THE TAX INSTITUTE

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1 Introduction

Division 7A has now been with us since December 1997.

Government announced in its 2016 Budget that it was intending to adopt some of the recommendations of the Board of Taxation's review of Division 7A with effect from 1 July 2018, but there has been no public consultation over what will in fact be adopted.

This first part of this paper deals with some of the issues I have experienced over the years in relation to Division 7A and covers the 2017 year developments, and speculates on what might need to be done in anticipation of the 1 July 2018 changes.

This paper assumes a working knowledge of Division 7A and how it applies to loans, payments and forgiveness involving a private company, its shareholders or associates of its shareholders, as well as how the Commissioner's position in relation to unpaid present entitlements changed with effect from 16 December 2009.

All references in this paper are to provisions of the *Income Tax Assessment Act 1936* unless otherwise noted.

2 Issues with the operation of Division 7A

Below are some of the issues identified in relation to day to day interactions with the operation of Division 7A. Unfortunately, the solution to a lot of the problems identified is to not put yourself in a position where the problem arises.

2.1 109R for repayment

Where a loan has been repaid by the 'lodgement day'[1] there is no need to put in place a complying Division 7A loan agreement. Where it has not been repaid by this time and there would otherwise be a deemed dividend, this can be avoided by putting in place a complying loan agreement.

Where a complying loan agreement has been put in place for a loan that would otherwise be a Division 7A deemed dividend, if minimum annual repayments are not made, the shortfall in the repayment calculated under section 109E is a deemed dividend, subject to the amount of the distributable surplus.

In working out how much of a loan has been repaid you need to consider the operation of section 109R.

Section 109R is effectively an anti-avoidance provision, the need for which can be best understood by considering the following example.

A loan is made to a person on 29 June 2016. The loan is repaid on 30 June 2016. Division 7A deems there to be a dividend on 30 June 2016 if the loan is not repaid by the lodgement day, unless one of the exceptions (such as having a written loan agreement) applies. The amount repaid is re-borrowed on 1 July 2016.

Without an anti-avoidance provision the operation of Division 7A could be thwarted by repaying and re-borrowing the amount of a loan each year.

Section 109R(2) provides:

> A payment [repayment] must not be taken into account if:
>
> (a) a reasonable person would conclude (having regard to all the circumstances) that, when the payment was made, the entity intended to obtain a loan or loans from the private company of a total amount similar to, or larger than, the payment; or
>
> (b) both of the following subparagraphs apply:
>
> (i) the entity 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;

[1] Lodgement day = EOTTTCTRILODFL = earlier of the time the company tax return is lodged or due for lodgement, noting that the tax agent lodgement program extends the due date for lodgement where applicable

(ii) a reasonable person would conclude (having regard to all the circumstances) that the entity obtained the loan or loans in order to make the payment.

Thus, if there is an intention to borrow a similar or greater amount when a repayment is made, the repayment is disregarded.

If a loan is obtained when there is the intention to borrow the amount to repay the company then the repayment is disregarded.

While on its face this anti-avoidance provision is reasonable, as it prevents repaying to borrow, and borrowing to repay, it has potentially dire consequences for private companies and people that borrow from them.

109R does allow for 7 year or 25 year loans to be refinanced to have longer or shorter terms, and also allows for certain refinancing to occur to give effect to a loan being subordinated.

2.1.1 Repaying from salaries or dividends

In a large number of private companies, shareholders borrow money from their companies each year. They meet with their tax advisers and then plan how the loans will be repaid. The loans are often repaid out of salaries or out of dividends. The shareholders, after making their repayments, then continue the practice of borrowing in later years, which habit it could be argued, would make a reasonable person consider that they intend to obtain a similar or greater amount as a loan.

Fortunately, there is an exception that prevents section 109R(2) from applying where the amount is repaid by setting off an amount that is a dividend, an amount that is subject to PAYGW (e.g. salary), or where the repayment occurs by way of setting off the difference between what might be paid by a party at arm’s length for property against the amount paid by the private company for the transfer of the property.

2.1.2 Repaying from someone else’s credit loan

There is also an exception from 109R(2) where another entity (other than the borrower) pays the private company an amount that has been included in the assessable income of the borrower in the year the payment is made or in an earlier year.

Note that there is no exception from 109R(2) applying where another person allows their credit loan account balance to be used to offset a shareholder or shareholder’s associate’s debit loan balance to be reduced. That is, if one person ‘gifted’ their credit entitlement to a borrower to allow them to repay or reduce their loan, and the borrower were to borrow a similar or greater amount, section 109R could operate to disregard the repayment.

2.1.3 What does not work

In some accounting firms there is a process of quarantining credit entries in a loan account from the debit entries in a loan account and using the credits to either repay the prior year loan or to meet the minimum annual repayment obligations. If someone is both repaying and re-borrowing in the same year this will clearly fall foul of section 109R.

2.1.4 How does 109R operate for current year loan accounts?

Section 109R could operate so that where a person borrows from a company during a year and also makes repayments, the repayments are disregarded while the amounts borrowed are not.

While it is sensible to treat the net movement in the loan account for a year as the ‘loan’ and indeed the definition of amalgamated loan in section 109E(3) contemplates this is the loan, this can only occur if the repayments made are taken into account in determining the amount of the loan.

A larger problem with section 109R though, is that while on its face it requires repayments to be disregarded in certain circumstances, its operation requires that you disregard them for all purposes. That is, you disregard them for the purposes of section 109D (current year loans) and for the purposes of 109E (amalgamated loans).

