Institute of Chartered Accountants Australia

22 February 2013

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

By email: taxboard@treasury.gov.au

Dear Sir / Madam,

Post-implementation review of Division 7A discussion paper

The Institute of Chartered Accountants in Australia (the Institute) welcomes the opportunity to provide a submission on the discussion paper entitled *Post-Implementation Review of Division 7A of Part III of the Income Tax Assessment Act 1936* (the Paper).

The Institute is the professional body for Chartered Accountants in Australia and members operating throughout the world. Representing more than 72,000 current and future professionals and business leaders, the Institute has a pivotal role in upholding financial integrity in society. Members strive to uphold the profession's commitment to ethics and quality in everything they do, alongside an unwavering dedication to act in the public interest.

We are pleased that the government has asked the Board of Taxation (the Board) to conduct a post-implementation review of Division 7A of the *Income Tax Assessment Act 1936* (ITAA 1936). Over the past few years, the Institute has consistently requested the government to ask the Board to review the current Division 7A tax laws.

In our view, the 'ad-hoc' and piecemeal approach to fix various concerns with the operation of Division 7A has resulted in overly complex law and a diminished ability of taxpayers to effectively comply with their obligations under Division 7A. Furthermore, the administrative developments in 2009 and 2010 around the treatment of unpaid present entitlements (UPEs) from a trust to a corporate beneficiary have increased the complexity of Division 7A, making it difficult for both tax practitioners and taxpayers to work with the intricate interactions between the legislative provisions and certain ATO rulings and determinations.

Therefore, it was our hope that a post-implementation review of Division 7A could reveal a pathway towards a major overhaul of Division 7A. A desirable overhaul would result in a significant simplification of the current structure of Division 7A, a more consistent application of the underlying policy throughout the provisions, and a re-write of Division 7A into *Income Tax Assessment Act 1997* (ITAA 1997).

While we commend the Board on the effort put into the Paper, the models as proposed in the Paper do not seem to achieve the significant simplification of Division 7A that we were hoping for. We believe that this may be partially due to the requirement in the Board's terms of reference that any reforms would need to be revenue neutral or have near revenue neutral outcomes.

In our view, if the terms of reference did not include a revenue neutrality requirement, the statutory interest model could use a commercial rate of interest[1], and remove the complex interposed entity rules[2]. The Institute believes that this version of the statutory interest model could lead to significant simplification of Division 7A.

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[1] A commercial rate would be similar to the benchmark interest rate that is used in the current rules.
[2] Assuming the intercompany payments and loan exclusion in section 109K is not retained.

Nevertheless, given the number of major tax reforms which are ongoing at the moment and the limited availability of Treasury resources to take on any major new reforms, out of the options proposed in the Paper, the Division 7A adjustment model seems to be the simplest one to implement at this point of time – with the Distribution model the most complex, and thus by far the least preferred, of the options. However, we do not consider that this would resolve the problem. The need for a significant simplification of Division 7A would remain.

Furthermore, as the application of Division 7A is impacted by the tax treatment of trusts, any reform model would need to take into account the outcome of the rewrite of the trust income tax provisions.

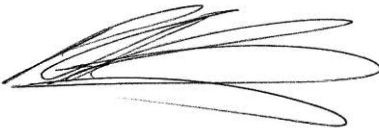
The Institute believes that Division 7A can be greatly simplified but until we have seen the outcome of the trust rewrite consultation and the removal of the 'revenue neutral' requirement for any reform model, we are not in a position to suggest an alternative model which would achieve the significant simplification of Division 7A that we desire.

In the interim, we would support targeted amendments to Division 7A which should address, at the very least, the issues we have identified in our submission. For the medium term, we would support further development of a simplified Division 7A model without the constraint of the revenue neutrality requirement.

We have set out our comments on the proposed models in more detail in the attached submission. Please note that we have set out our detailed comments in relation to the Division 7A treatment of UPEs in a separate submission.

If you have any queries regarding the content of this submission, please do not hesitate to contact me on 02 9290 5609 or Karen Liew 02 9290 5750.

Yours sincerely



Paul Stacey
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SUBMISSION ON THE POST-IMPLEMENTATION OF DIVISION 7A DISCUSSION PAPER

THE DIVISION 7A REFORM MODELS

1. Statutory interest model

Conceptually, the statutory interest model has the potential to achieve the desired result of simplifying Division 7A and therefore improve understanding and compliance by taxpayers. However, the Institute has serious concerns about certain aspects of the model as it is outlined in the Paper.

High rates of interest

Our main concern is with the proposed interest rates. In Appendix D, 'Option 2: Interest Only Loan (Break Even) uses an indicative interest rate of 10.59 per cent on the basis of achieving revenue neutrality. This in turn is based on the assumption that Division 7A loan repayments (of principal and interest) are made by way of paying a dividend to an individual who is on the top marginal rate. This assumption is more likely to be correct when the private company's funds are used for private purposes, and less likely to be correct when the funds are used for income producing purposes (such as a business activity carried on by an associated entity).

Therefore, family groups that, for example, use an 'in-house' financing company to secure funds from a bank and on-lend to members of the group would be severely disadvantaged by a higher statutory interest rate. A higher rate of interest would increase the cost of doing business. This problem would be exacerbated if the exclusion under section 109K for company to company loans were to be repealed.

Option 3 in Appendix D suggests that an even higher rate should be used where the loan is an 'interest only' one. The indicative rate of 13.5 per cent is used to incentivize the borrower to place the loan on a seven year repayment option, which is what the current rules require.

We see little value in rewriting the rules to encourage taxpayers to gravitate back to the existing rules (i.e. the 7 year maximum term for unsecured loans under section 109N).

The Institute would, however, support a statutory interest model if it were to be at a commercial rate of interest such as the benchmark interest rate that is used in the current rules. This would be particularly so where the funds are used by the borrower for the purposes of carrying on a business.

The statutory interest model only deals with loans

As the statutory interest model only deals with loans, the Paper acknowledges that there would still need to be rules that deal with payments and the forgiveness of debts. For example, even if the exclusion for company to company transactions is removed in respect of loans (as suggested in the Paper), the interposed entity rules in Subdivision E will need to be retained to address payments. Furthermore, the position for unpaid present entitlements (UPEs) is not clear.[3]

In light of the revenue neutral requirement, it follows that most of the complex rules embodied within Division 7A would remain in force and therefore the statutory interest rate model merely adds another option to deal with loans.

[3] However, it is likely that family business groups may move away from the use of UPEs as a source of funding and adopt the statutory interest model if this model is kept simple and the interest rate at a commercially competitive level.

2. Distribution model

In our view, the distribution model goes further than the policy intent of Division 7A. As recognised in the Paper, the Government requested that the review be considered in terms of the policy intent of the provisions. The Government (itself) identified the policy intent in its terms of reference as follows;

> "Division 7A was introduced into tax law in 1998 as an integrity provision designed to ensure that private companies would no longer be able to make tax-free distributions of profits to shareholders (and their associates) in the form of payments and loans"[4].

The Paper itself acknowledges that the distribution model would go further than the current policy intent of Division 7A. That is, at paragraph 5.35 the Board states

> "The Board is mindful that this model raises for consideration the introduction of a regime outside Division 7A."

We agree with this statement and believe that the review of the operation of Division 7A is not the place to be considering these broader policy questions which effectively address the progressive tax system and not issues associated with tax-free distributions of profit and compliance with such provisions.

Furthermore, the distribution model not only targets tax-free distributions, it also requires a company to trace the usage of its profits and to determine whether those profits are used for permitted purposes or for some other use. In our view this extra requirement adds a further layer of complexity to what is already viewed as a complex set of rules.

At this juncture, we question why such a distinction is drawn between public companies and private companies. We note that public companies are not required to trace the usage of its profits in determining the amount of profits they can retain.

Our primary concern is that unless a taxpayer has a very simple structure, the distribution model is likely to be even more complex than the existing provisions. Therefore, the Board's objective of seeking greater understanding and compliance is likely to be impeded by the inherent complexities embodied in this model.

We refer you to Appendix A of this submission, which contains two very practical examples, both of which illustrate what we see as a number of complexities associated with the distribution model.

Our main concerns with the distribution model as outlined in the paper are summarised as follows:

- The shift away from the structured concept of a distributable surplus to the less structured concept of profits. We note that section 254T of the *Corporations Act 2001*, which deals with the tests around the payment of dividends, was amended in 2010 because industry had raised a number of concerns about the former 'profits test'.
- The timing of the deemed dividend – companies would need to satisfy the tests in section 254T of the *Corporations Act 2001*, before being in a position to pay a dividend. Some companies may need to wait until the tax is paid in order to frank any dividends. Most companies would want to project how the profits would be used before determining the amount of any dividends to be paid.
- How would carried forward accounting losses impact a company's distributable amount?
- It is not clear how company to company dividends would be treated under a distribution model.
- Profits can be retained to the extent they are used for permitted purposes – how would one determine the permitted purposes, particularly throughout a group of associated entities.
- How will these measures affect tax consolidation groups (Single entity rule (SER) versus tracing the use of profits through a tax consolidation group)?

