



**Australian Government**

**The Board of Taxation**

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

Discussion Paper

the **board** of **taxation**  
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**The Board of Taxation**  
**December 2012**

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Division 7A of Part III of the  
*Income Tax Assessment  
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## FOREWORD

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

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

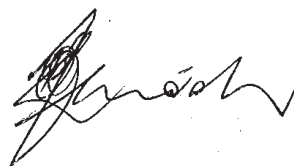
A significant number of amendments have been made to refine the Division 7A rules since its introduction, including rules to reduce the cost of complying with the provisions, prevent taxpayers from being inappropriately caught by the provisions, ameliorate otherwise harsh or unfair treatment and enhance the integrity of the provisions so that they apply in accordance with their policy intent.

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

This discussion paper is intended to facilitate public consultation and the preparation of written submissions to the Board on these aspects of Division 7A.



Chris Jordan AO  
Chair of the Board of Taxation



Curt Rendall  
Chair of the Working Group

# CHAPTER 1: INTRODUCTION

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

## BACKGROUND

1.2 Division 7A was introduced into the tax law in 1998 as an integrity provision designed to ensure that private companies would no longer be able to make tax-free distributions of profits to shareholders (and their associates) in the form of payments or loans. The Division treats amounts paid or lent by a private company to a shareholder (or a shareholder's associate) or debts owed by a shareholder (or a shareholder's associate) to a private company that are forgiven as unfranked dividends,<sup>2</sup> assessable to the shareholder or associate,<sup>3</sup> unless the loan, payment or forgiveness comes within specified exclusions.

1.3 Thus the provisions of Division 7A can apply to payments, loans and debt forgiveness (including through interposed entities), between private companies and their shareholders (or their associates), potentially affecting a wide range of closely held business arrangements involving small to relatively large businesses.

1.4 At the same time, Division 7A 'has been described by some tax practitioners as the most commonly encountered problem area for practitioners outside of the big four accounting firms'.<sup>4</sup>

1.5 A significant number of amendments have been made to Division 7A since its original enactment. Broadly, these amendments have been designed, variously, to:

- reduce the cost of complying with the provisions;
- prevent taxpayers from being inappropriately caught by the provisions;

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1 Unless stated otherwise, any legislative references in this discussion paper is to the *Income Tax Assessment Act 1936*.

2 Up until 1 July 2006, where a deemed dividend arises under Division 7A, the private company's franking account was debited.

3 A reference to shareholders (or a shareholder's associate) includes a reference to a former shareholder (or a former shareholder's associate).

4 Explanatory Memorandum to Tax Laws Amendment (2007 Measures No. 3) Bill 2007, at paragraph 1.81.

- ameliorate otherwise harsh or unfair treatment; and
- enhance the integrity of the provisions so that they apply in accordance with their policy intent.

1.6 The Board understands that the requirements of Division 7A are often misunderstood, particularly by business owners, resulting in frequent and unintended breaches of the provisions. Concerns have also been expressed by both the Australian Taxation Office (ATO) and practitioners about a number of administrative issues and the high compliance and administrative costs associated with Division 7A.

## TERMS OF REFERENCE

1.7 Against this background, the Board has been asked to undertake a post-implementation review of Division 7A. The terms of reference are set out below:

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

The Board should also examine the potential for broader reforms to Division 7A, including whether the provisions could be expressed in a clearer and simpler manner. Any reforms will need to maintain the integrity of the tax law and revenue neutral or near revenue neutral outcomes.

The Board may wish to conduct this review in stages due to the possible interactions with the Government's update and rewrite of the trust income tax provisions.

The Treasury is to regularly inform the Board of the progress and outcomes of the update and rewrite of the trust income tax provisions, especially in relation to unpaid present entitlements (UPEs).

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

The Board should complete its review by 30 June 2013.



## THE REVIEW TEAM

1.8 The Board has appointed a Working Group of its members comprising Curt Rendall (Chair of the Working Group), Keith James and Elizabeth Jameson to oversee the review. The Working Group is being assisted by members of the Board's Secretariat, the Treasury and the ATO.

1.9 Mark West has been engaged as a consultant to assist with the review. The Board has also received assistance from Alexis Kokkinos and Michael Parker in the development of this discussion paper.

## POST-IMPLEMENTATION REVIEWS

1.10 The Board's Charter provides that one of the Board's functions is to provide advice on the quality and effectiveness of tax legislation and the processes for its development, including the processes of community consultation and other aspects of tax design.

1.11 The Board's 2002 report, entitled *Government Consultation with the Community on the Development of Taxation Legislation*, recommended that the Board conduct post-implementation reviews of significant taxation legislation initiatives, consistent with this aspect of the Board's Charter.

1.12 Further, in 2008, the Tax Design Review Panel recommended that the Government should more frequently ask the Board of Taxation to conduct a formal post-implementation review of major policy initiatives, after two to three years of operation.

1.13 Essentially, these reviews are to consider the extent to which an announced policy has been effectively implemented. Usually, such reviews are conducted after major policy initiatives have been operating for a while, to allow for a reasonable period of practical experience, and also to allow tax return data to be taken into account.

1.14 To date, the Board has undertaken a number of post-implementation reviews – in relation to small business capital gains tax concessions; in relation to non-commercial losses; in relation to the implementation of the recommendations of the Tax Design Review Panel; and in relation to certain aspects of the consolidation regime – which have led to legislative and administrative improvements.

1.15 While the present review is a post-implementation review, its terms of reference go further than those typically found in other post-implementation reviews undertaken by the Board. The Board is asked here to examine the potential for broader reforms to Division 7A. At the same time, this is subject to such reforms maintaining the integrity of the tax law and delivering revenue neutral or near revenue neutral outcomes.

## REVIEW PROCESSES

### Consultation

1.16 The Board has conducted targeted preliminary consultations with a range of stakeholders.

### Submissions

1.17 The Board invites written submissions to assist with its review.

1.18 Submissions should address the terms of reference set out in paragraph 1.7 and the issues and questions outlined in this discussion paper (a full list of questions is at Appendix A). It is not expected that each submission will necessarily address all of the questions raised in the discussion paper. The closing date for submissions is 15 February 2013. Submissions can be sent by:

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

Fax to:            02 6263 2617

Email to:         [taxboard@treasury.gov.au](mailto:taxboard@treasury.gov.au)

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

### The Board's report

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

1.21 The Board has been requested to provide its report to Government by 30 June 2013.

## Interaction with the current update and rewrite of the trust income tax provisions

1.22 The Government is currently consulting on an update and rewrite of the trust income tax provisions. The Assistant Treasurer, the Hon David Bradbury MP, issued Press Release No. 80 on 30 July 2012, indicating that the Government has deferred the proposed start date for the broader reform of trust income taxation, from 1 July 2013 until 1 July 2014. The Press Release sets out the Government's revised consultation timetable for the trust reforms, noting that release of exposure draft legislation and consultation roundtables is expected in early 2013.

1.23 Changes made under that update and rewrite may impact on the way Division 7A operates or should operate. For example, if the tax rate for trust accumulations changes as a result of the review, it may not be appropriate to continue to apply Division 7A to payments and loans between companies and trusts. It may also mean, however, that Division 7A or a similar rule would need to apply to payments and loans between trusts and their beneficiaries (and the associates of those beneficiaries). The Policy Options paper titled 'Taxing trust income – options for reform' released in October 2012 indicates that the Government is not inclined to reduce the trustee rate unless a clear case can be made that the integrity, regulatory, and fiscal issues involved can be addressed. However, this paper is currently open for consultation and a final position on the matter has not been announced.

1.24 The Board will ensure that, as far as possible, recommendations contained in its final report (due to be delivered to the Government by 30 June 2013) take account of trust reform options under consideration by the Government.

## COMPLEXITY OF ARRANGEMENTS AND ISSUES

1.25 While Division 7A is a set of rules that focuses on private (rather than public) companies, as indicated above it is not the only provision that is relevant to the taxation of private groups. The interaction between the matrix of various provisions affecting such groups is complex.

1.26 Also, the structure of many private groups is complex. In this regard, it is clear that taxpayers make choices between the different structures that are available to them. Having regard to the framework of tax rules – including changes to that framework – as well as non-tax considerations, private groups may use a combination of entities and employ particular distribution policies to suit their circumstances. As noted in the Treasury's 'Architecture of Australia's tax and transfer system' paper:

In practice, both small and large businesses will often own assets and operate businesses using a combination of entities for both tax and non-tax reasons, and will choose

distribution and asset disposal strategies that best suit the particular entity or entities used.<sup>5</sup>

1.27 The above report noted that small businesses generally use a combination of entities to achieve a desired outcome, going on to say:

For example, a business may operate through a partnership to allow for outside investment, business succession, and losses to flow through to partner level. Partnership interests may be held by non-fixed trusts (such as discretionary trusts) to allow for income splitting, with a company among the trust beneficiaries to allow income to be retained in a company when advantageous. Another non-fixed trust may own the partnership business assets to protect them from business risks and maximise access to CGT concessions. In addition, trustees may themselves be companies to limit the trustee's liability.<sup>6</sup>

1.28 A choice to include a private company in a structure requires a decision to be made about the complexity and compliance costs associated with the structure against the tax and other benefits that the structure offers. That is, a decision must be made about whether the compliance costs of dealing with the tax and governance arrangements that apply to companies are sufficiently offset by the tax deferral and other benefits (such as separate legal identity) that may be available to a company.

## STRUCTURE OF THIS DISCUSSION PAPER

1.29 As noted above, the terms of reference ask the Board to recommend options for resolving any problems with the current operation of Division 7A. They also ask the Board to examine the potential for broader reforms to the Division. As a vehicle for consultation on the path forward, this discussion paper accordingly focuses on Division 7A issues at two levels:

- 1 problems with the practical operation of the current provisions; and
- 2 a high level summary of the development of the tax policy framework within which Division 7A operates.

1.30 This discussion paper is structured as follows:

- **Chapter 2:** historical overview of policy framework for Division 7A;
- **Chapter 3:** an outline of the provisions currently in Division 7A;
- **Chapter 4:** a provision-by-provision analysis of Division 7A, identifying some of the current issues and concerns in terms of the practical operation of the provisions; and
- **Chapter 5:** reform considerations.

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5 2008, *Architecture of Australia's tax and transfer system*, the Treasury, Canberra, at page 257.

6 2008, *Architecture of Australia's tax and transfer system*, the Treasury, Canberra, at page 258.

## CHAPTER 2: HISTORICAL OVERVIEW OF POLICY FRAMEWORK FOR DIVISION 7A

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2.1 To understand the nature of Division 7A and the issues it seeks to deal with, it is important to understand the income tax framework in which the provisions are found. Relevant to this is the history of the framework, particularly in relation to taxation of private companies, the taxation of dividends, the interaction between private company taxation and Australia's progressive taxation of personal income, the introduction of the capital gains tax regime, and the issues that provisions other than Division 7A seek to deal with.

2.2 This Chapter provides an outline of the history of this framework.

### TAXATION OF PRIVATE COMPANIES — THE CLASSICAL SYSTEM AND DIVISION 7: SECTIONS 103 -109

#### Sections 103 -107A

2.3 From 1934 to 1986, prior to the reforms of company and shareholder taxation enacted in 1987, Australia maintained a classical company taxation system. Corporate profits were taxed at the corporate level, and dividends were taxed in the hands of the shareholders without any credit allowed for the corporate tax. As the corporate tax rate was significantly lower than the maximum personal (and progressive) tax rate (in common with a number of other countries), Division 7, a sufficient distribution regime, was introduced into the *Income Tax Assessment Act 1936* (ITAA 1936) in 1938.

2.4 Division 7 divided the income of private companies into three classes, and provided for these different types of income to be distributed to shareholders in different percentages:

- (a) private company dividends received: 100 per cent of these amounts were required to be distributed;
- (b) other property income, that is, public company dividends, rent, trust distributions, interest etc: 90 per cent of these amounts were required to be distributed;
- (c) active business income. Over the years the percentage required to be distributed moved from 66.66 per cent to 20 per cent. This was a policy concession acknowledging that businesses needed to retain funds for working capital purposes.

2.5 Income not distributed in accordance with these requirements was subject to an ‘undistributed profits tax’ at the rate of 50 per cent, a rate higher than the then company tax rate. In effect, the undistributed profits tax amounted to an additional tax, levied against ‘private companies’ that failed to distribute a sufficient amount of their after-tax profits within a specified time.

2.6 Division 7 sought to prevent the accumulation of excessive profits in private companies so as to avoid tax which shareholders would otherwise pay if such profits had been distributed to them. His Honour Stephen J in *Stocks & Holdings (Constructors) Pty Ltd v FC of T* 73 ATC 4053 at p 4056 said:

Together these sections make up a complete legislative scheme for the imposition of additional tax upon private companies making an insufficient distribution. They operate to discourage, by that means, the retention of profits by those companies carried on for profit which, of their nature would otherwise be likely extensively to retain profits. Because companies are, as to the bulk of their income, taxed at a flat rate of tax which is lower than the upper ranges of the graduated rates of tax payable by individual taxpayers those companies which are closely held corporations would, but for Div 7, provide a ready means for the accumulation of profits which have borne a relatively light tax burden. It is to those closely held companies that Div 7 directs its attention and, by means of the threat of additional tax, seeks to deter the undue accumulation of profits which, if nevertheless occurs, attracts that tax.

### Sections 108 — 109

2.7 Another provision in Division 7 was needed to ensure that the profits able to be retained by the company – effectively for working capital purposes – without being subject to the undistributed profits tax, could not be distributed to shareholders or their associates in a tax free form. This was the essential purpose of section 108: it was not a primary integrity measure as such, but was necessary to protect abuse of a concession in the primary protection measure.

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

2.9 The Explanatory Memorandum to the Bill which proposed the enactment of section 108 (and section 109),<sup>7</sup> states:

These sections apply in cases where profits derived by a private company are made over to shareholders or directors in the guise either of loans or payments ostensibly related to services rendered to the company by the persons concerned. Although disguised, the loans or payments are in substance dividends paid by the company.<sup>8</sup>

2.10 The policy intent of sections 108 and 109 is further highlighted in the Explanatory Memorandum to the 1987 amendments which states;

Sections 108 and 109 are designed to prevent the avoidance of tax by private companies and their shareholders through the use of disguised dividend distributions. They do this by enabling amounts to be deemed to be dividends where private companies make loans or advances to, or payments on behalf of, their shareholders ('loans or advances') which are disguised dividend distributions, thereby avoiding tax at the shareholder level (section 108), and where private companies pay excessive remuneration or retirement allowances to their shareholders and directors and their relatives, thus obtaining a deduction at the company level (section 109).<sup>9</sup>

## INTRODUCTION OF IMPUTATION

2.11 The classical system of company taxation was replaced in 1987 by the imputation system. The imputation system meant that distributed company earnings moved from being subject to tax at two levels (at the company and the shareholder level) to effectively only one level. This is effected by resident shareholders receiving a credit for tax paid at the company level. Where the resident shareholder's marginal rate is below the company tax rate, the excess credit can be used to offset other taxes (for example, against tax on salary). Since 1 July 2000, certain taxpayers are also entitled to a refund of any excess imputation credits.

2.12 Under the current imputation system, Australia's company income tax system effectively operates as a withholding tax on the income Australian residents earn through Australian resident companies, and as a final tax on (primarily Australian sourced) income earned by non-residents.

2.13 The changes made to the company and personal income tax systems in 1987, particularly the introduction of the imputation system and the alignment at that time

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7 Section 109 empowers the Commissioner to disallow as a deduction so much of remuneration for services rendered or of a retiring allowance or termination payment or gratuity, paid or credited by a private company to an 'associated person' as he or she considers exceeds what is reasonable.

8 The Explanatory Memorandum to the Income Tax and Social Services Contribution Assessment Bill (No. 3) 1952, Clause 18.

9 The Explanatory Memorandum to the Taxation Laws Amendment Bill (No.3) 1987, Clause 15.

between the company tax rate and top marginal tax rate, removed the potential for tax deferral benefits that might have been achieved by accumulating amounts in a private company. As such, there was no longer any need for the undistributed profits tax and it became no longer payable (subject to complex transitional arrangements).