For example, if a loan was made in year 1 of $500, and in year 2 repayments of $200 were made and borrowings of $300 occurred, if 109R(2) applies the repayment could not reduce the year 1 loan, and could not reduce the year 2 loan.

In effect, in the example above, no credit is allowed for the $200 repayment. There is no provision allowing you to ignore part of the $300 borrowed where section 109R applies to the $200.

This seems unreasonable and is, in my opinion, unlikely to be a position adopted by the ATO or the Courts.

What is suggested as a conservative practice to adopt is to treat repayments as reducing a current year loan and not prior year loans, unless such repayments are made in a way that is exempted from section 109R. Where current year repayments exceed current year borrowings, but the conditions of section 109R apply it is not clear what should occur with the balance.

2.1.5 Refinancing and 109R

Section 109R also needs to be considered where refinancing occurs. Consider the following refinancing transaction:

Company 1 loans $100 to a shareholder. Company 2 (in which the shareholder is also a shareholder) loans money to the shareholder to allow them to repay company 1, with the overall effect being that company 2 now owes company 1, as no cash changes hands.

Section 109T can operate so that the loan from company 1 to company 2 to the shareholder is an interposed entity loan from company 1 to the shareholder. This can result in a deemed dividend if the amount is not repaid (subject to the Commissioner determining the amount under section 109W). In addition, the amount that the shareholder has repaid company 1 can be disregarded under section 109R as at the time the repayment was made there was the intention to borrow the same amount (the interposed entity 109T loan). This could result in double taxation. Note that 109K that ordinarily results in a company to company loan not resulting in Division 7A applying, but this provision is switched off for the purposes of the interposed entity provisions (see section 109X).

Where the refinancing does not trigger section 109R is where money is borrowed from one entity, in cash, to repay another entity, with the consequence that the two entities do not have a loan between them at the end of the transaction.

For example, company 1 is owed $100 by its shareholder. The shareholder also owns shares in company 2 which has $100 in cash. The shareholder could borrow money from company 2 in order to repay company 1 without triggering section 109R, unless a reasonable person would conclude that, when the payment was made, the entity intended to obtain a loan or loans from company 1 of a total amount similar to, or larger than, the repayment.

Theoretically, this refinancing could occur indefinitely, but the operation of Part IVA would need to be considered. Note that as well, using a credit loan in one entity to offset a debit loan in another entity should not, on its own, cause section 109R to apply.

For example, company 1 is owed $100 by its shareholder. The shareholder is in turn owed $100 by company 2. The shareholder asks company 2 to repay it the $100 by paying company 1 by direction. Although at the end of this transaction company 2 may not have settled its obligation to pay company 1 in cash, so that there is a borrowing by company 1 to make a payment of $100 to its shareholder, there should be no amount of deemed dividend under section 109T and 109V (the payment provision) as the payment is discharging company 2's obligation to pay its shareholder. 109R has no application as the shareholder has not indirectly borrowed from company 2, there is an indirect payment.

2.1.6 Consolidating loan accounts

Another example of refinancing, being a small variant on the above but that is more common, occurs in the practice of wanting to 'clean up' company accounts by consolidating loan accounts into only one entity. For instance, for a person with two operating companies might have debit loans in both companies, but for simplicity, only one company is to be recorded as having an amount due by the shareholder.

In this instance before the end of the year the parties could agree that the shareholder would be indebted to only one of the companies.

What would then happen is that the company that will not show the shareholder's debit loan will instead show that it is owed money by the company that will show the shareholder's loan.

For example, company 1 has loaned $100 to a shareholder. Company 2 is the one that is to show the debit loan. A journal will be done in company 1 debiting company 2 with $100 and crediting the shareholder loan with $100. In company 2 a journal will be done debiting the shareholder's loan and crediting company 1.

In this example company 1 has loaned money to company 2 in order for it to make a loan to the shareholder. The shareholder has used this money to repay company 1.

The effect of the interposed entity provisions in section 109T and 109W will be that company 1 will be taken to have loaned an amount of $100 to the shareholder. As this loan is the loan that has been used to repay company 1, section 109R(2) will operate to disregard the repayment.

If the transaction had been structured differently, so that company 2 agreed to loan money to the shareholder, but company 1 had advanced it the money for this purpose, while the interposed entity provisions would still have potential operation, a complying loan agreement between company 2 and the shareholder would prevent there from being a deemed dividend.

2.2 Interposed entity rules

2.2.1 Interposed entity mum, and dad

Consider the following transaction. A private company has all of the shares in it owned by Mum. Mum takes a dividend from the private company. Mum gifts the funds to Dad who uses the amount to pay his credit card bill.

Technically when Mum has taken a dividend from the company the company has made a payment to her. Division 7A does not deem this to be a dividend as it is an actual dividend. Actual dividends cannot be deemed dividends under section 109C (the payment provision) because of section 109L.

When Mum chooses to give the dividends to Dad she is making a payment. A payment in section 109C(3) is ‘a payment to the extent it is to the entity’, Dad is an entity.

A payment made by a private company to an entity (Mum) where the funds are then on-paid to a target entity (Dad) can result in there being a deemed dividend under section 109T if ‘ a reasonable person would conclude (having regard to all the circumstances) that the private company made the payment or loan solely or mainly as part of an arrangement involving a payment or loan to the target entity’.

In the circumstances, if Mum caused the company to pay the dividend in order to pay Dad, then these requirements would be satisfied.

