

TREASURY CONSULTATION PAPER

IMPROVING FAIRNESS AND INTEGRITY IN THE TAX SYSTEM — TIGHTENING THE NON-COMMERCIAL LOAN RULES IN DIVISION 7A OF THE *INCOME TAX ASSESSMENT ACT 1936*

PURPOSE

On 12 May 2009, as part of the 2009-10 Budget, the Treasurer and the Assistant Treasurer and Minister for Competition Policy and Consumer Affairs announced that the Government would tighten the non-commercial loan rules in Division 7A of the *Income Tax Assessment Act 1936* (Division 7A) to prevent shareholders and their associates avoiding tax on distributions and benefits they receive from private companies. The measure has effect from 1 July 2009. The media release is available on the Treasurer's website ([media release No. 67 of 2009](#)).

This discussion paper is a guide on how the decisions announced by the Government would operate and how they might be implemented. The purpose of this paper is to provide interested parties with an opportunity to comment on the implementation details of this proposal.

BACKGROUND

Division 7A provides tax integrity rules designed to prevent private companies from making tax-free distributions of profits to shareholders (or their associates). In particular, advances, loans and other payments or credits to shareholders or associates are, unless they come within specified exclusions, treated as assessable dividends to the extent that the company has realised or unrealised profits. These 'deemed dividends' do not attract franking credits.

Use of company assets by shareholders (or their associates)

The measure addresses concerns that individuals can avoid tax on non-dividend distributions when a private company allows its shareholders or their associates to use company assets such as real estate, cars and boats for free or at less than their arm's length value. The Government is tightening the operation of Division 7A, so that this loophole can no longer be exploited. There will be a carve-out for minor and infrequent use of company assets.

Tax avoidance using corporate limited partnerships

The measure targets the use of corporate limited partnerships as a means to circumvent Division 7A. The ATO has issued Taxpayer Alert 2007/5 regarding the possible use of a corporate limited partnership to avoid a deemed dividend arising under Division 7A. Division 7A will be amended to remove any scope for tax avoidance using corporate limited partnerships.

Other technical amendments

A number of other technical amendments will be made to improve the operation of Division 7A so it cannot be circumvented and to address some anomalous outcomes. The proposed changes are detailed below.

POLICY DESIGN OF THE PROPOSALS:

The policy behind all of the proposals in the attachment is either to prevent the exploitation of Division 7A through various means or to improve the equitable operation of Division 7A so that it operates more fairly on taxpayers.

SUBMISSIONS

We invite interested parties to lodge written submissions on the implementation details of this measure. We also invite comments on the need for any other amendments to Division 7A to ensure that it cannot be circumvented on technical grounds or to ensure that it operates equitably.

The closing date for submissions is 3 July 2009.

Submissions will be made available on the Treasury website unless you clearly indicate that you would like all or part of your submission to remain confidential. Automatically generated confidentiality statements in emails do not suffice for this purpose. A request made under the *Freedom of Information Act 1982* for access to a submission marked confidential will be determined in accordance with that Act.

Written submissions should be addressed to:

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DETAILED DISCUSSION OF PROPOSED DIVISION 7A AMENDMENTS

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

Division 7A deems certain payments, loans or debt forgiveness by a private company to shareholders (or their associates) to be dividends, where the company has realised or unrealised profits.

The Government proposes to extend the coverage of Division 7A to include as payments, benefits provided by way of a licence or right to use real property (or an interest in real property) and chattels.

Subsection 109C(3) of the *Income Tax Assessment Act 1936* (ITAA 1936) currently defines a payment to an entity to include ‘a transfer of property’ to the entity.

Where ‘a right to use’ has its source in an arrangement that involves a transfer of property it comes within the meaning of a transfer of property for the purposes of a ‘payment’ under Division 7A. However, where it is a ‘mere’ right to use without property rights being transferred, then it is not considered to be a transfer of property.

An example of a transfer of property currently caught by Division 7A is where a right to use is conferred by means of a lease in respect of real property. This is because the grantee (the shareholder or their associate) receives an interest in property (being the leasehold interest attached to the real property) as a result of the grant. In the case of a contractual right to use land under conditions (for example, a licence) the grantee normally receives no interest in property and so Division 7A is not triggered.

Therefore there is some doubt that ‘transfer of property’ covers the following:

- a licence over real property when there is no interest in property;
- a lease over chattels where there is no interest in property; or
- a licence over chattels where there is no interest in property.