[4] Paragraph 1.2 of the Post-Implementation Review of Division 7A of Par III of the *Income Tax Assessment Act 1936*

- In the event that a deemed dividend arises, how will the relevant shareholder that is to pay tax on the deemed dividend be identified?

3. Division 7A adjustment model

In view of the issues identified in the above two models, at this point in time, the Division 7A adjustment model seems to be the simplest model for taxpayers and their tax advisors to comply with in view of the volume of guidance provided over the years by the ATO. Furthermore, given the number of tax reforms that are ongoing and the lack of resources in Treasury to progress the reforms, the Division 7A adjustment model may be the simplest model to implement in the short term.

If the Division 7A adjustment model was to be implemented, at a minimum, the Division 7A issues identified in the table in Appendix B should be addressed.

These are listed below:

- Issues in relation to unpaid present entitlements
- Exclusion for arm's length loan made in the ordinary course of business is too narrow
- Valuation issues for the 'use of asset' payment
- Loan exclusion to purchase shares under employee share schemes is too limited
- The Commissioner's discretion in section 109RB has inherent limitations, in particular, it is not an effective remedy for tax advisors that take on a new client that has Division 7A problems that were not picked up by the new client's former tax advisor
- The provisions dealing with payments and loans through interposed entities are too complex and need to be simplified
- Some of the provisions in Division 7A should be reviewed to determine whether certain aspects can be simplified.

We believe that resolving these issues will reduce the complexity of Division 7A and will help taxpayers comply with the current Division 7A provisions. We have provided some recommendations in relation to the issues identified but note that we have not considered whether these recommendations are revenue neutral as this would be more appropriate for the ATO to address.

APPENDIX A

PRACTICAL EXAMPLES INVOLVING A DISTRIBUTION MODEL

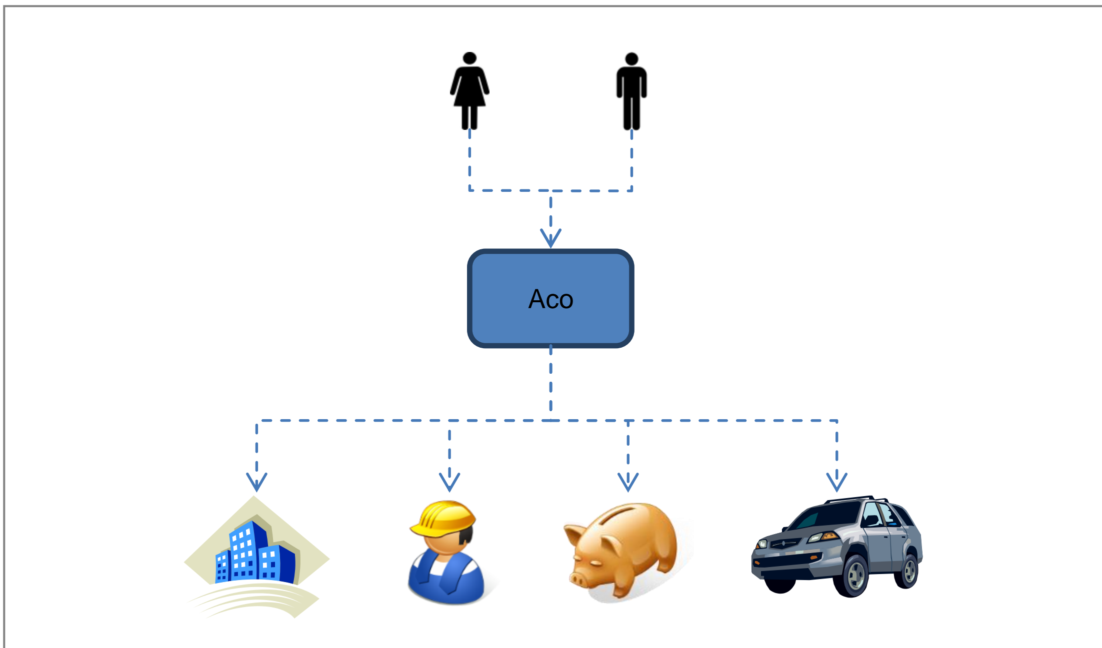
BACKGROUND

The following examples have been used to demonstrate some of the issues that maybe associated with applying the distribution model to some practical examples. We have put together two examples, one covering a basic taxpayer group and the other covering a more complex taxpayer group.

In essence, we highlight that the two taxpayer groups are effectively the same. The key difference, however, is that the more complex group utilises a number of entities to hold various assets and conducts components of the activities of the group.
In our view, the examples demonstrate the significant complexity required with applying a distribution model.

EXAMPLE 1 – BASIC TAXPAYER GROUP

The following diagram outlines the basic taxpayer group.



Aco is a small business entity (turnover is $1.9 million). The shares in Aco are owned 50 / 50 by individuals A and B. Aco conducts business operations. Contained within Aco are four main items: the business premises; cash at bank account (representing surplus working capital); contracts with employees (three employees); and personal motor vehicles used by individuals A and B.

Private expenses are paid for by Aco on behalf of individuals A and B. Such private expenses amount to $115,000 per annum. Individuals A and B earn a notional salary of $5,000 each for director duties. The profit for the year for Aco is approximately $400,000. The taxable income for the year is equal to $350,000. The tax liability is equal to $105,000. The after tax profit for the year is therefore equal to $295,000 ($400,000 - $105,000). However, there is an accounting loss from a prior year of $100,000. The retained earnings of the entity is therefore equal to $195,000 at the end of the year. The unrealised market value of the entity is equal to $900,000. The cash at bank at the end of the year is equal to $125,000. Aco has also borrowed $100,000 from the XYZ Bank which has been used as working capital. The payment of tax after year end ($105,000) will generate the first franking credits for the company.

Step 1: Applying a distribution model

Under a distribution model, we understand that Aco would be deemed to pay a dividend. Before considering exceptions to this rule, it would be critical to understand what this amount would be and whether this would provide appropriate outcomes.

The current Division 7A utilises a concept of a distributable surplus to calculate the amount of a maximum dividend. However, a distributable surplus would result in a dividend equal to (up to) $900,000. This would (in effect) result in the company paying dividends related to unrealised gains and losses.

Also, the year-end profit may not result in a tax liability until after year-end (and therefore final dividends would not be paid until franking credits have been generated). In this case, the $105,000 may not generate franking credits until a future time. Therefore, there is also a question as to when the distribution model would deem there to be a dividend paid by the company (the current Division 7A works on a year-end basis).

Furthermore, the prior year accounting loss brought forward would reduce the amount that the company can actually pay as a dividend and therefore may also need to be taken into account when determining the maximum distributable amount.

Finally, the shareholders of Aco may (instead) be other private companies. It is not clear how company to company dividends would be treated under a distribution model. For example, if there were 15 companies in a chain, would a distribution model deem the dividend to have been paid from the first to the last company on 30 June?

The above factors would need to be taken into account in this example to (prima facie) determine the extent of the dividend that needs to be paid. For the purpose of the example, we will assume this amount is equal to a dividend of $195,000 (i.e. the retained earnings).

Step 2: Exception for permitted purposes

Once the amount of the distribution has been determined, the Paper outlines that profit could be retained where it is used for permitted purposes. In this example, there is a question as to how one would determine the permitted purpose. Some of the complications include:

- Aco has borrowed $100,000 from the XYZ Bank. As this amount forms working capital, how does one distinguish between whether 'non-permitted' purposes have been funded by way of profit or funded by way of external third party loans?

- An amount of $125,000 is retained in the cash at bank account. Will this be regarded as a passive investment? How does one determine the limits and what is working capital and what is not working capital?

- If Aco is retaining amounts in the bank account for future expansion, how long does one have to determine whether the funds are used for permitted purposes? If the funds are not used for permitted purposes by that time, when does the deemed dividend arrive (i.e. at the end of that time, or at 30 June of the prior year)?

- Private expenses are equal to $115,000. The company also provides motor vehicles for personal use (which may or may not be subject to FBT). To what extent are these payments deemed to be for non-permitted purposes. What if it can be established that such amounts were funded by the XYZ Bank loan?

At a high level, a number of the above issues are ones that would ordinarily be subjective. However, it is possible that the Board could introduce objective rules to determine whether the funds have been used for permitted purposes.

We question (however) how easy it would be for a company to substantiate and determine whether the ’permitted purpose’ test would be satisfied and the level of certainty that would be provided to the taxpayers that the tests are not otherwise breached.

