Time for a Division 7A tidy up? Loans, sub-trusts and UPEs.

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1 Introduction

1.1 What is a loan?

Let's start with what we mean by loans, sub-trusts and UPEs.

Section 109D of the Income Tax Assessment Act 1936 (ITAA 1936) refers to loans and that term is defined inclusively, not exhaustively, in s109D(3) to include:

a) an advance of money;

b) a provision of credit or any other form of financial accommodation;

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.

It is clear therefore that the term loan has a very broad meaning for the purposes of Division 7A of the ITAA 1936 (Div 7A).

1.2 What is a UPE and is it a loan?

It used to be the case that the Commissioner considered that there was no loan for Div 7A purposes where a private company's present entitlement to an amount from a trust remained unpaid, i.e. where there is an unpaid present entitlement or UPE. That changed with the issue of ruling TR 2010/3, where UPE's arose or arise after 16 December 2009.

Where there is a mere UPE there is no debtor/creditor relationship. Rather, there is a trustee/beneficiary relationship. As a result, there would be no loan according to the ordinary meaning of that term. However, without changing the legislation, the Commissioner changed his interpretation of s109D(3)(b), deciding that where there is a UPE there is a provision of financial accommodation and therefore a loan.

Takeaway – not everyone agrees with the Commissioner's (revised) interpretation, i.e. that a UPE is the provision of financial accommodation and therefore a loan. So, in the event of a dispute with the Commissioner, consider raising the correctness of his interpretation.

1.3 What is a sub-trust and why do we care?

TR 2010/3 also raised the possibility of a sub-trust existing. By sub-trust, for Div 7A purposes, the Commissioner means a separate trust that arises in equity, where a private company is the sole beneficiary and upon which amounts that the private company is entitled from the main trust are held.

Many deeds provide that UPEs will be held on (separate) sub-trust for the relevant beneficiary. In the absence of a separate agreement such as a complying Div 7A loan agreement, when a beneficiary is made presently entitled to an amount but it hasn't been paid, property of (what we might call) the main trust representing the UPE is then held on sub-trust. The UPE would be corpus of the sub-trust, even though the trustee of the main trust would still hold the legal title in the relevant assets.

Why might this be important? Section 109N refers to loans that are subject to complying (maximum of) 7 or 25 year loan agreements. It doesn't refer to funds held on sub-trust. However, at paragraph 113 and following of TR 2010/3 the Commissioner says that if there is a sub-trust and the funds representing the UPE remain intermingled in the main trust (as a result of the investment by the sub-trust in the main trust), the private company beneficiary will not be taken to provide financial accommodation to the main trust if the terms of the arrangement entitle the sub-trust (and therefore the private company beneficiary) to repayment of the principal and all of the benefits from the use of those funds. Identifying the benefits derived from the use of the funds by the trustee of the main trust might be problematic but there might be a simple solution.

In Practice Statement Law Administration PS LA 2010/4 the Commissioner recognises that sub-trusts can be established pursuant to the deed of the main trust without any need for a resolution by the trustee. He then says (in paragraph 58 - and this is important as it does not appear anywhere in Div 7A) that the ATO will consider that the funds in the sub-trust are held for the sole benefit of the private company if they are invested in accordance with one of the following options:

Option 1 – the sub-trust lends to the main trust on a 7 year interest only basis;

Option 2 - the sub-trust lends to the main trust on a 10 year interest only basis; or

Option 3 – the funds representing the UPE are invested in a specific income producing asset or investment.

This might be attractive because it avoids the need for annual principal repayments. On the other hand, options 1 and 2 could be ticking bombs if plans are not made and acted upon to ensure that the principal can be repaid in years 7 or 10.

1.3.1 The ticking bomb

Why do I refer to options 1 and 2 as ticking bombs?

In my experience, a number of taxpayers cannot be relied upon to budget for a large principal repayment obligation in year 7 or 10.

Indeed, my experience in this regard is reinforced by the issue of Practical Compliance Guideline PCG 2017/13, which deals with UPEs under sub-trust arrangements which matured in FY2017, 2018, 2019, 2020 or 2021 but which were not repaid by the due date.

To the extent to which principal remains unpaid, the Commissioner will treat that amount as the provision of financial accommodation and therefore a Div 7A loan. The concession in PCG 2017/13 is that the Commissioner allows us to put that unpaid principal on s109N 7 year complying terms before the private company's lodgement day. Otherwise, if such a 7 year loan is not put in place, the Commissioner will treat a deemed dividend as arising in the year the loan matures.

According to the Commissioner, the annual interest must be paid. It cannot be capitalised.

Takeaways – ensure that you consider and document your discussions with your clients about the use of a sub-trust, including how they might repay the principal.

I advised in a matter where an accountant was sued for allegedly not presenting the sub-trust options to his client, as options to the usual 7 or 10 year annual principal and interest loan arrangements.

– make sure that you pay interest annually, if you go the 7 or 10 year sub-trust route.

- read the deed to see what it has to say about the (automatic) creation of a sub-trust when a beneficiary's entitlement arises.

2. How do we ensure that we have complying Div 7A loan agreements?

Another spin on the above question might be "how do we ensure that no loans slip between the cracks and get missed when we are documenting our Div 7A loans"? We might also ask whether we have to have multiple agreements, which adds cost and complexity, or whether one will do?

My preference is, wherever possible, to have a single agreement to which all of the related parties are listed as potential borrowers and lenders. If it turns out that some are nor or do not become borrowers or lenders, no harm has been done by including them in such a single agreement.

Commonly, such an agreement will provide that the terms of any loans are those which will ensure compliance with Div 7A. If we have a sub-trust, we typically can't refer to and rely on the repayment criteria in s109N. Further, the trust deed might provide for the creation of a sub-trust but not payment terms and s109N does not refer to sub-trusts.

So, if we want to go the sub-trust route we might refer specifically to adopting the terms of Options 1, 2 or 3 in PS LA 2010/4 - in which case, rather than meeting the minimum yearly repayment rules in s109N, the Commissioner treats the funds in the sub-trust as being held solely for the benefit of the private company, i.e. there is no provision of financial accommodation or loan.

Takeaway – can you use a single facility agreement that all parties sign up to as potential borrowers and lenders, so that no loans can slip between the cracks and you minimise the paperwork?

3. Records

It follows from the above that complying Div 7A loan agreements should be in place before, not simply by, the lodgement day (s109N(1)). Where we have a sub-trust, the terms should committed to writing, e.g. do we have an option 1, 2 or 3 sub-trust?

Just as we are diligent in ensuring that trustees resolve by year end to distribute (net) income in accordance with the terms of trust deed, and often that we have an electronic evidence trail of having done so, it is highly desirable to adopt the same approach to timeliness and evidence when it comes to Div 7A documentation.

Takeaway -the ATO has asked for wet copies of documents so that they can be forensically examined/aged. As a result, the need for timely documentation should not be treated lightly.