The Government is aware that some private companies permit their shareholders or the shareholders’ associates to use company assets as if on permanent loan, effectively giving them benefits upon which no tax is payable. When similar benefits are provided to employees, they are taxed to the employer through fringe benefits tax (FBT). It is noted, however, that the FBT law exempts minor benefits and the taxable value of some benefits to employees can be reduced if the “otherwise deductible rule” applies (that is, if the employee had purchased the benefit rather than being provided with a fringe benefit, they would be able to claim a deduction under section 8-1 of the ITAA 1997 for the expenditure).

Proposed legislative amendments

Amendments to subsection 109C(3) will ensure that ‘payment’ includes the use of any company assets, including the three types of arrangements mentioned above. Subsection 109C(4) will form the basis for valuing such use.

To address compliance cost concerns there will, however, be a carve-out for minor and infrequent use of company assets.

The use of a private company asset by a shareholder or their associate will be treated as minor and infrequent where, if the benefit were provided to an employee, the benefit would be a minor benefit under section 58P of the *Fringe Benefits Tax Assessment Act 1986*. This section excludes benefits from FBT if, having regard to various matters such as the small value of the benefit, the infrequency and irregularity of the benefit, it would be unreasonable to treat the benefit obtained by the employee as a fringe benefit. The provision includes a requirement that the notional taxable value of the benefit is less than \$300 in the income year (paragraph 58P(1)(e)).

In designing the legislative changes, stakeholder comments are sought on what account, if any, should be taken if the use of the private company asset by the shareholder or their associate is for a business related purpose and would otherwise be deductible to the shareholder or their associate.

Example 1.1

A private company XYZ is owned by two business partners. The company leases a motor vehicle and provides it to the spouse of one of the partners for their personal use for a two month period at no charge. Under this proposal, this use will be caught as a payment under Division 7A.

Consistent with subsection 109C(4) of the ITAA 1936, the value of the ‘payment’ would be the amount that would have been paid for the use over the two month period by parties dealing at arm's length, less any consideration actually paid.

Example 1.2

A private company owns a beach house valued at \$500,000 which is used to provide training services to staff and other clients.

On weekends, shareholders and their associates may use the beach house at a discount rate. The market price for the right or licence to use the property on a particular weekend is \$700. The shareholder is only required to pay \$300. Under these amendments a payment will arise. The value of the payment for Division 7A purposes is \$400, being the amount that would have been paid by parties dealing at arm's length (\$700), less the \$300 actually paid.

Minor or infrequent use

Example 1.3

A private company holds an annual general meeting and allows shareholders to keep the note pads and pens provided at the meeting. The value of the items is less than \$300 per shareholder. The use is minor and infrequent.

Example 1.4

A private company allows a shareholder to use a company car to make a one-off trip home for private purposes and return the car the following day. The value of the use is less than \$300 and it is the only occurrence in the income year. The arrangement is one-off and irregular. The use is minor and infrequent.

2. Amending the tax law to address tax avoidance arrangements involving corporate limited partnerships (CLPs).

To improve the fairness and integrity of the tax system, the Government proposes to amend the law to prevent taxpayers from using business structures involving corporate limited partnerships (CLPs) to avoid tax by circumventing the operation of Division 7A. The Government intends to address these concerns by effectively placing closely-held CLPs on the same footing as private companies for the purposes of Division 7A.

The Tax Office has become aware of many cases where taxpayers have exploited deficiencies in Division 7A to access accumulated profits in business entities in a tax-free manner by using a CLP in their business structure.

Whilst CLPs are taxed as companies under Division 5A of the ITAA 1936, the law specifically excludes CLPs from the definition of ‘private company’ for tax purposes. This exclusion is significant because it has the effect of deeming all CLPs to be public companies and therefore Division 7A will not apply, even where CLPs are used in closely-held business structures like a private company. As a result, shareholders and associates are able to access accumulated profits from the business without further personal tax. Such anomalies undermine the fairness and integrity of the tax system.

Examples of inappropriate arrangements

The Tax Office has raised concerns in Taxpayer Alert 2007/5 about the use of corporate limited partnerships (CLPs) as a potential means to circumvent the operation of Division 7A.

Examples of such arrangements involve:

- transferring accumulated profits from a corporate entity such as a private company to a CLP in a tax effective manner together with loans or payments being made by the CLP to associated parties; and
- distribution of the net income of trusts to a CLP together with loans or payments being made by the CLP to associated parties.

Example 2.1

Under an arrangement, a special class of share is issued by an existing private company with accumulated profits to a newly formed CLP.

