Australian Government

The Board of Taxation

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

A Report to the Assistant Treasurer

the board of taxation

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Board of Taxation

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CONTENTS

FOREWORD

The Board of Taxation (the Board) is pleased to submit this report to the Assistant Treasurer following its review of Division 7A of Part III of the *Income Tax Assessment Act 1936*.

The Board has concluded that the reform of Division 7A should be guided by a policy decision by the Government regarding its proper function in the broader tax system. The Board has set out alternative reform options that could be adopted, depending on the Government's policy decision.

The Board has also made a number of recommendations for improving Division 7A that could be adopted independently of the Government's policy decision.

The Board appointed a Working Group comprising Board members Curt Rendall, Keith James and Elizabeth Jameson, as well as Mark West, a Partner at McCullough Robertson. Mr Rendall chaired the review.

The Board would like to thank all those who contributed to the consultation process. Over the course of the review, the Board published two discussion papers and received 37 written submissions.

The Board would also like to express its appreciation to Alexis Kokkinos (Partner, Pitcher Partners), Mark Molesworth (Tax Partner, BDO) and officials from the Treasury and the Australian Taxation Office for their assistance with this review.

The *ex officio* members of the Board — the Secretary to the Treasury, Martin Parkinson PSM; the Commissioner of Taxation, Chris Jordan AO; and the First Parliamentary Counsel, Peter Quiggin PSM — have reserved their final views on the recommendations in this report for advice to Government.

Teresa Dyson
Chair, Board of Taxation

Curt Rendall
Chair of the Board's Working Group
Member, Board of Taxation

EXECUTIVE SUMMARY

Division 7A has an important role in the business tax system. It seeks to protect the integrity of the progressive tax system by regulating the way shareholders can access private company profits through payments, asset use, loans and debt forgiveness.

In their current form, the rules in Division 7A are complex, inflexible and costly to comply with. They fail to achieve an appropriate balance between ensuring taxpayers are treated fairly, promoting voluntary compliance and discouraging non-compliance. They can also operate as an unreasonable impediment for businesses operating through a trust that wish to fund their growth by reinvesting profits back into the business.

Through the course of this review, the Board has noted a number of tax system features that influence the way businesses are structured. These include the availability of capital gains tax (CGT) concessions, the difference between company tax rates and progressive rates of taxation, the operation of the imputation system and the tax treatment of trust accumulations. These factors create an incentive for businesses to adopt increasingly complex structures, placing rising pressure on Division 7A to safeguard the boundary between the company tax system and the progressive regime for taxing individuals.

As many of the problems with Division 7A are grounded in the current design of the business tax system, the Board believes there is merit in exploring system-wide solutions. In the longer term, structural reform could be achieved by aligning the treatment of entities so that income is taxed at an appropriate 'business tax' rate independent of the structure used, or changing the way that trusts are taxed on accumulated business income.

While the Board would welcome a longer-term commitment to redesigning the tax system, the potential for such reform does not reduce the urgent need for improvements to Division 7A. The Board believes there is significant scope for improving the Division in a way that would be complemented by longer-term reforms.

The first step in the process of improving Division 7A is to develop a coherent set of policy principles. The Board is proposing four guiding principles for the policy that could be incorporated into its framework:

- 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 of Taxation (Commissioner) and other stakeholders.
- It should not advantage the accumulation of passive investments funded by profits taxed at the company tax rate over the reinvestment of business profits in active business activities.

The Board believes that the proposed principles provide a coherent, workable framework to guide future reform of the Division.

To give effect to these principles, the Board has developed a reform model called the 'Amortisation Model'. Under this model, loans would be repayable over a 10-year period, have reduced documentation requirements, and have greater flexibility in repaying interest and the principal.

The Amortisation Model has an additional feature that will assist trading trusts wishing to reinvest profits as working capital. This is a 'business income election' exemption, under which unpaid present entitlements (UPEs) owed to corporate beneficiaries will not be subject to Division 7A if the trustee agrees to forgo the CGT discount concession on assets other than goodwill. The Board believes this exemption will deliver significant benefits in terms of resolving the current uncertainty surrounding the use of UPEs while providing a more level playing field in the private business sector.

The Board has encountered broad support for its proposed policy framework for reforming Division 7A. However, it acknowledges that a minority of stakeholders believe the Division should have a more limited role. This minority reject the inclusion of the fourth principle in the framework, arguing that deterring the accumulation of passive investments using profits taxed at the company tax rate should not be part of the function of the Division.

The policy framework for guiding future reform of Division 7A is, of course, a decision for the Commonwealth Government (the Government). If the Government adopts a policy framework that omits the fourth principle, the Board has recommended that it consider implementing an 'Interest Only Model'. Under this model, loans mandated by the Division would bear interest at a specified rate but principal payments would not be required.

The main advantage of the Interest Only Model is its simplicity. Another advantage is that it could address issues associated with trusts and UPEs. However, by sacrificing the fourth principle, the model would encourage passive wealth accumulation using profits taxed at the company tax rate and is likely to involve substantial revenue costs.

The Board has also proposed some reform elements that could be adopted in conjunction with either the Amortisation Model or the Interest Only Model. They are:

- simpler rules for regulating the use of company assets by shareholders and associates;
- a 'self-correction mechanism' that would help ensure compliance by taxpayers who inadvertently breach the provisions, coupled with proportionate penalties to promote voluntary compliance; and
- a new approach to imposing and remitting administrative penalties on deemed dividends, to reduce the implicit additional penalty that can arise as a result of deemed dividends being unfranked.

Guide to the Board of Taxation Report on Division 7A

Purpose

This report sets out an approach to fix certain identified problems with Division 7A.

From:

A complex system that imposes too high a regulatory burden on taxpayers and limits the ability of trusts to reinvest business profits.

To:

A simpler system that will reduce compliance costs, provide flexibility, encourage voluntary compliance and remove constraints on the reinvestment of business profits by trusts.

Policy framework (Chapter 3)

To achieve a simpler system a policy framework is proposed:

The policy framework is based on <u>three or four</u> broad principles:

- Tax private use of company profits at a user's progressive personal income tax rate
- Remove impediments to the reinvestment of business income as working capital
- Maximise simplicity by reducing the compliance burden on business and the administrative burden on the Commissioner of Taxation and other stakeholders
- Remove the advantage of the accumulation of passive investments funded by profits taxed at the company tax rate over the reinvestment of business profits in active business activities

Delivery

The first three principles can be delivered by the Interest Only Model.
All four principles can be delivered by the Amortisation Model.

Amortisation Model

- **New loan rules** – Replace existing rules for complying loans with a single 10-year loan period with a flexible repayment schedule **(Chapter 6)**
- Align treatments of UPEs and loans **(Chapter 7)**
- **A business income election** option, which will excuse trusts from Division 7A if they forego the CGT discount **(Chapter 8)**

Interest Only Model

- Relieve shareholders and associates from the obligation to repay principal on complying loans and exempt borrowings that are otherwise deductible for Division 7A obligations **(Chapter 9)**
- Align treatments of UPEs and loans **(Chapter 7)**

Aligned treatments of UPEs and loans is common to both models

With either model the following reform elements are recommended:

- **Use of company assets –** Provide safe harbours for the use of company assets **(Chapter 4)**
- **Self-correction mechanism** – Provide access to a self-correction mechanism for taxpayers who unintentionally trigger the provisions **(Chapter 10)**
- **Frankability of dividends** – Reduce the implicit double penalty from the inability to frank dividends **(Chapter 11)**

Other issues are canvassed in:

- **Chapter 5 –** Distributable surplus
- **Chapter 12 –** Other issues

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 (the Board) to undertake a post-implementation review of Division 7A of Part III of the *Income Tax Assessment Act 1936* (ITAA) (Division 7A) and provided the Board with terms of reference for the review.

1.2 The Board was asked to examine whether Division 7A was giving effect to the policy intent of preventing shareholders of private companies (or their associates) from inappropriately accessing the profits of those companies through payments, loans or debt forgiveness.

1.3 Through the terms of reference, the Board was asked to examine the potential for broader reforms, with the requirement that any reform would need to maintain the integrity of the tax law and be 'revenue neutral' or 'near revenue neutral'.

1.4 Feedback received in the first phase of the review indicated that much of Division 7A's complexity and difficulty related to its interaction with other areas of tax law, including the trust provisions. Against this background, the Board judged that the scope of the review needed to be broadened and requested an adjustment to the terms of reference and an extended reporting date.

1.5 On 8 November 2013, the then Assistant Treasurer, Senator Arthur Sinodinos AO, agreed to extended terms of reference for the review, requesting the Board consider the broader tax framework in which private businesses operate and report to the Government by 31 October 2014.

EXTENDED TERMS OF REFERENCE

1.6 The extended terms of reference allowed the Board to examine the broader tax framework in which private business structures operate. Also, the Board was no longer restricted to a revenue neutral or near revenue neutral outcome, although it was required to take into account the revenue implications of various options and, where appropriate, suggest approaches that minimise any revenue costs.

1.7 The extended terms of reference given for the Division 7A review are as follows:

> 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.

REVIEW PROCESSES

1.8 The Board appointed a Working Group to oversee the review, comprising Board members Curt Rendall, Keith James and Elizabeth Jameson, as well as Mark West, Partner at McCullough Robertson and a member of the Board's Advisory Panel. Mr Rendall chaired the review.

1.9 The Board also received assistance with developing this report from an Expert Panel comprising Mark Molesworth (Tax Partner, BDO) and Alexis Kokkinos (Partner, Pitcher Partners). Officials from the Australian Taxation Office (ATO) and the Treasury also assisted with the review.

1.10 The Board's consultation process has involved:

- preliminary consultation with a range of stakeholders;

- the release of a discussion paper on 20 December 2012;[1]
- the release of a second discussion paper on 25 March 2014;[2] and
- targeted consultation meetings with a number of key stakeholders.

Submissions

1.11 The Board received 19 submissions in response to the first discussion paper, three of which were confidential, and 18 written submissions in response to the second discussion paper, including one confidential submission.

Board's report

1.12 The Board has considered the issues stakeholders raised in their submissions and at the consultation meetings, as well as the views of the Expert Panel members. However, the Board's recommendations reflect its independent judgement.

1 Board of Taxation, *Post-Implementation Review of Division 7A of Part III of the* Income Tax Assessment Act 1936*: Discussion Paper* (December, 2012) (first discussion paper).

2 Board of Taxation, *Post-Implementation Review of Division 7A of Part III of the* Income Tax Assessment Act 1936*: Second Discussion Paper* (March, 2014) (second discussion paper).

CHAPTER 2: DIVISION 7A IN CONTEXT

BACKGROUND

2.1 The extended terms of reference ask the Board to examine the broader taxation framework in which Division 7A operates, including its interaction with other areas of tax law. This chapter provides background on the broader context in which Division 7A operates, summarising relevant developments that may impact on the effectiveness of the Division in meeting its policy intent.

2.2 In its second discussion paper, the Board noted that Australia maintained a classical company taxation system from 1934 to 1986, under which corporate profits were taxed at the corporate level, and dividends were taxed in the hands of the shareholders, with no credit allowed for company tax paid.

2.3 The Board noted that, under a classical system, there is a strong incentive for companies to accumulate profits in order to postpone further levies on company profits in the form of tax on shareholder dividends. To discourage private companies from accumulating profits, the Government introduced a sufficient distribution regime in the form of Division 7 in 1938.

2.4 Under Division 7, income of a company not distributed in accordance with the requirements was subject to an 'undistributed profits tax' at a rate of 50 per cent, which was higher than the then company tax rate. However, a significant proportion of active business income could be retained without attracting undistributed profits tax. This assisted businesses that needed to retain profits for working capital purposes.[3]

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

2.6 Division 7's restriction to private companies reflected the fact that shareholders in closely held private companies were more able, due to their limited numbers and greater control of the company, to adopt restrictive dividend distribution policies, potentially granting themselves (or their associates) inappropriate access to company profits.

2.7 The Board noted two relevant and significant changes made to the company and personal income tax systems, both of which took effect from 1 July 1986. The first was the replacement of the classical double taxation system with an imputation system,

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3 During Division 7's operative period, the proportion of active business income that could be retained without triggering undistributed profits tax increased from 33.3 per cent to 80 per cent.

under which resident shareholders were entitled to a credit for tax paid by the company against their personal tax liability on dividend income. The second change was the alignment of the company tax rate and the top marginal tax rate. The combined effect of these changes was to remove the potential for tax deferral benefits that might have been achieved by accumulating amounts in a private company (rather than distributing to individuals).

2.8 As a result of the 1 July 1986 changes, there was no longer any practical consequence arising from the undistributed profits tax, and Division 7 was repealed (subject to transitional arrangements).

2.9 However, the company tax rate and the top marginal tax rate were only aligned for the 1987 and 1988 years of income. 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.

2.10 The greater the gap between the lower company tax rate and the higher individual marginal tax rates, the greater the incentives to accumulate profits in private companies rather than distribute them to shareholders as dividends. 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 company tax rate). In summary, after-tax profits currently can be retained within companies and reinvested without being subject to the progressive tax system. The widening gap between the company tax rate and the top marginal rate for individuals, coupled with the lack of a sufficient distribution regime, represents a challenge for tax system progressivity.

2.11 The decision in 2000 to allow franking credits to be refunded to individuals has increased the incentives for corporate profits to be retained in private companies and paid out to shareholders as dividends when it is tax-effective to do so.

2.12 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 protecting assets, maintaining privacy, or limiting personal liability, are all relevant.

2.13 However, tax considerations are also important. The Board noted two key aspects of the tax system that influence the way small businesses are structured. The first of these was the rules governing the availability of the 50 per cent CGT discount[4]. The CGT discount is available to individuals on capital gains made directly and on trust distributions referable to capital gains. However, it is not available to companies.

4 The CGT discount provisions in Division 115 of the ITAA 1997 allow individuals (including partners in partnerships) to reduce their capital gain on assets held for 12 months or more by 50 percent. Distributions of trust income that includes a capital gain can also qualify for the CGT discount for eligible beneficiaries. The CGT discount is not available to companies.

This creates an incentive for businesses to ensure that appreciating assets are held by individuals (solely or in partnership) or in discretionary trusts.

2.14 The second key tax factor influencing small business structures is the tax treatment of accumulations. While a company is taxed at a fixed rate irrespective of whether income is accumulated, where there is trust income to which no beneficiary is 'presently entitled', a flat rate of tax equal to the highest personal marginal tax rate is imposed (currently 49 per cent, including the 2 per cent Medicare levy and the 2 per cent Temporary Budget Repair levy).[5] By contrast, distributed income (that is, income to which a beneficiary is presently entitled) is generally taxed at the entitled beneficiary's marginal tax rate.[6] Accordingly, in private group structures that operate through trusts, the trustee will generally ensure that all income is distributed annually.

2.15 The Board noted that these factors contributed to the emergence of more complex structures designed to provide businesses with access to the lower company tax rate while preserving access to the 50 per cent CGT discount. In particular, it noted the increasing prevalence since 1990 of so-called 'bucket company' arrangements.

2.16 Under a typical bucket company arrangement, a trust is settled with beneficiaries that include companies. It is common practice for the trustee to resolve that a company (the bucket company) is presently entitled to any residual income to which the individual beneficiaries are not presently entitled. This has the effect, initially at least, of ensuring that tax on such income is at the 30 per cent company tax rate rather than, potentially, the highest personal marginal tax rate.

2.17 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 — with the benefit of access to the CGT discount.

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

2.19 The Board noted that the owner of shares in a large incorporated business can usually secure the CGT discount by selling shares. By contrast, proprietors of incorporated small businesses are often unable to find a buyer for shares in the company and will be forced instead to effect a sale of the business by the company, losing the benefit of the CGT discount. Potential buyers may be reluctant to assume the risks associated with purchasing the company, instead preferring to purchase the business assets directly. A trust is able to sell assets directly and pass on the CGT discount to individual beneficiaries.

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5 Section 99A of the ITAA 1936.

6 Section 97 of the ITAA 1936.

2.20 The Board has noted that smaller business taxpayers have an incentive to operate through trusts (as opposed to companies) when taking into account the potential future exit options.

STRUCTURAL REFORM OF THE BUSINESS TAX SYSTEM

2.21 The Board notes that Division 7A is mainly concerned with the inappropriate personal access to wealth that has been accrued in the company 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.

2.22 The Board recognises that a principal role of Division 7A is to support the personal tax system's progressivity, but notes that, in their current form, the provisions lack a coherent policy framework to govern the taxation of the private use or enjoyment of corporate funds. The lack of a coherent policy is also evident in problems with the way the provisions are administered, including poorly targeted safe harbour arrangements.

2.23 More specifically, Division 7A in its current form fails to distinguish activities that involve privately using or consuming company wealth from those that merely apply income towards growing an active business through reinvesting profits in a non-corporate structure, such as a trust. Division 7A sometimes imposes a significant compliance burden, even on those businesses that operate in accordance with its intended policy.

2.24 Against the above background, the Board postulated that a case could be made for taxing business accumulations at a business tax rate, equal to the company tax rate, irrespective of the structure chosen. A reform of this nature would go some way towards simplifying the system and would, arguably, create an incentive for entrepreneurial risk-taking. Relevantly, it would reduce significantly the incentive for taxpayers to adopt complex bucket company structures to optimise their tax position.

2.25 The Board noted, however, that this reform may also create some consequential complexity by, for example, requiring detailed rules to deal with any associated individuals subsequently accessing business profits. It may also come at a cost to the revenue. While acknowledging that a reform of that nature would be outside the scope of the review, the Board sought stakeholder feedback on whether taxing business accumulations at a business tax rate, irrespective of the structure chosen, is an issue that should be considered as part of a wider tax reform process.

VIEWS IN SUBMISSIONS

2.26 A number of stakeholders supported the proposition that taxing business accumulations at a business tax rate, irrespective of the structure chosen, should be considered as part of a wider tax reform process. Koustas & Co. noted that:

> Taxing retained profits in trusts at the company tax rate would remove complexity and administration of the UPE management process, and the need to appoint a trust's income to a private company simply to satisfy the form (as the physical cash is needed within the business). This would further simplify the way private businesses operate and would no doubt reduce the associated compliance costs … We recognise that treating trusts as companies in a wider sense would be complex and involve broader taxation matters outside the scope of the current review.

