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25 February 2013

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 - Discussion Paper" ("the Discussion Paper").

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

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

If the Board does not accept this model as the basis for reforming Division 7A (but instead choses an alternative model), we would request that the proposed model be consistent with the outcomes of the statutory interest model – i.e. a reduction of complexity of the main issues identified above whilst being consistent with intent and policy.

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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

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1 THE POLICY OF DIVISION 7A

1.1 Current policy of Division 7A

Summary point 1
While it is acknowledged that Division 7 previously contained a "sufficient distribution" rule and a "disguised distribution" rule, the sufficient distribution rule was turned off (effectively) from 1 July 1986. The policy of Division 7A is therefore (currently) limited to dealing with disguised distributions.

Summary point 2
We do not believe that the Government's request to consider "broader reforms" to Division 7A should include the consideration of expanding the current policy of Division 7A within this review. We believe that this will bring into question other significant policy issues and questions. It is our view that such other policy issues should be considered separately to this review.

1.1.1 As outlined by the Board in the Discussion Paper, Division 7 of the Income Tax Assessment Act ("ITAA") 1936 (historically) had two aspects. The first essentially requiring that companies make "sufficient distributions" and the second essentially dealing with "disguised distributions" of retained profits.

1.1.2 However, with effect from 1 July 1986, the sufficient distribution rule was predominantly turned off through the operation of the new rule in s.105B(2) of the ITAA 1936. While Division 7 continued in operation from that date, its application was effectively limited to preventing "disguised distributions" under s.108.

1.1.3 Division 7A was drafted using the same policy intent of s.108 – that is, Division 7A has been drafted on the basis that only "disguised distributions" are treated as deemed dividends.

1.1.4 This current policy of the Division 7A is outlined quite clearly in the Explanatory Memorandum to s.108 when it was re-written in 1987, and was also clearly articulated when Division 7A replaced s.108. The following quotes from the Explanatory Memorandum have been provided below.

> *Section 108 - Taxation Laws Amendment Act (No.3) 1987*
> *Under the existing section 108, disguised distributions to shareholders by way of loans or advances or by way of payments by the company on behalf of, or for the individual benefit of, any of its shareholders, to the extent they represent distributions of income, are deemed to be dividends paid by the company, other than for withholding tax purposes. The existing section 108 is to be repealed and a strengthened provision inserted in its place.*

> *<u>Division 7A - Taxation Laws Amendment Act (No. 3) 1998</u>*
> *9.120 Private company dividends disguised as loans are currently addressed by section 108 of the Income Tax Assessment Act 1936 (the Act). Section 108 operates by deeming an amount to be a dividend where a private company lends, advances, or credits the amount to or on behalf of a shareholder or an associate of the shareholder. However, the section only deems so much of the amount to be a deemed dividend as in the opinion of the Commissioner represents a distribution of profits. The section relies on field audits to identify cases. Such audits have shown that it is difficult to determine whether section 108 applies to particular transactions and that the section does not always apply where it was intended to.*
>
> *9.2 The purpose of the amendments is to ensure that private companies will no longer be able to make tax-free distributions of profits to shareholders (and their associates) in the form of payments or loans.*

1.1.5 As correctly outlined in the Board's report, the Government has requested that the Board review Division 7A with respect to whether Division 7A is achieving its policy intent. We highlight that the reference to policy intent in this term of reference is a reference to "inappropriately accessing the profits of those companies", or alternatively "disguised distributions".

> *"Division 7A contains integrity provisions designed to prevent shareholders (or their associates) of private companies from inappropriately accessing the profits of those companies in the form of payments, loans or debt forgiveness transactions. Within this context the Board should … examine whether Division 7A gives effect to <u>this policy intent</u>."(Discussion Paper, Terms of Reference, page 2)*

1.1.6 While the terms of reference state that the Board is to have consideration to broader reforms to Division 7A, we do not believe that the Government requested the Board to re-consider the policy intent of Division 7A. When reading this statement in the context of the 18 May 2012 media release and the entire terms of reference, we believe the reference to broader reforms was in fact directed to items such as whether the provisions could be drafted in a "clearer and simpler manner".

1.1.7 We have serious concerns if the Board were to consider expanding the policy setting of Division 7A. Firstly, we believe that the main aim of this review is to address the significant complexity issues with Division 7A, from both a taxpayer and administrative perspective. We do not believe the Government intended that the Board re-engineer the policy of Division 7A.

1.1.8 However, even if the terms of reference could be read such that the Government considered the policy of Division 7A was to be reconsidered as a part of this review, we highlight the enormity of such an assignment given the vast number of additional and significant policy issues that would have to be brought into question, including: (a) the dichotomy between private and public companies and whether there should be a different treatment for such classes of companies; (b) the corporate tax rate for trusts; (c) whether entities should be able to group business activities outside of tax consolidation; (d) the broader ramifications for public

trading trusts; (e) the limitation of discount capital gains to certain entities and (f) other significant policy issues. The additional consultation and analysis required in respect to adequately covering a review of the policy of Division 7A and the myriad of issues would make it exceedingly difficult if not impossible for the board to complete its report by 30 June 2013.

1.1.9 We believe that each of these issues (systemically) require careful consideration and therefore should not be brought into the current review of the operation of Division 7A and the current policy intent of the provisions.

1.1.10 In summary, we believe that trying to address bigger policy questions, outside the current operation of Division 7A, would be overly ambitious for the Board and would make it difficult for the review of Division 7A to be completed and accepted by the Government in whole (rather than in part). That is, there would be a significant risk that the Government would accept in part (and not in whole) some of the recommendations made by the Board, resulting in what we believe would be a dysfunctional set of provisions and amendments to our current tax regime. In our view, this would simply result in the taxation law being more complicated than it is currently.

1.1.11 Accordingly, we strongly request that the Board restrict its current review of Division 7A to the boundaries of the current policy setting of Division 7A. Should the Board consider it worthwhile to consider additional broader policy questions and associated reforms, we would request that the Board seek approval from the Government to conduct a separate review on such aspects. In this way, the simple reform of Division 7A will not (in our view) be side-tracked by some very difficult and significant policy questions.

1.2 Identifying “disguised distributions” of profit

Summary point 3
Whether profits have been provided to shareholders (or associates of shareholders) as “disguised distributions” of profits requires consideration of the transaction and whether the transaction should be reclassified. A critical review of transactions by the Board would help to determine whether (in the Board’s view) such transactions should be reclassified as disguised distributions.

Summary point 4
In our view, a transaction should not be considered a “disguised distribution” if the company is otherwise compensated at an arm’s length rate for the relevant transaction. In such a case, we believe that the shareholder or associate has not received a benefit from accessing the relevant corporate funds (when measured against a transaction that could have been obtained from an external transaction).

Summary point 5
While an arm's length transaction test would be an appropriate policy for determining "disguised distributions", for compliance purposes, we believe that this should be codified into some simple bright line tests.

Overview

1.2.1 Both Division 7 and Division 7A were targeted at identifying disguised distributions to shareholders and associates of such shareholders.

1.2.2 While Division 7 required a Commissioner's determination, Division 7A has been drafted in a manner that (to some degree) removes this discretion so that all transactions with shareholders or associates are to be treated as deemed dividends (unless such transactions meet the requirements of an exclusion).

1.2.3 On a whole, we believe that this approach to identifying disguised distributions can be an effective mechanism to dealing with the integrity issue. However, it is critical that the exclusions are appropriately drafted and do not inappropriately categorise arm's length arrangements as being disguised distributions.

Identifying disguised distributions – Question 2.2

1.2.4 In our view, at a very general level, a disguised distribution would be one where a taxpayer has been able to access the profits of a company in a manner that provides a benefit to the taxpayer as compared to a transaction that the taxpayer would otherwise enter into with a third party. We believe that the provision of such a benefit to a shareholder or an associate would result (in most cases) in an inappropriate accessing of the profits of the company. We believe that this sets a high level principle or policy for when a transaction with a shareholder or associate would be considered a disguised distribution.

1.2.5 Where such a benefit does not occur, simply because the same result could have been achieved by contracting with third parties, we believe that a shareholder or associate should not be regarded as having received a disguised distribution of the profits of a company. –.

1.2.6 In its purest form, such a premise would effectively involve introducing an "arm's length" rule to determine whether a transaction is a disguised distribution. However, our main concern with the introduction of such a rule would be the high compliance costs associated with requiring all taxpayers to self-assess the commercial terms. This could lead to ambiguity in the law and difficulties from a tax administrative perspective.

1.2.7 We note that the loan and payment rules currently contain an arm's length rule in Division 7A. That is, there is an exception for arm's length loans (s.109M) and for arm's length consideration (s.109C and CA). However, the loan rules also allow taxpayers to use benchmark interest rates to avoid the requirement to self-assess arm's length loan terms (and thus avoid compliance issues). Accordingly, we believe that the same approach should be undertaken in the revised Division 7A – that is by providing for some (commercial) bright line tests that are more in line with

commercial transactions (other than the current seven year principal and interest loan).

1.2.8 In our view, applying this principle to the arrangements described in Question 2.2 of the Discussion Paper would highlight that (under the current policy setting of Division 7A), all such transactions identified would be considered an inappropriate use of the company's profits, unless access to such profits was provided to the entity under an "arm's length" rule.

1.2.9 Once an arm's length amount is charged to the relevant entity, the use of the funds by that relevant entity becomes (in our view) irrelevant. This is because, in all of the cases outlined in Question 2.2, the relevant entity could have obtained a loan from an external party to otherwise fund such transactions.

1.2.10 While it could be argued that some of these arrangements should be excluded from the operation of Division 7A (e.g. funding the business activities of a non-company entity within a group), we highlight that the current policy setting of both Division 7A and the relevant entity taxation provisions do not (in our view) support such exclusions being introduced into Division 7A.

