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19 May 2014

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

By e-mail to: taxboard@treasury.gov.au

Dear Sir / Madam

POST IMPLEMENTATION REVIEW OF DIVISION 7A

We thank the Board of Taxation ("the Board") for the opportunity to provide our submission on the "Post Implementation Review of Division 7A of Part III of the Income Tax Assessment Act 1936 – Second Discussion Paper" ("the Second Discussion Paper").

Support for the proposals

Division 7A is a set of integrity measures that deals with disguised distributions to shareholders or associates of those shareholders (hereafter referred to collectively as "shareholders or associates"). As these provisions are designed as an integrity measure, the provisions are extremely complex, involve significantly high compliance costs and are not flexible enough to deal with commercial transactions where there is no tax "mischief" present.

Pitcher Partners has long advocated the reform of Division 7A to deal with these issues. On 30 November 2012, Pitcher Partners made a detailed submission to the Parliamentary Joint Committee on Corporations and Financial Services on its "Inquiry into Family Business in Australia". In that submission, we highlighted that the middle market urgently needed changes to Division 7A to assist business taxpayers with accessing the corporate tax rate for working capital purposes. We also highlighted the importance of using trust structures for commercial reasons and the critical

importance of the 50% capital gains tax discount to business taxpayers when disposing of their business (in terms of funding retirement and for the provision of superannuation type benefits).

We are pleased that the Board's Second Discussion Paper is proposing systematic changes to the structure of Division 7A and the corporate taxation regime that will support these exact concerns. We therefore provide our strong support for the broad recommendations contained in the Second Discussion Paper and highlight our firm view that this would constitute a significant improvement to the middle market taxation regime..

While we understand that the Board is due to report to the Government in October 2014, we would urge the Board to have preliminary discussions with the Government in the intervening period. Through such early discussions the Government could be alerted to the fact that these proposed recommendations would significantly assist middle market taxpayers in reducing red tape and in addressing many of the critical compliance issues associated with Division 7A. As these reforms are urgently needed, there is significant merit in the Government exploring these proposals as soon as practically possible.

Summary of submission points

Attached to this letter is our detailed submission on the questions asked by the Board. The following summarises our response to those questions and our position in relation to how the new provisions could apply ("the New Regime").

1. We highlight that proposals contained in the Government's recent Budget will place even greater pressure on the operation of Division 7A going forward, simply due to the proposed reduction in the corporate tax rate to 28.5% and an increase in the personal marginal tax rate to 49%. We believe the lower value of franking credits (likely to be set at a rate of 28.5%), will have the behavioural effect of reducing the payment of dividends in the future (simply because there will be an increase in the top-up tax payable from 24% to 29% on the cash dividend). Accordingly, it is expected that there will be even greater pressure to accumulate profits in a company going forward and even further pressure for the creation of unpaid present entitlements ("UPEs") from trusts to companies under the current structure of Division 7A.

2. We therefore commend the Board for developing a real solution to the UPE problem, being the ability for a trust to make a tick the box ("TTB") election. The Board's recommendation will provide taxpayers in the middle market an appropriate opportunity to fund their working capital needs using the corporate tax rate. In effect, this option will allow business trusts to accumulate and invest their business profits into working capital using those profits that have been taxed at the lower corporate rate. In addition, this option does not require the introduction of a corporate tax regime for trusts, with all the associated complexities of trying to treat the trust like a company for tax purposes. Furthermore, by treating all other UPEs as loans, we believe that this will reduce the pressure and tension on Division 7A where bucket companies are used in any other case.

3. We therefore support the TTB election proposed by the Board, which will allow trusts to receive funding from companies without a Division 7A consequence. Where this proposal is implemented, we also support the classification of UPEs as loans. Together, these proposals will

greatly simplify the operation of the New Regime for the majority of taxpayers seeking to apply the provisions.

4. We support a "White Paper" consideration of the issue as to whether the corporate tax rate should be accessible by any business operation irrespective of the structure chosen. We do not believe that the current review being conducted by the Board needs to consider this issue any further, as this may unduly delay the implementation of the recommendations contained in the Second Discussion Paper.

5. We believe that the New Regime should contain an objects clause highlighting its main objectives. We agree with the four goals proposed by the Board being that the system should: (1) protect the marginal tax system; (2) remove impediments to accessing the corporate rate for business working capital; (3) reduce complexity and administration costs; and (4) should not advantage passive over active investments.

6. We note, however, that some of the propositions put forward by the Board may not be strictly compatible with the fourth goal (e.g. a higher interest rate under the proposed loan terms may encourage negatively geared investments). We therefore question whether some of the Board's recommendations need to be further examined or whether the fourth goal needs further refinement.

7. We have outlined a number of possible short-cuts that could be considered for "asset usage" arrangements. This includes proxies for lease charges on depreciating assets (based on depreciation and interest costs) and appreciating assets (based on a deemed interest charge on a deemed loan amount). We believe that these short-cuts could provide a proxy to calculating an arm's length rental charge for the use of assets.

8. We have also outlined our preference for including a short-cut for payment type arrangements that are "otherwise deductible". We highlight that where this is applied to arrangements that are payments (within its extended meaning, including "use" arrangements) this proposal is consistent with the four policy principles provided by the Board. Furthermore, this proposition is closely aligned to (and would assist in the application of) the TTB trust election.

9. We do not believe that the distributable surplus calculation needs to be refined in the manner suggested by the Board. We believe that it would be easier to simply revert to Corporations Law concepts of profit, which is done for all other provisions using a profit concept for dividend rules (e.g. s.45B of the ITAA 1936).

10. We broadly agree with the proposed rules for determining the quantum of a deemed dividend. We have recommended some slight modifications to the proposals so that they can be applied systematically to any type of benefit. That is, we have suggested a three step process whereby the New Regime would require one to: (1) identify the relevant transactions; (2) value the transactions based on safe harbours; (3) allow consideration to be paid for the transaction to reduce the value of the net benefit. We have also suggested safe harbours that would allow taxpayers an appropriate amount of time to pay consideration to the company (i.e. the lodgement date of the company tax return).

11. We agree that the New Regime should be based on a Transfer of Value ("TOV") Model. We therefore agree that the Board should not continue to review the Statutory Interest ("SI") Model

unless the Board comes to a position that the TOV Model will not deliver on the four policy goals proposed.

12. We believe that the TOV Model will be fairly similar (in structure) to the current Division 7A model, updated for the major deficiencies identified by the Board. We therefore believe that the New Regime will be similar in nature to a Division 7A Adjustment Model.

13. We have highlighted some minor operational issues that may occur with the terms proposed for a complying loan. We believe that these issues could be resolved fairly simply and therefore are minor items that should be considered by the Board. We have also provided some suggestions on how these issues could be addressed. The issues we have raised include: (1) an option to use a variable interest rate; (2) an option to calculate an arm's length interest rate; (3) clarification on the limited amendment period rules; and (4) a relaxation of the requirement to have written evidence for loans and non-cash loan repayments.

14. Where a trust makes a TTB election, we believe that the ability to access the 50% capital gains tax discount should be expanded to assets other than goodwill, where the capital gain is inherently connected with a business or the disposal of a business. We are concerned that the current proposal may result in disputes as to what constitutes goodwill and may ignore other assets that are akin to goodwill for the taxpayer.

15. For transitional simplicity, we would support the repeal of Division 7A and the introduction of the New Regime as a complete replacement. Under this approach, all arrangements would need to be transitioned into the New Regime. We have provided a number of suggestions on how this could be achieved on a comprehensive basis.

16. We are supportive of a self-correction mechanism in the New Regime. This will allow middle market taxpayers to self-correct inadvertent errors, without necessitating a request for the Commissioner to exercise his discretion. We have provided our suggestions on the gateway provision, together with integrity provisions to help ensure that the proposed rule is not otherwise exploited. We believe that a limited Commissioner's discretion would still be required for issues outside of the taxpayer's control.

17. There are two safe harbour rules that we believe would provide significant compliance savings for taxpayers under the New Regime. We have tested both of these suggestions and believe that they support the four policy goals as outlined by the Board. The first is an otherwise deductible rule for "payment" type arrangements. The second is a proposal to allow all Division 7A arrangements to be dealt with by the lodgement of the relevant tax return. We have provided some detail around these two suggested short-cuts.

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We would be happy to discuss any aspect of this submission with the Board. Please contact either Alexis Kokkinos on 03 8610 5170 or Greg Nielsen on 03 8610 5463.

Yours sincerely

A M KOKKINOS
Executive Director

G J NIELSEN
Executive Director

Contents of submission

1 Corporate tax rate

Q 4.1 Issues / Questions

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

1.1 Effect of announced tax rate cuts

1.1.1 We refer to the recently announced tax rate adjustments in the Budget, which will result in a decrease in the corporate tax rate to 28.5%, while increasing personal tax rates to 49%.

1.1.2 This increase in the disparity between the two tax rates will have the obvious effect of increasing the desire for many taxpayers to gain access to the corporate tax rate. This, in turn will put pressure on the use of companies for the accumulation of profits at the lower rate and thus the role that Division 7A will have to play to ensure that the marginal tax system is otherwise protected.

1.1.3 Furthermore, while company tax may have been paid at 30%, from 1 July 2015, it is likely that the change in tax rate may result in franking credits being limited to 28.5%. This may also provide an even greater incentive for taxpayers to retain funds in a company rather than paying dividends.

1.1.4 To demonstrate, we highlight the following example showing the increase in tax that will be payable post 1 July 2015 where a dividend is paid to taxpayers on the top marginal tax rate. The following uses the basic example where a company derives $100,000 of taxable income.

	Individual @ 46.5%, Company @ 30.0%	Individual @ 49.0%, Company @ 28.5%
Dividend	70,000	71,500
Company tax	30,000	28,500
Grossed up dividend	100,000	100,000
Individual tax	46,500	49,000
Franking credit	(30,000)	(28,500)
Top-up tax	**16,500**	**20,500**
% of Cash	**23.57%**	**28.67%**

1.1.5 As can be seen by the example, the effective top-up tax rate, expressed as a percentage of your cash dividend, increases from 23.57% for 30 June 2014 to 28.67% for 30 June 2016. Accordingly, as outlined by the Board, we would expect that any increase in the difference between the corporate rate and the marginal tax rates will place even further pressure on the operation of Division 7A in the future.

1.2 Issue for the White Paper

1.2.1 As a broad observation, a lower tax rate (for any type of taxpayer) will provide an incentive for the after tax accumulation of income at that rate and thus will encourage investment through the structure offering that lower rate. This is one of the key advantages of using a corporate or superannuation fund structure.

1.2.2 For middle market business taxpayers, the lower corporate tax rate has traditionally encouraged reliance on after tax profits as an efficient source for funding working capital. As access to funding is scarce for middle market taxpayers, we strongly support any recommendation that would assist middle market taxpayers to access the corporate tax rate for active income. We highlight that taxing middle market taxpayers at the corporate tax rate (regardless of their actual business structure) was one of the main points we made in our submission to the "Inquiry into Family Business in Australia", which was conducted by the Parliamentary Joint Committee on Corporations and Financial Services in 2012. While we are conscious of the integrity concerns that would be associated with the drop in the corporate tax rate, we believe that it is critical that middle market business taxpayers be given support to access the corporate rate for business purposes without legislative impediments.

1.2.3 We also note that taxing income based on income type, rather than on structure, could also address some of the complexity associated with dealing with different structures in our taxation system. However, that being said, complexity would also be introduced in requiring taxpayers to identify and segregate different classes of income derived for an income year. We would expect that this would also extend to the segregation of accumulated income into those various classes.

1.2.4 As an observation only, we note that an extension of the corporate tax rate to various structures would probably require a large number of provisions to be amended - i.e. it would require a comprehensive review of our whole tax system. For example, we would expect there would need to be amendments to the franking provisions, an extension of Division 7A to accumulated earnings and changes to other provisions such as the foreign dividend exemption for companies holding non-portfolio interests. Due to the complexity of these interaction issues, we believe that such an exercise could only be considered as a part of the White Paper review of the tax system as a whole.

1.2.5 That being said, if the Board's proposals in Chapter 6 of the Second Discussion Paper to (effectively) allow trusts to obtain access to a corporate tax rate for business profits are put into effect, we also make the broad observation below that there may be limited benefits provided by the proposed extension of the corporate tax rate to other vehicles.

1.2.6 That is, in Australia, while taxpayers can operate using "partnerships", these vehicles are treated as conduit vehicles and do not pay tax. Accordingly, we believe that the

proposed application of a corporate rate for non-corporate entities would only have effect for trusts, superannuation funds and individuals (as taxpaying entities).

1.2.7 As superannuation funds are already taxed at a 15% rate, and are unlikely be able to carry on business activities under a wider reform, the proposition would therefore only have relevance for trusts and individuals.

1.2.8 If trusts are therefore able to make a TTB election going forward, this will ultimately mean that the only taxpayers that will not be able to effectively access a corporate rate for business profits (going forward) will be individuals.

1.2.9 On this point, we also highlight that an individual taxpayer can currently incorporate a company and can obtain access to the corporate tax rate with very low barriers to entry. Therefore, if the TTB election is accepted, the White Paper review would need to consider whether the proposal (i.e. an extension of the corporate tax rate to all active income derived by any vehicle) would deliver significant benefits to taxpayers and the tax system as a whole.

1.2.10 We note that the above comments are only low level observations and that we have not performed a detailed analysis of this proposal. Due to the complexity of all of the expected issues associated with the proposal and the analysis required in considering them, we therefore would support the consideration of this issue as a part of the wider tax reform process.

2 Considering a policy framework

Q 4.2 Issues/Questions

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

a. It should ensure that the private use of company profits attracts tax at the user's progressive personal income tax rate.

b. It should remove impediments to the reinvestment of business income as working capital.

c. It should maximise simplicity by reducing the compliance burden on business and the administrative burden on the Commissioner and other stakeholders.

d. It should not advantage the accumulation of passive investments over the reinvestment of business profits in active business activities.

2.1 Response

2.1.1 The Board has sought comments on adopting a policy framework for private business that supports the progressivity of the personal tax system, while striking a balance between four main policy goals that have been put forward.

2.1.2 We broadly support the four goals proposed by the Board. We believe that these goals will provide an appropriate balance for the purpose of developing a framework for the New Regime.

2.1.3 We highlight that the current provisions contained in Division 7A lack over-arching goals and policy principles. In our view, this has meant that Division 7A has been drafted (and amended) over time with the main objective of providing integrity to the tax system (i.e. from the perspective of ensuring that the first goal is achieved) and has often failed to take into account other genuine considerations for taxpayers trying to comply with these measures. Accordingly, the current form of Division 7A has come at a significant cost to compliance and simplicity.

2.1.4 Therefore, we support the proposition of having these goals and objectives included within the actual provisions in the New Regime. We note that it is not uncommon for modern legislation to be introduced with an objects clause that is consistent with the Board's goals[1].

[1] See for example s.230-10 of the ITAA 1997.

2.1.5 We believe that including these goals in an objects clause will help to ensure that the provisions are drafted in a manner that is consistent with these goals. It would also help to ensure that future reforms and amendments are also made with these goals in mind.

2.2 Goal 1: Protecting the progressive tax system

2.2.1 The first goal put forward by the Board is to "ensure that the private use of company profits attracts tax at the user's progressive personal income tax rate." This goal is directly in line with supporting progressivity in the tax system.

2.2.2 We agree that this should be one of the main goals of the reformed provisions. From a tax integrity perspective, the objective of Division 7A should be to ensure that taxpayers do not avoid the progressive tax system by inappropriately accessing profits that have been taxed at a lower corporate tax rate.

2.2.3 While we believe this goal is consistent with the purpose of the current provisions contained in Division 7A, we highlight that Division 7A also currently targets arrangements that are otherwise "commercial" and do not involve the access of corporate profits for private purposes.

2.2.4 Accordingly, having "the private use of company profits" as a fundamental principle or goal within the provisions would help to ensure that appropriate safe harbours are provided where arrangements are otherwise commercial or do not result in private access of company profits.

2.3 Goal 2: Reinvestment of business profits

2.3.1 The second goal proposed by the Board is to ensure that the provisions "should remove impediments to the reinvestment of business income as working capital." We see this as a fundamental extension (and supporting principle) of the first goal outlined above. Together we believe that they go hand in hand.

2.3.2 That is, to the extent that the profits of a corporate entity are being used for the business purposes of another entity, such profits have not been accessed for private purposes and thus should not result in a Division 7A deemed dividend under the reformed provisions.

2.3.3 We highlight that achieving this goal would provide assistance for taxpayers in the middle market that are carrying on business activities. As such, taxpayers could seek to rely on after tax profits as a main source of funding their business activities and working capital. Outside of a corporate group, middle market taxpayers are currently faced with funding working capital using profits that have been taxed at marginal rates (sometimes up to 46.5% presently and increasing to 49% in the not too distant future). The current framework therefore hinders the ability for middle market taxpayers to fund growth using internal cash resources after paying for income tax.

2.3.4 We therefore strongly support appropriate rules and safe-harbours within the reformed provisions that would help to achieve this policy goal.

2.4 Goal 3: Compliance and administration

2.4.1 The third goal proposed by the Board is that the provisions "should maximise simplicity by reducing the compliance burden on business and the administrative burden on the Commissioner and other stakeholders".