The amount of the deemed dividend in the case of an interposed entity payment situation is the amount determined by the Commissioner under section 109V. In determining the amount of the deemed dividend, the Commissioner must have regard to:

(a) the amount the interposed entity paid the target entity; and

(b) how much (if any) of that amount the Commissioner believes represented consideration payable to the target entity by the private company or any of the interposed entities for anything (assuming that the consideration payable equals that for similar transactions at arm's length).

It is not clear how much the Commissioner would believe represented consideration payable by Mum to Dad for anything, though it could be hoped that the Commissioner would not seek to deem there to be an amount of dividend.

Usually the fact that the dividend received by Mum is assessable would be enough to prevent Division 7A applying because of section 109L. Section 109X states that for the purposes of determining whether there is a deemed dividend in Subdivision E of Division 7A (which is where section 109T is located) you ignore the operation of section 109L.

It is not clear how to handle a situation involving Division 7A where the Commissioner must exercise a discretion, as the legislation is silent on whether the Commissioner must be approached and asked to form a view in what is otherwise a self-assessment system.

That the Commissioner considers that a deemed dividend can arise in the above circumstances follows from a position outlined in ATO ID 2011/104 (this has now been withdrawn and replaced by the TD mentioned below).

The facts in the ID differ from the above, in that because of the arrangement in place, there is no tax paid by the recipient of the actual dividend. Those facts are:

Jack Jones is a shareholder of Private Company A, holding 100 A class shares.

Jack Jones needs $100,000 to enable him to purchase a new residence.

Private Company A has significant cash reserves and a distributable surplus.

Private Company B is also a shareholder of Private Company A, holding 100 B class shares.

Private Company A paid a fully franked dividend of $100,000 to Private Company B and on the same day Private Company B made an interest free loan of $100,000 to Jack Jones.

No repayments of the loan were made by Jack Jones before the private company's lodgment day for the relevant year of income.

Private Company B has no distributable surplus.

The ATO states that section 109T can operate to deem a dividend to Jack Jones. In relation to why they would consider that there is a deemed dividend of $100,000 the ATO say 'Under section 109W [as is the case for 109V] of the ITAA 1936, the amount of the notional loan is the amount (if any) determined by the Commissioner. Given the facts and circumstances relating to the loan made to Jack Jones, the Commissioner would determine that the amount of the notional loan was $100,000. There has been an informal or disguised distribution of Private Company A profits to Jack Jones.'

The difference between the Mum and Dad example is clearly that Mum pays tax on the dividends received and Company B in the ATO ID does not. If Mum was on a low tax rate however (or had losses) and Dad was on a high tax rate the ATO could use sections 109T and section 109W to assess Dad.

The ATO in their taxation determination TD 2011/16 consider that in forming their view on the amount of an interposed entity loan or payment that they are not restricted to taking into account the factors set out in 109V or 109W. That, combined with the Commissioner's remedial power, would result in the ATO not trying to tax Dad in the above 'Mum and Dad' scenario.

2.2.2 2017 TD on section 109T

In 2017 the Commissioner released TD 2017/D3 addressing the question ‘can section 109T of the *Income Tax Assessment Act 1936* apply to a payment or loan made by a private company to another entity (the 'first interposed entity') where that payment or loan is an ordinary commercial transaction?’ to which the answer given is ‘yes’. TD concerns the application of the interposed entity provisions to a number of different transactions, it does not address the amount of the deemed dividend (that is addressed in TD 2011/16), but instead addresses whether the transactions could result in a deemed dividend. The examples given are:

1. A dividend paid by a private company on class shares to another company with no distributable surplus – the amount received is then on-loaned to another natural person class shareholder.
2. A fully franked dividend paid by a private company to its discretionary trust shareholder, where the dividend is appointed to a non-resident for tax purposes, but loaned onto a resident shareholder.
3. A private company subscribes for units in a unit trust which then on-loans the funds to an associate of a shareholder.
4. A private company:
    1. Pays a fully franked dividend to a family trust shareholder;
    2. The shareholder trust uses some of the funds to acquire a property;
    3. The shareholder trust disposes of the property to a beneficiary causing a loss;
    4. The loss is offset against the dividend in calculating the shareholder trust’s distributable income;
    5. The shareholder trust appoints the income to another private company (in the process giving it less than the dividend received because of the loss, with there being no UPE because the remaining amount is paid to the private company).
5. A trust owning shares in a private company revalues the shares upwards in year 1. The revaluation amount is appointed to a beneficiary. In year 2 a fully franked dividend is paid causing a reduction in value of the shares which is treated as a loss, reducing distributable income, with the income for the year being appointed to a private company (which pays no tax because of the franking credits). The value of the dividend is used to satisfy the beneficiary’s appointment of the revaluation amount.

2.3 Goodwill and distributable surplus

In the case where a loan is made, and either there is no written loan agreement or there is no or insufficient minimum annual repayment made, it is necessary to consider the amount of the deemed dividend that might arise.

The deemed dividend is the amount of the loan under section 109D or the amount of the shortfall under section 109E, but the amount that can be deemed to be a dividend is limited by the distributable surplus of a company as determined under section 109Y(2).

The distributable surplus is broadly the company's assets less the value of its presently existing legal obligations and certain provisions, as increased by payments or debts forgiven that have resulted in deemed dividends during the year, less paid up capital, and as adjusted for loans that have previously been deemed to be dividends (loans that are there still or that have been repaid).

Importantly, in determining the distributable surplus it is the amount of the 'company's assets (according to the company's accounting records)' that is used.

An amount often not shown in a company's accounting records is internally generated goodwill.