2.27 Other stakeholders cautioned the Board on the extent to which trusts could be taxed as companies. Cleary Hoare Solicitors submitted that the question of whether business accumulations should be taxed at the company tax rate irrespective of the structure chosen is outside the terms of reference for the review and argued against returning to the 'profits first' rule 'proposed in the "entity taxation" system floated in 1998 and eventually rejected in 2001 after significant discussion'. It further submitted that the Government has publicly rejected taxing trusts as companies.

2.28 The Law Society of NSW's Young Lawyers Taxation Law Committee (NSW Young Lawyers) submitted that any proposed 'uniform business tax rate' should be considered as part of a wider tax reform, together with the rewrite of Division 6, and not only as part of a Division 7A review.

2.29 The Taxation Committee of the Business Law Section of the Law Council of Australia (hereafter Law Council of Australia) commended the Board for raising the question as to whether there should be a capped, competitive rate for business accumulations generally. However, it doubted whether it was appropriate to address the tax issues associated with working capital in respect of trusts and companies within the context of Division 7A. It submitted that these issues require 'root and branch' reform that has proper regard to small and medium enterprise (SME) entities of all types: companies, trusts, partnerships and sole traders.

BOARD'S CONSIDERATION

2.30 The Board agrees with the views from stakeholders that taxing business accumulations at a business tax rate, irrespective of the structure chosen, is an issue that should be considered as part of a wider tax reform process.

2.31 The Board further notes that significant structural reform of this nature would require extensively considering related issues, including the status of the current dividend system, and determining the tax treatment of subsequent applications of business profits that were taxed at a business tax rate.

2.32 Another more confined proposal would be to lower the section 99A tax rate[7] on undistributed trust income to a level equivalent to the lower company tax rate, while preserving the flow-through treatment on distributed income. Similar to the above proposal, this would also require considering whether a broader imputation system should apply and determining the tax treatment of subsequent applications of trust profits that were taxed at a company tax rate.

Recommendation 1:

As part of a wider tax reform process, the Board recommends explicitly considering wide-ranging reforms directed at treating profits consistently, including:

- taxing business accumulations at a business tax rate, irrespective of the structure chosen; and
- lowering the tax rate on undistributed trust income.

2.33 While considering broader reforms to the business tax system is clearly in Australia's long-term interests, the Board emphasises that the prospect of reform does not remove the need to address current problems with Division 7A.

2.34 In the remainder of this report, the Board outlines a number of significant reforms to Division 7A that could be undertaken in the short to medium term. The Board recommends the Government consider implementing these reforms as soon as practicable.

Recommendation 2:

The Board recommends that, in the more immediate term, the Government make significant reforms to Division 7A in accordance with recommendations 3 to 15 of this report.

7 See paragraph 2.14 above.

CHAPTER 3: POLICY FRAMEWORK FOR DIVISION 7A

POLICY FRAMEWORK

3.1 While recommending a capped tax rate for business accumulations irrespective of the structure chosen would be outside the scope of this review, the Board believes that there is scope under the terms of reference to examine whether a case could be made for providing active trading trusts with increased access to the company tax rate for profits used to finance their operations.

3.2 The Board is of the view that, in light of the current policy settings, it would be inappropriate to extend the company tax rate to other non-corporate structures for the private use of business income.

3.3 Providing businesses with improved access to working capital would support improved productivity and entrepreneurial growth. This is distinct from facilitating the private use of business income, which serves a different purpose; namely, enjoying and accumulating private wealth.

3.4 Against the above considerations and consistent with the high-level tax policy aims of efficiency, simplicity and equity, the Board propose a policy framework relevant to private businesses that is designed to assist with evaluating the existing Division 7A regime, and developing and evaluating possible reform models.

3.5 The Board's proposed policy framework, on which it sought stakeholder feedback, contains four principles for reforming 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.

VIEWS IN SUBMISSIONS

3.6 Stakeholders were broadly supportive of the proposed goals or principles that could define the policy framework for Division 7A, with some suggesting their inclusion as an 'objects clause' in any redrafted version of Division 7A.

3.7 Other stakeholders, while supportive of the framework, believe that the principles should not be given equal weighting. NSW Young Lawyers proposed that the third principle, which emphasises simplicity and reducing the compliance burden, is the most important factor regarding the Government policies of '"cutting red tape" for small businesses' and 'encouraging Australian innovation and start-up businesses'.

3.8 Pitcher Partners also supported the four principles but queried some of the practical difficulties that could arise when implementing them. Pitcher Partners suggested that it might be better to amalgamate the fourth principle into the proposed second principle, which refers to removing impediments to reinvesting business income as working capital. It submitted that:

> The fourth goal appears to be closely related to the second goal, being the ability to use corporate profits for active purposes. While we support this goal, we believe that it may be difficult to ensure that the reforms are consistent with this policy principle, as it forces a comparison of the outcome as between passive and active investments. Accordingly, we believe that the Board should consider whether it is better to amalgamate the fourth goal into the second goal, or whether some of the proposals need to be modified in line with this goal.

Alternative view

3.9 Although there was broad in-principle support for the Board's suggested policy framework, it was not unanimous. One stakeholder, the Law Council of Australia, saw a more limited role for Division 7A and questioned the relevance of the fourth principle.[8]

3.10 The Law Council of Australia submitted that Division 7A should not be concerned with shareholders' use of funds and, in particular, whether or not they are used for accumulating passive investments. It expressed the belief that it should be sufficient to ensure appropriate commercial consideration is payable by the shareholders or their associates. In this respect, the Law Council of Australia questioned the relevance of the fourth principle, stating that:

> Division 7A is concerned with arrangements for accessing taxed profits by shareholders and their associates. If appropriate commercial consideration is payable by the shareholder or associate at the point of extraction, that should be the end of the matter as far as the provisions of Division 7A are concerned.
>
> Accordingly, the Committee submits that it is the provision of the benefit to which any reform of Division 7A should apply, and not to the subsequent use of the benefit so received. The Committee is of the view that if there is an intention to favour one type of

8 Arnold Bloch Leibler also noted that they generally agreed with the submission of the Law Council of Australia.

investment over another that is a concern which should be dealt with elsewhere in the legislation.

BOARD'S CONSIDERATION

3.11 The Board agrees with stakeholder suggestions that the principles that define the policy framework for Division 7A should be included in an objects clause in a reformed Division 7A.

3.12 The Board has noted that the Government has established a working group with representatives of the Treasury, ATO and the private sector to look at creating a power, known as a statutory remedial power, for the Commissioner to resolve unintended and anomalous outcomes.[9] In addition to clarifying the policy intent and providing context for any further amendments to the Division, the inclusion of an objects clause could assist the Commissioner with exercising such a power should it be enacted.

3.13 The Board has noted that, of the four principles, the fourth attracted the most comment. On reflection, the Board believes the wording of this principle could be refined to make its intent clearer. Specifically, the fourth principle is directed at the advantage of indefinitely avoiding the application of the progressive tax system. The Board's intention with regards to the fourth principle is to ensure that reformed Division 7A provisions:

- do not adversely apply to trusts[10] that reinvest profits in an active business; and
- do not actively encourage entities (other than a company) to accumulate passive investments using profits taxed at the corporate rate.

3.14 Where company profits taxed at the company tax rate of 30 per cent are permitted to be made available to related trusts or individuals (that can access the 50 per cent CGT discount) through loans that do not require repayment within a reasonable time, there is an incentive to make such loans. The related trust or individual can use the borrowed funds (taxed only at 30 per cent) to invest in passive assets, obtain the advantage of the CGT discount (not available to companies) and thereby indefinitely defer being subject to any higher tax that would apply at the progressive individual tax rates.

3.15 The requirement to pay interest on such loans is not a disincentive, as the interest expense could be tax deductible against the income of the related trust or individual (including, but not limited to, income from the passive investment) where that income

9 The Hon. Steven Ciobo MP, Parliamentary Secretary to the Treasurer, Speech made to the 29th National Convention of the Tax Institute of Australia (28 March 2014).

10 Due to the issues identified in Chapter 2, the Board has noted the difficulties in extending this fourth principle to entities other than trusts (for example, individuals and partnerships).

would otherwise be subject to the progressive tax rates. The interest income would be taxed in the lending company at the 30 per cent company rate. In this way, the interest expense reinforces the advantage of avoiding the application of the progressive tax system.

3.16 The fourth principle is broadly aligned with a number of the policy issues discussed in Chapter 2; however, it is more refined in terms of its scope and what the current review could possibly achieve. However, with regard to the above discussion, the Board considers that there is scope to express the fourth principle more clearly to better reflect this purpose by expressly referring to passive investments 'funded by profits taxed at the company tax rate'. Accordingly, the Board's preferred wording of the fourth principle is:

> It should not advantage the accumulation of passive investments funded by profits taxed at the company tax rate over the reinvestment of business profits in active business activities.

3.17 Subject to this clarification of the fourth principle, the Board believes the proposed principles provide a coherent, workable framework to guide future reform of Division 7A. However, the Board acknowledges that, if the Government were to decide that Division 7A should not remove the advantage of accumulating passive investments over reinvesting business profits in active business activities, then the proposed fourth principle would be omitted. Only the first three principles would be included in the 'objects clause'.

Principles for reforming 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 funded by profits taxed at the company tax rate over the reinvestment of business profits in active business activities.

3.18 The Board considers that the decision on the policy principles will be relevant to choosing between the reform options. If there is no need to prevent, or to remove the advantage from, accumulating passive investments (using profits taxed at the company tax rate) over reinvesting business profits in active business activities carried out by non--company entities, such as individuals and trusts, then an Interest Only Model (referred to in the Board's second discussion paper as a Statutory Interest Model) could provide an effective and relatively simple solution to prevent shareholders and their associates inappropriately accessing private company profits temporarily through loans or UPEs.

3.19 The Interest Only Model allows loans of an indefinite term, thereby prioritising accumulating passive investments, funded by profits taxed only at the 30 per cent company tax rate. It therefore allows the progressive tax system to be indefinitely deferred. By contrast, the business profits of non-company taxpayers are immediately subject to the progressive rates.

3.20 If the Government believes Division 7A should support the overall objective of protecting the personal income tax system's progressivity and has a role to play in removing the advantage of accumulating of passive investments over reinvesting business profits in active business activities, then a different reform model — such as the proposed Amortisation Model — would be more appropriate.

3.21 As with the current complying loans under Division 7A, the Amortisation Model would support the personal income tax system's progressivity by enabling 'top-up' tax to be applied on the distributed dividends. In other words, by requiring the repayment of the loan principal, the Amortisation Model limits the time period over which the application of the progressive tax system can be avoided.

3.22 By contrast, the Interest Only Model would enable loan principal repayments to be indefinitely postponed, allowing the application of the progressive system to be indefinitely deferred. It is thus expected that an Interest Only Model would be simpler in its operation but, based on the Board's enquiries, would be expected to come at potentially significantly higher revenue costs compared with an Amortisation Model.

3.23 In this report, the Board has set out the key elements of both the Amortisation Model and the Interest Only Model. The Amortisation Model consists of three components:

- new complying loan rules, addressed in Chapter 6;
- a proposal to align the treatment of UPEs to companies and loans, addressed in Chapter 7; and
- a proposed business income election (referred to in the second discussion paper as a 'tick-the-box' election), enabling working capital to be retained by trusts that are willing to forgo access to the CGT discount on assets other than goodwill, examined in Chapter 8.

3.24 The Interest Only Model, as a broad reform option, is examined and discussed further in Chapter 9. It will be noted that the proposal to align the treatment of UPEs and loans (dealt with in Chapter 7) is also a recommended feature of this model.

3.25 The report also deals with a number of common areas that would require further attention irrespective of which of the above two reform options is chosen. Accordingly, Chapters 4 and 5 deal, respectively, with the rules governing the use of company assets and the calculation of distributable surplus.

3.26 Having considered these issues, the report then deliberates on the consequences that should arise when a deemed dividend is triggered. Chapter 10 sets out design considerations for a 'self-correction mechanism' that could operate to reverse the effect of the deemed dividend for taxpayers that meet specific criteria. Chapter 11 considers the impact of the rule that deemed dividends are unfranked. Again, the issues covered in these chapters are relevant to both the Amortisation Model and the Interest Only Model.

3.27 The report concludes in Chapter 12 with a discussion of other pending issues.

Recommendation 3

The Board recommends:

- including the principles that could define the policy framework for Division 7A in an objects clause in a reformed Division 7A; and
- making the content of the guiding principles a policy matter for consideration by the Government — in particular, whether Division 7A supports the overall objective of protecting the personal income tax system's progressivity and has a role to play in not advantaging the accumulation of passive investments over the reinvestment of business profits in active business activities.

Chapter 4: Rules for the use of company assets

Background

4.1 For Division 7A purposes, the provision of an asset for use (other than transfer of property) by an entity has, since 1 July 2009, been treated as a 'payment' under an extended definition of that term.[11] The extended definition prevents taxpayers from circumventing the operation of Division 7A through a private company providing an asset to a shareholder (or their associate) under a licence or another right to use. Assets covered include holiday homes, boats and other private-use assets.

4.2 Where an asset is provided for use by a company to a shareholder or associate, the amount of the deemed dividend is the amount that would have been paid for the provision of the asset by parties dealing at arm's length less any amounts actually paid. The shareholder or associate can avoid the operation of Division 7A by ensuring that an arm's length usage fee is paid.

4.3 The use of asset provisions also contains an 'otherwise deductible' rule under which the provision of an asset for use by a shareholder (or associate) is generally not taken to be a payment if, had the shareholder or associate incurred and paid expenditure for the provision of the asset, a once-only deduction would have been allowable to that shareholder or associate.[12]

4.4 In its second discussion paper, the Board proposed a conceptual framework that would provide a more coherent and clear starting point for addressing the issues arising under Division 7A. The rules for using company assets were identified as one area that would benefit from a new policy framework.[13]

4.5 As part of its proposed conceptual framework, the Board drew a distinction between:

- temporary transfers of value involving loans (funded from company profits) or the use of company assets (purchased with company profits or gains); and
- permanent transfers of value referable to company profits by way of loans forgiven and assets transferred.

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11 The extended definition applies to payments made on or after 1 July 2009: section 109CA of the ITAA 1936.

12 Subsection 109CA(5) of the ITAA 1936.

13 Second discussion paper, pages 33–35.

4.6 The Board proposed that permanent transfers of value, representing disguised access to a company's profits or gains, should give rise to a deemed dividend under Division 7A and be taxed accordingly. On the other hand, temporary transfers of value would be required to be repaid (loans) or be paid for appropriately (asset usage) in order to not give rise to a deemed dividend.

4.7 Because the temporary transfers of value could be seen as involving access to the company's cash — either directly as cash provided in loans, or indirectly as cash used by the company in acquiring assets used by the shareholder or their associates — it was suggested that common principles may be able to be applied to all temporary transfers of value, including use of asset provisions.

4.8 It was noted that loans require the principal and agreed interest to be repaid over a set period of time. As a possible basis for more certain and simple asset usage rules (which more closely align with the treatment of loans), it was suggested that an asset usage fee could be required over an appropriate time period, reflecting the asset cost and interest payments, akin to a finance lease.

4.9 It was further noted that the appropriate time period for an asset usage fee could reflect the period over which the asset depreciates. Circumstances where there is only a partial use of the asset or where there are appreciating assets, such as land, may require particular rules.

4.10 Against the above background, the Board sought stakeholders' views on how, if the suggested framework were to be implemented, the proposed asset usage rules could be implemented without introducing undue complexity.

VIEWS IN SUBMISSIONS

4.11 Stakeholders who commented on this issue believed that the framework of temporary and permanent transfers of value was a useful tool for evaluating the use of assets provisions. However, they cautioned against introducing new concepts into the tax law that may not promote simplicity. They favoured retaining the current rules but adding safe harbour rules to assist with simplified valuation methods.

4.12 BDO submitted that while the apparent simplicity of having common principles for loans, payments, debt forgiveness and use of company assets is attractive, the various ways that a company's assets can be used would make it difficult to implement a uniform approach to asset usage.

4.13 Similarly, Chartered Accountants Australia and New Zealand (CAANZ)[14] cautioned against introducing new legislative concepts. It was in favour of:

> retaining the current regime of classifying arrangements subject to Division 7A rather than developing new concepts like temporary transfers of value and permanent transfers of value as it would give rise to new issues in relation to defining these concepts legislatively and would not promote simplicity.

4.14 BDO and CAANZ were both in favour of introducing a safe harbour usage fee based on a finance lease approach, submitting that such rules would assist in addressing difficulties related to the required valuation of asset use. BDO noted that the finance lease approach may be appropriate when the shareholder has exclusive use of an asset but not where the use is sporadic.

4.15 The Tax Institute submitted that the amount 'charged' for the use of the asset should be equal to the total costs of holding and maintaining the asset, including all the expenses that can be deducted by the company when it derives assessable income from the use of the asset. It further suggested that, should these rules be adopted, the 'otherwise deductible' rule[15] that currently exists in relation to using assets should continue to be available.

4.16 CPA Australia submitted that the existing rules concerning an entity's right to use private company assets should be retained. It argued that the starting point in valuing asset usage should continue to be the arm's length value of that asset's usage by shareholders or their associates, which in many cases may be readily available.

4.17 CPA Australia also submitted that the 'otherwise deductible' and minor benefits rule exemptions should be retained, adding that the minor benefits exclusion should be raised to a more commercially realistic level of, for example, $3,000 rather than the $300 threshold that currently applies.

4.18 CPA Australia further argued that when the arm's length value of the asset's usage is not readily available, the valuation should be determined as a lease rental, which would vary depending on whether the assets used are depreciating or appreciating.

4.19 Pitcher Partners also supported the introduction of safe harbour rules in addition to the current arm's length test, and the otherwise deductible and minor benefits exclusions. It also suggested making a distinction between depreciating assets and appreciating assets, noting that the latter would most likely be limited to the private

14 Formerly the Institute of Chartered Accountants Australia.

15 Provision of a company asset for use by a shareholder (or associate) is not generally taken to be a payment if the shareholder or associate had incurred expenditure for the provision of the asset; a once-only deduction would have been allowable to that shareholder or associate: subsection 109CA(5) of the ITAA 1936.

use of the assets, given the proposed retention of the otherwise deductible exemption for income-producing uses:

- For depreciating assets, Pitcher Partners suggested a rental charge similar to that of an operating lease, comprising a finance amount (or interest amount), a depreciation component (being the cost of the asset to the lessor) and an amount for other operating costs. It argued that a similar approach could be applied for Division 7A purposes, applying a statutory interest rate to the opening written-down value of the asset at the start of the year and a depreciation component based on the ATO effective lives tables.