The accumulated profits of the private company are declared as a fully franked dividend to the CLP and therefore from the CLP’s perspective, the dividend income is sheltered from tax. In the context of Division 7A, this reduces the private company’s distributable surplus to nil.

An amount is then lent, either directly or indirectly, by the CLP or the private company to the shareholders or their associates.

The amount lent that is a deemed dividend under Division 7A is nil because the private company has no distributable surplus.

Example 2.2

The income of a discretionary trust has in prior years been appointed in favour of a private company with accumulated profits. A shareholder of the private company wishes to enjoy the net income of the trust without triggering Subdivision EA of Division 7A.

A CLP is established and the trust deed of the discretionary trust is amended to add the CLP as an additional discretionary object. The trustee appoints a share of the income of the trust in favour of the CLP and pays that purported present entitlement to the CLP.

The CLP then lends the funds received from the trustee to a shareholder of the private company or, instead, to the shareholder's associate.

Proposed legislative amendments

Many of these types of arrangements are considered ineffective under the current law, for example, due to the potential application of the general anti-avoidance provisions in Part IVA of the ITAA 1936. Notwithstanding this, a structural change to the law that systematically addresses such arrangements is preferred because such an approach not only promotes fairness and integrity of the tax system, it achieves those objectives in a manner that provides greater certainty to taxpayers.

The following alternatives are available to address the issue:

1. Amend section 94N of the ITAA 1936 so the exclusion of CLPs from the definition of a private company does not apply for the purposes of Division 7A.
2. Amend section 94M of the ITAA 1936 so that it has substantially the same effect as Division 7A. That is, expand the form of benefits and scope of entities receiving such benefits. This means that all CLPs would still be excluded from the definition of a private company.

The first option is the preferred approach as it would achieve a closer alignment between the tax treatment of private companies and CLPs that are closely-held.

Comments are sought on these options and on how the law should be amended to address the inappropriate arrangements using CLPs.

3. Other technical changes to Division 7A to improve its operation and address some anomalous outcomes for taxpayers.

Items 3.1 to 3.7 below concern Subdivision EA of Division 7A, which deals with trusts, unpaid present entitlements to income and payments or loans to shareholders or their associates.

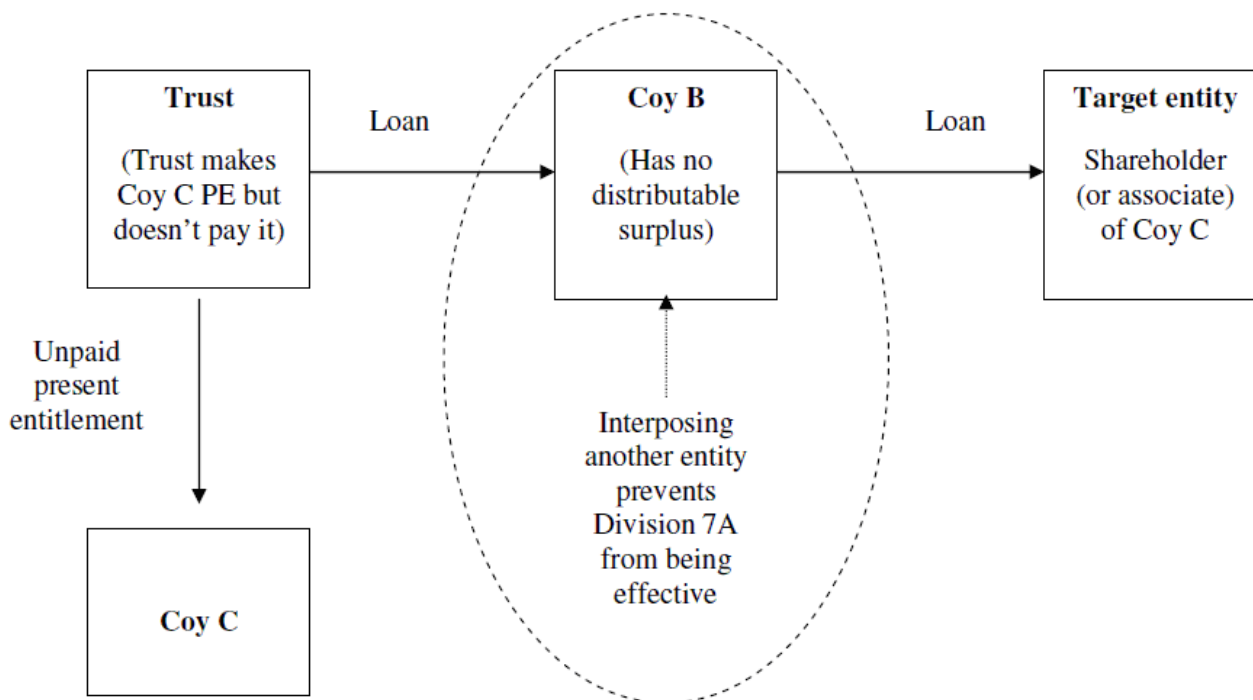
Subdivision EA of Division 7A came into effect from 12 December 2002 and replaced section 109UB of the ITAA 1936. The rules in this part of Division 7A are designed to ensure that a trustee cannot shelter trust income at the prevailing company tax rate. This could occur by the trust creating a present entitlement in favour of a private company as a beneficiary, not paying the amount to the company, and then distributing the underlying cash to a shareholder of the company.