2.14 About the same time, section 108 was strengthened so that certain loans or advances, or credits to associated persons, could be assessed as dividends. The provision was amended in June 1987 by the *Taxation Laws Amendment Act (No. 3) 1987* to:

... apply in a greater range of circumstances than the existing section. It will encompass arrangements that fall outside of the scope of s108 as it is currently worded but which achieve, in essence, exactly the same ends against which the section is directed

Instead of being limited to purported loans or advances to, or payments by a company on behalf of, or for the individual benefit of, actual shareholders, the new section will apply to loans or advances to, or payments of amounts credited on behalf of, or for the individual benefit of, a person associated with the company. An associated person for the purposes of the new section is to include a person who indirectly holds a beneficial interest in shares in addition to an actual shareholder, as well as relatives of such shareholders.<sup>10</sup>

2.15 The integrity sought to be protected by section 108 was restricted to the accumulated profits under the pre-imputation arrangements. These profits would, if paid as dividends, be unfranked and retain their pre-imputation 'classical' nature.

2.16 Nevertheless, in practice, section 108 remained deficient in that:

- (i) the deeming of an amount to be a dividend under section 108 was reliant upon the Commissioner forming an opinion that an amount loaned, paid or credited to an associated person represented a distribution of profits. In order to be in a position to form an opinion, the Commissioner needed to obtain much information, analyse that information, and consider many factors.
- (ii) the provisions operated in respect of the shareholder or associate at the time of the transaction, and did not extend to former shareholders or their associates.

2.17 Importantly up until 1990 there was not a practice in Australia of trusts distributing to companies. In the pre imputation period this resulted in a considerable

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10 The Explanatory Memorandum to the Taxation Laws Amendment Bill (No.3) 1987.



tax cost. In this early imputation system there was no advantage as such a distribution locked in the maximum marginal rate.

## REDUCTION OF THE CORPORATE TAX RATE

2.18 As noted above, the introduction of the imputation system and the alignment at that time between the company tax rate and top marginal tax rate, removed the potential for tax deferral benefits that might have been achieved by accumulating amounts in a private company.

2.19 However, the company tax rate and the top marginal tax rate were only briefly aligned in the late 1980's at 49 per cent. In 1990, the corporate tax rate was reduced to 39 per cent.

2.20 The company tax rate was progressively reduced to the current rate of 30 per cent. The rate reductions, which have largely corresponded with base broadening measures (such as the reduction of accelerated depreciation), have paralleled similar reductions in other developed countries.

2.21 The progressive fall in the rate means, however, that the withholding function of the company tax becomes less effective in terms of income tax progressivity unless there is a corresponding ability to levy a 'top up' tax at the personal level, either explicitly or implicitly. This reduction in progressivity was exacerbated in 2000 when franking credits were able to be refunded. That is, from then corporate profits could be banked and paid out in subsequent years where no further tax was payable and/or may even be refundable.

2.22 This raises the question why the undistributed profits tax was not re-introduced when the top personal marginal tax rate became higher (and substantially higher) than the corporate tax rate. In the Review of Business Taxation discussion paper, *A Platform for Consultation*<sup>11</sup> the appropriate treatment of profit retentions was raised as an issue for consultation however it was not addressed in the final report. Accordingly this question remains (and indeed has been heightened) in light of further reductions to the corporate tax rates and an increase in the differential between the current company tax rate (30 per cent) and the current top personal marginal tax rate (45 per cent excluding Medicare Levy).

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11 'A Platform for Consultation – Discussion Paper 2: Building on a strong foundation', February 1999, paragraphs 56 to 59. This discussion paper can be located at <http://www.rbt.treasury.gov.au>.

## ENACTMENT OF DIVISION 7A

2.23 Division 7A was enacted by *Taxation Laws Amendment Act (No. 3) 1998*, to give effect to the Treasurer's 1997-98 Budget announcement on 13 May 1997:

I am announcing tonight a range of further measures to enhance tax system integrity. These are not measures to increase revenue but are designed to guard against the potential erosion of revenue in the future. Many of these measures deal with tax avoidance, unfair minimisation and evasion ...

2.24 The Explanatory Memorandum to the Taxation Laws Amendment Bill (No. 3) 1998 noted the following (in paragraphs 9.8 to 9.10) with regard to the change from section 108 to the new Division 7A:

9.8 Section 108 of the Act is an anti-avoidance provision intended to prevent private companies distributing profits to shareholders and their associates tax free, in the form of loans or other advances. The section also operates to capture amounts paid or credited on behalf of an associated person, while transfers of property are treated as if they were payments of amounts equal to the value of the property.

9.9 Such an amount is deemed to be a dividend and included in assessable income by virtue of subsection 44(1). Paragraph 44(1)(a) includes in the assessable income of a shareholder in a company, 'dividends paid to him by the company out of profits derived by it from any source'. The deemed dividend is not subject to dividend withholding tax (payable on dividends to non-residents) and is unfrankable (that is, it cannot carry imputation credits to allow a rebate to the recipient for company tax paid).

9.10 The existing provision dealing with private company loans etc, section 108, operates only when the Commissioner forms the opinion that the amount loaned, paid or otherwise credited, represents a distribution of profits. In order to be in a position to form this opinion, the Commissioner needs to consider many factors and analyse much information, which usually will not be available unless the Commissioner conducts an audit. Consequently, many loans which should be taxable as dividends are not so taxed.

2.25 Division 7A re-enacts, in self-executing form, the main elements of section 108,<sup>12</sup> and has broadly the same legislative purpose.

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12 Section 108 was not repealed when Division 7A was enacted although it only had residual operation, effectively having been replaced by Division 7A with regard to transactions occurring on or after 4 December 1997. It was subsequently repealed (by Act No 79 of 2007) with application to assessments for the income year in which 1 July 2006 occurred and in later years.

2.26 The Explanatory Memorandum recorded that the amendments were expected to prevent revenue losses of \$2 million in 1997-98; \$50 million in 1998-99; \$30 million in 1999-2000; \$30 million in 2000-2001, and to result in total additional compliance costs of approximately \$2 million in 1997-98.

2.27 The second reading speech<sup>13</sup> further noted in relation to 'Distributions from private companies':

... The provisions contain exclusions from this treatment [as assessable dividends] for repayments of genuine debts, payments and loans to other companies, payments that are otherwise assessable, ordinary business loans made on the company's usual terms for arm's length loans of that type and loans meeting minimum interest rate and maximum term criteria.

The payment or loan treated as a dividend will not be frankable but making the payment or loan will result in a debit to the company's franking account in the same way as if the dividend had been franked ...

2.28 Division 7A commenced (with certain exceptions) to all payments or loans made on or after 4 December 1997, the day the legislation was introduced into Parliament. The main exception being section 109UB (certain trust amounts treated as loans) which commenced on 27 March 1998.

2.29 In 2002, the Board undertook a review of the taxation of discretionary trusts and in its recommendation on section 109UB provided two options to the Government. The first, and the one that the Government accepted, was to amend section 109UB to improve the effectiveness of the deemed dividend rules so as to more effectively prevent beneficiaries accessing trust income that has borne tax only at the company tax rate.<sup>14</sup>

2.30 The second option, which was not taken up, was in effect a distribution rule, it stated;

Alternatively, section 109UB could be repealed, and replaced with a section setting out the consequences where a trustee makes a company presently entitled to the income of a trust, but does not pay the funds to the company within a reasonable period. The consequences could be either that the trustee would be assessed on the amount of the income as if there had been no distribution, or that the company would have to pay a top-up tax (which could create franking credits in the company).<sup>15</sup>

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13 Delivered in both the House of Representatives and in the Senate.

14 Board of Taxation's 2002 report on the Taxation of Discretionary Trusts, paragraph 81. This was latter legislated in *Tax Laws Amendment (2004 Measures No. 1) Act 2004* by replacing section 109UB with a new Subdivision EA of Division 7A.

15 Board of Taxation's 2002 report on the Taxation of Discretionary Trusts, paragraph 82.

## INTRODUCTION OF THE CGT RULES

2.31 The capital gains tax (CGT) rules were introduced in 1985 and applied to realised gains and losses on assets acquired after 19 September 1985. Certain types of assets are exempt from CGT, such as owner occupied homes. From 1985 to 1999, an indexation system applied, so that only real, and not nominal, gains were taxed. An averaging system was also in place to reduce the impact of progressive income tax on realised gains over a period of years.

2.32 On 21 September 1999, the then Treasurer announced the Government's response to the Review of Business Taxation. This included a proposal to improve incentives to save and invest by introducing an internationally competitive capital gains tax regime, to include:

- For individuals, only 50 per cent of capital gains made on assets held for at least 12 months being taxed, with the result that the highest rate of tax for individuals was effectively 24.25 per cent.
- For superannuation funds, only two thirds of capital gains made on assets held for at least 12 months being taxed, effectively meaning a concessional rate of 10 per cent.
- Reducing complexity through freezing of indexation and the removal of the averaging provisions.

2.33 Companies do not attract this CGT discount treatment.

2.34 The relevant legislation provides a mechanism for dealing with trusts distributing amounts attributable to discount capital gains. Beneficiaries gross up the gain, offset capital losses and then reapply the CGT discount (as relevant, if at all, to them) to their share of the distribution.

2.35 Broadly, in respect of discount capital gains of trusts, beneficiaries receive the discount that would otherwise be available to them in respect of any gains they made directly on an asset held for at least 12 months.<sup>16</sup>

2.36 Amendments were made to CGT Event E4 to ensure that it applies correctly when a discount capital gain made by a trust is later reflected in a payment to a beneficiary. Broadly, the amendments ensure that the CGT discount is preserved for beneficiaries who are entitled to the discount and that beneficiaries who are not entitled to the discount (that is, companies) are not subject to double taxation.

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16 Trusts cannot apply the discount to trustee assessments under subsection 98(3) or section 99A.

## PROGRESSIVE TAXATION OF PERSONAL INCOME

2.37 As noted above, Australia has a progressive system of taxing personal income. Current features of the income tax system, including those found in the company tax system and the trust tax system, seek to support this progressivity. They do this to differing degrees and in different ways. In particular, they do this without the explicit method found in the sufficient distribution rule (or undistributed profits tax) under the former Division 7, which encouraged distributions from companies so that they would be taxed in the hands of individual taxpayers at their marginal tax rates. Examples of measures introduced to protect progressivity include the following trust taxation provisions: section 99A of Division 6, and Divisions 6AA and 6A of the ITAA 1936.

2.38 Sections 99 and 99A of Division 6 together govern the liability of the trustee of a trust, to be assessed on the net income of the trust estate to which no beneficiary is presently entitled.

2.39 Section 99A imposes a flat rate of tax (currently 45 per cent excluding Medicare levy) on that part of the net income to which it applies. It therefore takes away the advantage of arrangements to make beneficiaries on the highest marginal rate of tax not presently entitled to income of the trust estate. It also provides an incentive to distribute if the beneficiaries are taxed at a rate below the highest marginal tax rate.

2.40 However, the incentive to distribute is not as strong under section 99A as it was under the Division 7 sufficient distribution rule because the tax rate is equivalent to the highest marginal tax rate plus Medicare levy – it does not exceed it.

2.41 Also, it is evident that many private group structures operate so that as much of the net income of the trust as is possible is distributed so that section 99A does not apply, with amounts not distributed to individual beneficiaries being distributed to a corporate beneficiary (the ‘bucket company’) to cap tax at the 30 per cent corporate rate<sup>17</sup>. However, the declared distribution is often not paid, that is, it is retained in the trust. This unpaid (or uncalled) distribution is referred to as an UPE. As such, although the section 99A rate provides integrity, it does not necessarily ensure that trust distributions are taxed at marginal rates.<sup>18</sup>

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17 Importantly up until 1990 there was not a practice in Australia of trusts distributing to companies. In the pre imputation period this resulted in a considerable tax cost. In this early imputation system there was no advantage as such a distribution locked in the maximum marginal rate.

18 The role of Section 100A in respect of these practices is unclear. Broadly Section 100A may operate to tax the trustee (at the 99A rate) in circumstances where a beneficiary has become presently entitled to income that (by agreement) will be returned to the trustee (or never demanded) or paid elsewhere, with the purpose of ensuring less tax is paid. However, its exception for ordinary family and commercial dealings, and possible technical deficiencies, potentially limit its use in thwarting the practice of creating unpaid present entitlements in compromise of the policy of assessing trust accumulations under section 99A.

2.42 Division 6AA<sup>19</sup> was inserted in 1980 to discourage income splitting by means of diverting certain income to children under the age of 18 (although the Division is not confined to situations involving income splitting). Division 6AA created a new class of taxpayer consisting of persons under 18 years of age who are not engaged in full-time occupation and who are not within certain other defined categories. A minor within this class of taxpayer is currently liable to pay tax at the top marginal tax rate on unearned income (for example, interest, dividends, rent and royalties) above a certain threshold, whether derived directly or through a trust.

2.43 Again, unlike Division 7, this provision does not necessarily encourage distribution as the trust profits will be taxed at the highest marginal rate of tax regardless of whether they are retained in the trust (and taxed under section 99A), are paid to the minor beneficiary or to the adult highest marginal rate taxpayer. Indeed, there is still an incentive to make small distributions (up to the tax free threshold) to the minor beneficiary.

2.44 Division 6A was enacted in 1964, following the practice of alienating income in favour of an associate, without alienating the income producing assets as a means of tax avoidance. When Division 6A was introduced, it rendered ineffective for income tax purposes the transfer of the right to receive income from property, without the transfer of the underlying property, for a period of less than seven years.

2.45 Division 7A supports progressive taxation, albeit in a different way to the above trust provisions, by ensuring that private company profits that are enjoyed by shareholders and their associates are included in their assessable income and taxed at their personal marginal rates of tax. This is done by ensuring the proper characterisation of payments from the companies rather than by directly encouraging the distribution of profits. As indicated above, Division 7A applies in the same situation as the provision it replaced (section 108) which, in turn, applied where 'profits made by a private company are bestowed on shareholders in the guise of loans or advances or credits but these are in substance dividends paid by the company.'<sup>20</sup>

2.46 Consistently with section 108, one way that Division 7A supports progressivity is to treat certain non-commercial loans as dividends.

2.47 At the same time, Division 7A makes clear that loans made by private companies that are either repaid or that meet minimum interest rate, maximum term and minimum yearly repayment requirements by the relevant lodgment day should not be treated as dividends. These loans are accepted as being on a commercial footing such that it would be inappropriate to treat them as disguised distributions of profits to shareholders or their associates.

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19 Section 102AA - 102AGA of the ITAA 1936.

20 Taxation Ruling IT 2637, paragraph 9.

2.48 The Division sets out the criteria for acceptable unsecured loans and secured loans. The maximum term for an unsecured loan is 7 years and, for a loan secured by a mortgage over real property, it is 25 years. Under arrangements between associated private companies and trusts that involve Division 7A loans, there can be an effective sufficient distribution where as part of the arrangements to effectively fund the repayment of the loans, the private company makes distributions (which are taxed at the recipient's personal marginal rate of tax with a credit for tax paid at the company level) rather than make a Division 7A distribution (which is taxed at the recipient's personal marginal rate of tax without a credit for tax paid at the company level).

2.49 In effect, this means that in these sorts of arrangements Division 7A indirectly encourages distributions to be made in a particular way (through the payment of dividends) rather than through non-commercial loans or payments. Division 7A does not, however, encourage a distribution of a threshold amount. In particular, Division 7A only applies to profits that are enjoyed by shareholders or the associates of shareholders. It does not apply to amounts accumulated in the company (regardless of whether they are used as working capital or merely accumulated) and, in that sense and unlike Division 7, does not have as its central purpose a sufficient distribution requirement.

2.50 That Division 7A does not have the sufficient distribution role held by Division 7 is also evident in the different effect of the two provisions. The 7 year maximum for unsecured loans, and the 25 year maximum for loans secured by a mortgage over real property, for Division 7A purposes can have the effect of providing more favourable tax treatment for loans used for passive investment than for loans used to fund the carrying on of an active business.<sup>21</sup> On the other hand, the retention allowance in Division 7 allowed a significant proportion of profits from trading income to fall outside the undistributed profits tax while only a minor proportion of profits from property investment could do so.