The Commissioner is given a discretion to insert a different value for the assets where 'the Commissioner considers that the company's accounting records significantly undervalue or overvalue its assets or undervalue or overvalue its provisions.'

It should be noted that the Commissioner is not given an explicit opportunity to value assets that do not appear in the company's accounting records.

The ATO in TD 2009/5 express the view that they do have the power to include a value for unrecorded goodwill. The ATO set out that they consider that their power to adjust values does not generally allow them to include a value for assets that are not shown on the accounts where accounting standards do not require them to be shown (note that there is no reference in 109Y(2) to accounting standards needing to be applied) but that they will use the power they consider they have 'where it is plain that the company, its shareholders and directors have acted, in making loans or other payments, in a way that treats the real and higher value of assets as their true value, that is, regardless of their value shown in the accounting records, and that the mischief against which Division 7A is directed is present, the Commissioner may, and generally will, substitute their true value.'

The ATO guidance on when the shareholders and directors have acted as if there was a higher value of the assets than that shown in the accounts exists only in two examples, and what might be able to be gleaned from those examples. Unfortunately, both examples are extreme.

In both examples the ATO have set out that assets (goodwill and then a building) that are recorded at less than their worth, but that worth is either 'assessed by the shareholders and disclosed to third parties' or 'disclosed to third parties'. The shareholders then borrow interest free from their companies and have no distributable surplus. The ATO conclude in both cases that without the ATO revaluing the assets the shareholder would receive a 'tax free informal distribution' by way of the interest free loan.

Consider in both examples though how the shareholders were able to borrow from the companies if there was no distributable surplus. They could have been borrowing against paid up capital, which is accessing shareholders' funds. They could have raised money from a third party off the back of the value of the assets, which would be using the company's property to effectively secure their debt.

It is submitted, that if what they are effectively borrowing is the share capital, there should be no mischief to be attacked by Division 7A. There would be no accessing of company profits.

Alternatively, where they are effectively using the unrealized gain in company property to fund loans from a third party, it is the third party's money that is being accessed, and not the company profits. A company can provide a guarantee to a third party (that is not a private company, see section 109U) that loans funds to a shareholder or associate of a shareholder without there being a Division 7A issue until such time as there is a liability to make a payment under the guarantee (see section 109UA).

In both ATO examples interest deductions should be denied if there is external debt funding, which is the only tax result that should flow from the arrangement.

In practice the problem set out here can arise when an adviser advises a shareholder that it would be easier for a company to raise finance and on-lend to a shareholder, rather than the shareholder borrowing money directly.

2.4 Later dividends - 109ZC

Section 109ZC is the provision that deals with a later dividend that is set off against an amount of a loan that was an earlier deemed dividend and allows that later dividend to be disregarded.

Paragraph 3.52 of the Explanatory Memorandum for *Taxation Laws Amendment Bill (No. 4) 2003* confirms that the purpose of s109ZC is to prevent double taxation.

A dividend taken to be paid under Division 7A is unfranked (section 202-45 of the *Income Tax Assessment Act 1997* (ITAA1997)). Since 1 July 2006 there has been no debit to the franking account because of the deemed dividend.

Section 109ZC only allows a later dividend to be set off to the extent it is unfranked. The provision provides:

> The amount of the later dividend set off or applied is taken not to be a dividend for the purposes of this Act, except Part 3-6 of the Income Tax Assessment Act 1997 (which deals with franking of distributions). However, if the amount set off or applied exceeds the amount of the later dividend that is not either the franked part of that dividend, or the part of that dividend that has been franked with an exempting credit, the excess is still a dividend.

The franked part of a dividend (distribution) is defined in section 976-1 of the ITAA1997, which when combined with the current definition of 'corporate tax gross-up rate' is[2]:

$$\text{Franking credit on the distribution} \times \frac{100\% - {}^{*}\text{Standard corporate tax rate}}{\text{Standard corporate tax rate}}$$

Thus, where \$30 of franking credits are attached to a distribution, \$70 (\$30 x (100% - 30%)/30%) will be the franked part of a dividend.

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[2] Note that the definition of 'corporate tax gross up rate' has changed under the *Treasury Laws Amendment (Enterprise Tax Plan) Bill 2017* so that it picks up the current year's franking rate.

So, where there is an initial deemed dividend because of a loan of, say $100, and there is a later dividend set off against that amount of $100 and that later dividend is unfranked, then the later dividend can be disregarded as section 109ZC(3) treats the amount as non-assessable non-exempt income.

Where the later dividend is a franked dividend of $100 however (which would carry approximately $43 in franking credits) the later dividend is not disregarded at all. Instead there would be effectively double taxation.

If there is a later unfranked dividend that is disregarded because of section 109ZC then the amount of credits that relate to the funds from which the actual dividend is sourced are left in the franking account of the company. Unless the company earns untaxed profits which these excess credits could be used to frank, such credits are wasted.

The failure to be able to offset a later dividend that is franked is especially unfair in the circumstances where a company with multiple shareholders makes a loan to one or more, but not all, of those shareholders (or their associates). In most companies, shareholders have a preference for franked and not unfranked dividends (because of the franking credits) and it is unlikely that shareholders who have not suffered (or benefitted from) Division 7A loans would accept unfranked dividends simply because they are more tax effective for people offsetting their loan repayment obligations.

The protection in section 109ZC also extends to later unfranked dividends that are on-loaned by the shareholder to an associate, for set-off and repayment of a loan by the company to an associate, that was an amount previously deemed to be a Division 7A dividend[3].