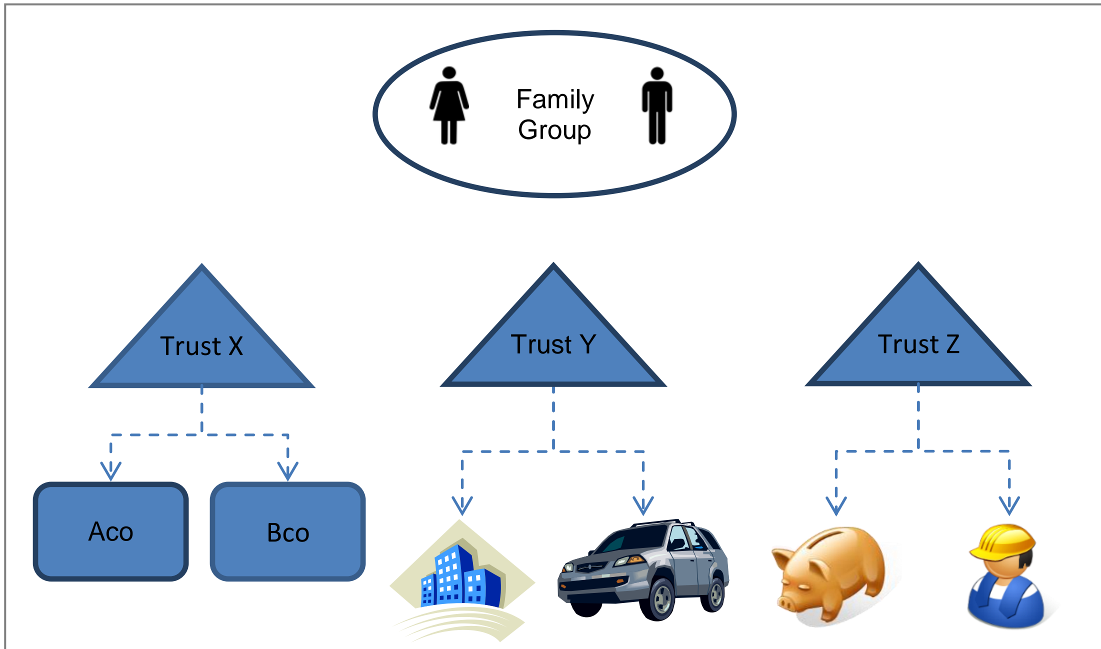
Comparison to the current Division 7A

In comparison, the current operation of Division 7A seems to be quite simple and mechanical. The private expenses would be subject to the deemed dividend rules and the use of assets (constituting payments) would also be subject to the deemed dividend rules, subject to any interaction with FBT. The provisions allow the ‘payments’ to be converted to loans.

The provisions would require a distributable surplus calculation, however this would only be used to limit the extent of a deemed dividend. As a dividend could be paid by the lodgement date to clear out the converted loan, there is unlikely to be an issue with the lag of company tax paid versus franking credits available.

EXAMPLE 2 – MORE COMPLEX TAXPAYER GROUP

The following diagram outlines the (more) complex taxpayer group.



This example uses the same facts as the previous example. However, it has been adjusted so that certain assets and activities are separated into various entities.

In this example, there are three trusts (X, Y and Z). Individuals A and B (and their family group) are beneficiaries of Trust X, Y and Z. The trusts have made a family trust election with reference to Individual A.

Trust Z carries on the business operations. Trust Y holds all assets and leases these to Trust Z for $20,000 per annum. There is one single bank account held by Trust Z which pays for all expenses.

All intra-entity transactions are recorded through loan accounts. Private expenses are paid out of the bank account of Trust Z. Aco is a corporate beneficiary, owned 100% by Trust X. Bco is a special purpose company that holds various licences. Bco derives no income for accounting or tax purposes.

The turnover of Trust Z is $1.9 million. The business profit of Trust Z is equal to $385,000. However, there is an accounting loss of a prior year of $100,000 (which is treated as a current year expense). Trust Y makes a net rental profit of $15,000. Trust Z distributes all income to Trust Y (which remains unpaid - UPE), which is on-distributed to Aco (which remains unpaid). The total accounting profit distribution is therefore equal to $300,000 (i.e. $385,000 - $100,000 + $15,000).

The taxable income of Trust Z and Trust Y combined is equal to $350,000. Due to the distributions, this becomes taxable income of Aco under section 97. Tax payable by Aco is equal to $105,000. The after tax profit of Aco is therefore equal to $195,000 (i.e. $300,000 distribution less $105,000).

As Aco does not hold any cash, Trust Y pays income tax on behalf of Aco. This is applied to the UPE as a reduction, so that the UPE is equal to $195,000.
The cash at bank at the end of the year is equal to $125,000 held by Trust Z. At the end of the year, Trust Z pays $15,000 into a new bank account held by Trust Y. This money is used to repay the rental income that is owed for the year.

Finally, Trust Z has also borrowed $100,000 from the XYZ Bank which has been used as working capital.

Step 1: Applying a distribution model

There are now two companies in this group, Aco and Bco. However, the only company that has derived a profit is Aco. It's after tax profit is equal to $195,000 in this example. As no further assets are owned by the company, it would seem that this would be the maximum dividend it could pay.

The additional complication that is imposed by this example is that Aco is owned by Trust X. In this example, Trust X has not derived any other income. Therefore, if the distribution model applied, it would be deemed to derive a dividend for tax purposes (and not accounting). This would mean that there would be issues on whether the deemed distribution could be flowed through to beneficiaries of Trust X.

Step 2: Exception for permitted purposes

This is perhaps the most complex part of the example, determining whether the $195,000 has been used by the group for a permitted purpose.

At first instance, the corporate funds are represented by a UPE to Trust Y, which is not income producing (i.e. no interest is charged on the UPE). To get passed this, one would need to trace funds through 'permitted entities'. This gives rise to the first complication – i.e. the ability to group the relevant entities in order to trace through to the actual use of the funds.

In this example, it is unclear how the relevant entities would be grouped. The connected entity test contained in Division 328 is significantly complicated and would be difficult to apply on an annual basis. Furthermore, not all groups would have made family trust elections to group only entities within a 'family group'.

The second complication is tracing the use of the corporate funds through that permitted group. That is, Aco has a UPE ($195,000) owing from Trust Y which (in turn) has a UPE owing from Trust Z ($180,000). Trust Z has also borrowed $100,000 from the XYZ Bank and has also paid for private expenses of beneficiaries of Trust Z. Trust Y has also allowed the beneficiaries to use assets for private purposes. Accordingly, it is not clear to what extent the private amounts have been funded by way of the corporate profits. Furthermore, given the differential in the amount of the loan balances between Trust Y ($195,000) and Trust Z ($180,000), it is unclear how the profits of Aco (of $195,000) are to be attributed through to Trust Y and Trust Z and whether a capping is required (or whether there is a duplication of the same amount between Trust Y and Trust Z).

The third complication is that both Trust Y and Trust Z have (when considered on their own) passive assets. Trust Y has a building that is used for rental purposes, and Trust Y and Trust Z have bank accounts. It is unclear to the extent to which these assets will be considered 'working capital' and to the extent to which this will form an exception, especially where the assets are used by other group entities.

The above items outline a number of significant complications that we believe would arise from applying the distribution model to a more complex group and in determining the amount of the "exception" allowed in this case.

Comparison to the current Division 7A

The current Division 7A is also quite complex in this example. However, it is noted that Division 7A can identify the arrangements that would be targeted and therefore would enable such arrangements to be put on compliant terms. Due to the ATO's views on UPEs, it would also unfairly treat the loan to Trust Y and Z as being loans subject to Division 7A, even if the funds are used in working capital.

In this example, there have been funds used for private purposes (i.e. the 'payments' from Trust Y and Z). It would seem that this is the amount that Division 7A would have (historically) targeted prior to the change in view on UPEs. Accordingly, if UPEs are subject only to Subdivision EA and EB, then one would argue that the Division 7A issues contained in this complex example are fairly simple to manage (that is, Division 7A would only apply to the private payments / loans from the trusts).

APPENDIX B

Top Division 7A issues	**Recommendation**
1. Issues in relation to unpaid present entitlements The difference in views between the ATO and the tax practitioner community on whether an UPE is a loan for Division 7A purposes has resulted in uncertainty as to whether the ATO's view in TR 2010/3 *Income Tax: Division 7A: trust entitlements* (i.e. a UPE is a 'loan' under section 109D) would prevail if it was challenged in the courts. The ATO's view in TR 2010/3 has the flow on effect that Subdivisions EA and EB would be applied if the UPE is not a loan in accordance with that explained in TR 2010/3. PS LA 2010/4 *Division 7A: trust entitlements* provides guidance on the administrative aspects of TR 2010/3 and outlines options available for a trustee to invest a private company's UPE without the UPE being treated as 'financial accommodation' or an 'in-substance' loan under Division 7A. The interaction of TR 2010/3 and PS LA 2010/4 with Subdivisions EA and EB has exacerbated the uncertainty and added a further layer of complexity to Division 7A.	Our recommendation in relation to UPEs is subject of a separate submission.
2. Exclusion for arm's length loan made in the ordinary course of business is too narrow The exclusion in section 109M is too narrow to be accessed where a family group of entities includes an 'in-house' financing company (a structure that is quite common for commercial reasons). The problem is that section 109M only excludes loans made in the ordinary course of the private company's business that are made on the usual terms on which the company makes similar loans to parties at arm's length. In TD 2008/1, the ATO take the view that shareholders (and their associates) have sufficient connection to not be parties at arm's length and therefore section 109M does not apply in those circumstances. A further problem arises because the entities in the group regularly borrow from the in house finance company, so there is always a danger that the arrangement will fall foul of section 109R and therefore any repayments could be disregarded. So in other words a compliant Division 7A loan may not be helpful. We know that the entities in the group could just borrow from the bank on an individual basis, but the banks prefer to deal with just one entity and have a facility arrangement in place for the group. In other words the use of the 'in house' finance company is often necessary for commercial reasons. So the current rules in Division 7A just add extra administrative costs with the bank and extra compliance costs with the tax laws.	Section 109M could be amended to exclude loans that are made in the ordinary course of the private company's business that are on (say) either commercial terms, arm's length terms, or something to that effect. Alternatively, this could be addressed by including a general exclusion for loans between associated entities for otherwise deductible purposes which is discussed at item 3. We note that in the large majority of cases entities that borrow from the 'in house' finance company should generate their own income and therefore should have the capacity to fund any repayments. In this case there is no need to pay dividends out to individuals who would have to pay top up tax to fund interest or principal repayments

