Division 7A Update
22/11/2023

CCH Learning:

Hello, everybody, and welcome to today's webinar Division 7A Update. 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. In the handout section, you'll find the PowerPoint slides for today's presentation. 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.

You can ask questions at any point during the presentation by sending them through the questions box. I will collate those questions and ask them at the Q&A towards the end of today's presentation.

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Your presenter today is Mark Chapman, director of Tax Communications for H&R Block Australia. Mark has over 25 years' experience as a tax professional, both in the UK and Australia, specialising in tax for small businesses and individuals. He is a member of the Institute of Chartered Accountants in England and Wales, the Chartered Institute of Taxation and is a fellow of CPA Australia.

He also holds a master's of taxation law with the University of New South Wales. I will now pass you over to Mark to commence today's presentation.

Mark Chapman:

Good afternoon, everybody, and thanks for taking the time to call along to today's session where we're going to be looking at the latest developments around Division 7A. Basically, as Susannah said, if you've got any questions which spring to mind during the course of the session, do please feel free to type those in the comments box. At the end of the session, I will hopefully have time to deal with questions. If I don't or if I don't know the answers to the questions or if you come up with something after the session has ended, do please feel free to email me. My contact details are on the final slide of the presentation.

Over the course of the next 55 minutes, basically, well, I'll give you a bit of an overview of the current legislation for Division 7A outlining the way the current law works and also outlining some of the possible ways of avoiding Division 7A. I'll then give you a very quick overview of the proposed changes to Division 7A legislation, which are currently... Well, who knows where they are? Basically they seem to have been buried, but we know that the government hasn't taken them off the table completely, so therefore you do need to have those at the back of your mind.

Then I'll spend quite a lengthy part of the session talking about the latest developments surrounding UPEs. This has been a bit of a saga really starting from 2009 onwards and culminating in the recent Bendel case, which has potential at least to completely rewrite the rules for UPEs and Division 7A. I'll give you an update of that.

And then at the end of the session, I'll also run through the latest ATO warning in relation to Division 7A, which is in relation to an arrangement where a holding company isn't deposed to access company profits tax free.

In terms of the current Division 7A legislation, I'll start with an overview of the way that Division 7A currently works. And by way of background, if you are a shareholder of a private company and you want to get some money out that private company, the theory is that you should do so in a taxable form. You should take, for example, unfranked dividend out of profits, or alternatively if you're an employee, you should get a wage or a salary.

Division 7A is designed to catch payments out of a private company to a shareholder or their associate, which basically aren't otherwise taxed. Under Division 7A amounts which are paid, lent or forgiven by a private company to certain associated entities, which includes individuals, basically treated as unfranked dividends.

Division 7A applies to payments, loans or amounts forgiven to shareholders, associates of shareholders or former shareholders or former associates. It is very much about catching those payments, which without Division 7A would simply be tax-free to the shareholder or their associate. As Division 7A treats these payments or loans as unfranked dividends, so a Division 7A deemed dividend, an unfranked dividend, it's generally taken to be paid at the end of the income year of the private company in which the amount is paid, lent or forgiven.

Now, there are all sorts of possible transactions which will give rise to Division 7A. However, four of the most common ones are set out on this slide, so in a situation where the company pays the private expenses of the shareholder or their associate out of company funds. In a situation where the company lends funds to shareholders without a loan agreement possibly at no interest or a reduced interest rate, Division 7A will apply in that situation.

In a situation where the company gives or allows to be used its assets for free or less than market value, such as for example, where a home is owned within the company or a boat is owned within the company, and the home or the boat is made available to shareholders or their associates.

And the fourth one, which we'll talk about in far more detail in the second half of the presentation are unpaid present entitlement issues if the company happens to be a beneficiary of a family trust. That's the particular controversial one, which we'll talk about in more detail later on.

All of those types of transactions are basically going to be subject to Division 7A because they're a way of getting funds out of the company to the individual basically in the absence of Division 7A completely tax-free, and therefore Division 7A catches them.

Now, how can we avoid Division 7A? Well, the simplest answer is that if a loan is paid out to a shareholder or an associate, that loan can simply be repaid. Alternatively, it can be put on complying loan terms. A payment or another benefit that's potentially subject to Division 7A isn't treated as Division 7A dividend. If it's repaid, that's the obvious route or if it's converted to a complying loan by the company's lodgement day for the income year in which the payment occurs.