In practice, there are two things that could be observed about the operation of section 109ZC:

- You would not want to inadvertently set-off a later franked dividend against a loan that was previously a deemed dividend, to do so would tax the amount twice, though if the shareholder was on a low tax rate, perhaps the benefit of a refund of franking credits would make this palatable;
- The loan that is to be reduced by set-off could also be forgiven without a later Division 7A consequence because of section 109G(3) or (3A), though care would need to be taken that other tax consequences do not arise.

2.5 Sub-trust arrangements

When the Commissioner's view on Division 7A and UPEs publicly changed on 16 December 2009 and later with the release of TR 2010/3 and PSLA 2010/4, the Commissioner began to treat UPEs subsisting between related party trustees and corporate beneficiaries in some instances as loans.

[3] It can also be observed that a payment to a shareholder, for them to pay an amount for the benefit of someone else so that section 109ZC(1A) applies, is a transaction to which section 109T and 109V or 109W could apply, as set out in the 'Mum and Dad' example earlier in this paper.

In practice, this saw many accountants deciding that dealing with corporate beneficiaries as 'too hard' so that their clients needed to either appoint income to only natural people, or that amounts owed to corporate beneficiaries had to be paid to them before a Division 7A problem could arise.

Others decided to follow the Division 7A path set out for them by the Commissioner and treat the UPE as being a Division 7A loan at the time nominated by the Commissioner, being the earlier of the time that the tax return is lodged or due for lodgement for the trust for the year in which the UPE was created. A complying loan agreement would then be put in place by the company's lodgement day and Division 7A loan repayments would be made as required.

The Commissioner set out an alternative in PSLA 2010/4, a sub-trust arrangement, that does not seem to have been adopted by many tax practitioners. Two of the sub-trust arrangements set out in the PSLA allow for an interest only loan between the company and the trustee, with either a 7-year or 10-year maximum term, with the difference between the two being that the 7-year loan has a lower interest rate (the normal Division 7A rate).

The benefit of a sub-trust arrangement is that it allows complete flexibility in when principal repayments need to be made, with them only needing to be made in practice by the end of the term.

This is also the disadvantage in the arrangement if a client chooses not to repay until the end of the term and does not plan for the cash-flow implications of this (having to pay in cash or kind to the corporate beneficiary, or dividend out the profits).

The benefit of keeping cash or assets in a trust for a 7 or 10-year term where they might be used to make discounted capital gains, or of deferring top-up tax on dividends to the end of a 7 or 10-year term, combined with the benefit of flexible repayments (which might be made in a year where a shareholder's income is otherwise low) mean that using a sub-trust arrangement rather than a standard Division 7A loan should be carefully considered.

2.6 2011 and 2012 sub-trust arrangements

The Commissioner released Practical Compliance Guideline PCG 2017/13 on 19 July 2017. The Guideline provides guidance on the repayment of UPEs owing from a trust to a corporate beneficiary under a 7-year interest only sub-trust arrangement due to be repaid in full on or before 30 June 2018.

The ATO indicates in PCG 2017/13 that when a 7-year sub-trust (an Investment Option 1 arrangement) ends, any unpaid principal of the loan will be treated by the Commissioner as the provision of financial accommodation and, therefore as a Division 7A loan. However, the Commissioner accepts that a 7-year Division 7A complying loan agreement may be put in place between the trust and corporate beneficiary to allow for a further 7 years for the amount to be repaid (with periodic payments of principal and interest thereafter). This loan agreement must be put in place prior to the corporate beneficiary's lodgment day for the year in which the sub-trust arrangements ends. This means for a sub-trust arrangement that ends on 30 June 2018 (which is the most likely end date for a sub-trust in relation to a 30 June 2010 UPE) the due date for the written loan agreement will be the corporate beneficiary's lodgement date for its 2018 income tax return.

If a Division 7A compliant loan agreement is not put in place by the lodgement time, a deemed dividend will arise at the end of the year in which the sub-trust arrangement ends.

In PCG 2017/13 the ATO notes that where the facts and circumstances indicate that there has never been an intention to repay the principal of the loan at the end of the 7-year interest only period, the sub-trust arrangement will be considered to have not been entered into in accordance with PS LA 2010/4 and this may lead to the view that the purported arrangement was a sham and/or that there was fraud or evasion. In such circumstances, the ATO may go back beyond the standard period of review and deem a dividend in the income year in which the loan initially arose.

The ATO also indicate that they will not apply section 109R (which disregards certain repayments) to arrangements covered by PCG 2017/13.

The PCG does not consider what will happen when sub-trust arrangements ending after 30 June 2018 come to an end, though by that time there is expected to be legislative change.

2.7 Pre-16/12/09 UPEs and sub-trust arrangements

Prior to the Commissioner's views set out in TR 2010/3 and PSLA 2010/4 it was thought that an outstanding UPE between a trustee and a corporate beneficiary could cause a loan, payment or forgiveness involving the trustee and a shareholder or an associate of a shareholder in the corporate beneficiary to have Division 7A consequences under Subdivision EA of Division 7A.

The Commissioner considers that whilst a post-16/12/09 UPE can cause there to be a Division 7A loan between a trustee and a corporate beneficiary, it does not cause a transaction between a trustee and a shareholder or associate of shareholder to become subject to Division 7A under the interposed entity provisions in Subdivision EA of Division 7A. The reason for this position is set out in the final paragraphs of TR 2010/3, in the non-binding section of the ruling which finishes with '…the Commissioner will not treat a UPE that is subject to this Ruling and is considered to constitute a Division 7A loan as a present entitlement that remains unpaid for Subdivision EA purposes.'