Can I simply rely on the journal entries to establish what happened? The short answer is typically, "no". The accounts should record what happened but they do not establish legal rights and obligations. Indeed, the entries could be wrong. Imagine a natural person shareholder paying out a motor vehicle lease residual at the request of a company. The payment could constitute a loan to the company, a reduction in the shareholder's loan account with (from) the company, or a payment to the company for the use of the car. The accounting treatment should record what was agreed. It won't determine the rights and obligations between the parties.

Takeaway – accounting journals should record what happened. They do not establish legal rights and obligations. So, be diligent in preparing supplementary documents such as minutes and resolutions, that record what was agreed.

4. An ATO review – what are the chances?

Since the ATO expanded its Top 500 private groups and its Next 5,000 Program to encompass the Medium and Emerging Private Groups, i.e. private groups with net assets of only $5M (or more), the prospect of an ATO review for a large number of groups has skyrocketed.

In addition, when conducting such reviews, the ATO will ask for a copy of your Tax Governance Framework (TGF).

If there is a private company in your group, it is inconceivable that your TGF and the ATO review would not consider Div 7A compliance. If you check the ATO website for issues that catch the ATO's attention, Div 7A compliance is specifically listed as an issue of interest.

Do I need a TGF? When it comes to ATO reviews and tax audits, the holy grail is achieving what is called justified trust. It is virtually inconceivable that you would achieve justified trust without a TGF and Div 7A is sure to feature in your TGF if you have a private company in your group.

Takeaway – if your group has net assets of $5M or more, expect a review by the ATO and expect Div 7A compliance to be an issue, so deal with it in your written TGF document now.

5. I breached Div 7A – what should I do?

5.1 Circumstances outside my control

Section 109RD contemplates that there might be a failure to make minimum yearly repayments for reasons beyond the recipient's control. Given the economic impact of the Covid pandemic, it is easy to see how we could need to rely upon s109RD.

Importantly, s109RD is not self-executing, meaning that in order to get protection, we have to apply to the Commissioner to make a decision.

In addition, a favourable decision under s109RD does not mean that we simply disregard the failure to have made the minimum yearly repayment.

Rather, s109RD(2) contemplates that we will make the shortfall payment within the time specified by the Commissioner.

Takeaway – if non-compliance with Div 7A was outside your control, you can take corrective action and seek the exercise of the Commissioner's discretion. You can't simply take corrective action and stay silent.

5.2 Honest mistake or inadvertent omission

Further, Div 7A contemplates that we will make mistakes, so it provides, in s109RB, for relief, in some situations. The main ATO guides to the Commissioner's views on the application of s109RB are ruling TR 2010/8 and PS LA 2011/29.

Importantly, it is not enough that we get it wrong. Rather, the deemed dividend must arise because of an honest mistake or inadvertent error (of the recipient, the private company or any other entity whose conduct contributed to the deemed dividend, e.g. the advisor).

In my experience, advisors sometimes pay insufficient attention to whether there was an honest mistake or inadvertent omission, virtually assuming that that will be the case if they, or their predecessor, made a mistake.

PS LA 2011/29 makes it clear that the onus is on the entity seeking the exercise of the Commissioner's discretion to demonstrate an honest mistake or inadvertent omission.

So, what is the evidence that supports or explains why the error occurred?

The Commissioner will have regard to the knowledge and expertise of the person who made the mistake.

Keep in mind that a potential downside of a tax agent claiming ignorance of the operation of Div 7A is that the ATO might refer them to the Tax Practitioner's Board, if there could be a breach of the Code of Professional Conduct under s30-10 of the Tax Agent Services Act 2009 (paragraph 19 of PS LA 2011/29).

Takeaway – ignorance of the operation of Div 7A could result in a referral to the Tax Practitioner's Board.

In TR 2010/8 the Commissioner says that the term honest mistake or inadvertent error takes its ordinary meaning. Broadly, a mistake is likely to be an incorrect view or opinion or misunderstanding and it must be honestly made.

Interestingly, the Commissioner considers that a mistake or omission can be a result of ignorance but ignorance doesn't necessarily establish that there was an honest mistake or inadvertent error. The reason for the ignorance is important. Also, he does not accept that there is an honest mistake or inadvertent error where there is deliberate behaviour to remain ignorant, there is deliberate indifference or wilful blindness.

When presenting evidence of a purported honest mistake or inadvertent omission, perhaps give consideration to the comments included (or which should have been included) in the transmittal letter that accompanied the draft income tax return when it was sent to the taxpayer for signing (as well as advice and file notes).

According to the Commissioner, the fact that a mistake or omission is common does not necessarily establish that there was an honest mistake or inadvertent omission in a particular instance but in the absence of evidence to the contrary it might support such a conclusion.

Takeaway - the fact that a mistake or omission is common does not necessarily establish that there was an honest mistake or inadvertent omission

He also says that a recurring mistake or omission will qualify as honest or inadvertent if it recurs for the same reason and the original mistake or omission and the original mistake or omission was honest or inadvertent.

5.2.1 Types of mistakes or omissions

Paragraph 8 of PS LA 2011/29 provides a number of examples of mistakes or omissions including:

- the meaning of associate
- the interaction between Div 7A and other provisions, e.g. FBT (see s109ZB, pursuant to which Div 7A applies to loans but not debt forgiveness or payments, where the event happens in relation to their capacity as an employee)
- the operation of contract law, e.g. is the agreement valid?
- using a company bank account or credit card believing that a personal account or card was being used
- recording errors such as miscoding
- minimum yearly repayment calculation errors
- loan agreement errors such as interest rate or term
- being late making a repayment
- failing to make minimum yearly repayments

5.3 Mistakes and what to do about it

Issues that I have encountered, in addition to those listed in 5.2.1 above, and subsequent actions that might be taken, include:

- A failure to prepare s109N complying loan agreements – an option includes taking corrective action and requesting the exercise of the Commissioner's discretion under s109RB. Another option is to seek to negotiate a reduced penalty;
- A failure to make minimum yearly repayments for reasons outside the control of the borrower – an option includes taking or proposing corrective action and requesting the exercise of the Commissioner's discretion under s109RD;
- Incorrectly calculating and therefore failing to make minimum yearly repayments - an option includes taking corrective action and requesting the exercise of the Commissioner's discretion under s109RB. Another option is to seek to negotiate a reduced penalty;
- Similar to the above, payments to a private company by shareholders might be shown as liabilities of the company rather than as a reduction in the amounts owing by the directors. This would effect the minimum yearly repayment calculations - an option includes taking corrective action and requesting the exercise of the Commissioner's discretion under s109RB. Another option is to seek to negotiate a reduced penalty;
- A tax agent might not have raised the sub-trust options with a client – you might determine the extent, if any of the loss or harm suffered by the client and negotiate a settlement with them (not with the ATO);
- A failure to have regard to the use of company assets and the resulting deemed dividend under s109CA - an option includes taking corrective action and requesting the exercise of the Commissioner's discretion under s109RB. Another option is to seek to negotiate a reduced penalty;
- A failure to prepare accounts and therefore an inability to determine any Div 7A exposure - an option includes taking corrective action and requesting the exercise of the Commissioner's discretion under s109RB. Another option is to seek to negotiate a reduced penalty. An explanation as to why accounts hadn't been prepared on a timely basis is likely to be important;
- Payments and loans being received from non-resident companies (or interposed entities) by Australian resident shareholders or their associates - an option includes taking corrective action and requesting the exercise of the Commissioner's discretion under s109RB. Another option is to seek to negotiate a reduced penalty; and
- Amending or reissuing accounts or making a prior period adjustment after a review (by the taxpayer) identifies errors in the related party accounts (perhaps following a change in tax agent or intergenerational transfer of wealth or control) - an option includes taking corrective action and requesting the exercise of the Commissioner's discretion under s109RB. Another option is to seek to negotiate a reduced penalty

Takeaway - a common theme is that corrective action is required and that neither s109RB nor s109RD are self executing, meaning that we must approach the Commissioner.