1.2.11 Therefore, under the current policy setting, we believe that it would be difficult for the Board to make such a recommendation without (once again) expanding the scope of the review. We note that once this policy is implemented with the appropriate arm's length exclusion outlined above, the operation of Division 7A would become significantly simpler as compared to the current regime.

1.3 Comparison to other jurisdictions

Summary point 6
While other jurisdictions contain provisions dealing with "disguised distributions", we believe it is difficult to use such principles for a comparison to the Australian provisions simply due to the key differences between the regimes (e.g. imputation versus classical systems, differential in tax rates, special concessions for small business companies, CGT differentials).

1.3.1 While we understand the need to consider what occurs in other jurisdictions with regards to "disguised distribution" rules, we do not believe that this provides meaningful analysis unless the "whole of tax" system is being reviewed.

1.3.2 This is because there are fundamental differences between other aspects of international regimes which make the comparison meaningless. For example, and as identified in the Discussion Paper, we would find it difficult to compare a regime that does not have imputation (i.e. a classical system) with the Australian taxation regime. We do not believe the same policy considerations occur under both. This is because imputation can result in no tax being paid by a shareholder if their marginal tax rate is less than 30% when receiving a dividend. Under a classical system, the non-payment of a dividend will always have an implication for the shareholders.

1.3.3 Furthermore, other major differences between the systems, such as the differentials in tax rates for all entities, special tax concessions for particular taxpayer classes, and the treatment of capital gains tax, would all need to be

compared and considered when assessing the exact impact and policy grounds for any decision.

2 THE DISTRIBUTION MODEL

2.1 Consistency with the current policy

Summary point 7
We do not believe that a distribution model would be consistent with the current policy intent of Division 7A and would result in significant policy change. We believe that such policy changes should be considered outside of this current review of Division 7A

2.1.1 We appreciate the statement that is made in the Discussion Paper at paragraph 5.35, being that the "Board is mindful that this model raises for consideration the introduction of a regime outside Division 7A.

2.1.2 However, we highlight that not only would a distribution model result in a regime outside of Division 7A, but it would also bring into question significant other policy questions and considerations (as outlined earlier).

2.1.3 Accordingly, a distribution model would expand the review of the current Division 7A and the policy intent of the current provisions, to a full review of a significant number of other issues including the progressive tax system and the taxation of trusts. In our view, such a review of policy considerations would be (effectively) a review of the whole system of taxation for private groups in Australia. We do not believe that the Government intended the review of Division 7A be extended to such a review.

2.1.4 We refer to the Press Reference by the Hon David Bradbury MP on 18 May 2012, where the following intent of the review was stated:

> *Division 7A plays an important role in <u>ensuring that the profits of private companies are not paid to shareholders</u> (or their associates) without being subject to the appropriate rate of tax.*
>
> *Since its introduction in 1997, Division 7A has been subject to numerous amendments to ensure the Division operates as intended.*
>
> *However, these amendments have increased its complexity and arguably led to unintended consequences.*
>
> *Last year's successful Tax Forum raised Division 7A as a particularly thorny issue for small business - especially for users of trusts that need working capital to reinvest in their business.*
>
> *This post-implementation review will examine whether there are <u>options to simplify this complex area of the law</u>, while still ensuring the integrity and fairness of the tax system.*
>
> *The Board will conduct the review in line with the attached terms of reference and provide the Government with a final report by 30 June 2013.*

2.1.5 As highlighted earlier, we believe there is significant risk in combining a review on the effectiveness and the complexity of Division 7A(within the current policy context) with a broader policy review of the operation of companies and trusts.

2.1.6 That is, a broader policy review contains a significant number of issues that must be considered, including its broader effect on the public (including its impact on small business and operations).

2.1.7 Furthermore, we believe there would be absolutely no guarantee that all of the policy recommendations that are to be made by the Board would be accepted by the Government in implementing the new regime. This could mean that the Government could very well accept a distribution model for private companies and not accept a working capital rule for trusts. We believe there are good grounds for such concern that this could occur, given the Government's track record for selective implementation of "grouped" policy recommendations, examples which occurred in the MIT review in relation to the Division 6C tests and the Rights to Future Income review in respect of the treatment of "income rights" on a prospective basis.

2.1.8 If such an outcome were to occur for the Division 7A review, we strongly believe this would be an absolute disaster for the taxation of private groups in Australia and not one for which we could offer any form of support in the current economic climate.

2.1.9 Accordingly, we cannot support the consideration of this model in the context of the current review and the policy intent of Division 7A.

2.1.10 If the Board feels strongly about these broader policy issues, we would recommend that such a review be conducted separately to the review of Division 7A, be one that is specifically sanctioned by the Government and that is not biased to recommendations of a revenue positive nature (e.g. a deemed distribution) as compared to recommendations that may have a cost to the revenue (e.g. a working capital exception).

2.2 Complexity of a distribution model

Summary point 8
The distribution model would introduce a significant layer of complexity for taxpayers in the middle market.

Overview

2.2.1 At a high level, we agree that the distribution model looks simple – that is, a company is required to distribute all of its profits except for those used for a permitted purpose.

2.2.2 However, we have tested the distribution model to a real life case study involving a simple group with four trusts, two corporate entities and a number of individual taxpayers. We have applied the high level principles to the case study with actual numbers and have identified significant complexities in trying to apply the proposed model.

2.2.3 We have not included the case study with this submission, simply due to the length of the document. However, we would be more than happy to provide this case study to the Board and walk the Board through the example and the sample financial statements.

2.2.4 For simplicity, we have summarised our findings and our main issues encountered below.

Requirement to complete a cash flow statement

2.2.5 Identifying whether funds were used for a permitted purpose required us to complete a cash flow statement for each entity in the private group. That is, only by way of preparing a cash flow statement were we able to identify the "source of funds" received by the entity and whether company profits were used to fund certain non-permitted activities.

2.2.6 For example, an entity within the group may have funded the acquisition of passive assets by cash received from several sources. Where all cash flows were received into a central location (e.g. one bank account), this also required an appropriate pro-rata of all of the working capital funding to various activities.

2.2.7 Accordingly, if the trust was funded by way of: (a) company profits; (b) trust profits; (c) sale of fixed assets for no profit; (d) bank loans; and (e) loans from shareholders; then this required us to calculate the amount of cash received from each source for the income year into the working capital account and then pro-rata the extent of this funding to determine the amount that was used to acquire the passive asset (being a "non-permitted" purpose of the company). Only after such an exercise was conducted could we determine whether the passive asset was "partly" funded by corporate profits and "partly" funded by other funds.

2.2.8 We found this exercise to be extremely difficult and onerous. That is, there was a negative onus placed on the entities to identify the extent to which an activity was funded by way of company profits in order to avoid a deemed distribution.

Tracing profits through private groups

2.2.9 Another problem encountered when applying the distribution model was that of tracing where the corporate funds have been disbursed (via working capital) throughout the group. This occurred, for example, where the corporate entity did not have a bank account and the various other entities within the group had their own bank account for operational purposes.

2.2.10 The difficulty with tracing occurred (for example), where four trusts distributed (in a chain) to the corporate entity. Where the amount remained unpaid, this was only a UPE between the corporate entity and the last trust in the group. However, where one of the trusts in the group subsequently (say two years later) used some funds to provide a private benefit to a shareholder or associate, we had great difficulty determining whether the corporate profits had been used to fund the private expenditure or that the expenditure had in fact been funded by other means.

2.2.11 As private group structures are now quite complex (involving companies, trusts, partnerships and individuals), we believe it would be very difficult to trace the

use of the corporate funds through the group of entities (i.e. in determining whether the private expenditure has been funded by those corporate profits). Furthermore, the passage of time (even a relatively small period) would quickly compound this difficulty.

Determining the relevant group of taxpayers

2.2.12 We also found it extremely difficult to determine whether such entities should be grouped for determining a "permitted purpose" of the corporate profits.

2.2.13 While we acknowledge that this could be quite simple in a "family trust" group that has made a family trust election, we note that many groups have not made family trust elections (i.e. they may involve simple companies in a flat structure). Accordingly more complex grouping rules would need to be introduced to deal with whether the entities would be grouped for this test.

2.2.14 On this point, we highlight the complexity in applying the grouping rules contained in Division 328 of the ITAA 1997 (i.e. the connected entity test of the small business CGT concession provisions). Such grouping is overly complex in a small business CGT concessions context, which is only applied when seeking to access the concessions (rather than on an on-going (day to day) basis).

2.2.15 We would therefore have serious concerns with using the Division 328 grouping rules for the purpose of annually testing whether entities are within a corporate group and whether corporate profits used by those entities are for "permitted purposes".

Determining whether an asset is truly passive or active

2.2.16 As a starting point, we highlight that the income / capital divide is a significantly complex issue and whether an item is held or income or capital account is not straightforward. There continues to be significant dispute with the ATO in this regard, noting that even the ATO's recent ruling on this issue (TD 2011/21) states that each case depends on fact and degree.

2.2.17 Accordingly, we believe that having an income / capital divide will (at first instance) be significantly difficult from a compliance and administrative perspective.

2.2.18 We note that the Board outlined a possibility of using the CFC "passive income" rules in determining whether an asset is passive or active.

2.2.19 While we understand that this was only a suggestion for further consideration, we highlight the significant complexities that are faced when trying to establish a passive / active divide. On this point, we are sure that the Board would be aware of its recommendations contained in its paper titled "Review Of The Foreign Source Income Anti-Tax-Deferral Regimes– A Report To The Assistant Treasurer And Minister For Competition Policy And Consumer Affairs" in respect of this issue.

2.2.20 In that report, the Board outlined the many issues faced with using the CFC "passive income" test and the recommendations to overcome those problems. Furthermore, the Board outlined the significant complexity in dealing with passive income that was effectively derived from another business of the group. In dealing

with this second issue, the Board recommended a "consolidation" approach, so that intra-group passive arrangements would be ignored.