To prevent this, Subdivision EA deems certain payments, loans, or forgiven debts by a trustee of a trust estate to a shareholder (or their associate) of a private company to be included in their assessable income as if it were a dividend, in situations where the private company is presently

entitled to an amount from the net income of the trust estate and that amount has not been fully paid. There are a number of deficiencies in this part of Division 7A that make it ineffective in certain situations (that is, they will allow tax-free distributions of profits to shareholders or their associates). There are also a number of minor technical corrections proposed that address some anomalous outcomes and are beneficial to taxpayers — items 3.4, 3.5, 3.6, and 3.7.

3.1 *The interaction between subdivision EA and the Interposed Entity Rules*

Subdivision EA may be ineffective where there is an entity, a company for example, interposed between the trust and the shareholder (or their associate) as the target entity as illustrated in the following diagram:



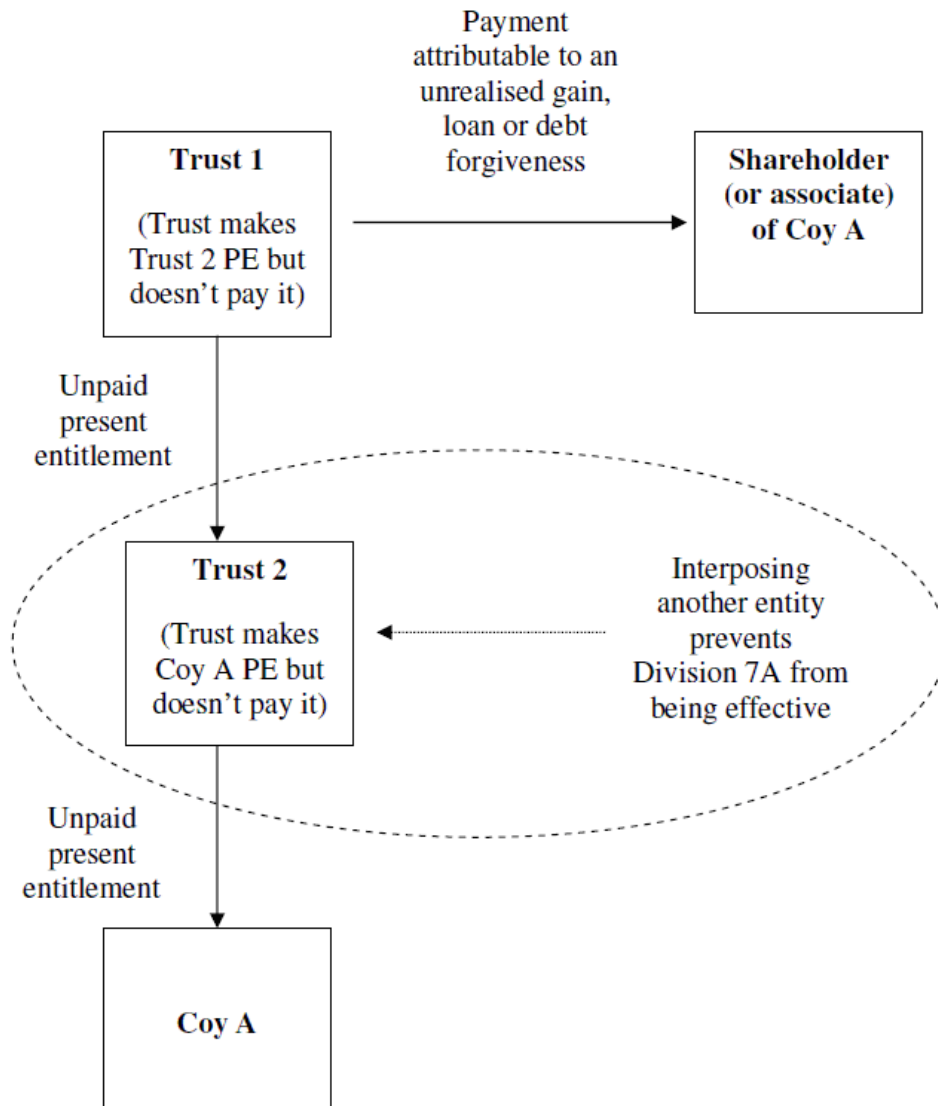
Subdivision EA is ineffective in this situation because of a deficiency in the wording of subsections 109XA(1) and (2) which excludes payments, loans and debt forgiveness made to shareholders or associates that are companies. This exclusion occurs because Division 7A does not generally need to apply to payments, loans and debt forgiveness made between companies as they are on the same tax rate. However, this carve-out is inappropriate in a trustee loan scenario involving interposed company arrangements.