For completeness, the professional bodies have ethical rules to be considered and there are the requirements of the Tax Agent Services Act 2009.

6. Arm's length exemptions

6.1 s109J – discharging a private company's obligation to pay an amount

Section 109J provides an exemption from Div 7A where a private company makes a payment for s109C purposes which discharges an obligation of the private company to pay such an amount.

S109J(b) restricts this exemption to situations where the amount paid is not more than would have been required to discharge the obligation of the private company if it and the other entity been dealing with each other at arm's length. An example might be a payment by a private company for trading stock acquired at market value from a shareholder.

For some time, this rule was applied in divorce situations where private companies were ordered by the Family Court to make payments to a spouse. However, the Commissioner changed his mind about the application of this rule in TR 2014/5. The subtlety is that the Commissioner considers that because the relevant order of the Family Court against a party to the marriage would cause a private company to make such a payment, there would be no binding obligation imposed upon the company.

6.2 s109M - loans made in the ordinary course of business

Loans made in the ordinary course of business can be excluded from Div 7A by s109M, if they are on the usual terms on which the private company makes similar loans to parties at arm's length.

This exclusion might apply to loan by a private company money lender, given that s109M(a) requires that the loan be in the ordinary course of the private company's business. For a moment, let us think of a loan as being limited to lending money.

It seems that, as a matter of fact, other private companies might make such loans in the ordinary course of their business as well, regardless of compliance, or otherwise, with AFSL or other legal requirements.

If so, we would still have to consider s109M(b), which requires that the loan to the shareholder or associate be on the usual terms on which the private company makes similar loans to parties at arm's length.

Now for a twist which reminds us of the considerable scope of Div 7A and a trap to avoid.

The expanded definition of the term "loan" in s109D(3) applies for the whole of Div 7A, e.g. it includes, in s109D(3)(b) "a provision of credit or any other form of financial accommodation" and in s109D(3)(d) it includes "a transaction (whatever its terms or form) which in substance effects a loan of money".

Think for a moment about a trading enterprise (private company) which sells to both related and unrelated parties. If the related party debtor that it sells to is a slower payer than the unrelated parties, in particular if payments fall outside the usual terms of trade, we could have a loan for Div 7A purposes and no safe harbour under s109M.

Determination TD 2008/1 provides a useful consideration of s109M. It tells us that the Commissioner will not apply Div 7A in the above situation of the private company deals with the failure by the related party to pay its debts on time in the same manner as it deals with such failures by arm's length parties.

TD 2008/1 also reminds us that s109M isn't a charging provision. It is a potential exemption provision. If it doesn't provide an exemption, we revert to the loan rules in s109D. So, if the (notional) loan is repaid by the lodgement day (s109D(1)(b)), we shouldn't have a deemed dividend.

Takeaway – where a private company's trade debtors include related parties which are slow payers, consider the extended meaning of the term loan in s109D(3) and whether s109M provides shelter.

7. Related party loans – what could possibly go wrong?

7.1 Journals and set-offs

I considered above that principal and interest payments might be made by particular due dates, under conventional loan or sub-trust arrangements. However, what is a payment?

ATO pronouncements such as paragraph 56 of PS LA 2010/4 and 9 and 55 of TR 2010/3 contemplate that a borrower (or where funds are held on sub-trust) might make a required payment by transferring cash or property or by agreed set-off but not by simply crediting it to a liability account owing to the company. This issue arose many years ago in an FBT context (i.e. making employee contributions) in MT 2050.

Broadly, it is not enough that journal entries are posted. Rather, both the employer and the employee must have obligations to make payments to each other and then there must be an agreement between them to set-off some or all of the those amounts.

7.2 Dividends and set-offs

Commonly, dividends will be declared and the shareholder will use the after tax amount to meet their minimum yearly repayment obligations.

Takeaway – the company and the shareholder should document their agreement to set-off some or all of the shareholder's dividend entitlement.

7.3 Journals but no set-off

What I mean by journals but no set-off is that a borrower might make a payment to a private company and instead of that payment reducing the amount owing by the borrower to the company, it might appear in the accounts as a loan to the company.

Economically, the borrower owes the company only the net amount but unless there is an agreement between the company and the borrower that the (re)payment is to be set-off against its obligation to the company, it seems that it would not count towards the minimum yearly repayment.

You will note that I said “agreement to set-off”. I meant to draw a distinction, if one exists, between the accounting treatment of the payments and the agreement between the parties, e.g. it might have been planned and agreed that a dividend would be declared and paid and set-off against the shareholder’s loan (owing to the company) but the accounting treatment was incorrect.

If so, we could go to s109RB if there is a breach of Div 7A but perhaps we don’t need to if what we are faced with is a mere accounting error.

What evidence exists as to the parties’ intentions? Was such an offset referred to in the dividend resolution and was the resolution signed by the shareholder as borrower as well as director?

Takeaway -to (re)pay principal and interest, have you made actual payments, e.g. payments of money or transferred assets, or have you offset rights and obligations? Simply posting a journal recording an obligation to make a payment will not satisfy the Commissioner.

7.4 Disregarding (re)payments

Section 109R(2) can result in us disregarding a (re)payment if a reasonable person would conclude that when the (re)payment was made the entity intended to obtain a loan (or loans) from the private company of (in total) the same or a similar amount (to the (re)payment).

There is a similar rule if the borrower borrows such an amount before the (re)payment is made.

Given that it is common to continue to borrow from private companies as each year’s profits are derived, this “disregarding (re)payments rule” can be particularly important.

Fortunately, s109R(3)(a) provides that s109R(2) does not apply to a payment made by setting-off against an amount payable in relation to a loan a dividend payable by the private company to the borrower.

However, if the borrower used funds obtained from other sources to meet its loan (re)payment obligations (and one of the other s109R(3) exceptions does not apply), s109R might cause us to have to disregard the (re)payment.

Takeaway – if you borrow to make Div 7A (re)payments, will the repayments be disregarded?

7.5 The interposed entity rules – subdiv E

The interposed entity rules in subdivision E of Div 7 are gobbledegook. This is where this paper becomes difficult.

