Division 7A Essentials
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CCH Learning:

Hello, everybody and welcome to today's webinar, Division 7A Essentials. My name is Susannah Gynther from Wolters Kluwer CCH Learning and I will be your moderator for today. A few quick pointers before we get started. You'll find the PowerPoint presentation in the handout section on the go-to webinar panel. If you're having sound problems, please check your audio settings, try to toggle between audio and phone, and just a reminder that within 24 to 48 hours, a notification for the e-learning recording will be emailed to you.

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For CPD purposes, your viewing is logged automatically. Your presenter today is Carlo Di Loreto from Crowe Australasia, an affiliate of Findex. Carlo is a partner and provides taxation advice on a broad range of taxation issues to many Crowe Australasia clients, including privately owned businesses and public companies. Carlo's expertise covers small business relief, capital gains restructures and GST related advice. He works with individuals, partnerships, trusts, and companies from many industry groups including property investment, manufacturing, mining technology, engineering, and retail. I'll now hand you over to Carlo to commence today's presentation.

Carlo Di Loreto:

Thank you very much, Susanna. Hello, everyone, and welcome to our first technical session for the 2023 calendar year. I trust everyone's had a really good break over Christmas and New Year and you've all come back refreshed and ready to tackle another year of taxation. So today's webinar, as Susanna has pointed out, is Division 7A Essentials and we've adopted a two stage approach this year for Division 7A and we'll follow up with a more advanced session later on.

Now, what we'll cover in today's presentation is really just a refresher of the key principles, how they apply in practice. We'll spend a little bit of time on trust because that always causes us a few issues, touch on the distributable surplus, and also just update you on the changes to unpaid present entitlement so we'll refer to those as UPS today because there's been some significant changes that came into effect on 1 July 2022.

We'll touch on some other key provisions and finish off with the commissioner's discretion and where Division 7A might be heading in the future. Now, before we go on, what I'd like to say is while this is an essentials presentation, in my experience and being involved in many Division 7A reviews and audits and also in the provision of advice, I've found that really the ATO very rarely have to go into the advanced topics that's in Part 2 of our presentation. Invariably, all the errors that are found in ATO audits are found in the basic or essential provisions that we are going to cover today. That might sound surprising to you given that a lot of what we cover, if you've been operating in tax for a while, you'd look at this and you'd think, "Well, yeah, this is fairly simple."

Yet, if that was the case, we really need to question then, "Why is it that these basic principles are really the low-hanging fruit that the ATO constantly finds in reviews?" and I would say, if you've got clients who are in the private space, whether they be a Top 500 private group or a Next 5,000 or even an emerging private group, they're the three categories of ATO review, be assured that if you or your client is selected for a review, Division 7A will always be on the list of things to review. So that's why I think it's important to go over the essentials and of course, we'll cover the more advanced topics at a later time. So let's have a look at the provision.

So critical date, 4th of December '97 and from that date, Division 7A had application to three broad types of transactions, your payments to either shareholders or their associates, and we used the definition in the 1936 Act which is within the CFC provisions there, covers loans which we're probably most familiar with, and of course, debts forgiven. Interesting point, the last one here, the last bullet point talks about Division 7A applying to non-share equity holders. So what that means is you would have to classify a financial interest in a company as either a debt interest or an equity interest under the debt equity rules and you'll find those in Division 974 of the '97 act.

So a non-share equity holder is someone who holds a financial interest in a company but they are not shares. So they might be, on the surface, a loan but that loan has failed the debt test so that's what a non-share equity interest is. So that would then make you a non-share shareholder for want of a better term. So just be aware that it's not always straightforward as to what is a debt interest, what is an equity interest, but you can be a shareholder without knowing it because you hold a non-share equity interest.

There's also a couple of interesting provisions. 109BB just makes it clear that closely held corporate limited partnerships are affected by Division 7A and B, C which was added into the legislation many years ago. Now, just to make it clear that non-resident private companies are affected by this where they have Australian resident shareholders. That's just for clarity there.

So the first category that we'll look at briefly is payments to shareholders. So if you have a private company making a payment to a shareholder or their associate, that's going to be treated as a dividend at year-end unless it's excluded and we'll cover exclusions in a moment. So when you're looking at payments, it's really very broad so a payment accrediting or a transfer of property to a shareholder or their associate or on their behalf or for their benefit.

Again, very, very broad. Now, a few years back, the legislation was also amended to cover where assets are used by a shareholder or associate. Now, previously, before this change came in, in some circumstance, it was possible for shareholders and their families to use, for example, a holiday home owned in a company but that is clearly now going to fall within this use provision and you'll find that in 109CA of the '36 Act so just be aware of those things. They're the sort of items at the ATO very are very happy to discover when they do a review. The main area of Div 7A is most likely going to be loans and possibly UPS which we'll cover shortly.

So in order to trigger a deemed dividend here, you've got to have a loan during the year of income and it's got to be made by a private company and it's not fully repaid by the lodgement day and we'll cover that in a moment. Now, of course, if you do have this situation and it's not an excluded loan which is under 109N of the '36 Act and it's made to a shareholder or their associate or a reasonable person would conclude that the loan is made because that entity has been a shareholder or associate at some time, all of these things you've got a deemed or a potential deemed dividend.