2.2.21 In applying the passive / active divide, we found it very difficult to ascertain whether assets would be considered active or passive – for example:

- A shopping centre that is owned by a land owning trust that is leased to a management company in the same group.
- A factory building that is owned by a company and is leased (95%) to another entity in the same group for business purposes and is also leased (5%) to an external party.
- Cash being retained in a bank account for future expansion or for future significant acquisitions (to occur in four years' time).
- Determining whether the levels of cash in a bank account would breach a passive income test.
- Determining whether significant levels of cash in a bank account would breach a passive income test if it was also matched by significant overdraft facilities.

2.2.22 In a practical sense, we therefore had some significant problems with being able to determine whether assets would be considered passive or active.

Applying the rules to arrangements having a dual purpose

2.2.23 We also ran into practical difficulties in determining whether the use of an asset that has a dual purpose would also result in a breach of the permitted purposes test.

2.2.24 For example, assume that a trust in the group owns an active asset that is used predominantly for business purposes (95% usage) and to a far lesser degree for the purposes of the shareholders or associates (5% usage).

2.2.25 Would this arrangement result in the loan funding to acquire the asset being partly for permitted purposes and partly for non-permitted purposes? Therefore, would part of the loan be deemed a non-permitted purpose? What if a charge were to be made to the shareholder or associate to compensate for this private use? Would this simply create further passive income which would require an additional distribution (being of passive income)?

2.2.26 What if the company continued to pay for expenditure of the trust in running the asset? Would 95% of the expenditure relate to permitted purposes and 5% of the expenditure relate to non-permitted purposes?

2.2.27 We also questioned what would occur in the times when the asset remains idle. Is the presumption that the asset is available for use by the shareholders / associates at those times and therefore used for a non-permitted purpose? Would there need to be an apportionment during those periods?

Dealing with profits that are no longer used for approved purposes

2.2.28 Our practical example demonstrated some issues associated with a change in the purpose or use of funds. Similar issues also occurred where (for example) the relevant asset acquired no longer existed.

2.2.29 For example, assume a company has retained profits which are lent to a trust in the group to acquire a business asset ($200). Assume that the value of the asset plummets to $100 and the asset is sold for $100. The $100 is used to repay the original loan, whereby the remaining $100 remains outstanding.

2.2.30 In this example, the ATO would agree (through TR 2004/4) that the loan from the private company would continue to have a nexus to the income producing asset (even though it is not owned by the trust). However, for the purpose of a distribution model, would the loan of $100 still be taken to have been used for funding an asset used for permitted purposes? If that's the case, what if the loan remains outstanding for 5 years or 10 years?

2.2.31 A similar example would occur where an asset (funded from corporate profits) is used for active purposes – whereby, it is temporarily (say 24 months) not used for active purposes. Assume that later the asset is subsequently used for income producing purposes. Would this result in a deemed distribution during the temporary period?

Transitional matters

2.2.32 We also identified a number of transitional issues that we believe would add to complexity of the capital / income divide. That is, there will be current assets held by group entities that are funded by existing profits.

2.2.33 We believe this gives rise to two important questions in relation to: (a) whether the rules will apply to existing profits; and (b) whether the rules will apply to existing assets that are passive assets.

2.2.34 When this coupled with tracing current versus existing profits and assets on a future basis, we believe that this adds significantly to the complexity of tracing funds through the group that are used for permitted purposes.

2.3 Differentiating between private and public companies

Summary point 9
We highlight that a distribution model would further place public companies at a competitive advantage as compared to private companies and thus would result in further distortions in the market place as compared to the current system.

2.3.1 A move to a distribution model for private companies will create further differentiations between private and public companies and will not address perceived issues of the progressive tax system if companies are used for investment purposes.

2.3.2 For example, a taxpayer could alternatively invest in a public company that invests in passive assets and, in this way, be able to overcome the distribution rules

brought in for private companies. Accordingly, we question whether the introduction of a distribution rule would deal with the perceived issue of investing in passive assets if shareholders could simply move to widely held public companies that do the exact same thing.

2.3.3 Again, as noted earlier, a distribution model in our view raises significant issues of policy and therefore we believe that such considerations should be performed outside of this review.

2.4 Revenue neutral outcomes

Summary point 10
While we cannot perform revenue costing, we believe that the distribution model is likely to result in a significant increase in revenue collection. We believe this is contrary to the terms of reference requiring revenue neutral or near revenue neutral outcomes.

2.4.1 While it is not possible for us to perform appropriate revenue costing on any of the models (simply due to our lack of access to costing information), we make a few high level comments on what we believe is likely to be the revenue implications of a distribution model.

2.4.2 Based on our comments below, we would be very surprised if the distribution would be "revenue neutral" or "near revenue neutral", as required by the terms of reference.

2.4.3 That is, if private companies were required to pay dividends to their shareholders, we would expect that this would give rise to a substantial amount of dividends (both franked and un-franked) that would be required to be paid on an annual basis when factored through the number of private companies that derive annual profits.

2.4.4 In comparison (and from a revenue costing perspective), unpaid present entitlements (UPE) that were used in the working capital of trusts would not have resulted in any revenue collection prior to 2010 (due to such UPEs being excluded from Division 7A). Subsequently, we highlight that PSLA 2010/4 also would only have resulted in interest income being recognised by companies in respect of such UPEs at 30%. However, where those UPEs have been used for income producing purposes in the trust, the interest amounts have also given rise to deductions to the relevant trust (offsetting the income included in the company return at 46.5%). Accordingly, on a systemic basis, if an allowance was provided for "trust" working capital, we do not believe that this would give rise to a cost to the revenue that would outweigh the amounts to be collected from deemed distributions.

3 RE-WRITING DIVISION 7A

3.1 Overview

Summary point 11
Division 7A should be based on a statutory interest model (with certain modifications). We believe that this model greatly simplifies the operation of Division 7A from a compliance and administrative perspective.

3.1.1 This section sets out how the revised Division 7A would operate, taking into account our comments regarding policy intent as contained in Section 1 of this submission.

3.1.2 At a high level, we support the statutory interest model. We believe that such a model provides the greatest possibility for reforming Division 7A as compared to the other models. Pursuant to the recommendations contained in this submission, the current Division 7A regime could be substantially simplified by:

- Turning all funding arrangements (including UPEs) into loans
- Removing (or greatly simplifying) almost all interposed entity provisions
- Removing requirements to calculate minimum loan repayments
- Simplifying the Commissioner’s discretion, by introducing self-correction mechanisms

3.1.3 At a high level, we believe that all of the proposals (and their outcomes) contained in this section are consistent with the overall policy intent of Division 7A That is, the new provisions as proposed in our submission would target disguised distributions from a corporate entity to shareholders or associates of those shareholders. Accordingly, the new provisions would achieve the policy intent in a greatly simplified manner.

3.2 Making Division 7A more readily understood

Summary point 12
We believe that voluntary compliance and understanding will improve if the Division 7A provisions are written in a manner that is less complicated and more intuitive.

3.2.1 Our submission has been focused on one key objective, improving the effectiveness of Division 7A in the most simplistic manner possible [or “one key objective, improving the effectiveness of Division 7A by introducing a greater degree of simplicity and equity”]. We believe that this is critical to ensuring that very complex provisions can be applied by small business.

3.2.2 To date, the ATO have embarked on a significant education campaign on the application of Division 7A. However, while compliance is improving, we are often surprised by how many taxpayers and tax agents are unaware of how some of the

more complex parts of Division 7A operate – for example how UPEs and the interposed entity rules work.

3.2.3 It is therefore important that the Board make recommendations that are intuitive for taxpayers and the administration. This, in our view, would help to ensure that there will be a greater level of voluntary compliance with the provisions, even if the complex parts of the provisions are not readily understood.

3.2.4 In our view, this is the best means by which Division 7A could be made more easily understood especially by small business owners.

3.3 Revenue implications

Summary point 13
We have aimed at providing the Board with a proposed package of suggested reforms that we believe would help to meet the criteria of "near revenue neutral". However, as costing is a matter for the Government, we cannot appropriately comment on this based on the limited information that we have available.

3.3.1 We highlight that throughout the submission we have provided our thoughts on the impact of our recommendations on revenue costing.

3.3.2 We have strived to put forward our recommendations as a complete package with a view to meeting this requirement as contained in the terms of reference as provided by the Government.

3.3.3 However, that being said, we have very limited information available to us. Furthermore, costing is a role for Government and it is very difficult for those consulting on reforms to accurately predict how measures will affect revenue costing. ,

3.4 Dealing with errors

Summary point 14
A self-correction mechanism could be inserted into the new Division 7A to allow for automatic adjustments where there is an honest mistake or inadvertent omission. The provisions could also build-in a penalty adjustment when the error is self-corrected.

Summary point 15
Provided that the recommendations contained in this submission are accepted, we believe Division 7A will be greatly simplified. Accordingly, if a self-correction mechanism is introduced, we do not see a significant requirement to maintain a Commissioner's discretion.

Summary point 16
If the recommendations contained in this submission are not accepted, the requirement for a Commissioner's discretion would depend on the overall complexity of the new model, the level of the penalty imposed on self-correcting, and whether the Board can address the issue by introducing a self-correction mechanism.

Summary point 17
In order for a dividend to be franked under Division 7A, one is generally required to apply to the Commissioner. This is not an efficient way of dealing with the integrity provision. A deemed dividend should either be frankable (to the extent of franking credits) or should be dealt with better under the "later dividend" rules contained in s.109ZC.

Introducing a self-correction mechanism

3.4.1 Before outlining our recommendations, we believe it is worthwhile first addressing Question 5.2 – i.e. whether a revised Division 7A would require a Commissioner's general relieving discretion.

3.4.2 One of the key issues with the current Division 7A is its complexity. As the consequences of failing Division 7A can be quite significant, a Commissioner's discretion is required to ensure that Division 7A does not inappropriately operate in an unjust and unfair manner for taxpayers that have made an honest mistake or inadvertent omission.