Furthermore, Subdivision EA is ineffective because section 109XB does not focus on the target entity and because of the absence of any deeming of the target entity as a shareholder or associate of the notional company (the trust in this case). The Government proposes amendments to cover situations where there is an entity interposed between the trust and the target entity.

3.2 *Subdivision EA circumvented by introducing a second trust*

Subdivision EA may also be circumvented by simply interposing an entity, for example a second trust, between the trust making the payment, loan or debt forgiveness and the private company with the unpaid present entitlement to income. The first trust declares present entitlement to net income

in favour of the second trust and the second trust declares present entitlement in favour of the private company. Each present entitlement remains unpaid. The following diagram illustrates this:



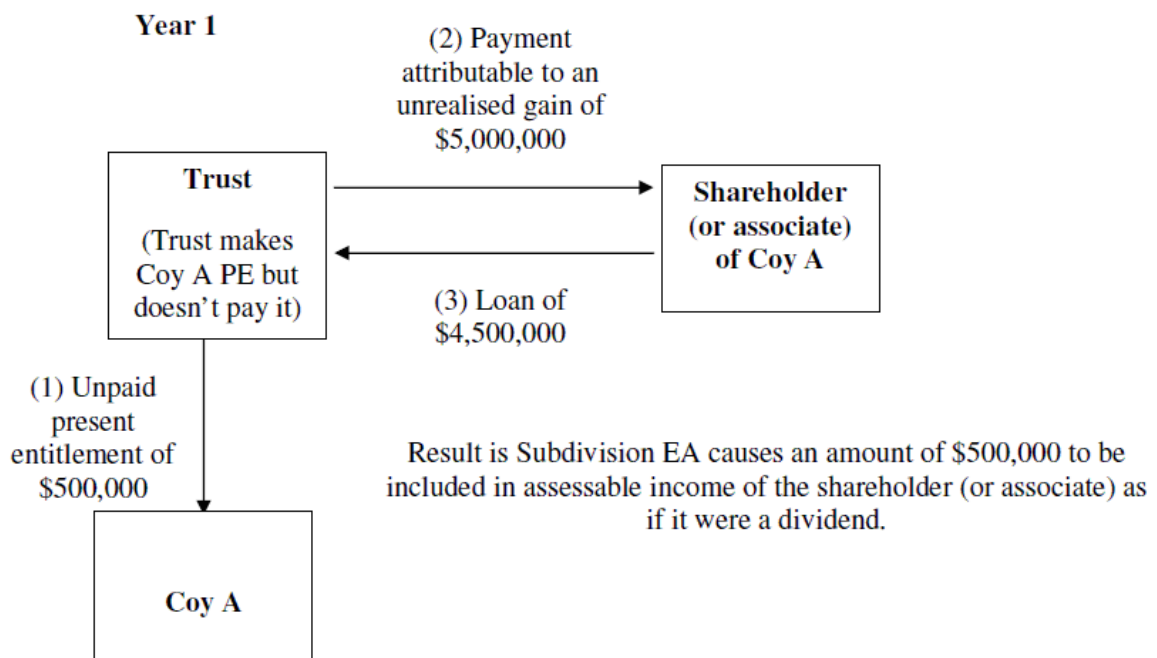
This arrangement severs the nexus required for Subdivision EA to be triggered. That is, the private company does not have an unpaid present entitlement due from the trust (Trust 1) making the payment, loan or debt forgiveness in favour of the shareholder (or associate). Subdivision EA will be tightened to stop this arrangement being employed.