So just because the recipient is not a shareholder or associate at that time, you need to go and search the history a little bit and ask some questions to make sure that they haven't been one in the past. And then, the reasonable person test is always a very difficult one to apply. It's not done from the aspect of a lawyer or a tax accountant, it's really done by what would the average person think of this situation? So I'd be very careful there. Lodgement date, very simply, just simply means the earliest of the due date for lodgement of the company's tax return so that's the private company and the actual date.

Now, there's a similar concept for trust which we'll cover us separately in a moment. So when we talk about loans, what do we mean by a loan? Well, essentially, it's an advance of money which is pretty much the legal definition but then you'll see that this definition gets extended and the next one. I think, is particularly problematic. It's provision of credit or any other form of financial accommodation. It's a very broad term and we'll see the commissioner using that when we go and have a look at our UPS a bit later in the presentation. It's also where there is a payment of an amount and there's an obligation to repay. Again, that's more in line with the general legally accepted definition of a loan and anything which is, in substance, a loan.

Now, there is an interaction with FBT here so if you've got a loan, it will be caught by Division 7A even if the recipient is an employee. So in other words, Division 7A operates before FBT when it comes to loans. Be very careful with freshening up old loans. So you would've done the right thing back in December '97 and quarantine these pre-4th of December loans. Please do not extend their term or increase their amount. Now, if you find that these are at call loans and interest free, I would not even put a loan term in there, I would really just leave it alone. If you do any of those two things, extend or increase, you will refresh that loan and it will then become a loan that is subject to Division 7A so I would be very careful with those loans.

There's a number of excluded loans and payments. So genuine debts, what that means is the private company is simply repaying a presently existing obligation to someone and that's fine. Company to company is generally okay but be aware that there are some anti-avoidance provisions that apply a look through. If the loan or payment is accessible in the recipient's hands, then Div 7A doesn't apply.

Ordinary course of business, just exercise a little bit of caution there. That exclusion is in 109M in the 1936 act. One of the requirements to use that exclusion is that the private company extends a loan to a shareholder or associate on substantially the same terms as it does with parties at arm's length. I've seen many people try to use this in your typical family or private group. Be aware that in most situations, these private companies in our family groups do not lend to parties at arm's length. They generally only lend to related parties, so it's going to be very difficult to demonstrate that the terms are similar to dealings with arms length parties, so be very careful on that one.

The next one, the certain criteria, that is 109N which we'll talk about later and then there's an exclusions for liquidator's distributions. Be aware that that is subject to a time limit so this is for companies that are being wound up and that's generally around 18 months. There are certain employee share schemes where loans made under those would be excluded and then there is a general exclusion if you can show undue hardship. So the final category would be forgiveness of debts. So if you forgive a debt to a shareholder or associate, then you trigger a deemed dividend so the debt's forgiven if you release, waive, or otherwise extinguish in some way.

The other way that you can forgive a debt is if a reasonable person, and again substitute the word average there, would conclude that the company will not insist on repayment of the debt. Now, if this provision applies, then the commercial debt forgiveness rules don't apply. Now, this is what I'll call an in-substance forgiveness. So in other words, a reasonable person decides that, "Well, yes, we think the company will not insist on repayment of the loan," can have particular application to our pre-4th of December loans.

Now, a lot of these have become statute barred because if you don't repay a loan or there hasn't been a call made on that loan for six years, then generally under the various state laws, the limitations, statute prevents you from seeking recovery after that point in time. Now, the ATO is saying they're not going to look at statute barred pre-4th of December loans. However, be very careful with these ones because if those loans have been refreshed, say annually, then the statute of limitations hasn't been triggered.

So you have a live pre-4th of December loan and the risk is the ATO comes in there after all this time and says, "Well, we think the company doesn't want to take action to recover this loan." So be very careful with these. Probably the next question it comes to mind is, "Well, what do we do with these?" Well, you've probably already done the first suggestion here and that is quarantine these accounts, don't extend the term or increase the loan, and do not forgive the loan. I would suggest give some thought to repaying this loan over an extended period of time. I did that with one of our clients many years ago who borrowed some money pre-Div 7A to buy their main residence. When Division 7A came in, we advised some of the risk in this area and the client was happy to pay off the loan over 20 years.

The client was used to getting substantial dividends each year so it was really quite possible to divert part of those dividends to meet a small annual repayment each year. So something to think about, you can certainly pay down a loan. The reason for doing a little repayment schedule, even if it's only small amounts, is it demonstrates that the loan is being repaid and that the company is calling on repayment of that loan. Otherwise, the risk is still there but, I will reiterate, only if the loan is still live and being refreshed.

Now, if you want to know how to refresh a loan, if you've got private companies in a client group that are being audited each year because they might be large, one of the real issues you have is that the directors will probably be asked by the auditors to seek confirmation from its debtors that the loan... Or to acknowledge the loan and that acknowledgement can actually then refresh the loan and therefore, your statute of limitations may not have been triggered which makes it a live loan. So just something to be aware of and it's easy to overlook. Okay, Susanna, I'll hand over to you to run our first poll question for today.

CCH Learning:

Thank you, Carlo. So poll question Number 1, Division 7A can apply to loans, payments, and other benefits provided by a non-resident private company. Is that A, true or B, false? I'm going to launch the poll so please click in the radio button next to the answer you believe to be correct, I should say, and I'll just give you some time to answer the poll.