- For appreciating assets, Pitcher Partners suggested a usage charge calculated by multiplying the statutory interest rate by the asset's indexed value, which could be required to be updated with an arm's length valuation every five years, thus reducing the need for yearly valuations. The usage charge should also include the relevant asset's other operating costs.

- For partial use, Pitcher Partners proposed that rental or user charges should be based on the actual number of days used by the shareholder or their associates during the relevant income year, except where the asset is acquired by the company for the exclusive use of the shareholder or their associates, in which case the charge should be for the full income year irrespective of the number of days used.

BOARD'S CONSIDERATION

4.20 The Board considers that — while there would be advantages in having common principles for loans, payments, debt forgiveness and the use of company assets — introducing new concepts into legislation, like temporary transfers of value and permanent transfers of value, has the potential to add complexity, particularly given that a number of stakeholders have indicated that taxpayers are broadly familiar with the existing rules regarding asset use.

4.21 The Board therefore considers that the existing rules concerning an entity's right to use a private company asset should be retained, including the otherwise deductible and minor benefits rule exemptions, but supplemented with the provision of legislative safe harbour rules that would assist in facilitating compliance with the rules, reduce uncertainties for taxpayers and lower administrative costs for the ATO.

4.22 The Board further recommends, in order to better approximate what would otherwise be the arm's length value of the corresponding asset usage by the shareholders or their associates, designing appropriate safe harbour rules that distinguish between those that would apply to depreciating assets and those that would apply to appreciating assets, such as land and buildings.

4.23 For depreciating assets, a rental charge could apply, similar to that of an operating lease, comprising a finance amount (or interest amount), a depreciation component (being the cost of the asset to the lessor) and an amount representing the relevant asset's operating costs.

4.24 For appreciating assets, a usage charge could apply, calculated by multiplying the statutory interest rate by the asset's indexed value, which could be required to be updated with an arm's length valuation every five years, thus reducing the need for yearly valuations. The usage charge could also include an amount representing the relevant asset's other operating costs.

Recommendation 4

The Board recommends:

- retaining the existing rules concerning an entity's right to use a private company asset, including the otherwise deductible and minor benefits rule exemptions;
- supplementing the existing rules with the provision of legislative safe harbour rules, which would assist in facilitating compliance, reduce uncertainties for taxpayers and lower administrative costs for the ATO;
- designing appropriate safe harbour rules that distinguish between those that would apply to depreciating assets and those that would apply to appreciating assets, such as land and buildings:
  - for depreciating assets, a rental charge could apply, similar to that of an operating lease, comprising a finance amount (or interest amount), a depreciation component (being the cost of the asset to the lessor) and an amount for the relevant asset's other operating costs; and
  - for appreciating assets, a usage charge could apply, calculated by multiplying the statutory interest rate by the asset's indexed value, which could be updated with an arm's length valuation every five years, thus reducing the need for yearly valuations. The usage charge could also include an amount representing the relevant asset's other operating costs.

Chapter 5: The calculation of distributable surplus

5.1 The rules for determining a distributable surplus are used to identify whether company profits exist and have been accessed. A company must have a distributable surplus as a precondition for a deemed dividend to arise when company profits are inappropriately accessed.

5.2 In its second discussion paper, the Board suggested a possible adjustment to the rules and made a number of observations regarding the calculation of the distributable surplus. The Board sought feedback from stakeholders on whether these adjustments would assist in simplifying compliance and addressing potential anomalies.[16]

5.3 The Board noted that there is early taxation 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.

5.4 The adjustment proposed by the Board involved excluding unrealised gains from the calculation of distributable surplus, except where those gains are the subject of a permanent transfer of value (for example, by way of asset transfer). This change was designed to provide increased fairness. The Board acknowledged that this proposal may come at a cost to revenue, and therefore suggested that it be considered in conjunction with a separate proposal to address a potential timing advantage that may arise from the operation of the current rules.

5.5 The Board noted that 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. In these circumstances, no deemed dividend could arise, providing a timing advantage for the shareholders. It noted that 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 or their associates in the first instance.

5.6 The Board sought stakeholders' comments on whether the intended Division 7A objectives would be achieved if the general distributable surplus was defined as realised profits (subject to a market-value adjustment for asset transfers) and testing was conducted each year end, without the need for tracking individual liabilities that funded particular earlier transfers of value to shareholders or associates.

16 Second discussion paper, pages 36–40.

VIEWS IN SUBMISSIONS

5.7 Some stakeholders supported the proposal to exclude unrealised gains from the calculation of distributable surplus, as it would assist in removing the potential for double taxation. However, others noted that the Board's proposals to amend the calculation of distributable surplus would add unnecessary complexity and could lead to considerable difficulties and compliance costs.

5.8 NSW Young Lawyers noted that the proposed amendments to the calculation of distributable surplus would not necessarily simplify compliance. It argued that if the proposed approach were to be adopted, it would require an education campaign to raise awareness about the annual test and its application to all prior-year loans.

5.9 The Law Council of Australia submitted that the proposals would perpetuate the complexity that currently surrounds the Division and would most likely lead to further and different aspects of complexity.

5.10 Some stakeholders noted that the theoretical appeal of the proposal to exclude unrealised gains from the calculation of distributable surplus was outweighed by more practical considerations, including the potential to trigger avoidance activity, and suggested that the current definition of distributable surplus should be retained. CPA Australia acknowledged the theoretical attraction of the proposed framework but believed that it would be practically difficult in some cases for accruals taxpayers to distinguish between realised and unrealised profits. It submitted that:

> … most companies will have retained earnings and that it will seldom be the case that a company would only have unrealised profits in the form of an asset revaluation reserve. Thus, the potential benefit of the proposed changes would appear to be quite narrow.

5.11 CPA Australia further argued that if any group deliberately engineers their activities so there is no distributable surplus in the year in which Division 7A is triggered, the general anti-avoidance provisions of Part IVA of the ITAA 1936 should be available to the Commissioner to deter such behaviour.

BOARD'S CONSIDERATION

5.12 The Board acknowledges the feedback received from stakeholders and concluded that, despite its theoretical appeal, the proposals to amend the rules regarding the calculation of distributable surplus should not be pursued further, as they have the potential to add complexity and could lead to difficulties and compliance costs.

5.13 Further, the Board understands that the circumstances where a company would not have distributable surplus and would be able to benefit from a timing 'advantage' in the operation of the rules are not common and would not warrant an amendment of the rules.

5.14 The Board therefore recommends retaining the rules regarding the calculation of distributable surplus as part of any rewrite of the Division 7A rules.

5.15 For clarification, the Board notes that annual testing of distributable surplus is a feature of the current Division 7A rules where a complying loan is in place and the borrower fails to make a minimum yearly payment. The deemed dividend is calculated by referring to the distributable surplus for the income year in which the shortfall occurs.[17] Periodic testing (and the relevant period of review for making amended assessments) would be extended under the Board's recommended changes to the complying loan rules outlined in Chapter 6, which should, in any case, address the concerns raised about possible timing advantages. The Board considers that periodic testing of distributable surplus is necessary and appropriate, and should be retained in future reforms to the Division.

Recommendation 5

The Board recommends retaining the rules regarding the calculation of distributable surplus, including the requirement for periodic testing, as part of any rewrite of the Division 7A rules.

17 Subsections 109D(2) and 109Y(1) of the ITAA 1936.

CHAPTER 6: AMORTISATION MODEL

6.1 This chapter deals with proposed rules for complying Division 7A loans under a proposal that the Board has named the Amortisation Model.

6.2 In its second discussion paper, the Board proposed that all complying Division 7A 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 lodgement day for the income year in which the loan was made.
- The statutory interest rate would be set at the start of the loan and fixed over the term of the loan.
- The statutory interest rate would be the Reserve Bank of Australia's indicator lending rate for a *small business*; *variable*; *other*; *overdraft* for the month of May immediately before the start of that income year. For example, the rate for the year ending 30 June 2014 would have been 9.20 per cent.
- The maximum loan term would be 10 years.
- The prescribed maximum loan balances during the term of the loan (including any accumulated interest) would be as follows:
  - 75 per cent of the original loan by the end of year three;
  - 55 per cent of the original loan by the end of year five;
  - 25 per cent of the original loan by the end of year eight; and
  - 0 per cent of the original loan (that is, fully repaid) by the end of year 10.
- Subject to meeting the maximum loan balances, there would be no specified annual principal repayments.
- Interest would be able to be accrued annually but would have to be paid by the end of each milestone period — the end of years three, five, eight and 10.
- Interest deductibility would be governed by existing income tax rules.

6.3 The Board proposed that 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.

6.4 In relation to the choice of interest rate under an Amortisation Model, the Board stated that the current Benchmark rate, based on indicator rates for variable housing loans,[18] is too low. It was seen as providing 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. The Board considered that the small business variable overdraft rate provided a more appropriate benchmark.[19]

6.5 The Board further proposed that the Commissioner's period of review would commence from the date of lodgement for the income year in which each milestone payment is required (or would have been required, had a complying loan agreement been entered into).

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

VIEWS IN SUBMISSIONS

6.7 Stakeholders generally agreed that the proposed terms would assist in simplifying compliance, particularly for small businesses, but some noted that they may be too restrictive for mid-sized and larger businesses.

6.8 Stakeholders also welcomed the proposal that there should be no requirement for a formal written agreement between the parties, and some suggested that administrative guidance should be provided on what constitutes acceptable evidence, in order to avoid inadvertent non-compliance.

6.9 Stakeholders who found the proposed terms were favourable for small businesses emphasised the benefits in terms of reduced complexity, acknowledging that they provide some flexibility to comply with the requirements. CPA Australia supported the proposed design features of the 10-year complying loan detailed in the discussion paper. They noted that:

> … much of the complexity associated with the current differential rules regarding secured or unsecured loans will no longer be required.
>
> This measure would also strike an appropriate balance between ensuring that stakeholders or associates repay private company loans over a reasonable period (regardless of whether the loans are secured or not) at an appropriate arm's length

18 Specifically, the Benchmark interest rate is based on the *Housing loan; Banks; Variable* rate last published by the Reserve Bank of Australia before the start of the income year.

19 This is the same as the rate that currently applies to 10--year interest-only loans outlined in PS LA 2010/4, as discussed further below.

interest rate whilst providing some flexibility for interest and principal repayments over the loan term.

6.10 Stakeholders who supported the proposed terms noted that fixing the interest over the term of the loan provided simplicity and certainty. They also agreed that the proposed terms provided some flexibility for the repayments, as it may be difficult to make annual payments of principal and interest in the early years. The Institute of Public Accountants (IPA) stated that:

> Setting the interest rate at the start of the loan and leaving it fixed over the term of the loan provides for more simplicity and certainty.
>
> The prescribed maximum loan balances as outlined in the discussion paper provide for a reasonable flexible repayment schedule in contrast to the existing requirement to make minimum yearly repayments of principal and interest.

6.11 As noted above, other stakeholders acknowledged that the proposed terms would simplify compliance but argued that borrowers should not be required to borrow on terms that are less favourable than those they could obtain from a third-party financial institution, and that the distinction between secured and unsecured loans should be preserved. KPMG submitted that a fixed interest rate is inconsistent with commercial practice, as a standard commercial loan would be permitted to be refinanced or moved to a variable rate. They noted that:

> It would be highly unlikely that an arm's length commercial borrower would be locked into a fixed interest rate without any ability to renegotiate — particularly when looking at a 10-year period.

6.12 KPMG also submitted that:

> … the adoption of the statutory interest rate does not distinguish between secured and unsecured loans and the statutory interest rate suggested is based on an unsecured loan. We believe that this may be again inconsistent with normal commercial terms. We suggest that if a loan is able to be secured, a reduced interest rate should be available.

6.13 Some stakeholders submitted that allowing the option to use fixed or variable rates at the start of a loan arrangement would be particularly useful for taxpayers in the middle to larger end of the market, as they may potentially have 20 or more separate Division 7A arrangements operating simultaneously in any one year. While acknowledging that the option may create complexity for small businesses, these stakeholders argued that these issues could be addressed with the parallel introduction of a self-correction mechanism.

6.14 Pitcher Partners submitted that:

> We acknowledge that tax agents advising taxpayers in the smaller end of town may become confused with two rates being published on a yearly basis. However, if the revised provisions come with a self-correction mechanism, we do not see this as being an issue that would result in significant compliance or errors that cannot be otherwise corrected. Accordingly, we recommend that the Board consider providing an option for the use of fixed or variable rates at the start of the arrangement.

6.15 Other stakeholders, while generally supportive of the proposed terms and noting that a statutory fixed rate set at the start of a loan would reflect the commercial reality of many loans in the business environment, suggested that transitional provisions should ensure that existing 25-year loans are 'grandfathered'. For example, Cleary Hoare Solicitors submitted that:

> The remainder of the suggested terms are reasonable; however, the existing compliant 25 year loans should be allowed to continue and protected under legislation consistent with the view proposed elsewhere that the Commissioner's period of review should run from the last milestone payment date rather than being open-ended.

BOARD'S CONSIDERATION

6.16 The Board acknowledges that the proposed terms for complying loans may not fully accord with the terms taxpayers could obtain from third-party financial institutions and would not allow taxpayers to differentiate between the costs of loans that are secured against real property from those that are unsecured.

6.17 However, the Board is of the view that the purpose of the complying loan exemption is not simply to mimic the terms that different taxpayers would face in the context of arm's length borrowing. While commerciality is one factor in the design of the rules, other factors are also important. In particular, the Board considers that most taxpayers should find the loans easy to comply with. They should be repayable within a reasonable period and provide flexibility in terms of the timing of required repayments.

6.18 The Board further agrees with the views from stakeholders that fixing the statutory interest rate at the start of the loan would simplify repayment calculations and provide certainty to taxpayers with respect to their repayment obligations. It believes the benefits in terms of simplifying compliance obligations, particularly for small businesses, outweigh the disadvantages of not being able to match the more favourable terms that some taxpayers could potentially obtain from a third-party financial institution or the additional compliance costs that taxpayers in the middle to larger end of the market may face in dealing with multiple loans simultaneously.

6.19 Moreover, the Board notes, as some stakeholders have observed, that in the case of complying loans, the remuneration and margin charge paid to the company for using its funds (reflected in the interest rate charged for complying loans) is not being paid to a third party but rather remains within the private group, which is thus able to maximise the use of its available funds.

6.20 The Board also notes that, with respect to the need to facilitate financing the working capital needs of businesses run through a trust, a separate proposal that loans from companies to trusts should be excluded from the operation of Division 7A is discussed in the next chapter — namely, the business income election option — which could be adopted as an accompanying feature of the proposed Amortisation Model.

6.21 With respect to the proposed interest rate, the Board notes that it is consistent with the interest rate currently used for 10-year interest-only loans under the sub-trust arrangements outlined in PS LA 2010/4 and, in this respect, is a benchmark reference rate that taxpayers already have some familiarity with.

6.22 In line with the above discussion, subject to the Government's policy decision on the formulation of the policy framework (see Recommendation 3), the Board recommends enacting legislation that prescribes the terms of the complying loan rules as outlined in paragraphs 6.2 to 6.4 of this chapter.

6.23 The Board also recommends providing administrative guidance on what constitutes acceptable evidence that a loan was entered into by lodgement day for the income year in which the loan was made, in order to avoid inadvertent non-compliance. This guidance should reflect general legal principles on forming binding contracts.

Quantifying the deemed dividend

6.24 In considering the practical application of the proposed changes to the complying loan rules, the Board has given specific attention to the design of rules for quantifying deemed dividends.

6.25 To set the context for this issue, consider a shareholder who borrows $100 from a private company on an interest-only basis using a fixed interest rate of 5 per cent per annum. The shareholder makes no repayments and allows the interest to be capitalised. This makes the loan non-complying, as the Amortisation Model mandates that the loan is repayable over 10 years and bears interest at an assumed rate of 10 per cent per annum.

6.26 Table 1 below shows the actual balance of the loan compared with the balance recalculated on the basis that the loan was on complying terms, assuming no repayments are made.

Table 1

Year	Actual balance	Notional balance	Required balance	Deemed dividend	Adjusted deemed dividend
1	105.00	110.00			
2	110.25	121.00			
3	115.76	133.10	75.00	58.10	58.10
4	121.55	146.41			
5	127.63	161.05	55.00	106.05	47.95
6	134.01	177.16			
7	140.71	194.87			
8	147.75	214.36	20.00	189.36	83.31
9	155.13	235.79			
10	162.89	259.37	0.00	259.37	70.02

6.27 It is noted in this case that calculating the deemed dividend to be the difference between the actual balance and the required balance at each milestone date will not produce the correct result. Instead, the loan balance needs to be restated using the correct interest rate.

6.28 It is expected that the deemed dividend will be calculated at the end of each period based on the difference between the required balance and the notional balance (that is, the actual balance, recalculated if necessary using the required interest rate). However, as the table shows under 'Deemed dividend', if a dividend were to be deemed at the end of each period, it would then result in duplications at each point in time (as the year five deemed dividend would include the year three deemed dividend).

6.29 A deemed dividend should therefore not include a prior-year deemed dividend amount that has been assessed to a taxpayer in a prior year. The rule for quantifying the deemed dividend should contain an anti-duplication mechanism to prevent this outcome. The effect of this mechanism is shown in the table in the column headed 'Adjusted deemed dividend'.[20]

20 The adjusted deemed dividend assumes that prior dividends have been assessed to the borrower.

6.30 The Board notes that this rule would need to take into account the Commissioner's period of review, as discussed in further detail in paragraphs 6.39 to 6.50 below.

6.31 The Board further notes that, under the Amortisation Model, the distributable surplus of a company should be tested periodically. That is, it should be calculated by reference to the distributable surplus for the income year in which each milestone payment is due. This is a change from the current rules, where periodic testing only applies to actual loans placed on complying terms under section 109N. This is considered a necessary change to prevent taxpayers gaining an advantage from non-compliance by originally treating a payment as a loan (even without adequate evidence) and later claiming an expired period of review. This issue is discussed further below under 'Periods of review'.