3.3 Subdivision EA and the revaluation scheme

A tax avoidance arrangement that Subdivision EA was intended to stop is the revaluation scheme that typically involved a trust holding real property such as a shopping mall, revaluing the real property and declaring present entitlement to the unrealised gain in favour of a shareholder (or associate) of a corporate beneficiary of the trust with an unpaid present entitlement to income. The trust would then pay out the amount of the unrealised gain to the shareholder (or associate) who in turn would then loan the amount back to the trust. The trust would then be able to make repayments in subsequent years when the corporate beneficiary had an unpaid present entitlement to income and not trigger the old section 109UB.

Subdivision EA attempts to address this scheme. However, the problem lies in that although the payment of the unrealised gain triggers its operation, the amount of the deemed dividend is limited to the unpaid present entitlement in the income year the payment is made. Typically, the unrealised gain far exceeds the value of the unpaid present entitlement in the income year that present entitlement to the unrealised gain is declared in favour of the shareholder (or associate).

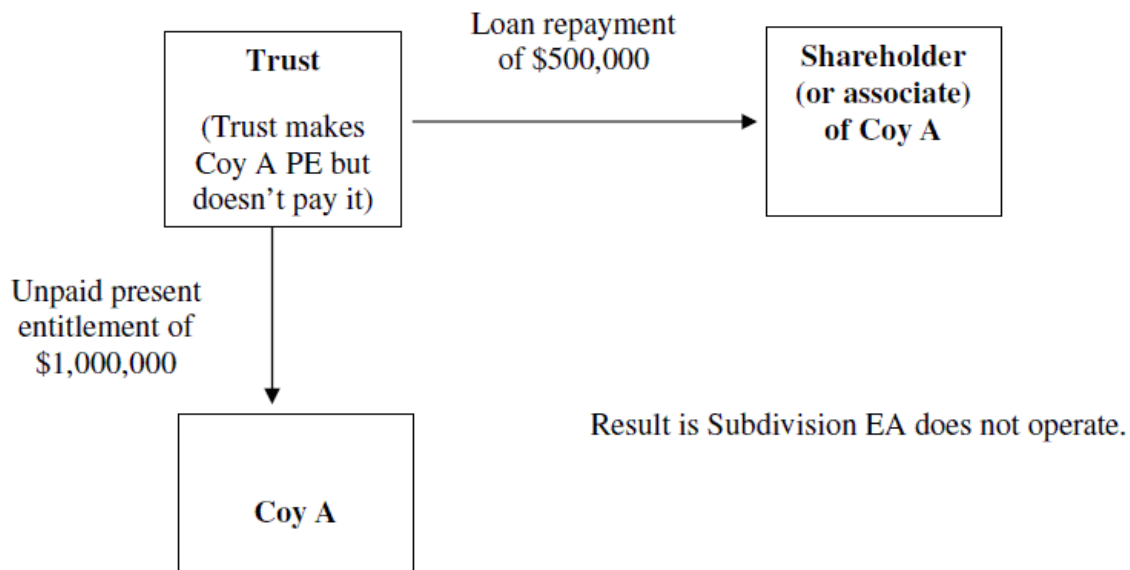
An example of this scheme is illustrated in the following diagrams:



If the unrealised gain is in the order of \$5,000,000, and the unpaid present entitlement in the year the payment is made is \$500,000, only \$500,000 is deemed a dividend in that year.

Assume shortly after the payment is made that an amount of \$4,500,000 is loaned back to the trust from the shareholder (or associate).

Year 2 and years following



In subsequent years the trust could declare present entitlement to the private company (of say a further \$500,000) which is not paid while a loan repayment of \$500,000 is made to the shareholder (or associate) and there will be no event which triggers subdivision EA. This is because the loan repayment does not discharge a present entitlement attributable to an unrealised gain (as subdivision EA requires).

This problem is exacerbated by the operation of section 109J which provides that a private company is not taken to pay a dividend because of payments, to the extent that they discharge an obligation of the private company to pay money to the entity on an arm's length basis (this is now the case because of the arm's length loan between the trust and the shareholder of the private company).

The Government proposes amendments to tighten the operation of subdivision EA and to stop the potential inappropriate application of section 109J.

3.4 Subdivision EA and definition of 'non-commercial loan'

Amounts treated as dividends under Division 7A (including Subdivision EA) are limited to the private company's distributable surplus. When Division 7A treats an amount as a dividend the distributable surplus is reduced by the amount of the dividend. This reflects the policy that profits are taken to have been paid out to the extent of the disguised distribution. The formula for calculating the distributable surplus is contained in subsection 109Y(2) of the ITAA 1936.

Distributable surplus is defined as follows:

- Net assets **less** non-commercial loans **less** paid-up share value **less** repayments of non-commercial loans.