Just a reminder that if you do have any questions, please put them into the questions box and we'll get to those questions at the end of the presentation. I'll just give you about 10 more seconds to get your votes in so please get your votes in now. Okay. I'm about to close the vote so please, any last minute votes, get them in now. All right. I'm going to be closing the vote. Okay. Closing it now. Let's have a little look. All right. So 69% said it was true while 31% was false. Back to you, Carlo.

Carlo Di Loreto:

Thank you, Susannah.

Hmm. Thank you, Susannah. Thanks, everyone, for having a go at that. Yes, if you said true, you'd be right and we covered that right at the very start of the presentation today. So those of you who got that one wrong, you probably have to pay a little bit more attention because this is where the ATO can get you on a review on missing out on some essential and fundamental principles.

So let's just quickly cover then another topic which is really loans made under 109N so excluded loan agreements. So just a couple of key points here. Make sure that agreement is in writing and it's done before the lodgement date of the company's tax return. I've included the benchmark interest rates there. You can see that they're probably starting to climb again. So while it's not a huge increase from '22 to '23, I'm expecting that FY '24 will be a bit higher and these rates are set just before the start of the financial year so that 4.77% probably comes from around June of last year.

So in June this year, we'll see what the FY '24 rate looks like. I think rather than doing a loan agreement each year, use a facility agreement that way, you enter into it once and it's covered then for each shareholder and I think that is a much better way and then it prevents you forgetting to put one in place. The interesting thing about the way the minimum yearly repayments work in the interest is you only start paying interest the year after the loan is advanced. In terms of the loan agreement itself, it's very simple. Just identify the parties, the terms of the loan which would be the amount and the period of time so it's either 7 or 25, that there's general agreement. I would also have in there a reference to interest at the benchmark interest rate, make a specific reference and you might also want to include the requirement to make minimum yearly repayments as well. You could even put the formula in there which I'll show you in a moment.

The maximum terms are here, 7 or 25, but 25 needs to be secured and if you do that, it's got to be real property and that real property has to be at least 110% of the value of the loan so be very careful. I'd recommend that if you're talking about fairly large loans, I'd certainly be looking for a formal valuation of the property and make sure that valuation is done by a person who is knowledgeable and experienced in relation to the property that's being offered. So if it's commercial property, yeah, use a value of who's got experience in that area.

You can extend a 7-year term to 25 years, easily done. Of course, the security has to be offered, registered mortgage over real property yet again. Again, make sure you have the right valuation support in place. 25 is the maximum so any years that have already expired under the original 7 years have to be eliminated. So you cannot have the total period here exceeding 25 years and so, there's extension or there's refinance. There's two ways of doing it. Either way, you cannot extend beyond 25 years in total so just be aware of that.

This is the formula for the minimum yearly repayment which I'm sure you are all familiar with. The benchmark interest rate for the year goes in there and then the remaining term on the bottom line and you use this to calculate your minimum yearly repayment each year. There is provision for the commissioner to extend the period of time to make your minimum year yearly repayment but I wouldn't rely on this so make sure you do it on time by 30th of June each year.

If you don't do that, then a deemed dividend's going to arise and in order to get the commissioner to exercise his discretion, you're going to have to show that there were circumstances beyond your control that led to the deemed dividend arising which can be difficult to do. So again, very important to talk to clients well before year-end just to make sure everything is organized. If you have to rely on this, make sure you put the request to the commissioner in writing, setting out in detail all of the circumstances to give yourself the best opportunity to get a favourable decision from the commissioner. So the commissioner will look at all of the circumstances of the shortfall and any matters he considers relevant. Therefore, the more information you provide, the better your chances so something to consider there in case you need to rely on it.

In terms of the way the loans work you, you'll often find that in the course of a year, clients will draw down a number of different amounts. Now, provided that each of those drawdowns is all done on the same time period, so 7 years or 25 years, all of those drawdowns form one amalgamated loan in a particular year so that's all the amalgamated loan provisions really does. What that does is just simplifies then the way we calculate our minimum yearly repayments and you don't have to do separate calculations for each drawdown in a year.

There's also a very important anti-avoidance rule in 109R that operates to disregard repayments if a reasonable person concludes that the shareholder intended to obtain a similar or larger loan. So this is really designed to prevent people from repaying and then borrowing to avoid deemed dividends, to avoid minimum yearly repayments, and all of that. So the ATO tweaked this and back in July 2009, they made a few changes.

Now, the way we used to get around this prior to July 2009 was you borrowed a further amount from the company and then used that to repay the existing loan. You can't do that now. So from 1 July 2009, that strategy is no longer available to us. There are some exclusions. So if you are converting a 7 year to a 25 or vice versa, 109R doesn't apply to that so you don't have to be worried about that. Also, if a refinancing is involved because there's an arms length transaction such as with a bank that's required that, so there's a few exceptions to 109R applying.

Okay. So we'll move on now to talk a little bit about trust and the application of subdivision EA. So this is something we have to consider if a trust confers what we call a present entitlement or PE to a private company. So in other words, the trustee has appointed net income of the trust to a company and then the trust makes a payment, a loan or forgives a debt to a shareholder or associate of a shareholder in that private company.