Whilst the Commissioner expresses the view that post-16/12/09 UPEs are subject to Division 7A and so are not UPEs for Subdivision EA purposes, he considers that pre-16/12/09 UPEs are still UPEs, as are amounts brought under sub-trust arrangements.

Two points need to be made about the Commissioner's position.

One is that whilst I advocate for use of the sub-trust arrangements given their flexibility, care would need to be taken if they are used that it is recognised that the Commissioner's view is that these arrangements are subsisting UPEs that can cause Subdivision EA (section 109XB) to continue to apply to loans, payments and forgiveness transactions involving the trustee and a shareholder or associate of a shareholder in the corporate beneficiary.

The other point is that the Commissioner is either correct or incorrect about his view on whether a UPE can be seen to be a Division 7A loan. If he is correct, then Subdivision EA never had any work to do unless there was a sub-trust arrangement, and pre-16/12/09 UPEs cannot now cause Subdivision EA problems. If he is incorrect and a UPE is not a Division 7A loan, then UPEs have always been able to cause Subdivision EA problems, so that pre and post-16/12/09 UPEs can continue to cause problems, but there would be no need to put in place Division 7A loan agreements or sub-trust agreements. It is hoped that at some point some certainty will be obtained on which view of the Commissioner's is correct, that understood to apply pre-16/12/09, or the view he currently adopts.

2.8 Terms of loan agreements

Often facility agreements are used to ensure that future loans between a company and its shareholders or associates are covered by complying Division 7A loan agreements. Such agreements largely work by identifying whether a loan is covered by the agreement (to meet the ATO requirement in TD 2008/8) and state that the agreement will apply to any later loans.

In some cases though, it will be preferable that a loan not be covered by a Division 7A loan agreement. This could occur where the loan is made in a year where there is no distributable surplus, so that you would prefer that the loan is not covered by the agreement so that there would be a deemed dividend, but of an amount of $nil. If a facility agreement were to cover loans made in a year when there is no distributable surplus, then the borrower would be committed to making later minimum annual repayments, which if not made would be tested against a later year's distributable surplus in working out whether there is a deemed dividend.

I suggest reviewing the terms of your standard Division 7A facility agreements to determine whether you want them to operate when there is no distributable surplus.

Similarly, having a 'facility'[4] sub-trust agreement could lock your clients in to having to pay interest on a sub-trust arrangement where they might otherwise have been able to discharge a UPE in full without paying interest. Consider the position where a facility sub-trust agreement is place and a distribution is made to a corporate beneficiary. The interest would need to begin to be payable from the earlier of the time that the trust tax return is lodged or due for lodgement for the year that the UPE is created (e.g. 15 May 2017 for the 2016 year). If there is no sub-trust however, the resulting Division 7A loan, which would arise in the following year (e.g. the 2017 year), could be discharged without interest if paid out by the earlier of the time that the company tax return is lodged or due for lodgement in the following year (e.g. the 2017 year, so often by 15 May 2018).

Paying the interest would not be problematic if the interest is deductible to the trustee, and is not more than the net income of the trust for the year, as paying the interest would be akin to making a distribution to the beneficiary.

2.9 Washing machines

The ATO in their publication on section 100A[5] (the reimbursement agreement provision) set out an arrangement they say they section 100A would apply to, which involves Division 7A.

The arrangement involves the following, or some variant on the following:

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[4] Referred to as an 'ongoing investment agreement' by the ATO in https://www.ato.gov.au/printfriendly.aspx?url=/business/private-company-benefits---division-7a-dividends/in-detail/division-7a---unpaid-present-entitlement/ retrieved 17 May 2017.

[5] https://www.ato.gov.au/general/trusts/in-detail/distributions/trust-taxation---reimbursement-agreement/#Interactionofsection100AwithDivision7A retrieved17 May 2017

1. A trustee in year 1 appoints income to a corporate beneficiary in which it, or another trustee, owns shares, say a $100 appointment of income and tax law income;

2. This amount is not paid across to the corporate beneficiary, resulting in a UPE;

3. The company needs to pay 30% tax, and the trustee pays this amount on behalf of the company, reducing the UPE to $70;

4. In year 2, the corporate beneficiary declares a dividend to its shareholder, being either the trustee or another trustee, but with the consequence that the trustee that made the original distribution is now owed $70;

5. The trustee of the original trust and the corporate beneficiary agree to set off the dividend amount of $70 against the $70 UPE so that there is no longer a UPE that could become a Division 7A loan;

6. The trustee now has $70 of income and tax law income to appoint in year 2;

7. Start again at step 1.

The arrangement can be referred to as a 'washing machine' as the funds can go around and around.

The ATO consider that as the corporate beneficiary does not get the benefit of the distribution then the reimbursement agreement provision can apply to tax the trustee at the top marginal rate.

2.10Prior period Division 7A issues

A detailed explanation about what to do with historic Division 7A is cover in detail in a paper prepared for the Queensland Branch in a 2015 session for the Private Business Retreat, simply titled 'Division 7A'. Historic issues are those that arise after a tax return has been lodged without the taxpayer that should have been assessed on a deemed dividend including the amount in their return.

The short version of that paper is that to deal with a prior period Division 7A issue you need to:

1. Identify the issue, usually this will be Division 7A, but could be something else such as PSI (so that the amount taken from the company could be NANE under section 86-35 of ITAA1997) or interest deductibility (such as where a company borrows to make an interest free loan to a shareholder).