They start simply enough in s109T which, broadly, provides that Div 7A applies as if a private company makes a payment or loan (to a target entity) if it makes a payment or loan to an entity (the **first interposed entity**) and a reasonable person would conclude that it did so solely or mainly as part of an arrangement involving a payment or loan (by the interposed entity) to a target entity.

It contemplates multiple interposed entities.

Note – it is not that simple, as you will see.

Takeaway - if you are a private company, don't put funds on deposit with a bank and ask it to lend a similar amount to one of your shareholders or associates.

S109U applies if, broadly, a private company guarantees a loan made by another private company (the **first interposed entity**) and a reasonable person would conclude that it did so solely or mainly as part of an arrangement involving a payment or loan to a target entity.

It also contemplates multiple interposed entities.

Takeaway - continuing the above example, if you are a private company, don't provide a guarantee for a loan to a shareholder or associate, if it is to be made by another private company.

Section 109UA continues the guarantee theme. Broadly, it applies as if a private company (the **first entity**) makes a payment to a second entity (e.g. a bank), if the first entity guarantees a loan the second entity makes to a third entity (the target entity) and the first entity has other than a contingent liability to make a payment to the second entity, e.g. because the borrower defaults.

This triggers multiple provisions which the s109UA(1) example illustrates, i.e. it results in s109T operating as if the private company made a payment to a bank and s109V then treats the private company as having made a payment to a shareholder (the bank being a notional interposed entity).

Takeaway - continuing the above example, if you are a private company, think carefully before providing a guarantee for a loan to a shareholder or associate made by another entity, e.g. a bank.

As just hinted at, s109V provides, broadly, that Div 7A treats a private company as having paid an amount to a target entity, when an interposed entity pays a target entity. It extends to multiple interposed entities.

Section 109W is similar to s109V except that it applies to loans rather than payments.

If you thought that the operation of s109UA and how it triggered s109T and s109V (above) was complex, s109X is a high point in tax legislation gobbledegook.

Section 109X(1) operates despite s109K, which provides that intercompany loans and payments aren't deemed dividends, and despite s109L, which provides that payments and loans aren't deemed dividends to the extent that they are assessable apart from Div 7A. This statement sits somewhat uncomfortably with what follows.

Section 109X(1) goes on to say that a private company can be taken to pay a dividend (under s109C – payments, or s109D - loans), as a result of that subdivision (i.e. subdiv E, the interposed entity rules) treating the private company as making a payment or loan (through an interposed entity) to a target entity, even if:

i) The interposed entity is another private company; or

ii) Some or all of the amount paid or lent by the private company to the interposed entity is included in the interposed entity's assessable income.

If that doesn't seem too complicated, you might consider determination TD 2001/2, which is quite possibly the most difficult to follow TD ever issued by the ATO.

7.5.1 TD 2001/2 and s109K – company to company dividends

If I understand both TD 2001/2 and the relevant provisions in Div 7A (which I do not claim to do), it seems that:

- Section 109T can result in s109V (payments) or s109W (loans) applying to deem a private company to have made a payment or loan to the target entity if the private company makes a payment or loan to an interposed entity;
- Section 109K (the company to company rule) ordinarily stops deemed dividends from arising (under s109C – payments and s109D – loans), where the party that made the initial payment or loan is a private company and the target entity is as well;
- Section 109X ensures that the interposed entity rules can deem dividends to arise under s109C (payments) or s109D (loans), despite the company to company exclusion in s109K, if the interposed entity is a company
- If the target entity (not the interposed entity) is a private company, the s109K exclusion can (still) apply and s109X (in the interposed entity rules) will not result in there being a deemed dividend (under s109C – payments or s109D – loans).

TD 2001/2 provides two examples, being:

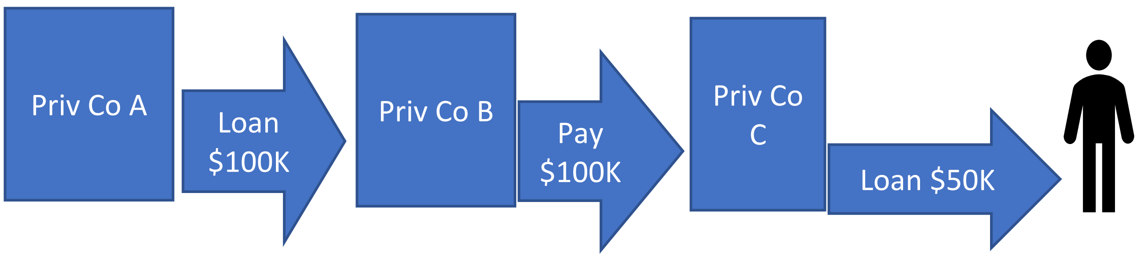
Example 1

The Commissioner says that Private Co A is taken by s109V (an interposed entity payment rule), to have made a payment to Private Co C of $50K.

However, s109K (the company to company payment or loan exclusion), applies to excludes such payments from being deemed dividends under s109C (payments).

In addition, s109X(1) does not deny the operation of s109K.

Example 2



According to the Commissioner, under s109W (an interposed entity loan rule), Private Co A is taken to have lent Mr D $50K.

He says that, in the absence of a repayment, s109D applies to deem Private Co A to have paid a dividend to Mr D.

This is because s109X(1) allows Private Co A to be taken to pay a dividend to Mr D notwithstanding s109K (the company to company exclusion) in light if the interposed companies.

7.5.2 TD 2012/12 – the exclusion rules in subdiv D and the interposed entity rules in subdiv E

The relationship between the exclusion rules (from Div 7A applying) found in subdiv D, e.g. the company to company exclusion in s109K, and the interposed entity rules in subdiv E, were also considered in TD 2012/12, which also provides two examples.

Example 1

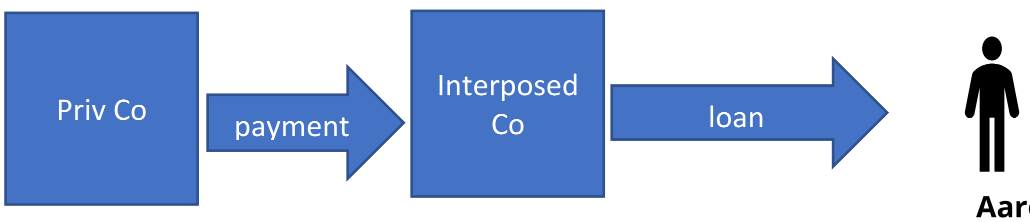
Profit Co had a distributable surplus but Loss Co didn't .

According to the Commissioner, s109K (the company to company exclusion) doesn't prevent the operation of s109D (deemed dividend as a result of a loan) to the notional loan from Profit Co to the shareholder.

Section109X was quoted as authority for this proposition.

This was said to prevent the circumvention of Div 7A by routing funds through entities with no distributable surplus.

Example 2



According to the Commissioner, if the loan from Interposed Co to Aaron, under an arrangement with Private Co, is put on complying s109N terms, s109X(3) and (4) will treat the loan from Interposed Co to the individual as the relevant agreement for the purposes of s109N (so there will be no deemed dividend if minimum yearly repayments are made).