So what that looks like is this, you have a trust, there's a UPE to a private company which either exists at the time a trust makes a payment loan or forgiveness to a shareholder or associate or subsequent to that, it doesn't matter, the UPE doesn't have to exist when that payment loan or forgiveness takes place. So when we are looking at these provisions, it talks about a due date for lodgement of the trust's return so that means the due date or the earlier of the due date or actual date, that's what the lodgement deadline means so very similar to the company lodgement deadlines we talked about earlier.

Now. That present entitlement to the private company can arise after the payment loan or forgiveness is actually made. So if there is a present entitlement conferred anytime right up to the trust lodgement date, then these provisions can apply. So deferring that present entitlement isn't going to save us from a deemed dividend.

So it applies if you have a payment that represents an unrealized gain, if you make a loan, if you forgive a debt by a trustee to a person who is a shareholder or associate of a private company and then the trust also has that unpaid present entitlement owing to that private company. Quick word, unrealized gain, what that means is you might have assets in a trust that are recorded at book value but have increased in value significantly. There is a practice goes back many years to re-value those assets and then to make a distribution out of that asset re-valuation reserve. So if you do that now, source a distribution out of that, that can trigger a deemed dividend.

If you satisfy all of these conditions, then essentially the trust is treated as if it was a private company for Div 7A purposes and that payment loan or forgiveness is in a deemed dividend paid by the trust to the shareholder or associate but that deemed dividend can be limited by the distributable surplus of the private company that has the unpaid or the UPE from the trust.

So important to note that just because you've created a PE does not necessarily create a problem under EA regardless of whether the present entitlement is from net income or from an unrealized gain. The problem occurs if you've got this PE and then you do one of those three things, a payment loan or debt forgiveness to a shareholder or associate. So one thing we'd want to do with this present entitlement is just make sure we describe it as that in the accounts of the trust and the company balance sheet. Don't call them loans but be aware that some trust deeds automatically convert PEs to loans so be very careful there. It just changes, potentially, the timing of things and we'll cover UPEs in a bit more detail shortly because there are other circumstances now where it creates a problem regardless of whether you have a loan payment or forgiveness to a beneficiary so just be very careful.

Review the trust deed and I strongly recommend read the trust deed each year. So trusts that have a present entitlement that they owe to a company, look, these loans that arise then sudden death. You've got a couple of options to deal with this. You can repay the loan before the lodgement date. Be careful of the anti-avoidance rules in 109R and that involves re-borrowing or you can enter into a written loan agreement before the trust lodgement date. So if a trustee has made a loan to a shareholder or associate, these are the two things you can do. So you could enter into a 109N loan agreement between the trust and that individual or that individual could think about repaying that loan before the lodgement date. There's some exceptions as we've found earlier on as well. So if it's trust to company... Sorry. If that payment alone is made to another company, you should be okay.

Again, forgiveness with another company, okay. 109M, ordinary course of business, I've already covered that. Be careful with that one. The trust paying down a genuine liability won't be caught as a payment or loan or whatever and you can also make sure that the trustee actually pays out the entitlement to the company before the trust's lodgement date. Commercially, what that means is you've got to transfer the cash to the company and often, that is a real restriction in our private groups. I'm not going to spend much time on this slide but just be aware, when we are talking about trusts and UPEs and distributions to companies, reimbursement agreements must be considered so section 100A. We're not going to cover this today at all, it's just here as a bit of a flag.

You can have a look at TR 2022/4 recent ruling that the ATO has issued on that. This is a very complex area. So what I would like to do is properly address this in a separate session, probably in the second half of this calendar year but always be aware of 100A when you're doing a distribution to a private company. Okay. Just moving on, a quick word on the distributable surplus because as we've seen, if your distributable surplus is low or nil, you may not have a deemed dividend. So important to get the calculation of this right and I have seen some terrible mistakes made in this calculation in the audit of very high net wealth individuals, so be very careful with it but that's the formula there. Net assets, you add back Division 7A amounts, and then you deduct your non-commercial loans, your paid up share value, and your repayments of non-commercial loans and that's your distributable surplus.

So the Division 7A amounts, really, that was brought in there because there were some strategies going around which artificially reduced the distributable surplus so the previous formula didn't cope with this. One of the ways you could do that is you could sell an asset by a private company to a shareholder at less than market value and it could then cause the company's distributable surplus to be very low or even nil. Now, of course, you have to add this back in there and the reason this was allowed to happen is because your distributable surplus is calculated at the end of the year and it doesn't take into account what's happened during the year.

So there you go. This is designed to prevent or cut out that artificial reduction in distributable surplus. When we talk about non-commercial loans, that's basically a loan that's been treated as accessible income either under the old 108 or under 109 C or D and repayments are also disregarded. So once you've been hit with Division 7A, it then doesn't stay in your distributable surplus calculation. So if you have a nil surplus, then there would be a nil deemed dividend. Now, if you have a loan and you have a nil surplus, if you were to forgive that loan subsequently, just be aware if you have a distributable surplus in that later year, you can still trigger Division 7A and a potential deemed dividend in that later year. Okay. That's all I have for this part so I'll hand it over to you, Susanna, to run through our next poll question please.

CCH Learning:

Thank you for that, Carlo. So here is poll Question 2. Which of the following is the correct formula for calculating a company's distributable surplus? Now, I am not going to read this out. I'm going to let you all sit and read this because I just know that I'll get my pluses and less' all mixed up so please have a look at your possible answers, A, B, or C or 1, 2, 3 as they are there. And so, I'm going to actually give you some time to read the slide so that you can think about the answer because on our poll question, when I launch it, I'll say acronyms to describe each part because it wouldn't fit in the question for my poll.