3. General exclusion for loans where the interest would be otherwise deductible to the shareholder/associate There are a series of circumstances where Division 7A may apply to arrangements in groups of associated entities that may not be expected nor anticipated by taxpayers because they are not done for private purposes. This includes in particular where funds are lent between entities to fund income producing activities, such as in the section 109M issue outlined above and in other circumstances. Our members regularly see these circumstances arising. In the interest of simplicity, it would greatly assist taxpayers if all such arrangements were not subject to Division 7A and we believe this is consistent with the approach taken for loans to employees for FBT purposes.	A general exclusion for loans between associated entities for otherwise deductible purposes should apply equally to business and investment purposes. This would also avoid unnecessary work and uncertainty where there are both business and investment activities in an entity, which is common. We note that the above issue would also be addressed.
4. Valuation issues for the ‘use of asset’ payment Where the use of an asset of the private company is available to a shareholder (or their associate), section 109CA only allows for the value of the ‘payment’ to be determined based on an arm’s length principles. As such, the legislation in its current form can create a higher compliance burden for taxpayers where there is no readily available market for the asset, for instance, antiques or collectables. Furthermore, determination of whether an asset is has a right to use the asset i.e. it is available for use to a shareholder (or their associate), adds another layer of complexity to the valuation process.	To remove a layer of complexity, we recommend that section 109CA be amended to include only the actual use of the asset by the shareholder (or their associate). The Institute had recommended this previously in its submission to Treasury dated 4 February 2010 in relation to Tax Laws Amendment (2010 Measures No.2) Bill 2010: Division 7A – Exposure draft and explanatory material which introduced the amendments to the definition of ‘payment’ to include the use of private company assets by a shareholder (or their associate) (attached as Appendix C for ease of reference). We also recommend that an alternative valuation method be made available where it is not practical to determine an arm’s length value. This was also recommended previously in the abovementioned submission. In this submission, we suggested that such a method might be based on applying the Division 7A interest rate to the original cost of the asset. Alternatively, the valuation methodology in the *Fringe Benefits Tax Assessment Act 1986* for fringe benefits, such as cars, could be adopted for the purposes of valuing the ‘payment’ made to shareholders pursuant to section 109CA. This would simplify compliance with Division 7A by providing an alternative valuation methodology for taxpayers where an active market does not exist for the private company’s asset.

5. Loan exclusion to purchase shares under employee share schemes is too limited The exclusion under section 109NB is too limited for the small and medium enterprise (SME) sector. Under the FBT rules, the consequences that would otherwise arise from an interest free loan are effectively carved out under the 'otherwise deductible' rule. Employees still have to repay the principal, but no FBT is payable in respect the fact that no interest is charged. However, Division 7A can still apply in the SME sector because section 109NB only provides relief from the application of Division 7A where, broadly, a private company makes a loan to a shareholder (or associate of a shareholder) that is solely for the purpose of allowing the shareholder or associate to acquire what were formerly referred to as qualifying shares or qualifying rights in the company under an employee share scheme. For this purpose, a reference to qualifying shares or rights is a reference to shares or rights that that meet the exemption or deferral conditions in Division 83A of the ITAA 1997. Typically, the SME market seek to issue shares to incentivise key personnel, but cannot afford to offer the shares on a non—discriminatory basis, and therefore cannot access the exclusion under section 109NB.	It would be more appropriate to align the treatment of loans made to employees to purchase shares in the private company with the treatment under the FBT rules. If there is any integrity concerns, the exclusion could be limited to shareholders that hold (say) 10% or less of the total shares that the company has on issue.
6. The Commissioner's discretion in section 109RB has inherent limitations While we consider section 109RB to be a major improvement to Division 7A, our view is that section 109RB still has inherent limitations and is not wide enough to encourage compliance with the intent of the law when problems are identified after lodgement of the relevant return(s). In particular, it is not an effective remedy for tax advisors that take on a new client that has Division 7A problems that were not picked up by the new client's former tax advisor. The Division 7A provisions are complex and it is easy for tax practitioners to make a simple oversight where complex private group structures are involved. This is particularly so in relation to business to business loans. Common practice for tax advisors when they are approached by potential new clients incorporating one or more companies is to review the companies' recent financial statements and income tax returns to identify whether the companies and their shareholders have any Division 7A exposure. Our members have indicated to us that it has been quite common that Division 7A breaches have been identified. In most instances, clients were not made aware of any potential problems by their former tax	We propose that section 109RB be amended to incorporate a self-assessment element in appropriate circumstances. The Commissioner issued PS LA 2007/20 with the effect of allowing taxpayers to self assess their ability to take 'corrective action' to put them in a position that complied with the Division 7A requirements for the 2001-2002 to 2006-2007 income years. During that period, taxpayers were not required to make a written request for the Commissioner to exercise his discretion, thereby making it easier and cheaper to comply. It is our view that PS LA 2007/20 provided an effective and inexpensive process for taxpayers to come forward and disclose previous breaches of Division 7A. It is accepted that certain conditions would need to be satisfied to avail oneself of self-assessed corrective action. These might include: 1. Existence of a honest mistake or inadvertent error – albeit with those terms being interpreted broadly and with the benefit of any doubt being made available to taxpayers; 2. Corrective action being taken to place all parties in the same place as had Division 7A been complied with. This would include charging interest where appropriate;

advisor. In these circumstances, the new tax advisor must then discuss with the client the options available to the taxpayer. These options generally include:

1. Disclose the error(s) to the ATO, potentially resulting in catastrophic tax consequences;
2. Disclose the error to the ATO but seek an exercise of the Commissioner's discretion under section 109RB;
3. Make no disclosure to the ATO and wait out the statutory amendment periods (noting that the ATO could argue fraud or evasion and accordingly an unlimited amendment period).

In our view, all of these options are far from ideal for both the taxpayer and the new tax advisor. Whilst Option 2 would be the preferred alternative for most tax advisors, it is difficult to advise clients (especially new clients, where mutual trust and respect are still at an early stage) to take this course of action due to the lack of certainty as to whether the Commissioner will exercise his discretion. The main guidance tax advisors have on this matter is PS LA 2011/29, and Example 4 in particular.

The fact pattern in Example 4 is not particularly unusual. However, the decision of the Commissioner to exercise his discretion seems to be substantially influenced by the facts that the accountant and the taxpayer shareholders are aging and the accountant is in very poor health. The example gives little confidence to taxpayers and their advisors that if similar circumstances arose, but absent the age and health issues, the Commissioner would similarly exercise his discretion. This leaves both well meaning advisors and taxpayers in a very difficult and uncertain position. It seems to us that it also encourages taxpayers to gamble on the statutory amendment periods passing without disclosure. In our view, there needs to be greater certainty available to taxpayers and their advisors on the operation of section 109RB.

3. The taxpayer being up to date with all income tax returns.

The advantages of this approach include:

1. Greater certainty to taxpayers, in not needing to await a Commissioner's decision;
2. Increased equity to taxpayers in situations where previous advisors have not made their clients aware of potential problems;
3. Less difficulty in interpreting the terms 'honest mistake' and 'inadvertent error'.
4. Reduces complexity for the Commissioner in administering the discretion;
5. Minimises the need for objections and appeals;
6. Minimises situations where taxpayers take corrective action to increase the likelihood of the Commissioner exercising his discretion, only to find that the discretion is not exercised
7. Reduced costs for taxpayers and the ATO alike

We acknowledge that Division 7A is an anti-avoidance measure and that in some circumstances there should rightly be punitive consequences for breaching the rules therein. Accordingly, if a taxpayer has self-assessed corrective action, adopting the approach in PS LA 2007/20, the payment would involve two components:

1. The capital component which is the difference between the original amount of the loan and the carried forward loan balance if all the complying minimum yearly repayments had been made; and
2. The interest component – an amount equaling the sum of the annual interest that would have accrued on the loan from the date the loan should have commenced with interest compounding.

This would ensure the taxpayer would incur a cost equal to the time value of deferring any interest and principal on the loan.

In our view, most breaches of Division 7A nowadays are inadvertent and practitioners need to have the ability to work through problems discovered to arrive at a fair and not unreasonably penal outcome. Amending section 109RB to allow taxpayers to undertake appropriate corrective action and self-assess the discretion achieves a reasonable balance between these outcomes.