### International comparison

2.51 Other countries which have an undistributed profits tax include the United States which imposes a 15 per cent additional tax on undistributed income of personal holding companies,<sup>22</sup> and an additional accumulated earnings tax<sup>23</sup> on all other

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21 It is arguable, on the other hand, that this is not an intended outcome of Division 7A, as it does not make a distinction between these two types of loan on the basis of what the loan funds are used for.

22 Any corporation (other than those specifically exempted) in which at least 60 per cent of adjusted ordinary gross income is from passive investments (such as rent, dividends, interest, royalties and annuities) and where 50 per cent is owned by less than five individuals.

23 For tax years beginning before January 1, 2013, the accumulated earnings tax rate is 15 per cent of the corporation's accumulated taxable income. Accumulated taxable income means taxable income with certain adjustments, minus the sum of the dividends-paid deduction and the accumulated earnings credit (profits retained for reasonable business needs of the business).

corporations.<sup>24</sup> Canada does not have sufficient distribution rules, but discourages the distribution of funds of a corporation for the benefit of its shareholders, free of tax, through loans<sup>25</sup> by, in the simplest case, including the amount of the loan in the income of that person for the year in which the loan was made.<sup>26</sup> In the United Kingdom, a company that makes a loan to one of its shareholders outside the ordinary course of its business is chargeable to tax at 25 per cent for the accounting period when the advance is made.<sup>27</sup>

2.52 For any international comparison to be meaningful it is necessary to examine the wider taxation regime into which the rules have been incorporated. For example, in order to compare the above United States, Canadian and United Kingdom rules it is important to note that only Canada has full dividend imputation, the United Kingdom has a partial system,<sup>28</sup> and the United States has no dividend imputation. Importantly however, the United States taxes dividends from domestic corporations at the lower capital gains rate<sup>29</sup> and the United Kingdom has a reduced tiered dividend rate.<sup>30</sup> Differences in tax rates both at the individual and corporate rate also impact on any international comparisons.

## REVIEW CONSIDERATIONS

2.53 In simple terms, Division 7A is concerned with the nature of payments from private companies to shareholders or their associates. However, it is part of a broader and complex tax framework, and is required to operate in the context of what can be complex private group structures involving trusts, companies and potentially other tax entities that, in turn, may often take into account the changes in the tax framework that have taken place.

2.54 The historical overview of the above tax policy framework highlights various issues that form part of the matrix of issues relevant to the Board's review of Division 7A. They include the following.

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24 Other than personal holding companies, tax exempt organisations or passive foreign investment companies.

25 Or other transactions where the shareholder becomes indebted to the corporation.

26 There are a number of exclusions, one of which is where the loan is repaid within one year from the end of the lending corporation's taxation year. A shareholder who has obtained a loan or other indebtedness which is included in income will be entitled to deduct amounts repaid on the loan or other indebtedness in subsequent years.

27 If the loan is repaid within nine months relief for tax is given.

28 The maximum amount of tax credit attaching to dividends is 10 per cent.

29 For the years 2008 through to 2012, the capital gains rates are zero per cent for taxpayers in the 10-15 per cent brackets and 15 per cent for those in the higher tax brackets.

30 For the 2011-12 tax year for taxpayers above \$35,000 the tax rate on dividends is 7.5 per cent lower than the marginal tax rate and for taxpayers with taxable incomes below \$35,000 the tax rate is 10 per cent which with the 10 per cent tax credit gives an effective rate of zero.



2.55 Reflecting international competitiveness considerations, the tax rate for companies has fallen to the current rate of 30 per cent. At the same time, the highest personal marginal tax rate is 46.5 per cent (including the Medicare levy). This gap is the source of complexity relating to the use of companies, on the one hand, and the progressive nature of the personal income tax system, on the other.

2.56 Another source of complexity is that companies are taxed differently to trusts, which are often taxed on a flow-through basis. Importantly, the CGT discount is available to beneficiaries of trusts in respect of the disposal of assets by trustees, but is not available in respect of disposal of assets by companies.

2.57 In the absence of a provision like Division 7, there is no rule that directly requires distributions from companies, allowing retention irrespective of the reason for it. The Board observes that, on one hand, after-tax profits can be retained within companies and be reinvested without being subject to the personal tax system. The profits can, for example, be invested to earn interest. On the other hand, they can be used to support a business being carried on by an associated trust, for example by acquiring plant and equipment, trading stock (on a consignment basis) or factoring receivables.

2.58 In some circumstances, Division 7A can have an effective sufficient distribution requirement for certain arrangements including, as described in paragraph 2.48, those between associated private companies and trusts. These arrangements allow funds to be retained in, for example, the trust business for a period of time while being subject only to the company tax rate.

2.59 Importantly, Division 7A applies to the form as contrasted to the substance of the financial support provided to an associated business.

2.60 A key issue for the review is the balance between the policy supporting why funds can be retained in companies and preserving the integrity of the tax system and revenue neutral or near revenue neutral outcomes.

### **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.

### 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; and
- 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?

## CHAPTER 3: OVERVIEW OF DIVISION 7A

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3.1 This chapter provides an overview of the key elements of Division 7A as enacted at the time of release of this discussion paper.

### OVERVIEW OF THE OPERATION OF DIVISION 7A

3.2 Key elements of Division 7A, as at the time of the release of this discussion paper, are set out below.

3.3 As noted in chapter 2, Division 7A is an integrity measure directed to ensuring that disguised or informal distributions of company profits to shareholders (and their associates) are included in the assessable income of the shareholders or associates in the form of unfranked deemed dividends. An example of an informal distribution of company profits is where, as an alternative to distributing profits by way of dividends, the company makes an uncommercial loan to a shareholder.

3.4 Unlike section 108, the self-executing provisions in Division 7A, which commenced in 1997-98, were designed within the context of a self-assessment system. However, Division 7A re-enacts, in self-executing form, the main elements of section 108, and has broadly the same legislative purpose.

3.5 Division 7A operates where:

- there is a payment,<sup>31</sup> loan<sup>32</sup> or debt forgiveness<sup>33</sup> in favour of a shareholder or their associate by a private company; or
- there is a payment, loan or debt forgiveness by a trust in favour of a shareholder or their associate, where a private company is a presently-entitled beneficiary that has not been paid its entitlement.<sup>34</sup>

3.6 Subject to the exclusions (see below), Division 7A may operate to deem that a private company has paid an assessable dividend where it pays an amount to, or makes a loan to, or forgives a debt owed by, a present or former shareholder of the company (or present or former associate of a shareholder). This dividend is taken to be paid to the entity as a shareholder of the private company and out of the private company's profits. The deemed dividend is capped at the private company's

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31 Section 109C.

32 Sections 109D and 109E.

33 Section 109F.

34 Subdivision EA.

distributable surplus, an amount determined by a formula which replaces the looser notion of 'profit' and provides greater certainty.

3.7 Where Division 7A operates to deem a dividend to be paid by a private company, it is taken to be paid on the last day of the income year in which the payment, loan or debt forgiveness occurred, or the minimum repayment was required.

3.8 A 'payment' includes provision of an asset for use by a shareholder or an associate of a shareholder.<sup>35</sup> Payments that are generally excluded from the operation of Division 7A broadly include:

- payments of genuine debts;
- payments to other companies; and
- payments otherwise assessable or that are specifically excluded from assessable income.<sup>36</sup>

3.9 Loans that are generally excluded from the operation of Division 7A broadly include:

- loans to other companies;
- loans otherwise assessable or that are specifically excluded from assessable income;
- loans made in the ordinary course of business and on the usual terms on which the private company makes similar loans to parties at arm's length;
- loans that meet criteria for minimum interest rate and maximum term, provided the loan agreement is in writing before the company's lodgment date (the earlier of the date of actual lodgment and the due date of lodgment of the company's income tax return for the income year in which the loan was made);
- certain loans and distributions by liquidators; and
- loans that are for the purpose of funding the purchase of shares or rights under an employee share scheme.<sup>37</sup>

3.10 The following categories of debt forgiveness are generally excluded from the operation of Division 7A:

- forgiveness of a debt owed by a company (other than debt owed by a company in its capacity as trustee);
- forgiveness of a debt because the debtor becomes a bankrupt or because of Part X of the *Bankruptcy Act 1966*;

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35 Section 109CA.

36 Section 109H.

37 Section 109H.

- forgiveness of debts or part of debts that have caused the company to be taken to have paid a dividend under another provision of Division 7A; and
- certain debts forgiven because their payment would have caused undue hardship.

3.11 Loans that are excluded because a written loan agreement has been put in place (before the private company's lodgment day and the criteria for minimum interest rate and maximum term are satisfied), become what is called an amalgamated loan for the purposes of Division 7A. An amalgamated loan comprises all constituent loans made during the income year that have the same maximum term. In subsequent income years, minimum yearly repayments based on a formula in the law are required. Failure to meet the minimum yearly requirement can result in a deemed dividend (subject to the exercise of a relieving discretion in undue hardship cases) of the amount of the shortfall in the minimum yearly repayment. There are provisions which prevent temporary repayments being made and the Commissioner has a discretion to extend the period for repayments of amalgamated loans.

3.12 Provisions also provide for the refinancing of excluded loans in certain circumstances.<sup>38</sup>

3.13 Repayment in full of a loan before the company's lodgment date (or getting it within an exempted category, such as meeting the criteria in section 109N for minimum interest and maximum term) will avoid deeming of a dividend. However, there are provisions that seek to ensure that certain payments to the company are not treated as repayments, namely:

- a repayment, that when made, a reasonable person would conclude was intended to be followed by a subsequent re-borrowing; and
- a borrowing, that a reasonable person would conclude was obtained in order to make a subsequent repayment (from 1 July 2009).

3.14 A deemed dividend is unfrankable, except:

- where it arises because of a 'family law obligation'; or
- where the Commissioner exercises a discretion to allow the dividend to be franked.

3.15 Deemed dividends taken to be paid in 2005-06 or an earlier income year gave rise to an automatic franking debit to the private company's franking account.

3.16 The Commissioner has a relieving discretion, which may be exercised to avoid the consequences of Division 7A from applying where the Division 7A result arises because of an honest mistake or inadvertent omission. In making a decision, the

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38 Sections 109R(5) to 109R(7) of the ITAA 1936.

Commissioner must take into account a range of factors and can make the decision subject to conditions (for example, making of a specified payment within a specified time).

3.17 Division 7A also includes rules dealing with the interaction between Division 7A and fringe benefits tax.

## INTERPOSED ENTITY & TRUST PROVISIONS

3.18 There are interposed entity provisions to prevent Division 7A being circumvented by interposing an entity between the private company and the shareholder (or their associate). Provisions operate to deem a private company to make a payment or loan where there is an indirect payment or loan by the company. They also activate Division 7A in certain circumstances where a private company guarantees a payment or a loan.

3.19 There are also rules designed to ensure that Division 7A cannot be circumvented by shareholders receiving a financial benefit through a trust loan, payment or a forgiven debt.<sup>39</sup> In particular, a trustee cannot shelter trust income at the company tax rate by creating a present entitlement to a private company without paying it and then distributing the underlying cash to a shareholder (or their associate). These rules also ensure that a trustee cannot enable profits to which a private company is entitled to instead be enjoyed by a shareholder (or their associate).

3.20 For trusts, Division 7A can extend to payments (in limited circumstances), loans and debt forgiveness by a trustee, where:

- before the trust's lodgment date, a private company becomes presently entitled to an amount from the net income of the trust estate;
- the present entitlement has not been paid;
- the payment or loan by the trust is to a shareholder (or associate of the shareholder) of the private company or debt forgiveness by the trust is of a debt owed by a shareholder (or associate of a shareholder) of the private company; and
- the private company has a distributable surplus.

3.21 From 1 July 2009, provision is made for circumstances where there is an indirect payment or loan by a trust, and where a private company has a present entitlement

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<sup>39</sup> From 27 March 1998 to 12 December 2002 these rules were contained in section 109UB of the ITAA 1936. After that date they were repealed and replaced with subdivision EA, which now comprises sections 109XA to 109XD of the ITAA 1936.

(directly or indirectly) to the income of a trust that remains unpaid to the private company.

3.22 Where the trust provisions apply, they deem an amount to be included in assessable income of the shareholder (or shareholder's associate) as if it were a dividend.

3.23 In December 2009, the Commissioner published his view that an UPE is capable of amounting to the provision of financial accommodation by the private company beneficiary in favour of the trust and may therefore be a loan for Division 7A purposes.<sup>40</sup> Where a trust entitlement is treated as a loan for Division 7A purposes, the trust entitlement provisions will not also be triggered.

3.24 The ATO accepts that if funds representing the UPE are used only for the private company's sole benefit, then the private company does not provide financial accommodation in respect of that UPE because the main trust receives no pecuniary aid or favour from the private company. Therefore there is no loan for Division 7A purposes.<sup>41</sup> Administrative guidance and safe harbours on the evidentiary requirements for UPEs that are used solely for the private company's benefit can be found in ATO Law Administration Practice Statement PS LA 2010/4. This enables a trust to continue to use UPEs as working capital subject to the creation of a sub-trust and the conditions outlined in the practice statement. However, the trust entitlement provisions may still apply in these circumstances if the trust then directly or indirectly makes a relevant payment or loan to, or forgives a debt of a shareholder or an associate of a shareholder of the private company.

## BOARD OBSERVATIONS

3.25 Division 7A operates in conjunction with various components of the income tax system, including the trust taxation provisions, the company tax provisions (including the imputation system) and the personal income tax system.

3.26 While it is an integrity measure and supports the policy of the broader income system, there may be other measures better suited to protecting certain aspects of that system. The Board will be further considering the particular role of Division 7A vis a vis other measures in the course of its review.

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40 Draft Taxation Ruling TR 2009/D8 later confirmed in Taxation Ruling TR 2010/3.

41 Taxation Ruling TR 2010/3, paragraph 113 to 115.

## CHAPTER 4: PROVISIONS OF DIVISION 7A AND PROBLEMS IDENTIFIED IN THEIR OPERATION

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

4.2 There appears to be a number of significant difficulties and issues in the operation of the provisions within Division 7A. This chapter seeks to highlight the depth and breadth of a number of those difficulties and issues.

### DIVISION 7A FRAMEWORK

4.3 Division 7A has a number of Subdivisions, namely:

- **Subdivision A** – Overview of this Division, which explains the structure of the Division.
- **Subdivision AA** – Application of Division, the application to non-share dividends, the application to closely held corporate limited partnerships and the application to non-resident private companies.
- **Subdivision B** – Private company payments, loans and debt forgiveness are treated as dividends.
- **Subdivision C** – Forgiven debts that are not treated as dividends, an exception to Subdivision B.
- **Subdivision D** – Payments and loans that are not treated as dividends, the exceptions to Subdivision B.
- **Subdivision DA** – Demerger dividends not treated as dividends.
- **Subdivision DB** – Other exceptions, the general discretion under section 109RB, a discretion to extend the period for repayments of an amalgamated loan and rules to ensure dividends may be franked if taken to be paid because of a family law obligation.
- **Subdivision E** – Payments and loans made by private companies through interposed entities.



- **Subdivision EA** –The distribution of private company profits tied up in unpaid present entitlements to shareholders (or their associates) of the private company in the form of certain payments, loans and forgiveness of debts.
- **Subdivision EB** – UPEs – interposed entities.
- **Subdivision F** – General rules applying to all amounts treated as dividends, the distributable surplus, characteristic of deemed dividend, interaction with Fringe Benefits Tax (FBT) and later dividend rules.
- **Subdivision G** – Defined terms.

## OVERVIEW

4.4 To ensure that Division 7A operates as intended:

- ‘Payment’, ‘loan’ and ‘forgive a debt’ are defined and have extended meanings.
- ‘Associate’ is defined broadly.
- There are a number of exclusions for payments, loans and debts forgiven.
- A number of the provisions including the exclusions have multiple conditions that must be satisfied before the provision can have application.
- A number of the provisions have ‘reasonable person’ tests.
- Some provisions, mainly the interposed entity provisions, require the Commissioner to determine transaction amounts (for example, the amount of a notional loan) and take into account a number of factors.