So now that you've had a chance to perhaps look at each different one, I'm now going to launch the poll and you can see what I've got. So as you can see, please, A, B, or C. So NA is net assets, NCL is non-commercial loans, PUSV is paid up share value, and as I said, NCL is non-commercial loans. So please pick A, B, or C and just a reminder, if you have any questions, please put them into the questions pane. Okay. So I'm just going to give you a few more moments to put in your vote. Okay. Get in those last minute votes because I'm just about to close it and I'm closing the vote and let's have a little look. So 58% said the answer was C, 30% said B, and 13% said A. Back to you, Carlo.

Carlo Di Loreto:

Thank you, Susanna, and thanks, everyone, for having a go at that. Those that said C would be right. So when we do our calculation, we start with net assets and generally speaking, net assets is just taken straight from the financial statements. Of course, the commissioner has some ability there to play around with asset values so you got to be really careful with your starting point. But as we've covered, we add Division 7A amounts, these are amounts that could be used to artificially reduce our distributable surplus. But then, we reduce our calculation for non-commercial loans and repayments of those loans because they've already been affected by Division 7A and of course, paid up share capital reduces the surplus also. So thank you, everyone, for having a go at that and we'll just continue on with our final section of the presentation today.

We're going to spend a little bit more time looking at unpaid present entitlements because as you're probably well aware, there's been some significant changes to this in the last six months. So the starting point here is if we look back to before TR 2010/3 came out some 13 years ago, very common practice for a corporate beneficiary to be made presently entitled to trust income and for that entitlement to not be satisfied, hence the unpaid present entitlement. So while the company paid tax on its share of the trust's net income relative to that entitlement, the funds remained with the trust.

So the UPEs essentially tax up the corporate rate as opposed to potentially much higher rates that would've been applicable had that distribution been made to individuals within the family group. Then, the trust uses those funds as working capital or might purchase personal assets for individual beneficiaries or their associates or what have you. But either way, the benefit would go to other entities and not to the private company beneficiary. Now, in the past, the ATO didn't treat these UPEs as loans for Division 7A purposes but that all changed in 2009.

They realized they had significant amounts of UPEs, probably around a billion dollars at the time, and then immediately, that caused them some concern. So the concern was that as a trustee, you could accumulate income for I guess... Well, not effectively no cost but certainly, there was some tax to be paid by the company but certainly, the trustee retained those funds and didn't have to pay anything for the use and you could use these for trust purposes rather than set those funds aside for the benefits solely of the corporate beneficiaries.

So that resulted in the ruling TR 2010/3 and the view that the UPEs may in fact be loans. So what we're dealing with here is quite different to what we covered under subdivision EA. This is just a straight application of Division 7A to an unpaid present entitlement that a trust owes to a private company and the ATO's view now is that UPE is a loan for Division 7A purposes. So you need to be aware of TD 2022/11. These are the ATO's current views on Div 7A and unpaid present entitlements.

It was released in July last year and it applies to trust entitlements that arise on or after 1 July '22. So any distributions made in the June '22 income tax year, you can still rely on TR 2010/3 and the Practice Statement 2010/4, those continue to apply for that income year. However, those two publications have been withdrawn and will have no application from 1 July 2022.

So the other thing to note is the Determination 22/11 won't apply to UPEs that arose before 16th of December 2009 and that's essentially the line in the sand that the ATO drew when they brought out Taxation Ruling 2010/3. You might remember we were asked to do the right thing there and quarantine those UPEs in the accounts which hopefully, we've all done. So those UPEs remain untouched and somewhat protected from the ATO.

So the reason for this is that the ATO take the view that a company provides financial accommodation if it's a beneficiary of a trust. So you have the trustee resolving to make this company presently entitled to some income and doesn't discharge the obligation to pay that private company, that's how we have the UPE. Where the private company is made presently entitled and the trustee sets aside this amount on subtrusts, you might think, "Well, maybe I'm safe there." Unfortunately, you're not. Even if you go to the trouble of establishing a genuine subtrust arrangement, if the subtrust then allows those funds to be used by the main trust and to benefit others, then you still have a financial accommodation. So very important to be aware of this change from 1 July of last year.

There's a couple of circumstances that the TD talks about and the first one is where the trustee makes a private company presently entitled to income and doesn't discharge its obligations, that's clearly the provision of a financial accommodation and a loan under Division 7A arises. It arises when the company has knowledge of an amount that it can demand immediate payment from the trustee but doesn't demand that payment. So this is where you have your loan, 109D(3) is the relevant definition. It's a form of financial accommodation. There's another circumstance... Oh, sorry. We'll come to another circumstance shortly but the timing of things is that if you have a corporate beneficiary and a trustee with the same directing mind, the corporate beneficiary is taken to have knowledge of that UPE, that it can demand immediate payment of when the trustee knows about it.

But generally speaking, the ATO recognizes that typically, this time when the corporate beneficiary knows is generally later. So it might be after year-end when the accounts are finalized and this is the case regardless of how the distribution is worded, whether it's a fixed amount, whether it's a percentage, or some combination of fixed and calculable amounts. So that's the first thing.