To get there, we go to s109X(2), which says that s109X(3) and (4) apply if a notional loan under s109W (loans from interposed entities) arises.

Section 109X(3) says that we treat the agreement under which the actual loan, i.e. the real loan above, was made as the agreement under which the notional loan was made.

Section 109X(4) then tells us that when working out the (amalgamated) loan (under s109E), we treat the agreement under which the actual loan was made as the agreement under which the amalgamated loan was made and that we treat repayments of the actual loan as repayments of the notional loan.

We need to do this as the target entity will never make repayments to the Private Co, as the actual loan came from the Interposed Co.

My gloss on this is that if the actual loan is put on complying terms, s109N(1) will take it out of s109D because s109X(3) "picks up" the s109N loan agreement to take us out of s109X.

Deciphering s109X and its interaction with the rest of Div 7A is a nightmare.

The explanatory notes in TD 2012/12 are actually helpful, albeit complex.

They explain that, on its face, subdivision B brings to account many private company loans and payments.

It would be inappropriate for subdivision B to operate unchecked, so there are exclusions in subdivision D, e.g. for company to company payments and loans (s109K), payments to discharge commercial debts (s109J), etc.

Subdivision E then contemplates loans and payments through interposed entities and it responds by treating them as payments and loans from the private company directly to the target entity (under subdivision B).

Double taxation could arise where the interposed entity is a shareholder or associate of the private company and the interposed entity is a private company.

To avoid double taxation, apparently we ignore the (notional) payment or loan to the target entity, if Div 7A applies to the (actual) payment or loan to the interposed entity (see s109T(3)).

Takeaway – ignore the notional payment/loan between the private company and the target entity if Div 7A applies to the payment/loan between the private company and the interposed entity.

7.5.3 ATO ID 2011/104 – where the interposed entity has no distributable surplus

Once the explanation in TD 2012/12, of the interaction between subdivisions B, D and E is understood, ATO Interpretative Decision ATO ID 2011/104 becomes a little easier to understand.

The facts in ATO ID 2011/104 were that:

- Jack and Private Co B were both shareholders in Private Co A.
- Private Co A had a distributable surplus but Private Co B didn't.
- Private Co A paid a fully franked dividend to Private Co B, which then made a loan to Jack, who made no repayments by the lodgement day.

The Commissioner advised that s109T applied to treat Private Co A as having made a payment or loan to the target entity (Jack), even though the payment by Private Co A to Private Co B was an actual dividend. Section 109T(1), triggers s109V (where the target entity is paid and amount) or s109W (where a target entity is lent an amount), but it is subject to s109T(3).

Section 109T(3) says that s109T(1) doesn't trigger s109V or s109W if the private company is taken under subdivision B (e.g. s109C – payments or s109D - loans) to have paid a dividend as a result of the payment or loan to the interposed entity.

Private Co A paid an actual dividend to Private Co B, so it wasn't taken to have paid a dividend under subdivision B (see also s109L), s109T(3) didn't apply to exclude s109T(1) and s109T(1) caused s109W to apply to deem Private Co A to have made a loan to Jack.

For completeness, Private Co B was also taken to pay a dividend to Jack but it had no distributable surplus so the deemed dividend was capped at $0.

7.5.4 The s109T(3) safe harbour

Section 109T(3) provides that subdivision E will not apply (to deem the private company to have made a payment or loan to a target entity, as contemplated under s109V and s109W), if the payment or loan by that private company to the first interposed entity is deemed to be a dividend under subdivision B, e.g. s109C – payments or s109D – loans.

That is, s109T(1) and subdivision E will only apply if a payment or loan to the first interposed entity is an actual (not a deemed) dividend or if the loan is put on complying s109N terms.

This is important as I have seen commentators suggest that subdivision E applies where a company lends to another company, which lends to an individual, whereas it seems that, as a result of s109T(3), that cannot be the case if the loan between the companies is put on complying terms.

7.5.5 What is an interposed entity?

Section 109T refers to entities. Section 109ZD picks up the meaning of this term in s960-100 of the Income Tax Assessment Act 1997, which picks up just about every type of legal person imaginable.

7.5.6 Calculating the deemed payment or loan under s109T when the interposed entity rules apply

Determination TD 2011/16 is a useful reference for determining the quantum of the deemed payment or loan but it seems quite straightforward so I will not consider it.

7.5.7 Group finance entity

We might have a designated finance company that has no distributable surplus because it borrows from say a bank to on-lend within the group and any margin it makes on on-lending is used to cover costs.

A payment from a related private company borrower to the group finance company would seem to be a payment to an interposed entity, i.e. an entity interposed between the private company and the target entity/bank.

In my view, notwithstanding concerns expressed by some commentators, this should not cause a Div 7A problem because either:

- the Commissioner could reduce the payment made by the interposed entity to the bank to $nil under s109V(2); or
- When subdivision E applies the Commissioner considers that s109T takes us to subdivision B and the bank would not be a shareholder or associate of a shareholder as required for s109C to operate.

7.5.8 TD 2018/13 examples of s109T applying

Determination TD 2018/13 provides 7 examples which allow us to draw together a number of the above threads.

Before we launch into TD 2018/13, let's recap and recall a couple of key points.

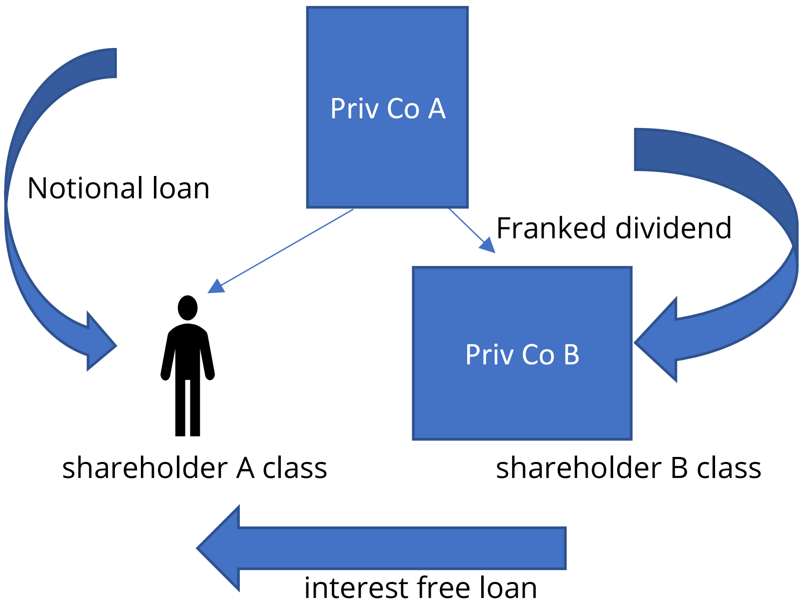
Takeaways - s109T is the key provision that activates s109V (payments to interposed entities) and s109W (loans to interposed entities).

- - The interposed entity doesn't have to be a shareholder or associate of a shareholder of the first entity.