4.5 Division 7A has been amended to strengthen the rules, for example, the meaning of payment for Division 7A purposes was extended to include the provision of an asset such as a holiday home or boat for use by an entity (other than a transfer of property).<sup>42</sup> Division 7A has also been amended to make it easier to comply with, to reduce the extent to which taxpayers can trigger a deemed dividend inadvertently and to reduce the punitive nature of the provisions. The amendments made have included:

- Removal of the automatic debiting of the private company’s franking account when a deemed dividend arises.

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42 Note, however, that this extended meaning has no application in the context of the trust rules which, as already noted, only apply to payments referable to unrealized gains (for example, payments out of asset revaluation reserves).

- Allowing loans to be repaid and loan agreements to be put in place at any time up to the private company's lodgment day rather than the end of the year of income in which the loan is made (as was the case when Division 7A was inserted). This enables a taxpayer's Division 7A outcome for a particular income year to be determined at any time up to the relevant lodgment day which allows taxpayers and tax agents to identify Division 7A issues during preparation of the tax returns and to take appropriate action to prevent a deemed dividend.
- Allowing payments to be converted to loans before the relevant lodgment day.
- The amount taken to have been paid as a dividend as a result of the failure to make minimum yearly repayments on complying loans was changed to the shortfall amount rather than the amount of the loan that had not been repaid by the end of the income year in which there was a shortfall.
- Allowing dividends to be franked if taken to be paid because of a family law obligation.
- Introducing a general discretion which enables the Commissioner to either disregard a deemed dividend or allow a private company to frank a deemed dividend that has been taken to have paid in cases where the Division 7A result arose because of an honest mistake or inadvertent omission.

## Administrative and Interpretational Matters

4.6 The law has been amended and has been clarified in a number of areas, nevertheless, there remains technical difficulties, uncertainties and compliance difficulties with many of the provisions. Division 7A can apply to a wide range of transactions and arrangements from individuals carrying on a small business through one private company to groups of entities with multiple businesses and investment activities.

4.7 It has been brought to the Board's attention that not all operators of private businesses fully appreciate the operation of the rules in Division 7A and as such the provisions are the subject of frequent non-compliance. Many private companies use tax agents who are expected to be aware of the requirements of tax law and who can advise their clients on various aspects of their tax affairs, including Division 7A requirements.<sup>43</sup>

4.8 Contributing to this are the administrative and interpretational difficulties within the Division. A number of the administrative and interpretational difficulties relate to interpretation of the defined terms, the number of exclusions, the multiple conditions,

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43 The Explanatory Memorandum to the Tax Laws Amendment (2007 Measures No.3) Bill 2007, paragraph 1.85.

the reasonable person tests, the determination of amounts by the Commissioner and the discretions. In addition, a number of terms and phrases used in Division 7A such as 'similar loans', 'similar to', 'honest mistake', 'inadvertent omission' are not defined. There is some uncertainty in the application of the relevant provisions, with a consequent desire for ATO guidance on these matters.

4.9 The need for Subdivision EA has been questioned given the ATO view that UPEs may be loans for Division 7A purposes in certain circumstances. If all UPEs are loans then Subdivision EA should have no application. However, the ATO view is that certain UPEs are not loans within, the extended definition, in which case Subdivision EA brings the taxing point home to the beneficiary that is able to enjoy the profits.

4.10 To clarify the operation of a number of the Division 7A provisions and the way that the ATO administers the provisions, the ATO has issued a range of Taxation Rulings, Taxation Determinations, Law Administration Practice Statements and ATO Interpretative Decisions. A number of Taxpayer Alerts have also been issued.

4.11 The Subdivisions and their main interpretation and administrative issues are discussed in the following paragraphs.

#### **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.

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

4.12 Subdivisions A and AA<sup>44</sup> provide a simplified outline of Division 7A and cover the application of the Division to non-share dividends, closely-held partnerships and non-resident private companies.

### **Scope of application — private companies**

4.13 Division 7A is primarily directed at distributions to entities connected with a private company.

4.14 The extent of the application of Division 7A is unclear in some circumstances and may not be broad enough to capture some arrangements that should fall within the measure.

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44 Comprised of section s109B – 109BC.

4.15 Corporate limited partnerships are deemed to be companies, but not private companies, for tax purposes. This led to corporate limited partnerships being used in some structures or arrangements to circumvent Division 7A. Accordingly, section 109BB was introduced to extend the application of Division 7A to closely-held corporate limited partnerships. For payments made, loans made and debts forgiven on or after 1 July 2009, Division 7A applies to certain corporate limited partnerships in the same way as it applies to a private company.

4.16 Since the application of Division 7A was extended to include certain corporate limited partnerships, new arrangements have been identified whereby taxpayers have introduced entities that are companies or taxed as if they were companies for tax purposes but are not private companies, as a possible means of circumventing the application of Division 7A. Examples of such arrangements include the interposing of limited by guarantee companies to corporate structures and certain arrangements involving the use of public trading trusts.

#### Application to non-share equity interests

4.17 The provisions apply equally to a non-share equity interest holder as compared to a shareholder. Therefore, if you are an entity in the group and you lend an amount to the company (interest free), such that the loan is an equity interest, then Division 7A can apply to you and any of your associates. There is a risk that Division 7A may be overlooked in these circumstances.

#### Non-resident private companies

4.18 Further clarification on the application of Division 7A to non-resident private companies is required. Section 109BC was introduced to put beyond doubt that Division 7A applies to circumstances where the private company involved in the arrangement is a foreign resident and the shareholder (or their associate) is an Australian resident. However, a number of issues remain, including:

- Whilst section 109BC applies on its face to all foreign resident companies, some confusion has been caused due to definition of 'tax accounting period' (as used in section 109BC but defined in section 317) only referring to companies resident in listed countries;
- Whether Division 7A applies to cases involving both non-resident private company's and non-resident shareholders to the extent the disguised distribution has an Australian source in terms of paragraph 6-10(5)(a) ITAA 1997, and if so the mechanism for determining the extent of that Australian source; and
- The interaction between section 47A and Division 7A.

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

4.19 Subdivision B<sup>45</sup> of Division 7A broadly provides that certain payments, loans, amalgamated loans and forgiven loans are to be treated as dividends. For the purposes of Division 7A 'payment', 'loan' and 'forgive a debt' are defined terms which provides them with extended meanings to capture a broad range of transactions.

4.20 Most of the issues relating to payments, loans and debt forgiveness relate to the exclusions. The currency of the exclusions in the present day commercial world is open to question.

4.21 For a number of the provisions, there is also some uncertainty as to how the provisions operate when there is a novation, a legal assignment or an equitable assignment.

### Payments — section 109C

4.22 Subject to the exclusions, all payments made by a private company to a shareholder (or their associate) results in the private company being taken to have paid a dividend to the recipient of the payment. Relevant exclusions include where the payment is otherwise assessable or specifically excluded from assessable income, or where it discharges a pecuniary obligation.

4.23 In Division 7A, a payment to an entity means:

- (a) A payment to the extent that it is to the entity, on behalf of the entity or for the benefit of the entity; and
- (b) A credit of an amount to the extent that it is:
  - (i) to the entity;
  - (ii) on behalf of the entity;
  - (iii) for the benefit of the entity; and
- (c) A transfer of property to the entity.

4.24 For Division 7A purposes, the meaning of payment was extended to include the provision of an asset for use (other than transfer of property) by an entity. This applies to payments made on or after 1 July 2009. The extended meaning was required to prevent taxpayers from circumventing the operation of Division 7A through a private company providing an asset to a shareholder (or their associate) under licence or other right to use. Assets covered include holiday homes, boats and other private use assets.<sup>46</sup>

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45 Comprised of sections 109C - 109F.

46 See footnote 42 above.

4.25 For right to use payments there are exceptions covering minor use, otherwise deductible amounts (to the user) and the use of certain residences.

4.26 For payments, apart from the exclusions, an area of uncertainty and compliance difficulty is the valuation of certain kinds of payments. The value of a transfer of property or provision of an asset is the amount that would have been paid by parties dealing at arm's length less any consideration given for the transfer of property or provision of the asset. There is difficulty in valuing a right to use asset payment where there is no market for that right or where the asset type or manner of the asset usage departs from readily comparable benchmarks. Costs of compliance can be an issue, however, there are a number of other provisions in the income tax laws that require taxpayers to self-assess the market value of goods or services.<sup>47</sup>

4.27 Another issue is the inconsistency with the way in which certain payments are treated. Unlike the position for a transfer of property, if a company pays something on behalf of a shareholder or associate, the amount is not reduced by consideration given to the company by the shareholder or associate. Instead, the shareholder or associate must convert the payment to a loan and then repay the loan under section 109D.

#### Loans — section 109D

4.28 A private company is taken to pay a dividend to a shareholder (or their associate) at the end of the entity's year of income if the company has made a loan to the entity during the year, the loan is not fully repaid before the company's lodgment day and none of the exclusions apply. One of the main exclusions for loans is where a section 109N complying loan agreement is put in place before lodgment day. Failure to make minimum yearly repayments in subsequent years will result in the private company being taken to have paid a dividend in the later year.

4.29 A loan has the meaning given by subsection 109D(3). For the purposes of Division 7A a loan includes:

- (a) an advance of money;
- (b) a provision of credit or any other form of financial accommodations;
- (c) a payment of an amount for, on account of, on behalf of or at the request of, an entity, if there is an express or implied obligation to repay the amount; and
- (d) a transaction (whatever its terms or form) which in substance effects a loan of money.

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<sup>47</sup> For example, the capital gains tax market value substitution rule in section 116-30 of the *Income Tax Assessment Act 1997*.

4.30 The definition is broad and it has been argued open ended resulting in uncertainty. This is highlighted by the differing views on whether a UPE constitutes a loan for the purposes of Division 7A.

4.31 A practical difficulty arises where all loans and repayments are recorded in one general ledger account which spans multiple years and for repayments made, no consideration is given as to which loan or loans are being repaid. Does the repayment, for example, relate to current year loans or prior year loans?

#### Loans — section 109E

4.32 Loans that are accepted as being commercial for the purposes of Division 7A because they comply with the requirements of section 109N require a minimum yearly repayment to made with the amount determined by the formula in subsection 109E(6).

4.33 The minimum yearly repayment is required to be calculated each year.

4.34 The formula for the minimum yearly repayment calculates the annual repayment of principal and interest required to repay the loan over the term of the loan. Failure to make the minimum yearly repayment results in the private company being taken to have paid a dividend to the recipient of the loan.

4.35 The criteria for a complying loan, together with the requirement to make a minimum yearly repayment, are as a matter of practice, unable to be satisfied by taxpayers undertaking certain types of commercial activity which do not generate sufficient cash flows in the relevant year to pay the minimum yearly repayments, despite being able to pay a different but otherwise commercial return. While any apparent harshness is arguably mitigated by the fact that any deemed dividend is limited to the distributable surplus of the private company under section 109Y, some consider that Division 7A has application in circumstances where it should not.<sup>48</sup>

4.36 The application of section 109E has also been found to be uncertain and confusing in certain circumstances such as those detailed below.

4.37 Each loan made during an income year which complies with section 109N and is not repaid before the private company's lodgment day and has the same maximum term for the purposes of section 109N is grouped together and forms an 'amalgamated loan'. For each amalgamated loan a minimum yearly repayment is required to be made to prevent the private company from being taken to have paid a dividend. The amount of the dividend taken to be paid is the shortfall in the minimum yearly repayment.

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48 However, it is not clear why the borrower shareholder should not be treated as receiving a benefit equivalent to the commercial cost of their borrowing. In any event, the deemed dividend is limited to the surplus of the private company under section 109Y.

4.38 The Commissioner does have a discretion to disregard the deemed dividend in certain hardship cases and also has discretion to extend the period for making repayments if the shortfall arises because of circumstances beyond the loan recipient's control.

4.39 For the 2005-06 and earlier income years, the amount of the deemed dividend was not the shortfall amount but rather the amount of the loan that had not been repaid before the end of the year of income, subject to the distributable surplus. The change to the shortfall amount rather than the amount of the loan outstanding has reduced the consequences arising from the failure to make the minimum yearly repayment.

4.40 The amount of the shortfall remains as part of the outstanding debt with the company and the options open to the loan recipient are to make the shortfall payment, ask the private company to forgive the amount of the debt (which will not trigger a new deemed dividend) or the company could use the later dividend rule<sup>49</sup> and pay an unfranked dividend to offset the amount that gave rise to the deemed dividend.

4.41 There are a number of issues with the application of section 109E which has caused some confusion and uncertainty. These include:

- The calculation of the first minimum yearly repayment. The first element in the formula for the minimum yearly repayment is the 'amount of the loan not repaid by the end of the previous year of income'. As the amount of an amalgamated loan is the sum of the loans (constituent loans) that have not been fully repaid before the lodgment day the question arises as to which amount is included in the formula when calculating the first minimum yearly repayment. The ATO view is that 'the amount of the amalgamated loan not repaid by the end of the previous year of income' is not the amount at year end but the amount at lodgment day.<sup>50</sup>
- A related issue for the first minimum yearly repayment is whether repayments made which have been taken into account in determining the amount of the amalgamated loan and therefore in determining the amount of the first minimum yearly repayment are payments which can also be counted in determining whether there is a shortfall. The ATO view in ATO Interpretative Decision ATO ID 2010/82 is yes.
- Unless the action referred to above in relation to the shortfall (for example, payment of shortfall amount) is taken, there is no reduction in, or adjustment to, the amount of the amalgamated loan. As a result the minimum yearly repayment in subsequent

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49 See paragraphs 4.153-4.154 below, also section 109ZC.

50 Refer to ATO ID 2010/82.



years is higher than it would otherwise have been and could lead to cumulative shortfalls in excess of the amount of the loan.

#### Debt forgiveness — section 109F

4.42 A private company is taken to pay a dividend to a shareholder (or their associate) at the end of the company's year of income if all or part of a debt owed to the private company is forgiven in that year.

4.43 A debt is forgiven for the purposes of Division 7A if and when the amount would be forgiven under section 245-35 or 245-37 of the ITAA 1997, assuming the amount were a debt to which Subdivisions 245-C to 245-G of that Act apply (subsection 109F(3)). There is therefore a link to the commercial debt forgiveness provisions. Basically, a debt is forgiven when the debtor's obligation to pay the debt is released or waived, or is otherwise extinguished other than by paying the debt in full or the creditor (the private company) loses its right to sue for recovery of the debt, due to the operation of a statute of limitations.

4.44 Subdivisions 245C to 245G do not apply to certain forgiveness of debt including where:

- the debt is waived and the waiver constitutes a fringe benefit;
- the amount of the debt has been or will be included in the assessable income of the debtor in any year of income;
- the forgiveness is effected by will;
- the forgiveness is effected under an Act relating to bankruptcy; and
- the forgiveness is for reasons of natural love and affection.

4.45 However, the above exclusions are not relevant for the purposes of Division 7A because the meaning of when a debt is forgiven assumes that the amount is a debt to which Subdivisions 245-C to 245-G apply.

4.46 In addition, an amount of debt is also forgiven for the purposes of Division 7A if the private company will not insist on the entity paying the amount or rely on the entity's obligation to pay the amount and in circumstances where the private company assigns its rights under the debt to a third party (including an associate of the debtor) without the debtor's obligations under the debt being forgiven and it is concluded that the new creditor will not exercise the assigned right.

4.47 For Division 7A purposes, a 'loan' has an extended meaning; however, a 'debt' does not. How the debt forgiveness rules apply if there is the provision of financial accommodation that does not amount to a debt; to the extent that a loan within the

extended meaning is waived, released, disclaimed, abandoned or otherwise extinguished for less than its original value, is therefore unclear.

## SUBDIVISION C — FORGIVEN DEBTS THAT ARE NOT TREATED AS DIVIDENDS

4.48 The first of the exclusions, section 109G in subdivision C, provides that certain kinds of debt forgiveness do not give rise to a deemed dividend. Included is where the debt is forgiven because the debtor becomes a bankrupt or payment of the debt in certain circumstances would have caused the loan recipient undue hardship. In addition, the debt forgiveness does not give rise to a deemed dividend if, because of the loan, the private company had been taken to have paid a dividend under sections 109D or 109E.