3.4.3 One of the key advantages of the proposals contained in this submission would be to greatly reduce the complexity of the revised Division 7A provisions. However, it must be acknowledged that there will always be some degree of complexity in relation to how a "Division 7A" set of provisions would apply. This is because the provisions are integrity provisions involving significant transactions on a systemic basis – and thus the system must have some rigor.

3.4.4 However, a lot of the work that is currently performed by the Commissioner's discretion contained in s.109RB could be reduced by implementing a "self-correction" mechanism in the redrafted provisions.

3.4.5 By way of example, assume that a company charged interest at a 7.5% interest rate rather than an 8% interest rate. Rather than deem a dividend to have been derived as a result of the error, the provisions could allow a taxpayer to self-correct the error that resulted in the breach of Division 7A.

3.4.6 We acknowledge that a self-correction mechanism could result in complacency and a loss to the revenue by virtue of the time value of money (e.g. by not charging interest on a loan).

3.4.7 However, this issue could be addressed by restricting the self-correction mechanism to cases involving an honest mistake or inadvertent omission, similar to the current s.109RB (see also PSLA 2007/20 which supported an honest mistake or

inadvertent omission approach). That way, taxpayers could not take advantage of the self-correction mechanism by virtue of deliberately ignoring Division 7A.

Potential loss to revenue under self-correction

3.4.8 Arguably, a self-correction mechanism would allow a taxpayer to self-correct for all errors where the error is a result of an honest mistake or inadvertent omission. We are conscious that such a suggestion may result in a revenue cost to the extent that the Commissioner has not exercised his discretion for this simple fact alone. We are not aware of the cases where this has occurred and thus cannot comment on the revenue costing of this suggestion.

3.4.9 Should this result in an unacceptable revenue cost, the loss to revenue could also be compensated by imposing some form of penalty on the operation of the self-correction provision. The extent of the penalty would need to be considered by the Board, but would be a matter of detail in drafting the provisions.

3.4.10 An example of a provision that self imposes a penalty is contained in s.205-70 in respect of franking deficit tax. Where franking deficit tax is paid, a credit is allowed to the franking account. However, if the amount of the deficit tax exceeds all credits by more than 10%, the credit is reduced by 30%, thus imputing a penalty.

3.4.11 Accordingly, while we do not believe it is important for the Board to determine the actual specifics of such a rule, we highlight that it would be possible for such a rule to be introduced under a self-correction mechanism.

3.4.12 We believe that a simpler and more attractive self correction mechanism would elicit a greater take up by taxpayers and their advisors thus generating an increase in revenue compared with current collections.

Dealing with the frankability of deemed dividends

3.4.13 Section 109RB(2) allows the Commissioner to make a determination that a deemed dividend under Division 7A is to be frankable for tax purposes. We believe that this places an enormous burden on the Commissioner to determine whether or not to apply the discretion.

3.4.14 We believe that the ability to frank the distribution should be automatic. This could be achieved in one of two ways.

3.4.15 Our preference would be to simply allow deemed dividends to be frankable for tax purposes. While Division 7A is an integrity provision, we are unclear why a taxpayer who receives a dividend (as opposed to one who is deemed to have received a dividend) should be treated any differently under the Tax Act. In our view, other than in a case of fraud or evasion, there seems to be no real strong policy reason for penalising deemed dividends under Division 7A.

3.4.16 If this recommendation (for whatever reason) is not accepted, it is our strong view that s.109ZC needs to be improved to deal with franked dividends. A franked dividend that is paid after a deemed dividend should be capable of being a “later dividend” as defined (and thus offset against the prior dividend). In such a case, the dividend should be non-assessable – however the franking credit gross up should be assessable and the franking credit should also be available as a credit.

3.4.17 To demonstrate, consider an example where 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. Compare this to a case where the $70 is a deemed dividend. In this case, the taxpayer will pay $32.55 as tax. However, if an actual fully franked dividend is later paid and offset against the loan, then we believe that only the franking credit gross up of $30 (and not the dividend) should be included in income (i.e. resulting in additional tax of $13.95) and a credit of should be provided for the franking credit of $30. The total tax paid after the later dividend would be equal to $16.50. Thus the adjustment to s.109ZC will put the taxpayer in the same position, however would compensate the revenue for any lost interest or penalties

3.4.18 Under this mechanism, the revenue is compensated upfront for the tax on the deemed dividend transaction – and the franking credit is only provided once paid. This provides a far more equitable result than is currently the case under s.109ZC.

Retention of the Commissioner's discretion

3.4.19 The requirement to retain the Commissioner's discretion will depend on a number of factor's including: (a) the consequences of breaching the revised Division 7A; (b) the overall complexity of the revised Division 7A; and (c) whether a self-correction mechanism could be employed to deal with the majority of errors.

3.4.20 If these items cannot be dealt with appropriately within the reforms of Division 7A, then we believe that there would be some requirement to retain a Commissioner's discretion over and above a self-correction mechanism.

3.5 Arm's length consideration

Summary point 18
A disguised distribution will effectively occur where a company (with profits) transacts with a shareholder or associate at a value that is not arm's length.

Summary point 19
In addition to an arm's length rule (which is currently contained in Division 7A), from a compliance and administrative perspective, the revised Division 7A would prescribe appropriate arm's length bright line tests. These bright line tests would reflect commercial arrangements and would be aimed at removing compliance and administrative issues associated with applying an arm's length rule.

3.5.1 As noted earlier in our submission, we believe that a disguised distribution can be identified by looking to whether a company has transacted with the shareholder or associate at a value less than market. In such cases a benefit would be provided to the shareholder or associate.

3.5.2 We note that the use of an arm's length test is currently employed by Division 7A for both loans and payments. That is, s.109M currently applies an arm's length rule for loans made in the ordinary course of business and s.109C and CA apply an arm's length test for valuing payments.

3.5.3 While an arm's length test would help to establish whether there has been a disguised distribution, we believe that the use of such a test would be very difficult for many SMEs to implement. That is, an arm's length test would be very difficult for the ATO to police from an administrative perspective and would be very difficult for taxpayers in the SME space to comply with if this were the sole test.

3.5.4 Therefore, and similar to the current Division 7A, we believe that the revised regime would stipulate appropriate "arm's length" arrangements that allow compliance with Division 7A for both the loan and payment rules. We note that this would be a change to the current Division 7A, which does not provide benchmark mechanisms for the payment rules other than an arm's length test.

3.5.5 On this point, we highlight the ATO's view of the definition of "arm's length" in TR 2002/2 as used in s.47A and outline that such a view would result in impractical outcomes. In the following section we provide a number of examples on where the arm's length rule would be required, and we request (specifically) that the Board consider a more appropriate operation of an arm's length rule that does not involve the kind of interpretation as contained in TR 2002/2.

3.6 Treatment of loans

Summary point 20
Loans provided by companies to all entities (other than companies) would require the loan to either be at "arm's length (similar to s.109M) or comply with legislatively prescribed terms (similar to s.109N).

Summary point 21
The principal and interest requirements of section 109N would be replaced by a requirement to charge interest at a statutory interest rate. The statutory interest rate will depend on whether the loan is structured as one being either secured or unsecured and whether the loan had an approved sunset clause.

Summary point 22
Where there is a sunset clause on the loan arrangement, we see no reason why interest could not be capitalised to the loan. This would overcome commercial problems currently being encountered where the borrower will not have cash flows during the early stage of a project to fund interest or principal repayments. This would reduce pressure of requiring the Commissioner to exercise his discretion. The sunset clause protects both revenue and integrity in this case.

Summary point 23
Where the loan is used for non-private purposes, we request the Board to consider an exception to the refinancing principle contained in s.109R, to allow the loan to be refinanced for a second term. This exception is only really required where the Board does not accept loans to be put on terms without a sunset clause.

Move to a statutory interest model

3.6.1 Essentially, we support the proposal to move to a statutory interest model, as outlined in Chapter 5 of the Board's Discussion Paper, with modifications as outlined in this section. The key benefits of implementing this model include:

- The removal of the minimum loan repayment rules contained in section 109E (as discussed at Section3.9).
- The ability to ignore the interposed entity rules where the "sunset clause" option is used for the loan from the company to the interposed entity (as discussed at Section 3.11).
- The ability to simplify all UPEs to companies, so that they are treated as loans requiring interest to be charged (as discussed at Section 3.8)
- The ability to ignore the trust interposed entity rules dealing with UPEs (as discussed at Section 3.8).
- The ability to provide commercial business to business funding from a company to a trust.

3.6.2 We believe that an equivalent to the current s.109M (for "arm's length loans) and s.109N (for compliant terms) would be used to identify acceptable loan arrangements under the statutory interest model.

Commercial loan options

3.6.3 One of the problems with Division 7A is the requirement to make interest and principal loan repayments on an annual basis. This requirement under s.109E and s.109N has given rise to significant compliance issues for taxpayers and has resulted in the Commissioner's discretion being sought where the borrower is unable to fund minimum loan repayments.

3.6.4 Essentially the problem with the current Division 7A loan requirements is its inflexibility to deal with real commercial arrangements of a private company and its relationship with other entities within the group. That is, the current seven year principal and interest option does not cater for most business to business loan arrangements.

3.6.5 Currently there is only one "commercial" exception to s.109N, which is contained in s.109M. This current exception is provided where the loan is made in the ordinary course of the private company's business and on the usual terms on which the private company makes similar loans to parties at arm's length.

3.6.6 However, the ATO's narrow view of this exception (as contained in TD 2008/1) is that it is only available where the private company also deals with external parties. Therefore, where a group borrows externally and lends such funds to group entities via a private company (e.g. an internal finance company) on terms it would provide to parties at arm's length, s.109M is not available. Therefore, the private company is unable to provide funds to related entities on broadly similar terms to that provided by the external financier. Accordingly, Division 7A, as presently drafted, cannot deal appropriately with commercial reality.