7. The provisions dealing with payments and loans through interposed entities are too complex and need to be simplified As many private businesses involve multiple entities and various target individuals, taxpayers and their advisors need certainty in relation to the application of section 109T. As noted by the Board of Taxation in the paper, subsection 109T(1) may be relatively straight forward to apply if there is a direct correlation of transactions between the private company, the interposed entity and the target individual but in reality, it is likely that the structure of the private business is more complex with no obvious correlation of amounts between the private company, interposed entity or entities and the target individual(s).	We note that based on TD 2011/16, it appears that the Commissioner considers that the amount of a deemed dividend that could otherwise arise by virtue of the operation of section 109T, may be (say) nil if the first leg of the arrangement is put on the terms that comply with section 109N of Division 7A (i.e. the same terms as an excluded loan). For example, one of several relevant factors that the Commissioner will take into account when determining the amount of the payment or loan arising under section 109T, is the extent to which any loan made from the private company to an interposed entity is part of the arrangement meets the criteria set out in section 109N (that is a compliant Division 7A loan'). Section 109T could be simplified by excluding arrangements where the first leg of the arrangement is a compliant Division 7A loan under section 109N.
8. Some of the provisions in Division 7A should be reviewed to determine whether certain aspects can be simplified Some of the provisions in Division 7A could be subject to targeted simplification. For example, the Board has identified a number of issues with the treatment of amalgamated loans as dividends if the minimum yearly repayment (worked out under subsection 109E(5) is not made under section 109E. These are found in paragraph 4.41 of the paper and are copied below: • The calculation of the first minimum yearly repayment. The first element in the formula for the minimum yearly repayment is the 'amount of the loan not repaid by the end of the previous year of income'. As the amount of an amalgamated loan is the sum of the loans (constituent loans) that have not been fully repaid before the lodgment day the question arises as to which amount is included in the formula when calculating the first minimum yearly repayment. • A related issue for the first minimum yearly repayment is whether repayments made which have been taken into account in determining the amount of the amalgamated loan and therefore in determining the amount of the first minimum yearly repayment are payments which can also be counted in determining whether there is a shortfall. • Unless the action referred to above in relation to the shortfall (for example, payment of shortfall amount) is taken, there is no reduction in, or adjustment to, the amount of the amalgamated loan. As a result the minimum yearly repayment in subsequent years is higher than it would otherwise have been and could lead to cumulative shortfalls in excess of the amount	<u>Section 109E</u> We recommend reviewing the minimum yearly repayments provisions under section 109E for simplification. Each of the issues (and any further issues identified) could be addressed separately by amending section 109E. As noted in the paper, the ATO has considered and expressed its administrative views for the first two items in ATO ID 2010/82 so changes to adopt the ATO's views, if appropriate, could be easily made. The third issue should be addressed by including a provision that reduces the amount of the opening loan balance used in the formula in subsection 109E(6) by the paragraph 109E(1)(c) shortfall of the previous year. <u>Section 109N</u> The ATO allows some flexibility with the section 109N requirement that the loan agreement be in writing in TD 2008/8. In TD 2008/8, the requirement for the agreement to be in writing would also be sufficiently satisfied if there is written confirmation of the existence of the agreement and the essential elements. For example, an exchange of letters, emails, fax, or other means of communication would be sufficient if they are dated and provide written evidence of the terms of the agreement and the parties' acceptance of those terms. Accordingly, the unnecessarily onerous requirements for the form of loans required to meet the section 109N could be simplified by: • Removing the strict requirements specifying how the excluded loan is to be made under an agreement in writing

of the loan. Another example of a provision review would be section 109N which contains the criteria for a loan which would not be treated as a deemed dividend. Given most taxpayers attempt to comply with Division 7A by entering into section 109N loans, section 109N should be made simpler for taxpayers to comply with, in particular, the requirement under paragraph 109N(1)(a) that the loan agreement is in writing.	• Allowing loans to be evidenced by other means including for example by an exchange of letters or other correspondence (e.g. emails) and minutes of meetings • Allowing loans to be excluded provided the taxpayers elect to have a seven year term with the Division 7A benchmark interest rate being charged.

APPENDIX C

The Institute of Chartered Accountants in Australia

4 February 2010

Mr Paul McCullough
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By email: sbtr@treasury.gov.au

Tax Laws Amendment (2010 Measures No.2) Bill 2010: Division 7A – Exposure draft and explanatory material

Dear Paul

The Institute of Chartered Accountants in Australia (the Institute) welcomes the opportunity to provide a submission on Tax Laws Amendment (2010 Measures No.2) Bill 2010: Division 7A exposure draft legislation (ED) and explanatory materials (EM), containing the changes to the non-commercial loan rules in the *Income Tax Assessment Act 1936* (ITAA 1936).

The Institute is the leading tax and accounting professional body in Australia. Our reach extends to more than 62,000 of today's and tomorrow's business leaders, representing over 50,000 Chartered Accountants and 12,000 of Australia's best accounting graduates who are currently enrolled in our world class Chartered Accountants postgraduate program.

The Institute supports the need to improve the operation of Division 7A of the ITAA 1936 to address arrangements that circumvent the operation of Division 7A and to ensure that current technical deficiencies in Division 7A are corrected.

Nonetheless, the Institute believes that the best course of action in this area is for a major overhaul and re-write of Division 7A to achieve a more consistent application of policy throughout the Division as well as simpler drafting of these laws (see the Institute's 2010-2011 pre-Budget submission to the Federal Government). In particular, recent developments in relation to the Australian Taxation Office (ATO)'s administration and interpretation of corporate beneficiary unpaid present entitlements (UPEs), has rendered Subdivision EA of ITAA 1936 (dealing with corporate beneficiary UPEs) practically unworkable, which has a flow on effect on some of the proposed provisions in the ED.

That said, we understand that the ED will be introduced into Parliament in the Autumn sittings and we are of the view that further changes are is required to ensure the amendments contained in the ED are appropriately targetted and can be applied practically.

In broad terms, our key recommendations include:

- The new measure dealing with the use of assets should be based on a shareholder's (or their associates') actual use of the asset and the exceptions to the use of assets need to be extended further.

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- The amendments to Subdivision EA and proposed Subdivision EB to cover interposed entities need to be reconsidered in light of the Commissioner of Taxation (Commissioner)'s view in the draft public ruling TR 2009/D8 dealing with trust entitlements and consequential interaction issues, as well as the new measure covering the use of assets. Or as an interim solution to alleviate the complexity of the provisions, section 109D should be clarified as 'excluding' UPEs.
- Further clarification should be given as to how the application date (item 170) applies to the amendments in the ED, in particular, the new 'use of asset' measure and the amendments to Subdivision EA dealing with interposed entities (item 125) (especially in view of TR 2009/D8).

We have provided our detailed comments on the exposure draft materials in the attached submission.

Please do not hesitate to contact Karen Liew on (02) 9290 5750 if you need further clarification of our comments.

Yours sincerely

Yasser El-Ansary
Tax Counsel
The Institute of Chartered Accountants in Australia

APPENDIX

1. Use of company assets by shareholders (or their associates)

1.1. Extension of the definition of 'payment'

The proposed amendment to the definition of 'payment' in paragraph 109C(3)(d) will include as a payment "a grant of a lease, or a licence or other right to use an asset". The terms 'grant' and 'right to use' (or 'right' and 'to use') are not defined. However, based on this proposed wording and the valuation provision in subsection 109C(4), it appears that an asset available for use by a shareholder or associate as well as the actual use of the company's assets could be deemed a Division 7A dividend.

As mentioned before in the Institute's submission on the Treasury discussion paper for the Division 7A amendments dated 3 July 2009 (Institute's previous submission), we submit that only the **actual** private use of an asset should be captured by Division 7A. When the proposed measure was announced as part of the 2009 - 2010 Federal Budget it seemed implicit that it would be the 'use' of the asset that would be viewed as a payment. The following is an extract from Budget Paper No 2 (2010 Federal Budget) regarding this:

> *"The measure extends the non-commercial loan rules to include payments by way of a licence or right to use real property and chattels. This reduces the scope for private companies to allow their shareholders or associates **to use company assets** such as real estate, cars and boats for free, or at less than their arm's length value.*
>
> *The measure will provide greater equity in treatment between the shareholders of private companies on the one hand and employees more generally. In kind benefits provided by employers to an employee are generally subject to fringe benefits tax." [emphasis added]*

Furthermore, in the joint media release by the Treasurer and the then Assistant Treasurer announcing the proposed measure, the Government's intention to align the treatment of any use of a company's assets by shareholders (and their associates) to the Fringe Benefits Tax (FBT) regime indicated that only the use of assets by shareholders (and their associates) should be subject to tax under the proposed measure. The relevant excerpt from the media release states:

> *"The Government will extend the operation of the non-commercial loan rules in Division 7A of the Income Tax Assessment Act 1936 to cover circumstances where a shareholder (or their associates) is permitted to use a company asset such as real estate, a car or boat for free or at a discounted rate. While fringe benefits tax would apply **to the use** of such assets by employees, the **same use** of the assets by shareholders would be tax free.*
>
> *This measure will remove this inconsistent treatment by deeming a 'payment' made to a shareholder through the **free use of a company asset** to be a dividend and taxable accordingly. In doing so, it will ensure that shareholders pay their fair share of tax." [emphasis added]*

We also highlight that the proposed exception for minor benefits would appear to only work if a 'payment' subject to tax under Division 7A arises from the actual use of the asset as illustrated in example 1.3 of the EM to the ED.