4.49 The main issue with section 109G is the inconsistency between subsections 109G(3) and 109G(3A).

4.50 Under subsection 109G(3) the private company is not taken to have paid a dividend because of the forgiveness of an amount of a debt resulting from a loan if, because of the loan, the private company is taken under section 109D to pay a dividend at the end of the income year or an earlier one. The private company only needs to have been taken to have paid a dividend under section 109D with no reference to the amount of the dividend taken to have been paid which could be \$nil if no distributable surplus.

4.51 Under subsection 109G(3A) which concerns subsection 109E and amalgamated loans the position is different. The amount the private company is taken under section 109F to have paid as a dividend as a result of the forgiveness of a debt resulting from a loan is reduced by the amount of the dividend the private company is taken to have paid under section 109E at the end of an earlier year of income in respect of the loan.

4.52 The amount a private company is taken to have paid under either section 109D or 109E is subject to the company's distributable surplus. In the extreme case, if there is no distributable surplus, then the amount of the dividend the private company is taken to have paid is \$nil.

4.53 In summary, if section 109D has applied in respect of a loan (even if the amount of the deemed dividend is \$nil) the forgiveness of the loan in a later year will not be treated as a dividend whereas the forgiveness of a section 109E shortfall amount can result in the private company being taken to have paid a dividend because reference is made in the provision to the amount of the dividend taken to have been paid.

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

4.54 Subdivision D<sup>51</sup> includes a number of exclusions or exceptions for payments and loans that would otherwise result in the private company being taken to pay a dividend to the recipient of the payment or the loan, most of which are found in Subdivision D.

4.55 However, not all exclusions or exceptions are found in Subdivision D. For example, subsection 109ZB(3) provides that Division 7A does not apply to a payment made to a shareholder, or an associate of a shareholder, in their capacity as an employee or an associate of such an employee.

4.56 Section 109CA (provision of an asset payment) includes an otherwise deductible rule. It has been argued that this approach should not be limited to the use of company assets but should apply to all other payments and loans. For example, if the loan recipient could otherwise claim a deduction for interest incurred if in fact interest were charged, the argument is that Division 7A should have no application. Against this, it is noted that taxpayers using actual (real) dividends paid to them for income-producing purposes are nonetheless assessable on those dividends at their marginal rates.

### Section 109J Payments discharging pecuniary obligations not treated as dividends

4.57 Section 109J excludes payments to the extent that the payment discharges an obligation of the private company to pay money to the entity and is not more than would have been required to discharge the obligation had the private company and the entity been dealing with each other at arm's length.

4.58 The Explanatory Memorandum to Taxation Laws Amendment Bill (No.3) 1998 at paragraph 9.49 states that section 109J 'ensures that such commercial dealings are not unfairly taxed'. It is unclear as to whether the provision was also intended to apply to non-commercial obligations of the private company such as obligations arising because of, for example, family law obligations.

### Family law obligation payments

4.59 Section 109RC enables a private company to frank a deemed dividend that arises because of a family law obligation. If the recipient of the deemed dividend is not a shareholder the recipient is treated as such a shareholder.

4.60 Family law obligation is defined to mean an order, agreement or award mentioned in paragraphs 126-5(1)(a), (b), (d), (e) or (f) of the ITAA 1997. Section 126-5

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51 Comprised of section 109H - 109R.

concerns CGT events involving spouses and provides for a roll-over if the CGT event happens because of specified circumstances including those in the five paragraphs. As a result, the dividend may only be franked in the same circumstances that CGT roll-over relief applies in relation to relationship breakdowns.

4.61 A transfer of real property made because of a court order made under section 79 of Part VIII of the *Family Law Act 1975* in relation to the parties to a marriage is a payment for the purposes of Division 7A. In property proceedings the Court has the power to bind third parties including private companies. Therefore, the company can have an obligation to transfer property.

4.62 If the private company is not a party to the proceedings then section 109J has no application because there is no obligation as defined.

4.63 In ATO Interpretative Decision ATO ID 2004/462 which concerned a transfer of an investment property, the company was not a party to the proceedings. However, in the Reasons for Decision it was stated that ‘if it were an “obligation” on the private company, was not an obligation to “pay money”’. That was because it was a transfer of property. Therefore, section 109J would have no application because one of the conditions is not satisfied.

4.64 There are cases where Family Court orders (including consent orders) are not taking account of the Division 7A consequences with the effect that one or both of the matrimonial parties are not receiving in net after tax terms the contemplated division of matrimonial property. This is to be contrasted with the case with CGT where the Family Court and practitioners are very much alive to triggerings and as such, these are taken into account in the division of matrimonial property. When Division 7A is not taken into account the Commissioner may exercise his discretion under section 109RB to disregard the deemed dividend without conditions, where this discretion is exercised, then the remedy is effectively made out of consolidated. The section 109RC discretion presupposes the private company will act to frank the deemed dividend, however, this does not necessarily follow especially in cases where the other party controls the private company.

#### **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.

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

4.65 A payment or loan made to another company (other than a company acting in capacity as a trustee) will not result in the private company being taken to have paid a dividend. However, if the recipient company is a private company and it pays or loans an amount to a shareholder (or their associate) Division 7A may apply to that subsequent payment or loan (under the ordinary application of the provisions – that is, section 109D). In addition, the interposed entity provisions could apply if a reasonable person concluded that the private company made the payment or loan to the recipient company solely or mainly as part of an arrangement involving a payment or loan to the shareholder (or their associate).

### Section 109L Certain payments and loans not treated as dividends

4.66 To the extent that a payment or loan made by a private company to a shareholder (or their associate) forms part of assessable income or is specifically excluded from the assessable income of the shareholder (or their associate) by virtue of some other provision of the Act the payment or loan will not be treated as a dividend.

4.67 Therefore, Division 7A only has application if another provision in the Act does not deal with the transaction.

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

4.68 For the exclusion to apply, the loan is required to be 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. The ATO view in Taxation Determination TD 2008/1 is that in the context of Division 7A private companies, the shareholders and associates of such shareholders have sufficient connection to not be parties at arm's length. As a result where the private company only transacts with related parties (for example the finance entity of a family group) section 109M has no scope for operation as there are no 'similar loans made to parties at arm's length'.

4.69 There are also issues as to the meaning of 'in the ordinary course of a private company's business' and 'similar loans'.

4.70 Some taxpayers claim that section 109M applies in circumstances where the Commissioner's view is that section 109M has no application.

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

4.71 Within the policy framework of Division 7A, it is acknowledged that loans made by private companies that are either repaid or that meet minimum interest rate, maximum term and minimum yearly repayment requirements by the relevant lodgment day should not be treated as dividends. These loans are on an acceptable commercial footing for Division 7A purposes such that it would be inappropriate to treat them as being disguised distributions of profits to shareholders or their associates.

4.72 Section 109N sets out the criteria for unsecured loans and secured loans. The maximum term for an unsecured loan is 7 years and for a secured loan it is 25 years. Section 109N provides for adjustment to terms where refinancing occurs (for example, secured loans are replaced by unsecured loans).

#### Section 109NA Certain liquidator's distributions and loans not treated as dividends

4.73 A private company is not taken to pay a dividend under section 109C (payments) or section 109D (loans) because of a distribution or loan made in the course of the winding up of the company by the liquidator. However, if the loan is not repaid by the end of the following year of income, the company will be taken to have paid a dividend (subsection 109D(1A)).

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

4.74 A private company is not taken to pay a dividend because of a loan made solely for the purpose of enabling the shareholder (or their associate) to acquire an ESS interest under an employee share scheme (within the meaning of the *Income Tax Assessment Act 1997*) to which certain provisions of that Act apply.

#### Section 109P Amalgamated loans not treated as dividends in the year they are made

4.75 As amalgamated loans are broadly the total of the loans put on section 109N complying terms for a year, they will only give rise to a deemed dividend in years in which there is a shortfall in the minimum yearly repayment.

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

4.76 This is the original discretion in Division 7A. It gives the Commissioner a discretion to disregard the failure to make a minimum yearly repayment if the failure was caused by circumstances beyond the control of the loan recipient and the inclusion of the deemed dividend in assessable income will result in the recipient suffering undue hardship. The Commissioner is required to consider a number of factors including whether the loan recipient had the capacity to repay the loan at the time it was granted and the circumstances that reduced the capacity of the recipient to make the minimum yearly repayment.

4.77 An issue with section 109Q is determining the scope of the 'beyond the control of the loan recipient' test.

#### Section 109R Some payments relating to loans not taken into account

4.78 Section 109R is intended to prevent shareholders (or their associates) from avoiding the operation of Division 7A by temporarily repaying a loan. The section provides for some payments not to be taken into account for the purpose of working out how much of a loan has been repaid.

4.79 Payments are not taken into account if:

- (a) a reasonable person would conclude that, when the payment was made, the shareholder (or their associate) intended to obtain a loan or loans from the private company of a total amount similar to, or larger than, the payment; or
- (b) the shareholder (or their associate) obtained, before the payment was made, a loan or loans from the private company of a total amount similar to, or larger than, the amount of the payment and a reasonable person would conclude that the shareholder (or their associate) obtained the loan or loans in order to make the payment.

4.80 There is an issue as to the meaning of 'similar to'. Is, for example, \$48,000 similar to \$54,000? If such small differences in quantum enable the 'similar to' test to be overcome, then this frustrates the intent of section 109R by enabling taxpayers to temporarily repay part of a loan (essentially allowing re-borrowings to push out the term of the loan without consequence).

4.81 The provision also requires the loan or loans to be obtained from the private company. Section 109R does not capture circumstances where the private company indirectly funds the repayment or has other entities in the group funding the repayments in the current year and later income years. This may also frustrate the policy intent of section 109R. Note however that where the private company indirectly funds the loan repayment, the interposed entity provisions may have application.

4.82 Some payments can be taken into account even if there is an intention to redraw. These are limited to:

- dividends payable by the company to the entity;
- payments sourced from PAYG earnings of the borrower; or
- where property transferred to the company – the difference between the arm's length value of the property and consideration provided by the company.

which are offset against amounts payable in relation to the loan.

4.83 In addition, payments made by third parties on behalf of the borrower are also taken into account, provided the amount is owed by the third part to the borrower and included in the assessable income of the borrower (the shareholder or associate of the shareholder).

4.84 The above exceptions only apply where there is a setting off or payment direct from the third party to the company. Therefore, the exceptions do not apply in

circumstances where the shareholder or associate of the shareholder receives the amount direct and then makes a payment to the company.

4.85 In addition, the exceptions do not explicitly provide an exception for ordinary business trading type activities where loans are genuinely repaid and new loans established as part of the trading activities. Therefore, there is a question as to how the repayments rules may operate in this case.<sup>52</sup>

## SUBDIVISION DA — DEMERGER DIVIDENDS NOT TREATED AS DIVIDENDS

### Section 109RA Demerger dividends not treated as dividends

4.86 A demerger dividend is assessable as a dividend or would be assessable but for subsections 44(3) and (4). Section 109RA provides that Division 7A does not apply to demerger dividends to which section 45B does not apply. Section 45B is an anti-avoidance measure the purpose of which is to ensure that relevant amounts are treated for taxation purposes as if:

- components of a demerger allocation as between capital and profit do not reflect the circumstances of the demerger; or
- certain payments, allocations and distributions are made in substitution for dividends.

## SUBDIVISION DB — OTHER EXCEPTIONS

4.87 Subdivision DB<sup>53</sup> contains the set of measures designed to nullify or modify the application of Division 7A in circumstances where that application is deemed to be hard or unfair.

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

4.88 Before the section 109RB general discretion was inserted into Division 7A, the Division provided only a very limited discretion to the Commissioner to disregard its application in respect of loan repayments, where he considered it reasonable in cases of undue hardship. Section 109RB provides a more general and flexible discretion to the Commissioner to enable him to provide relief for deemed dividends that have arisen because of an honest mistake or inadvertent omission.

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52 That is, whether the reasonable person test in section 109R(2) would allow the payments to be taken to be repayments for the purposes of Division 7A.

53 Comprised of sections 109RB - 109RD.



4.89 The exercise of the discretion involves a two-step process. First, before the Commissioner is empowered to make a decision to disregard the operation of Division 7A or allow the dividend taken to have been paid under Division 7A to be franked the result from the operation of Division 7A must arise because of an honest mistake or inadvertent omission of the recipient of the dividend, the private company or any other entity that contributed to the result. In each case it is a question of fact whether an honest mistake or inadvertent omission has occurred.

4.90 If the honest mistake or inadvertent omission condition is satisfied, then the Commissioner has the power to make a decision. A finding that the application of Division 7A arose because of honest mistake or inadvertent omission does not, in and of itself, justify the exercise of the discretion.

4.91 Where the Commissioner has a discretion under section 109RB, the Commissioner is required to consider a range of factors in deciding whether, and how, to exercise it. They are:

- (a) the circumstances that led to the mistake or omission;
- (b) the extent to which any of the entities have taken action to try to correct the mistake or omission and if so, how quickly that action was taken;
- (c) whether Division 7A has operated previously in respect of the relevant taxpayers, and if so, the circumstances in which this occurred;
- (d) any other matters the Commissioner considers relevant.

4.92 Section 109RB gives the Commissioner considerable flexibility as to how to exercise the discretion. He can disregard the deemed dividend or instead allow the deemed dividend to be franked. He can also exercise the discretion subject to conditions. The Commissioner has said that he will generally impose such conditions as he considers necessary to ensure that the parties are put in the same position as they would have been had Division 7A not been triggered.<sup>54</sup>

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54 Paragraph 81 of Law Administration Practice Statement PS LA 2011/29.

4.93 The discretion in section 109RB is generally welcomed by tax practitioners. It provides an avenue for openness between the ATO and taxpayers who have inadvertently been exposed to Division 7A and are prepared to take steps to correct their error. However, there are a number of difficulties associated with its interpretation and administration:

- (a) The ATO has found the discretion to be complex to administer. The operation of section 109RB requires the Commissioner to consider many factors and to obtain and analyse a large amount of information, relating to the conduct of various parties involved in the transaction.
- (b) There is disagreement as to the meaning and breadth of the terms 'honest mistake' and 'inadvertent omission'. A broad interpretation of the terms 'honest mistake' and 'inadvertent omission' would generally enable the conditions in the first step to be satisfied and in most cases the Commissioner would then be required to make a decision on whether the discretion should be exercised. However, the Commissioner does not accept that the parties' honesty must be positively established and does not accept that honesty should be inferred from the absence of dishonesty.<sup>55</sup> This is seen by commentators as an overly restrictive interpretation.<sup>56</sup>
- (c) Difficulties can arise where conditions are imposed but are unfulfilled at the time of making the decision. Where the Commissioner imposes a condition in making a decision, then Division 7A will only be taken not to operate if the condition is satisfied. When making the decision the condition may be unfulfilled but capable of fulfilment. The condition may, for example, require the equivalent of minimum yearly repayments to be made in subsequent income years. If relevant conditions remain unfulfilled outside the taxpayer's amendment period, then the Commissioner may have no remedy. That is, no Division 7A triggering point arises if the conditions are not fulfilled.
- (d) Section 109RB is silent on the remedies available to taxpayers dissatisfied with the decision or non-decision by the Commissioner. There are alternative views on the avenues for review of decisions made under section 109RB. The Commissioner's view is that he must consider whether to apply section 109RB when making an assessment based on the operation of Division 7A.<sup>57</sup> It follows that decisions made under section 109RB may be reviewed in objection decisions and in later

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55 Taxation Ruling TR 2010/8.

56 ATO Ruling Compendium - TR 2010/8.

57 Refer to PS LA 2011/29.

reviews by the Administrative Appeals Tribunal (AAT) or appeals to the Federal Court. The alternative view is that the proper jurisdiction for the review of decisions made under section 109RB is the High Court under section 75(v) of the Constitution, or in the Federal Court under either section 39B of the *Judiciary Act 1903* or under the *Administrative Decisions (Judicial Review) Act 1977*.<sup>58</sup>

- (e) The Commissioner has indicated that more than a willingness to take corrective action as a condition of the discretion being exercised favourably is generally required. In some cases, where the Commissioner decides not to exercise the discretion, taxpayers who have taken corrective action may be disadvantaged.
- (f) There is a lack of clarity as to the range of 'any other matters that the Commissioner considers relevant'.