2.4.2 Division 7A is one of the most complex set of provisions that can apply to middle market taxpayers. After some 17 years of its application, taxpayers and advisors still struggle with applying the provisions to basic transactions.

2.4.3 While Division 7A plays an important role in protecting the progressive tax system, the provisions demand a significant investment of resources from taxpayers, advisors and the Australian Taxation Office. The current provisions are often counter-intuitive, lack coherent fundamental policy principles and can have a disastrous effect on taxpayers when they apply.

2.4.4 One of the problems with the current provisions is that they have been established as a set of integrity provisions. Compliance and maximising simplicity have not always been at the forefront of considerations when drafting the provisions and amendments. Accordingly, in recent times, amendments to the law to remove loopholes have resulted in significant complexity.

2.4.5 For example, Subdivision EB was introduced to deal with the avoidance of Division 7A through chains of trusts. We highlight that while the amendments addressed the integrity risk, the provisions are practically impossible for the majority of taxpayers to comprehend or apply.

2.4.6 Accordingly, we fundamentally support this goal as being critical to the reform of Division 7A. We believe that including this goal within the objects clause of the provisions will force all stakeholders to ensure that amendments (or proposed amendments) to the provisions take into account an appropriate balance between integrity and compliance costs.

2.5 Goal 4: Accumulation of passive income

2.5.1 The fourth goal proposed by the Board is that the reformed Division 7A provisions “should not advantage the accumulation of passive investments over the reinvestment of business profits in active business activities.”

2.5.2 This 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 this fourth goal into the second goal, or whether some of the proposals need to be modified to be in line with this goal.

2.5.3 By way of example only, we highlight that the higher “statutory interest rate” proposed for the safe-harbour 10-year loan could encourage negative gearing of passive

assets. That is, it could encourage the ability to create negatively geared losses on passive investments where those investments generate annualised returns lower that the statutory interest rate. Those losses could then be utilised against a discount capital gain in future years, thus providing an overall tax advantaged return for the passive investment.

2.5.4 While the higher statutory interest rate is consistent with the first goal of protecting the progressive tax system against the "private use" of corporate profits, the higher rate may have a different and opposite effect on the use of corporate funds for investing in passive CGT assets.

2.5.5 We also note that the Board could find that some of the "safe-harbours" that are introduced to make the New Regime consistent with the third goal (i.e. reducing the compliance burden on business and the administrative burden on the Commissioner and other stakeholders) may not always be consistent with the fourth goal. Therefore, further work may be required to ensure that the detailed mechanics for implementing the other goals are consistent with this fourth goal.

3 Asset usage shortcuts

Q 4.3 Issues/Questions

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

3.1 Response

3.1.1 Division 7A currently contains specific provisions that seek to bring to tax the "arm's length" value of an asset that is used by a shareholder or associate. Currently, there are minimal shortcuts that have been provided for asset usage arrangements, being a minor asset rule, an "otherwise deductible" rule and certain exclusions for specific assets.

3.1.2 While we are not opposed to an asset usage provision in Division 7A, the provision must be capable of application by taxpayers without undue compliance costs. That is, consistent with policy goals one and three, there must be a balance between integrity and compliance.

3.1.3 As a basic observation, we believe that there are two types of assets that can be acquired by a company. The first is a depreciating asset (as defined in Division 40 of the Tax Act). The second being all other assets (or appreciating assets). This second category typically would include land and buildings (which are excluded from Division 40) and all other appreciating assets (e.g. art works). Other than land and buildings, we do not believe there are many appreciating assets that are held by companies, where those appreciating assets are used by the shareholders or associates.

3.1.4 In this section of the submission, we highlight a number of items that we believe the Board should consider in trying to implement safe harbour rules on the valuation of asset usage arrangements.

3.2 Choice to obtain a market valuation

3.2.1 While the Board is considering safe harbour rules for asset usage arrangements, we highlight that many taxpayers may prefer to use an "arm's length" test in determining the value of the asset used.

3.2.2 For example, the asset may be a holiday home that is otherwise leased to third parties (thereby creating an appropriate benchmark price). Accordingly, the compliance requirements for such arrangements (i.e. in terms of obtaining the arm's length price) would be relatively simple.

3.2.3 Therefore, we would recommend that the value of a benefit for Division 7A purposes should start with an "arm's length value" amount, which could be determined as

either the actual arm's length amount or (alternatively) under one of the allowed shortcuts (if so elected or used by the taxpayer).

3.3 Use of minor assets

3.3.1 Currently an exclusion applies for the provision of assets that would constitute a minor benefit (s.109CA(4)). We believe that this is a sensible exclusion and believe that the Board should consider continuing with the application of a similar exclusion within the New Regime. Where the value of the benefit is minor, the value would be deemed to be nil.

3.4 An otherwise deductible rule

3.4.1 Division 7A currently contains an otherwise deductible rule for asset usage arrangements in s.109CA of the ITAA 1936. We have provided detailed comments on an otherwise deductible rule in Section 12 of this submission. As outlined in that section, an otherwise deductible rule is consistent with the four goals proposed by the Board.

3.4.2 That is, it is simple to implement for taxpayers carrying on business, it protects the marginal tax system by increasing the incidence of taxation, and it does not encourage passive investment over active business activities.

3.4.3 Accordingly, for business taxpayers, we believe that this short-cut method should carry through to the New Regime and would provide an appropriate supporting provisions for the TTB election.

3.5 Depreciating assets

3.5.1 Where the relevant company asset that is used by the shareholder or associate is a depreciating asset, the use of the asset is effectively similar to that of an operating lease. The rental charge for an operating lease typically comprises two components, being a finance component (or the interest amount) and a depreciation component (being the cost of the asset to the lessor). Accordingly, it would be fairly simple for a short-cut to be developed using these two key components.

3.5.2 We refer to the FBT provisions, where a mechanism is effectively used to determine the "deemed" cost of a motor vehicle owned by an employer that is used by the employee. The deemed annual interest cost component is calculated by applying the statutory interest rate to the opening written down value ("WDV") of the asset at the start of the year. The deemed depreciation cost is simply calculated by applying the relevant depreciation rate to the opening WDV of the asset. These two costs are added together to determine the cost of operating the lease.

3.5.3 We highlight that these two elements could be combined to determine an operating lease cost for Division 7A purposes. This would be calculated using the Division 7A statutory interest rate, together with the ATO effective lives.

3.5.4 To demonstrate this proposal, assume that the company acquires a depreciating asset worth $1000 at the start of Year 1. Assume that the asset has an effective life of 8 years and thus an annual diminishing value rate of 25%. Further assume that the benchmark

interest rate is equal to 10%. The following table outlines the annual charge for the use of the asset under this short-cut method.

Year	Cost	O/B WDV	Interest	Depn	Charge	C/B WDV
0	1000.00					1000.00
1	1000.00	1000.00	100.00	250.00	350.00	750.00
2	1000.00	750.00	75.00	187.50	262.50	562.50
3	1000.00	562.50	56.25	140.63	196.88	421.88
4	1000.00	421.88	42.19	105.47	147.66	316.41
5	1000.00	316.41	31.64	79.10	110.74	237.30
6	1000.00	237.30	23.73	59.33	83.06	177.98
7	1000.00	177.98	17.80	44.49	62.29	133.48
8	1000.00	133.48	13.35	33.37	46.72	100.11
Total			**359.95**	**899.89**	**1259.84**	

3.5.5 The table shows that the lease charge for a full year lease in Year 1 would be equal to $350. However, if the asset were to be used for a full year in Year 8, the lease charge would be equal to $46.72.

3.5.6 The above calculation is relatively simple and could easily be incorporated into a "calculator" on the ATO website. That is, if a taxpayer is looking to determine a usage charge for Division 7A purposes with respect to a depreciating asset, the taxpayer could simply type in four variables into a website, being: (a) the cost of the depreciating asset; (b) the ATO's effective life for the asset; (c) the year the use took place; and (d) the number of days that the asset was used. The website would then provide a figure for the annualised rental charge for the use of the asset.

3.5.7 In considering the appropriateness of this calculation, we believe it is worth comparing the lease charge for the arrangement with the provision of a loan under Division 7A. The following table outlines the outcomes for a loan arrangement under the Board's proposed terms over the eight year period.

Year	O/B	Interest	Repayment	C/B
1	1000.00	100.00	-	1100.00
2	1100.00	110.00	(460.00)	750.00
3	750.00	75.00	-	825.00
4	825.00	82.50	-	907.50
5	907.50	90.75	(448.25)	550.00
6	550.00	55.00	-	605.00
7	605.00	60.50	-	665.50
8	665.50	66.55	(482.05)	250.00
Total		**640.30**	**(1390.30)**	

3.5.8 By way of comparison, it is noted that the requirements under the loan agreement provide for a very similar result to the deemed lease charge over the life of the arrangement. That is, while the loan arrangement requires a higher amount of repayments to the company over the eight year period (i.e. $1390.30 as compared to $1259.84), the lease arrangement provides the company with the ownership of the asset (where its WDV at the end of eight years is equal to $100) – resulting in an overall difference of some $30.

3.5.9 While this short-cut will not be perfect in all cases, we believe that a short-cut method similar to the one proposed could provide a relatively simple solution for depreciating assets that would be easy to calculate and administer.

3.6 Appreciating assets

3.6.1 While it may be more difficult to provide short-cut valuation methods for appreciating assets (i.e. due to the requirement to estimate the value of an asset), we nonetheless provide some suggestions that could be considered more closely by the Board. We note that these shortcuts would most likely be limited to the private use of assets, as in the event that the Boards accepts an otherwise deductible rule for income producing use, these shortcuts would not apply.

a) Using a statutory interest rate on a base value

3.6.2 In our view, we believe that there would not be a significant number of appreciating assets that would be held in a company, where that asset is also used by a shareholder or associate for private purposes.

3.6.3 We therefore would expect that the main asset class that would fall into this category would be real property type assets (e.g. a holiday home). For these types of appreciating assets, the “lease” or “usage” charge would usually reflect a rate of return multiplied by the market value of the asset.

3.6.4 We have proposed a number of shortcuts in the following paragraphs. However, we note that the rate of return that we have used in those shortcuts is the statutory interest rate proposed by the Board (e.g. 10%). We highlight that the current statutory interest rate under Division 7A (and the Board’s statutory interest rate proposed) is higher than the typical yield on these types of real estate assets. Accordingly, it would be expected that a shortcut that is based on a statutory interest rate would likely result in a higher charge to the shareholder or associate (rather than a lower charge).

3.6.5 Therefore, the use of this higher statutory interest rate for private use may provide a safeguard or protection to the revenue when using the shortcuts outlined in this section.

b) Appreciating assets with a low value

3.6.6 To the extent that an appreciating asset is under a certain low value (e.g. $2 million), the revenue risk of determining an appropriate usage charge would not be expected to be significant. The low value threshold could be set at a reasonable level that

would more than likely deal with the majority of appreciating assets held in a company (e.g. holiday home).

3.6.7 For such assets, it is possible to establish a short-cut method which is determined by applying an appropriate rate of return for the use of the asset, multiplied by its determined value. For example, the rate of return could be set at the "statutory interest rate", which would be multiplied by the cost of the asset (increased by an indexation rate).

3.6.8 To demonstrate, assume that the asset is acquired at the start of Year 1 for $1000. Assume that the statutory interest rate is 10% and the indexation rate is 3.5%. The usage charge for the asset in Year 1 would be equal to $100. The usage charge for the asset in Year 2 would be equal to $104. The usage charge for Year 10 would be equal to $141.[2]

3.6.9 The indexation rate could be set with reference to inflation for the income year. Alternatively, the legislation could fix the indexation rate for all years at a constant rate. By way of example, the indexation rate could be fixed at 3.5% for all years. The benefit of this latter option is that the formula for determining the annual charge would simply be as follows.

[Cost x (1 + indexation rate) ^{years}] x benchmark interest rate

3.6.10 Applying this formula in Year 10 results in [1000 x [1.035]) ^{10}] x 10%] = $141. Again, due to the simplicity of this formula, we highlight that this method could easily form the basis of a toolkit calculator on the ATO website.

3.6.11 To ensure that this method does not pose significant integrity or revenue risks, the method could be limited to low value assets. Accordingly, even if the market value of the asset were to be substantially different, the low asset threshold would ensure that the revenue implications would not be significant.

3.6.12 By way of example, if the formula determines the value of the asset to be $250,000 at the end of Year 10, when the market value is instead equal to $350,000, the difference in value would result in a lower charge of only $10,000 (or a cost of $4,650 at top marginal rate of 46.5%).

3.6.13 Furthermore, if the statutory interest rate is used to determine the charge (e.g. 10%), then this would likely over-inflate the rental / lease charge for the use of the asset and thus compensate for the possibility of any error in the value of the asset. That is, a rental charge at 6% on $350,000 would otherwise be equal to $21,000 - being below the amount calculated of $25,000 using this proposed formula.

3.6.14 Accordingly, if the shortcut is used solely for low value appreciating assets, then this could provide a simple valuation mechanism with (what we believe to be) a low risk to the revenue for understatement of the relevant usage charge.

[2] Calculated simply as $1000 x (1.035)^10

c) All other appreciating assets

3.6.15 For all other (higher value) appreciating assets, there would be a question as to whether a short-cut would be appropriate. We believe that this would be a question for the Board to consider, taking into account integrity risks as well as compliance costs.

3.6.16 That being said, we note that the formula proposed for low value appreciating assets above could equally be applied to high value appreciating assets. One adjustment to the formula could be a requirement to "revalue" the asset every five years. Accordingly, the risk of undervaluing the asset would be removed significantly by adding this requirement for high value assets. The valuation requirement would only be required if the asset is used by a shareholder or associate for private purposes.

3.6.17 Alternatively, for higher value appreciating assets, the taxpayer could be required to determine an "arm's length price", which is indexed by a set rate (e.g. 3.5%) for a period of five years. At the end of the period, the taxpayer would be required to re-determine the arm's length price.

3.6.18 We note that these are only suggested methods that could be considered by the Board in determining valuation shortcuts for asset usage arrangements of high value appreciating assets.

3.7 Determine the use by the shareholder or associate

3.7.1 If shortcuts similar to the ones outlined above are used, then there would be two residual questions dealing with usage. The first would be to determine how to allocate the value where there is partial use. The second would be to determine when a shareholder or associate is taken to use the relevant asset for Division 7A purposes.

3.7.2 We believe that the first issue would be relatively easy to determine. That is, one could simply take the value (as determined by the shortcut method) and multiply that by the number of days of use, divided by the days in the relevant income year.

3.7.3 The second issue, however, would not be as simple. This issue would require consideration as to whether the rules should be based on "actual use" or "available to use". We highlight that these considerations or issues are not new and that each of these issues have been considered in some detail in the past for the purposes of the current Division 7A provisions and the FBT provisions. That being said, we highlight that there are two types of assets that may warrant different consideration or conclusions.

3.7.4 The first class are those assets that are held by a company with the intention that they are not acquired for the exclusive use by the shareholder or associate. That is, the shareholder or associate may use the asset, but the asset is otherwise used for other purposes. An example of this type of asset would be an apartment, where the shareholder or associate can only use the property when the company grants their request to do so. While the property could be available for use all year round, it would not be appropriate to tax the shareholder or associate on an "available for use" basis in this type of example.

3.7.5 The second class of asset would include those assets that are acquired for the full benefit of the shareholder or associate. For example, a motor vehicle that is acquired by the company for the use by a shareholder or associate. While the shareholder or associate may only use the asset for a limited number of days in an income year, it is questionable whether a (day) usage basis would be appropriate where the asset is not really available to be used by any other party other than the individual.

3.7.6 Essentially, in our view, the method of apportionment chosen should be consistent with goal one (i.e. to prevent private use of company profits) and goal three (i.e. being simple to determine and calculate).

4 Distributable surplus calculation

Q 4.4 Issues/Questions

The Board seeks stakeholders' comments on:

a) whether excluding unrealised gains from the distributable surplus would assist in simplifying compliance with the provisions and address the potential for double taxation;

b) whether there would be integrity concerns or likely cost to revenue if the proposed approach to distributable surplus were to be adopted; and

c) whether, as an alternative to the proposed approach, unrealised gains and losses should be included in the basic calculation of distributable surplus, but then be subtracted when dealing with temporary transfers of value.

4.1 Response

4.1.1 There are a number of complex aspects to the modifications proposed, being complexities over and above the issues already faced with the current distributable surplus rule. That is, the proposals would seem to require a different calculation depending on whether the "transfer of value" constitutes a temporary or permanent transfer. Furthermore, the proposals would seem to require one to determine whether value is realised or unrealised.

4.1.2 We highlight that this latter concept alone is ambiguous (i.e. unrealised versus realised), especially where accrual accounting and accrual taxation is used by the company. For example, would taxed profits based on accrued interest income for accounting and TOFA (but which has yet to be received) be treated as realised or unrealised profits for this calculation?

4.1.3 Furthermore, the proposal to test distributable surplus at the end of each year, when assessing potential deemed dividend value transfers, could present challenges in respect to tracing those value transfers that are properly referable to the distributable surplus identified in a particular income year.

4.1.4 We therefore express our reservation with the proposed modifications to the distributable surplus rules. While the proposals are aimed at ensuring that Division 7A does not apply inappropriately to tax amounts to shareholder or associates, we have reservations that the proposals will achieve the third goal, being a reduction in compliance.