To ensure that only the actual use of a company asset by a shareholder (or their associate) is subject to tax under Division 7A, we recommend that either:

- proposed paragraph 109C(3)(d) be amended to make it clear that 'payment' only captures the actual use of an asset; or
- proposed subsection 109C(4) be amended to ensure that the value of the 'payment' is based on the arm's length value of the actual use of the asset.

If a 'payment' is to be deemed a Division 7A dividend because an asset is available for use (rather than being based on actual use) by a shareholder (or their associates) there would be difficulties and inequities in applying the proposed provisions as they are currently drafted including:

The Institute of Chartered Accountants in Australia

- it would be difficult to identify the recipient of any deemed dividend, particularly, where there are a number of shareholders (and associates) who have a right to use an asset in their capacity as a shareholder but do not actually use the asset;
- if there were a number of shareholders who had a right to use an asset but only one shareholder used the asset, it would be inequitable to assess all shareholders on the 'payment' from the company based on the asset being available for use for all shareholders;
- how would you value the 'right to use' where a shareholder has the right to use a company asset for 365 days in a year but during the income year has paid a market value amount for the actual use of the asset for one weekend only – it would be inequitable to treat the market value of the use of the asset for 365 days in a year as being the relevant amount of the deemed divided assessable to the shareholder just because the asset is available for use 365 days in a year.

We submit that if the policy intention is that a 'payment' arises because an asset is available for use, rather than when it is actually used by a shareholder or their associate, the proposed amendment should only apply prospectively (ie. from the date of Royal Assent), rather than retrospectively to 1 July 2009 (as proposed). In our view, the available for use concept is a departure from the Budget announcement and further rules will need to be drafted to clarify the tax treatment of that concept.

We recommend that only actual use of an asset be captured by Division 7A by either:

- **amending proposed paragraph 109C(3)(d) to make it clear that 'payment' only captures the actual use of an asset; or**
- **amending proposed subsection 109C(4) to ensure that the value of the 'payment' is based on the arm's length value of the actual use of the asset.**

1.2. Application of new measure

In the Institute's previous submission, we recommended that the new measure to include the use of company assets by a shareholder (or their associates) should only apply to new transactions and the continued use of assets under licences and leases granted before the start date for the new measure should not be subject to the new measure. Based on the way paragraph 109C(3)(d) is currently drafted, it is clear when the new measure is to apply to a lease or a licence of an asset since it only applies to 'payments' (ie. grant of a lease or licence) made on or after 1 July 2009 (item 170 of the ED). However, further clarification of 'grant' is required in relation to 'other right to use' an asset. Where a shareholder simply uses a company asset without any formal agreement or acknowledgement of a right to use has been documented, the issue is when is the 'right to use' granted?

For example, Mr & Mrs Smith established a company, Smith Pty Ltd in 1977 for estate planning purposes to purchase a residential property in Sydney for $200,000. The company owns nothing else except the residential property. After the purchase, Mr & Mrs Smith and their children immediately occupied the residential property as their main residence. The Smith's are now aged in their 80's and still residing in this property, which is currently estimated to be worth approx $2,000,000. There is no agreement or other documentation acknowledging the Smith's right to use the property and the Smith's do not pay any rent to Smith Pty Ltd but do pay the property expenses privately.

In the above scenario, when is the Smith's 'right to use' granted? Based on the principle that the new measure should only apply to transactions entered into on or after the 1 July 2009, we submit that the above scenario should not be subject to the new measure as this arrangement was set up before 1 July 2009.

If this scenario was subject to the new measure, there would be two options for the Smith's:

- the Smith's could continue to not pay rent for the property and the value of the rent not paid by them would be considered to be a 'payment' made by the company to them thereby giving rise to a deemed a Division 7A dividend, increasing the elderly couple's personal tax liabilities; or
- to not invoke Division 7A, the Smith's could pay market value rent to Smith Pty Ltd so that there would be no 'payment' for Division 7A purposes but Smith Pty Ltd would be required to pay tax on the rental income received for the Smith's home.

Given this arrangement was not set up to circumvent the operation of Division 7A, it would be inappropriate to require the Smith's to be caught by the new measure.

We recommend that further clarification is provided on the meaning of 'grant', especially in the context of 'other right to use' an asset and to ensure that only arrangements established after 1 July 2009 are subject to the new measure.

1.3. Value of 'payment' made

Significant costs of compliance may result from the requirement for taxpayers to determine the value of a payment for assets subject to the rules.

In addition, section 109C operates when a payment is 'made'. There may be some confusion as to the value of the 'payment' made when paragraph 109C(3)(d) and subsection 109C(4) applies. Neither of the two use the term 'made'. The analysis of 'made' will be critical for determining the value of the 'payment' and whether there is an overlap between certain payments (for example, the value of a lease granted will equal the present value of the future benefits over the period of use under the lease compared with actual lease payments made under the lease for the use of the assets). Without clarification, this may result in difficulties in determining which is the correct payment made when such an arrangement exists.

The requirement to find an arm's length value will be difficult to determine where an asset does not have a readily available market such as for the use antiques etc. One option could be to include an optional 'safe harbour' valuation method where it is not practicable to determine an arm's length value. Such a method might be based on applying the Division 7A interest rate to the original cost of the asset.

We recommend further clarification be provided on determining the value of the 'payment' made under paragraph 109C(3)(d) and suggest that a valuation method be included as an option.

1.4. Converting the payment to a loan

The issue of when a 'payment is made' is critical where a taxpayer wishes to comply with subsection 109C(3A) and subsection 109D(4A) which addresses the situation where a payment is converted into a loan. If the payment made is on granting the lease (or the use of the lease asset), there is the issue of how the granting of the lease (or the use of the asset) can be converted to a loan. Enabling a payment to be converted into loan allows a taxpayer to put a section 109N loan agreement in place so that the loan would not be treated as a deemed dividend under Division 7A. To convert the 'right to use' an asset into a loan, the taxpayer would need to acknowledge, under a separate agreement, that it is to borrow the value of the right from the company. However, further clarification is required as to what the value is for a 'payment made' under paragraph 109C(3)(d) so that it can be converted into a loan under subsection 109D(4A) and subsection 109C(3A).

We recommend that further clarification be given under subsection 109C(3A) and subsection 109D(4A) so that the 'deemed' payment made under paragraph 109C(3)(d) can be converted to a loan.

1.5. Residence exception

We support the Government's introduction of the residence exception in response to concerns raised by the Institute and other stakeholders. Nevertheless, based on the current drafting of paragraph 109C(4)(3D), the following issues arise.

1.5.1. The entity carrying on the business may not be the shareholder (or associate)

In practice, many shareholders/associates who live on the business property to run the business, eg. farming and motel accommodation, would not be able to fall within this exception. Paragraph 109C(4)(3D) provides that Division 7A does not apply to a licence or other right to use a dwelling if:

- the entity (e.g. an individual) carries on a business; and

- the entity (e.g. the individual) is or has been granted a lease, licence or other right to use the land or water on which the dwelling is situated etc.

The provision as it is presently drafted appears to only apply where the entity that is occupying the dwelling is the same entity that is carrying on the business. However, in reality, it is much more common for the business, eg. farming business, to be carried on by a company or a trust and for the individual shareholders and their associates to occupy the farmhouse so that they can physically conduct their farming duties.

Furthermore, where it is the company that is carrying on the farming business and it also owns the land on which the farm and farmhouse are situated, a lease/licence/right to use the land on which the farmhouse is situated for the primary purpose of carrying on the farming business (ie. the requirement in paragraph 109C(3D)(b)) would not exist since the company would own that land.

In light of the above, we recommend that residence exception in paragraph 109C(4)(3D) be amended such that the entity that is carrying on the business can be the private company, shareholder or any associate and it is not necessary that there be a lease/licence/right to use the land/water/building where the dwelling is situated for the primary purpose of carrying on that business, where the entity carrying on the business is the same entity that owns the land/water/building.

We recommend paragraph 109C(4)(3D) be amended such that:

- **the entity that is carrying on the business can be the private company, shareholder or any associate**
- **where the entity carrying on the business is the same entity that owns the land/water/building where the dwelling is located, there does not need to be separate rights to use in respect of the land on which the business is carried on and the dwelling.**

1.5.2. Area of dwelling is less than 10 per cent of land/water/building area

Using the requirement for the dwelling to be less than 10 per cent of the area of the land, water or building to limit the scope of the exception is rather arbitrary and is set too low. This potentially discriminates against businesses which, unlike a farming business, do not necessarily need to operate on large land holdings relative to the dwelling.

For example, a private company owns land in regional Australia on which there is motel accommodation plus an attached dwelling to house the individual shareholders (husband and wife) so that they can attend to guests at any time of the day. In reality, it is likely that the land area of the individual shareholders' dwelling is not less than 10 per cent of the land area of the motel accommodation and therefore these shareholders would not be able to access the exception.

Therefore, we recommend that an alternative requirement for dwellings be included based on a 'reasonableness' test taking into account whether it is necessary for shareholders or associates to live on the property given the nature of the business and/or the distance from major city centres.