4.94 It may be desirable to clarify the circumstances in which section 109RB was intended to apply.

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

4.95 Although CGT roll-over relief is available for transfers of CGT assets, the transfer of the asset is a payment for Division 7A purposes and can result in a deemed dividend. The ability to frank the deemed dividend recognises the fact that there is no attempt to make a disguised distribution.

4.96 The dividend may only be franked in the same circumstances that CGT roll-over relief applies in relation to the marriage breakdown.

4.97 For some taxpayers the relief provided may not be sufficient. To pay the additional tax some taxpayers may need to sell the property resulting in both a capital gain and a deemed dividend. It has also been suggested that there are some inappropriate interactions with the CGT regime.

4.98 As noted at paragraph 4.64, a question which arises is that if an error of the Family Court and/or Family Law practitioners is remedied by the exercise of the Commissioner's section 109RB discretion without conditions, that remedy is provided out of consolidated revenue. This is to be contrasted with the case where the Division 7A consequence is taken into account by the Family Court and the remedy occurs as part of the division of matrimonial property (as is the case for CGT events

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58 The AAT recently handed down a decision on an application by a taxpayer for review of a decision of the Commissioner not to exercise his discretion under section 109RB: *Building Company Owner and Commissioner of Taxation* [2012] AATA 755. The question of the AATs jurisdiction to hear application was not questioned.

where the taxation consequences are generally well understood by the Family Court and family law practitioners).

### Section 109RD Commissioner may extend period for repayments of amalgamated loans

4.99 This is the second of the discretions relating to amalgamated loans. The first in section 109Q can be exercised in hardship cases.

4.100 The Commissioner has the power to disregard the deemed dividend and extend the time for making the payment if the shortfall arose because the loan recipient is unable to pay the minimum yearly repayment because of circumstances beyond his or her control.

## SUBDIVISION E — PAYMENTS AND LOANS THROUGH INTERPOSED ENTITIES

4.101 Subdivision E<sup>59</sup> contains the interposed entity provisions to prevent Division 7A from being circumvented by structuring a loan or payment to a shareholder (or their associate) through a company that has little or no distributable surplus. Other entities not themselves subject to Division 7A could be interposed in order to gain a similar tax advantage.

4.102 There appear to be a number of issues and difficulties with the operation of the interposed entity provisions.

### Section 109T Payments and loans through interposed entities

4.103 The interposed entity provisions are concerned with back-to-back arrangements under which a private company pays or loans an amount to an interposed entity on the understanding that the interposed entity or another interposed entity will pay or loan an amount to the shareholder of the private company or an associate of the shareholder (the 'target entity'). Specifically, subsection 109T(1) provides that Division 7A will operate as if the private company makes a deemed payment or notional loan, as described in section 109V or 109W, to the target entity if:

- (a) the private company makes a payment or loan to another entity (the first interposed entity) that is interposed between the private company and the target entity;
- (b) a reasonable person would conclude (having regard to all the circumstances) that the private company made the payment or loan

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59 Comprised of sections 109S - 109X.

solely or mainly as part of an arrangement involving a payment or loan to the target entity; and

- (c) either:
  - (i) the first interposed entity makes a payment or loan to the target entity; or
  - (ii) another interposed entity between the private company and the target entity makes a payment or loan to the target entity.

4.104 Arrangement is broadly defined as 'arrangement' has the meaning given by section 995-1 of the *ITAA 1997*.

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

4.106 Subsection 109T(1) may be relatively straightforward to apply if there is a direct correlation between the transactions. However, that will not always be the case. There may be a number of transactions involving multiple private companies and multiple target entities in the arrangement(s). The application of section 109T in these cases is uncertain. However, it can be difficult to provide more prescriptive provisions that are sufficiently flexible to deal with the complex arrangements that may arise.

4.107 A deemed payment or notional loan can arise in circumstances where the private company has paid an actual dividend to the interposed entity. It has been argued that a deemed dividend should not arise in these circumstances because there has been an actual distribution of profits by the private company. However, the interposed entity may not be the intended recipient and a scheme to circumvent Division 7A could easily be implemented should this rule not exist (involving making the actual dividend to a private company with no distributable surplus).

4.108 This is to be contrasted with the case of a deemed dividend where section 109T is expressly provided not to apply.<sup>60</sup>

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60 Section 109T(3).

### Sections 109V and 109W Amount of deemed payment or notional loan

4.109 If the conditions in subsection 109T(1) are satisfied then the Commissioner is required to determine the amount of the deemed payment or notional loan.

4.110 Section 109V concerns deemed payments and section 109W notional loans. If the shareholder (or their associate), the target entity, is paid an amount by the interposed entity then Division 7A operates as if the private company had paid an amount determined by the Commissioner to the shareholder (or their associate) when the interposed entity paid the shareholder (or their associate). Likewise, if the shareholder (or their associate) is lent an amount by the interposed entity then Division 7A operates as if the private company had made a loan of an amount determined by the Commissioner to the shareholder (or their associate) when the interposed entity paid the shareholder (or their associate).

4.111 The target entity or recipient of the notional transaction is not required to make a judgement on quantum or to self-assess a deemed dividend. It is not clear whether the policy intent was that all arrangements involving interposed entities should be referred to the Commissioner. The requirement for the Commissioner to determine the amount of the deemed payment or notional loan in all cases involving interposed entities is not consistent with self-assessment. It has also been argued that without a determination by the Commissioner the amount is nil.

4.112 In determining the amount of the deemed payment or notional loan the Commissioner must take account of certain factors specified in the sections 109V and 109W. However, many other factors which are not specified in the provisions can be taken into account. Taxation Determination TD 2011/16 sets out many of these factors. These factors should be included in the provision.

4.113 One of the factors that the Commissioner must take account of is how much (if any) of the amount the Commissioner believes represented consideration payable to the target entity by the private company or any of the interposed entities for anything. Theoretically, the right to receive repayment of the loan and any relevant interest is consideration for anything.

4.114 One of the factors that the Commissioner has said that he will take into account is the extent to which an interposed entity has put its loan on section 109N complying terms. However, in such instances, there is an issue regarding the extent to which the requirements for minimum yearly repayments and the restrictions imposed by section 109R apply to an entity that is not otherwise subject to Division 7A (the interposed entity) and/or the target entity.

4.115 Section 109X clarifies the application of only some of the Subdivision D exclusions (sections 109K, 109L and 109N) in the operation of the interposed entity provisions.

## Sections 109U and 109UA Guarantees

4.116 Subdivision E also includes two sections relating to the provision of guarantees by private companies, sections 109U and 109UA.

4.117 Section 109U is intended to prevent Division 7A from being circumvented by structuring a loan through a company with no (or little) distributable surplus, the repayment of which is guaranteed or secured by a private company with distributable profits. If a number of conditions are satisfied then Division 7A operates as if the company with distributable profits makes a payment to a shareholder (or their associate). The amount of the deemed payment is determined by the Commissioner. That amount is then reduced by the amount of the interposed company's distributable surplus adjusted for other amounts taken to have been paid as dividends by the interposed company. In determining the amount of the deemed payment the Commissioner can take into account a wide range of factors. If there is no attempt to circumvent Division 7A and no aggravating factors then the amount of the deemed payment could be \$nil.

4.118 Other than in the circumstances to which section 109U applies, under section 109UA a guarantee given by a private company for a loan by a third party to a shareholder (or their associate) is deemed to be a payment made by the private company to the shareholder (or their associate) only where a liability (other than a contingent liability) is actually incurred by the private company as a result of providing the guarantee. Again, the Commissioner determines the amount of the deemed payment. The amount of the payment is reduced by any amount treated as a dividend as a result of the operation of section 109U in relation to the payment or loan made by the interposed entity to the shareholder (or their associate).

4.119 Issues raised with the operation of section 109UA include:

- the section can operate to give rise to a deemed dividend where there is a technical default such that the guarantee can be called upon, regardless of whether the guarantee actually is called upon. The debtor may, for example, ultimately make the required payment under the borrowing and so no call under the guarantee is required.
- as a technical default could arise more than once in relation to a loan section 109UA will operate on each occasion that there is a default even if the debtor makes good the payments. In later defaults the Commissioner could take the circumstances into account in determining the amount of the deemed payment; and
- where a private company guarantor makes a payment under the guarantee a debt arises between the private company guarantor and the shareholder (or their associate) debtor. The debt arising when the payment is made is a loan for the purposes of Division 7A and as a result section 109D may operate with the result that the private company is taken to pay a further dividend.

## SUBDIVISIONS EA AND EB — UNPAID PRESENT ENTITLEMENTS

4.120 Subdivision EA<sup>61</sup> contains the rules for working out when a shareholder of a private company (or an associate of the shareholder) will by virtue of Division 7A, have a dividend included in their assessable income as a result of receiving a financial benefit through a trust loan, payment or a forgiven debt. Subdivision EB<sup>62</sup> operates to give effect to subdivision EA when an interposed entity has made a payment or loan to the shareholder or associate.

4.121 It has been argued that if an UPE is a loan for Division 7A purposes then there is no need for Subdivisions EA and EB. However, both Subdivisions do have a residual operation in cases where the UPE is not a loan for section 109D purposes in accordance with that explained in Taxation Ruling TR 2010/3 and the other ingredients necessary for the Subdivisions to apply are present. In addition, relying on the taxation ruling would not always allow the corporate profits to be traced through to the shareholder or associate that ultimately gets to enjoy the profits. Tracing the amount to the shareholder or associate is necessary in some cases to protect the integrity and progressivity of the tax system.

4.122 Nevertheless, both Subdivisions are complex and difficult to comply with.

4.123 Views differ on whether an UPE is a loan for Division 7A purposes. In Taxation Ruling TR 2010/3 Income tax: Division 7A loans: trust entitlements, the ATO view is that UPEs may be treated as loans in certain circumstances. Furthermore, the ATO believes that its position in TR 2010/3 is clear and consistent with the policy intent of Division 7A.

4.124 If Subdivision EA has application, it is necessary to work out the amount of the Subdivision EA deemed dividend under section 109XB which modifies the application of the Division 7A provisions to the trust. The amount of the deemed dividend is determined under section 109XB by assuming that the transactions had been done by a private company (the notional company) and that the shareholder (or their associate) of the private company were a shareholder (or their associate) of the notional company. The amount included as though it were a dividend in the shareholder (or their associates) assessable income is subject to the private company's distributable surplus.

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61 Comprised of sections 109XA – 109XD.

62 Comprised of sections 109XE – 109XI.



4.125 As the policy is concerned with the amount of the UPE and the application of the underlying cash, the amount of the payment, loan or debt forgiveness for the purposes of Subdivision EA is taken to be the lesser of the amount actually involved in the transaction and the amount worked out under the formula:

$$UPE - \textit{Previous transactions}$$

where previous transactions are amounts that have been included in an entity's assessable income because of a previous applications of Subdivision EA.<sup>63</sup>

4.126 By deducting previous transactions from the UPE, amounts that have previously attracted the operation of Subdivision EA are not further subjected to the rules.

4.127 However, there appears to be a problem with the formula in that it does not account for other transactions in the same income year that are subject to Subdivision EA. There is no basis for apportionment, by ordering of the transactions or otherwise, and no previous transaction involved. As a result the total of the transactions amounts could exceed the UPE (as adjusted).

4.128 Subsection 109XA(3) is intended to enable section 109XB to apply to debts forgiven by the trustee. Subdivision EA may not apply in all cases where it is intended to apply because 'forgive a debt' has the meaning given by section 109F which in many instances refers to debts forgiven by a private company. It may not apply to some debts forgiven by trustees. Special rules arguably need inserting to create symmetry.

4.129 There was a major problem with the operation of Subdivision EA which has been fixed. Prior to the introduction of Subdivision EB (interposed entity provisions) the operation of Subdivision EA could be circumvented by interposing an entity between either the trust making a payment or loan to a shareholder (or their associate) or between the trust and the private company that holds an UPE to an amount from the net income of the trust. Subdivision EB is, however, only applicable in relation to payments made, loans made and debts forgiven on or after 1 July 2009.

## **SUBDIVISION EB — UNPAID PRESENT ENTITLEMENTS — INTERPOSED ENTITIES**

4.130 Subdivision EB was introduced because the interposed entity provisions in Subdivision E did not apply to arrangements involving the application of Subdivision EA. As stated above, Subdivision EA could be circumvented by interposing an entity between either the trust making a payment or loan to a shareholder (or their associate) or between the trust and the private company that holds an UPE to an amount from the net income of the trust.

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63 Subsection 109XA(4).

4.131 Many of the provisions in Subdivision EA are conceptually equivalent to provisions in Subdivision E, with the addition of corresponding provisions for interposed presently entitled beneficiaries.

4.132 To highlight the position before Subdivision EB was introduced, take the interposing of a trust such that a company became presently entitled to an amount from the net income of the interposed trust. For an amount to be included as if it were a dividend in the assessable income of a shareholder (or their associate) pursuant to section 109XB, the conditions in subsection 109XA(1) for payments, subsection 109XA(2) for loans and subsection 109XA(3) for forgiven debts, must be satisfied. For each of the subsections one of the conditions is:

either:

- (i) the company is presently entitled to an amount from the net income of the trust estate at the time the actual transaction takes place, and the whole of that amount has not been paid to the company before the earlier of the due date for lodgment and the date of lodgment of the trustee's return of income for the trust for the year of income of the trust in which the actual transaction takes place; or
- (ii) the company becomes presently entitled to an amount from the net income of the trust estate after the actual transaction takes place, but before the earlier of the due date for lodgment and the date of lodgment of the trustee's return of income for the trust for the year of income of the trust in which the actual transaction takes place, and the whole of the amount has not been paid to the company before the earlier of those dates.

4.133 The interposing of a trust prevented the above condition from being satisfied because the company was no longer presently entitled to an amount from the net income of the trust estate. It is presently entitled to an amount of the net income of the interposed trust estate.

4.134 To enable the conditions in subsections 109XA(1), (2) and (3) to operate where there is an interposed trust the private company is now taken to be or to become entitled to an amount of the net income of the trust estate (a deemed entitlement). There are a number of conditions including a reasonable person test that must be satisfied before a deemed entitlement can arise. The reasonable person test requires a reasonable person to conclude (having regard to all the circumstances) that the company is or becomes so entitled to an amount of the income from another trust solely or mainly as part of an arrangement involving an entitlement to an amount from the target trust.

4.135 Similar to what happens with sections 109T, 109V and 109W in the general interposed entity provisions, the Commissioner determines the amount of the deemed

entitlement to an amount of the net income of a trust estate (the target trust) taking into account a number of factors.

4.136 As with Subdivision E (the interposed entity rules for private companies) there are issues relating to the breadth of the provision, the reasonable person test and the determination of the amount by the Commissioner.

4.137 Also, as with Subdivision E, the provisions are relatively straightforward to apply if there is a direct correlation between the relevant transactions or entitlements. That will not always be the case. The interposed trusts may be entitled to an amount from the net income of multiple trusts and have other income. The trustee may incur a range of expenses some of which are general expenses of the trust. If the private company receives a payment of part of the company's entitlement from an interposed trust, what was the source of the income that formed the basis of the entitlement? No guidance is provided in Division 7A as to how composite entitlements and payments are to be dealt with. Taxation Determination TD 2011/15 provides some guidance on deemed entitlements and composite entitlements.

4.138 The above paragraphs are concerned with the deemed entitlements. Subdivision EB also includes provisions for payments and loans being made through interposed entities which results in the provisions applying to deemed payments and notional loans in a similar manner to that for payments and loans made by private companies through interposed entities. Similar issues and problems arise – the breadth of the provisions, the reasonable person tests and the determination of the amounts of the deemed payments and notional loans by the Commissioner.

### **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).

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

4.139 Subdivision F<sup>64</sup> contains a number of general rules which apply to all amounts taken to be dividends under Division 7A.

4.140 Apart from the general rules discussed below (distributable surplus, FBT and later dividend rules) the other rules are:

- If the private company is taken to have paid a dividend under Division 7A then the dividend is taken for the purposes of the Act to be paid to the entity as a shareholder in the private company and out of the private company's profits; and
- No dividend is taken to be paid for withholding tax purposes.