4.1.5 As per our previous submission, we again reiterate that Division 7A is an effective expansion to s.44 of the ITAA 1936, being rules to determine whether a dividend has effectively been paid to the shareholder or associate. Therefore, we highlight that it may be simpler to determine whether there is a deemed dividend with reference to "profits" using Corporations Law concepts.

4.2 Limited taxpayers will benefit from the proposed changes

4.2.1 We highlight that the proposed amendments to the distributable surplus provisions are aimed at "benefits" provided to shareholders or associates in the form of temporary transfers of value. Examples of such benefits include those attributable to asset usage arrangements or loan arrangements.

4.2.2 Excluding unrealised gains for the purpose of working out whether these benefits should be treated as a "deemed" dividend will mean that arrangements would only be excluded if the entity does not have retained earnings, but has an asset revaluation reserve. We would expect that the number of such cases would be in the minority.

4.2.3 However, while there would be few taxpayers that would benefit from these changes, the new method would be imposed on the greater majority of taxpayers applying Division 7A. Not only would this involve adjustments for temporary arrangements, but it would also involve yearly testing.

4.2.4 While initially the change may not add to compliance costs (as most taxpayers are likely to ignore the requirement to calculate a distributable surplus), we believe that over time the difference in result that occurs would require all taxpayers to consider the relevant calculation at the end of each income year. Accordingly, we believe that there is a risk that the proposed methodology may result in an increase in unnecessary complexity.

4.3 Arbitrage possibilities

4.3.1 We highlight that there may be arbitrage opportunities that could occur under the Board's proposal of removing unrealised gains from the distributable surplus calculation.

4.3.2 For example, assume a company (Aco) is funded with $1000 of share capital, whereby $500 is used to acquire a subsidiary entity (Bco) and the other $500 is placed in a bank account. At the end of year 2, Bco has generated $2000 of after tax profits, which results in an unrealised gain to Aco of $2000. Assume that Aco wishes to provide $500 to its sole shareholder. Aco could do this in at least two different ways. Aco could require Bco to pay a fully franked dividend, which could in turn be paid to the ultimate shareholder by Aco. Alternatively, Aco could acquire an asset for $500 and allow the asset to be used by the shareholder for private purposes. In both alternatives, the shareholder would receive $500 worth of value.

4.3.3 In the second alternative, assume that the shareholder uses the asset for five years, until the depreciable asset is worth nil. Further assume that the asset is scrapped at the end of five years. In this case, Aco would record a "retained loss" of $500. Assume that Bco subsequently pays a fully franked dividend to Aco in a later year, which returns the retained loss to nil.

4.3.4 The effect of this alternative arrangement is to provide value to the shareholder of at least $500. However, the proposed amendments to the distributable surplus rule would seem to provide an exclusion for this arrangement, thereby ensuring that the arrangement would be excluded from Division 7A and eliminating any top-up tax on the profits not otherwise distributed to the shareholder. We believe that this arrangement would not be

excluded from the current Division 7A provisions, as the distributable surplus would include the unrealised gain.

4.3.5 We have provided the above example as one possible example where the exceptions may encourage tax arbitrage opportunities. We note this would not be the only case where the proposed changes could be used to advantage taxpayers. Accordingly, we highlight our reservations with introducing these proposed amendments as they seem to provide an unnecessary loophole to the provisions.

4.4 Private assets in a non-income producing company

4.4.1 We acknowledge that the proposed changes will seem to address the inadvertent application of Division 7A where a private asset is acquired by a company using sources other than profit, where the distributable surplus of that company is only referable to unrealised gains related to the relevant asset.

4.4.2 We agree that applying Division 7A to this example is inconsistent with the first goal outlined by the Board, as it would inappropriately tax an arrangement that does not involve company profits. However, we believe that this situation (which is not commonplace) could be alternatively addressed by way of an exclusion from Division 7A, rather than by way of broad based amendments to the distributable surplus provisions.

4.5 Applying a "profit" determination rule

4.5.1 Division 7A was introduced originally as effectively an extension to s.44. Section 44 deals with the extraction of company profits by virtue of corporate law dividends, while Division 7A deals with "disguised distributions" of company profits to shareholders or associates.

4.5.2 As these are effectively companion provisions, there seems to be a case that the test for whether company profits exist should be the same in both cases.

4.5.3 As a starting point, there is a question whether the determination of "net assets" or "profits" is now relevant for s.44 purposes. Reference is made to s.44(1A) which states that for "the purposes of this Act, a dividend paid out of an amount other than profits is taken to be a dividend paid out of profits." Accordingly, while the Board's report is seeking to restrict the calculation of profits to realised profits, it is noted that s.44(1A), which has been recently introduced for dividends, seems to expand the assessability of dividends.

4.5.4 For s. 44 purposes, when determining whether a dividend is paid out of profit, reference is made to the ATO's ruling TR 2003/8. This has been further considered in the ATO's ruling TR 2012/5 in determining dividends for the purposes of section 254T of the Corporations Law. It is noted that a net asset type approach is effectively taken for income tax purposes.

4.5.5 The current concept of distributable surplus in Division 7A is therefore similar to the view contained in TR 2003/8. That is, the concept of distributable surplus currently commences with net assets in the balance sheet, adjusted to exclude certain liabilities and adjusted for certain valuation differentials. Accordingly, both s.109Y and TR 2003/8 use a

"net asset" approach. However, s.109Y only allows certain liabilities to be used, whereby TR 2003/8 does not appear to have that limitation.

4.5.6 To avoid possibilities of arbitrage and to simplify the calculation of the distributable surplus, we reiterate our view that it may be better to consider (as a starting point) the profits of a company, as determined for the purposes of TR 2012/5 and TR 2003/8.

4.5.7 We acknowledge that Division 7A would require some adjustments to this amount, (e.g. for non-commercial loans, for current year breaches, or for amounts already treated as a deemed dividend in prior years). Where this is the case, then the ordinary "profit" position could otherwise be adjusted for Division 7A purposes as appropriate.

Q 4.5 Issues/Questions

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

a) tested at year end for permanent transfers of value, as well as for temporary and ongoing transfers of value (for example loans, asset usage) at each year end; and

b) based on the amount of available realised profits of the company as reflected in its accounts (net assets), but with appropriate adjustments to address situations:

- of possible double counting; and
- where value which has not been reflected as realised in the accounts has been transferred to shareholders/associates

4.6 Response

4.6.1 Our response to Question 4.5 follows on from our response to Question 4.4. If the concept of "profit" is used for determining a distributable surplus (as outlined in the previous section of this submission), then we do not believe that an annual test would be necessary.

4.6.2 That is, the company would simply determine whether a "benefit" has been provided and the extent to which it is deemed to have been paid or sourced from profits. Where the benefit is not sourced from profits, Division 7A should not otherwise apply, as the benefit provided to the shareholder or associate would not be an inappropriate access of the company's profits (i.e. it would not contravene the first goal).

4.6.3 However, if the Board proceeds with its recommended changes to the calculation of the distributable surplus, then we agree that annual testing may be required in order to reduce arbitrage opportunities, as highlighted in the Board's Second Discussion Paper.

5 Rules for determining deemed dividends

Q 4.6 Issues/Questions

The Board seeks stakeholders' comments on:

a) the proposed general rules for determining when deemed dividends should arise; and

b) whether, and in what circumstances, deemed dividends should be frankable.

5.1 Response

5.1.1 We broadly support the proposed general rules for determining when deemed dividends should arise. However, we make the following observations and recommended changes to the proposed methodology contained in the Board's Second Discussion Paper:

- We agree with a transfer of value test as a starting point. We believe that this requires determining whether a transaction has occurred between the shareholder or associate that could result in some form of benefit to the shareholder or associate.

- Specific rules could then be provided on how to value the benefit provided. We believe that the valuation rules should be based on the form of the transaction to ensure that there is some certainty as to when the valuation rule applies (e.g. loans or asset usage arrangements). Where no safe harbour rule applies to the arrangement, we believe that the value of the benefit would be taken to be the "arm's length" value. We refer to the value determined under this step as the "gross benefit provided" to the shareholder or associate.

- Where a shareholder or associate pays consideration to the company for the benefit received at the first step, then the gross benefit provided would be reduced by the amount of that consideration. We refer to this value as the "net benefit provided" to the shareholder or associate.

- In addition to safe harbour valuation provisions, we have also suggested that the Board consider additional safe harbour timing provisions that could be introduced to ensure that appropriate time is provided for taxpayers to correct transactions and to pay compensation for their respective benefits. We naturally believe that this should be the lodgement of the company's tax return for the income year of the benefit.

5.1.2 We note that the above four points are consistent with the Board's recommendations. However, we have noted a few minor differences with respect to the methodology that we believe would be worth exploring. We have also provided some commentary below providing further detail on our reasoning.

5.2 Methodology used in the trust loss provisions

5.2.1 We refer to s.272-60 of Schedule 2F to the ITAA 1936, which contains an extended definition of distribution for the purpose of the trust loss provisions. Subsequent (1) identifies the relevant transactions that are taken to be distributions, while subsection (2) provides the determination of value and the ability to reduce the amount by way of consideration paid by the recipient entity. We have replicated the contents of the provision below (for convenience).

> **272-60 Other distributions of income and capital**
>
> (1) A company, partnership or trust (an entity) also distributes income or capital to a person in circumstances not covered by section 272- 45, 272-50 or 272-55 if it:
>
> (a) pays (including by way of a loan) or credits money of the entity to the person, or reinvests such money for the person; or
>
> (b) transfers property of the entity to, or allows use of property of the entity by, the person; or
>
> (c) deals with money or property of the entity for or on behalf of the person or as the person directs; or
>
> (d) applies money or property of the entity for the benefit of the person; or
>
> (e) extinguishes, forgives, releases or waives a debt or other liability owed by the person to the entity.
>
> **Limit on distributions**
>
> (2) However, subsection (1) only applies if, and to the extent that:
>
> (a) the amount paid, credited, reinvested or applied, the value of the property transferred, or the value of the other thing done;
>
> *exceeds:*
>
> (b) the amount or value of any consideration given in return.

5.2.2 Our slightly modified approach to determining a deemed dividend under Division 7A is broadly consistent with this methodology contained in Schedule 2F. That is, the above provision identifies various transactions under subsection (1), requires a value to be attributed to the transactions under paragraph (2)(a), and then allows the amount of the benefit to be reduced by way of consideration through paragraph (2)(b).

5.2.3 It is noted that while the drafting of the provision is very simple, the provision above allows for three different values to be used, depending on the type of transaction. That is, it uses the amount of the payment, the value of property transferred, or the value of any other benefit in paragraph (2)(a).

5.2.4 One of the additional key advantages of the above methodology is that it has considerable flexibility in terms of identifying transactions and the respective value for each of those transactions.

5.2.5 For example, the transactions could be identified at Step 1 using a broad principle based approach. That is, the provision could simply capture “any transaction or

arrangement resulting in a benefit to a shareholder or associate of the shareholder, where that benefit is derived through the use of the company's resources". Broadly, this is similar to the Board's proposed rule that Division 7A should capture a transfer of value that results from the use of a company's cash or assets.

5.2.6 Alternatively, the provision could more specifically identify transactions (similar to s.272-60(1)), with a catch-all provision for all other benefits. For example, the provision could identify the following types of transactions:

- Loans made by the company to the entity.
- Payments made by the company to (or for) the entity.
- The provision of services by the company to the entity.
- The extinguishment of a loan provided by the company to the entity.
- The transfer of property owned by the company to the entity.
- The use of property owned by the company by the entity.
- Any other benefit (related to the company assets) provided to the entity.

5.2.7 The advantage of this second approach is that it would be used to identify specific transactions, which would be easier to understand by taxpayers and practitioners. That is, accountants that would need to apply these provisions on a daily basis would more readily understand a shopping list of transactions (coupled with a catch-all provision), than understand a single broad based principle.

5.2.8 Furthermore, it may be easier to link safe harbour valuation methods to the second approach, as the safe harbours could attach themselves to various transaction types. For example, as loans would be identified as a specific type of transaction, the valuation of the benefit for such arrangements could be linked to the safe harbour for valuing loans.

5.2.9 The following sections expand further on the above concepts and how we believe the methodology could work under the reform proposals for Division 7A.

5.3 Step 1: Identifying the relevant transaction

5.3.1 As outlined above, we agree with the Board that the first step is to identify transactions that would transfer value to the shareholders or associates through the use of the company's cash or assets.

5.3.2 Broadly, we have provided different ways in which this identification could occur, ranging from a very general principle based approach, to a more form based approach (with a catch-all). We believe that the latter approach is likely to be easier to apply and administer, due to the certainty that specific transactions are caught within the provisions.

5.4 Step 2: Valuing the relevant transactions

5.4.1 As outlined earlier, s.272-60(2) of Schedule 2F to the ITAA 1936 examines "value" by reference to the type of transaction. That is, the value of a payment is effectively determined as "the amount paid, credited, reinvested or applied". Where there is a transfer of an asset, the value is determined as "the value of the property transferred". For all other things, the value is simply "the value of the other thing done".

5.4.2 We propose that a similar mechanism be used in the proposed Division 7A provisions. That is, the starting point for determining value would simply be "the arm's length value of the benefit to the shareholder or associate".

5.4.3 Using this as the underlying principle, safe harbour rules could then be applied by the shareholder or associate to determine the value of the benefit received. We highlight that the Board's Second Discussion Paper provides a number of these safe harbours. That is, the safe harbour terms for loans and the TTB election are included in the Board's report. We have also detailed a number of other safe harbours throughout this submission that could be used to prima facie value the relevant benefits provided to shareholders or associates.

5.4.4 We have summarised these safe harbours into a table to outline how they would all interact with the proposed methodology. Where the safe harbour relates to an item contained in this submission, we have provided a link to the relevant section that provides further detail on the item.

#	Type	Applies to	Value under safe harbour rule	Refer to
1	Loans placed on complying terms	Loans (as defined, including UPEs)	The benefit would be equal to the difference between the actual loan balance at the end of the year as compared to the required loan balance at the end of that year.	Per Board's paper
2	Otherwise deductible rule	Any benefit provided (other than loans)	Where the charge by the company would otherwise be deductible to the shareholder or associate, the value of the benefit provided is taken to be nil.	Section 12
3	Short term arrangements	Payments (as defined) and services	The amount of the actual cost incurred by the company directly related to providing the benefit to the shareholder or associate.	Section 13
4	Tick the box election	Loans (as defined, including UPEs) provided to trusts that have ticked the box	Where the trust has ticked the box, the value of the benefit provided is taken to be nil.	Per Board's paper

#	Type	Applies to	Value under safe harbour rule	Refer to
5	Use of depreciating assets	Asset usage arrangements	The arm's length value. However, the taxpayer can choose to use a proposed approximation method to determine usage value.	Section 3.5
6	Use of appreciating asset	Asset usage arrangements	The arm's length value. However, the taxpayer can choose to use a proposed approximation method to determine usage value.	Section 3.6
7	Transfer pricing for interest rate on loans	Loans (as defined including UPEs)	The arm's length interest rate can be used in lieu of the benchmark rate where transfer pricing analysis is conducted and documented by lodgement date.	Section 8.6
8	All other benefits	All other benefits	The arm's length value.	None

5.4.5 Item 8 of the table is intended to provide a "Catch-all" provision for all other benefits not otherwise listed in the table. That is, where a benefit is not covered by a safe harbour rule, the value of the benefit could be determined by the arm's length value – that is, the amount that the shareholder would be required to pay as arm's length consideration for the benefit provided. It is not expected that many benefits would fall within this final category.

5.5 Step 3: Consideration paid

5.5.1 Once the gross benefit is determined by virtue of applying the valuation rules in Step 2, the amount of the benefit would be reduced by allowing consideration to be paid by the shareholder or associate for each of the arrangements (i.e. the net benefit).

5.5.2 This differs substantially from the way in which Division 7A currently operates for a number of arrangements. Under the current provisions, each set of transactions provides for different rules as to whether consideration can be provided to rectify a transaction. For example, a cash payment to a shareholder or associate cannot be "repaid" as such. Division 7A requires the payment to instead be converted into a loan. However, a transfer of property or a use of asset arrangement can be reduced by way of consideration paid by the shareholder or associate.

5.5.3 This is different to Schedule 2F, which allows consideration to be paid by the taxpayer in all circumstances (due to the drafting of paragraph (2)(b)). This mechanism therefore allows for the ability to rectify any benefit received by paying appropriate consideration.

5.5.4 Furthermore, safe harbours could be provided for both timing (on paying consideration) and recording (in terms of offsetting the consideration).

5.5.5 On timing, if appropriate safe harbours are provided for when consideration needs to be paid, we believe that this would greatly reduce the incidence of error. That is, in broad terms, if a shareholder or associate is given until the lodgement time to pay any consideration required under Division 7A, the relevant tax agent can review Division 7A compliance as part of the tax return process and ensure that relevant payments are made in compliance with the provisions before lodging the return. This would extend to all transactions, ranging from loan repayments, to property transfers, to debt forgiveness transactions.

5.5.6 For example, a company may forgive a debt owed by a shareholder without understanding the Division 7A consequences. Provided the shareholder pays consideration back to the company by the lodgement time, this should not be taken to result in a benefit to the shareholder or associate.