We recommend that:

- **the 10 per cent level be reconsidered as it is too low;**
- **an alternative requirement for dwellings be included based on a 'reasonableness' test taking into account whether it is necessary for shareholders or associates to live on the property given the nature of the business and/or the distance from major city centres.**

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1.5.3. <u>How to measure the area of the dwelling and land/water/building</u>

Further clarification is needed regarding how to calculate the percentage area of the dwelling as the way paragraph 109C(3D)(d) is currently drafted raises several issues including:

- It is not clear whether the area of space that you measure for the dwelling is the area of land that the dwelling takes up on the area of land on which the business is conducted, or whether you measure the floor space of the dwelling so that where you have a double story dwelling you would include the area of the ground floor and the first floor of the dwelling.
- Given some farming areas are very expansive, in determining the area of land, it is also not clear whether you measure the area of the legal interest in the land e.g. the Torrens title land lot, or whether you measure the physical area of the land on which the farming activities are carried on. Some farming businesses may not necessarily be on one singe land title and may encompass several land titles which also may not be adjacent to each other.

A farmhouse may also be on a separate land title from the farming business land and sometimes may not be adjacent to the farming business land but is in very close vicinity. Based on the policy intent underlying the residence exception, it seems reasonable to extend the residence exception to cover these circumstances.

In addition, some farms may have more than one dwelling - maybe the homestead and one or more cottages where adult kids live and work on the farm. Consideration needs to be given on whether the homestead and cottages be treated as one dwelling or the exception should not be restricted to a single dwelling.

We recommend further clarification be given on how to measure the area of the dwelling and area of the land/water/building on/in which the business is carried on.

1.6. 'Otherwise deductible' exception

In the Institute's previous submission, we recommended the 'otherwise deductible' rule should not be limited to just the use of assets but should also apply to other 'payments' and in relation to loans or deemed loans as defined throughout Division 7A.

There is no policy reason why the 'otherwise deductible' rule to be contained in subsection 109C(3C) should be limited to leases, licences etc. That is, if the company pays for expenses of another entity, which are not a lease of an asset, and those expenses are otherwise deductible, we query why the exception in subsection 109C(3C) should not extend to those other types of payments. For the same policy reasons, such payments should be excluded from Division 7A. Similarly, the 'otherwise deductible' exception ought to apply to loans advanced by a private company if the borrower could otherwise claim a deduction under section 8-1 of the *Income Tax Assessment Act 1997* for any interest incurred if interest were in fact charged.

The absence of the extension of this rule may lead to anomalous results under Division 7A. To illustrate, the 'otherwise deductible' exception should also be extended to the transfer of property where it is a lease of real property.

Example 1.5 in the EM describes the situation where Farm Pty Ltd owns a farm and the shareholders of Farm Pty Ltd (Aaron and Liz) run a farming business on the land owned by Farm Pty Ltd under a licence arrangement for no payments. In the example, the use of the farmland by Aaron and Liz is not a payment for the purposes of paragraph 109C(3)(d) because if they had made a payment during the income year for the use of the farmland a once-only deduction would have been allowable.

Assume the facts in Example 1.5 are changed such that instead of a licence arrangement between Farm Pty Ltd and the shareholders over the farmland, there is a lease agreement over the land and a nominal lease payment is made. It seems inequitable that the 'otherwise deductible' exception should not similarly apply.

We recommended the 'otherwise deductible' rule should not be limited to just the use of assets but should also apply to other 'payments' and in relation to loans or deemed loans under Division 7A.

1.7. Carve-out company title apartments

We recommend that Treasury include provisions such that individuals who 'own' company title apartments are not captured by the new 'use of asset' measure. In simple terms, an individual 'owning' a company title apartment involves the individual being a shareholder of the company that owns the apartment building and attached to the individual's shares in the company is the right to occupy the apartment. This situation should not be caught within Division 7A.

We recommend that company title apartments be carved out from the extension of 'payment' to the use of a company asset.

1.8. Division 7A and FBT anti-overlap

We understand that where a company is carrying on a business, shareholders of the company may also be employees of the company or associates of the employees. Any use of the company assets by these shareholders may be caught by the FBT rules and we recommend that anti-overlap provisions dealing with Division 7A and FBT be included in the ED.

We recommend the inclusion of anti-overlap provisions dealing with Division 7A and FBT in the ED

2. Interposed entities provisions and further complexity in the operation of Division 7A

Division 7A is an integrity measure to be applied by private companies. By virtue of the definition of a private company, the provisions are essentially applied by small medium enterprises (SMEs). In our view, the amendments proposed by the ED will make the provisions overly complex and almost impossible to be applied by the average taxpayer and advisor. Coupled with the Commissioner's views contained in the draft public ruling TR 2009/D8, we believe that there will be a significant amount of non-compliance in Division 7A, simply due to the unworkability of the provisions and the complex analysis required to understand how the provisions operate to very simple transactions.

To demonstrate this complexity, an example is provided in point 2.2.1 below. We note that the example is very simple, with a UPE of $100 and a loan of the same amount. The example demonstrates how complex the provisions can become even on such a simple example. We envisage that this will become unworkable where an SME group consists of say 5 to 25 entities, with related party transactions between the various entities. Tracing through the proposed interposed entity rules and conducting a reasonable person test will be virtually impossible.

2.1. Division 7A was intended to be substantially 'self operating'

Division 7A was introduced to replace the problems contained in section 108 of the ITAA 1936. That is, Division 7A is intended to be self operating and to provide some degree of certainty as to which arrangements are caught within the provisions. This is made clear in the original EM to the provisions:

> *"9.138 Currently, section 108 of the Act is not as effective as it should be in preventing private companies from distributing profits in the form of loans. It relies on the identification by the ATO of such loans, which will occur only in individual cases where there has been an audit or where there has been a voluntary disclosure of information. There are often significant costs to taxpayers involved in ATO audits and examinations.*
>
> *9.139 The amended provisions will apply automatically, and as such, will place an increased burden on taxpayers to ensure they have complied with the rules. However, the Government believes that these costs are more than offset by the prevention of further revenue leakage."*

The amendments contained in the ED introduce a new reasonable person test in subsection 109R(2), a new reasonable person test in subsection 109XA(1A), a reasonable person test in section 109XF, a Commissioner's determination in subsection 109XF(3), a reasonable person test in section 109XG, and a Commissioner's determination in subsection 109XG(4).

We believe that it will be difficult to argue that the provisions, together with the ED, will be 'self operating'. The level of reasonable person tests and Commissioner's determinations to be applied in Division 7A will make the provisions almost on par with section 108. This type of drafting contained in the ED is clearly inconsistent with the reason why Division 7A was introduced.

The proposed measures also closely mirror the 'current payments and loans through interposed entities' in Subdivision E of Division 7A which include Commissioner's determination rules. Although Subdivision E has existed since the introduction of the Division we note that there is still only very limited ATO public guidance on the rules which could be used to assist taxpayers to determine whether the Commissioner might make a determination to apply these similar new provisions to them.

We recommend that Treasury reconsider the amendments and the policy of the provisions. Amendments proposed must provide certainty to taxpayers, generally being SME taxpayers, which are required to apply these complex provisions.

2.2. Treatment of UPEs under Division 7A

From our review of the ED, for the proposed provisions to work, a different view of the classification of a UPE would need to be taken as compared to the Commissioner's view contained in TR 2009/D8. Broadly speaking, based on the Commissioner's views in TR 2009/D8, in practice, a corporate beneficiary's UPE would be either converted into a loan or be treated as a loan under section 109D (by way of financial accommodation). If UPEs are treated as loans, as described in TR 2009/D8, the interposed entity provisions proposed by Treasury in the ED would not be required. That is, the current section 109T would cater for such arrangements.

Accordingly, we believe it is critical for Treasury to address the issue of TR 2009/D8 in the first instance and clarify the treatment of UPEs. If Treasury accepts the Commissioner's views in relation to TR 2009/D8, then we cannot support the proposed interposed entity amendments, which add a significant level of complexity to the provisions (as section 109T would already cater for such arrangements as outlined above).

However, if Treasury do not accept the ATO's position contained in TR 2009/D8, Treasury should clarify the definition of a loan in section 109D. That is, section 109D should be clarified as 'excluding' UPEs, with retrospective effect. Clarity could be provided along the lines of inserting at the end of section 109D:

> *"Note 1: A present entitlement from a trust to an entity is not a loan for the purposes of this Division.*
>
> *"Note 2: A present entitlement from a trust to an entity can only be, or be converted into, a loan for the purposes of this Division by a formal written agreement between the trust and the entity which evidences the terms of the loan and is signed by all of the parties to that loan."*

Where this is the case, the interposed entity provisions will have some role to play in the legislation. Where Treasury does not clarify this important difference, we highlight our opposition to these provisions that will only add to further confusion and ambiguity in the law.

2.2.1. <u>Example of complexity of potential Division 7A application</u>

The following example is used to demonstrate the possible complexity of the proposed Division 7A principles, together with the application of section 3 of TR 2009/D8 (this deals with subsisting company UPEs being s109D loans due to the UPE being financial accommodation from the company to the trust). On an initial review of the following example, it would seem that Division 7A can apply under a number of provisions, without an anti-overlap provision. It is questionable whether this means that one is required to include the deemed dividend in the assessable income of the relevant taxpayers a number of times, or how one is to determine the ordering of the provisions. For many SME taxpayers, the following analysis will be impossible to complete.