2. Identify the taxpayer that should have been impacted by the Division 7A issue. This could be a company in relation to a debit that should have occurred in its franking account in relation to a pre-1 July 2006 deemed dividend, or the taxpayer that should have paid tax on the deemed dividend, noting that it is the person that benefits from the loan, payment or forgiveness that is taxed, and that person is not necessarily a shareholder.

3. Identify the year in which the issue arose. The scheme of Division 7A is that it operates on a year by year basis. The existence of a large debit loan balance in 2016 does not mean that there is a 2016 issue, it is effectively the loan movement from year to year that might result in a deemed dividend for a particular year.

4. Either:

    1. Identify whether the assessment for the year in which a deemed dividend should have been included in assessable income is out of time for amendment or within time; or

    2. Work out whether there was sufficient distributable surplus in the year in which the deemed dividend arose to quantify whether some or all of the loan, payment or forgiveness should have been a deemed dividend. Here you need to have regard to the reduction in distributable surplus that arises because of amounts that have been deemed to be dividends in earlier income years.

5. If there is a deemed dividend and it is within time to be dealt with by way of amendment, make a decision between:

    1. Making an application to the Commissioner for him to disregard the deemed dividend or allow it to be franked under section 109RB; or

    2. Amend to include the amount of the deemed dividend; or

    3. Do nothing, noting that the Commissioner may treat doing nothing in relation to the deemed dividend amount as a basis for later making a finding of evasion.

3 The future of Division 7A

In the 2016 Federal Budget papers Government set out that there would be changes to Division 7A that will apply from 1 July 2018. The purpose of discussing them here is to speculate on how the changes might alter the way that Division 7A needs to be dealt with, and in one case, in identifying what action might need to be taken prior to 1 July 2018 in preparation for the potential changes.

Note that I have no specific knowledge on what the changes will be or how the changes will be implemented.

Ten Year Enterprise Tax Plan — targeted amendments to Division 7A

Revenue ($m)

	2015-16	2016-17	2017-18	2018-19	2019-20
Australian Taxation Office	-	-	-	-	*

The Government will make targeted amendments to improve the operation and administration of Division 7A of the *Income Tax Assessment Act 1936* (an integrity rule for closely held groups).

These changes will provide clearer rules for taxpayers and assist in easing their compliance burden while maintaining the overall integrity and policy intent of Division 7A. It includes a self-correction mechanism for inadvertent breaches of Division 7A, appropriate safe-harbour rules to provide certainty, simplified Division 7A loan arrangements and a number of technical adjustments to improve the operation of Division 7A and provide increased certainty for taxpayers.

These changes draw on a number of recommendations from the Board of Taxation's Post-implementation Review into Division 7A and will apply from 1 July 2018.

This measure is estimated to have an unquantifiable cost to revenue over the forward estimates period.

This measure forms part of the Government's Ten Year Enterprise Tax Plan, which will encourage Australians to work, save and invest.

The 2016 Budget also contained the measure dealing with reducing the corporate tax rate over time, that found expression in the *Treasury Laws Amendment (Enterprise Tax Plan) Bill 2016* which passed through Parliament on 9 May 2017. While it was necessary for the tax rate changes to be introduced early, given for small business entities the tax rate changes apply from 1 July 2016, it is regrettable that we have not yet seen consultative material or draft legislation on the Division 7A changes. It is however possible that confidential consultation has been going on.

In addition to the summary above the Budget Fact Sheet No 4 'Less Red Tape for Business' set out the following:

> Some tax rules are complex and difficult to apply, imposing unnecessary red tape and cost on business.
>
> One particularly complex set of tax rules is Division 7A of Part III of the Income Tax Assessment Act 1936. This Division contains detailed rules to determine what kinds of benefits to shareholders and their associates are treated like unfranked dividends and therefore subject to personal income tax without any credit for company tax paid.
>
> Breaches of these complex rules result in additional tax being imposed on income distributed by businesses.
>
> **The details**
>
> The Coalition Government believes that it should be as easy as possible for businesses to comply with the regulations and laws that apply to them.
>
> For this reason the Government will work with stakeholders to develop targeted changes to simplify Division 7A and make it easier to understand and apply. Subject to the outcomes of consultation, the Government will amend these rules to include:
>
> - A self-correction mechanism providing taxpayers whose arrangements have inadvertently triggered Division 7A with the opportunity to voluntarily correct their arrangements without penalty;
> - new safe harbour rules, such as for use of assets, to provide certainty and simplify compliance for taxpayers;
> - amended rules, with appropriate transitional arrangements, regarding complying Division 7A loans, including having a single compliant loan duration of ten years and better aligning calculation of the minimum interest rate with commercial transactions; and
> - technical amendments to improve the overall operation of Division 7A.
>
> These changes will mean less red tape, greater certainty, improved integrity and more time for businesses trying to do the right thing to get on with actually doing business.
>
> The changes are expected to commence from 1 July 2018.
>
> **Budget impact**
>
> This measure has an unquantifiable cost to revenue.

The Board of Taxation's Post-Implementation Review included a number of other recommendations, but from the above it is not clear which recommendations will be adopted, and in what way. In particular, it is not clear whether the Board's recommendation that the treatment of UPEs be simplified, with pre and post-2009 UPEs becoming 10 year loans, and that the 'business income election' be adopted for trusts, will be accepted. The business income election would allow a trustee to distribute to a corporate beneficiary without Division 7A applying if they agree to forego the CGT discount on pre-existing assets that are not goodwill or assets inherently connected with a business carried on by the trustee.