Transitional rules

6.32 The Board has considered five categories of existing arrangements for which transitional rules could be applied:

- loans entered into before 4 December 1997 that predate the application of Division 7A (pre-1997 loans);
- complying 25-year loans entered into on or after 4 December 1997 (complying 25-year loans);
- complying seven-year loans;
- UPEs that came into existence before 16 December 2009 and are therefore quarantined from the application of Division 7A[21] (pre-2009 UPEs); and
- UPEs that came into existence on or after 16 December 2009 (post-2009 UPEs).

6.33 In terms of transitional provisions, the Board supports the proposition that complying 25-year loans should have their terms grandfathered — that is, they should be paid with interest over the remainder of the 25 years. This is in order to avoid a detrimental impact on taxpayers who would otherwise face having the terms of their pre-existing loans significantly shortened.

6.34 The Board further believes that, in order to promote simplicity in applying the law and avoid a detrimental impact on taxpayers, all other pre-existing Division 7A loans should transition to the new 10-year loans from the application date of the new provisions.

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21 The Commissioner has stated in PS LA 2010/4 that Division 7A will not treat UPEs created prior to 16 December 2009 as loans, even if partly repaid, unless the UPEs have been converted into Section two loans. A Section two loan is a loan within the ordinary meaning of that term.

6.35 In accordance with the above, all complying seven-year loans would have their terms extended to the new maximum of 10 years, thus benefitting from a longer repayment period.

6.36 In addition, all pre-1997 loans would be deemed to be new Division 7A—complying loans, with a 10-year term starting from the application date of the new provisions. Although these loans would now be required to be repaid, the Board considers that this transitional rule would be in the longer-term interests of affected taxpayers. Under the current law, a taxpayer with a pre-1997 loan faces a significant tax risk from the possibility of the Commissioner challenging the commerciality or existence of the loan. This risk might include the possibility that the loan has been forgiven, triggering the application of Division 7A or other adverse tax consequences. The proposed transitional rule will give affected 'borrowers' an opportunity to normalise their related-party loans.

6.37 A further advantage of the proposed transitional rule is that it will provide administrative simplicity by ensuring that legacy transitional arrangements do not persist indefinitely. That said, the Board has proposed a transitional rule with maximum flexibility in mind. At the transition time, an affected borrower will have three years before the first repayment is due and 10 years before the loan is due to be repaid in full, irrespective of the age of the loan. This would mean, for example, that if the reform was enacted with effect from 1 July 2015, borrowers would have at least 27 years before repayment obligations were imposed.

6.38 Table 2 below summarises the proposed transitional rules for existing loans and UPEs.

Table 2

Proposed rules for pre-existing loans and UPEs

<table>
<tr><td>Pre-1997 loans</td><td rowspan="3">Repayable with interest over 10 years from the date of enactment in accordance with new complying loan rules.</td></tr>
<tr><td>Pre-2009 UPEs</td></tr>
<tr><td>Post-2009 UPEs</td></tr>
<tr><td>Complying seven-year loans</td><td>Term extended to 10 years, repayable with interest, in accordance with new complying loan rules.</td></tr>
<tr><td>Complying 25-year loans</td><td>Repayable in accordance with existing terms (that is, grandfathered).</td></tr>
</table>

Period of review

6.39 As outlined above, the extended loan period (of up to 10 years) will give rise to timing issues as to when a deemed dividend will arise in respect of a loan and whether the Commissioner will be able to amend a return with respect to a deemed dividend that arises due to a prior breach of the minimum loan repayment requirements.

6.40 Again, context for these issues can be gained by considering a shareholder or associate who borrows $100 from a private company. The Amortisation Model mandates that the loan is repayable over 10 years and bears interest, indicatively, at a rate of 10 per cent per annum.

6.41 As the Table 1 at paragraph 6.26 shows, the amount of the deemed dividend in a subsequent year should be reduced by any earlier dividend (that is, an anti-duplication rule).

6.42 Two important questions arise in relation to periods of review under the Amortisation Model. The first question is whether the subsequent dividends in years five, eight and 10 should be reduced by any prior dividends where the amount has not been assessed to the taxpayer.

6.43 The Board notes that the ATO applies the current law so that earlier deemed dividends that arise due to a shortfall in a minimum repayment (under section 109E) are not taken to reduce the loan balance and thus the amount of a subsequent dividend under a seven-year complying loan.[22] Furthermore, as interest must be charged on the daily balance at the statutory rate under section 109E,[23] the deemed dividend is calculated by reference to the loan balance inclusive of accumulated interest at the statutory rate.

6.44 Accordingly, the Board highlights that the proposed anti-duplication rule goes further than what is currently provided under Division 7A and would improve it by ensuring that subsequent deemed dividends do not result in double taxation.

6.45 However, the Board also notes that it may not encourage active compliance if the proposed anti-duplication rule was to apply on the basis that an amount was 'assessable in an earlier year' rather than 'assessed in an earlier year'. That is, it may also encourage taxpayers to argue that loans have been forgiven in earlier years (where that year is outside the amendment period) or encourage taxpayers to take no remedial action in the hope that the ATO will not discover the breach.

6.46 Furthermore, the Board highlights that complications may arise under the self-correction mechanism if the anti-duplication rule were based on prior 'assessable amounts' rather than prior 'assessed amounts'. For example, the ATO may require

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22 See ATO ID 2013/36.
23 Paragraph 109N(1)(b) of the ITAA 1936.

significantly more proof that the error is due to an honest mistake or inadvertent omission if the taxpayer identifies the issue in a later year (say, year nine) that is outside the amendment period for a component of the deemed dividend.

6.47 Based on the above, the Board considers that the proposed anti-duplication rule would improve the current operation of Division 7A, but that it would be preferable to only extend this new rule to amounts that have been or will be assessed to the relevant taxpayer in respect of an earlier year. Dividends that arose at a prior milestone date, but had not been or could not be assessed, would not be subject to the anti-duplication rule.

6.48 Where this is the case, the Commissioner's period of review would commence from the date of lodgement for the income year in which the deemed dividend occurs (for example, the year of income where there is a shortfall in a milestone payment).

6.49 The second issue concerns the possibility of a non-compliant taxpayer arguing that a deemed dividend was triggered not by a loan but by a payment, so as to establish that the Commissioner is out of time to amend the relevant assessments. A taxpayer may seek to make this argument where, for example, the Commissioner conducts a review of a private company and discovers that the company advanced funds to a shareholder or associate six years prior. The argument would be more plausible if there were no payments of interest or principal on the loan and no evidence to establish the nature of the payment.

6.50 The Board notes that, under the current law, taxpayers are sometimes able to gain a tactical advantage by asserting that a payment was not subject to a complying loan. This position should not be reproduced in a reformed Division 7A. Accordingly, the Board recommends that, where the Commissioner is out of time to assess a deemed dividend arising from a payment, the rules should prevent the taxpayer from asserting that the payment was not subject to a loan. This could be achieved by deeming payments to be a loan if they have not been, or cannot be, assessed as a dividend from a payment for the relevant year.

Recommendation 6

Subject to the Government's policy decision on the policy framework for reform of Division 7A (see Recommendation 3), the Board recommends enacting legislation that prescribes the following terms for complying Division 7A loans:

- 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 lodgement day for the income year in which the loan was made.

- The statutory interest rate would be set at the start of the loan and fixed over the term of the loan.

- The statutory interest rate would be the Reserve Bank of Australia's indicator lending rate for a *small business; variable; other; overdraft* for the month of May immediately before the start of that income year.
- The maximum loan term would be 10 years.
- The prescribed maximum loan balances during the term of the loan (including any accumulated interest) would be as follows:
  - 75 per cent of the original loan by the end of year three;
  - 55 per cent of the original loan by the end of year five;
  - 25 per cent of the original loan by the end of year eight; and
  - 0 per cent of the original loan (that is, fully repaid) by the end of year 10.
- Subject to meeting the maximum loan balances, there would be no specified annual principal repayments.
- Interest would be able to be accrued annually but would have to be paid by the end of years three, five, eight and 10.
- Interest deductibility would be governed by existing income tax rules.

The Board further recommends:

- where a payment is not treated as a dividend, deeming the taxpayer liable for loan repayments as if a loan were made, and to which the Commissioner's period of review may apply as if to a loan;
- ensuring that failure to make the repayments by the end of the milestone period results in the private company being taken to have paid a dividend to the entity;
- basing the amount of the deemed dividend on the amount of the shortfall in the payment required, calculated using the appropriate statutory interest rate, reduced by the amount of any prior deemed dividends assessed to the taxpayer;
- commencing the Commissioner's period of review from the date of lodgement for the income year in which each milestone payment is required (or would have been required had a complying loan agreement been entered into);
- providing administrative guidance, reflecting general legal principles relating to forming binding contracts, on what constitutes acceptable evidence that a loan was entered into by lodgement day for the income year in which the loan was made, in order to avoid inadvertent non-compliance;

- grandfathering the terms of complying 25-year loans — that is, they should remain payable with interest over the remainder of the 25 years; and
- transitioning all other pre-existing Division 7A loans to the new 10-year loans from the application date of the new provisions. In accordance with this:
  - all existing complying seven-year loans would have their terms extended to the new maximum of 10 years;
  - all pre-1997 loans would be deemed to be new complying Division 7A loans, with a 10-year term starting from the application date of the new provisions; and
  - where the Commissioner is out of time to assess a deemed dividend arising from a payment, the rules should stipulate that the taxpayer is prevented from asserting that the payment was not made in the context of a loan.

Annual repayments of complying loans

6.51 The Board understands that while most taxpayers will welcome the increased flexibility for repaying complying loans in four instalments over 10 years, some may prefer the simplicity and certainty of repaying the loan via annual instalments, preferably in equal amounts. The Board has considered this issue. It found that, assuming an interest rate of 10 per cent, a borrower who repays a complying loan in equal annual instalments according to a precise amortisation would fall short of meeting the first three minimum loan balance targets under the Amortisation Model.

6.52 However, the Board understands that it would be relatively simple for advisers to devise an annual repayment schedule that would ensure the targets are met. The Board recommends to the ATO that, in the event that the Amortisation Model is implemented, it develop an online tool for calculating an amortisation schedule for taxpayers who choose to pay annually.

Recommendation 7

The Board recommends that the ATO adopts administrative measures to assist taxpayers who choose to repay complying loans in annual instalments. This administrative assistance could include an online tool for calculating an annual repayment schedule under which minimum loan balance targets would be met.

CHAPTER 7: DIVISION 7A AND UNPAID PRESENT ENTITLEMENTS TO COMPANIES

7.1 This chapter deals with an issue that was raised by the Board in its second discussion paper: the treatment of UPEs for Division 7A purposes.

TREATMENT OF UPES AS LOANS FOR DIVISION 7A PURPOSES

7.2 The treatment of UPEs under Division 7A is a highly contentious area. Until 2009, the Commissioner generally administered the Division on the basis that a UPE was not a loan for Division 7A purposes.[24] In 2009, the Commissioner departed from this practice and ruled that 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 provides financial accommodation or an in-substance loan.[25] In recognition of the departure from past practice, the Commissioner only applied the interpretation for UPEs that arose on or after 16 December 2009.

7.3 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 a sub-trust for the sole benefit of the private company beneficiary by adopting one of the investment options set out in the practice statement. These options include investing the funds under a seven- or 10-year interest-only investment agreement with the trust owing the UPE, or in a specific income-producing asset or investment held by the trustee of the trust owing the UPE.

7.4 The Board notes that the tax profession does not universally accept the Commissioner's view that a UPE can be a loan under the current definition. However, the Board is more concerned with the question of whether, with regard to the policy considerations, UPEs should be subject to obligations under a reformed Division 7A. The Board proposed in the second discussion paper that greater simplification, certainty and policy coherency could be gained from a legislative amendment that aligns the treatment of UPEs for Division 7A purposes with the treatment of loans. The Board considers this would eliminate the need to create sub-trusts and comply with the conditions outlined in PS LA 2010/4.

7.5 The Board observed that, under a system that aligns the treatment of UPEs and loans, no deemed dividend would arise from a UPE if the company beneficiary's

24 Taxation Ruling TR 2010/3, paragraph 28.
25 Draft Taxation Ruling TR 2009/D8, finalised as Taxation Ruling TR 2010/3.

present entitlement is paid or distributed by the time the trust tax return was due to be lodged in the income year following the year in which the entitlement arose.

7.6 The Board observed that consistency in the treatment of UPEs and shareholder loans from a timing perspective would significantly reduce compliance costs.

7.7 Finally, the Board also proposed that, while there would be merit in clarifying that UPEs are loans for Division 7A purposes, it would be undesirable to adopt this simplification or clarification without at the same time addressing the use of company UPE funds (and other loans) as working capital to carry on a business in a trust.

7.8 Against the above background, the Board sought feedback from stakeholders on whether a legislative amendment should be introduced to clarify that all UPEs are loans for Division 7A purposes.

VIEWS IN SUBMISSIONS

7.9 Stakeholders were broadly supportive of the proposal for a legislative amendment to clarify that all UPEs are loans for Division 7A purposes, with some noting that the existing UPE rules are cumbersome, complex and have a high compliance cost.

7.10 Several stakeholders emphasised that any alignment in the treatment of UPEs and loans should only be implemented in conjunction with the Board's tick-the-box proposal (as it was called in the second discussion paper), to ensure there are no adverse tax implications for such trusts. BDO, for example, supported the proposal subject to the 'significant proviso' that:

> … the other recommendation of the Board is adopted whereby loans and UPEs owed by trusts to private companies can be ignored for Division 7A purposes where the applicable trust elects to forgo the CGT discount except in relation to goodwill.

7.11 Laird Advisory Services (Laird) submitted that pre-2009 UPEs should be grandfathered, preserving the position of Taxation Ruling TR 2010/3,[26] which provided the Commissioner's view of when a subsisting UPE may be a loan for the purpose of Division 7A.[27]

7.12 KPMG also suggested that pre-2009 UPEs should be grandfathered. It further suggested that any current sub-trust arrangements in accordance with PS LA 2010/4 should continue to be subject to the existing requirements and that the approach in PS LA 2010/4 should receive legislative backing.

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26 TR 2010/3, *Income tax: Division 7A loans: trust entitlements.*
27 TR 2010/3 does not apply to UPEs arising before 16 December 2009.

7.13 For clarification, Cleary Hoare Solicitors noted that, under a UPE, the beneficiary retains ownership of the appointed income rather than creditor status, and that a change of status from owner to creditor would require documenting the 'getting in' and 'lending' of the appointed income as if those events had occurred.

7.14 Commenting on the timing of the loan, CAANZ suggested that a UPE arising during or at the end of an income year should become a loan for Division 7A purposes at the end of the following income year to the extent it remains unpaid, as that would enable the actual amount of the loan to be determined.

BOARD'S CONSIDERATION

7.15 The Board has considered the views relating to UPEs and believes that a UPE (in substance or effect) provides financial accommodation from the company to the trust. Thus, a UPE is akin to a loan provided to a trust. However, the Board also acknowledges that UPEs provide a significant source of funding, which is used by business taxpayers for working capital purposes. To address these two issues, the Board proposes the following recommendations.

7.16 The Board recommends introducing a legislative amendment to align the treatment of UPEs and loans for Division 7A purposes. This will assist in providing clarity and consistency in the treatment of loan arrangements, contributing to reduced compliance costs.

7.17 As noted above, the Board is of the view that it would be undesirable to adopt the above simplification or clarification without at the same time addressing the use of company UPE funds as working capital to carry on a business in a trust.

7.18 Apart from wide-ranging proposals, such as lowering the section 99A tax rate on undistributed trust income to a level equivalent to the company tax rate, there are two reform options that could be adopted to assist in addressing the use of company UPE funds as working capital to carry on a business in a trust:

- a business income election option (referred to in the second discussion paper as a tick-the-box election), which could be adopted as an accompanying feature of the Amortisation Model proposed in the previous chapter; or
- the Interest Only Model, which is examined further in the next chapter.

Existing UPEs

7.19 The Board's support for a business income election has informed its view on the appropriate rules for UPEs that predate future reforms to Division 7A.

7.20 The Board believes that clarity and consistency in applying the law would be further advanced by deeming all outstanding UPEs (whether pre- or post-2009, and no matter how they are managed under PS LA 2010/4) to be loans under Division 7A, from the application date of the new legislation. In accordance with the requirements of the Amortisation Model, principal and interest payments would be required on these loans, with their 10-year term starting on the application date of the legislation.

7.21 While the Board acknowledges that the above proposal may impose an additional payment obligation on some taxpayers, the Board has designed its proposed business income election to give all trusts the choice to access an exemption from the requirements of Division 7A for all their existing arrangements. There are various matters that would remove or limit the disincentive for trusts to make the election. These matters are discussed below.

Recommendation 8

The Board recommends introducing legislative amendments to align the treatment of UPEs with the treatment of loans for Division 7A purposes in conjunction with either Recommendations 6 and 9 (Amortisation Model option) or Recommendation 10 (Interest Only Model option).

CHAPTER 8: A BUSINESS INCOME ELECTION OPTION (AMORTISATION MODEL)

8.1 In its second discussion paper, the Board proposed that trusts could be eligible to make a once-and-for-all election to exclude loans from companies (including UPEs owing to companies) from the operation of Division 7A (referred to as the tick-the-box option). It suggested that it would be appropriate for a trust that makes such an election (an excluded trust) to forgo the CGT discount on capital gains arising from assets (other than goodwill) held within the trust.

8.2 The proposed tick-the-box option was designed to put loans from companies to trusts that make the election on an equal footing with inter-company loans. It would do this by, in effect, replicating the exception in section 109K that currently applies to inter-company loans. That 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.

8.3 The Board noted that denying the CGT discount in these circumstances is consistent with allowing loan (including UPE) funds to be used as if they were still in a company environment, where companies cannot access the CGT discount. The Board further noted that the proposed exclusion will put loans from companies to trusts that make the election on an equal footing with inter-company loans.

8.4 The Board proposed retaining the CGT discount for goodwill because goodwill is, by its nature, an asset solely connected with using funds in a business. It suggested that allowing trusts to continue to access to the CGT discount for goodwill arising from business activities was consistent with the proposed policy framework for reforming Division 7A and was aligned with the characterisation of goodwill under the CGT small business relief provisions as an asset 'inherently connected' with a business.[28] The Board further suggested that the CGT discount might also be preserved on capital gains to the extent that a capital gain on disposing of shares could be attributed to underlying goodwill.