4.141 Since Division 7A was inserted in 1998 there have been many changes in other areas of tax law (for example, CGT) and new measures (such as the consolidation provisions) have been introduced. Subdivision F provides little or no guidance or rules on how Division 7A interacts with these areas of tax law. For example, in Division 7A there are no specific exceptions or exclusions related to CGT. There is, however, a note to subsection 109C(1) on payments treated as dividends which states:

This section also does not give rise to a dividend if the amount is paid to a CGT concession stakeholder under subsection 152-325(1) of the *Income Tax Assessment Act 1997* (see subsection 152-325(11))

4.142 The exclusion or exception is not found in Division 7A. Instead, CGT Subsection 152-325 is found in Subdivision 152-D, which concerns small business retirement exemptions.

### Distributable surplus formula — subsection 109Y(2)

4.143 The distributable surplus is a proxy for 'profits'. The amount of a deemed dividend is limited to the amount of the distributable surplus. If there is more than one dividend that the company is taken to have paid then there is an apportionment based on the amount of the dividend that the private company is taken to have paid divided by the total amount of the dividends taken to have been paid.

4.144 The distributable surplus formula is found in subsection 109Y(2) and takes the value of the company's assets disclosed in the accounting records and subtracts the amount of present legal obligations, certain specified provisions and the paid-up capital. Also subtracted are amounts that the private company has been taken to have paid as dividends.

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64 Comprised of sections 109Y - 109ZCA.

4.145 The Commissioner has the power to substitute values if he considers that the company's accounting records significantly undervalue or overvalue its assets or undervalue or overvalue its provisions. Taxation Determination TD 2009/5 provides guidance on when the Commissioner will substitute an appropriate value for a private company's assets. TD 2009/5 also makes the point that section 109Y is not concerned with identification of particular assets but rather with the value of the company's assets and that the unqualified use of the word 'asset' means that anything of commercial value recognised in ordinary use as an asset is an asset for the purposes of Division 7A.

4.146 Issues with the distributable surplus formula include:

- The meaning of 'significantly undervalue or overvalue'.
- The circumstances in which assets not recorded in the company's accounting records should be taken into account.
- In the formula, non-commercial loans are defined to be the total of any amounts that the company is taken under the former sections 108, 109D or 109E to have paid as dividends in earlier years of income and are shown as assets in the company's accounting records at the end of the year of income. There has been some confusion as the amount deducted is not the amount of the loan shown in the accounting records (the non-commercial loan) but rather the total of the amounts taken to have been paid as a dividend under sections 108, 109D and 109E. A similar issue exists with the definition of repayments of non-commercial loans.
- Amounts taken to have been paid as a dividend as a result of debt forgiveness are added back in the formula. However, for some debt forgiveness the debt remains on foot. For example, the debtors obligation to pay the debt may not cease immediately but at some time in the future.
- The formula may not properly account for some notional loans and deemed payments. Notional loans and deemed payments will not be shown in the company's accounting records. What will be shown in the accounting records are the transactions that gave rise to the deemed dividends. The formula has as its starting point the net assets of the company less paid-up share value. Adjustments are then made for amounts the company is taken to have paid as a dividend even if the recipient of the deemed dividend has not been included in the recipient's tax return and the Commissioner is out of time to amend the recipient's assessment.

#### Fringe benefits tax — section 109ZB

4.147 Shareholders (or their associates) may also be employees of the private company. There may be more than one reason for making the payment or loan.

4.148 Section 109ZB includes rules on the interaction between FBT and Division 7A and is intended to ensure that Division 7A applies in priority to FBT except in relation to payments to a shareholder (or their associate) in their capacity as an employee or

associate of an employee. However, in certain circumstances that may not be the case and contrary to the intention.

4.149 FBT is payable on loan benefits and debt waiver benefits provided in relation to an employee. As a 'fringe benefit' as defined excludes anything done in relation to a shareholder in a private company (or their associate) that causes or will cause the private company to be taken to have paid a dividend under Division 7A to the shareholder (or their associate), double taxation is avoided. However, as the exclusion uses the terms 'shareholder in a private company' and 'associate of such a shareholder' it is not clear that it will extend to a former shareholder or associate receiving a loan or debt forgiveness. If the exclusion does not apply, section 23L may treat the amount as not assessable and not exempt income.

4.150 There is also an issue with payments made in respect of employment. Subsection 109ZB(3) refers to payments to a shareholder, or an associate of a shareholder, in their capacity as an employee. It does not use the general term 'entity'. Therefore, if the shareholding ends before the payment is made and the payment is in respect of employment and also because the entity was a shareholder at some time, subsection 109ZB(3) may not apply. In this case there may be a deemed dividend and no FBT. In the definition of fringe benefit there is an exclusion for a payment of an amount that is deemed to be a dividend paid to the recipient.

4.151 As such, payments made in relation to employees that are still shareholders or associates of shareholders at the end of the income year will be treated differently to payments made to employees that are no longer shareholders at the end of the income year. It is not clear whether this is on the basis that, given that the recipient is still an employee, it is considered more appropriate to apply the FBT provisions rather than the more onerous Division 7A provisions.

#### Later dividend rules — section 109ZC

4.152 To prevent double taxation, there are rules for actual dividends distributed if some or all of the later dividend is set off against some or all of an amount taken under Division 7A to be a dividend previously paid by the company. As a general rule, the amount of the later dividend set-off or applied is taken not to be a dividend and is neither assessable income nor exempt income. There is an exception to the general rule. Dividends may be partly or fully franked. The later dividend, to the extent that it is franked, remains assessable income (and a dividend). This means that the franking credit attached to the dividend is still available to the shareholder.

4.153 The later dividend rules were extended to enable the later dividend paid to a shareholder to be applied to repay all or part of loans obtained by an associate of the shareholder and in relation to which a dividend was previously taken to have been paid by the private company. In addition, they were also extended to include dividends paid to a shareholder to be applied to repay all or part of a loans obtained by a shareholder or an associate or an associate of a shareholder and in relation to an

amount included in the shareholder's or associate's assessable income under Subdivision EA.

## SUBDIVISION G — DEFINED TERMS

4.154 'Associate' is defined in Division 7A to have the meaning given by section 318. This definition is very broad. For example, the associate of a trustee includes any entity that benefits under the trust and to benefit under a trust all that is required is that you are capable of benefiting under the trust either directly or through any interposed companies, partnerships or trusts. It also includes associate of entities that benefit under the trust. It has been argued that the broad definition of associate results in Division 7A extending beyond what was intended.

### 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.

## CHAPTER 5: DIVISION 7A REFORM CONSIDERATIONS

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5.1 The Board's terms of reference require it to recommend options for resolving identified problems so that, having regard to the policy intent of Division 7A and potential compliance and administration costs, the tax law operates effectively. The Board is also asked to examine the potential for broader reforms to Division 7A, including whether the provisions could be expressed in a clearer and simpler manner. Any reforms proposed must maintain the integrity of the tax law, as well as revenue neutral or near revenue neutral outcomes.<sup>65</sup>

5.2 This Chapter raises for consideration and stakeholder input various approaches to reform having regard to the policy intent of Division 7A. These approaches or models can be grouped under three headings:

1. One approach is to address the individual issues and problems in Division 7A by way of specific legislative amendment. This approach, which is referred to in this Chapter as the 'Division 7A adjustment model', would take Chapter 4 as a starting point in determining which matters to fix. Further details of this approach are at paragraphs 5.7 to 5.21.
2. An alternative approach is to largely replace Division 7A with a requirement that loans to related entities carry a statutory rate of interest, but with no requirement that principal be repaid prior to termination of the loan. This is referred to as the 'statutory interest model', further details of which are at paragraphs 5.22 to 5.29.
3. A third approach is to allow the retention of profits within the private group for permitted purposes and to treat any profits not so used, and not distributed, as deemed dividends (which would be able to be franked). This is referred to as the 'distribution model', further details of which are at paragraphs 5.30 to 5.41.

5.3 These models, which are sketched out below, are not mutually exclusive. Elements of Division 7A would be retained to a greater or lesser degree in all models. In that sense, there is some overlap between the models. At the same time, they offer different advantages and disadvantages.

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65 The Board notes that the Government is currently undertaking its update and rewrite of the trust provisions into the *Income Tax Assessment Act 1997*, and that the proposed start date for the broader reform of trust income taxation has been deferred from 1 July 2013 until 1 July 2014. The Board will seek to ensure that the recommendations in its final report, which is not due to be delivered to the Government until 30 June 2013, are cognisant of the development of the trust reforms.



5.4 In setting out these models for stakeholder input, the Board is mindful of the need for an appropriate balance between facilitating the financing of businesses and maintaining the integrity of the tax system.

5.5 The former might entail an explicit form of retention of funds within the private group, which might include a trust or trusts, for specified purposes and under certain conditions. In this regard, a view has been expressed that a commercial loan – from a private company to a trust within the private group – that does not comply with Division 7A, but in respect of which the loan funds do not permanently leave the group for private use or consumption and are used as working capital or for investment in the business (rather than for passive investment), should be the subject of an exclusion from Division 7A.

5.6 The latter would need to have regard to the progressivity of the personal income tax system. It would also need to have regard to, for example, the differences between trust and company tax settings. Thus, the models do not propose changing basic settings such as the flow through nature of trusts or the CGT treatment for assets disposed of by companies.

## 1. DIVISION 7A ADJUSTMENT MODEL

5.7 In terms of legislative design, Division 7A adopts a detailed and relatively prescriptive approach to its integrity role. On one view, some of the mechanics in the provisions do not reflect existing business practice, raising a question about whether there are better ways to do so while maintaining the requisite degree of certainty and integrity.

5.8 As indicated, this model would encompass addressing specific issues and problems listed in Chapter 4. It could also involve extending or fixing some of the exclusions from Division 7A or clarifying areas of uncertainty. Some examples of this approach follow.

5.9 The advantage of this approach is that it could deal with known issues. However, it has the potential to be a piecemeal solution and would be unlikely to be able to significantly simplify the law or its understanding.

### Treatment of UPEs

5.10 As indicated, a common occurrence within family groups comprising a trust and a private company beneficiary of the trust is for the company's entitlement to an amount from the trust to be unpaid – hence unpaid present entitlement or UPE. This allows the amount to be retained for use as, for example, working capital in a business carried on by the trustee.

5.11 The Commissioner considers that in certain circumstances a UPE is a Division 7A loan from the company to the trust: Taxation Ruling TR2010/3. A particular circumstance for the operation of this Ruling is that the funds representing the present entitlement remain intermingled with other funds of the trust estate, or are otherwise able to be used for 'trust purposes'.

5.12 The Commissioner has issued a Practice Statement (PS LA 2010/4), which provides practical guidance and examples on when a UPE is considered not to be a Division 7A loan, namely where the funds representing the UPE are held on sub-trust for the sole benefit of the private company beneficiary.

5.13 Whilst there is generally high compliance with PS LA 2010/4, some consider that the Commissioner's view is not a technically correct interpretation of the current law.

5.14 While there are differences in view about the operation of the current law in relation to whether UPEs are Division 7A loans, the question for the review is whether this issue ought to be clarified as a matter of policy.

### 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.

### Commissioner's general relieving discretion

5.15 As noted in Chapter 3, Division 7A was originally designed within the context of a self-assessment system. This was manifested in a very limited discretion being given to the Commissioner to not apply Division 7A. In relation to loan payments, for example, the disregarding of Division 7A was limited to cases where the Commissioner considered that it was reasonable to do so in cases of undue hardship.

5.16 The *Tax Laws Amendment (2007 Measures No. 3) Act 2007* made amendments intended to ease the potentially onerous operation of some of the Division 7A rules, by conferring on the Commissioner a general relieving discretion, and removing the automatic debit that arises in respect of a private company's franking account as a result of a Division 7A deemed dividend.

5.17 There is nevertheless uncertainty about aspects of the Commissioner's discretion, including its scope. Moreover, there is a question about the degree of reliance that should be placed on the discretion, given that Division 7A was originally designed with self-assessment in mind.

5.18 If some of the concerns about the treatment of loans could be addressed, there may be less of a need for a relieving discretion, at least in its current terms. For example, adoption of the 'statutory interest model', described below, may reduce the need for the discretion.

5.19 An alternative approach would be the provision of greater clarity about the scope and operation of the discretion. Also, a discretion may be warranted in order to address unforeseen situations, even if broader reforms of Division 7A are undertaken.

### 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 are any other circumstances where the Commissioner's discretion would still be needed?

## Franking credits

5.20 Division 7A eliminates the flow through of franking credits where it deems a dividend to have been paid and, in effect, imposes double taxation. It has been argued that Division 7A should be amended to allow franking credits to attach to any deemed dividend, with the consequence that deemed dividends are taxed at personal marginal rates of tax (at least for residents).

5.21 On the other hand, it is clear that Division 7A was always intended to deter private companies from entering into arrangements that trigger deemed dividend treatment. Without an effective deterrence, private companies could seek to test the limits of the integrity provision knowing that the only outcome of mischaracterisation of payments would be an appropriate characterisation. This would provide an incentive to undertake such activity, potentially leading to increased disputes between taxpayers and the ATO.

### 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.

#### **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.

## **2. STATUTORY INTEREST MODEL**

5.22 As stated, the statutory interest model would largely replace Division 7A with a requirement that loans to related entities bear interest at a rate specified by law from time to time. Progressive loan repayments may not be necessary and re-borrowings (of principal) would be permitted.

5.23 While many parts of Division 7A would be unnecessary, there would be a need to deal with forgiveness of debt and payments which are not loans. For example, it may be necessary to ensure that such non-loan amounts would, possibly subject to an otherwise deductible rule or being for the discharge of genuine indebtedness, be treated for tax purposes as dividends.

5.24 An advantage of this model is that it would potentially address the use of private company loans for private purposes without complicated rules. This would occur by way of the interest on the loans not being deductible.

5.25 Such an approach has the potential to make the law relating to loan arrangements (as opposed to debt forgiveness and non-loan payments) between private companies and related entities more understandable to taxpayers.

5.26 However, the model would require the interest rate on the loan to be a commercial rate. In this regard, the benchmark interest rate in Division 7A may be too low to cover all types of loans, for example unsecured loans. Also, for the interest rate not to provide a benefit where the loan is used for private purposes, it would have to be higher when the loan is on an interest only basis than when principal is repaid on a progressive basis. This is illustrated by the examples provided in Appendix D.

5.27 The model would require that the interest be taxed, whether or not it is paid. Otherwise, the non-deductibility of interest on borrowings to finance private expenditure would have little consequence. However, consideration would have to be given to circumstances where the non-payment is due to inability to pay, as well as where this arises after the funds have been used for private purposes.

5.28 The model would enable loans from private companies to trusts to be retained indefinitely in the private group, and to be used for passive (as well as active) investment. This ability to finance passive investment is notwithstanding that the loan funds arose from trust income that was taxed at the corporate tax rate of 30 per cent rather than potentially the highest personal tax rate if otherwise distributed by the trust to individual beneficiaries.

5.29 In summary, while in concept there are potential simplification benefits of the statutory interest model in relation to loans, there would remain a need to address issues such as what constitutes a loan rather than a debt forgiveness or non-loan payment. Also, the question would remain whether passive income should attract more favourable tax treatment if earned in a company rather than any other form of tax entity.

### 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.

## 3. DISTRIBUTION MODEL

5.30 As stated, the distribution model would allow the retention of profits within the private group for permitted purposes and to treat any profits not so used, and not distributed, as deemed dividends (which would be able to be franked). Profits able to be retained in this way would be taxed at the company tax rate, and deemed dividends would be taxed at the personal tax rate of relevant shareholders.

5.31 Permitted purposes would centre on the use of profits for working capital and other active business purposes of the private company or related entity (for example, another trust or company in the group). Use of the profits for passive investment purposes would not be permitted, although the acquisition of assets used in an active business would be. This would be similar in certain respects to the sufficient distribution rules in Division 7, which allowed a proportion of income that did not comprise dividends and property income to be retained by private companies.