3.1 Self-correction mechanism

The Board recognised in their second discussion paper that the current mechanism allowing relief from the effect of Division 7A under section 109RB involves excessive compliance costs for taxpayers.

One of their recommendations was that there be a self-corrective action that allows putting complying loan agreements in place and making catch up payments of principal and interest. They also suggested that self-correction should only be available where, on the basis of objective factors, the breach that triggered Division 7A was unintentional and that voluntary corrective action be prima facie evidence that the original breach of Division 7A was unintentional.

They also recommended that in the case of corrective action there be a shortfall penalty of 25% where the breach was from failure to take reasonable care, but only 5% where the self-correction was made voluntarily.

Another part of the self-correction commentary by the Board recommended that the decision not to allow a 109RB application should be subject to the objection and review procedures in Part IVC of the *Taxation Administration Act 1953*. It is entirely unclear whether Government intends to adopt this recommendation.

3.2 Safe harbour

The safe harbour rules recommended by the Board in relation to the use of assets. Currently where a shareholder or associate of a shareholder uses an asset there is the potential for that use to be treated as a payment for Division 7A purposes, subject to an otherwise deductible rule and certain other carve-outs. The Board recommended:

- In relation to depreciating assets, that a rental charge could apply, as would occur under an operating lease. The amount to be paid would comprise of an interest amount, a depreciation component and an amount for the relevant asset's other operating costs; and
- For appreciating assets such as land and buildings, a usage charge could apply, calculated by multiplying the statutory interest rate by the asset's indexed value, which could be updated with an arm's length valuation every five years. The usage charge could also include an amount representing the relevant asset's other operating costs.

3.3 Amended rules

The Board's recommendation for the amendment of the Division 7A rules was to have only 10-year loans, at the RBA indicator lending rate for a small business – variable – other – overdraft rate for the month of May immediately before the start of the year in which the loan is made. This rate would then apply for the term of the loan.

There would be no need for a formal written loan agreement, merely written or electronic evidence by the lodgement day that the loan was entered into.

There would then be prescribed maximum loan balances during the term, which would include accumulated interest, so that the loan balance would be at most:

- 75% of the original loan by the end of year 3;
- 55% of the original loan by the end of year 5;

- 25% of the original loan by the end of year 8; and
- 0 at the end of year 10.

There would be no specified annual repayments subject to the above requirements for minimum balances being correct.

Interest would then be able to be accrued annually, but would need to be paid by the end of years 3, 5, 8 and 10.

The Board made additional recommendations and it is not clear whether they will be picked up along with the 10-year term:

- That where a payment has not been declared as a deemed dividend it be treated as a loan, so that later deemed dividends can arise;
- That deemed dividends where milestone payments are not met (at years 3, 5, 8 and 10) be the amount of the shortfall in the required balance, with interest calculated at the statutory rate, less amounts **assessed** as deemed dividends in earlier years.
- That the ATO period of review for payments commence at the date of lodgement for an income year in which each milestone payment is required.
- That there be administrative guidance on what constitutes acceptable evidence that a loan was entered into by the lodgement date, presumably in the absence of there needing to be a complying loan agreement.

3.4 Transitional rules

The Board recommended in addition to the 10-year loan terms noted above, that there be transitional arrangements put in place to bring all loans, excepting 25-year loans, onto 10-year footing.

This would involve:

- Grandfathering existing 25-year loans;
- Bringing all pre-4/12/97 loans onto 10-year terms from the time of the application of the new provisions;
- Extending the term of existing 7-year loans to 10-years; and
- '*where the Commissioner is out of time to assess a deemed dividend arising from a payment, the rules should stipulate that the taxpayer is prevented from asserting that the payment was not made in the context of a loan.*'

There are two action points that come out of the above list, should it be adopted by Parliament:

1. Ensuring that any current 7-year loans that might be refinanced to be 25-year loans are refinanced as soon as possible. This is in case it is decided at the time the new draft legislation is introduced Parliament decides not to grandfather 25-year loans after this date.

2. Considering the implications of forgiving amounts recorded as pre-4 December 1997 loans so that they will not be required to be repaid in future.

In relation to pre-4 December 1997 loans it should be noted that the ATO issued a Practice Statement in 2006, PSLA 2006/2(GA) where they set out that the ATO will not take 'active compliance action' in relation to determining whether pre-4 December 1997 loans should have resulted in deemed dividends because they became statute barred at some point and were therefore required to be accounted for as deemed dividends under section 109F(3).

If it turns out that the debt has become statute barred at an earlier point, then it would be prudent to write it out of the accounts of the company to prevent it potentially becoming necessary to put the loan on 10-year terms. The Commissioner also considers in the Practice Statement that a loan that has been refreshed outside of the statute period (which cannot happen in NSW) does not result in there being a new loan that is subject to Division 7A.

Despite the Board's recommendation that pre-4 December 1997 amounts be brought under 10-year loan terms, that a debt that has become statute barred in NSW cannot be legally recovered means I would suggest, that it cannot be made subject to a 10-year term. This issue will no doubt be raised during the consultation phase.

If the decision is made to write a pre-4 December 1997 loan out of a company's accounts regard would need to be had (particularly if the amount was not statute barred in a period that is not out of time for amendment) as to whether there are other implications of the amount being forgiven to the borrower such as:

- Ordinary income being derived
- A fringe benefit being provided
- A capital gain arising
- Commercial debt forgiveness applying
- The value shifting rules applying