5.5.7 On recording consideration paid, Division 7A currently requires legal offsets to occur. The ATO do not seem to accept journal entries as evidence and require further evidence to prove that there has been a legal offset of amounts. We submit that this legalistic approach to Division 7A unnecessarily complicates compliance with the provisions. To the extent that consideration paid is evidenced by way of a journal entry recorded in the ledger or accounts, being an entry that, for accounting purposes, demonstrates a genuine transfer of value from one entity to another, we believe that this should be regarded as a repayment for Division 7A purposes.

5.6 Franking deemed dividends

5.6.1 As Division 7A deems there to be a dividend to shareholders or associates, we see no reason why the provisions should (at first instance) prevent the dividend from being franked. We understand that the consequence of this could result in franked dividends being paid to associates that are not shareholders of the company and thus could open up streaming opportunities.

5.6.2 However, that being said, we note that Division 7A currently operates so that the recipient is deemed to be a shareholder and the benefit is deemed to be a dividend paid out of profits (s.109Z). This provision operates for the "purposes of this Act". Therefore, deemed Division 7A dividends would be within the ambit of the many streaming provisions contained in the Tax Act, including the dividend stripping provisions (s.177E) and the franking credit streaming provisions (Division 204 and s.177EA). We believe that these provisions would ordinarily operate to deny streaming benefits and thus would offer some level of protection to the revenue for the behavioural issues that may occur if deemed dividends were allowed to be franked.

5.6.3 Furthermore, we note that where a benefit is provided to a shareholder in lieu of a dividend, we see no reason why the deemed dividend should not otherwise be frankable. That is, we see no reason why an extra step is required to "offset" a franked dividend against the benefit provided. Accordingly, where the benefit is intended and is franked by the company, we see no reason why such benefits should not be frankable dividends and thus an extension to the ordinary dividend rules for the whole of the Act.

5.6.4 We note that allowing a deemed dividend to be franked under this proposal would not necessarily extend to retrospectively allowing a deemed dividend to be franked. This is because the franking rules require a determination of the benchmark franking by reference to the first dividend in the income year, or alternatively by the following 31 October (s.203-30 together with s.202-75(3)(a))). Retrospectively allowing a deemed dividend to be franked would require departures from these rules.

5.6.5 We highlight that the above mechanism is not the only approach to providing franking credits. An alternative approach may be to allow the franking of current year deemed dividends, with a "later dividend" rule being used for subsequent dividends. The later dividend rule proposed is outlined in the following section.

5.7 Later dividend rule

5.7.1 Currently, Division 7A avoids duplication issues by allowing for a "later dividend" rule (contained in s.109ZC). This rule allows the payment of a later dividend which is treated as a non-assessable dividend to the extent that the taxpayer (or associate) has received a deemed dividend under Division 7A. The advantage of this mechanism is that it allows the offset to be applied to all deemed dividends and is not limited to dividends paid to the shareholder.

5.7.2 We believe the issues with franking could also be addressed by improving the "later dividend" rules so that they allow franked dividends to be offset against prior deemed unfranked dividends.

5.7.3 Under this alternative, the later franked dividend would be non-assessable - however, the franking credit gross up would be assessable and the franking credit would also be available as an offset. Essentially what this does is provide the franking credit for the earlier dividend, but does this at the later time. This means that the revenue is compensated for the period over which an unfranked dividend is paid (by way of collecting tax on the higher amount upfront).

5.7.4 By way of example, assume that a taxpayer has a loan of $70 and receives a fully franked dividend of $70. In this case, the taxpayer can repay the loan with the dividend and would pay top-up tax of $16.50.

5.7.5 Compare this to a case where the $70 loan is a deemed dividend. In this case, the taxpayer will pay $32.55 as tax. However, if an actual fully franked dividend of $70 is later paid and offset against the loan, then the taxpayer would be assessed on a further $16.50 of tax, resulting in total tax paid of $79.05 (i.e. $30 of company tax, $32.55 of tax on the deemed dividend, and $16.50 of tax on the franked dividend that is later paid).

5.7.6 In this case, we believe that the later dividend rule should allow the later franked dividend to be offset against the earlier deemed dividend, so that only the franking credit gross up of $30 (and not the dividend) should be included in income and the franking credit also applied. Where this rule is applied, the taxpayer would receive a refund on the later dividend equal to $16.05 (i.e. 46.5% x $30 less $30 franking credit). Accordingly, the total tax paid under the later dividend rule would be equal to $46.50 (i.e. $30 of company tax, $32.55 of tax on the deemed dividend, less $16.05 refunded on the later dividend).

5.7.7 Thus the proposed later dividend rule would aim to put the taxpayer with a deemed dividend in the same position as if the dividend had been frankable from the outset. The advantage of our proposal would be to compensate the revenue for any lost interest or penalties during the time between the deemed dividend and the later dividend (which would not occur if the deemed dividend was frankable retrospectively).

5.7.8 That being said, we highlight that there may be integrity concerns with a later dividend rule that may need to be considered further by the Board. We believe, however, that these integrity concerns can be easily managed provided that the later dividend rules are restricted to certain cases. For example, in order to ensure that taxpayers do not use the rule to retrospectively apply franking credits to prior year dividends, the ability to frank the later dividend may need to be limited to franking credits available at the time of the deemed dividend.

5.7.9 In effect, the later dividend rule would therefore operate to allow the company an ability to frank the deemed dividend. The only key difference would be that the franking credits would be allowed as an offset in the subsequent year (rather than at the time of the earlier deemed dividend), providing some protection to the revenue.

6 Statutory interest model

Q 5.1 Issues/Questions

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

6.1 Response

6.1.1 In our previous submission, Pitcher Partners provided support for the Statutory Interest Model. We have reflected on the Board's recommendations contained in the Second Discussion Paper. In our view, while the Statutory Interest Model could provide simplification with respect to the treatment of loans, we believe that the Transfer of Value Model recommended by the Board provides a more systemic solution to Division 7A.

6.1.2 To the extent that the recommendations contained in the Board's report can be implemented consistently with the four goals proposed, we believe that the Board should focus on the implementation of the Transfer of Value Model. To the extent that difficulties arise with implementing the Transfer of Value Model, we would support the continued consideration of the Statutory Interest Model.

7 The Division 7A adjustment model

Q 5.2 Issues/Questions

The Board seeks stakeholders' comments on:

a) whether a number of administrative issues and the high compliance and administrative costs associated with Division 7A are due to the prescriptive and, in some cases, form based provisions within the Division;

b) whether pursuing the Division 7A Adjustment Model alone would have only limited impact in moving the system in the direction of the Board's preferred policy framework as discussed in Chapter 4; and

c) if the new model suggested in Chapters 4 and 6 (and summarised in the Executive Summary) were to be adopted, what remaining aspects of the Division 7A Adjustment Model (if any) should be progressed, any in what priority.

7.1 Compliance and administrative issues

7.1.1 In our view, the proposed new model (being the Transfer of Value Model) will be very similar in structure to the current provisions contained in Division 7A. In effect, we believe that the recommendations being proposed by the Board could also be implemented within the current provisions. For example, the Board could implement their recommendations by modifying Division 7A in the following manner:

- Introducing an objects clause containing the four principles
- Modifying the meaning of loans to clarify that they include UPEs
- Removing Subdivisions EA and EB
- Changing the safe harbour loan terms to 10 years etc
- Amending the minimum loan repayment rules
- Better integrating the payment rules so that they apply consistently
- Modifying the interposed entity rules to simplify compliance
- Introducing a TTB election for trusts
- Updating the distributable surplus rules
- Removing the general Commissioner's discretion
- Introducing a self-correction mechanism

7.1.2 All of these changes would essentially modify the existing provisions so that they are consistent with the recommendations. Furthermore, a lot of the prescriptive rules causing administrative issues within Division 7A would be repealed through the above changes. Accordingly, one would expect that the proposed recommendations by the Board would address many of the complexities contained in the current provisions.

7.1.3 That being said, the extensive nature of the recommendations listed above would essentially modify Division 7A substantially, to the extent that the provisions would be largely re-written (but for the main operative provisions of s.109C to 109G).

7.1.4 We also have a number of additional recommendations for dealing with certain issues that are currently faced in applying Division 7A. For example, we have suggested that a "short term arrangement" safe harbour rule should allow a shareholder or associate the opportunity to repay consideration to the company for all benefits by the lodgement date of the company's tax return (see Section 13). This recommendation would also help to reduce uncertainty as to when transactions need to be paid under Division 7A. We note that this exception is currently contained in the existing provisions and helps to ensure that taxpayers have an opportunity to correct Division 7A errors before lodging the tax return.

7.1.5 Accordingly, while we are not supporting the Division 7A Adjustment Model, we are noting that the implementation of the Transfer of Value Model would be broadly similar to the Division 7A Adjustment Model.

7.2 Consistency with the policy framework

7.2.1 As noted above, modifications could be made to Division 7A in line with the Board's recommendations. By implementing these changes, we note that Division 7A would become more consistent with the four main policy goals outlined in Chapter 4 of the Second Discussion Paper. Accordingly, while many of these goals are currently not achieved, we believe that Division 7A would become more consistent with the Board's framework if the recommendations were implemented within Division 7A.

7.3 Remaining aspects to be progressed

a) Overview

7.3.1 We highlight that the Board's First Discussion Paper and Second Discussion Paper contain a large list of issues with Division 7A. This list provides a useful reference point in determining whether the New Regime will address the relevant issues, or whether the same issues will carry through to the New Regime.

7.3.2 Accordingly, we believe that the Board should recommend that Treasury be required to review the list of issues contained in the First and Second Discussion Papers to ensure that these issues do not carry through to the New Regime.

7.3.3 We also highlight that there are a number of supporting operative principles in Division 7A that are likely to be required within the New Regime, or which (in our view) should be removed. We highlight those briefly below for consideration.

b) Application to non-resident companies

7.3.4 Section 109BC was introduced with effect from 1 July 2009 to ensure that Division 7A applies to all non-resident companies in the same manner that it applies to resident companies. However, s.47A still takes primacy to Division 7A.

7.3.5 A deemed dividend occurs under s.47A(1) where a company that is a CFC of an unlisted country makes a "disguised distribution" of its accumulated profits after 3 June 1990. The application of s.47A to non-resident companies is limited by virtue of the requirements of s.47A(1) to be a CFC of an unlisted country.

7.3.6 One of the main differences between s.47A and Division 7A is that it is extremely difficult, if not impossible in practice, to satisfy the "arm's length" transaction rule contained in s.47A under the ATO's view in TR 2002/2. This is because the ATO believe that the provision still operates even if arm's length conditions are established.

7.3.7 That is, even if the interest rate applicable to the loan is an arm's length interest rate, it is still necessary to determine whether independent parties would have entered into the loan at all.

7.3.8 Accordingly, even if taxpayers comply with Division 7A with respect to loans from non-resident companies, there is a material risk that the ATO could seek to apply s.47A to the transaction. This outcome is clearly overly complicated and unintuitive.

7.3.9 Another key difference is that if a benefit is inadvertently provided by an unlisted CFC to an Australian tax resident associate there is no window of opportunity to fix this problem as there is with Division 7A. For example an unlisted CFC makes a short term interest free loan to an associated Australian tax resident which is repaid within one week. Where Division 7A applies the taxpayer would have an opportunity to repay the loan by the lodgement date of the lender, however under s.47A a repayment will not prevent the application of the provisions. The lack of parity between Division 7A and s.47A in this context is clearly inconsistent with policy and makes it difficult for taxpayers to comply.

7.3.10 A further difference between Division 7A and s. 47A is that the latter can apply to loans between companies. At the time that s.47A was introduced this made sense because dividends from unlisted CFCs to their Australian parents could not qualify for relief pursuant to s.23AJ. However since the reforms to s.23AJ in 2004 to broaden the application to dividends from unlisted jurisdictions, the application of s.47A to loans between companies again is not consistent from a policy sense.

7.3.11 As it is now very common for middle market taxpayers to have international dealings, this interaction issue is becoming more prevalent. We highlight that this compliance cost is unnecessary and that s.47A should be repealed so that Division 7A can be applied to both resident and non-resident companies. We note that Division 7A would provide appropriate integrity around "disguised distributions" and thus should render s.47A unnecessary. Furthermore, as both provisions can possibly apply to the same transaction, we believe that the duplication of these provisions results in an unnecessary high compliance cost for taxpayers.

c) The "refinancing" principle

7.3.12 Division 7A currently contains a refinancing principle in s.109R. The principle essentially ignores repayments that are funded by way of a refinancing amount. This provision provides appropriate integrity to the safe harbour repayment terms, to ensure that the terms are not otherwise breached by way of a refinancing of the same amounts.

7.3.13 However, we note that the current provisions are very prescriptive and provide for anomalous outcomes. There appears to be no logic to some of the limitations of the exceptions provided.

7.3.14 For example, where an amount that is assessable to a borrower is banked in a company (by a third party) and therefore offset against the loan from the company to the borrower, an exception is provided for the refinancing principle (s.109R(4)). However, for some reason, this exception is not applied where the assessable amount is banked by the borrower and then repaid by the borrower to the company. Economically, the two are identical.

7.3.15 On this point, the payment of loans through assessable amounts is effectively limited to dividend income under s.109R(3)(a). It is unclear why an amount that is assessable to the borrower should not otherwise be excluded from the refinancing principle. In such a case, clearly the repayment is being funded using assessable income of the borrower. Accordingly, by using after tax dollars to repay the company loan, the system should acknowledge that the marginal tax system is not being eroded. Accordingly, it is curious that Division 7A does not provide an exception for such an arrangement, other than assessable repayments via third parties (s.109R(4)).

7.3.16 Due to the limited application of s.109R(4) to third party arrangements, there is uncertainty as to whether revolving trade credit arrangements would be caught within Division 7A, even where the revolving credit is repaid by amounts assessable to the borrower.

7.3.17 While we support the introduction of a s.109R equivalent rule within the New Regime, we would strongly recommend that its replacement provision be drafted in a simple and effective manner. In our view, the two key aspects are as follows:

- The provisions should restrict the ability to make a repayment that is funded from a re-borrowing; and

- An exception should apply where the repayments are made by amounts that are assessable income to the shareholder or associate (i.e. as the loans are being funded using amounts taxed at marginal rates).

d) The interposed entity provisions

7.3.18 We would expect the New Regime to contain an interposed entity rule. This is simply because exceptions to Division 7A (e.g. an exclusion for company to company loans) could otherwise result in taxpayers circumventing the operation of Division 7A.

7.3.19 One of the key problems with an interposed entity rule is that it could become impossible to apply where the provisions are drafted in a mechanical sense. For example, a mechanical interposed entity rule could apply where a company makes a payment to an interposed company, which later made a payment to a shareholder or associate. However, assume that the first payment is made to the company in year 1 and the second payment is made in year 65. Under a purely mechanical test, this arrangement would be caught by Division 7A. In our view, this would make the interposed entity provisions impossible to comply with.

7.3.20 While the current interposed entity provisions contain a mechanical test as a component, paragraph 109T(1)(b) requires an additional component to be applied, being a reasonable person test. The reasonable person test requires a conclusion "(having regard to all the circumstances) that the private company made the payment or loan solely or mainly as part of an arrangement involving a payment or loan to the target entity".

7.3.21 In effect the reasonable person test would ensure that the example outlined earlier (involving a 65 year period span) would unlikely need to be examined under the interposed entity rule. Accordingly, in our view, we believe that any interposed entity should not be mechanical, but instead should be drafted in a manner that is consistent or similar to s.109T.

7.3.22 Furthermore, to the extent that any leg satisfies the application of Division 7A, the interposed entity rule should not have operation. For example, if any leg of the arrangement (involving a loan) is placed on complying terms, then that part of the arrangement should not be included within the interposed entity rules. To demonstrate, assume that Aco loans $100 to Bco which loans $100 to Cco which loans $100 to individual D. Assume that the loan from Aco to Bco is placed on 10 year complying terms, which are complied with by Bco. Where this occurs, the interposed entity rules should not include this leg between Aco to Bco. If the loan from Cco to D is placed on complying terms, this part of the leg should also be excluded from the interposed entity rule.

7.3.23 Similarly, to the extent that a payment is made by a company to a party as a repayment of an arm's length loan, such a payment should be excluded from the interposed entity provisions. To demonstrate, assume that Aco owes $100 to Bco which makes a payment to individual D. To the extent that the repayment by Aco to Bco is a repayment of a genuine loan, this leg of the arrangement should be excluded from the interposed entity rules (as Aco is simply returning the money owed to Bco).

7.3.24 We believe this last aspect has caused the most difficulty with the application of s.109T in practice. While the ATO effectively applies the law in the manner outlined above (through TD 2011/16), the provision relies on a Commissioner's determination. Accordingly, it is difficult to obtain certainty on these exceptions without legislative support.

7.3.25 Therefore, we highlight the importance of addressing these main uncertainties that exist under the interposed entity rule contained in Division 7A where a new interposed entity rule is introduced within the New Regime.

e) Family law interactions

7.3.26 We highlight that Division 7A still does not deal with family law settlements in an equitable manner. While the family court must take into account the tax effect of the settlement, we highlight that family law settlements can provide for an inappropriate outcome to shareholders and their associates where the taxation matters are not appropriately dealt with.