Now, a company's lodgement day is the actual day on which the company lodges its income tax return or it's the due date for lodgement, whichever is earlier. Basically, a shorthanded way of looking at that is that the company's lodgement day is the 15th of May in the year following the year in which the payments are actually made.

Now a complying loan agreement has to have a certain number of features. Firstly, it must be in writing. Secondly, it should identify the names of the lender and the borrower. Thirdly, it should set out the essential conditions of the loan, including the amount of the loan, the requirement to repay the loan, the interest rate payable, which is basically going to have to be the benchmark interest rate set by the ATO, which is currently about 8.27% and also the term of the loan. And fourthly, the loan agreement must be signed and dated before lodging the income tax return. All of those conditions have to be met in order for it to be a complying loan agreement.

Now, there are two types of complying loan agreements. First of all, there's an unsecured loan and that has a maximum term of seven years, or there's a secured loan which has a maximum term of 25 years, and the security has to be by way of a mortgage over real property where the market value of the property is at least 110% of the loan amount. And with each of those types of Division 7A loan agreements, there's an obligation for the individual to make minimum loan repayments and they must be made by the 30th of June each year. And those minimum loan repayments consist of interest and capital.

Now, the law does contain some exceptions, which are basically payments made by private company to a shareholder or to its associate which aren't treated as unfranked dividends. Examples include a repayment by genuine debt owed to a shareholder or its associate, a payment to a company but not a company acting as a trustee. If one company pays another company, there's no Division 7A loan there. A payment that's otherwise accessible under another provision of the act, a payment made to a shareholder or shareholders associate in the capacity as an employee or an employee's associate because typically, those payments would be subject to either PAYGW or alternatively FBT and a liquidator distribution.

Those types of payment, the five types of payment on the slide there are not actually included within Division 7A.

Now, there are lots of common traps. There are lots of areas where people routinely screw up their Division 7A responsibilities. These are simply some common ones, but there are lots of them. It is a very, very easy mistake to make to get involved in Division 7A and not realise it or to realise it and not do anything about it.

Common traps, for example, the first one is entering into a 25-year agreement related to property or forgetting to register a mortgage or leaving it too late to register a mortgage in time for tax return lodgement date. Keeping poor records of amounts paid, lent or repaid, it isn't possible for you to accurately establish what the Division 7A balance is actually are at a point in time because the ATO may well ask to see those records. And obviously, their substantiation requirements do require that proper records are kept. And if they're not kept, basically you don't really stand the chance if the ATO audits you.

The third one is obviously failing to put in place a compliant loan agreement by the deadline. This is a very common situation where an accountancy practise might've taken on a new client. They look at the books, and they see that there've actually been all these Division 7A loans in the past and the previous accountant hasn't declared them as Division 7A loans. They come to you and say, "Well, can we rectify that to retrospectively? Can we go back and put in place a compliant loan agreement?"

Well, no, the compliant loan agreement has got to be put in place by the 15th of May following the year in which the loan is made and if it is after that, then basically it's going to be subject to Division 7A. Failing to abide by the terms of the compliant loan agreement, for example, setting the interest rate too low. Particularly in the current climate, many people might bulk at paying 8.27% interest plus the capital repayments in respect of a compliant loan and they might say, "Well, I'm not paying that. I'll pay 3% or 4%."

Well, that's fine, but in that case, the agreement that they've entered into is not a complying loan agreement and though they've obviously got themselves into Division 7A hot water by doing that. Or failing to make the necessary loan repayments in accordance with a compliant loan agreement. Again, very common shareholders go through the motions of putting in place a compliant loan agreement. It's worded properly, it's signed, all the terms are there and then quite simply, they don't follow through and make the minimum yearly repayments. And therefore, they give themselves a Division 7A liability in relation to those outstanding minimum yearly loan repayments.

In addition, there are three forms of statutory relief from the operation of Division 7A. They're contained in Section 109Q, Section 109RD and Section 109RB. And basically, these either disregard or extend the obligations according to the commissioner's discretion. For example, the commissioner may disregard a failure to make a minimum yearly repayment. If he's satisfied that the failure was due to circumstances beyond the shareholder's control and the inclusion of the deemed dividend in their accessible income would cause undue hardship. That's in Section 109Q. It's quite difficult to prove on due hardship. There's a very high bar for that.