3.6.7 While a move to an “arm’s length” type principal could address these issues, such a move would result in significant non-compliance and administrative problems if this were to be the sole approach contained in Division 7A.

3.6.8 Accordingly, we believe that the Board should consider two approaches to dealing with the non-commercial aspects of the terms required by Division 7A (being very similar to the current system).

- Arm’s length rule – The first approach is to use an “arm’s length” approach, as currently contained in s.109M. However, the approach should clearly be available to a private company even where it does not deal with external parties. It should also be flexible enough to ensure that a group can charge a consistent interest rate without having to price each and every loan. This is discussed further below.

- Legislatively prescribed terms – The second approach is to prescribe approved loan arrangements, as currently contained in s.109N. However, the prescribed arrangements should be more commercially flexible, similar to those options contained in PSLA 2010/4 for UPEs. This is further discussed below.

Arm’s length rule

3.6.9 As outlined above, we believe that an exception similar to s.109M should be included in the legislation. However, the rule must overcome the impracticalities of the ATO view contained in TD 2008/1 (i.e. that the private company must at least deal with one external party on similar terms). In our view, the following two examples should fall within the arm’s length rule.

Example 1 – central financing entity
The Widget Group operates several businesses through companies and trusts. All funding is centralised through Aco Pty Ltd, which borrows $20 million from ABC Bank at 6.2% (interest only). The loan from ABC Bank is a rolling facility, renewed every three years. Aco Pty Ltd wishes to lend funds to the group at a small margin (i.e. 7.2%) at interest only, reflecting the same terms as that contained in the facility provided by ABC Bank.

Example 2 – arrangements equivalent to external financier
The Widget Group operates several businesses through companies and trusts. The net loan balance provided to trusts in the group is equal to $20 million. The Widget Group could borrow $20 million from an external financier at 6.2% (interest only and secured), on a rolling facility, renewed every three years. Based on this information, the group wishes to simply replicate those terms (plus a small margin) on all loans between group members that are considered associates for Division 7A purposes.

3.6.10 We believe that both of the above examples demonstrate a reasonable application of the arm’s length principal that should otherwise be available under s.109M. We believe that for many commercial groups, this option would alleviate many concerns with Division 7A. However, we are also conscious of the view taken by the ATO in TR 2002/2 on the meaning of “arm’s length” for s.47A purposes and

the impracticalities of that view in the above two examples. We recommend that the Board consider this and ensure that "arm's length" is interpreted in a manner that is consistent with it being applied to the examples above.

3.6.11 We also understand that one of the more significant challenges with this proposal is ensuring compliance with the arm's length principle such that the taxpayers have had proper regard to commercial comparatives. Where this is a concern, the Board could consider restricting this option to those groups that obtain appropriate documentation to support the commerciality of the relevant arrangements between group entities.

Legislatively prescribed terms

3.6.12 As outlined above, we believe that the stringent principal and interest terms required by Division7A as contained in s.109N and 109E should be replaced with two (more commercially viable) options for taxpayers. We believe that the two loan options that should be available to taxpayers should include:

- An interest only option (with no sunset clause)
- An interest only option (with a sunset clause).

3.6.13 It is noted that (depending on which option is chosen by the taxpayer), other terms and conditions could be attached to the loan to ensure the option is commercial from both a compliance and administrative perspective. These items are also discussed further below.

Determining the statutory interest rate

3.6.14 While Division 7A generally uses one statutory interest rate for all loans, we believe that the system could cater for different interest rates depending on the loan option chosen.

3.6.15 That is, a different rate should be allowed where the loan is secured by real property (as compared to unsecured) and where the loan has a sunset clause (as compared to having no sunset clause). In both cases, including security and a sunset clause should result in a reduced interest rate under Division 7A.

3.6.16 We note that the RBA publishes a range of interest rates that could easily be obtained by the ATO and used as the basis for the differing rates.

3.6.17 While some may argue that multiple interest rates will result in complexity, we do not agree that this would be the case. Currently, PSLA 2010/4 provides for two separate interest rates, which we believe is simple to determine and follow.

3.6.18 Furthermore, the proposed self-correction mechanism (as contained in Section 3.4 of this submission) would deal with any accidental errors that may occur in applying the interest rates.

Implications of using a penalty rate

3.6.19 We understand that the Board may consider a higher penalty rate to compensate for the revenue. We note that, in most cases, a commercial benchmark RBA rate is likely to be higher than the current benchmark Division 7A rate.

3.6.20 While we understand the revenue considerations, we also note that using an excessively high interest rate will result in a number of commercial problems.

3.6.21 For example, this is likely to result in issues for internal financing structures which receive interest at (say) 11% from the group under Division 7A and pay interest at (say) 6.5% to external financiers. This would result in an excessive profit margin, which would otherwise be avoided if the single group entities were to seek funding directly (rather than indirectly).

3.6.22 Furthermore, a penalty rate of interest may give rise to deductibility of interest issues where the relevant business begins making losses. We highlight that this is an issue that is currently targeted by the ATO under transfer pricing, where interest rates result in domestic losses. We understand that the ATO could question the deductibility of interest under such circumstances if there is never a prospect of deriving a profit due to the excessively high interest rates.

3.6.23 Accordingly, while we understand the basis for considering higher interest rates from a revenue perspective, we believe it will result in other significant and practical issues under Division 7A. We therefore believe the Board needs to provide for commercial rates rather than arbitrary rates under the revised provisions.

3.6.24 Furthermore, we believe that this issue could also be dealt with if an arm's length rule is provided to all taxpayers, which would allow for interest to be charged at an appropriate commercial rate between group members.

Capitalisation of interest

3.6.25 As illustrated by Appendix D, it would appear that one of the main issues associated with capitalising interest (from a revenue perspective) is the loss of revenue in respect of the repayment of interest through dividends.

3.6.26 However, where the arrangement involves a sunset clause and requires a higher rate of interest to be charged as compared to the current regime, we believe that this risk is reduced significantly.

3.6.27 For example, compare the following loan requiring interest to be charged at 10.59% over a ten year period. This is compared to Example 1 in Appendix D below.

Appendix D – Example 1								
Year	Opening	Interest	Payment	Closing		Co Tax	Ind Tax	Total tax
0	100.00			100.00		0.00	0.00	0.00
1	100.00	7.05	-18.59	88.46		2.12	4.38	6.50
2	88.46	6.24	-18.59	76.11		1.87	4.38	6.25
3	76.11	5.37	-18.59	62.89		1.61	4.38	5.99
4	62.89	4.43	-18.59	48.74		1.33	4.38	5.71
5	48.74	3.44	-18.59	33.58		1.03	4.38	5.41
6	33.58	2.37	-18.59	17.36		0.71	4.38	5.09
7	17.36	1.22	-18.59	0.00		0.37	4.38	4.75
Total		**30.11**	**-130.11**			**9.03**	**30.67**	**39.70**

Recalculation using 10 years, capitalised interest, higher interest rate								
Year	Opening	Interest	Payment	Closing		Co Tax	Ind Tax	Total tax
0	100.00			100.00		0.00	0.00	0.00
1	100.00	10.59		110.59		3.18	0.00	3.18
2	110.59	11.71		122.29		3.51	0.00	3.51
3	122.29	12.95		135.24		3.88	0.00	3.88
4	135.24	14.32		149.56		4.30	0.00	4.30
5	149.56	15.83		165.39		4.75	0.00	4.75
6	165.39	17.51		182.90		5.25	0.00	5.25
7	182.90	19.36		202.26		5.81	0.00	5.81
8	202.26	21.41		223.68		6.42	0.00	6.42
9	223.68	23.68		247.36		7.10	0.00	7.10
10	247.36	26.19	-273.54	0.00		7.86	64.48	72.33
Total		**173.54**	**-273.54**			**52.06**	**64.48**	**116.54**

3.6.28 As demonstrated by the above table, the revenue collected over the 10 year period is close to 3 times the ordinary revenue collected from a standard Division 7A loan agreement. While revenue collection is lower in the early years, we highlight that the present value revenue differential would still be substantially positive.

Providing for an appropriate sunset clause

3.6.29 Where the Board accepts the option of an interest only loan without a sunset clause (i.e. the statutory interest method contained in the Discussion Paper), then the issue of an appropriate sunset clause is less likely to be of a concern.

3.6.30 However, if the Board were to conclude that a sunset clause is required, we make the following comments.

3.6.31 The current Division 7A sunset clauses are effectively 7 years, 10 years and 25 years (s.109N and PSLA 2010/4).

3.6.32 In our view, the 10 year sunset clause is likely to provide an appropriate term for most loans. However, in many long term business to business funding

arrangements (e.g. a long term construction or development contract), a 10 year term will still not be sufficient.

3.6.33 We are aware of many cases involving a request for the Commissioner's discretion where the long term arrangements will not generate sufficient cash flows to fund the principal and interest repayments in the early years. Accordingly, we believe that it is crucial that the Board consider some flexibility in this area. We believe that the sunset clause issue could be addressed in a number of ways.

3.6.34 Firstly, it is possible to address this issue by allowing an exception to s.109R (the refinancing principle) where the loan is not used for private purposes. However, where a loan is refinanced, we believe that it should only be the original principal that is available for refinancing. Therefore, any capitalised interest remaining on the loan at that time would need to be repaid before the principal component could be refinanced.

3.6.35 In the alternative, we would recommend that the Board consider a sunset clause for non-private loans to be something that is in excess of 10 years. We understand that the Board has questioned the appropriateness of the 25 year loan arrangement at paragraph 2.50 of the Discussion Paper. While we do not appreciate the exact issue being contended in the Discussion Paper with respect to 25 year arrangements (i.e. as the shareholder or associate could obtain the same terms by borrowing from a bank), we simply request that the Board consider a sunset term that is at the very least 10 to 15 years for non-private loans. We believe that such a change to terms that reflect business lending reality is imperative. It is difficult to understand why funding requirements that would be used in actual business arrangements can currently fall foul of Division 7A. This has been one of the reasons why smaller SMEs have fallen foul of Division 7A – due to its lack of intuitive provisions and its ability to cater for "voluntary compliance".