So if there's a U P E that you declare, say, on the 30th of June 2023, in reality, the financial accommodation is considered to be provided essentially in the following year. And then, what about the other circumstance that the ATO talks about is where we've got a subtrust? Unfortunately, if that subtrust makes those funds available to the broader trust, then a financial accommodation is still going to be provided even if that subtrust applies those funds on commercial terms, that is still a financial accommodation, Division 7A will be triggered.

My reading of TD 22/11 is that if you were to set up a genuine subtrust and invest those funds independently, so you might put it in a term deposit or you might invest in a managed fund or a managed investment, by way of example, and that is for the sole benefit of the corporate beneficiary, that could be acceptable because the funds are not being used by the broader trust and the beneficiaries of the broader trust. But in reality, in commercial limitations, those funds are generally needed in the main trust. Therefore, even if you do try and set up a subtrust, you're most likely going to be caught under Division 7A.

So worth recapping, what was the situation like prior to 1 July '22? Well, we had 2010/3, the ruling, and the Practice Statement 2010/4 applying. So anything arising on or before 30th of June '22, those two publications still apply. So in that ruling, you might remember the ATO classified UPE arrangements in two forms, your Section Two loans which are loans within the ordinary meaning and your Section Three loans which are caught by Division 7A because they fall within the extended meaning.

So those two publications have the ATO's view that a UPE could be the provision of financial accommodation where it hasn't been paid out and the trustee fails to hold those funds on subtrusts for the sole benefit of the company and you would have to do that subtrust by the main trust lodgement day and I guess the commissioner confirmed that if you were able to do that, if you were able to set up a proper subtrust and the funds were used only for the company's sole benefit, you wouldn't have a Division 7A problem.

These are the factors that the ATO think give rise to a valid subtrust. If you invest those funds on commercial terms, if all the benefits from the investment flow back to the subtrust in the company and all the benefits are actually paid, then you would basically have a good subtrust arrangement so very limited and many people probably didn't avail themselves of the subtrust solution. Instead, what they might have done is use one of the three investment options that the ATO made available to people.

So you're probably very familiar with this. One option was an interest only 7-year loan, an interest only 10-year loan, or invest in a specific income producing asset. To be clear now, any entitlements arising from 1 July 2022, these are no longer available to you. However, for the year just ended, June '22, these are still valid options for you.

So prior to the TD coming out, if you had a subtrust arrangement, you could have invested that in the main trust. So the main trust could use it for working capital and it could be based on interest only loan arrangements and what have you. However, just to be very clear, from 1 July 22, these arrangements are not going to be effective and they will not avoid triggering a deemed dividend under Division 7A. So yeah, big changes and it does cause us to be very careful in our planning in the current year so in the FY '23 income year.

Now, there's a number of other provisions which we won't be talking about today but they're the more complex provisions that you should be aware of. I mentioned briefly the use of private company assets under 109CA. There's also loan back to the trustee so these are anti-avoidance provisions in 109XA. There's payments through interposed entities, again, an anti-avoidance or I guess, integrity measure. Then, there's measures that cover indirect present entitlements and indirect trust payments as well as indirect trust loans. And then, there's also loan guarantee provisions in 109U. So these are more complex provisions which we will cover in an advanced session.

Just to wrap up today's presentation, we need to make a mention of the commissioner's discretion in 109RB. So if the worst happens, and let's hope that it doesn't, your client's triggered a deemed dividend under Division 7A. One resort you may have is to apply to the commissioner for the exercise of his discretion under this particular section. So this can be exercised if a deemed dividend arises and that deemed dividend happens because of an honest mistake or inadvertent omission by either the shareholder or associate, the private company, or any other entity whose conduct contributed to Division 7A being triggered. That could be us, it could be another advisor.

The key thing to note here is you have to go through a gateway or the commissioner needs to go through a gateway before he can exercise this discretion and he's got to be satisfied that the deemed dividend arises because of an honest mistake or inadvertent omission. If you can't demonstrate that either of those things has happened, then the discretion is not available to be exercised. One of the problems that we do have is that as registered tax practitioners, we're expected to be competent and knowledgeable and it would make it a bit harder, I think, for clients who use registered tax practitioners to claim honest mistake or inadvertent omission. So have a careful look at the facts and circumstances. You need to, I think, pursue this in writing and really set out as much supporting and factual matters as you can to strengthen your case on this one.

If you are successful in showing honest mistake or inadvertent omission, then what the commissioner can do is he can disregard the dividend or he can allow it to be franked. However, franking is really only a benefit if the individual involved is actually a shareholder of the company. If not, it might be very difficult. The decision can be made retrospectively as well so dividends arising in the 2001/02 and later years are impacted by this so be very careful. My advice is steer clear of Division 7A problems but if you are caught out or your client, should I say, is caught out, there is this discretion which you might be able to use.

If you have a look at Taxation Ruling 2010/8 ATO talks about what an honest mistake or inadvertent omission is so things like an incorrect view or understanding of how the provisions operate or perhaps incorrect understanding of the facts or other matters. So all of these things could be very important in demonstrating that you have made an honest mistake. Inadvertent omission means failure to take action that's relevant so it could be failure to put in place, say, a loan agreement or what have you.