Section 109RD says that the period for making a minimum yearly repayment may be extended by the commissioner in cases where the failure to make the minimum yearly repayment was due to circumstances beyond the shareholder's control. And Section 109RB says that the commissioner has a discretion to completely disregard a deemed dividend or to allow the deemed dividend to be franked if the dividend arose because of an honest mistake or inadvertent omission.

Now, let's explore that in a bit more detail what is an honest mistake or an inadvertent omission and in what circumstances can the commissioner exercise the discretion to disregard that deemed dividend. Well, basically there's a two-step process to obtain that relief. First of all, we've got to ask ourselves, was Division 7A triggered because of either an honest mistake or an inadvertent omission? Secondly, if the answer to that is yes, the commissioner then needs to determine whether the discretion should be granted taking into account a whole range of circumstances, including the circumstances that led to the mistake or omission, the extent of attempts to correct the mistake or omission, and if so, how quickly that action was taken.

Whether Division 7A has operated previously, so whether the company asked for, for making Division 7A loans and if so, the circumstances in which this occurred and also any other matters that the commissioner considers relevant.

Now the terms honest mistake and inadvertent omission aren't defined in the tax legislation. However, according to the ATO, a mistake is an incorrect view, opinion or misunderstanding as to how Division 7A operates and such a mistake must be honestly made. An omission on the other hand, is a failure to take action that's relevant to or affects the operation of Division 7A and such an omission must be inadvertent.

Now, a mistake or an omission arising as a result of ignorance can attract relief under this section provided the state being ignorant or the reasons for it are honest or inadvertent. There was a recent case two or three years ago, which involved a firm of tax agents which made Division 7A loans out to the shareholders. This firm of tax agents was routinely advising clients on a daily basis about how Division 7A works, and they also claimed Section 109B relief on the basis that there'd been an honest mistake or an inadvertent omission.

Basically, the course looked at that and said, "Well, you're a tax agent. You are advising other clients on Division 7A. So how can you argue that you personally have made an honest mistake or inadvertent omission because you should have known better?" That's an example of a situation in which Section 109RB would not be given.

Deliberate action to remain ignorant of the requirements of Division 7A, including taking a head in the sand approach where the taxpayer is generally aware of the existence of the provisions wouldn't constitute an honest mistake or inadvertent omission. That's the situation which I'm sure we've all encountered, where the client is aware that there are these loans floating about and they're potentially aware that they can't make a loan such as that, and they simply choose to bury their head in the sand. They think that if they ignore the ATO, if they ignore the legal provisions, nobody will notice, nobody will care. That is not an honest mistake or inadvertent omission.

Now those are the current rules. That's obviously very, very quick, very brief overview. However, it's probably worth bearing in mind that the proposed changes and what those proposed changes actually are. These proposals have been around for over a decade really. There's a Board of Tax review back in 2012, discussion papers 2014, which led to the issue of a treasury consultation paper, which was named "Targeted amendments to the Division 7A integrity rules" which came out at the backend of the last decade.

The proposals in that consultation paper were intended to be put into legislation which would apply from the 1st of July 2019. Now, we came to 2019, there'd been no legislation and the federal government announced that the start date for these new measures have been shifted to the 1st of July 2020, which was of course in the early phase of COVID when there was obviously a great deal of other matters on the radar for the federal government.

Therefore, on the 30th of June 2020, the government announced that the new rules will now apply, but not until the date of royal ascent of the enabling legislation. They committed to the principles of these changes, but basically they have kicked into the long grass the actual legislation which will bring them about.

Now obviously since then, there's been a federal election, the government has changed and hasn't been any further word on what's happening with these changes. The labour government hasn't said it won't introduce these changes, but on the other hand, it hasn't said that it will. So, at the moment these changes are certainly still in the ether, but they're very much on the back burner.

What are the changes? Well, the proposal is that the 7-year and 25-year loan model will be replaced with a single 10-year loan model. At the same time, interest rates will increase. The RBA rate, which is proposed to be used, is actually a higher one than the current one. Obviously, that's particularly concerning because even under the current interest rate, rates of interest are 8.27%, so it'll be even higher potentially if these proposals are passed into law.