- S109T(3) provides a safe harbour, i.e. subdivision E doesn't apply, if the private company making the payment to the interposed entity is taken to pay a dividend to the interposed entity under subdivision B, e.g. s109C (payments) or s109D (loans). So, if the payment by the private company to the interposed entity is a dividend according to ordinary concepts, s109T(3) does not apply and s109T(1), the interposed entity rules, can apply. Similarly, if a loan to the interposed entity is put on complying s109N terms so it isn't a deemed dividend, s109T(3) does not apply and s109T(1), the interposed entity rules, can apply.

- - If the payment or loan to the interposed entity is a deemed dividend, subdivision E (the interposed entity rules), should not apply (s109T(3).

TD 2018/13 Example 1

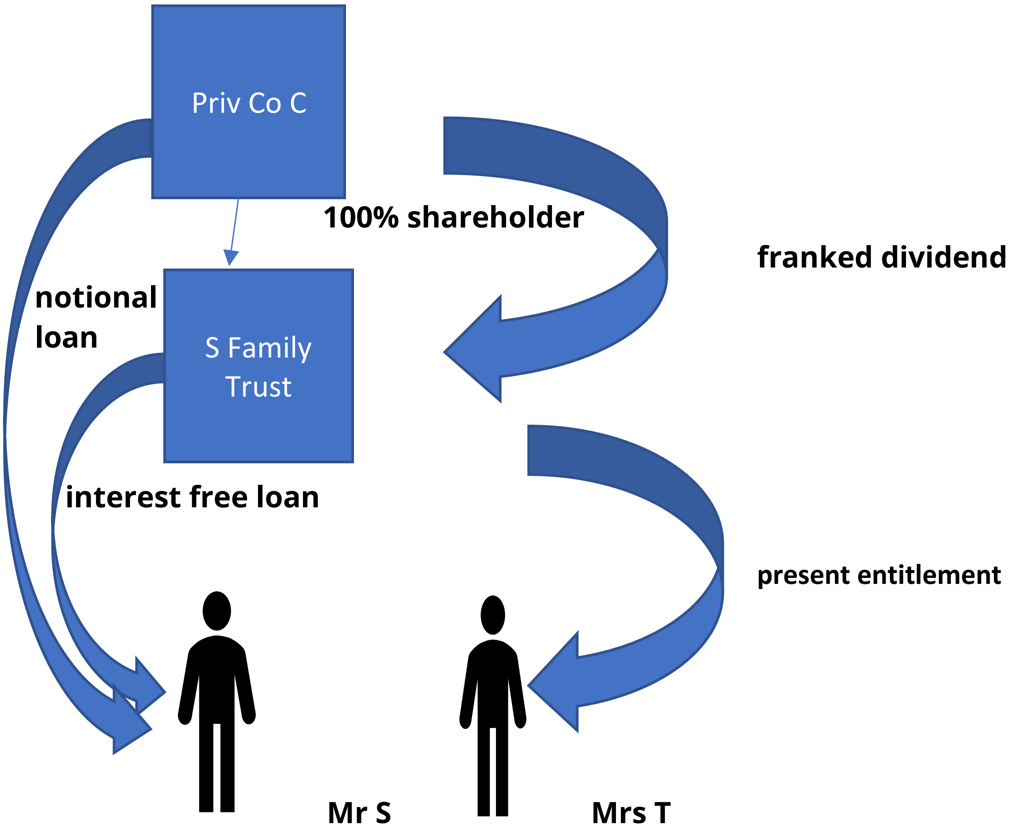


It is said to be important that subdivision E applies in this situation because Private Company B might have no distributable surplus and therefore no deemed dividend might otherwise arise on the loan to the individual.

Importantly, the actual loan from Private Company B to the individual is then disregarded, as s109W(1) deems the loan to the individual to have come from Private Company A.

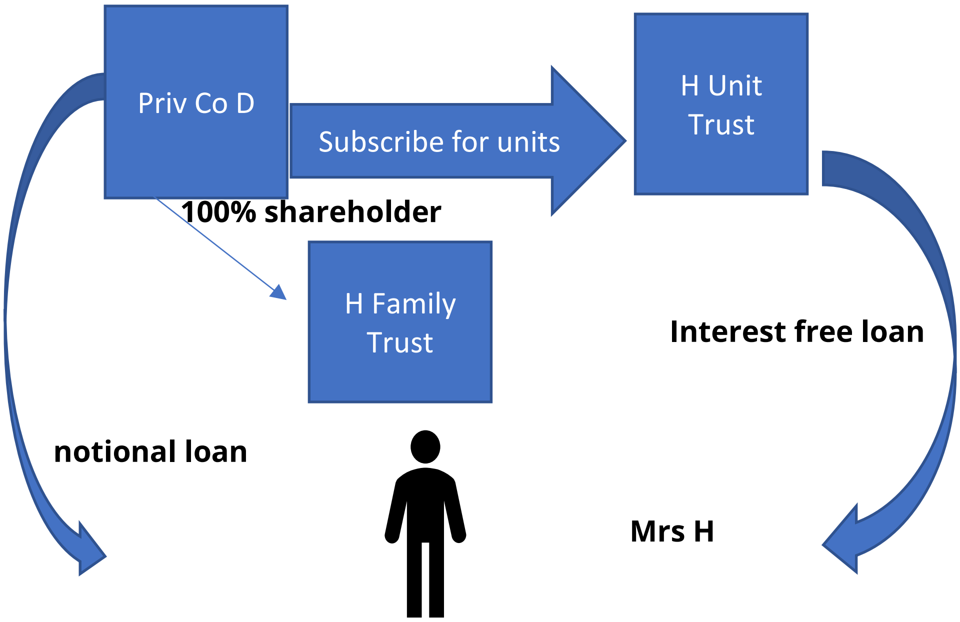
In addition, s109X provides that repayments by the individual (the target entity) will be treated as payments to the private company (in this case Private Company A).