3.7 Treatment of payments

Summary point 24
We believe that the current "payment" provisions contained in Division 7A could be used as a starting point for the framework under the revised provisions (including the otherwise deductible rule). However, we would strongly recommend that concerns with the "use of assets" rules be addressed. We also recommend that some of the more significant technical issues with the payment rules be addressed in the redrafting of the provisions.

Use of assets rule – private assets

3.7.1 A number of concerns are raised with respect to the use of asset rule. Firstly, Division 7A now applies to an asset that has been acquired by a company that does not necessarily carry on business and has not used the asset for income producing purposes (other than by way of rent charged to shareholders and their associates to comply with Division 7A). We also note that, but for the Division 7A mandated charges, the only source for the distributable surplus is the asset's increase in value. We can only understand the reasoning for this where (in the future) a sale of the asset will attract the 30% tax rate.

3.7.2 However, it has been unfortunate that (where the assets have not been sold), an option was not provided to taxpayers to "divest" or "demerge" those assets out of companies to ultimate non-corporate shareholders. It is unfortunate as those taxpayers are now required to apply s.109CA of Division 7A, and were not provided with an ability to restructure their affairs

3.7.3 As mentioned earlier, we can understand the rationale for applying Division 7A in this case. However, we believe that the Board should consider options allowing such assets to be rolled out to the shareholders. This is no different to the rollover provided for demergers, which does not result in a dividend to the recipient shareholders.

Use of assets rule – valuations

3.7.4 We are concerned that the application of s.109CA is based on an arm's length rule and does not provide any mechanism to determine the "arm's length" value for the use of the asset.

3.7.5 We agree with the Board's Discussion Paper at paragraph 4.26 – that this is an issue that not only involves compliance issues but also is one that involves a higher degree of risk of error (as it involves a requirement to value an arrangement). We would also expect that this would be a provision that is difficult to administer, as it also requires the ATO to obtain an arm's length price for the provision of the asset.

3.7.6 We understand the difficulty that could also arise with mandating valuation rules within the legislation. Accordingly, we believe that there are some options that could be considered by the Board, including an ability to use the Fringe Benefits Tax value as a shortcut available for taxpayers to comply with the provision.

Inconsistent repayment rules for different types of payments

3.7.7 We note that there are three types of payments covered by s.109C and s.109CA. The first is a payment that is effectively made on behalf of a taxpayer. The second is a payment made by transferring an asset to a taxpayer. The third is a payment made by allowing a taxpayer to use an asset.

3.7.8 It is noted that the second and third type are valued after taking into account the amount that the recipient repays the company for the relevant "payment". That is, they are net rules. However, the first is calculated on a gross basis. In order to repay the first payment type, the payment needs to be converted to a loan and then repaid.

3.7.9 While there are numerous technical issues such as this scattered throughout Division 7A, this example is highlighted to demonstrate some of the very simple internal inconsistencies contained within Division 7A. We recommend that these types of issues be addressed and examined when drafting the revised version of Division 7A.

3.8 Treatment of unpaid present entitlements

Summary point 25
Provided that the commercial options relating to loans are accepted by the Board and Government (i.e. in lieu of the current restrictive seven year requirements), then we believe that UPEs could be treated as loans under a revised Division 7A. We believe that this approach would greatly simplify the operation of the regime and would be consistent with the policy principles outlined in Section 1 of this submission.

Summary point 26
However, we highlight the significant historical issue associated with UPEs and that it would be inappropriate to apply this view on a retrospective basis to quarantined UPEs (i.e. simply by virtue of the financial impact that such a view may have for historical arrangements). It is therefore imperative that the Board recognise this one significant transitional issue and provide appropriate mechanisms to deal with this issue.

Treating UPEs as loans

3.8.1 The treatment of UPEs for Division 7A purposes is a longstanding issue. We note that while many taxpayers may not agree with the view that has been taken by the ATO in TR 2010/3, we generally believe there is widespread compliance with the terms mandated in the resulting practice statement PSLA 2010/4.

3.8.2 Accordingly, on go-forward basis, we believe that the treatment of UPEs as loans would provide for a significantly greater simplification of Division 7A for all taxpayers. However, we make this statement on the basis that the Board will consider and make recommendations to allow for loans between companies and trusts to be placed on commercial terms that do not only involve a seven year interest and principal repayment term.

3.8.3 From a transitional sense, for 30 June 2010 UPEs and subsequent, a transition from the current Division 7A (i.e. PSLA 2010/4) to a proposed new Division 7A would be made simpler if the loan options recommended in this submission were recommended by the Board. That is because there would be little change to the UPE terms.

3.8.4 However, we note that there has been over 12 years where PSLA 2010/4 did not apply to UPEs. Accordingly, there are a substantial number of UPEs that are not on 7 or 10 year repayment terms. We believe that this involves the single biggest transitional issue concerning Division 7A and that it would be inappropriate to bring such amounts within the realms of a new “deemed loan” rule. We therefore believe it is imperative that the Board considers and deals with this issue in its final report to the Government.

Removing the requirement for Subdivision EA and EB

3.8.5 Subdivision EA and EB are drafted on the premise that there is an unpaid present entitlement to a corporate beneficiary (either directly or indirectly). Where

such UPEs are treated as loans, we believe that the ordinary provisions of Division 7A would apply and that there would be no need for Subdivision EA and EB.

3.8.6 We believe that Subdivision EA and EB are two of the most complicated subdivisions within Division 7A. We therefore believe that there would be a significant reduction in complexity if UPEs were treated as loans under Division 7A.

3.9 Removal of the minimum loan repayment requirements

Summary point 27
If the Board accepts the loan options outlined earlier, the minimum loan repayment rules contained in s.109E could be repealed.

3.9.1 The minimum loan repayments contained in s.109E are (in themselves) quite complex and have involved a number of significant issues over the past few years. Furthermore, the calculation of daily interest and minimum loan repayments for many corporate groups involves significant compliance requirements.

3.9.2 It is noted that the seven year interest and principal model mandates a requirement for a s.109E type provision. However, under a statutory interest type model, there would be no requirement for such a provision.

3.9.3 In our view, significant compliance and complexity could be reduced through the removal of s.109E, which would only be available through the introduction of a statutory interest model.

3.10 Company to company exception

Summary point 28
A company to company exception should still be allowed under a revised Division 7A. However, we believe that such an exception will require an interposed entity rule as an integrity provision. We believe that this would require s.109T or a similar type provision to cater for this issue.

3.10.1 We believe that there are continued grounds for allowing the company to company exception as currently contained in s.109K. In such a case, we do not believe that loans from companies to other companies are to be considered disguised distributions.

3.10.2 However, we believe that there still will be a requirement for integrity provisions where a loan is made to a company without "profits", which then on-lends such amounts to an individual. In this context, we agree that a s.109T type equivalent provision would be required to cater for such issues.

3.10.3 We note that there may be alternatives to s.109T that may be more simple. For example, the interposed company could be deemed to include an additional distributable surplus equal to an amount (e.g. the lower of the loan balance from the original lending company and the distributable surplus of that original lending company). Furthermore, by using an "automatic" distributable surplus calculation, the reasonable person test could be removed. We are unable to say whether this

option would be a better substitute for s.109T, but highlight this for the Boards consideration nonetheless.

3.11 Exceptions to the interposed entity provisions

Summary point 29
Applying s.109T to cases not involving a purpose of avoiding Division 7A is contrary to the way in which the provisions should operate and needs to be addressed in the re-write.

Summary point 30
Where the first leg of a loan from an original lending company is on terms with a sunset clause, there should be no requirement to apply an interposed entity rule. We believe that this would significantly reduce the complexity of the interposed entity provisions and increase compliance with the provisions.

Summary point 31
Where the loan is interest bearing with no sunset clause, modifications would be required to an interposed entity rule to address integrity concerns. This would include a requirement that the interposed entity place all loans to trusts and individuals on complying terms and a rule addressing any debt forgiveness that occurs by the interposed entity.

The purpose test

3.11.1 One key current issue is the current debate as to whether s.109T involves a purpose test. While the ATO contend that no purpose test exists (TD 2012/12, para 18 and TD 2011/16, para 34), we highlight that this is clearly in contract to the Explanatory Memorandum which refers to a purpose test.

3.11.2 Accordingly, the fact that the ATO believe that s.109T can apply to ordinary transactions that have no purpose of avoiding Division 7A is an unacceptable application of the interposed entity rules. We therefore believe it is critical to make it clear that s.109T contains a purpose test and / or implement appropriate exclusions that can be used in a business sense (as outlined by the exclusions below).

Loans with sunset clauses

3.11.3 One key issue of the current Division 7A is the complexity of determining whether the interposed entity provisions apply. The ATO partly addressed this issue in TD 2011/16, paragraph 2(e). That is, where the original lending company places a loan on terms to the interposed entity, the interposed entity provisions should not apply.

3.11.4 We believe that this conclusion makes logical sense and should have legislative backing. That is, if the company makes a loan to an interposed entity and expects the money to be repaid, it has not made the loan to an interposed entity with an objective of providing the money to a target entity. That is, it has made the

loan for the purpose of deriving commercial interest and its money back by the end of the arrangement.

3.11.5 We understand that this logic applies if there is a sunset clause with respect to the loan from the original lending company. Therefore, we request that the Board consider recommending simplification of the interposed entity rule by providing an exception to the rules where the first leg is placed on terms. Essentially, this would remove the need to have this exception in a Taxation Determination.

3.11.6 We note for completeness that a similar exception applies if the leg from the interposed entity to the target entity is placed on commercial terms. The logic with respect to exception is almost exactly the same.