7.3.27 By way of example, the requirement by a company to pay cash to a person under a family law settlement may result in a deemed (frankable) dividend. However, to the extent that the cash payment comes before franking credits are generated this situation can (in itself) result in an unfranked dividend, with wasted franking credits being received subsequently by the company. For example, if assets are disposed of to fund the cash payment, the tax may not become payable until lodgement time (in the following year). Accordingly, franking credits may not be available at the time of the deemed dividend.

7.3.28 Furthermore, the in-specie distribution of an asset may result in the CGT rollover having application. Even where the dividend is franked, the rollover will result in double taxation as the property receives a lower cost base due to the rollover. Accordingly, the shareholder is assessed on a franked dividend and on the latter sale of the property. Essentially double taxation is paid by the recipient shareholder in such a case. Simply disposing of the property to a third party and paying a franked dividend to the shareholder only results in taxation on one economic gain. Therefore, in our view, the current law provides an anomalous result.

7.3.29 We note that these issues have now been highlighted for over seven years and are still to be addressed. We highlight that amendments to correct these problems could be easily addressed in the proposed reforms (for example, by limiting the deemed dividend to the CGT cost base, of the asset received) and therefore would recommend that the Board consider providing final recommendations on this issue.

f) Retaining certain exceptions

7.3.30 Division 7A contains a number of important exceptions. These exceptions ensure that the provisions do not apply inappropriately to certain arrangements. In our view, the following exceptions should be replicated within the New Regime, as they provide an appropriate exception for Division 7A:

- An exception for arm's length repayments by a company (s.109J).
- An exception for company to company benefits (s.109K).
- An anti-duplication exception (s.109L).

g) The interaction between FBT and Division 7A

7.3.31 Specific rules deal with the priority of FBT and Division 7A, as it is common for a shareholder to also be an employee of the business. Paragraph 6.49 of the Board's Second Discussion Paper states that loans under the New Regime would be excluded from FBT.

However, there is no mention on how other benefits would be treated, including payments and debt waiver arrangements.

7.3.32 We therefore believe it is important for the New Regime to provide an appropriate interaction with the FBT provisions that is both simple to apply and provides certainty to taxpayers.

8 The transfer of value model

Q 6.1 Issues/Questions

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

8.1 Response

8.1.1 We support the proposals by the Board to simplify the safe harbour (complying term requirements) for loans. We believe that the Board's proposals provide a more flexible and practical set of terms. As a part of this, we believe that the treatment of unpaid present entitlements ("UPEs") as loans would also greatly simplify the application of Division 7A. That being said, while we provide this support for such a change, it is done so on the proviso that it is accompanied by changes that allow a business trust the ability to utilise UPEs for working capital purposes (e.g. a TTB election for trusts).

8.1.2 Following are some of our comments with respect to each of the proposed terms and conditions of the safe harbour loans.

8.2 One size fits all

8.2.1 In discussions with taxpayers and tax agents, we believe that the proposed terms and conditions are generally helpful for the majority of taxpayers. However, one of the main concerns that has been raised is that the proposals provide a "one size fits all" solution.

8.2.2 While the Board's proposed terms try to cater for this by being more flexible than the current regime, some of the options provided (e.g. a fixed interest rate) may provide less flexibility than the current regime for certain middle to large sized taxpayers.

8.2.3 While Division 7A will predominantly be applied by smaller taxpayers, it must be acknowledged that there will be middle to large business that will also need to apply these rules. For example, a publicly listed but closely held company may be deemed to be a private company for taxation purposes and therefore may also be required to apply the Division 7A provisions.

8.2.4 We therefore believe that there should be some consideration as to whether special rules should be provided to ensure that those larger businesses can appropriately apply Division 7A to their more complicated circumstances. Given that these taxpayers typically have better access to advisors, we do not believe that this would change compliance costs for the majority of taxpayers if these measures are appropriately targeted.

8.2.5 One example we have provided below is the ability to use a variable interest rate rather than a fixed rate. This is because a larger taxpayer may have numerous loans

between a company and various trusts over a number of years, making it difficult to track different fixed interest rates to different loan balances annually.

8.2.6 Accordingly, we have outlined below some of the issues that have been identified during the consultation period and have provided our suggestions to deal with those issues. We believe that certain changes could be made to the Boards proposed terms, which we do not believe would increase compliance for the smaller "end of town". These items are discussed in further detail below. We would be more than happy to discuss these items in further detail.

8.3 Requirement for a formal loan agreement

8.3.1 We support the proposal to remove the requirement for there to be a formal written agreement between the parties. However, we do not believe that there needs to be a rule in the legislation requiring written evidence that a loan was entered into.

8.3.2 We believe that, under ordinary common law principles, some evidence (rather than strictly written agreements) is required to demonstrate that there is a loan between the relevant parties. Reference is made to cases such as Richard Walter Pty Limited v FC of T [4550] 96 ATC 4550, Raftland Pty Ltd as Trustee of the Raftland Trust v FC of T [2008] HCA 21, and Haritos v FC of T [2014] FCA 96.

8.3.3 In each of the cases referred to above, the Court concluded that no loan or UPE existed where there was no evidence to support the obligation. Accordingly, we see no reason why Division 7A would need to impose an additional statutory rule that is already contained in common law principles.

8.3.4 By way of example, assume that all loans are made under verbal agreements and the annual accounts record the relevant obligations as loans (which are then signed by the relevant parties). Having a statutory requirement that there be "written evidence" would create uncertainty as to whether the signed accounts would be sufficient.

8.3.5 We believe that in most situations, tax agents would advise that a written loan agreement should be entered into to ensure that the arrangement complies with the New Regime. However, given that the New Regime will essentially tax non-compliance with an arrangement (by way of a deemed dividend), and given the Board has recommended proposed changes to the amendment period to deal with Division 7A breaches, it would therefore seem (in our view) unnecessary to impose this additional requirement in the legislation.

8.4 Fixed versus variable interest rate

8.4.1 The proposition to move to a fixed interest rate has some attraction for taxpayers with a low volume of Division 7A arrangements. However, for taxpayers in the middle to larger end (e.g. with a group of 20 or more entities), it is possible to have 20 or more separate Division 7A agreements operating simultaneously in any year. If a new loan is entered into each year for 10 years, by the end of 10 years there could be up to 200 different loans that are being recorded under Division 7A (due to the facility nature of the loan).

8.4.2 The maintenance of this number of loans under the current provisions is fairly simple. This is because each loan needs only to apply one single interest rate for any income year – being the statutory interest rate for that year. Accordingly, there is no need to track each of the loans to determine the correct fixed interest rate.

8.4.3 We highlight that this is a real issue for middle to larger groups and that we believe taxpayers should be given an option to use either the fixed or variable interest rate in the first year interest is charged. If no option is taken, then the loan could simply default to the fixed rate.

8.4.4 Having only a fixed rate option would not only be commercially inflexible, but could also cause issues with internal hedging for groups with finance entities. For example, a group may borrow centrally (using its finance company) at variable rates and naturally hedge this rate by lending to group entities at variable rates. The variable interest rates on both sides provide a natural hedge. However, if (alternatively) the finance entity is required to lend at fixed rates, the finance entity will have an unhedged position. Appropriate hedging strategies may then be required by the finance entity.

8.4.5 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.

8.5 The interest rate chosen

8.5.1 The Board has recommended the use of an interest rate, such as the variable overdraft rate, for the purpose of setting the complying terms. We understand that this is just an example of a rate and that this does not necessarily highlight the relevance of the rate or the final recommendations of the Board to use this rate.

8.5.2 In determining its final recommendations, we note that the Board could link to various other interest rates, such as the 10 year Government bond rate. This rate is published by the ATO on an annual basis[3] and reflects a fixed rate based on a 10 year arrangement. Furthermore, the rate can simply be increased by adding a basis points adjustment. For example, the 30 June 2013 rate was 3.76%. This rate could simply be increased by (say) 6 basis points to 9.76%, if required.

8.6 Penalty interest rate

8.6.1 We understand the reasoning for the higher interest rate. Where a shareholder or associate borrows money from a company for personal reasons, the higher interest rate ensures appropriate protection of the marginal tax system (the first goal).

[3] https://www.ato.gov.au/rates/key-superannuation-rates-and-thresholds/?page=34#10_year_Treasury_bond_rate

8.6.2 However, where the money is used for income producing purposes, the higher rate may encourage passive investments and thus may not be consistent with the fourth goal. That is, the higher interest rate may result in negative gearing for an investment property, where the tax losses are ultimately used to reduce the capital gain on disposal. As losses are applied to the net capital gain (after applying the 50% capital gains tax discount), the higher interest rate could ultimately result in more taxpayers seeking to use company funds for passive investment related activities.

8.6.3 Furthermore, as an ancillary issue, the higher interest rate may be set at a level over and above normal commercial returns. That is, the business venture may be expected to have returns of 8% (net profit), while the statutory interest rate under the New Regime may be set at a higher rate. Where this occurs (and where there is no prospect of deriving a profit due to the high interest cost), there will be a question as to whether the interest amount will be fully deductible. Reference is made to cases such as the Full High Court decisions in Fletcher & Ors v FC of T 91 ATC 4950, Ure v. F.C. of T. 81 ATC 4100, and Spassked Pty Limited v FC of T 2003 ATC 5099, where deductions were denied for interest for this reason.

8.6.4 We highlight that there will be a number of businesses that are operated, where the value of the business will be tied up in a CGT asset other than goodwill. An example would include a shopping centre, where the value of the business would be included in the value of the land. These types of asset classes are discussed further at Section 10.3. In these cases, the relevant trusts would be reluctant to make a TTB election. Accordingly, the non-deductibility of interest under the cases referred to above would be relevant where the business returns a loss after interest.

8.6.5 To address this issue, the TTB election could cover a wider range of CGT assets. Alternatively, the New Regime could allow taxpayers an option to set the interest rate at the arm's length interest rate. This option would only be available where certain conditions are satisfied (for example, the loan is used solely for income producing purposes, an appropriate benchmark rate is established, based on the arm's length interest rate payable by the taxpayer or where relevant, a financing entity within the taxpayer group, and appropriate documentation is put in place by the lodgement time). The requirement to document the pricing by a certain time is currently used in the transfer pricing provisions and in thin capitalisation. We highlight that due to the strictness of the thin capitalisation tests, there are only a handful of taxpayers that utilise this method. This has been evidenced by the statistics produced by the Board in its review of the arm's length debt test under the thin capitalisation provisions.

8.6.6 We do not believe that providing this option will result in additional compliance costs for the vast majority of taxpayers. We highlight that Division 7A currently provides an arm's length exception in s.109M. In our experience, the difficult conditions that need to be satisfied for this provision to apply mean that the section is rarely used or considered by taxpayers. We have yet to experience one case where this provision has been said to increase compliance costs for taxpayers, as most taxpayers simply do not even consider this option.

8.6.7 We note that this option may be easier to implement than trying to identify a larger class of CGT assets that are inherently connected with a business. Accordingly, we see this as being a simpler option to address this issue.

8.7 The amendment period

8.7.1 While we understand the issue raised with respect to the proposal to extend amendment periods, we remain unclear as to what is being proposed by the Board. While we would support the ability for the Commissioner to seek an appropriate adjustment, we believe that there needs to be some certainty as to the amendment periods. We provide the following observations for further consideration by the Board.

8.7.2 The example provided in paragraph 6.21 looks at an arrangement that "would ordinarily result in a deemed dividend in year one, rather than year 10." This case could cover a benefit that is provided as a "payment" in year 1 rather than as a loan. The proposed solution in paragraph 6.22 is to provide four years from the date of lodgement of the milestone payment. However, as the arrangement is a payment and not a loan, we would question how the proposal in paragraph 6.22 would address the issue identified in the previous paragraph.

8.7.3 Furthermore, it would seem that this type of issue would therefore open up debate as to whether an arrangement is in fact a loan or a payment, irrespective of the documentation in place.

8.7.4 We highlight that the reason for the limited amendment period is to provide taxpayers with a degree of certainty. Due to the previous reviews of the amendment period (conducted by Treasury) and the willingness of the Government to reduce extended periods of review, we believe that appropriate conditions need to be put in place to limit the circumstances in which the extended period will be provided to the ATO.

8.7.5 To try and address some of these concerns, we have provided an alternative set of rules below that we believe may address the issue identified by the Board.

- To the extent that the deemed dividend is due to fraud or evasion, the ATO should continue to have an unlimited amendment period under s.170.

- To the extent that fraud or evasion has not occurred and the arrangement is (or was in the year it occurred) recorded in the accounts as a loan, the Commissioner's period of review could run from the later of: (a) the lodgement date for the last year in which the loan was recorded in the accounts; and (b) the lodgement date for the year in which the deemed dividend would arise.

- To the extent that fraud or evasion has not occurred and the arrangement is not (and has never been) recorded in the accounts as a loan, the Commissioner's period of review commences to run from the date of lodgement for the income year in which the deemed dividend would otherwise occur.

8.7.6 To demonstrate the application of these broad principles, the following examples have been provided for further consideration.

a) Example 1: Fraud or evasion

8.7.7 In year 1, Aco makes a payment to individual X, for private purposes. The amount is not disclosed in the accounts or tax returns. In year 8, the amounts are discovered by the ATO. It is held that the case involves fraud or evasion by the relevant taxpayers. In this case, the ATO will be able to amend the return in year 1 using its ordinary powers of amendment under s.170.

b) Example 2: Loan recorded in the accounts

8.7.8 In year 1, Aco provides $100 of cash to individual X. The amount is recorded as a loan in the accounts to X. In year 9, the ATO reviews the loan and assesses the taxpayer for a deemed dividend as no repayments have ever been made. The taxpayer argues that the amount is not a loan, but rather was a payment in year 1 (due to a technicality), and that there has been no fraud or evasion. In this case, because the $100 was recorded as a loan in the accounts of the company for the year in which it was provided (and continues to be recorded as a loan until year 9), under the proposal we have put forward, the ATO would have 4 years from the date of lodgement of the tax return for year 9. Accordingly, the ATO can amend the arrangement in either year 1 (where the arrangement is treated as a payment) or in year 9 (where the arrangement is treated as a loan). This approach seems reasonable where the taxpayer is aware of there being a loan in the accounts from a company to an individual.

c) Example 3: Loan recorded in the accounts

8.7.9 In year 1, Aco provides $100 of cash to individual X. The amount is recorded as a loan in the accounts to X. In year 9, the ATO reviews the loan and assesses the taxpayer for a deemed dividend. The taxpayer notes that the loan had been forgiven in year 3 and produces the relevant documentation. The taxpayer successfully argues that the accounts are simply in error and that there has not been fraud or evasion in this case. In this case because the $100 was recorded as a loan in the accounts for the year it was provided (and continued to be recorded as a loan until year 9), under the proposal we have put forward, the ATO would have the power to amend the return in year 3 (where the arrangement is treated as being forgiven) or in year 9 (where the arrangement is a treated as a loan). This approach seems reasonable where the taxpayer is aware of there being a loan in the accounts from a company to an individual.

d) Example 4: Payment to the taxpayer

8.7.10 In year 1, Aco makes a payment to individual X, for private purposes. The amount is disclosed in the accounts as a payment. The taxpayers are not aware of the application of Division 7A and the case does not involve fraud or evasion. In year 8, the amounts are discovered by the ATO. The ATO will be out of time to amend the assessment in accordance with s.170.

9 Treatment of UPEs as loans

Q 6.2 Issues/Questions

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

9.1 Response

9.1.1 We support providing legislative clarity to treating UPEs as loans. There are significant simplification benefits that can be achieved where UPEs are treated as loans. We believe that this would ensure that two whole Subdivisions do not need to be replicated in the New Regime, being Subdivision EA (dealing with direct UPEs) and Subdivision EB (dealing with indirect UPEs). Accordingly, the standard interposed entity rules could apply to the arrangement.

9.2 Dual recommendation

9.2.1 However, we believe that this legislative change should only be implemented if it is accompanied by a solution that appropriately addresses business use of a UPE. On this point, we refer to our submission to the "Inquiry into Family Business in Australia", which was provide to the Parliamentary Joint Committee on Corporations and Financial Services on 30 November 2012. Our submission highlighted the importance of funding working capital using after tax profits. This is critical for taxpayers in the middle market, which have limited access to borrowings and funding. Without an ability to utilise the 30% corporate tax rate, small business taxpayers that operate through trusts would be unfairly disadvantaged.

9.2.2 As outlined in our response at Section 10 below, we are pleased that the TTB election will seek to address this concern.

9.2.3 Therefore, provided that these two options go hand in hand, we believe that this recommendation will simplify Division 7A for the majority of taxpayers.

9.2.4 One residual issue that may need to be considered by the Board is that the treatment of a UPE as a loan may not address some of the technical issues raised by the ATO in their rulings and practice statements on the legal nature of a UPE. That is, the ATO hold the view that a UPE consists of "corpus" of the company to a sub-trust and an investment of assets from the sub-trust to the main trust (where the assets are not separately identified and placed on sub-trust). In such a case, there are two trusts (one of which is effectively ignored by the ATO administratively in PSLA 2010/4).

9.2.5 If UPEs are to be treated as loans, we recommend that the Board consider an appropriate recommendation that effectively ignores the "sub-trust" arrangement for all purposes of the Act. For example, the deeming rule could ensure that to the extent that the

UPE remains unpaid and the funds remain in the main trust, the whole arrangement would be taken to comprise only a loan from the company to the main trust.