8.5 The Board sought stakeholders' views on whether the proposed limited exception would address issues with retaining working capital and reduce compliance costs where a business is carried on in a trust. It also sought stakeholders' input on the

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

nature of the consequential and transitional rules that would be required if such a limited exception were applied.[29]

VIEWS IN SUBMISSIONS

8.6 Stakeholders were generally supportive of the tick-the-box proposal, with some providing advice on the scope of assets that should retain access to the CGT discount, and with several providing suggestions for appropriate consequential and transitional rules.

8.7 Laird submitted that existing assets held by trusts choosing the limited exception should continue to be eligible for the CGT discount, and that the election should be able to be revoked when all loans from a private company (including UPEs that are deemed loans) have been fully extinguished. To manage integrity concerns arising from trusts making the election shortly before buying new assets, thereby granting unintended access to the CGT discount, Laird was in favour of a fixed commencement date. It submitted that this approach:

> … would be consistent with allowing taxpayers to make informed decisions for new investments whilst preserving the CGT discount for existing investments. Such a date should be a future date or if it is to be retrospective, certainly not before 16 December 2009.

8.8 Some stakeholders raised the possibility of retrospectively applying the limited exception, arguing that trusts should have the right to elect backwards to the time when the UPE arose and then be able to amend returns to eliminate CGT discounts claimed that would not have been available under the tick-the-box option. It was argued that the possibility of retrospective application would assist with small business cash flow issues. IPA submitted that a:

> … big issue for our members would be how to take advantage of not having to repay existing UPEs that comply with PS LA 2010/4. This administrative ruling requires repayment of principal in year seven or year 10. The repayment of these UPE loans will cause cash flow issues for small businesses.

8.9 Laird proposed that the scope of assets that should be able to retain access to the CGT discount under the proposal should include identifiable intangible assets subject to CGT — such as trademarks, as they are inherently connected with the business — and to which separate value is not usually attributed on the sale of private businesses.

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29 Second discussion paper, pages 64-65.

8.10 Other stakeholders suggested a broader definition, such as the one used for small business CGT concessions. Halperin & Co., for example, submitted that:

> There are business assets other than goodwill which should enjoy the CGT discount, as they do under the small business concessions. The small business concessions in Division 152 ITAA 1997 apply to 'active assets' as defined in section 152-40 ITAA 1997.

8.11 NSW Young Lawyers noted that the amendments to impose the election would be quite complex; that the apportionment of the trust's proceeds of sale between goodwill and other assets would have increased significance, which could result in valuation disputes and administrative uncertainty; and that there would be a need to confirm that any UPEs owed by the trust to a private company could not be subject to section 100A, which could otherwise defeat the purpose of the exception.

8.12 NSW Young Lawyers further argued that the alternative Interest Only Model, combined with an otherwise deductible rule, would remove the need for the tick-the-box approach altogether.

8.13 KPMG suggested that the definition of goodwill should be clearly stated to ensure no ambiguity. It further submitted that other business assets that provide enhanced value through the trading business should also be able to retain access to the CGT discount.

8.14 With respect to integrity measures, KPMG supported the retention of section 109T in relation to interposed structures to avoid the risk of potential abuse.

BOARD'S CONSIDERATION

8.15 The Board notes the overall positive feedback received on the tick-the-box proposal, and it is of the view that its introduction via a legislative amendment would help to alleviate compliance costs for privately held businesses that are carried on in a trust and need to retain working capital to fund their operations and growth.

8.16 The Board therefore recommends that, if the Amortisation Model is adopted, trusts should 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. A consequence of making the election should be that the trust (an excluded trust) forgoes the CGT discount on capital gains arising from assets, other than those designated as excluded assets. The Board considers 'business income election' to be an appropriate name for the proposal, reflecting its core purpose of better enabling business trusts to reinvest business income as working capital.

8.17 The Board agrees with stakeholders that the category of excluded assets that continue to enjoy the CGT discount should not be strictly confined to goodwill. However, it believes that care should be taken to avoid extending the definition in a way that will lead to difficulties in interpretation, reducing taxpayer certainty and adding to compliance costs. Accordingly, the Board believes the relevant definition should be based on existing tax law concepts that are well understood. Specifically, the Board recommends preserving the CGT discount for goodwill and 'intangible assets inherently connected with the business carried on by the trustee'. This language is adapted from the definition of 'active asset' for the purposes of small business relief in Division 152 of the ITAA 1997.[30]

8.18 An advantage of retaining the CGT discount for intangible assets inherently connected with a business is that it will relieve businesses of the need to hold intangible assets in a separate entity that is not subject to the business income election. It is not intended to extend to assets related to businesses carried on by associates, affiliates or connected entities.

8.19 The Board has further considered the question of whether the CGT discount should be preserved for capital gains arising from the underlying goodwill component of a capital gain from disposing of shares. The Board believes that extending the provisions in this manner would lead to complexity, create uncertainty and add to compliance costs. It believes that a trustee who conducts a business through an operating company would not require a business income election to manage loans owed by the trust to another creditor company and which relate to the business of the operating company. Such loans could, in any event, be restructured to be owed directly from the operating company and the creditor company, thereby bringing them within the inter-company exception in section 109K of the ITAA 1936. Accordingly, the Board is not in favour of retaining the CGT discount for shares under the election.

8.20 The Board notes, for clarification, that a trustee who makes the business income election:

- would not be precluded from claiming small business CGT concessions in Division 152 of the ITAA 1997, where the relevant conditions are met; and
- would be eligible to use a cost base that may be indexed for inflation occurring before 1 October 1999 in working out a capital gain for a CGT asset acquired at or before 11.45 am on 21 September 1999.[31]

8.21 Ensuring that access to these features of the CGT provisions is retained is consistent with the Board's intention of ensuring that a trust that makes a business income election is placed on an equal footing with a private company.

8.22 In the interests of efficiently administering the business income election, the Board believes the trustee election should be made in the relevant trust return for the year from which the election first applies (that is, the election will apply from 1 July).

30 See section 152-40 of the ITAA 1997.
31 Section 100-45 of the ITAA 1997.

Recognising that there will be some taxpayers who, due to extenuating circumstances, fail to meet the deadline, the Board recommends making the due date for the election the due date for the relevant tax return or 'such further time as the Commissioner allows'. An election made after the due date with the Commissioner's permission should be in the form specified by the Commissioner.

8.23 The Board further recommends amending the interposed entity rules to preserve the integrity of the provisions, without imposing undue compliance costs on trusts that wish to benefit from making the proposed election.

8.24 An entity that does not make the business income election will retain access to the CGT discount on all its assets, will be subject to Division 7A obligations in respect of any future loans (including UPEs), and will be subject to the proposed transitional rules for existing loans and UPEs. Under those rules, UPEs will be taken to be new complying loans repayable with interest over 10 years from the enactment of the new measures, 25-year complying loans will have their terms grandfathered, and seven-year complying loans will be extended to 10 years.

Timing and transitional issues

8.25 The Board has noted that, while stakeholders were generally supportive of the proposed exception, a number were concerned with how the transition to the new regime would be effected.

8.26 In accordance with its policy framework, the Board believes transitional rules should give effect to, or strike an appropriate balance between, the following objectives:

- In accordance with their objective of lowering compliance costs, they should ensure that the election is available to as many businesses as possible.
- They should be simple and easy to comply with by, for example, eliminating the need to trace borrowed funds or apportion the CGT discount. They should limit the extent to which legacy tax regimes operate in parallel with a reformed Division 7A.
- They should ensure that the treatment of assets and liabilities is 'matched' by ensuring the CGT discount is preserved only for assets financed by loans that continue to be subject to Division 7A obligations.

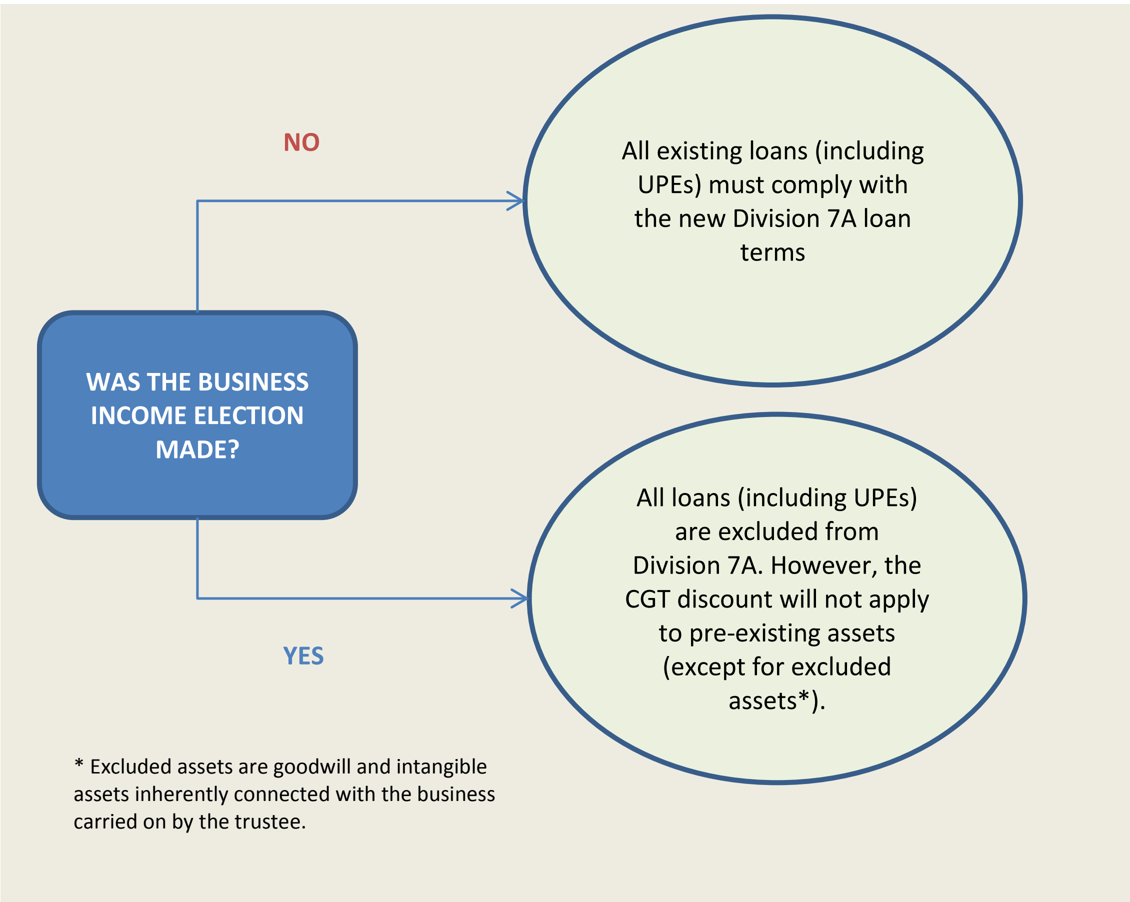
8.27 In the second discussion paper, the Board suggested that one option would be for the exception to operate on a purely prospective basis. Under this option, loans (including UPEs) owing to a company that were in place prior to a trust making an election would continue to be subject to existing Division 7A requirements, and CGT assets acquired by the trust prior to making an election would continue to be eligible for the CGT discount on disposal.

8.28 The Board has reconsidered the prospective approach to the application of the Amortisation Model and has concluded that it would have two significant limitations. Firstly, it would create an opportunity for taxpayers to enter into refinancing arrangements to convert existing loans and UPEs into new loans or UPEs that enjoy the benefit of the exemption while retaining access to the CGT discount on existing assets. This would require complex integrity rules. Secondly, prospective application would not assist those trustees who, for the sake of simplicity, wish to make a complete transition to the new regime.

8.29 With regard to the objectives stated above at paragraph 8.26, the Board has concluded that, as a general rule, when a trustee makes the business income election, it should operate on an 'all-in' basis. That is, it should have the effect that:

- all its loans and UPEs owed to companies, whenever created, should be exempt from Division 7A; and
- all its CGT assets other than excluded assets, whenever acquired, should be ineligible for the CGT discount.

8.30 The effect of the business income election on existing loans, UPEs and CGT assets is illustrated in the following chart.



8.31 It should be emphasised that making an election would not excuse a trustee from Division 7A obligations for the period prior to the income year for which the election is made. Accordingly, a deemed dividend would still arise if a trustee fails to make required payments under existing Division 7A rules or under the proposed transitional rules as summarised in paragraphs 6.32 to 6.35 above.

8.32 Example 1 below illustrates the effect of deferred business income election on a trust with pre-2009 UPEs.

Example 1

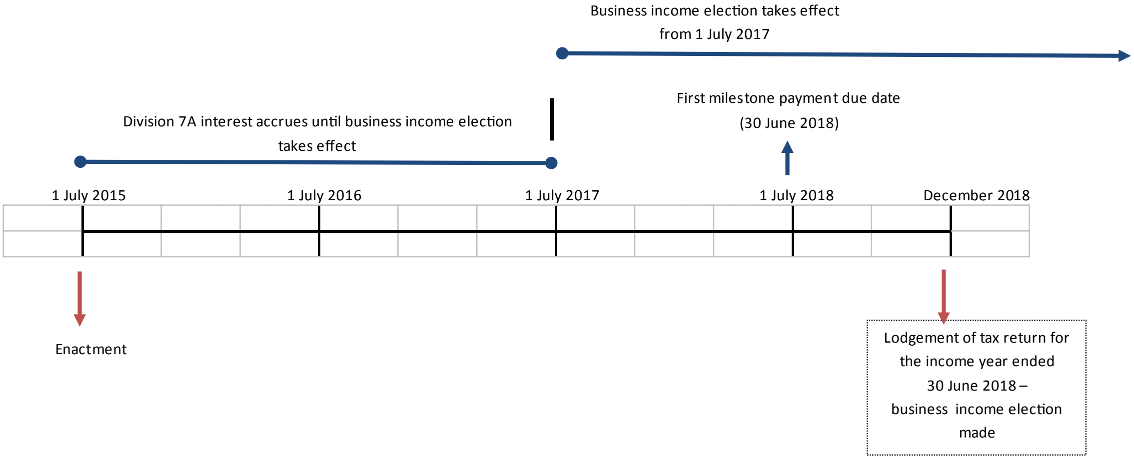
The Amortisation Model, including the business income election mechanism, is enacted with effect from 1 July 2015.

The ABC Trust has pre-2009 UPEs owing to Company X that are deemed to be new complying loans repayable with interest over 10 years from 1 July 2015.

The trustee of the ABC Trust lodges its tax return for the income years ending 30 June 2016 and 30 June 2017 without making the business income election. It makes the business income election in its ‘tax return for the year ending 30 June 2018. The election applies from 1 July 2017.

The trustee of the ABC Trust incurs interest on the new complying loans from 1 July 2015 and is assessable to Company X in the income years ending 30 June 2016 and 30 June 2017. The interest may also be deductible to the ABC Trust depending on how the retained funds are used by the trust.

For the year of income ending 30 June 2018, interest no longer accrues on the new complying loans. Further, as the business income election takes effect before the milestone payment is due (30 June 2018), the trustee is not required to make any principal or accrued interest payments.



8.33 Although Division 7A obligations should remain in place until a business income election takes effect, the Board believes that a trustee should be open to make the business income election in any income year they choose. This is a critical feature, as it is designed to provide trustees with flexibility by allowing them to defer the election until conditions are suitable.

Issues with the all-in approach

8.34 The Board acknowledges that, under an all-in approach, some trustees who would otherwise be attracted to the business income election will be discouraged by the prospect of losing the CGT discount on existing CGT assets. A taxpayer who is so discouraged would not be relieved of the compliance obligations associated with Division 7A, including for some arrangements (pre-1997 loans and pre-2009 UPEs) that do not currently require interest and principal payments.

8.35 The Board considers that, inevitably, the design of the transitional rules will involve some trade-offs. In particular, there is likely to be some tension in extending the new exception to cover existing arrangements while retaining their simplicity. That said, the Board emphasises that the business income election is intended to provide simplicity and reduce compliance costs, and should therefore be extended to as many taxpayers as possible. Accordingly, the Board has designed the business income election in such a way to ensure that there would be little or no disincentive for the majority of taxpayers to make the election.

8.36 Some of the factors that will ensure trustees are not discouraged from making a business income election have been discussed above. Most importantly, it was recommended that the CGT discount, although it will be lost on some CGT assets, should be preserved on key business assets, namely goodwill and intangible assets inherently connected with the business.

8.37 Furthermore, the Board has stipulated that there should be no time limit for making the business income election. This will provide trustees with flexibility to organise the trust's affairs and make the election in later income years when conditions are more favourable. For example, a trustee may choose to make the election after certain CGT assets have been sold and, in the meantime, comply with Division 7A obligations on existing arrangements. The flexibility would be increased because a trustee would have three years until the first milestone payment is due on arrangements that are deemed to be new 10-year loans under the Amortisation Model.

8.38 Example 2 builds on Example 1. It illustrates the effect of a deferred business income election on a trust with existing UPEs and non-goodwill CGT assets.

Example 2

The Amortisation Model, including the business income election mechanism, is enacted with effect from 1 July 2015.

The ABC Trust has pre-2009 UPEs owing to Company X that are deemed to be new complying loans repayable with interest over 10 years from 1 July 2015. It also owns a portfolio of investment assets and a rental property, both held on capital account.

The trustee of the ABC Trust lodges its tax returns for the income years ending 30 June 2016 and 30 June 2017 without making the business income election. In the income year ending 30 June 2017, the trustee sells the investment assets.