Ignorance of Division 7A should lead to that honest mistake or an inadvertent omission and I think that's where it becomes a little difficult where registered tax practitioners and other skilled advisors are involved. It's difficult to show ignorance of Division 7A in those circumstances so something to think about and certainly, have a look at the ruling. Also, have a look at this Practice Statement 2011/29. Now, what the Practice Statement is, is the commissioner's guidance or instruction, for want of a better word, to his tax officers on how to deal with these sorts of requests under 109RB.

The final point I'd like to make today is you're probably all sitting there wondering, where are these changes to Division 7A? Now, back in the 2016/17 Federal Budget, it was announced that changes would be made, things like a self-correction mechanism, safe harbor's technical adjustments to improve Division 7A's operation and increase certainty. There was also talk of a different benchmark rate so moving away from the current one to one which actually will give us a much higher interest rate which is not good news but also, having just a single maximum loan term of 10 years rather than two.

All of these wonderful changes and announcements are made so long ago and unfortunately, I can't report anything new because there is no draft legislation out on this yet. All the deadlines have long since passed. So now, the rule is that any changes will come into effect in the year that Royal Assent is given for the legislation. So yes, we all sit here waiting and I think there's no doubt, just going through the simple provisions we have today, that some change would be a good thing. So thank you, everyone, for your attention and I'll hand over to Susanna to run through any questions and close the session.

CCH Learning:

Thank you very much for that, Carlo. Yes, we will be spending the next few minutes taking questions so just a reminder to please type them into the questions pane. We do have quite a few questions already so we'll just have to see how we go.

I will mention, however, some of our upcoming webinars. So tomorrow, we're looking at succession planning. Just a reminder that unfortunately, our choosing a business structure webinar that was scheduled for tomorrow has unfortunately had to be postponed. We will be sending out information shortly in regards to a new date for that webinar. Then next week, we'll be looking at salary packaging opportunities. We're also looking at back to basics for financial law agreements. We're going to be thinking about how to maintain our stamina and motivation for the marathon in 2023 and looking at financial reporting, what to expect in financial and sustainability reporting in 2023.

So let's have a little look at our questions. Okay. So Carlo, my first question comes from Joanna. Joanna was asking, "In regards to the lodgement due date, what if the company's original lodgement due date is extended? Does that new date then apply?" I'm assuming that-

Carlo Di Loreto:

Thank you.

CCH Learning:

Yep.

Carlo Di Loreto:

Thank you, Susanna. Look, I meant to check up on that, Joanna, so I'm really sorry that I didn't so I won't give you a definitive answer but I believe that does extend the due date for lodgement. So if you get a formal extension from the ATO, then that would be your due date for lodgement but I think you can very, very quickly look up on the ATO website. I did think about that and I just forgot to go and double check before the presentation today but I think that the new due date for lodgement would then apply.

CCH Learning:

Thank you. So there you go, Joanna. Might just need a small confirmation on that. I then have a question from Edward. Edward was asking, "Company A made a loan to its sole director, shares held in a family trust that he's the shareholder in trustee Company B. Do we apply Division 7A to the loan made from Company A?"

Carlo Di Loreto:

Yeah. That's a really good question. So Company A is the private company and you can correct me if I've misunderstood the facts but if the director is a beneficiary of that trust, then he may very well be an associate of a shareholder. So if the family trust owns the shares in that private Company A, then very likely, there is a risk there that it can apply. So probably need a bit more clarity on the factual background on that but the key, and even if we don't know the facts, it's fine. The key thing here is to work out whether that director, that individual, is either a shareholder of Company A or an associate of a shareholder of Company A.

So you'd need to go back, have a look at the ownership share structure of Company A and then have a look at how the trust fits in and then go back to the definition. If you look at Section 318 of the 1936 Act, there's a definition of associate for individuals, for companies, for partnerships, for trusts, and see if this director, if he's not a direct shareholder, whether he's an associate under those rules. So I think all of these questions, they're highly factual and we would need a lot of precision on the group structure but I think if you follow that path, I'm pretty sure you'll get an answer quite accurately. Thank you, Susannah.

CCH Learning:

Thank you for that, Carlo. We also have another question from Edward. He asked, "If a shareholder failed to pay the minimum yearly repayment, do we add the shortfall to the old loan balance or create a new loan for the shortfall?"

Carlo Di Loreto:

Yeah. That's a really good question. It's not a new loan, you've essentially got a deemed dividend equal to that shortfall. So therefore, once you've triggered Division 7A, then you could consider, I don't know whether this will work in your situation, but you could consider just forgiving that shortfall because the individual's going to be taxed on that. So you wouldn't show it as a new loan per se, it just stays part of the existing loan. But one of the things you can consider is because you've triggered Division 7A, is... Well, you could potentially look at a forgiveness there.

CCH Learning:

Thank you for that, Carlo. I hope that helps you there, Edward. Alistair had a question. He just asked, "If the loan is repaid by the lodgement date, does interest apply at all?"

Carlo Di Loreto:

Yeah. No, I believe it does because if you are paying it by the lodgement date, you are then in the subsequent income tax year. So if you were to repay the loan by the end of the tax year, I don't believe you'd have any interest obligation but I think if you wait until the lodgement day, yeah, you are then potentially... Actually, no. Let me take that back because it's a bit of a tricky situation because there's no requirement to enter into a loan agreement. Sorry. I'm a bit blindsided by that one. So you may not actually have to. No, I agree. Without a Division 7A loan agreement in place, there would be no requirement to have one if you repay by that date, then there's no obligation there.