Non-commercial loans are defined to be the total of any amounts already treated as deemed dividends (under the former section 108 and sections 109D or 109E) in earlier years of income. Non-commercial loans and repayments of non-commercial loans reduce the distributable surplus.

However, when Subdivision EA was inserted into Division 7A there was no consequential amendment to the meaning of ‘non-commercial loans’ to include amounts treated as dividends by section 109XB of Subdivision EA. This means the amount of a company’s distributable surplus and any subsequent deemed dividend would potentially be higher than what is fair or equitable when the non-commercial loan is made through a payment from a trust.

The Government proposes amendments to include a reference to section 109XB of Subdivision EA in the definition of non-commercial loans. This amendment would reduce the amount of the distributable surplus and be beneficial to taxpayers who are treated as receiving a deemed dividend.

3.5 *Subdivision EA and the exclusion in subsection 109G(3)*

Under subsection 109G(3), when a debt is forgiven by a private company in favour of a shareholder (or associate), this amount of debt forgiveness will not be treated as a deemed dividend under the appropriate provisions of Division 7A where the loan has previously been treated as a deemed dividend. This is to avoid a double application of Division 7A to the same amount.

However, in a trustee loan scenario of Subdivision EA, subsection 109G(3) does not stop an amount being treated as a dividend where the loan, which has previously been treated as a dividend, is forgiven by the trustee in favour of the shareholder (or associate) of the private company.

The Government proposes an amendment to subsection 109G(3) to include a reference to section 109XB of Subdivision EA. This amendment would prevent a double application of Division 7A and would be beneficial to taxpayers.

3.6 *Mismatch between Division 7A treatment of private company and trustee loans*

Section 109ZC has the effect that where a private company loan to a shareholder (or associate) is treated as a deemed dividend, a later distribution to the shareholder (or associate) that is offset against that loan (as an earlier deemed dividend) is excluded from the assessable income of the shareholder to the extent the distribution is unfranked.

With Subdivision EA, the loan is made by the trust estate and not the private company. Therefore, a subsequent distribution by the private company to the shareholder (or associate) that is made out of profits is incapable of being set off against the loan which triggered Division 7A.

The Government proposes amendments to rectify this mismatch between Division 7A treatment of private company and trustee loans and provide a similar exclusion from assessable income in the case of trustee loans. This amendment would be beneficial to taxpayers.

3.7 *Subdivision EA and paragraphs 109R(3)(b) and 109R(3)(ba)*

Subsection 109XC(8) of Subdivision EA provides that certain provisions that apply to a private company do not apply where a trust is involved and a deemed dividend arises under Division 7A. These provisions include paragraphs 109R(3)(b) and 109R(3)(ba) that allow repayments of a loan, by the private company withholding amounts from an employee’s salary or bonus and offsetting these against the loan.

However, as a trustee of a trust can employ staff, this provision will also be made available in trustee loan arrangements. The Government proposes an amendment to omit the reference to paragraphs 109R(3)(b) and 109R(3)(ba) in subsection 109XC(8).

3.8 *Certain payments to be disregarded as repayments*

To prevent shareholder loans never being repaid, there are integrity rules which stop certain re-borrowings from the private company counting towards determining whether a loan has been repaid in whole or in part or determining whether a minimum yearly repayment has been made. This section is currently only effective where a loan is obtained after a repayment is made.

The provision may not operate, however, if a re-borrowing is undertaken and then that money is used to repay an existing loan.

For example, suppose a loan is made on 1 July 2005 for \$100,000. The taxpayer has until the 'lodgment day' of the private company's tax return to repay the loan in full and avoid triggering Division 7A. Suppose the lodgment day is 15 May 2007. On 1 May 2007 the taxpayer obtains a further loan of \$100,000 from the private company and on 14 May 2007 they repay the \$100,000 loan taken out on 1 July 2005. The same strategy is then repeated in respect of the 1 May 2007 loan and so on in future years. The advances to the shareholder are purportedly repaid but in a way that circumvents Division 7A. The effective deferring of payment of the loans year by year and the uncertainty of the amounts ever being repaid ostensibly results in tax free distributions of profits to the shareholders.

While the Tax Office considers that in certain circumstances it may still be able to disregard the payment, it is proposed to put this matter beyond doubt. Hence, the Government proposes amendments be made to section 109R to remove ambiguity and ensure that a re-borrowing taken out before a loan is repaid is captured. However, the amendments would continue to allow refinancing of an unsecured loan to replace it with a loan secured by a mortgage over real property.