9.3 Timing of the UPE being treated as a loan

9.3.1 One issue that may need to be considered further is the timing of the UPE being treated as a loan. We note that paragraph 6.30 suggests that UPEs be treated "as loans for Division 7A purposes as at 30 June in the year of the relevant distribution".

9.3.2 We highlight the practical problems with this, as the proposed rule will extend to all UPEs, including UPEs to other trusts and UPEs to individuals. By way of example, assume that Trust A distributes to Trust B, which distributes to Trust C (50%) and Trust D (50%), whereby Trust D distributes to Company X (100%). If all of these UPEs remain unpaid, then they will all be deemed to be loans. However, this could give rise to deemed dividends to all trusts in the chain, including Trust A. This could create significant compliance issues, especially if the trusts have earlier lodgement dates as compared to the relevant company, or where the entities are looked after by different tax agents. For example, at the time Trust A lodges its tax return, it may have no certainty as to how Company X has treated its UPE with Trust D and whether this has been placed on complying terms.

9.3.3 We request the Board consider whether it would be preferable for the UPE to be treated as a loan on 1 July following the year of creation. In this case, taxpayers will have extra time to identify the quantum of the UPE and then deal with the UPE for the purpose of the New Regime.

9.3.4 In our view, having the arrangement as a UPE in the first year will not change the Division 7A consequences. That is, if the arrangement is not placed on complying terms in the second year, then there would still be a deemed dividend from Company X to Trust D. Furthermore, if Trust A makes a payment to an individual on 30 June in year 1, a s.109T equivalent would simply apply to the arrangement. This is because the interposed entity rule is not dependent on whether the loan or payment comes first (see s.109T(2)).

9.3.5 We only highlight this point for consideration and note that this extension of time would deal with cases where the relevant interposed trusts are not aware of the treatment of UPE amounts owing the corporate beneficiary until the lodgement of the relevant tax return.

10 Tick the box ("TTB") election

Q 6.3 Issues/Questions

The Board seeks stakeholders' comments on:

a. whether the issues associated with retaining working capital for the carrying on of a business in a trust can be addressed with the use of a limited exception;

b. whether the limited exception (provided through legislation) should be that all loans to trusts (including UPEs) can be excluded from the operation of Division 7A, where the trust makes a once and for all election to forgo access to the CGT discount on its capital gains arising from assets held within the trust;

c. whether the proposed limited exception would reduce compliance costs in instances where a business is carried on in a trust;

d. the nature of the consequential rules that would be required if such a limited exception were to be applied;

e. the nature of any transitional rules that would be required if such a limited exception were to be applied; and

f. the merits of a transitional rule that provides that:

   i. any loans in place prior to a trust making an election would continue to be subject to the existing requirements; and

   ii. any CGT assets acquired by the trust prior to the making of an election would continue to be eligible for the CGT discount on disposal; or

g. alternative suggestions for a transitional rule that maintain integrity, provide simplicity and reduce compliance costs.

10.1 Response

10.1.1 We support the proposed exception for loans (including UPEs) from companies to trusts. The recommendation is both a fair and equitable mechanism that will deal with one of the longest standing (critical) issues for middle market taxpayers. The Board's recommendation will provide taxpayers in the middle market an appropriate opportunity to fund their working capital needs using the corporate tax rate. In effect, this option will allow business trusts to accumulate income using the corporate rate, without introducing the complexity associated with the Tax Act of trying to treat a trust like a company.

10.2 TTB election and the extent of benefits provided

10.2.1 We note that the Board's proposal deals solely with loans and therefore is unlikely to extend to business payments, such as the use of company assets by a trust.

10.2.2 At a high level, we agree with the limited exclusion and do not suggest that the recommendation be extended to payments made by the company to the trust. We acknowledge extending the exception could otherwise open up tax planning opportunities which may not be covered by the integrity rules (i.e. an interposed entity rule). For example, the TTB should not be extended to payments such as where a company settles a discretionary trust with $1 million of trust capital. Accordingly, we are conscious that this important TTB exception needs to be a limited exclusion to ensure that it is capable of practical administration.

10.2.3 However, we do highlight that, where trusts have made a TTB election, many taxpayers and practitioners will expect the relevant entities to be able to operate as though Division 7A would not apply. That is, where the trust is used solely for business purposes, many would expect all Division 7A arrangements to be excluded. Therefore, this expectation will likely mean that there will be arrangements that inevitably trigger the operation of the New Regime inadvertently, due to what is expected to be a common misunderstanding that the TTB election covers more than it otherwise should.

10.2.4 An example would be where the trust uses the depreciable assets owned by the company for business purposes. Such a transaction is currently excluded from Division 7A. However, under the current recommendations, it would not be excluded under a TTB election and could therefore give rise to a deemed dividend under the revised provisions.

10.2.5 As highlighted at Section 12, we believe that this issue could be dealt with by the introduction of an otherwise deducible rule concurrently with the New Regime. However, without such a rule, we note that there is likely to be a misconception as to the extent of the TTB election and what transactions are safe under Division 7A (the most common being payments).

10.3 CGT on goodwill assets

a) Support for proposal

10.3.1 The Board's discussion paper proposes that a trust that has made a TTB election will be excluded from applying the 50% capital gains tax discount, unless the capital gain relates to goodwill (either directly or indirectly through the sale of shares). Although not stated in the Board's report, we expect that the reference to shares would extend to other equity interests, including units in a unit trust.

10.3.2 We support the retention of the CGT exemption for goodwill on the disposal of the business by the trust. This is in line with the policy principles covered in Chapter 4. It also ensures that trusts are not disadvantaged as compared to companies.

10.3.3 That is, outside of the proposals, a company (owned by a trust) can be established to run the business, whereby the 50% capital gains tax discount is available on the disposal of its shares. Accordingly, the business can obtain access to the 30% tax rate on profits, whilst the owners can enjoy the CGT discount on the sale of the business. The TTB election will replicate this scenario for smaller business taxpayers, by allowing a 30% tax rate for business profits and the CGT discount on the ultimate disposal of the business.

b) Identifying goodwill

10.3.4 We note that restricting the CGT exemption to goodwill is likely to give rise to disputes as to whether the relevant consideration is attributable to goodwill, or other intangible assets closely related to goodwill (such as trademarks or intellectual property). We believe that this this will cause unnecessary compliance.

10.3.5 We provide two possible approaches that the Board could consider to address this issue. The first is to exclude all capital gains based on an active (business) asset definition, similar to that contained in Division 152. An alternative would be to allow the CGT discount to apply where it is related to the disposal of a business (or the disposal of equity interests where the assets are predominantly employed in a business). These various options would have their benefits and limitations. That being said, if the extension of the CGT discount to business assets is accepted by the Board, the method chosen should be the one that takes into account compliance costs associated with applying the relevant test.

c) Other CGT assets that are active

10.3.6 Arguably there will be some active assets that are (in their very nature) viewed as passive assets. For example, "real property" type assets. There will however, be cases where the value embedded in such assets will be no different to "goodwill" value for the business owner that operates their business through the asset.

10.3.7 For example, a business owner may run a business using a factory or other real estate as the base of their operations. To the extent that the business is run through a trust and the asset is active, one would argue that such an asset should be capable of accessing the 50% capital gains tax discount provisions on a disposal of the business.

10.3.8 Likewise, a shopping centre business may also be a long term business that may attract CGT discount on the sale of the shopping centre (whereby the value of the business may effectively be embedded in the real property and land). To the extent that the disposal of these types of assets are connected with a business or the sale of a business, the ability to claim the CGT discount is no different to selling shares in a company that would otherwise hold these assets.

10.3.9 Accordingly, the principle for allowing the CGT discount in these cases seems consistent with the Board's recommendation.

10.4 An ability to retrospectively apply a TTB election

10.4.1 The Board's discussion paper recommends the ability to make a TTB election, having application from the time of making the election. The consequence of the election would be that pre-TTB assets would still be eligible for the 50% capital gains tax discount, while pre-TTB loans and UPEs would be subject to their existing terms.

10.4.2 We have provided our detailed comments on transitional arrangements in Section 10.5. However, we make two recommendations in respect of the timing of a TTB election. We believe that both of these options could help to reduce compliance costs associated with these two classes of arrangements.

10.4.3 The first is that we believe it should be possible to make a TTB election to cover all CGT assets that are held by the trust at the start of the year for which the election is made. That is, under this option, all assets would lose the CGT discount if they are held at the time of making the election if the taxpayer so chooses. In such a case, the trust should be given the option of applying the TTB exception for all existing loan and UPE arrangements. This ability to apply the TTB election to all CGT assets would greatly simplify the tracking of loans and UPEs where the trust does not hold any CGT assets other than goodwill related intangibles.

10.4.4 The second is that we believe a retrospective TTB should be allowed as a part of the self-correction mechanism. That is, similar to allowing a family trust election ("FTE") to be made retrospectively, the legislation should allow for TTBs to be made retrospective where the following types of conditions are satisfied:

- The election can be made retrospectively to a prior year, at the request of the taxpayer only.
- Making a retrospective election would mean that any CGT asset acquired after that date would not be eligible for the 50% capital gains tax discount.
- The limited amendment period in s.170 would be opened for any net capital gain that has been derived post the retrospective election, due to the removal of the 50% capital gains tax discount on the relevant asset.

10.4.5 The key risk associated with allowing the retrospective election would be that taxpayers may wait and see whether the CGT asset results in a capital gain, prior to electing to retrospectively make a TTB. This may be seen as defeating the purpose of having an election that was irrevocable. However, if the election is required to be lodged with the ATO (as with the FTE), taxpayers may be reluctant to make retrospective elections. Furthermore, additional criteria could be introduced to provide some integrity around this issue.

10.4.6 Where a retrospective election is provided to taxpayers, such taxpayers will be able to fix inadvertent Division 7A issues that are discovered some years down the track by making a retrospective TTB election in an earlier year (as though the election had been made for all of the intermediary income years).

10.5 Transitional provisions

a) Basic case

10.5.1 We agree with the proposed transitional rules contained at paragraphs 6.50 to 6.52 of the Second Discussion Paper. That is, that existing terms continue to apply to transitional arrangements under the reform provisions. We have also commented on transitional CGT arrangements at Section 10.4 above. In general, we believe that the proposal forms the basis for the majority of transitional provisions required.

10.5.2 Due to the complexity of the arrangements that currently exist, we highlight that a number of additional transitional rules will be required to bring in those other arrangements in an appropriate manner. We believe that these transitional rules can be based on similar

propositions to that contained in the Second Discussion Paper. We have provided our thoughts on these proposed transitional rules below.

b) Summary of transitional provisions

10.5.3 The following dot points summarise suggested transitional rules that could be used to deal with a number of transitional arrangements that are currently covered by the operation of Division 7A.

10.5.4 In our view, the transitional rules should try to ensure that all existing arrangements can be transitioned into the New Regime, so that the existing Division 7A provisions can be repealed. We believe that it is important to achieve this objective, as the complexity that would otherwise be associated with running two regimes would be very difficult to comply with, as well as administer from an ATO perspective.

10.5.5 In order to achieve this, we refer to the Board's transitional recommendation. We submit that all existing Division 7A transitional arrangements should be able to continue on their "existing terms" under the New Regime. Those arrangements should be deemed to be complying arrangements for the purpose of the New Regime. For example, pre 16-12-2009 UPEs, post 16-12-2009 UPEs on sub-trust arrangements, seven year loans and 25 years loans under Division 7A would all be treated as loans and would all be deemed to satisfy the safe harbour loan terms under the New Regime.

10.5.6 A reference to the phrase "existing terms" above should include compliance with the terms under Division 7A or an ATO pronouncement (including a ruling or practice statement in force at the time of transition). Accordingly, the New Regime could provide support and certainty for UPEs under the practice statement.

10.5.7 As an exception to the rule outlined in the first dot point, an existing seven year loan arrangement should be allowed to be transitioned into the new 10 year loan safe harbour rules, provided that the loan complies with the new safe harbour provisions from the day the loan is transitioned into the New Regime.

10.5.8 No special transitional arrangements should be required for existing asset usage arrangements, provided that the New Regime broadly applies in the same manner as the existing provisions.

10.5.9 To the extent that a pre 16-12-2009 UPE is owed by a trust that makes a TTB election, we believe that the arrangement should be capable of being refinanced under the New Regime without any consequences under the New Regime.

10.5.10 Each of these proposed transitional items is discussed in further detail in the following paragraphs.

c) Trans Rule 1: Repeal of Division 7A

10.5.11 It is our preference that Division 7A is repealed and that existing arrangements be transitioned into the New Regime.

10.5.12 We believe that it would be overly complex to have two regimes apply concurrently at the same time. We note that this was the case when Division 7A was introduced, which gave rise to significant complexity on the operation of s.108. We highlight that s.108 was subsequently repealed.

10.5.13 We therefore recommend that the Board consider recommending the repeal of Division 7A (in its entirety) and that all arrangements be transitioned into the new regime.

10.5.14 Our transition recommendations below are consistent with being able to transition all existing arrangements into the New Regime. We understand that our suggestions will not provide a perfect solution for all arrangements. However, in order to reduce complexity, we believe that a practical approach may be required where both compliance costs and integrity of the provisions are appropriately balanced.

d) Trans Rule 2: Loans made by companies under existing terms

10.5.15 In line with the propositions at paragraphs 6.50 to 6.52 of the Second Discussion Paper, where a company has a pre-existing loan with a trust or individual under complying terms (i.e. not including UPEs), we believe that the transitional provisions should treat the existing terms of the loans as being compliant for the purpose of the New Regime.

10.5.16 Accordingly, a principal and interest loan over seven years or 25 years at the current benchmark interest rate under Division 7A should be deemed to be compliant under the New Regime.

e) Trans Rule 3: Converting seven year existing loans to the new safe harbour terms

10.5.17 Taxpayers could be given an option to transition loans (under the current seven year terms) to the new safe harbour terms. Under this transitional rule, the statutory interest rate under the New Regime would apply at the time of transition, with loan repayment amounts required from that date onward in compliance with the New Regime. Therefore, taxpayers would need to simply ensure that the loan complied with the New Regime from that period onward. No loan term conversions would be necessary (outside of requirements that may be contained in legal documents).

10.5.18 To demonstrate this type of transitional rule, assume an existing seven year Division 7A loan (of $100) is already into its fourth years of operation under Division 7A (with three years of the loan term remaining). Assume that the loan balance at the end of the fourth year is equal to $50.

10.5.19 For the purpose of transitioning the arrangement into the New Regime, the interest rate charged for the fifth year would be equal to the statutory interest rate under the New Regime (e.g. say that is 12% for the purpose of this example). Accordingly, $6 of interest would be charged for the fifth income year. At the end of the fifth income year, the loan balance would be equal to $56 (including accumulated interest). Under the New Regime, the loan balance would need to be reduced to 55% of the original loan, being $55. Accordingly, a loan repayment of $1 would be required in order to comply with the New Regime.

10.5.20 The above transitional rule could be utilised for loans under the seven year arrangement terms contained currently in Division 7A. However, the above transitional rule is unlikely to be practical for loans made under the 25 year arrangement terms (e.g. where a loan is already in its 11th year).

f) Trans Rule 4: Existing asset usage arrangements

10.5.21 We do not believe that special transitional rules would be required for asset usage arrangements, provided that the safe harbours in the New Regime are broadly the same as the current provisions in Division 7A.

10.5.22 That is, provided the New Regime contains an otherwise deductible rule allows for similar exclusions such as those relating to the principal residence exemption, and ensures that the FBT interaction is broadly consistent with the existing measures, we do not envisage significant issues with transferring transitional asset usage arrangements to the New Regime.

g) Trans Rule 5: Pre 16-12-2009 UPEs – TTB election

10.5.23 Where a pre-16 December 2009 UPE exists, and the entity has made a TTB election, there will be no real difference between the treatment of a UPE under the current Division 7A provisions as compared to a UPE under the proposed New Regime.

10.5.24 Accordingly, we see no reason why such transitional UPEs could not simply fall into the TTB election exception. That is, while the Board has proposed that such UPEs should be excluded from the TTB election, we believe that an exception should be made for these UPEs.

h) Trans Rule 6: Pre 16-12-2009 UPEs – no TTB election

10.5.25 Where a trust that does not make a TTB election has an existing UPE with a company, we understand that it is the Board's recommendation that any loans (including UPEs owing to a company) in place prior to transition to the New Regime would continue to be subject to the existing requirements.

10.5.26 Generally, most pre-16 December 2009 UPEs would be on terms that are "at call" and interest free with the relevant corporate beneficiary. Accordingly, such UPEs should continue to remain on these terms. This proposition is consistent with the treatment of pre-UPEs where the trust makes a TTB election.

10.5.27 We note that the treatment of the transitional arrangement in this manner is likely to give rise to transitional issues around the application of the interposed entity provisions (refer to Section 10.6). This is because this rule (coupled with Trans Rule 1 and an exception for the interposed entity rule where the first leg is complying) would effectively circumvent the interposed entity rules that would otherwise apply currently (i.e. Subdivision EA). Accordingly, where this is the case, the proposed interposed entity rule (see Section 10.6 below) should still apply.