5.32 The focus on how private company profits are used would arguably constitute a more comprehensive and direct approach to dealing with the inappropriate accessing of private company profits.

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

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

5.35 The Board is mindful that this model raises for consideration the introduction of a regime outside Division 7A. In this regard, the terms of reference ask the Board to examine the potential for broader reforms to Division 7A and Chapter 2 makes clear that Division 7A must be seen and understood in the light of an income tax framework dealing with income at the non-individual entity level, and of the interaction between that level and the personal tax system: this is at the heart of the progressivity of the income tax system.

5.36 As part of its analysis of current arrangements involving private groups, the Board is also mindful of the following factors:

- Trusts are commonly used in Australia to carry on business.
- There are arrangements commonly used to keep funds within a private group for the purpose of carrying on a business.
- Where trust income is re-invested in the trust business via private company loans, top-up tax is paid over a period of time through a form of forced distribution to individual shareholders.
- There are opportunities to indefinitely defer or shelter tax on passive income at the corporate tax rate where funds are not re-invested in the trust business.

5.37 A number of design issues would need to be addressed for this model to operate effectively. (And the design issues would, in turn, depend on the particular form of distribution model adopted.)

5.38 Active income would need to be distinguished from passive income. The tax law does make this active / passive distinction in various contexts and in various senses. For example:

- Division 152 provides capital gains tax relief for small business in respect of active assets. Relief may be available under this provision when, for example, an asset is used in the course of carrying on a business. Alternatively, the rule could be structured to provide an exception where the funds are used in an active business of an 'associate' of the company.
- The controlled foreign corporation (CFC) rules in Part X of the *Income Tax Assessment Act 1936* seek to tax passive income – which includes rent, royalties, 'tainted interest' and dividends – of CFCs as it is earned unless it is taxed offshore in a comparably taxed jurisdiction or the income is derived almost exclusively from active business activities.

5.39 Complex tracing rules may be required and the distribution model does not obviate the need for Division 7A type rules in respect of income able to be retained. In particular, they would be needed to deal with non-loan payments.

5.40 Also, whether it would be necessary to re-introduce the complex rules that supported the repealed Division 7 would need further consideration.

5.41 Nevertheless, this model offers the prospect of facilitating the financing of businesses, particularly small businesses, while maintaining revenue integrity.

### 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.

## PRINCIPLES-BASED PROVISIONS

5.42 -The terms of reference ask the Board to examine the potential for expressing Division 7A in a clearer and simpler manner. There are various ways in which this may be done, which would be affected by which model for reform was adopted.

**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.



## GLOSSARY

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AAT	Administrative Appeals Tribunal
ATO	Australian Taxation Office
Board	Board of Taxation
CGT	Capital gains tax
ESS	Employee Share Scheme
FBT	Fringe Benefits Tax
ITAA 1936	<i>Income Tax Assessment Act 1936</i>
ITAA 1997	<i>Income Tax Assessment Act 1997</i>
UPE	Unpaid present entitlement

## APPENDIX A — QUESTIONS

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### CHAPTER 2: HISTORICAL OVERVIEW OF POLICY FRAMEWORK FOR DIVISION 7A

#### 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.

#### 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?

### CHAPTER 4: PROVISIONS OF DIVISION 7A AND PROBLEMS IDENTIFIED IN THEIR OPERATION

#### 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.

#### 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.

#### 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).

#### 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.

## CHAPTER 5: DIVISION 7A REFORM CONSIDERATIONS

### 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

### 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?

### 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.

### 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.

### 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

the design of the model to ensure it operates as intended.

#### 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.

#### 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.

## APPENDIX B — RELEVANT MEDIA STATEMENTS

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### *Division 7A- — Taxation Laws Amendment Act (No. 3) 1998*

- The measure was announced in the 1997-1998 Budget speech, delivered by the then Treasurer on 13 May 1997.<sup>66</sup>
- Amendments to the provisions introduced into the Parliament were announced in:
  - The Assistant Treasurer’s Press Release No. 6 of 9 March 1998.<sup>67</sup>
  - The Assistant Treasurer’s Press Release No. 11 of 27 March 1998.<sup>68</sup>

### *Announcement of A New Tax System*

- In Press Release No. 79 of 13 August 1998<sup>69</sup>, the then Treasurer announced that the Government will consult on the implementation of consistent taxation of trusts like companies under a clear, fair and simple regime of redesigned company taxation.

### *Announcement of Government’s Response to the Review of Business Taxation*

- The Treasurer’s Press Release No. 58 of 21 September 1999.<sup>70</sup>

### *Announcement of details of the CGT Treatment of Assets Disposed of By Trusts After 1 July 2001 (the proposed entity taxation commencement date)*

- Details were announced in the then Treasurer’s Press Release No. 93 of 23 December 1999.<sup>71</sup>

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66 <http://www.budget.gov.au/1997-98/budgetsp.asp#Speech-REVENUEMEASURES>.

67 <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/1998/006.htm&pageID=003&min=crk&Year=1998&DocType=0>.

68 <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/1998/011.htm&pageID=003&min=crk&Year=1998&DocType=0>.

69 <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/1998/079.htm&pageID=003&min=phc&Year=1998&DocType=0>.

70 <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/1999/058.htm&pageID=003&min=phc&Year=1999&DocType=0>.

71 <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/1999/093.htm&pageID=003&min=phc&Year=1999&DocType=0>.

### *Exposure draft legislation to tax certain trusts like companies*

- Exposure draft legislation was released under the then Treasurer's Press Release No. 95 of 11 October 2000.<sup>72</sup>
- Exposure draft legislation was withdrawn under the then Treasurer's Press Release No. 8 of 27 February 2001<sup>73</sup>

### *Announcement of Government's Business Tax Reform Implementation Timetable*

- In Press Release No. 16 of 22 March 2001, the then Treasurer announced the Government's timetable for delivering the balance of its tax reforms.<sup>74</sup>

### *Division 7A amendment- — Tax Laws Amendment (2004 Measures No. 1) Act 2004*

- In Press Release No. 81 of 12 December 2002, the Treasurer announced that the Government would legislate to introduce new provisions in place of section 109UB,<sup>75</sup> adopting the first of the two options proposed by the Board in its report on the Taxation of Discretionary Trusts, November 2002.
- Further details were announced in the Treasurer's Press Release No. 55 of 25 June 2003.<sup>76</sup>

### *Tax Laws Amendment (2004 Measures No. 7) Act 2005*

- The changes in Part 1 of Schedule 9 of the Bill were not earlier announced as they corrected a minor defect in Subdivision EA of Division 7A.
- The changes in Part 2 of Schedule 9 were announced in the 2004-05 Budget. The joint press release issued by the Treasurer (Treasurer's press release No. 36 of 2004<sup>77</sup>) and Minister for Small Business was dated 11 May 2004.

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72 <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2000/095.htm&pageID=003&min=phc&Year=2000&DocType=0>.

73 <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2001/008.htm&pageID=003&min=phc&Year=2001&DocType=0>.

74 <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2001/016.htm&pageID=003&min=phc&Year=2001&DocType=0>.

75 <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2002/081.htm&pageID=003&min=phc&Year=2002&DocType=0>.

76 <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2003/055.htm&pageID=003&min=phc&Year=2002&DocType=0>.

77 <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2004/036.htm&pageID=003&min=phc&Year=2004&DocType=0>.

*Tax Laws Amendment (2007 Measures No. 3) Act 2007*

- This measure was announced in the Minister for Revenue and Assistant Treasurer's Press Release No. 089 of 6 December 2006.<sup>78</sup>

*Tax Laws Amendment (2010 Measures No. 2) Act 2010*

- This measure was announced jointly in the Treasurer's and the then Assistant Treasurer and Minister for Competition Policy and Consumer Affairs' Media Release No. 067 of 12 May 2009.<sup>79</sup>

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78 <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2006/089.htm&pageID=003&min=pcd&Year=2006&DocType=0>.

79 <http://ministers.treasury.gov.au/wmsDisplayDocs.aspx?doc=pressreleases/2009/067.htm&pageID=003&min=wms&Year=2009&DocType=0>.



## APPENDIX C — INVESTMENT AGREEMENT OPTIONS IN PRACTICE STATEMENT PS LA 2010/4

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As per paragraph 61, of PS LA 2010/4, the table below provides an overview of the three available investment options.<sup>80</sup>

	<b>Option 1 — interest only 7-year loan</b>	<b>Option 2 — interest only 10-year loan</b>	<b>Option 3 — invest in a specific income producing asset or investment</b>
<b>Amount of the annual return</b>	Main trust to pay interest calculated at the Benchmark interest rate to the sub trust.	Main trust to pay interest calculated at the Prescribed interest rate to the sub trust.	Sub trust is entitled to receive the share of net return (for example, interest income or rental income) derived as a result of the specific asset or investment to the sub trust.

Sub trust to pay annual return to the private company beneficiary by the lodgment day of the income tax return for the main trust except for the final payment of the annual return which must be paid to the private company when the investment or loan is due to be repaid.

<b>Nature of the annual return</b>	Interest.	Interest.	Depends on the specific asset or investment.
<b>Repayment of the funds representing the UPE (the principal)</b>	The principal must be repaid at the end of the 7 year loan.	The principal must be repaid at the end of the 10 year loan.	The principal must be repaid by the lodgment day of the tax return of the private company beneficiary for the year in which the investment ends.
<b>Deductibility of the annual return</b>	Yes, the amount is deductible to the main trust provided that the trustee of the main trust satisfies section 8-1 of the ITAA 1997.	Yes, the amount is deductible to the main trust provided that the trustee of the main trust satisfies section 8-1 of the ITAA 1997.	No.
<b>Assessability of the annual return</b>	Yes, the amount is assessable to the private company beneficiary.	Yes, the amount is assessable to the private company beneficiary.	Depends on the specific asset or investment.
<b>Sub-trust tax return</b>	Not required.	Not required.	Required.

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80 These options are explained in detail in paragraphs 62-94 of PS LA 2010/4.

## APPENDIX D — CONSIDER THE EFFECT OF INTEREST RATES UNDER THE STATUTORY INTEREST MODEL

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### Overview

Under the statutory interest model, loans would bear interest at a statutory rate specified by the law from time to time. This is not dissimilar to the current operation of Division 7A, which requires interest to be charged at the benchmark interest rate. That rate is currently equal to 7.05 per cent for the 30 June 2013 income year.

However, under Division 7A, minimum loan repayments must be made by the shareholder (or associate) to the company. In many cases, this may involve a payment of a franked dividend to fund the minimum loan repayment by the borrower, which can give rise to additional amounts of tax being collected by the system on the franked dividend paid by the company.

If Division 7A were to provide an option for interest only loans, this could result in a reduced requirement to pay dividends to fund the relevant loans repayments. This, of itself, may give rise to revenue costs as compared to the current system. Furthermore, this may result in an increasing number of loans being provided by companies, with no real requirement to pay or distribute profits.

One way of possibly ensuring revenue neutrality is to impose a higher interest rate on loans where those loans are interest only. Furthermore, a higher rate imposed on such loans (as compared to an interest and principal loan) could also encourage taxpayers to place such loans on interest and principal terms.

The following four calculations outline four options that could be considered by the Board in recommending the relevant interest rates to be used under the Statutory Interest Model. The following calculations assume that the private company makes a loan of \$100 to a shareholder out of after tax profits, where the funds are used for private purposes.

### Option 1: Minimum Loan Repayments

This first calculation considers the total tax payable under the current system, using minimum loan repayments that are funded by franked dividends. The following table outlines the repayments required by the shareholder on an annual basis.

	Loan calculation				Tax payable		
	A	B	C	D	E	F	G
Year	Opening	Interest	Payment	Closing	Co Tax <sup>81</sup>	Ind Tax <sup>82</sup>	Total Tax
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
<b>Total</b>		<b>30.11</b>	<b>-130.11</b>		<b>9.03</b>	<b>30.67</b>	<b>39.70</b>

Under this option, the total tax collected from both the company and the individual over the seven years is equal to \$39.70.

### Option 2: Interest Only Loan (Break Even)

This second calculation considers the total tax payable where the loan is an interest only loan and Division 7A only requires the repayments of interest (rather than interest and principal). In this example, an interest rate of 10.59 per cent equates the total tax collected from both the company and the individual to the amount of tax collected under Option 1, being \$39.70.

	Loan calculation				Tax payable		
	A	B	C	D	E	F	G
Year	Opening	Interest	Payment	Closing	Co Tax	Ind Tax	Total Tax
1	100.00	10.59	-10.59	100.00	3.18	2.50	5.67
2	100.00	10.59	-10.59	100.00	3.18	2.50	5.67
3	100.00	10.59	-10.59	100.00	3.18	2.50	5.67
4	100.00	10.59	-10.59	100.00	3.18	2.50	5.67
5	100.00	10.59	-10.59	100.00	3.18	2.50	5.67
6	100.00	10.59	-10.59	100.00	3.18	2.50	5.67
7	100.00	10.59	-10.59	100.00	3.18	2.50	5.67
<b>Total</b>		<b>74.11</b>	<b>-74.11</b>		<b>22.23</b>	<b>17.47</b>	<b>39.70</b>

81 Calculated as interest (column B) x 30 per cent.

82 Calculated as repayments (column C) x 30/70 x 46.5 per cent - franking credits.

### Option 3: Interest Only Loan (Higher Rate)

It is noted that the tax effect of Option 2 is the same as Option 1. However, this may provide little incentive for taxpayers to make repayments of principal over time.

Accordingly, Division 7A could provide a bias for loan repayments by requiring a higher interest rate to be charged on loans that are interest only. This third calculation compares the outcome that would occur where the interest rate charged on the interest only loan is slightly higher than the rate charged under Calculation 2. The interest rate used in this calculation is equal to 13.5 per cent.

	Loan calculation				Tax payable		
	A	B	C	D	E	F	G
Year	Opening	Interest	Payment	Closing	Co Tax	Ind Tax	Total Tax
1	100.00	13.50	-13.50	100.00	4.05	3.18	7.23
2	100.00	13.50	-13.50	100.00	4.05	3.18	7.23
3	100.00	13.50	-13.50	100.00	4.05	3.18	7.23
4	100.00	13.50	-13.50	100.00	4.05	3.18	7.23
5	100.00	13.50	-13.50	100.00	4.05	3.18	7.23
6	100.00	13.50	-13.50	100.00	4.05	3.18	7.23
7	100.00	13.50	-13.50	100.00	4.05	3.18	7.23
<b>Total</b>		<b>94.50</b>	<b>-94.50</b>		<b>28.35</b>	<b>22.28</b>	<b>50.63</b>

While more tax would be collected under this option (that is, \$50.63) as compared to Option 1 (\$39.70), the higher rate could provide an incentive to place the loan on a seven year repayment option as compared to an interest only option where the loan is used for private purposes. This could ensure that companies are not prone to providing interest only loans as compared to interest and principal loans to shareholders.

### Option 4: Interest Only Loan (No Repayment)

This fourth calculation looks at a circumstance where interest is not repayable to the company, but instead is capitalised on the loan. By way of comparison to Option 3, an interest rate of 15.17 per cent could result in the same tax collection outcomes and could have the same commercial effect as Option 3.

	Loan calculation				Tax payable		
	A	B	C	D	E	F	G
Year	Opening	Interest	Payment	Closing	Co Tax	Ind Tax	Total Tax
1	100.00	15.17	0.00	115.17	4.55	0.00	4.55
2	115.17	17.47	0.00	132.64	5.24	0.00	5.24
3	132.64	20.12	0.00	152.76	6.04	0.00	6.04
4	152.76	23.17	0.00	175.94	6.95	0.00	6.95
5	175.94	26.69	0.00	202.63	8.01	0.00	8.01
6	202.63	30.74	0.00	233.36	9.22	0.00	9.22
7	233.36	35.40	0.00	268.77	10.62	0.00	10.62
<b>Total</b>		<b>168.77</b>	<b>0.00</b>		<b>50.63</b>	<b>0.00</b>	<b>50.63</b>

While more tax would be collected under this option (that is, \$50.63) as compared to Option 1 (\$39.70), the higher rate of 15.17 per cent would provide an incentive for taxpayers to place the loan on a seven year principal repayment option as compared to an interest only option where the loan is used for private purposes.