TD 2018/13 Example 2



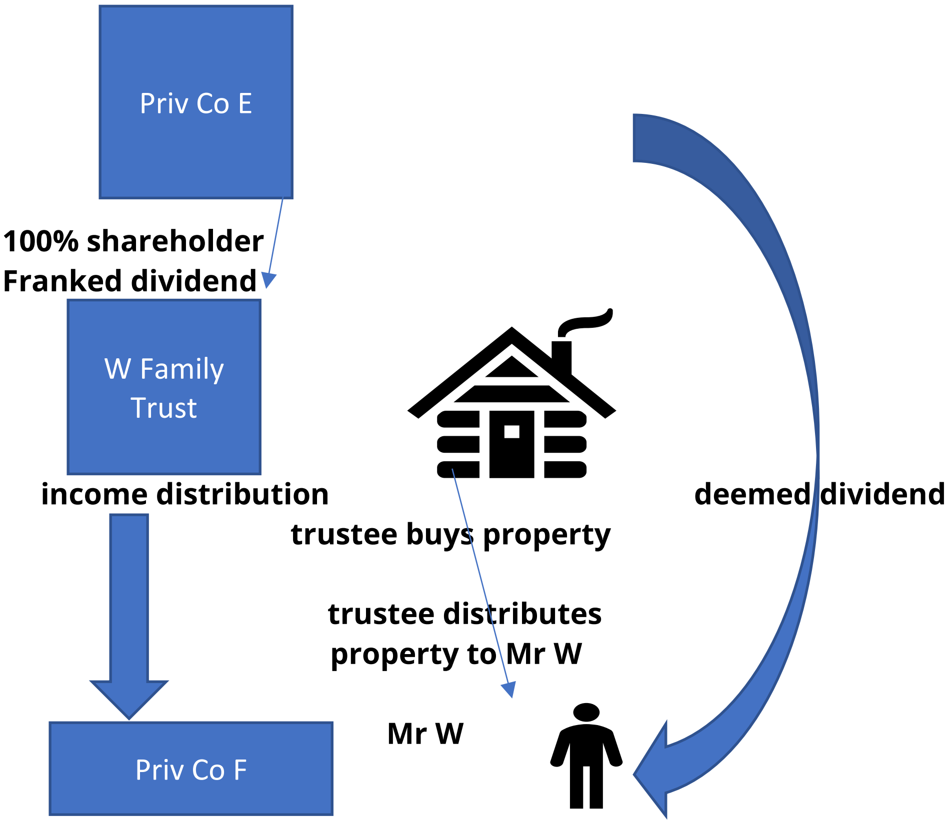
S Family Trust received an actual dividend, so s109T(3) (in the interposed entity rules) don't prevent subdivision E (the interposed entity rules) from operating.

TD 2018/13 Example 3



Mrs H was a trustee of both trusts and the notional loan arose in light of the payment to the interposed entity (to acquire units), which on-lent to Mrs H (the target entity).

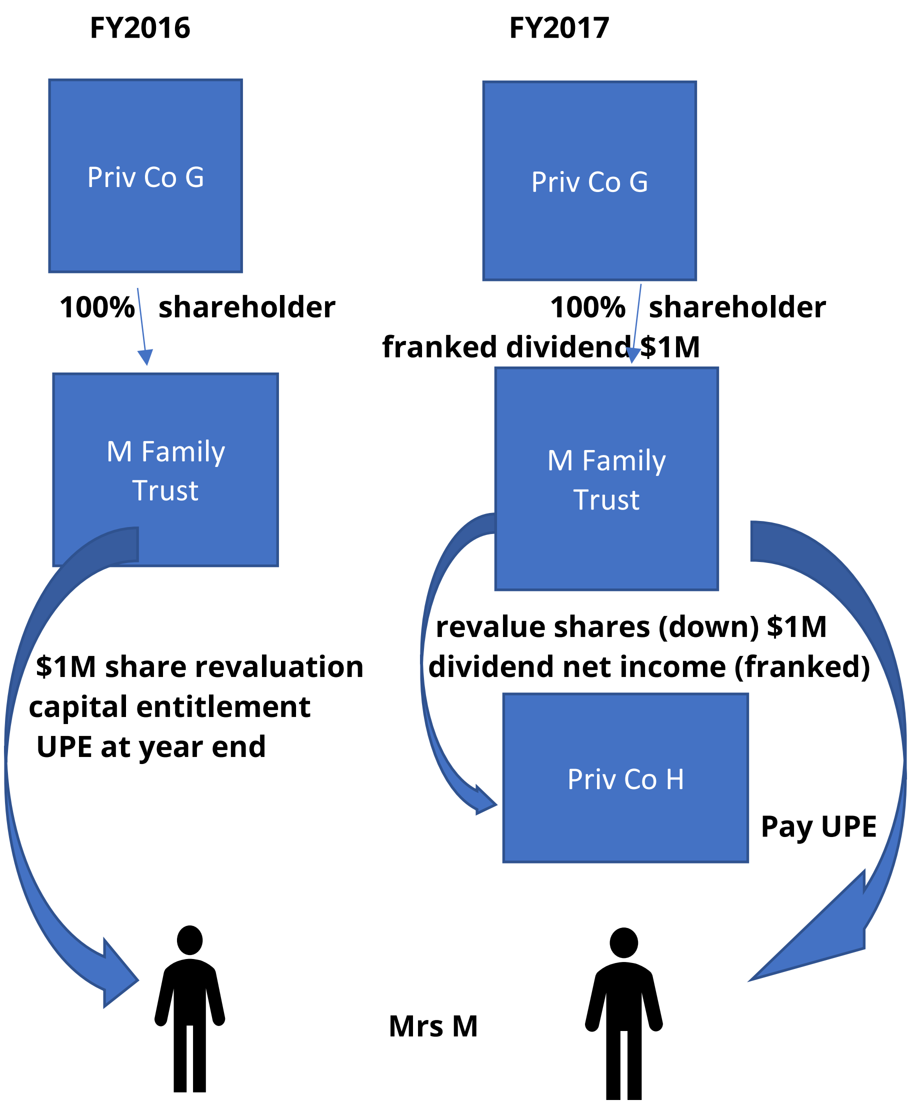
TD 2018/13 Example 4



$950K of the $1M dividend to the trust is used by the trustee to buy a property and the trustee claims a loss on the distribution of that property to Mr W, so Private Co F becomes entitled to only $50K, arguably.

The Commissioner apparently treats s109V as being triggered, i.e. there is a payment to a target entity (Mr W) by an interposed entity (W Family Trust).

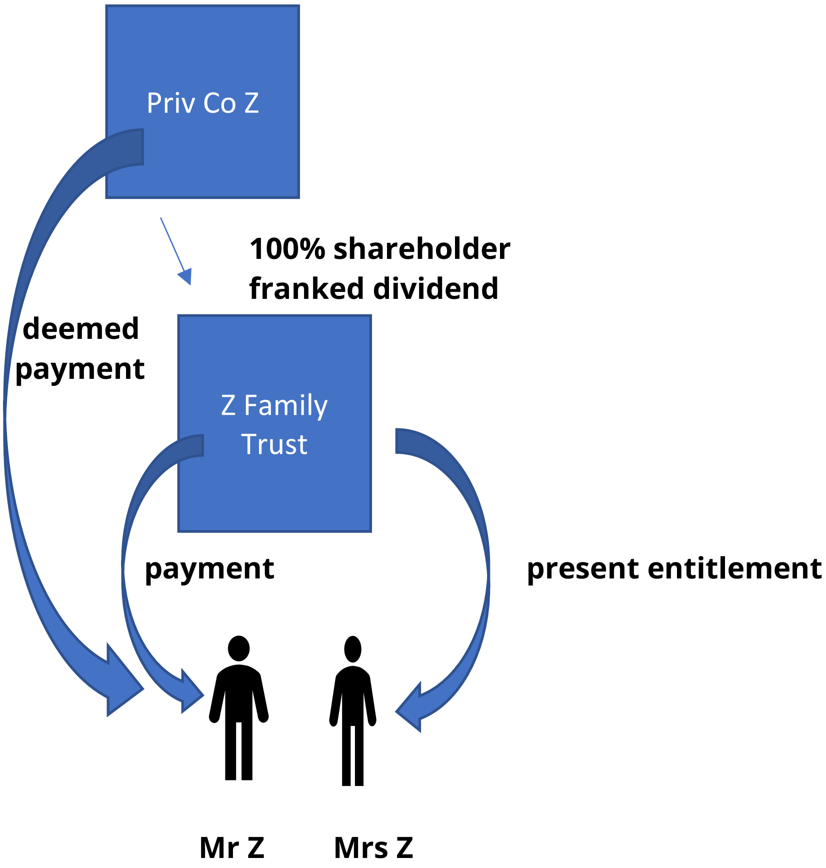
TD 2018/13 Example 5



If the asset revaluation downwards (post dividend) in FY2017 reduces the income of the trust to a nominal amount and its net income, being mainly franked dividends, is subject to a tax offset in Private Co H, M Family Trust might have the cash to pay out the UPE owing to Mrs M, which was argued to be tax free.

