore, some entities included in the definition are not legal persons per se.

Section 960-100 makes provision for trusts by providing that the trustee of a trust is taken to be an entity because a right or obligation cannot be conferred or imposed on an entity that is not a legal person.

For entities that are not legal persons, notwithstanding that an association is an entity as defined, it is not clear if that entity can be a loan or payment recipient and be taken to have received a deemed dividend.

GLOSSARY

ATO	Australian Taxation Office
Board	Board of Taxation
Commissioner	Commissioner of Taxation
CGT	Capital gains tax
ESS	Employee Share Scheme
FBT	Fringe Benefits Tax
ITAA 1936	<i>Income Tax Assessment Act 1936</i>
ITAA 1997	<i>Income Tax Assessment Act 1997</i>
PS LA	Law Administration Practice Statement
TD	Taxation Determination
TR	Taxation Ruling
UPE	Unpaid present entitlement