Loans without a sunset clauses

3.11.7 We understand that the logic provided above is unlikely to apply where a loan is provided to an interposed entity under an interest only loan. That is, a company (with a distributable surplus) makes a loan to another company (without a distributable surplus) which makes a loan to an individual or trust (interest free). Or alternatively, a company (with a distributable surplus) makes a loan to another company (without a distributable surplus) which makes a loan to an individual or trust (on complying terms) which is later forgiven.

3.11.8 In both of these cases, we understand that the interposed entity provisions should not be turned off simply because the first leg is on complying interest only terms, as this may result in an integrity issue. However, we believe that the interposed entity rule is not required if either of these two conditions are satisfied:

- The loan to the trust or individual from any interposed entity is placed on complying terms; and
- The relevant loan to the trust or individual is not subsequently forgiven (either directly or indirectly).

3.11.9 Where those two conditions are satisfied, we believe that s.109T could allow for an exception that again would be easy to comply with and is unlikely to cause a revenue integrity issue.

3.12 Retaining exclusions

Summary point 32
There are a number of additional exceptions contained in Division 7A. We believe that these exceptions would still be required in a re-write of the provisions

3.12.1 Subdivision D, DA and DB currently contain a number of exceptions to Division 7A. In our view, these exceptions are consistent with the policy intent of the provisions and should be retained going forward.

3.12.2 We therefore support the inclusion of these exceptions within the re-written Division 7A provisions.

3.13 Amendments to the distributable surplus calculation

Summary point 33
The distributable surplus calculation needs to be greatly simplified so that it follows ordinary principles. These principles are already applied when paying dividends, in accordance with TR 2003/8.

Summary point 34
We understand that extending the repayment of principal date can coincide with changes in the distributable surplus of a company at a later time. We therefore understand that the Board may wish to recommend the continuation of the adjustment requirement by s.109Y for "Division 7A amounts".

Determining profits

3.13.1 For s.44 purposes, a dividend is required to be paid out of profit. The concept of profits for the purpose of s.44 is contained in the ATO's ruling TR 2003/8 and has been referred to recently in the ATO's ruling TR 2012/5 in determining dividends for s.254T purposes.

3.13.2 It is therefore unclear why Division 7A uses a different starting point under s.109Y. That is, the concept of distributable surplus commences with net assets in the balance sheet, adjusted to exclude certain liabilities and adjusted for certain valuation differentials. We are unsure why this "net asset" calculation differs from what is required as profit under TR 2003/8.

3.13.3 We believe that the provisions could be further simplified by (essentially) determining that the starting point of a distributable surplus be the amount of the profit of a company using general law principles that are applicable for s.44 purposes. If adjustments need to be made (e.g. for commercial loans etc), then the common law position should otherwise be adjusted for Division 7A purposes as appropriate.

Integrity if debt forgiveness of principal

3.13.4 We understand that the Board may become concerned with integrity issues associated with provided an extended period of time to repay principle (i.e. under an interest only loan), as the distributable surplus of the company may move over time.

3.13.5 However, s.109Y was changed so that the distributable surplus includes an amount equal to the debt forgiveness amount treated as a deemed dividend. Accordingly, even if the distributable surplus was equal to nil, the current adjustment ensures that the loan forgiven is deemed to give rise to "profit" in the company for the purpose of having a dividend under s.44.

3.13.6 We believe that this type of adjustment would also need to be carried through under the amendments, especially if the Board accepts a move to a statutory interest model.

3.14 Family law obligations

Summary point 35
While s.109RC allows dividends to be franked, family law arrangements can still result in double taxation. We recommend that further refinements are introduced to remove this double taxation that may occur.

Outlining the problem

3.14.1 We have previously provided calculations to the Board indicating the double taxation issue that still occurs under family law arrangements, even where s.109RC allows amounts to be franked. Without going through these calculations in detail again, we highlight this point with a very simple example.

3.14.2 Assume Aco has share capital of $10 and acquires property for $10. Later the property is worth $110. Assume that under a family law obligation the property is to be provided to individual A. Assuming rollover relief occurs under Subdivision 126-A of the ITAA 1997, individual A assumes the cost base of $10 and there is no capital gain to Aco.

3.14.3 However, individual A is taken to receive a dividend equal to the market value of the property (under s.109C). Therefore, there is a frankable dividend of $110 to the individual. There are three problems with this approach.

- Firstly, only $100 represents an unrealised gain. Therefore, the dividend to the shareholder is excessive to the extent to which it is funded by share capital. However, this issue is generally dealt with by limiting the dividend to the distributable surplus of the company. Accordingly, this is generally not a practical issue.

- Secondly, the company does not have franking credits in this example, as it has never paid any tax on the unrealised gain. Accordingly, the dividend is not frankable under s.109RC.

- Thirdly, the individual is taxed twice on the same gain by virtue of the rollover. That is, the inherited cost base of $10 means that that the unrealised gain on the property will once again be taxable on a subsequent sale.

3.14.4 If rollover relief is not chosen, then the company will pay tax on the disposal of the property. However, due to the time delay of franking credits on capital gains, this will still not allow the dividend to be franked under s.109RC. Furthermore, this may be considered an unacceptable way of dealing with family settlements (i.e. requiring significant tax to be paid by the company). Finally, it would also provide an unacceptable outcome if the property is to be the personal residence of one of the spouses.

Addressing the problem

3.14.5 We believe that addressing the double taxation problem could be improved by adjusting the current rules.

3.14.6 Where CGT rollover relief is provided, the deemed dividend should be capped at the cost base of the relevant property (rather than picking up the unrealised profit). This is because the ordinary disposal of the property at a later date will tax the unrealised gain. In the example provided earlier, this would mean that the dividend would be capped at $10 in relation to the property, leaving the unrealised capital gain of $100 to be taxed on the ultimate disposal by the recipient.

3.14.7 Where CGT relief is not chosen and tax is paid by the company on the unrealised gain associated with the relevant property being distributed to the recipient, we believe that the dividend should be frankable to the extent of tax payable by the company on the disposal of the property.

3.14.8 While these are complex interactions, we highlight that they would provide more appropriate economic and tax result to taxpayers involved in a family law settlement of property that is owned by a company.

3.15 Interaction with s.47A

Summary point 36
Currently s.47A applies a similar provision to Division 7A, however the arm's length rule contained in s.47A is difficulty to comply with. It is also difficult to ascertain whether Division 7A or s.47A applies to any particular case. As Division 7A now applies to all non-resident companies, we do not believe that there is a policy ground for retaining s.47A.

3.15.1 A deemed dividends 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.

3.15.2 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 takes primacy to Division 7A.

3.15.3 One of the main differences between s.47A and Division 7A is that it is near impossible to satisfy the "arm's length" transaction rule contained in s.47A if one were to accept the Commissioner's view in TR 2002/2. This is because the ATO believe that the provision operates even if arm's length conditions are established:

> *6. 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. (See paragraph 19).*

3.15.4 Accordingly, even if taxpayers comply with Division 7A with respect to loans from non-resident companies, they are still likely to be subject to s.47A. This outcome is clearly overly complicated and unintuitive.

3.15.5 We believe that this could be addressed by repealing s.47A and ensuring that Division 7A applies to all companies (resident and non-resident). We understand that there are special interaction provisions that occur under Division 7A for s.23AI and the foreign tax credit rules. These consequences are contained in s.47A(2). We simply believe that these provisions could be placed in Division 7A

where the company is a CFC of an unlisted country (if the Board considers that these adjustments are still warranted).

3.16 Modifications to the refinancing principles

Summary point 37
We believe that s.109R needs to be reviewed so as to explicitly allow for the appropriate refinancing of many commercial arrangements, whilst retaining its integrity.

3.16.1 In addition to allowing a non-private loan to be refinanced for a second term (as outlined earlier), s.109R should be improved in the new Division 7A to allow for more appropriate cases of refinancing.

3.16.2 In particular, a refinancing of loans is allowed if the loan is repaid by way of a dividend under s.109R(2). However, it is unclear why the same exception is not explicitly provided for the case where the loan is offset against other amounts that are assessable to the borrower. For example, if the shareholder or associate receives a salary or wage that is assessable, it is unclear why s.109R(3) does not more broadly apply to assessable offsets.

3.16.3 Furthermore, s.109R(4) contains an assessable offset rule, however it only applies if the offset occurs indirectly, rather than directly. Again, it is unclear why the provisions would differentiate between a refinancing on an indirect basis as opposed to a direct basis.

3.16.4 Finally, s.109R becomes complicated to apply where a non-corporate entity trades with a corporate. For example, Trust A purchases widgets from Company A on credit for resale to the market. Another example is where Company A (being the company with all employees) charges an annual management fee to Trust A for the use of the employees.

3.16.5 It is noted that the ATO have yet to provide a view as to whether s.109R applies to simple trading / service credit accounts, which by virtue of ongoing trading or services, results in new loans being provided on a regular basis. This is a significant issue that needs to be addressed in the rewrite if a s.109R equivalent provision is to be used in the re-write.

3.16.6 Applying s.109R to deny refinancing would be (in our view) contrary to the policy of the provisions (i.e. this is not a case of a disguised distribution). Accordingly, Division 7A should be able to explicitly deal with simple commercial matters such as this where there is intra-group transactions.

3.17 Additional comments on Chapter 4

Summary point 38
We believe that a considerable number of issues outlined in Chapter 4 of the Discussion Paper would be addressed by adopting the recommendations contained in Section 3 of this submission. We believe that it would be impossible for the Board to address all issues and therefore (with limited resources) any additional issues need to be appropriately prioritised.

3.17.1 In this section of the submission, we have highlighted some of the main features that we believe need to be included within the re-written Division 7A. In our view, this would address the majority of the critical issues contained within Division 7A.