Arguably, subdivision E, in particular s109V, applies, there being a payment by an interposed entity (M Family Trust) to a target entity (Mrs M).

TD 2018/13 Example 6

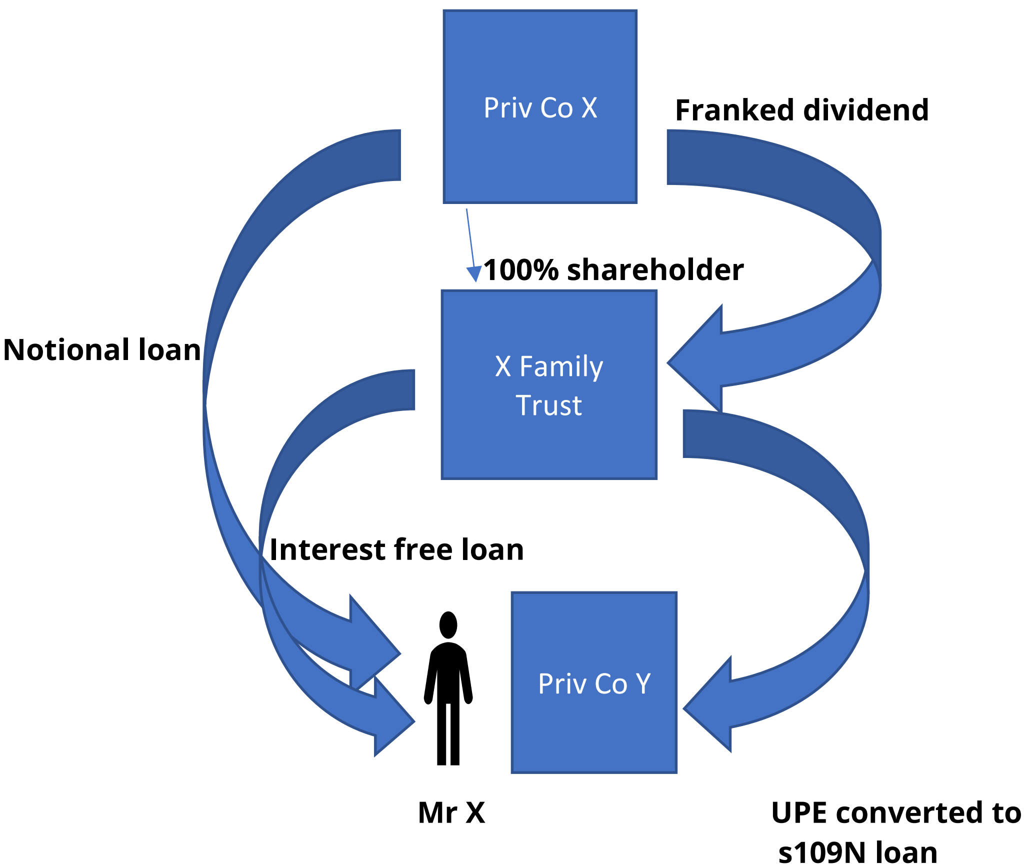


Now for some good news.

The Commissioner says that subdivision E will not apply if Mrs Z directs the trustee to pay Mr Z, both Australian residents, in order to discharge her UPE, or if the trustee paid Mrs Z and she made a payment to Mr Z.

This is what we would expect without reading subdivision E but how does the legislation achieve this outcome? The answer is that, at first blush, s109V (a payment by an interposed entity to a target entity) applies but the Commissioner says that he would reduce the deemed payment by the private company to $nil. This is important because it draws out how open ended the Commissioner's discretion is under s109V(1) and it is useful to remember that the exercise of discretions can work against us as well as in our favour.

TD 2018/13 Example 7



In this example, the interest free loan to Mr X is not repaid or put on complying s109N terms by Private Company X's lodgement date.

Similar to s109V, s109W gives the Commissioner the broadest of discretions in determining the amount of the loan by the interposed entity to the target entity that is to be treated as a loan by the private company to the target entity.

In this case, the Commissioner says that we would reduce the notional loan under s109W (i.e. from Private Co X to Mr X) by the amount of the private company loan to the interposed entity(i.e. from Private Company Y to X Family Trust) that is subject to a s109N loan agreement.

8. Dates

For convenience and completeness:

- References to **pre 4 December 1997 loans** are typically references to loans that came into existence pre that date, which is when Div 7A commenced, which are currently outside the scope of Div 7A;
- References to **pre 16 December 2009 UPE's** are typically references to UPE's that came into existence before that date, commonly UPE's for the years ended 30 June 2009 and earlier, which are not subject to TR 2010/3 or PS LA 2010/4, i.e. the UPE's are not taken to constitute the provision of financial accommodation and they are therefore not deemed to be loans under s109D(3)(b);
- **A loan is taken to be paid** on the last day of the year in which it is made (the current year) if it is not repaid by the lodgement day (s109D(1) and (6));
- **Payments are effectively taken to be made** in the year of income in which they are made (s109C(1));
- **UPEs not put on sub-trust** – if a UPE arises on say 30 June 20X0 and it is not paid or put on sub-trust by say 15 May 20X1, it becomes a loan. To avoid a Div 7A deemed dividend, the UPE must be paid out or put under a s109 complying loan agreement by say 15 May 20X2. The 15 May lodgement dates above and following might vary (paragraph 46 of PS LA 2010/4);
- **UPEs put on a 7 year sub-trust** – if a UPE arises on say 30 June 20X1, it is put on a 7 year sub-trust by 15 May 20X2, a liability to pay interest arises on 30 June 20X2 and the private company will include that interest in its income for the year ending 30 June 20X2, the interest must be paid to the private company by 15 May 20X3 and the principal must be raid by 15 May 20X9, being 7 years from the creation of the sub-trust on 15 May 20X2 (paragraph 71 of PS LA 2010/4).

9. Div 7A to be amended

The Government announced in a number of Budgets that Div 7A will be amended, without providing details. They were originally to apply from 1 July 2018 and then from 1 July 2019. My sense is that it would be prudent to assume that when we finally receive them, they will only operate from the date introduced into Parliament, or from the date of Royal Assent

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