The example involves T2 (discretionary trust) distributing $100 of income to T1 (discretionary trust), which in turn distributes $100 to Aco (private company) in Year 1. No cash is paid to the beneficiaries. In Year 2, T2 loans the $100 to Individual A. Assume that Aco has a prima facie distributable surplus of $5,000. Assume that in applying TR 2009/D8, the UPEs are treated as loans. The example is demonstrated below.

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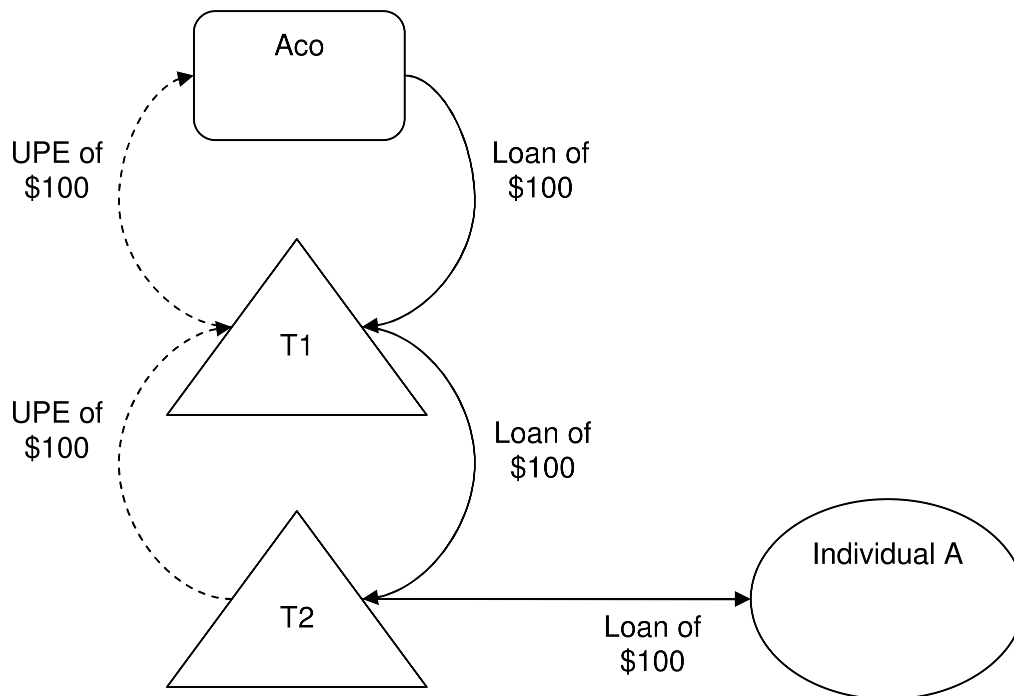

2.2.1.1. Application of section 109D – T1

It is questioned when Aco will be taken to have made a loan to T1 under TR 2009/D8. Typically, accounts are not prepared by the trust until tax return lodgement time. Accordingly, is the loan 'made' in Year 1 or Year 2 under TR 2009/D8. This is critical in order to determine whether the UPE is to be converted into a section 109E compliant loan in Year 1 or Year 2. Nonetheless, TR 2009/D8 demonstrates that the UPE to Aco can be a section 109D loan under Division 7A.

2.2.1.2. Application of section 109T – T2 and Individual A

Once the UPEs are treated as loans, the loan to Individual A can be within the requirements of subsection 109T(1). The application of section 109T can be precluded by the operation of subsection 109T(3), if the UPE is caught by section 109D in relation to T1. However, where the UPE is placed on compliant section 109E terms, the subsection 109T(3) exception will not apply. Accordingly, the provisions could apply to treat the loan to Individual A as a deemed dividend under section 109T.

2.2.1.3. Application of subsection 109XA(2) – T2

Arguably, as some point in time, the requirements of subsection 109XA(2) are satisfied. That is, Aco is presently entitled to income from T1, and T1 subsequently makes a loan to T2. If and when the provision applies may depend on when the UPE is converted to a loan (ie. Year 1 or 2) and the Commissioner's view contained in TR 2009/D8, at paragraph 155 onwards. Accordingly, taxpayers would need to analyse compliance with this proposed new interposed entity provision.

2.2.1.4. Application of section 109XG – T2 and Individual A

Prima facie, subsection 109XG(1) could seem to operate such that Aco is presently entitled to the net income of T2 (thus capturing the loan to the Individual A under subsection 109XA(2)). However, if subsection 109XA(2) has previously applied to T2, subsection 109XG(3) may preclude this operation. Accordingly, the operation of

this provision is dependent on a review on the operation of section 109XA which is dependent on the operation of section 109D to other interposed entities. Furthermore, the taxpayer needs to consider two reasonable person tests and possibly two Commissioner's determinations in coming to this conclusion.

2.2.1.5. Application of section 109XF – Individual A

As the UPE from T2 to T1 is a loan, section 109XF could possibly apply to treat the loan through T2 to Individual A as a loan from T1 to Individual A. Accordingly, through the application of subsection 109XF(1), subsection 109XA(2) could operate to treat the loan to Individual A as a deemed dividend pursuant to section 109XB. This would depend on the Commissioner's view contained in TR 2009/D8, in paragraph 155 onwards, and the time in which the UPE is taken to be converted to a loan. Furthermore, this would also depend on the reasonable person test and a Commissioner's determination.

2.2.2. Trying to overcome complexity – inability to refinance UPEs

The relationship between TR 2009/D8 and the proposed ED amendments will render Division 7A impossible to apply from a practical perspective by SMEs where they have UPEs. In order to avoid the possible application of Division 7A, taxpayers will be required to consider placing all UPEs and loans on Division 7A compliant terms, ie. convert them into section 109N loan agreements. Practically, this would occur whether or not the loan would be within the ambit of Division 7A.

However, the practical problem with this is that subsection 109R(2) does not allow one to refinance a UPE as a loan. That is, in order to comply with section 109E, such UPE's would need to be converted into compliant loans on terms (i.e. repaid and refinanced), over seven years bearing interest. However, the current subsection 109R(2) (and the proposed amendments to that section), does not allow the conversion of the UPE to a legal loan that would satisfy the requirements of section 109N (which would legally require the repayment of the UPE and the re-borrowing of the same amount).

The inability to comply with TR 2009/D8 and the proposed amendments to subsection 109R(2) would mean that a trust will not be able to finance its UPEs to companies. On a distribution of $100, the effective tax rate of the deemed dividend would mean that $62.55 would be paid on the $100 UPE.

In our view, Treasury needs to critically address this interaction issue. Treasury needs to clarify that a UPE is not a loan for the purpose of Division 7A (as mentioned earlier). In the alternative, it is critical that the amendments proposed to subsection 109R(2) contain an exclusion where a UPE is converted into a loan for the purpose of Division 7A

2.2.3. Interest deductibility on converted loans

Even if Treasury allows UPEs to be converted to loans, interest on such loans may not be tax deductible in accordance with TR 2005/12. Accordingly, Division 7A will force businesses (operating through trusts) to pay interest on UPEs, which may be considered by the ATO as non-tax deductible. Such a policy would have a detrimental effect on SMEs. We query if Treasury has this intention and whether it is the current policy of Government for this tax burden to occur for SMEs. We request Treasury to clarify this policy intent. Where this is not the intention, we request that the provisions be clarified so that interest on a converted UPE is deductible where the funds have been used for working capital that is employed in the income producing activities of the trust.

We recommend that:

- **the amendments to Subdivision EA and proposed Subdivision EB to cover interposed entities (item 125) be reconsidered in light of the Commissioner of Taxation's view in the draft public ruling TR 2009/D8 dealing with trust entitlements and interaction issues with the Commissioner's view in TR 2009/D8 as well as the new measure covering the use of assets; or**
- **at least as an interim solution to alleviate the complexity of the provisions, section 109D should be clarified as 'excluding' UPEs.**

2.2.4. Anti-overlap rule

We note section 109XF is based on section 109T. However, we query why section 109XF does not contain an anti-overlap provision such as subsection 109T(3). The lack of an anti-overlap provision means that the Division 7A can apply twice, in respect of the same amount, to two different taxpayers. This is clearly an unacceptable position.

We recommend an equivalent provision to subsection 109T(3) should be included if section 109XF is introduced.

3. Application of Division 7A to non-resident companies

In the Institute's previous submission, we recommended that the application of Division 7A to non-resident companies, which have resident Australian shareholders, should form part of the wider foreign source income anti-tax deferral consultation and not part of the consultation for amendments to Division 7A. This was to ensure that we had a consolidated set of rules dealing with non-resident companies.

That said, we understand the consultation for the foreign source income anti-tax deferral rules is still ongoing and draft legislation has yet to be prepared. Therefore, we submit that proper consideration of the interaction between the Division 7A application to non-resident private companies and the foreign source income anti-tax deferral rules be given during the ongoing consultation on the controlled foreign company rules. The Institute would be happy to participate in any targeted consultation in this regard.