3.17.2 We acknowledge that there are a large number of technical issues detailed in the Discussion Paper, which provides a very comprehensive list of those issues. While it is important to address many of these issues, we believe that a number of the issues are not high priority. Accordingly, the Board should ensure that resources are not dedicated to addressing issues of the current Division 7A in lieu of the critical issues identified in Chapter 3 of this submission.

3.18 Drafting the new provisions

Summary point 39
We support a simpler mechanism of drafting for the new provisions, being the use of high level policy principles, coupled with supporting principles. We believe this will resolve many issues faced to date with the black letter law approach adopted by Division 7A.

3.18.1 The structure of the revised Division 7A is likely to be very similar to the existing provisions. This is because Division 7A contains all of the building blocks necessary for the provisions to operate including: (a) its scope; (b) determining transactions that are disguised distributions; (c) determining profits; (d) exceptions; etc.

3.18.2 However, the current rules are very prescriptive and require careful consideration of all of the words in the statute when applying the provisions. Furthermore, due to the black letter law approach, there is sometimes very little flexibility that is offered to the Commissioner to take a reasonable view.

3.18.3 For example, an issue evolved in relation to s.109E concerning minimum loan repayments and whether a minimum loan repayment could be counted in the first year if it was made before lodging the return. This is because the loan balance on which a minimum loan repayment was calculated could (on one interpretation) only be determined by reference to the lodgement date and not the 30 June balance.

3.18.4 While almost everyone would acknowledge that the wording (if interpreted in that manner) would unlikely meet the policy objects – i.e. taxpayers would not satisfy the minimum loan repayment rules in most cases even if they made the appropriate minimum loan repayment – the black letter wording of the legislation

made it very difficult for the ATO to interpret the provisions in a manner that was consistent with policy. It took somewhere close to 18 months before the ATO released ATOID 2010/82, which provided for a sensible outcome.

3.18.5 We therefore believe that the relevant provisions need to be clear as to their intent and that the supporting provisions do not need to be drafted in a strict black letter law approach. We believe that this is critical to ensure the effectiveness of the operation of the provisions.

3.18.6 However, we are also mindful that the High Court is interpreting legislation based on the words and not the intrinsic material. Accordingly, we believe that the words do need to be clear as to the operation of the provisions to ensure that they achieve the correct outcomes. Furthermore, we would be concerned if the provisions required extensive taxation rulings and regulations to determine the application of the provisions, as this would give rise to significant complexity and uncertainty for taxpayers and present a further drain on ATO resources.

4 RESPONSE TO SPECIFIC QUESTIONS

4.1 Question 2.1

The Board seeks stakeholder views on:

a) whether there are other aspects of the Australian tax framework or other factors generally that should be taken into account in the review; and

b) whether there are any international comparative regimes relevant to the policy intent of 'inappropriately accessing' company profits worth considering in the review.

4.1.1 In relation to Question 2.1(a), please refer to our comments on s.47A as contained in Section 3.15 of this submission.

4.1.2 In relation to Question 2.1(b), please refer to our comments on international considerations as contained in Section 1.3 of this submission.

4.2 Question 2.2

The terms of reference state that Division 7A contains integrity provisions designed to prevent shareholders (or their associates) of private companies from inappropriately accessing the profits of those companies in the form of payments, loans or debt forgiveness transactions. The Board seeks views, including the reasons for such views, on what inappropriate accessing of profits means in this context. For example, does it mean use of private company profits:

a) for private purposes (and inappropriate access is limited to such use);

b) to (indirectly) fund the purchase by trusts of assets that attract the CGT discount;

c) for any non-business, including passive investment, purpose;

d) for funding any activity of a related non-company entity of the company, including a business activity, which effectively allows income to be accumulated in a private group comprising the private company and other non-company entities?

4.2.1 Please refer to our comments contained at Section 1.1.11 and Sections 1.2.4 to 1.2.11 of this submission which addresses our view in relation to each of the transactions referred to in the question.

4.3 Question 4.1

The Board seeks information and stakeholder views on the means — including communication strategies and legislative design — by which Division 7A could be made more easily understood especially by small business owners.

4.3.1 Please refer to our comments contained at Section 3.2 of this submission which addresses our view in relation to this question.

4.4 Question 4.2

The Board seeks stakeholder views on whether in cases where Division 7A is not taken into account in Family Court orders that the appropriate remedy is for the Commissioner to exercise his discretion under section 109RB to disregard the deemed dividend or whether this issue is more appropriately addressed by ensuring a better understanding of these provisions by litigants and courts.

4.4.1 Please refer to our comments contained at Section 3.14 of this submission which addresses our view in relation to this question.

4.5 Question 4.3

The Board seeks stakeholder comment on whether Subdivisions EA and EB appropriately balance the complexity of the tax system with protection of the revenue and other policy goals, such as progressivity, or whether it could be more appropriately replaced with another rule (for example, a rule whereby a private company's unpaid trust entitlements were always treated as a loan or a rule that excludes all UPEs from being loans but increases the scope of Subdivisions EA and EB to other forms of benefits for shareholders or associates).

4.5.1 Please refer to our comments contained at Section 3.8 of this submission which addresses our view in relation to this question.

4.5.2 In particular, we highlight that Subdivision EA and EB are overly complex provisions. Provided that the options regarding "commercial loans" as recommended by this submission are accepted by the Board, we would support the simplification of the provisions by treating UPEs as loans. However, we believe that allowing for commercial options is critical, as it would involve a significant change to what is currently allowed for UPEs as compared to PSLA 2010/4.

4.6 Question 4.4

The Board seeks information and stakeholder views on:

a) whether stakeholders agree with the problems raised in this or the previous chapter with regard to the operations of the provisions in Division 7A. If not, what is your view?

b) are there any problems not already identified in this or the previous chapter that should be considered in the review?

c) the relative prioritisation of the problems identified (high, medium or low priority).

d) what solutions there may be for addressing the identified problems, including how they would operate.

e) whether Division 7A helps or hinders the maintenance of the integrity of the income tax system.

f) whether additional integrity measures are needed.

g) other improvements to the operation of the Division, including its interaction with other provisions of the Act that you would like to suggest.

4.6.1 Please refer to our comments contained at Section 3 of this submission which cover our view in relation to this question and highlights a number of our main concerns.

4.7 Question 5.1

The Board seeks stakeholder views on:

a) whether there is a need to clarify the circumstances in which a UPE should be treated as a Division 7A loan and, if so, how that clarification should be provided;

b) generally, whether Subdivisions EA and EB of Division 7A should be amended so that they are more effective in addressing the inappropriate accessing of profits of private companies; and

c) specifically, whether UPEs should be treated as financial accommodation for the purposes of Division 7A and, if so, at what point in time

4.7.1 Please refer to our comments contained at Section 3.8of this submission which addresses our view in relation to this question.

4.7.2 In particular, we highlight that Subdivision EA and EB are overly complex provisions. Provided that the options regarding “commercial loans” as recommended by this submission are accepted by the Board, we would support the simplification of the provisions by treating UPEs as loans. However, we believe that allowing for commercial options is critical, as it would involve a significant change to what is currently allowed for UPEs as compared to PSLA 2010/4.

4.8 Question 5.2

The Board seeks stakeholder views on:

a) the scope and application of the Commissioner's general relieving discretion;

b) whether, in respect of loans, there is an ongoing need for the Commissioner's discretion if the issues are addressed (the 'statutory interest model' should be considered before addressing this question); and

c) whether there any other circumstances where the Commissioner's discretion would still be needed?

4.8.1 Please refer to our comments contained at Section 3.4 of this submission which addresses our view in relation to this question.

4.9 Question 5.3

The Board seeks stakeholder views on whether there are alternatives to making deemed dividends unfranked which would nevertheless not provide an incentive for private companies to seek to undermine the integrity of Division 7A.

4.9.1 Please refer to our comments contained at Section 3.4 of this submission which addresses our view in relation to this question.

4.9.2 In particular, please refer to the section titled "Dealing with the frankability of deemed dividends".

4.10 Question 5.4

The Board seeks stakeholder views on whether, in addition to matters covered by Question 4.4 (b) there are any other issues or problems that should be considered by the review. Consistent with Question 4.4 (c), your views on the prioritisation of these issues is also sought.

4.10.1 We have not raised any additional issues that are not otherwise identified in the Discussion Paper.

4.11 Question 5.5

The Board seeks stakeholder comments and views on:

a) the extent to which Division 7A could be replaced by the statutory interest model;

b) whether the model is consistent with the policy intent of the tax framework of which Division 7A is a part;

c) whether inter-company loans should be excluded from the requirements of this model and, if so, whether they would need to be accompanied by interposed entity integrity rules; and

(d) the design of the model to ensure it operates as intended.

4.11.1 Please refer to comments and recommendations contained at Section 3of this submission which addresses our view in relation to this question. In particular, Pitcher Partners supports the statutory interest model. We have outlined our views in relation to each of the four items contained in Question 5.5.

4.12 Question 5.6

The Board seeks stakeholder views and comments on:

a) the likely impacts of the distribution model;

b) the 'permitted purposes' for which private company profits could be retained under the distribution model;

c) whether and, if so, how the distribution model could be designed in a way that, having regard to small as well as large private groups, was understandable and could be complied with and administered relatively easily in accordance with the policy intent.

4.12.1 Please refer to our comments contained at Section 2of this submission which addresses our view in relation to this question. In particular, Pitcher Partners does not support a distribution model.

4.12.2 We believe that the questions of policy raised by this model are significant and should be considered outside of this review. We are also concerned with the significant compliance issues that we believe this model would contain.

4.13 Question 5.7

The Board seeks general comments on how to express Division 7A more clearly and simply having regard to the reform considerations discussed in this Chapter. More specifically, the Board seeks stakeholder comments on:

a) the use of principles-based drafting for any significant re-drafting of Division 7A; and

b) the use of regulations to provide an appropriate level of guidance.

4.13.1 Please refer to our comments contained at Section 3.18 of this submission which addresses our view in relation to this question. In particular, Pitcher Partners does not support a distribution model.