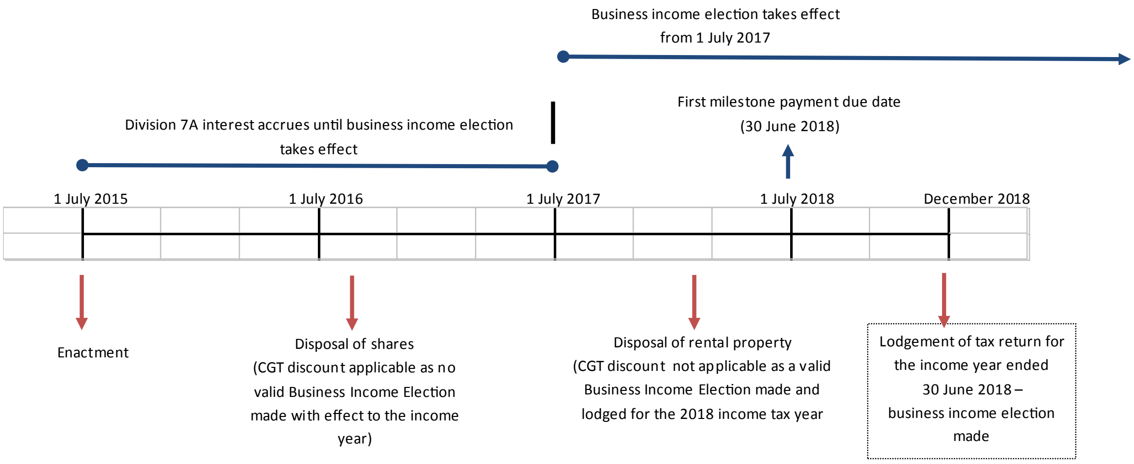
In the income year ending 30 June 2018, the trustee sells the rental property and makes a capital gain.

The trustee makes the business income election in the trust's tax return for the year ending 30 June 2018. The election applies from 1 July 2017.

The trustee of the ABC Trust incurs interest on the complying loans from 1 July 2015 and is assessable to Company X in the income years ending 30 June 2016 and 30 June 2017. The interest may also be deductible to the ABC Trust, depending on how the retained funds are used.

In the income year ending 30 June 2017, the trustee is entitled to claim the CGT discount on capital gains from disposing of investment assets.

For the income year ending 30 June 2018, interest no longer accrues on the new complying loans. Further, as the election takes effect before the milestone payment is due (30 June 2018), the trustee is not required to make any principal or accrued interest payments. However, the trustee is not entitled to claim the CGT discount on the capital gain made from disposing of the rental property.



8.39 There is a range of other factors that will minimise the disincentive to make a business election. As noted above, a trust that is a small business entity, while forgoing the CGT discount on some assets, may retain access to substantial concessions in the form of the small business CGT concessions on active business assets. Further, a trustee who makes the business income election will be able to use an indexed cost base (capped at the September 1999 quarter) for assets acquired before 21 September 1999.

Impact on the small business sector

8.40 Under the proposed all-in model, trustees of trusts holding CGT assets (other than excluded assets including goodwill) at the selected date would lose the ability to claim the CGT discount. The trustees who would be least attracted to the business income election are those taxpayers who hold a mixture of excluded assets and other investments.

8.41 Although it is not possible to comment on the circumstances pertaining to all trusts, the Board understands that larger taxpayers would typically structure 'risky assets' (for example, business assets) in a vehicle separate to 'non-risky' assets. Accordingly, it is believed that the mixed nature of trusts would be more common among smaller taxpayers. Furthermore, smaller businesses are likely to have less capacity than larger businesses to reorganise their affairs so as to best take advantage of the election.

8.42 The Board recommends that, if the Amortisation Model is adopted, the Government further consider the impact of the all-in approach on small businesses in order to determine whether additional transitional relief should be provided to that sector. That additional relief could, for example, involve continuing small businesses' ability to claim the CGT discount on all assets owned at the announcement date of the new legislation, for trusts that fall within an appropriate definition of 'small business'.

Recommendation 9

If the Amortisation Model is adopted, the Board recommends:

- introducing a legislative amendment that allows trusts 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 business income election);
- making the election by completing a label in the trust's tax return by the due date for lodging the return for the year of income in which it is made (or such further time as the Commissioner allows);
- enabling the election to be made in any income year, subject to the requirement that Division 7A obligations must remain in place for income years prior to the income year in which the election is made;
- ensuring that a trust that makes such an election (an excluded trust) forgoes the CGT discount on capital gains arising from assets other than goodwill and 'intangible assets inherently connected with the business carried on by the trustee';
- applying a business income election to all loans the trust owes to a private company, whenever created, and to all CGT assets (other than goodwill or

relevant intangible assets) whenever acquired;

- not excusing entities that make a business income election from Division 7A obligations for the period prior to the income year for which the election is made; and

- amending interposed entity rules to preserve the integrity of the provisions, without imposing undue compliance costs on trusts that wish to benefit from the proposed limited business income exception.

The Board further recommends that the Government consider the impact of applying a business income election to existing arrangements for small businesses in order to determine whether special transitional relief for that sector is warranted.

Chapter 9: The Interest Only Model

9.1 In its discussion of the policy principles contained in Chapter 3 of this report, the Board noted that, if a policy choice were made that there is no need for the fourth principle,[32] an Interest Only Model[33] could provide an effective and relatively simple solution to address shareholders or their associates accessing private company profits through loans or UPEs.

9.2 An Interest Only Model would largely replace the provisions in Division 7A that deal with loans. Under this Model, all Division 7A loans would be required, from time to time, to bear interest at a rate specified by law. However, progressive loan repayments would not be necessary and reborrowings (of principal) would be permitted.

9.3 The Board noted that an advantage of the Interest Only Model is that it may address the use of private company loans for private purposes without complicated rules, as interest on such loans would be non-deductible. Such an approach has the potential to make the law relating to loan arrangements between private companies and related entities more understandable to taxpayers.

9.4 The Board further noted that, 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 loan interest rate to be considerably higher than the current Division 7A rate to compensate for an interest-only loan with no principal repayments being made.

9.5 However, the Board observed that, where funds are put to a deductible use, the Interest Only Model would lead to a significant cost to revenue. This was due to a range of factors but, principally, because the individual borrower would be able to deduct the higher interest expense on the loan at their marginal tax rate, while the company would only pay tax on the higher-interest income at 30 per cent. In this context, the Board believed that an increased interest rate would exacerbate, rather than minimise, revenue costs.

9.6 Noting the Interest Only Model's potentially significant revenue costs, the Board queried whether the simplification benefits of an Interest Only Model could outweigh

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32 The fourth principle emphasises that Division 7A should support the overall objective of protecting the progressivity of the personal income tax system by not advantaging the accumulation of passive investments over the reinvestment of business profits in active business activities.

33 In the discussion papers on this review the Board has referred to the Interest Only Model as a Statutory Interest Model. The change in name highlights that a key attribute of the model is not to require principal repayments prior to the termination of the loan.

its revenue costs and sought stakeholder input on ways to minimise or offset costs with changes that are beneficial to revenue.

VIEWS IN SUBMISSIONS

9.7 A number of stakeholders expressed support for the Interest Only Model, as it would greatly reduce complexity and compliance costs, with some noting that it should be retained as an option if it is concluded that the --Amortisation Model (with the business income election) proposal is not a valid option.

9.8 CAANZ stated that:

> We understand the Board's concerns with the Statutory Interest Model and the behavioural effect on taxpayers which would encourage the accumulation of passive income thereby failing the fourth principle of the Board's proposed framework for Division 7A. However, the Institute believes the Board should not completely dismiss the Statutory Interest Model because the simplification benefits would go a long way towards simplifying Division 7A as a whole (i.e. it satisfies the third principle of the Board's proposed policy framework).
>
> Nonetheless, as the Board has proposed a new option, the 'tick-the-box' option, we understand that there may be difficulty getting the Statutory Interest Model and the 'tick-the-box' option to operate together coherently …
>
> If, however, the 'tick-the-box' option is no longer a valid reform proposal for Division 7A, we recommend that the Statutory Interest Model be revisited.

9.9 The Law Council of Australia submitted that the Interest Only Model should adopt a market-level measure of interest, and that the interest should be deducted according to the normal use of the funds, with no requirement for principle repayments.

9.10 NSW Young Lawyers suggested that the revenue concerns could be addressed by adopting an otherwise deductible rule, in accordance with which no statutory interest would apply where the funds were used by a borrower for a deductible purpose.

9.11 NSW Young Lawyers also suggested other features that could assist further in addressing revenue concerns, acknowledging they may diminish the simplicity of the Statutory Interest Model. These include introducing a rising statutory interest rate over the term of the loan, to encourage repayments, and a potential 'three-tier-system', under which (a) a full interest rate would apply where the funds were used for private purposes; (b) a lower rate, assessable to the company but not deductible to the borrower, would apply where the funds were used for an income-producing purpose other than carrying on a business; and (c) the otherwise deductible rule (no interest charged) would apply where the borrower used the borrowed funds in the business.

9.12 The Tax Institute submitted that the otherwise deductible rule could be applied only to the requirement to charge and pay interest, with principal payments still required over the maximum loan term under Division 7A.

9.13 Commenting on the first discussion paper, Pitcher Partners submitted that, as part of implementing an Interest Only Model, a company-to-company exception should continue to apply, as it assists in simplifying compliance with the rules, but noted that such an exception would require an appropriate interposed entity rule as an integrity provision.

9.14 Other stakeholders noted some practical issues related to the absence of a requirement to make principal repayments. For example, CPA Australia stated that removing this requirement would:

> … replicate some of the practical issues associated with unpaid present entitlements which are put on a sub-trust under Options 1 and 2 under Practice Statement PSLA 2010/4 as there would be no requirement for the shareholder or associate to make principal repayments. As set out under paragraph 5.32 of the second discussion paper the absence of a requirement to make principal repayments will reduce the need to make dividend payments to fund the payment of top-up tax by shareholders which is problematic where the loan funds are applied to fund the purchase of passive investments.

BOARD'S CONSIDERATION

9.15 If the Government were to decide that there is no need for Division 7A to prevent or avoid advantaging accumulating passive investments in businesses using profits taxed at the company tax rate over reinvesting business profits taxed at higher progressive tax rates in active business activities, the Board recommends adopting rules for exempting complying loans under an Interest Only Model.

9.16 Rules for exempting complying loans under an Interest Only Model would provide an effective and relatively simple solution to address shareholders or their associates inappropriately accessing private company profits through loans or UPEs.

9.17 The Board further recommends enacting legislation that prescribes the following terms for a complying Division 7A loan exemption under an Interest Only Model:

- 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 lodgement day for the income year in which the loan was made.

- A fixed statutory interest rate should apply for a complying Division 7A loan commencing in a particular year, equal to 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.

- There would be no prescribed term for the loan, no required annual principal repayments, and reborrowings (of principal) would be permitted.
- Interest deductibility would be governed by existing income tax rules.

9.18 Adopting the Interest Only Model would be an alternative to the proposed complying loans rules under an Amortisation Model and the accompanying proposal for a business income election.

9.19 In order to facilitate further compliance with an Interest Only Model, the Board recommends giving taxpayers the option to apply an otherwise deductible rule, under which there would be no requirement to charge statutory interest where the company loans or UPEs were used by a borrower for a deductible purpose. The application of an otherwise deductible rule would require the borrower to inform the lender about the proportion of the loan that is used for income-producing purposes, in order to appropriately charge interest on the loan. However, as Division 7A applies to associated entities, and given that the otherwise deductible exception would be optional, the Board believes it would not be difficult to determine whether the rule applies.

9.20 The Board further recommends that, to assist with compliance with the rules, an exception for inter-company loans[34] should be maintained, but with an appropriate interposed entity rule as an integrity provision.

9.21 For the Amortisation Model, the Board recommends adopting fixed statutory interest rate Division 7A loans. In that context, a fixed interest rate has the advantage of simplicity, particularly for taxpayers who have less complex arrangements. However, for the Interest Only Model, the Board believes greater simplicity would arise from applying a variable interest rate, nominated at the commencement of each year, and applicable to all existing Division 7A loans in place during that period. This will enable taxpayers with multiple loans to maintain a single pooled-loans account that is similar to a pooled overdraft, and will eliminate the need to separately track individual loans.

9.22 The Board recommends determining the interest rate under the Interest Only Model annually at the Reserve Bank of Australia's indicator lending rate for a *small business; variable; other; overdraft* for the month of May immediately before the start of that income year.

9.23 The Board further recommends, in order to promote simplicity in applying the law, transitioning all pre-existing Division 7A loans to new Interest Only loans from the application date of the new provisions.

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34 The inter-company exemption is described at paragraph 8.2 above.

9.24 The proposed transitional rule would have the effect of making pre-1997 loans and pre-2009 UPEs subject to an interest obligation that is not currently imposed. However, the Board believes that practical disadvantages to existing arrangements will be minimal for the following reasons:

- For pre-1997 loans and pre-1999 UPEs that continue to be used for income-producing purposes, the Board is proposing an otherwise deductible rule, which will remove the obligation to charge interest.
- Where UPEs are being accessed through private loans from a trust to an individual or trust, there are existing Division 7A obligations from Subdivisions EA and EB of Part III of the ITAA 1936. Accordingly, the transitional rule would impose no additional burdens.
- In any event, on rewriting the 'payment' rules and the interposed entity rules for payments, the Board expects changes to be made that would pick up the private 'use of assets' held by trusts funded under Division 7A UPEs or loans. These arrangements would be caught even in the absence of the transitional rules.

9.25 With regard to these considerations, the Board believes its proposed transitional rule is reasonable and appropriate.

Recommendation 10 — Alternative option: the Interest Only Model

If, as a result of a policy choice, there is no need for Division 7A to support the overall objective of protecting the personal income tax system's progressivity and not advantaging the accumulation of passive investments using profits taxed at the company tax rate over the reinvestment of business profits taxed at higher progressive tax rates in active business activities, the Board recommends enacting legislation that prescribes the following terms for a complying Division 7A loan exemption under an Interest Only Model:

- 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 lodgement day for the income year in which the loan was made.
- A variable statutory interest rate should be set annually for all complying Division 7A loans in place in the relevant year of income.
- The interest rate for complying loans should be equal to the Reserve Bank of Australia's indicator lending rate for a *small business; variable; other; overdraft* for the month of May immediately before the start of that income year.

- There should be no prescribed term for the loan, no required annual principal repayments, and reborrowings (of principal) would be permitted.

- Interest deductibility would be governed by existing income tax rules.

The Board further recommends:

- providing administrative guidance on what constitutes acceptable evidence that a loan was entered into by lodgement day for the income year in which the loan was made, in order to avoid inadvertent non-compliance;

- giving taxpayers the option to apply an otherwise deductible rule exemption, in accordance with which there would be no requirement to charge statutory interest where company loans or UPEs were used by a borrower for a deductible purpose;

- maintaining a company-to-company exemption under the new rules, but with an appropriate interposed entity rule as an integrity provision; and

- transitioning all pre-existing Division 7A loans to the new Division 7A complying loan terms from the application date of the new provisions.

The Board notes that, if adopted, this recommendation supersedes Recommendation 6 for complying loan rules under an Amortisation Model and Recommendation 9 for a business income election option.

CHAPTER 10: A SELF-CORRECTION MECHANISM

10.1 The proposed reforms considered up until this point have been designed to provide greater flexibility and simplicity, and thereby reduce the incidence of deemed dividends under a reformed Division 7A.

10.2 However, whichever reform model is adopted, deemed dividends will continue to arise, either because of a simple lack of awareness of the provisions' requirements, or more calculated attempts to avoid them.

10.3 This chapter and the following chapter set out the Board's views on the consequences that should follow when a deemed dividend is triggered. There are two issues for consideration.

10.4 The first issue, addressed in the current chapter, concerns the circumstances in which it is appropriate for a taxpayer, having triggered a deemed dividend, to be entitled to relief from the strict operation of the provisions.

10.5 The second issue relates to the requirement that deemed dividends arising under the provisions are generally not frankable. Chapter 11 considers the implicit penalty that arises from the inability to frank a deemed dividend.

General relieving discretion

10.6 Relief from the effect of Division 7A is currently provided through the general relieving discretion in section 109RB of the ITAA 1936. Under that provision, where a deemed dividend arises because of an 'honest mistake' or 'inadvertent omission', the Commissioner may decide in writing either that the deemed dividend did not arise or that the deemed dividend may be franked.

10.7 In determining whether to make a such decision, the Commissioner is required to consider a range of factors, including the circumstances that led to the mistake or omission, the extent of any action taken by the parties to correct the mistake or omission, whether there have been any prior applications of the Division, and other factors the Commissioner considers relevant. Importantly, the Commissioner is empowered to impose conditions when exercising the discretion. Generally, the Commissioner imposes such conditions as necessary to put the parties in the position they would have been in had they complied with Division 7A from the outset.[35]

35 PS LA 2011/29, paragraphs 102-106.

10.8 In the second discussion paper, the Board noted that the discretion involves an excessive compliance cost for taxpayers and is difficult for the Commissioner to administer. The Board queried whether, in a self-assessment environment, the discretion should be exercised to obtain relief from Division 7A.

10.9 The Board sought feedback from stakeholders on the merits of replacing the Commissioner's discretion with a legislated self-correction mechanism. As with the current discretion, a self-correction mechanism would have 'gateway' criteria governing eligibility for relief. However, unlike the present system, a taxpayer satisfied that the criteria have been met would be able to self-assess eligibility for relief. As with any other form of self-assessment, it would be open for the Commissioner to review the assessment and make tax adjustments where the Commissioner determined that relief was not validly claimed.

10.10 The eligibility criteria suggested by the Board as the basis for relief had two components. The first component relates to the standard of care exercised by the parties when deemed dividends arise. It was suggested that, at a minimum, relief should not be available when, on the basis of objective factors, it can be inferred that the parties deliberately ignored or attempted to circumvent the provisions.

10.11 The second component of the eligibility criteria for relief was a requirement for corrective action. It was suggested that the corrective action would be sufficient if it ensured that the parties were placed in the same position they would have been in had they complied with Division 7A from the outset. Typically, this would involve putting complying loan agreements in place and making the required 'catch-up' interest and principal payments.

VIEWS IN FROM SUBMISSIONS

10.12 There was broad support from stakeholders for introducing a legislative self-corrective mechanism. In comparison with the current system, self-correction was considered to be better aligned with the principles of self-assessment, and would have a lower cost of compliance.

10.13 While acknowledging the benefits of self-correction, stakeholders also submitted that eligibility criteria should be designed carefully in order to promote compliance, encourage voluntary disclosure of deemed dividends when they arise, and discourage tax avoidance.

10.14 Some stakeholders noted difficulties interpreting the eligibility requirements for the general relieving discretion and emphasised that eligibility for self-correction should be based on objective factors. CAANZ and Family Business Australia and KPMG believed that the eligibility test should be focused on corrective action rather than on the conduct that caused the deemed dividend to arise.