10.5.28 Provided that the interposed entity rules are drafted in a manner that specifically deals with this issue, we see no reason why these arrangements could not be transitioned into the new Division 7A provisions on this basis.

i) Trans Rule 7: Post 16-12-2009 UPEs (all trusts)

10.5.29 The existing terms for a post 16-12-2009 UPE that has been placed on a sub-trust investment arrangement may be various. Generally speaking, the arrangements could be either a 7 or 10 year interest only arrangement, or may be an alternative commercial arrangement that has been accepted by the Commissioner under a private ruling.

10.5.30 One problem that occurs with the arrangements that are in compliance with PSLA 2010/4 is that their terms are governed by a non-binding practice statement, rather than legislation. Accordingly, this may present challenges for a transitional rule seeking to rely on a non-binding ruling.

10.5.31 One way to deal with the above issue is to ensure that a reference to "existing terms" be taken to be a reference to terms determined under the legislation, or in accordance with a ruling (private or public) or practice statement issued by the ATO. Accordingly, while the loan terms contained in the practice statement may not have the force of law, the transitional provision could be drafted to respect those terms and conditions on transition into the new Division 7A.

10.6 Interposed entity rule

a) Overview

10.6.1 As outlined in paragraph 6.45 of the Second Discussion Paper, the TTB election will likely need to be supported by an interposed entity provision, similar to s.109T. We agree with this recommendation as a necessary consequence of providing an exception from Division 7A where a trust makes a TTB election. However, we acknowledge that some modifications may be required for transitional UPEs, which are discussed below.

b) Modifications

10.6.2 The discussion paper also suggests that the provision will need to be "strengthened" to deal with arrangements through trusts that make a TTB election. Our consideration of s.109T and how it would apply to ordinary arrangements through interposed trusts that have made a TTB election does not suggest that there would be technical issues with being able to apply the main operative provisions of s.109T. We highlight that the application of s.109T to these cases would be no different to its application where benefits are provided through one or more companies that are excluded by virtue of s.109K (where those companies do not have a distributable surplus).

10.6.3 However, we understand s.109T may not apply where transitional arrangements are brought within the New Regime, where those transitional arrangements are UPEs. Reference is made to the proposed rules for transitional UPE arrangements, where it is

understood that the Board's is proposing to allow transitional UPEs (that are pre-16 December 2009 UPEs) to remain on their original terms (at call, interest free).

10.6.4 Where this is the case, we note that it will be difficult to apply s.109T to those pre-existing arrangements, even where such UPE arrangements are treated as "loans" for the purpose of the New Regime. This is because these transitional UPEs may be long standing UPEs (for example, a UPE that was created in the 30 June 2000 income year). Where such a UPE exists, it may be difficult to apply a reasonable person test to both the transitional UPE arrangement and the arrangement involving the target entity (even if the arrangement with the target entity is subsequent to transition into the New Regime).

10.6.5 We note that this issue does not occur under the current provisions contained in Division 7A, as the interposed entity rule contained in Subdivision EA does not apply a reasonable person test. That is, provided there is a UPE outstanding that exists with a private company at the relevant point in time, Subdivision EA can be applied to the interposed entity (which may cover one or more interposed entities through Subdivision EB).

10.6.6 Taking this into account, we do not believe significant modifications are required to ensure that an interposed entity rule can apply appropriately to such transitional arrangements under the New Regime. That is:

- We believe that s.109T can be used (in principal) as the basis for the interposed entity provisions.
- Where the first leg of the arrangement is a loan (including a UPE), a "reasonable person test" may not be necessary (in a similar manner to Subdivision EA in the current law).
- Where the first leg involves any other benefit (e.g. a payment), a reasonable person test may be necessary to ensure that taxpayers are able to track and apply the interposed entity rule in a practical sense.

10.6.7 Based on the above, we do not believe that the interposed entity rules will need to be "strengthened" per se. However, we acknowledge that they will need to be appropriately considered and drafted to take into account various different arrangements that may be in place at the commencement of the provisions.

11 Self-correcting mechanism

Q 6.4 Issues/Questions

The Board seeks stakeholders' comments on:

a. whether a legislative self-correction exception should be available to taxpayers to correct mistakes or omissions;

b. the nature of any eligibility requirements for the exception;

c. the nature of any conditions that should be satisfied to qualify for the exception;

d. appropriate record keeping and evidentiary requirements that must be met to qualify for the exception; and

e. any impediments to the practical administration of the exception.

11.1 Response

11.1.1 We provide our support for a legislative self-correction measure, to be included within the New Regime as an effective replacement of the Commissioner's broad discretion.

11.1.2 Due to the complexity of Division 7A and the punitive tax outcome that can result when a taxpayer contravenes the provisions, we believe that a self-correction measure would provide a fair outcome to taxpayers that have inadvertently breached the provisions.

11.1.3 However, it will also be important that a self-correction provision must not be seen by taxpayers as a means to escape taxation – i.e. as it would then encourage non-compliance with Division 7A. If this were the case, then the provision is unlikely to have a long shelf life under the New Regime.

11.1.4 Accordingly, it is important that the self-correction mechanism will need to include certain integrity measures to ensure that the provision continues to encourage active compliance with Division 7A and does not result in mass non-compliance or arbitrage opportunities.

11.2 The eligibility requirements

11.2.1 In order to achieve the objectives outlined above, we believe that the self-correction mechanism will need to contain a number of elements. We have listed a few for consideration by the Board.

11.2.2 A self-correction mechanism should allow taxpayers to be given an opportunity to correct a Division 7A error once the error has been detected (subject to time extensions outlined below).

11.2.3 Broadly, this would mean that the self-correction mechanism would not be available where the breach was deliberate (i.e. either intentional or where the taxpayer knew the error existed and did not try to comply with Division 7A until discovered in the course of an ATO audit).

11.2.4 The consequence of applying the self-correction mechanism would be that the arrangement would not be taken to have given rise to a deemed dividend.

11.2.5 Limiting the provision to unintentional breaches will ensure that active compliance is maintained. It will also limit the ability for taxpayers to manipulate the timing of income and dividends using hindsight.

11.2.6 The self-correction mechanism should require the Division 7A error to be corrected by the time the tax return is lodged for the year in which the error is discovered.

11.2.7 In order to self-correct the Division 7A error, the taxpayer should be required to make a correction to the arrangement such that it would be compliant with Division 7A from the moment the self-correction is implemented.

11.3 Non-deliberate failures of Division 7A

11.3.1 As noted above, we believe that the self-correction mechanism should be limited to non-deliberate failures of Division 7A. We believe that this could be identified by ensuring that a Division 7A error can only be corrected by the time of lodgement of the tax return for the year in which the error is detected.

11.3.2 We acknowledge that this may give rise to difficult questions as to when the self-correction mechanism would be available. As with all other taxation provisions, the onus will be on the taxpayer to prove that the Division 7A error was not part of a deliberate failure of the provisions.

11.3.3 Theoretically, there will be a question as to whether any taxpayer will be able to access the self-correction measure if they knew of the operation of Division 7A, but did not detect the relevant error. This would arise as a question for example, in a case where a taxpayer (or their advisor) are aware of Division 7A, but did not comply with the safe harbour loan terms with respect to an arrangement. Objectively, where an error is simple, there will naturally be a concern that the error was deliberate in the absence of sufficient evidence to the contrary..

11.3.4 If this were to be considered a real concern, we believe that a reasonable person test could be employed as a gateway test to address this concern. For example, a self-correction provision could operate when a Division 7A error is detected; and it is reasonable to conclude that the Division 7A error was not due to a deliberate failure of Division 7A. It is noted that this is not very different to the current threshold test of inadvertent omission or honest mistake. Essentially, the test proposed in this submission is similar, except that it looks at whether the error is dishonest – i.e. the onus is on taxpayers to prove that they have not been dishonest in the event that the ATO challenges their use of the self-correction mechanism.

11.4 Ways to self-correct

11.4.1 Provided that the Division 7A error is corrected by the lodgement time for the income year in which the error is detected, we believe that the error should be capable of correction using any mechanism available to the taxpayer.

11.4.2 This would include: (1) the repayment of the loan; (2) the payment of consideration for services; (3) the charging of interest at the appropriate rate; (4) the payment of a dividend; and (5) the offset of the loan payable with a loan receivable that exists with the same entity.

11.4.3 Therefore, the self-correcting measure should simply require that appropriate action be taken to put the arrangement in a position that would be compliant from that moment onward. We do not believe it would be necessary to provide detailed rules within the legislation.

11.4.4 We refer to PSLA 2007/20, where the Commissioner provided guidance on how to self-correct a Division 7A error. The practice statement covered errors involving loans, payments, expenses, minimum loan repayments and interposed entity arrangements. We therefore believe that a high level principle that provides appropriate flexibility could be administered appropriately by the ATO.

11.4.5 As outlined in Section 10.4, we also believe it will be important to provide a trust with the ability to make a retrospective TTB election. We believe that this would greatly assist those taxpayers that use trusts for business purposes that inadvertently fail the requirements of Division 7A where they did not otherwise know of the consequences of the provisions. We note that under the current law, the ATO have applied the Commissioner's discretion where the trust has agreed to distribute and pay all profits to a corporate entity. A retrospective TTB essentially achieves this same outcome.

11.5 Continuation of a limited Commissioner's discretion

11.5.1 While the self-correcting mechanism would help to address the majority of cases involving Division 7A errors, we would still expect there to be cases where it is not possible to comply with Division 7A. For example, cases involving financial hardship or distress, or where it is not possible to make a minimum loan repayment due to factors outside of the taxpayers control.

11.5.2 Accordingly, we would welcome the ability for there to be a limited Commissioner's discretion within the New Regime that covered these cases. Reference is made to s.109Q and s.109RD within the current legislation.

11.6 Examples demonstrating a self-correction mechanism

a) Example 1 - payment to shareholder

11.6.1 Aco makes a payment on behalf of individual X, the shareholder in year 1. The amount is for $100. The taxpayer becomes aware of the Division 7A breach in year 3. Ordinarily, a deemed dividend would have arose in year 1 for $100.

11.6.2 On discovery, Aco and X look to self-correct the Division 7A error. Aco converts the payment to a loan and charges interest in year 2, and year 3 at the benchmark interest rate. Aco adjusts its tax returns for the interest income (assessable) and pays tax on that amount. The balance of the loan is repaid by the shareholder at the end of year 3.

11.6.3 The error is therefore corrected and the amount of the correction at the end of the income year places the company in the same position as if it had a complying arrangement at that time. The effect of the correction is that a deemed dividend does not arise for the taxpayer.

b) Example 2 – deliberate breach of Division 7A

11.6.4 Aco loans an amount of $100 to individual X who buys an asset. Aco and X deliberately do not comply with Division 7A. In year 5, X sells the asset for $180 and repays the loan to Aco at the end of year 5.

11.6.5 Aco and X then seek to correct the Division 7A breach. In the ordinary case, the charging of interest and the repayment of the loan at the end of year 5 could possibly result in the satisfaction of the self-correction provisions. Accordingly, charging $61.05 of interest and repaying the full amount of $161.05 may ordinarily amount to correction of the problem. However, the effect of the self-correction mechanism in this case is that it would change a principal and interest loan to an interest only loan. That is, when you examine what the taxpayer has done in this case, they have not been required to make minimum repayments during the course of the loan. Thus, the self-correction mechanism could be seen as defeating the requirement to comply with the loan terms under New Regime.

11.6.6 If in this case Aco and X have deliberately failed to comply with the requirements of Division 7A, the self-correction mechanism should not be available. Allowing retrospective correction in these cases would not encourage active compliance with the provisions and may subject the provisions to manipulation. The unfortunate consequence of this behaviour could result in the self-correction mechanism being ultimately unsustainable and thus taxpayers who legitimately wish to correct errors may not be given an opportunity. Accordingly, we support a proposal of limiting the self-correction mechanisms to errors that are not deliberate.

11.6.7 We acknowledge that this may give rise to difficult questions as to when the self-correction mechanism would be available, as the onus will be on the taxpayer to prove that the Division 7A error was not part of a deliberate failure of the provisions. If this is considered to be a real issue, we have suggested the possibility of a reasonable person test to provide some level of comfort on this issue (see Section 11.3 above).

12 Proposed safe harbour – otherwise deductible rule

12.1 Overview

12.1.1 The purpose of this section is to provide further detail on a possible "otherwise deductible" rule that could be used as a safe harbour under the New Regime.

12.1.2 We believe that a limited safe harbour for arrangements (other than loans) should apply in the New Regime, consistent with the exception contained in the current Division 7A provisions.

12.2 Summary of proposal

12.2.1 One of the key problems that may occur when trusts interact with companies is that key transactions between the relevant related party entities are not otherwise identified or priced in accordance with arm's length pricing. If the New Regime proceeds with a requirement to identify the "value" of arrangements between such entities, this could lead to an unintended application of the New Regime to business related transactions.

12.2.2 This issue is somewhat avoided under the current Division 7A for non-private transactions, where most transactions are either priced at "cost", or enjoy the benefit of the current "otherwise deductible" rule. This makes the provisions relating to "payments" under the current regime relatively simple to comply with. It is not common for there to be Division 7A issues under the current payment rules.

12.2.3 In replicating this in the New Regime, we would support the introduction of an "otherwise deductible" rule as an exception to there being a deemed dividend. We believe that the exception would be a relatively simple test that could be applied by business taxpayers operating through numerous entities. We note that it is a test that currently sits in s.109CA(5) and is also applied for Fringe Benefits Tax purposes. Furthermore, we would envisage that the exception would be limited to arrangements other than loans. Accordingly, we would expect that the provision would apply to payments, asset usage arrangements and services performed between various business related entities.

12.2.4 With respect to all arrangements other than loans, our testing has indicated that an "otherwise deductible" rule has the immediate effect of shifting income to the shareholder or associate. That is, the provision operates akin to an automatic "deemed dividend", by ensuring that the amount that otherwise would have been charged to the recipient does not shelter its other income. Accordingly, from a policy perspective, applying this principle provides effectively the same outcome as though the arrangement resulted in a deemed dividend.

12.2.5 We have also tested the application of this proposed exception to loans, but acknowledge that it is likely that an otherwise deductible rule for loans could produce benefits for some passive investments held by individuals or trusts. This would occur where the shareholder or associate does not rely on assessable dividends to fund loan repayments. We are conscious that this could have the behavioural effect of encouraging loans to be

taken out for non-business (but still income producing) purposes. Accordingly, our proposal has not sought to extend this exception to loans under the New Regime.

12.2.6 Therefore, in the testing provided in this submission, we believe that the otherwise deductible rule will lead to an increase in the incidence of taxation, rather than a reduction of tax payable. We therefore believe that, as our testing indicates, the proposed exception will be consistent with the four policy principles contained in Chapter 4.

12.3 Key aspects of an otherwise deductible rule

12.3.1 An otherwise deductible rule would be framed in a similar manner to that contained in the current s.109CA(5). That is, to the extent that the company would have charged for the "benefit", the otherwise deductible rule would test whether the recipient of the benefit would have otherwise obtained a full deduction for that charge.

12.3.2 Where the amount satisfied the otherwise deductible test, the company would not be required to charge an amount for the benefit provided to the shareholder or associate for Division 7A purposes.

12.3.3 We believe that this rule could mainly be applied to "payments" that are made by a company. This would include services and assets provided by the company to the shareholder or associate.

12.3.4 However, for the rule to apply, the charge would need to be otherwise deductible. Accordingly, if an asset were transferred to the shareholder or associate (e.g. the transfer of a depreciable asset), the charge would be for a capital asset and not deductible. The same conclusion would also apply to a debt waiver or forgiveness transaction, where the recipient of the benefit would not otherwise obtain a deduction if no such waiver or forgiveness had occurred. Accordingly, the otherwise deductible rule would only apply to business type transactions as between companies, trusts and individuals.

12.3.5 The following sections provide a number of examples which are used to demonstrate the application of the otherwise deductible rule to various payment type transactions. For the purpose of the example, the corporate tax rate of 30% has been used and a top marginal tax rate of 46.5% has also been used.

12.4 Example 1 – Payments to shareholders or associates

a) Background

12.4.1 The purpose of this example is to demonstrate the application of the proposed otherwise deductible rule to payments made by a company on behalf of a shareholder or associate.

12.4.2 In this example, the relevant company has assessable income of $100 and after tax profits of $70, out of which it pays an expense worth $70 on behalf of the relevant shareholder. The company subsequently charges $70 to the shareholder to avoid the application of Division 7A, where the charge is deductible to the shareholder in full. The shareholder derives $200 of other assessable income during the same income year.

12.4.3 This example is considered using three different scenarios. The first is where the shareholder is an individual at the top marginal rate. The second is where the shareholder is a trust that uses a corporate beneficiary. The third is an expansion of the second, whereby all companies distribute 100% of their profits to their individual shareholders.

b) Scenario 1 – individual taxed at marginal rates

Charge by the company to the shareholder

12.4.4 In this first scenario, the company charges the individual $70, which is assessable to the company and deductible to the individual.

12.4.5 The net tax position of the company arising from this charge would be nil (i.e. income of $70 is equal to its expense of $70). The net tax income position of the individual is equal to $130. The tax payable by the individual is equal to $60.45.

Otherwise deductible rule applied by the shareholder

12.4.6 If an otherwise deductible rule is applied to this example, the company would incur a $70 expense, which would be potentially non-deductible[4] .This would reduce its retained earnings to nil. The company would still have assessable income of $100 and therefore an income tax expense of $30.