CCH Learning:

Thank you, Carlo. There you go, Alistair. I have a question from Shahan. Shahan asks, "If we assume that the lodgement date for a company was the 15th of May '22, would it be any difference if we entered into the complying loan agreement on the 1st of January '22 or the 1st of July '21?"

Carlo Di Loreto:

So the loan agreement, the deadline is the due date for lodgement so you're right about that. Would it make any difference? Look, to be honest, in practice, I've never done that. I've never had that situation where we do it in advance. We usually just wait until... Well, the first time that it happens, we just usually typically put in place a facility agreement so we only do it the one time and I don't believe it makes any difference simply because of the way that the rules work.

If you have the loan and it's not repaid by the end of the income tax year that you've made it, then as long as you have your loan agreement in place, you then start making minimum yearly repayments which includes interest in the year after the loan is first advanced. So I don't believe the timing of when you enter into the loan agreement is an issue, what's important is that you put it in place by the due date which is the lodgement date and it has to be done before that date so it's 15th of May. I wouldn't do it on the 15th of May, I'd be doing it well before that. So thank you for that one, Susannah.

CCH Learning:

Yeah. That's all right. He also asked, "Do we need to accrue interest from the lodgement date which is the 15th of May to the 30th of June?"

Carlo Di Loreto:

No, no. You'd have to accrue interest from 1 July of that year."

CCH Learning:

Right.

Carlo Di Loreto:

Yeah. For the whole year, not just for that short period. You have to accrue it for that whole year. So the agreement is made in, say, on the 14th of May 2022, then essentially what that means is the loan was made up to the 30th of June '21 so you are accruing interest from 1 July '21 to 30th of June '22.

CCH Learning:

Thank you for that. So there you go, Shahan. Fiona had a question, "If you have distributable surplus in the first year of the loan and pay a dividends in a subsequent year but have new distributable surplus in a future year prior to the end of the loan period, do you still need to pay a dividend in that year or does the loan no longer require a minimum payment?"

Carlo Di Loreto:

Well, look, the loan... Yeah. That's a very interesting question. So the loan always requires a minimum yearly repayment because you're under an excluded loan agreement but the issue is that if you don't make that minimum yearly repayment when there is no distributable surplus, then there are no Division 7A consequences. So I think that's as simply as I can express that, Susanna.

CCH Learning:

Thank you for that, Carlo. There you go, Fiona. We have a question from Ming. Ming is asking, "A non-resident private company made a loan to a temporary tax resident here, if it is deemed to be an unfranked dividend, will the temporary resident be exempt from it because it is his overseas investment income?"

Carlo Di Loreto:

Yeah. That's a really good question. Off the top of my head, I don't have an answer to that. Yeah. It's a little bit more on the complex side but yeah, I'd have to give that some thought. It's a tricky one once we start involving temporary residence. Thank you.

CCH Learning:

Okay. Well, there you go, Ming. What we might do is we'll let Carlo have a thought and maybe we can provide an answer to be put up with our e-learning recording. Would that be all right, Carlo?

Carlo Di Loreto:

Yeah.

CCH Learning:

Yep. All right.

Carlo Di Loreto:

Thank you, Susannah.

CCH Learning:

So Ming, we're not able to answer that question right now but we'll get an answer for you to be posted with the e-learning recording. I have another question from Shahan. Shahan is asking, "If a trust makes a UPE to a company in Year 1 then if the UPE is not settled in Year 2, do we need to convert the UPE to a loan? If yes, do we need to record a journal entry in the company/trust to re-classify the UPE to a loan?"

Carlo Di Loreto:

Look, I'll address this one just based on the new position as it is no so the current year, so under the new tax determination. So if you make a UPE on the 30th of June this year, the loan is going to be deemed to arise next year which means you then have until the lodgement date of next year's return to put in place a Division 7A loan agreement so just be very careful with the timing of that.

None of what I just said applies if you are talking about a UPE in the June 2022 year because the existing rules in TR 2010/3 and Practice Statement 2010/4 apply if you are talking about a UPE in the '22 year and there's no journal entries or anything needed simply because you'd be recording this as a UPE which is fine but it's Division 7A that treats it as a loan.

The fact is it's still a UPE unless, of course, your trustee says otherwise but what we're talking about here is taxation treatment. So I don't believe you need to do anything fancy with your accounting on this particular one but just be aware that if you are talking about a UPE that's going to arise this current tax year, then the new TD applies to you and that loan or that financial accommodation is generally generally taken to arise in the following year because that's when the corporate beneficiary, the ATO considers that's when they're most likely to know.

So then, all the timing rules then get triggered from that in terms of when an excluded loan agreement is needed and also when minimum yearly repayments need to be made. So thank you very much for that, Susanna, and I think if we can just leave it there, Susannah, because time has marched on and if there are any further questions, if you'd like to send them through, I can respond directly to those.

CCH Learning:

Oh. I realized I've just been on mute but that's okay. I'd like to thank you, Carlo, for the session today and to you, the audience, for joining us. We do hope to see you back online for another CCH Learning webinar very soon. Enjoy the rest of your day. Thank you very much.

Carlo Di Loreto:

Thanks, Susannah.