3.9 *Division 7A payments and the definition of distributable surplus*

For Division 7A purposes, a deemed dividend can only arise if the private company has a distributable surplus at the end of the income year in which the 'payment' occurs. The formula for calculating the distributable surplus is contained in subsection 109Y(2) of the ITAA 1936.

Distributable surplus is defined as follows:

- Net assets **less** non-commercial loans **less** paid-up share value **less** repayments of non-commercial loans.

Essentially, a distributable surplus will arise where the company has undistributed after tax profits or any unrealised capital gains.

Where during an income year, a private company makes a payment to which section 109C applies, the asset disposed of in favour of the shareholder (or associate) is not included in the net asset calculation. This is because at the time the calculation is performed (being the end of the income year), the asset is no longer owned by the private company and not included in its accounting records. The Commissioner's power to substitute a value for an asset he considers undervalued is inapplicable as the asset is no longer owned by the private company.

Therefore, if the disposed asset reflects in whole or in part the 'profits' of the private company that existed immediately prior to the disguised distribution, the disguised distribution escapes in whole or in part being treated as a dividend under Division 7A.

Example:

On 29 June 2005 a private company has real property valued at its historical cost in the company's accounting records of \$500,000. The real property has a market value of \$1,500,000 and the private company has liabilities of \$400,000 and no provisions and paid-up capital of \$100,000.

For section 44 purposes, the private company has 'profits' of \$1,000,000 which reflects the unrealised gain in the real property. If, on 29 June 2005, the private company made an *in specie* distribution of the real property to a shareholder, an amount of \$1,000,000 would be included in the shareholder's assessable income as a dividend under section 44.

However, if instead of making the *in specie* distribution, the private company sells the real property to the shareholder for \$500,000, the sale of the real property is a payment within the meaning of paragraph 109C(3)(c) of Division 7A of an amount determined under subsection 109C(4) – being \$1,000,000.

The private company's distributable surplus under section 109Y is determined according to the private company's accounting records as at 30 June 2005. As at that date, the private company has assets of \$500,000 (being the proceeds on disposal of the real property), liabilities of \$400,000 and paid-up capital of \$100,000. The net assets of the private company for section 109Y purposes, and therefore the private company's distributable surplus, are both nil. The end result is no amount is treated as a dividend under Division 7A.

By selling the real property to the shareholder at its historical cost, the private company has achieved a disguised distribution of \$1,000,000 to the shareholder tax free.

Proposed legislative amendment

The Government proposes amendments to include the value of Division 7A 'payments' into the distributable surplus formula. A revised formula would be:

- Distributable surplus equals net assets **less** non-commercial loans **less** paid-up share value **less** repayment of non-commercial loans **plus** Division 7A 'payments'

Using the corrected formula, in this example, the distributable surplus would then be \$1,000,000 as follows:

- net assets - \$100,000 (i.e. \$500,000 cash, minus \$400,000 liabilities)
- **less** non-commercial loans - nil
- **less** paid-up share value - \$100,000
- **less** repayment of non-commercial loans - nil
- **plus** Division 7A 'payments' (\$1,000,000)

3.10 Non-resident private companies

There are contrary views about whether Division 7A applies to disguised distributions made by non-resident private companies to resident Australian shareholders (or their associates) where the private company has no Australian source ordinary or statutory income. That is, the private company has no income tax responsibilities in Australia and therefore the concepts of income year, franking and lodgment day, etc are strained.

The risk to revenue sits with non-resident private companies which are not subject to the accruals regime – that is, those in listed countries. Private companies in non-listed countries are subject to section 47A of the ITAA 1936.

This uncertainty could lead to non-resident private companies seeking to make non-commercial loans or Division 7A ‘payments’ to resident shareholders, without the amounts being subject to Australian tax.

As actual distributions can be captured by section 44 of the ITAA 1936, disguised distributions should be captured by Division 7A. This will improve the fairness and integrity of the tax system.

Proposed legislative amendment

To put this matter beyond doubt, it is proposed that specific rules be inserted into Division 7A to accommodate non-resident private companies with no Australian source ordinary or statutory income. Such rules would clarify that non-resident private companies fall within Division 7A. Furthermore, modifications are proposed that will deal with situations where such companies are not required to lodge tax returns in Australia.

A consequence of this change may be that section 47A of the ITAA 1936 can be repealed. Treasury is currently consulting with industry as part of re-writing the controlled foreign company tax rules and will explore the feasibility of this as part of that exercise.

Comments are sought on the legislative design issues associated with this amendment.