12.4.7 The individual would not obtain a deduction and thus would be assessable on $200. The individual would therefore incur a tax liability of $93.

12.4.8 Accordingly, this represents an increased incidence of income tax by $32.55, calculated as 46.5% of $70. In effect, the application of an otherwise deductible rule in this scenario results in a wastage of franking credits ($30) and treats the benefit of $70 in an equivalent manner to an unfranked dividend to the shareholder.

c) Scenario 2 – tax payable at the corporate tax rate

Charge by the company to the shareholder

12.4.9 In this second scenario, the company charges the trust $70, which is assessable to the company and deductible to the trust. The trust distributes all profits to a corporate beneficiary.

12.4.10 The net tax position of the company arising from this charge would be nil (i.e. income of $70 is equal to its expense of $70). The net tax position of the trust would be equal to $130. Using a corporate beneficiary, the tax payable by the corporate beneficiary would be equal to $39.

[4] We note that a deduction may be potentially available if the amount is incurred in earning assessable income. To the extent that the company owns an interest in a trust and expected to derive assessable income from the trust, a *Total Holdings* argument may allow the deduction.

Otherwise deductible rule applied by the shareholder

12.4.11 If an otherwise deductible rule is applied to this example, the company would incur a $70 expense, which would be potentially non-deductible. This would reduce its retained earnings to nil. The company would still have assessable income of $100 and therefore an income tax expense of $30.

12.4.12 The trust would not obtain a deduction and thus would be assessable on $200. The total tax payable using a corporate beneficiary would be equal to $60.

12.4.13 The key difference with this scenario is that no benefit is obtained for the expense paid by the company of $70. That is, the amount is not deductible. Accordingly, the company forgoes a tax effected deduction of $21 (being $70 x 30%).

d) Scenario 3 – all dividends paid to shareholders

Charge by the company to the shareholder

12.4.14 This third scenario is an expansion of the second, whereby all of the retained earnings of each company is paid to an individual shareholder at top marginal rates.

12.4.15 As the original company has $70 of retained earnings, this results in additional top-up tax of $16.50. The corporate beneficiary has retained earnings of $130. This results in additional top-up tax of $21.45. The total top-up tax payable would be equal to $37.95.

12.4.16 Taking into account the tax payable under scenario 2, this scenario would result in total tax payable of $76.95.

Otherwise deductible rule applied by the shareholder

12.4.17 If an otherwise deductible rule is applied to this example, there would be no profit in the original company and thus no dividend or top-up tax payable with respect to this entity. As the entity has $30 of franking credits, such credits would be wasted.

12.4.18 The corporate beneficiary would have $140 of retained earnings after tax. This would result in a dividend of $140 and additional top-up tax of $33.

12.4.19 Taking into account the tax payable under scenario 2, this scenario would result in total tax payable of $93. When compared with the tax outcome of a charge by the company this is an additional amount of tax equal to $16.05.

12.4.20 This additional tax represents the loss of a deduction of $21 to the corporate entity for the expense incurred ($70 x 30%), less the reduction of tax paid on the after tax dividend of $59 as compared to $70 (i.e. $4.95). The net of these two amounts is equal to $16.05.

e) Summary of results

12.4.21 Where a company applies an otherwise deductible rule for expense payment type benefits, the effect is akin to a distribution of profit to the shareholder or associate to the extent that the shareholder or associate does not shelter its taxable income.

12.4.22 All examples indicate that there is an increased incidence of taxation where the otherwise deductible rule is applied to such cases and thus the proposition is consistent with Policy Principle 1. Furthermore, the payment of expenses on behalf of a shareholder or associate does not promote passive activities over active activities. Finally, as demonstrated by the example, the otherwise deductible rule would be relatively simple to apply in practice.

12.5 Example 2 – Use of assets by the shareholder

a) Background

12.5.1 The purpose of this example is to demonstrate the application of the proposed otherwise deductible rule to a transaction involving company assets that are used by a shareholder or associate.

12.5.2 In this example, the relevant company has after tax profits of $70 and acquires a depreciating asset worth $70, which will be used by the shareholder of the company for income producing purposes. The asset has an effective life of seven years, and is depreciated using the prime cost method (i.e. at $10 per annum).

12.5.3 An annual rental charge of $17 is to be charged to the shareholder. The shareholder is expected to derive $50 of net assessable income for each of the 7 income years.

12.5.4 This example is considered using three different scenarios. The first is where the shareholder is an individual at the top marginal rate. The second is where the shareholder is a trust that uses a corporate beneficiary. The third is an expansion of the second, whereby all companies distribute 100% of their profits to their individual shareholders.

b) Scenario 1 – individual at marginal rates

Charge by the company to the shareholder

12.5.5 In this first scenario, the company charges the individual $17 per annum, which is assessable to the company and deductible to the individual. The tax calculation for both the company and the individual is contained in the following schedule.

Tax payable calculation of company (lessor)				
Year	**Rental**	**Depn**	**Total**	**Tax**
1	17.00	(10.00)	7.00	(2.10)
2	17.00	(10.00)	7.00	(2.10)
3	17.00	(10.00)	7.00	(2.10)

4	17.00	(10.00)	7.00	(2.10)
5	17.00	(10.00)	7.00	(2.10)
6	17.00	(10.00)	7.00	(2.10)
7	17.00	(10.00)	7.00	(2.10)
Total	**119.00**	**(70.00)**	**49.00**	**(14.70)**

Tax payable calculation of shareholder (lessee)				
Year	**Income**	**Rental**	**Total**	**Tax**
1	50.00	(17.00)	33.00	(15.35)
2	50.00	(17.00)	33.00	(15.35)
3	50.00	(17.00)	33.00	(15.35)
4	50.00	(17.00)	33.00	(15.35)
5	50.00	(17.00)	33.00	(15.35)
6	50.00	(17.00)	33.00	(15.35)
7	50.00	(17.00)	33.00	(15.35)
Total	**350.00**	**(119.00)**	**231.00**	**(107.42)**

12.5.6 The above table shows that the net tax payable over the seven years would be equal to $122.12, consisting of $14.70 of company tax and $107.42 of tax at the top marginal rate.

Otherwise deductible rule applied by the shareholder

12.5.7 If an otherwise deductible rule is applied to this example, the company would incur a $70 expense over seven years (i.e. the depreciation charge). This charge would be non-deductible as no income is derived by the company. The transaction would have the effect of reducing its retained earnings to nil. The individual would not obtain a deduction and thus its assessable income would remain at $350 over the seven year period. The total tax payable would be equal to $162.75. These calculations are shown in the following tables.

Tax payable calculation of company (lessor)				
Year	**Rental**	**Depn**	**Total**	**Tax**
1	-	(10.00)	(10.00)	-
2	-	(10.00)	(10.00)	-
3	-	(10.00)	(10.00)	-
4	-	(10.00)	(10.00)	-
5	-	(10.00)	(10.00)	-
6	-	(10.00)	(10.00)	-
7	-	(10.00)	(10.00)	-
Total	**-**	**(70.00)**	**(70.00)**	**- ****

*** Note, while there is annual depreciation, this amount is not incurred for a taxable purpose.*

Tax payable calculation of shareholder (lessee)				
Year	**Income**	**Rental**	**Total**	**Tax**
1	50.00	-	50.00	(23.25)
2	50.00	-	50.00	(23.25)

3	50.00	-	50.00	(23.25)
4	50.00	-	50.00	(23.25)
5	50.00	-	50.00	(23.25)
6	50.00	-	50.00	(23.25)
7	50.00	-	50.00	(23.25)
Total	**350.00**	**-**	**350.00**	**(162.75)**

12.5.8 The total tax collected under this scenario is equal to $162.75. The increase of tax collected of $55.33 represents top-up tax paid on the additional income derived by the shareholder (i.e. 46.5% x $119 = $55.34). In effect, the otherwise deductible rule works to distribute the value of the "asset usage" charge to the recipient over the seven year period (similar to a deemed unfranked dividend).

c) Scenario 2 – tax payable at the corporate rate

Charge by the company to the shareholder

12.5.9 In this first scenario, the company charges the trust $17 per annum, which is assessable to the company and deductible to the trust. The trust distributes all profits to a corporate beneficiary. The tax calculation for both the original company and the corporate beneficiary is contained in the following schedule.

Tax payable calculation of company (lessor)				
Year	**Rental**	**Depn**	**Total**	**Tax**
1	17.00	(10.00)	7.00	(2.10)
2	17.00	(10.00)	7.00	(2.10)
3	17.00	(10.00)	7.00	(2.10)
4	17.00	(10.00)	7.00	(2.10)
5	17.00	(10.00)	7.00	(2.10)
6	17.00	(10.00)	7.00	(2.10)
7	17.00	(10.00)	7.00	(2.10)
Total	**119.00**	**(70.00)**	**49.00**	**(14.70)**

Tax payable calculation of shareholder (lessee)				
Year	**Income**	**Rental**	**Total**	**Tax**
1	50.00	(17.00)	33.00	(9.90)
2	50.00	(17.00)	33.00	(9.90)
3	50.00	(17.00)	33.00	(9.90)
4	50.00	(17.00)	33.00	(9.90)
5	50.00	(17.00)	33.00	(9.90)
6	50.00	(17.00)	33.00	(9.90)
7	50.00	(17.00)	33.00	(9.90)
Total	**350.00**	**(119.00)**	**231.00**	**(69.30)**

12.5.10 The above table shows that the net tax payable over the seven years would be equal to $84.00. This is effectively the same as paying 30% tax on all profits generated.

Otherwise deductible rule applied by the shareholder

12.5.11 As with scenario 1, if an otherwise deductible rule is applied to this example, the company would incur a $70 expense over seven years (i.e. the depreciation charge). This charge would be non-deductible as no income is derived by the company. The transaction would have the effect of reducing its retained earnings to nil. The corporate beneficiary would not (effectively) reduce its taxable income for the charge made by the company and its taxable income would remain at $350 over the seven year period. The total tax payable would be equal to $105 (i.e. 30% x 350).

12.5.12 This scenario represents an increase in tax payable of $21. Essentially, this is due to the tax effect of the depreciation expense being non-deductible (i.e. $70 x 30%). Accordingly, the otherwise deductible rule results in more taxable income being collected in this scenario.

d) Scenario 3 – all dividends paid to shareholders

Charge by the company to the shareholder

12.5.13 This third scenario is an expansion of the second, whereby all of the retained earnings of each company is paid to an individual shareholder at top marginal rates.

12.5.14 The original (lessor) company had $70 of retained earnings, which was increased by after tax net lease profits of $34.30 (i.e. retained profits is equal to $104.30). The payment of this as a dividend results in additional top up tax of $24.59.

12.5.15 The corporate beneficiary also has retained earnings of $161.70. This is calculated as the income ($300) less the rental charge ($119) less tax at 30% ($69.30). The payment of this as a dividend and the top-up tax on that dividend would be equal to $38.12.

12.5.16 This results in additional top-up tax of $62.70. Taking into account the tax payable under scenario 2, this scenario would result in total tax payable of $146.70.

Otherwise deductible rule applied by the shareholder

12.5.17 If an otherwise deductible rule is applied to this example, there would be no profit in the original company and thus no dividend or top-up tax payable with respect to this entity. As the entity has $30 of franking credits, such credits would be wasted.

12.5.18 The corporate beneficiary would have $245 of retained earnings after tax (i.e. $350 less $105). This would result in a dividend of $245 and additional top-up tax of $57.75.

12.5.19 Taking into account the tax payable under scenario 2, this scenario would result in total tax payable of $162.75. This is an additional amount of tax equal to $16.05.

12.5.20 This additional tax represents the tax effect of $21 due to the lost deduction of $70 to the original corporate entity for the depreciation expense incurred, less the reduction of tax paid on the after tax dividend of $59 paid by the corporate beneficiary as compared to $70 (i.e. $4.95). The net of these two amounts is equal to $16.05.

e) Summary of results

12.5.21 Where a company applies an otherwise deductible rule for an asset usage arrangement, the examples demonstrate that there is a higher incidence of taxation. In many cases, the effect is akin to a distribution of profit to the shareholder or associate to the extent that the shareholder or associate does not shelter its taxable income. Furthermore, as the asset is retained by the company, it does not provide a trust or an individual with an ownership interest in a capital / passive asset.

12.5.22 As per Example 1, we believe that this is therefore proposition is consistent with the policy principles contained in Chapter 4 of the Board's Second Discussion Paper. We also believe that this is the reason that the current s.109CA(5) provides for such an exception within the current Division 7A provisions.

13 Proposed safe harbour – short term arrangements

13.1 Overview

13.1.1 The purpose of this section is to provide further detail on a possible short-cut method of dealing with short term arrangements.

13.1.2 In effect, this proposal aims at providing some relief to taxpayers who look at their arrangements on an annual basis (through a tax agent) and corrects those problems before lodging their tax return.

13.1.3 We believe that the New Regime should support active compliance and therefore should provide a method of clearing these short term arrangements in an appropriate fashion. Accordingly, linking this with the lodgement date will (in our view) provide significant compliance benefits where all benefits under the New Regime can be satisfied by the shareholder or associate at that time.

13.1.4 We believe that by correcting the benefit (i.e. paying consideration) within a short period of time, the arrangement should not give rise to a deemed dividend. We believe that this rule could be applied to all types of benefits and would greatly assist taxpayers in voluntary compliance with the provisions.

13.1.5 We note that the current Division 7A provisions contain this exemption sporadically. We submit that the provisions will be simpler to apply if this exception is applied more broadly to all benefits.

13.2 Application of the proposed short term safe harbour

13.2.1 Many taxpayers are unaware of the application of Division 7A to their companies. For example, Division 7A issues occur where private business owners inadvertently mix their personal affairs within the operations of a company (e.g. by way of paying personal expenses through the company).

13.2.2 We do not expect the New Regime to completely address this issue. We believe that this problem is simply due to the type of taxpayer that is predominantly required to apply Division 7A (i.e. small taxpayers) and therefore non-compliance would typically be attributable to a lack of knowledge of the provisions rather than any technical aspects of Division 7A.

13.2.3 In our experience, many Division 7A issues are identified by the tax agent when completing the relevant company tax return. Accordingly, to ensure maximum compliance with the provisions, we believe that it should be possible for taxpayers to simply correct all of their Division 7A problems prior to lodging their company tax return.

13.2.4 Due to the short period of time that would elapse for the purpose of this short term exclusion, we do not see any integrity concerns with this recommendation. We highlight that the current provisions in Division 7A already allow this exception for certain

arrangements and this could be used as a basis for all types of benefits provided under the New Regime.

13.2.5 In basic terms, where a company provides a benefit to a shareholder or associate during an income year, the shareholder or associate should be able to provide consideration to the company for the benefit at any time up until the lodgement of the company tax return. To the extent that an amount was incurred by the company in providing the benefit during the income year, the amount of the benefit should be limited to that amount incurred.

13.2.6 Accordingly, this safe harbour would work in a two-step manner. Simply put, where the benefit is repaid to the company by the lodgement date, the value of the benefit would be taken to be the amount of the payment incurred by the company. The payment of consideration will therefore reduce the net benefit to nil. The following examples are used to demonstrate the application of this proposed short-cut method.

13.3 Example 1 – Payments made by the company

13.3.1 In this example, assume that the company pays an amount of $100 on behalf of a shareholder or associate during the year of income. As the benefit relates to an amount incurred by the company during the income year, the amount of the benefit is equal to $100.

13.3.2 Under the proposed safe harbour, the shareholder or associate would have until the lodgement date of the company's tax return to provide consideration to the company to offset the benefit received. This would be done by paying the amount of $100 back to the company or by borrowing the amount from the company (i.e. converting the benefit to a loan).

13.4 Example 2 – Services provided by the company

13.4.1 In this example, assume that the company provides services to a shareholder or associate during the year of income. The cost incurred by the company in providing those services is equal to $100. As the benefit relates to an amount incurred by the company during the income year, the amount of the benefit is equal to $100.

13.4.2 Under the proposed safe harbour, the shareholder or associate would have until the lodgement date of the company's tax return to provide compensation to offset the benefit received. This would be done by paying an amount of $100 to the company or by borrowing the amount from the company (i.e. converting the benefit to a loan).

13.5 Example 3 – Accidental acquisition of an asset by the company

13.5.1 In this example, assume that the company accidentally acquires an asset to be used by the shareholder or associate personally. The cost incurred by the company in acquiring the asset is equal to $100. As the benefit relates to an amount incurred by the company during the income year, the amount of the benefit is equal to $100.

13.5.2 In this example, the proposed safe harbour would provide an option that would allow the shareholder or associate an ability to correct the error by acquiring the asset from the company by the lodgement date of the company's tax return.

13.5.3 Therefore, the shareholder or associate could pay an amount of $100 to the company or borrow $100 from the company to pay for the asset (i.e. converting the benefit to a loan)[5].

13.6 Example 4 – Loans provided by the company

13.6.1 In this example, assume that the company provides a loan of $100 to a shareholder or associate. By lodgement date the loan is discovered by the tax agent who recommends the amount be repaid.

13.6.2 In this example, the proposed safe harbour would provide an option that would allow the shareholder or associate an ability to repay the loan by lodgement date of the company's tax return.

[5] The effect of this transaction would be to reverse any depreciation claimed (if allowed) to the extent of a balancing adjustment on the sale.