10.15 Koustas & Co. submitted that a legislative self-correction should be available retrospectively to allow past breaches to be remedied. However, Family Business Australia and KPMG made the general observation that self-correction should be limited to the current amendment period of four years.

10.16 The Law Council of Australia did not discuss the merits of making relief from Division 7A available on a self-assessment basis. It was in in favour of retaining the Commissioner's discretion for honest mistakes and inadvertent omissions, but believed that consideration should be given to lowering the threshold for eligibility by relaxing the requirement to provide evidence of an honest mistake or inadvertent omission.

10.17 The Law Council of Australia also submitted that the discretion should be reviewed by the Administrative Appeals Tribunal (AAT). It expressed the view that, currently, avenues for review are usually limited to Federal Court appeals under the *Administrative Decisions (Judicial Review) Act 1977* (ADJR Act) or the *Judiciary Act 1903* (Judiciary Act). This was seen as prohibitively expensive for the vast majority of taxpayers.

Board's consideration

10.18 Having considered stakeholders' submissions, the Board is of the view that there is scope to provide greater simplicity, lower compliance costs and better promote compliance by providing access to a self-correction mechanism.

10.19 The Board believes the current discretion is too inflexible. When a deemed dividend arises under Division 7A, and an exercise of the discretion is sought, the Commissioner generally has two options: to exercise the discretion, thereby reversing the deemed dividend and eliminating any tax shortfall, or to decline to exercise the discretion and expose the parties to a significant tax liability on an unfranked dividend as well as significant penalties and interest.

10.20 The Board has noted that, under the current system, a taxpayer who detects a prior deemed dividend may be discouraged from remedying the breach and making a voluntary disclosure to the ATO. Such taxpayers may not wish to expose themselves to the risk of the Commissioner declining to exercise the discretion. On the other hand, if relief was made too readily available, taxpayers may have an incentive to adopt more aggressive tax positions, confident that the consequences will not be severe if a breach is detected.

10.21 In order to provide the appropriate balance between fairness for taxpayers, promoting voluntary compliance and discouraging avoidance, the Board is in favour of a legislated, self-correction mechanism with the following features:

- a single, clear, objective test for governing eligibility for self-correction; and
- a mechanism to allow the Commissioner to apply an appropriate penalty, even where self-correction is validly made.

Eligibility requirements

10.22 The Board agrees with stakeholders that self-correction should be available where, on the basis of objective factors, it can reasonably be concluded that the breach that triggered the deemed dividend was unintentional. As with other taxing provisions, if the Commissioner challenges a self-correction, the onus should be on the taxpayer to prove that the breach was not deliberate.

10.23 The second requirement for eligibility for self-correction should be that sufficient steps have been taken to ensure the parties have been placed in the same position that they would have been had they complied with the provisions from the outset. As noted above, this will involve putting complying loan agreements in place and making catch-up interest and principal payments for the period starting when the dividend would, but for the self-correction, have arisen. The Board recommends providing taxpayers with clear guidance on what constitutes appropriate corrective action, either in legislation or in the form of administrative guidance developed by the ATO.

10.24 The Board agrees in principle that when a taxpayer unilaterally corrects a mistake without prompting from the ATO, there should be a strong presumption that self-correction relief should be available. However, the Board does not believe eligibility should focus exclusively on corrective action. For example, there will be occasions where a deemed dividend arises unintentionally but is not detected until an ATO review is commenced. In cases like this, the absence of any corrective action should not automatically disqualify the taxpayer from relief.

10.25 However, to encourage voluntary self-correction, the Board recommends enacting a rule stipulating that voluntary corrective action shall constitute *prima facie* evidence that the original breach was unintentional. This rule will also encourage voluntary disclosures in the common situation where a prior application of Division 7A is discovered when a business appoints a new adviser.

10.26 To avoid doubt, the Board proposes replacing the Commissioner's general relieving discretion under section 109RB of the ITAA 1936 with a self-correction mechanism. The Board has not considered other relieving discretions that apply in circumstances beyond the taxpayer's control or where undue hardship would result if a deemed dividend were to arise.[36] The Board believes discretion for these residual cases should be retained.

10.27 If the Amortisation Model is adopted, the Board would not recommend making self-correction available where the application of Division 7A is alleged to have been caused by a taxpayer's failure to make a timely business income election. For that situation, the Board recommends giving the Commissioner discretion to allow trustees to make a late election (Recommendation 9).

36 Sections 109Q, 109RD and 109UA of the ITAA 1936.

Penalty

10.28 The guiding principle to applying penalties in cases where self-correction is exercised is that the penalty should reflect the degree of culpability shown by the parties in triggering the deemed dividend. It should also take into account any subsequent conduct of the parties.

10.29 In the context of the Amortisation Model, the Board has considered an approach in which, when self-correction relief is applied, a penalty would be imposed on the notional 'shortfall amount' — that is, the tax shortfall that would have arisen had self-correction relief not applied. This approach could be modelled closely on existing law and administrative procedures for applying penalties for actual shortfall amounts under the uniform administrative penalty regime.

10.30 An advantage of this approach is that it would be based on existing concepts that are already well understood in the market and which the ATO is experienced in administering. Under this approach, self-correction has been exercised would be:

- where the notional shortfall was caused by a lack of reasonable care, there would be a penalty of 25 per cent of the notional shortfall; and
- where the self-correction was made voluntarily, the base penalty would be reduced by 80 per cent to 5 per cent depending on whether reasonable care had been exercised.

10.31 A typical outcome under this approach would be that a taxpayer who discovers a breach, and accesses self-correction relief, would be exposed to a penalty of 5 per cent of the deemed dividend that was triggered.

10.32 In the context of the Interest Only Model, tax shortfalls are calculated by referencing only the required interest and do not include a principal component. This means that tax shortfalls under the Interest Only Model would be significantly lower than under the Amortisation Model. It would follow that, if existing administrative penalties were applied to the notional shortfall amount, the penalties for non-compliance would also be significantly lower and may be insufficient to promote voluntary compliance.

10.33 If a self-correction mechanism is adopted in conjunction with the Interest Only Model, the Board recommends undertaking further analysis to ensure any notional shortfall penalty is proportionate and represents an appropriate disincentive.

Recommendation 11

The Board recommends enacting a self-correction mechanism with the following features:

- Qualifying taxpayers can self-assess their eligibility for an exception to Division 7A that will operate to reverse the effect of a prior deemed dividend.
- Eligibility for the exception will be based on satisfying two criteria:
  - It is reasonable to infer, on the basis of objective factors, that the conduct that caused the deemed dividend was unintentional; and
  - Appropriate steps have been taken to ensure that affected parties are placed in the position they would have been in had the dividend not arisen.
- Voluntary corrective action shall constitute *prima facie* evidence that the original breach was unintentional.
- A taxpayer who validly exercises self-correction may be liable for a penalty reflecting the degree of culpability (the self-correction penalty).

The Board further recommends:

- providing taxpayers with clear guidance on what constitutes appropriate corrective action, either in legislation itself, or in a form of administrative guidance developed by the ATO;
- if the Amortisation Model is adopted, designing the self-correction by applying the existing administrative penalty regime for tax shortfalls to the 'notional tax shortfall' that would have arisen had self-correction not been exercised; and
- if the Interest Only Model is adopted, ensuring any notional shortfall penalty is proportionate and represents an appropriate disincentive.

Review rights

10.34 The Board has noted the Law Council of Australia's submission that a taxpayer who is denied access to relief from Division 7A should be entitled to a review of the decision by the AAT. Although the Law Council of Australia made this suggestion in the context of a discussion of the current relieving discretion, review rights will also be a concern when a self-correction is made by a taxpayer but subsequently denied after an ATO review or audit.

10.35 The Board has noted that the Commissioner does not share the Law Council of Australia's views on the AAT's jurisdiction to review decisions under section 109RB. Although the issue is not free from doubt, the Commissioner has stated that:

> An assessment under section 166 that includes as one of its particulars an item of assessable income under section 44 resulting from the deeming effected by Division 7A is, like any other assessment, subject to rights of objection, review and appeal under Part IVC. A decision by the Commissioner to exercise, or refuse to exercise, his discretion under subsection 109RB(2), or to exercise it subject to conditions, is an essential part of the process by which the taxpayer's taxable income, and the amount of tax payable thereon, is ascertained. That is, it is a decision that goes directly to whether the taxpayer's assessable income properly includes a dividend under section 44.[37]

10.36 The Board agrees that the AAT should review decisions by the Commissioner to deny access to relief in the context of a review of the objection decision on the relevant income tax assessment. It is noted that this avenue of review is cheaper and provides more certainty than alternative avenues of review under the ADJR Act or Judiciary Act.

Recommendation 12

Under a legislated self-correction mechanism, where the ATO determines that self-correction was not validly made by a taxpayer, the Board recommends entitling the taxpayer to a review of the Commissioner's decision via the AAT.

37 PS LA 2011/29, paragraph 115.

CHAPTER 11: FRANKABILITY OF DEEMED DIVIDENDS

11.1 As the original terms of reference for this review made clear, Division 7A is principally designed to prevent shareholders from accessing company profits in a manner that is considered to be 'inappropriate'. Put another way, Division 7A was principally conceived as an 'integrity regime' that influences the way taxpayers conduct themselves rather than as a 'taxing regime' that prescribes appropriate tax treatment for transactions.

11.2 As with other integrity regimes, Division 7A is open to the criticism that when it applies (that is, when a deemed dividend arises), the tax and penalties imposed can be disproportionate to the 'tax mischief' that the provisions are designed to counteract. The Board has noted that, since its enactment, there have been a number of amendments designed to ameliorate some of the more punitive aspects of Division 7A.

11.3 One of the more punitive aspects of Division 7A as currently enacted is the requirement that, except in very exceptional circumstances, a deemed dividend arising under Division 7A cannot be franked. In its second discussion paper, the Board noted that relaxing this requirement may ensure that the Division applies in a more proportionate manner by accounting for tax already paid at the company level when determining the shareholder's tax shortfall and associated penalties. However, it may also remove an important disincentive for private companies that might seek to make disguised transfers of value to associates. The Board expressed interest in further exploring this issue.

VIEWS IN SUBMISSIONS

11.4 The issue of whether deemed dividends should be frankable attracted many comments from stakeholders.

11.5 Some stakeholders were unqualified in their support for making deemed dividends frankable. Arnold Bloch Leibler submitted that the inability to frank leads to effective double taxation and cannot be justified. They expressed the view that imposing penalties and interest on the additional tax payable at the shareholder level, net of an allowance for company tax, would be sufficient to deter shareholders from breaching the provisions.

11.6 Similarly, Family Business Australia and KPMG submitted that non-frankability is overreaching and inconsistent with the policy aim of protecting progressivity. Like Arnold Bloch Leibler, they saw the inability to frank as constituting a new penalty, rather than correcting the tax arbitrage.

11.7 Cleary Hoare Solicitors also supported making deemed dividends frankable. It submitted that franking would ensure equal treatment of taxpayers who are subject to the provisions and those who access profits in the form of a dividend from the outset.

11.8 Pitcher Partners were also in favour of a principle that deemed dividends should be frankable, at least in the first instance.

11.9 Other stakeholders were more qualified in their support for franking deemed dividends. The Institute of Public Accountants (IPA) proposed that an advantage of franking would be that shareholders would only be subject to top-up tax and could therefore avoid the need to apply for the Commissioner's discretion. However, the IPA submitted that only deemed dividends assessable to shareholders should be frankable, in light of the potential complexities associated with franking dividends assessable to non-shareholders.

11.10 CAANZ was also concerned about the practicalities of franking deemed dividends. They observed that franking a deemed dividend would generally need to occur retrospectively and require a complex deconstruction of the company's franking account.

11.11 Pitcher Partners acknowledged the potential complexities of designing a system in which deemed dividends could be franked. However, they believed these issues could be effectively managed. They proposed ways of addressing issues associated with franking dividends paid to associates and retrospective franking. They also observed that the rules relating to franking credit streaming and franking credit trading would provide additional integrity if a general principle of frankability was adopted.

11.12 NSW Young Lawyers was in favour of more limited access to frankability. They submitted that deemed dividends should only be frankable when a shareholder voluntarily discloses the dividends and initiates self-correction. However, they proposed that, where ATO review processes identify a deemed dividend, dividends should remain unfrankable to discourage non-compliance and encourage self-correction.

Board's observations

11.13 The Board remains of the view that the inability to frank deemed dividends operates in practice as an additional penalty that is often disproportionate to the tax mischief that the provisions are designed to address. The effective penalty can have a strong deterrent effect but can also produce harsh outcomes for some taxpayers. More importantly, the threat of the penalty can be a disincentive to taxpayers who, having inadvertently triggered the provisions, wish to make a voluntary disclosure and correct the breach.

11.14 The Board considers that the implicit penalty is not confined to situations where unfranked dividends are assessable to shareholders. In a practical sense, it also applies where an associate is assessable on the deemed dividend.

11.15 In this report, the Board has proposed reforms that are designed to promote voluntary compliance with the provisions. They include simpler, more flexible rules that will reduce the number of inadvertent breaches, and a readily accessible self-correction mechanism to remedy breaches when they occur. The Board has also proposed, as part of the Amortisation Model, a business income election option that would take an important class of business transactions[38] outside the reach of the provisions. Similarly, in the event that the Government opts to pursue the Interest Only Model, the Board recommended the inclusion of an otherwise deductible rule under which there would be no requirement to charge statutory interest where company loans or UPEs were used by a borrower for a deductible purpose.

11.16 The Board considers that the reforms will significantly reduce the number of instances in which deemed dividends arise. Moreover, deemed dividends would be largely confined to taxpayers who intentionally sought to avoid the provisions, and who are therefore ineligible to access self-correction relief.

11.17 The question that now falls for consideration is whether, in addition to the reforms already proposed, the Board should recommend the additional step of removing the implicit penalty in the current rules by implementing a system in which deemed dividends are frankable.

11.18 The Board considers that there would be a number of challenges involved in extending the imputation system to deemed dividends. Some of these challenges were noted by stakeholders:

- Deemed dividends are often, if not typically, assessable not to shareholders but to non-shareholder associates.
- Deemed dividends are generally not disclosed in the year in which they arise, creating a potential need for retrospective franking.

11.19 Extending the imputation system to deemed dividends assessable to associates would depart from existing policy. The imputation system is intended, according to its objects clause, to allow corporate tax entities to pass the benefit of company tax to their members, and to deny that benefit to members who lack a ‘sufficient economic interest’.[39]

11.20 Addressing the need to allow dividends to be franked retrospectively also presents significant challenges. The imputation provisions contain benchmarking rules

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38 That is, trusts’ retention of UPEs and other loans owed to corporate beneficiaries.
39 Section 201-1 of the ITAA 1997.

that broadly ensure the same franking percentage is used for an entire income year by referring to the first dividend paid. Taxpayers are limited in their ability to depart from the benchmark for a given period. Accordingly, where dividends are discovered after the fact, the franking outcome would depend on whether other dividends had been paid during the year of income and, if so, the extent to which they were franked. The outcome would be arbitrary.

11.21 Furthermore, even if deemed dividends were frankable *prima facie*, taxpayers would be subject to the potential overriding effect of dividend integrity rules for franking credit streaming and franking credit trading. They may also be exposed to the general value-shifting regime. While these rules may provide integrity, they would also create uncertainty and administrative complexity, adding to compliance costs.

11.22 Having considered these issues, the Board has concluded that, while there is a case for addressing the implicit double penalty that arises from the inability to frank deemed dividends, it is not in favour of making deemed dividends automatically frankable. The Board believes that reforms already proposed will reduce the incidence of deemed dividends, and provide readier access to relief where dividends arise unintentionally. Extending the imputation system to deemed dividends would be a departure from policy, introduce unnecessary complexity, and — given the potential operation of other integrity rules — provide taxpayers with limited certainty. The Board recommends against adopting a reform of this nature.

Recommendation 13

The Board recommends against adopting a principle that deemed dividends arising under a reformed Division 7A should generally be frankable.

Extending the imputation system to deemed dividends would introduce unnecessary complexity and, given the potential operation of other integrity provisions, provide limited certainty to affected taxpayers.

Administrative approach

11.23 Although not in favour of extending the imputation system to deemed dividends, the Board considers there is scope, within the current legislative framework, for the Commissioner to administer the tax law in a way that ensures the effective penalty for deemed dividends more closely reflects the degree of tax mischief. In particular, the Board has engaged in discussions with the Commissioner on whether there is scope to use the administrative penalty regime to mitigate the effect of the Division 7A assessment process.

11.24 The Commissioner has advised the Board that, under the current legislative framework, the *automatic* remission of penalties would not be appropriate. The Commissioner sees the imposition and remission of penalties as matters requiring conscious deliberation and adherence to administrative law principles. An automatic exemption from, or reduction or remission of, a penalty is not compatible with those principles.

11.25 The Board agrees that automatic relief from administrative penalties on deemed dividends would be inconsistent with the Commissioner's obligation to determine each case according to its merits.

11.26 However, the Board understands that the Commissioner has agreed that the unfranked status of a deemed dividend in a Division 7A assessment may constitute, in the circumstances of a given case, a harsh or unjust outcome, justifying some remission of penalty for both shareholders and non-shareholder associates.

11.27 The Board agrees with the Commissioner that there is scope, under the current penalty regime, to consider the *implicit* penalty arising from unfrankability as a factor that may justify the remission of administrative penalties. It further considers that remission may be warranted where the deemed dividend is assessable to a non-shareholder. The Board recommends that the ATO amend its guidance material, specifically PS LA 2012/5, to ensure these outcomes.

Recommendation 14

The Board recommends that the ATO reviews its guidance material on the imposition and remission of administrative penalties on tax shortfalls, with a view to amending it to give effect to the following principles:

- The inability to frank a deemed dividend under Division 7A can, depending on the circumstances, lead to an implicit penalty.
- The implicit penalty can arise both where the deemed dividend is assessable to a shareholder or a non-shareholder associate.
- The implicit penalty can, depending on the circumstances, constitute a harsh or unjust outcome.
- The implicit penalty should be considered when determining whether there are grounds for remitting an administrative penalty.

CHAPTER 12: OTHER ISSUES

12.1 In its first discussion paper, the Board noted that there are a number of significant difficulties and issues with operating specific provisions within Division 7A. It outlined a number of known issues based on information provided by stakeholders in preliminary consultations and the ATO. The Board sought stakeholders' feedback on whether they agreed with the Board's characterisation of the problems, on whether there were any additional issues not identified, and on the relative priorities.[40]

12.2 In its second discussion paper, the Board referred stakeholders to a list of additional problems identified with operating the provisions[41] and sought stakeholder feedback on any other aspects of Division 7A that should be progressed and in what priority. The Board noted in the second discussion paper that the proposed models to reform Division 7A did not mention other issues with Division 7A that might require further consideration.

VIEWS IN SUBMISSIONS

12.3 A confidential submission highlighted that, under section 109CA of the ITAA 1936, a deemed dividend can arise when a company purchases assets for no other purpose than to make it available for the private use of shareholders. In particular, the stakeholder was referring to a private arrangement in which a group of siblings owned a holiday house through an interposed company. The possibility of a deemed dividend arose because, on the face of it, the unrealised profit from the increase in value of the property could be included in the company's distributable surplus for Division 7A purposes. This was seen as an unintended application of the use of assets provisions.

12.4 The stakeholder submitted that it was unfortunate that they were not provided with an opportunity to restructure their affairs to 'divest' or 'demerge' the assets out of private companies to the ultimate non-corporate shareholders. They proposed that, if section 109CA is producing unintended outcomes, taxpayers ought to be provided with that opportunity.

12.5 A complementary proposal was put forward by Family Business Australia and KPMG to facilitate compliance costs under a tick-the-box exemption:

40 First discussion paper, pages 26-57.
41 Second discussion paper, Appendix C.

> We propose that the taxpayers should be permitted to set up a separate trust to allow separation of 'lifestyle assets' from business assets without any adverse tax consequences on transfer (that is through provision of a specific rollover relief for a transitional period). This will allow the taxpayer to treat each trust separately and not taint the trading trust with 'lifestyle' assets. We anticipate that the compliance costs for the trading trust would be reduced, if the lifestyle assets could be quarantined in this manner.

12.6 The Law Council of Australia noted that anomalies and unfair outcomes are likely to continue to emerge under the provisions as they presently apply, listing — among other areas — the rules that apply for private company liquidations where debts are forgiven, the rules that apply for family law–driven transfers and the rules that potentially apply for executors of deceased estates.

12.7 Pitcher Partners acknowledged the list of other remaining issues, irrespective of the reform model chosen, and suggested that the Board recommend that, in implementing a reformed Division 7A, Treasury be required to review the list of other outstanding issues to ensure they do not carry through to any new regime. In this context, it noted — among other issues — Division 7A interactions with non-resident companies under the controlled foreign company rules, with the fringe benefits tax provisions and with family law–driven transfers.

BOARD'S CONSIDERATION

12.8 The Board is of the view that the reform proposals outlined in the previous chapters of this report will go a long way towards simplifying compliance with the Division 7A provisions.

12.9 The Board is also of the view that non-compliance with the provisions is, in many cases, due to a lack of awareness of the provisions. It recommends that the Government should, for whichever reform model it decides to implement, support its implementation with a targeted education campaign on the scope of the provisions and how to comply with them.

12.10 The Board agrees with the views from stakeholders that, irrespective of the reform model chosen, a number of other issues would remain that need to be addressed to ensure consistency with the provisions under a new regime. In this respect, as part of a second stage of implementing the reforms, the Board recommends:

- ensuring that anomalies in the existing law are not reproduced in the new regime; and
- identifying and addressing remaining high-priority issues that need to be addressed to ensure consistency with the new provisions.

12.11 The anomalies in the existing law include its interaction with other parts of the tax system. One issue identified by the Board in the second discussion paper concerned the interaction of Division 7A and the Consolidation regime. The Board noted in particular that unintended consequences have arisen from the failure of the Consolidation rules to make clear that the 'single entity rule' applies to the calculation of distributable surplus. The interaction of Division 7A and the Taxation of Financial Arrangements (TOFA) was also identified as an area requiring clarification.

12.12 In relation to the specific issue of assets held by companies purely for private use, one of the Board's suggestions in the second discussion paper was an approach that would have eliminated these consequences by largely excluding unrealised profits from the distributable surplus calculation. However, as explained in Chapter 5, this suggestion was not strongly supported by stakeholders, and the Board does not recommend its adoption.

12.13 The Board understands that it is only in rare cases that companies have distributable surplus consisting solely of unrealised profits. However, it agrees with the submission that no Division 7A consequences should arise for the use of assets of a company that exists solely to hold assets for the private use of shareholders and associates.

12.14 In addressing high-priority issues, the Board recommends providing relief to remove the Division 7A consequences where a company funds the acquisition of property from share capital and its distributable surplus is comprised solely of unrealised profits. This relief could take the form of a specific exclusion from section 109CA or a limited roll-over relief that would enable taxpayers to restructure their affairs to 'divest' or 'demerge' the assets out of private companies to the ultimate non-corporate shareholders.

Recommendation 15

The Board recommends:

- that the Government, for whichever reform model it decides to implement, should support its implementation with a targeted education campaign on the scope of the provisions and how to comply with them;
- as part of a second stage in implementing the reforms:
  - ensuring anomalies in the existing law are not reproduced in the new regime; and
  - identifying and addressing remaining high-priority issues that would need to be addressed to ensure consistency with the new provisions; and
- providing relief to remove the Division 7A consequences where a company funds the acquisition of property from share capital and has a distributable surplus limited to unrealised profits.

- Relief could take the form of:
  - a specific exclusion from section 109CA; or
  - limited roll-over relief that would enable taxpayers to restructure their affairs to ‘divest’ or ‘demerge’ the assets out of private companies to the ultimate non-corporate shareholders.

APPENDIX A: SUMMARY OF RECOMMENDATIONS

Recommendation 1:

As part of a wider tax reform process, the Board recommends explicitly considering wide-ranging reforms directed at treating profits consistently, including:

- taxing business accumulations at a business tax rate, irrespective of the structure chosen; and
- lowering the tax rate on undistributed trust income.

Recommendation 2:

The Board recommends that, in the more immediate term, the Government make significant reforms to Division 7A in accordance with recommendations 3 to 15 of this report.

Recommendation 3

The Board recommends:

- including the principles that could define the policy framework for Division 7A in an objects clause in a reformed Division 7A; and
- making the content of the guiding principles a policy matter for consideration by the Government — in particular, whether Division 7A supports the overall objective of protecting the personal income tax system's progressivity and has a role to play in not advantaging the accumulation of passive investments over the reinvestment of business profits in active business activities.

Recommendation 4

The Board recommends:

- retaining the existing rules concerning an entity's right to use a private company asset, including the otherwise deductible and minor benefits rule exemptions;
- supplementing the existing rules with the provision of legislative safe harbour rules, which would assist in facilitating compliance, reduce uncertainties for taxpayers and lower administrative costs for the ATO;

- designing appropriate safe harbour rules that distinguish between those that would apply to depreciating assets and those that would apply to appreciating assets, such as land and buildings:
  - for depreciating assets, a rental charge could apply, similar to that of an operating lease, comprising a finance amount (or interest amount), a depreciation component (being the cost of the asset to the lessor) and an amount for the relevant asset's other operating costs.
  - for appreciating assets, a usage charge could apply, calculated by multiplying the statutory interest rate by the asset's indexed value, which could be updated with an arm's length valuation every five years, thus reducing the need for yearly valuations. The usage charge could also include an amount representing the relevant asset's other operating costs.

Recommendation 5

The Board recommends retaining the rules regarding the calculation of distributable surplus, including the requirement for periodic testing, as part of any rewrite of the Division 7A rules.

Recommendation 6

Subject to the Government's policy decision on the policy framework for reform of Division 7A (see Recommendation 3), the Board recommends enacting legislation that prescribes the following terms for complying Division 7A loans:

- 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 lodgement day for the income year in which the loan was made.
- The statutory interest rate would be set at the start of the loan and fixed over the term of the loan.
- The statutory interest rate would be the Reserve Bank of Australia's indicator lending rate for a *small business; variable; other; overdraft* for the month of May immediately before the start of that income year.
- The maximum loan term would be 10 years.

- The prescribed maximum loan balances during the term of the loan (including any accumulated interest) would be as follows:
  - 75 per cent of the original loan by the end of year three;
  - 55 per cent of the original loan by the end of year five;
  - 25 per cent of the original loan by the end of year eight; and
  - 0 per cent of the original loan (that is, fully repaid) by the end of year 10.
- Subject to meeting the maximum loan balances, there would be no specified annual principal repayments.
- Interest would be able to be accrued annually but would have to be paid by the end of years three, five, eight and 10.
- Interest deductibility would be governed by existing income tax rules.

The Board further recommends:

- where a payment is not treated as a dividend, deeming the taxpayer liable for loan repayments as if a loan were made, and to which the Commissioner's period of review may apply as if to a loan;
- ensuring that failure to make the repayments by the end of the milestone period results in the private company being taken to have paid a dividend to the entity;
- basing the amount of the deemed dividend on the amount of the shortfall in the payment required, calculated using the appropriate statutory interest rate, reduced by the amount of any prior deemed dividends assessed to the taxpayer;
- commencing the Commissioner's period of review from the date of lodgement for the income year in which each milestone payment is required (or would have been required had a complying loan agreement been entered into);
- providing administrative guidance, reflecting general legal principles relating to forming binding contracts, on what constitutes acceptable evidence that a loan was entered into by lodgement day for the income year in which the loan was made, in order to avoid inadvertent non-compliance;
- grandfathering the terms of complying 25-year loans — that is, they should remain payable with interest over the remainder of the 25 years; and
- transitioning all other pre-existing Division 7A loans to the new 10-year loans from the application date of the new provisions. In accordance with this:
  - all existing complying seven-year loans would have their terms extended to

the new maximum of 10 years;

- all pre-1997 loans would be deemed to be new complying Division 7A loans, with a 10-year term starting from the application date of the new provisions; and
- where the Commissioner is out of time to assess a deemed dividend arising from a payment, the rules should stipulate that the taxpayer is prevented from asserting that the payment was not made in the context of a loan.

Recommendation 7

The Board recommends that the ATO adopts administrative measures to assist taxpayers who choose to repay complying loans in annual instalments. This administrative assistance could include an online tool for calculating an annual repayment schedule under which minimum loan balance targets would be met.

Recommendation 8

The Board recommends introducing legislative amendments to align the treatment of UPEs with the treatment of loans for Division 7A purposes in conjunction with either Recommendations 6 and 9 (Amortisation Model option) or Recommendation 10 (Interest Only Model option).

Recommendation 9

If the Amortisation Model is adopted, the Board recommends:

- introducing a legislative amendment that allows trusts 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 business income election);
- making the election by completing a label in the trust's tax return by the due date for lodging the return for the year of income in which it is made (or such further time as the Commissioner allows);
- enabling the election to be made in any income year, subject to the requirement that Division 7A obligations must remain in place for income years prior to the income year in which the election is made;
- ensuring that a trust that makes such an election (an excluded trust) forgoes the CGT discount on capital gains arising from assets other than goodwill and

'intangible assets inherently connected with the business carried on by the trustee';

- applying a business income election to all loans the trust owes to a private company, whenever created, and to all CGT assets (other than goodwill or relevant intangible assets) whenever acquired;
- not excusing entities that make a business income election from Division 7A obligations for the period prior to the income year for which the election is made; and
- amending interposed entity rules to preserve the integrity of the provisions, without imposing undue compliance costs on trusts that wish to benefit from the proposed limited business income exception.

The Board further recommends that the Government consider the impact of applying a business income election to existing arrangements for small businesses in order to determine whether special transitional relief for that sector is warranted.

Recommendation 10 — Alternative option: the Interest Only Model

If, as a result of a policy choice, there is no need for Division 7A to support the overall objective of protecting the personal income tax system's progressivity and not advantaging the accumulation of passive investments using profits taxed at the company tax rate over the reinvestment of business profits taxed at higher progressive tax rates in active business activities, the Board recommends enacting legislation that prescribes the following terms for a complying Division 7A loan exemption under an Interest Only Model:

- 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 lodgement day for the income year in which the loan was made.
- A variable statutory interest rate should be set annually for all complying Division 7A loans in place in the relevant year of income.
- The interest rate for complying loans should be equal to the Reserve Bank of Australia's indicator lending rate for a *small business; variable; other; overdraft* for the month of May immediately before the start of that income year.
- There should be no prescribed term for the loan, no required annual principal repayments, and reborrowings (of principal) would be permitted.

- Interest deductibility would be governed by existing income tax rules.

The Board further recommends:

- providing administrative guidance on what constitutes acceptable evidence that a loan was entered into by lodgement day for the income year in which the loan was made, in order to avoid inadvertent non-compliance;
- giving taxpayers the option to apply an otherwise deductible rule exemption, in accordance with which there would be no requirement to charge statutory interest where company loans or UPEs were used by a borrower for a deductible purpose;
- maintaining a company-to-company exemption under the new rules, but with an appropriate interposed entity rule as an integrity provision; and
- transitioning all pre-existing Division 7A loans to the new Division 7A complying loan terms from the application date of the new provisions.

The Board notes that, if adopted, this recommendation supersedes Recommendation 6 for complying loan rules under an Amortisation Model and Recommendation 9 for a business income election option.

Recommendation 11

The Board recommends enacting a self-correction mechanism with the following features:

- Qualifying taxpayers can self-assess their eligibility for an exception to Division 7A that will operate to reverse the effect of a prior deemed dividend.
- Eligibility for the exception will be based on satisfying two criteria:
  - It is reasonable to infer, on the basis of objective factors, that the conduct that caused the deemed dividend was unintentional; and
  - Appropriate steps have been taken to ensure that affected parties are placed in the position they would have been in had the dividend not arisen.
- Voluntary corrective action shall constitute *prima facie* evidence that the original breach was unintentional.
- A taxpayer who validly exercises self-correction may be liable for a penalty reflecting the degree of culpability (the self-correction penalty).

The Board further recommends:

- providing taxpayers with clear guidance on what constitutes appropriate corrective action, either in legislation itself, or in a form of administrative guidance developed by the ATO;
- if the Amortisation Model is adopted, designing the self-correction by applying the existing administrative penalty regime for tax shortfalls to the 'notional tax shortfall' that would have arisen had self-correction not been exercised; and
- if the Interest Only Model is adopted, ensuring any notional shortfall penalty is proportionate and represents an appropriate disincentive.

Recommendation 12

Under a legislated self-correction mechanism, where the ATO determines that self-correction was not validly made by a taxpayer, the Board recommends entitling the taxpayer to a review of the Commissioner's decision via the AAT.

Recommendation 13

The Board recommends against adopting a principle that deemed dividends arising under a reformed Division 7A should generally be frankable.

Extending the imputation system to deemed dividends would introduce unnecessary complexity and, given the potential operation of other integrity provisions, provide limited certainty to affected taxpayers.

Recommendation 14

The Board recommends that the ATO reviews its guidance material on the imposition and remission of administrative penalties on tax shortfalls, with a view to amending it to give effect to the following principles:

- The inability to frank a deemed dividend under Division 7A can, depending on the circumstances, lead to an implicit penalty.
- The implicit penalty can arise both where the deemed dividend is assessable to a shareholder or a non-shareholder associate.
- The implicit penalty can, depending on the circumstances, constitute a harsh or unjust outcome.

- The implicit penalty should be considered when determining whether there are grounds for remitting an administrative penalty.

Recommendation 15

The Board recommends:

- that the Government, for whichever reform model it decides to implement, should support its implementation with a targeted education campaign on the scope of the provisions and how to comply with them;
- as part of a second stage in implementing the reforms:
  - ensuring anomalies in the existing law are not reproduced in the new regime; and
  - identifying and addressing remaining high-priority issues that would need to be addressed to ensure consistency with the new provisions; and
- providing relief to remove the Division 7A consequences where a company funds the acquisition of property from share capital and has a distributable surplus limited to unrealised profits.
  - Relief could take the form of:
    - a specific exclusion from section 109CA; or
    - limited roll-over relief that would enable taxpayers to restructure their affairs to ‘divest’ or ‘demerge’ the assets out of private companies to the ultimate non-corporate shareholders.

Appendix B: List of public submissions

The following is a list of organisations and individuals who made submissions (excluding confidential submissions) to the Board as part of the review. Submissions can be viewed on the Board's website at www.taxboard.gov.au.

First discussion paper

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

Second discussion paper

BDO

Business SA

Cleary Hoare Solicitors

CPA Australia

Family Business Australia and KPMG

Halperin & Co.

Institute of Chartered Accountants Australia

Institute of Public Accountants

Ken Mansell

Koustas & Co.

Laird Advisory Services

Law Council of Australia

Mark Leibler — Arnold Bloch Leibler

Pitcher Partners

PricewaterhouseCoopers

The Law Society of NSW, Young Lawyers Taxation Law Committee

The Tax Institute

GLOSSARY

General	
ADJR Act	*Administrative Decisions (Judicial Review) Act 1977*
ATO	Australian Taxation Office
Board	Board of Taxation
CGT	Capital gains tax
CAANZ	Chartered Accountants Australia and New Zealand
Commissioner	Commissioner of Taxation
Division 7A	Division 7A of Part III of the ITAA 1936
Excluded assets	Goodwill or intangible assets inherently connected with the business carried on by the trustee
First discussion paper	Board of Taxation, *Post-Implementation Review of Division 7A of Part III of the* Income Tax Assessment Act 1936*: Discussion Paper* (December, 2012)
IPA	Institute of Public Accountants
ITAA 1936	*Income Tax Assessment Act 1936*
ITAA 1997	*Income Tax Assessment Act 1997*
Laird Advisory Services	Laird
PS LA	Law Administration Practice Statement
Second discussion paper	Board of Taxation, *Post-Implementation Review of Division 7A of Part III of the* Income Tax Assessment Act 1936*: Second Discussion Paper* (March, 2014)
TR	Taxation Ruling
UPE	Unpaid present entitlement
Transitional arrangements	
Pre-1997 loans	Loans entered into before 4 December 1997 that predate the application of Division 7A
Complying 25-year loans	Complying 25-year loans entered into on or after 4 December 1997

Transitional arrangements (continued)	
Pre-2009 UPEs	UPEs that came into existence before 16 December 2009 and can therefore be quarantined from the application of Division 7A under PS LA 2010/4.
Post-2009 UPEs	UPEs that came into existence on or after 16 December 2009