There's a revised method for calculating repayments whereby the principal amount is written off in equal annual instalments over the term of the loan. If you've got a hundred thousand dollars loan over a 10-year loan model, basically there'll be $10,000 of principal repayable each year. An interest will be calculated on the opening balance of the loan each year using the benchmark interest rate, and there won't be any requirement for formal written loan agreement, which is quite a significant change.

Some other key changes, the concept of distributable surplus is to be removed. On the current legislation, a Division 7A loan can't exceed the amount of distributable surplus, which basically means that in a situation where the company doesn't have a distributable surplus, it can't make Division 7A loans. That concept is to be removed completely.

Self-correction mechanism is to be introduced in terms of the interaction between Division 7A and FBT. If the payment is made to a shareholder in the capacity as an employee, but it isn't subject to FBT, then Division 7A will apply instead. This is to be an optional safe harbour formula to be introduced to simplify the market valuation of private company assets such as houses, boats, cars, et cetera, used by shareholders. And this is to be an extended period of review for Division 7A.

Currently, the ATO is restricted to the standard four-year period of review. That needs to be increased 14 years after the end of the year of income in which the loan payment or debt forgiveness gave rise to or would've given rise to a deemed dividend. That's basically the current four-year period plus the period of the 10-year loan agreement gives us that 14-year period of review. The ATO can potentially go back up to 14 years. That will apply from the commencement date. There are some pretty radical changes in there.

Obviously, there's no point getting too upset about that because these changes, they may not happen. They may happen but either way, it will be several years into the future. But it is worth bearing in mind that Division 7A has a potential to change quite dramatically.

Now, let's just spend a little bit of time talking about UPEs. What is a UPE? Say, we've got a trust with a corporate beneficiary and that trust makes a distribution to that corporate beneficiary, but it doesn't actually pay that distribution. The corporate beneficiary is taxed on that distribution at a rate of 30% usually, or possibly 25%. But because the trust hasn't actually paid it across, the trust has still got the cash.

The trust couldn't either make a loan or another payment to some other shareholder or an associate or it can simply retain the cash and use it for, pardon me, and use it for its own purposes. That is a UPE.

Now until December 2009, the ATO basically accepted that UPEs were not subject to Division 7A. Pre-December 2009, basically if there's a UPE out there, it won't be subject to Division 7A. However, in 2009, the ATO changed its view. And the ATO basically said that UPEs will be subjected to Division 7A going forward on the basis that the company hasn't called for the payment or investment of the UPE. In effect, the company is actually agreeing that the funds representing the UPE can be used for trust purposes.

Now the rules surrounding UPEs were set out in a taxation ruling in 2010. The original draught came out in 2009, but the actual ruling was 2010/3. That basically set out the rules and said that UPEs aren't going to be subject to Division 7A going forward. However, there were three opt-outs and they were set out in PSLA 2010/4.

That document states that the UPE won't be treated as a Division 7A loan if the funds are held on a sub-trust for the sole benefit of the corporate beneficiary with taxpayers determining the appropriate terms of the investment or adopting one of the three safe harbour investment options.

And those three investment options are option one, that the funds are invested on an interest only seven-year loan at the Division 7A benchmark interest rate, that the funds are invested on an interest only 10-year loan at a prescribed interest rate, that's option two. Or option three, that the funds are invested in a specific income-producing asset or investment. In either situation, if one of those three options is pursued, the ATO accepts that a UPE would not actually arise in that situation.

Now rolling forward to 2017, obviously there may well have been UPEs which came about in 2010 or 2011 and by 2017, they would be in danger of maturing if that seven-year option for example had been pursued. The UPE would've been potentially maturing and therefore, the question arose as to what happens then. So PCG 2017/13 introduced effectively a rollover.

For example, if the amount was put into an interest only loan on seven-year terms in 2010, the 2017 PCG basically allows the company to put the trust to roll that over into a further seven-year loan. Basically, it allowed option one or option two arrangements to roll over.

That PCG was reissued in each subsequent year in 2018, 2019, et cetera, allowing those UPEs as they came off their original option one or option two loan to be rolled over, and that treatment applied to all UPEs which are arising during but not after because we'll come to that in a moment, 2021, 2022 until the maturity of the sub-trust arrangement.

Now, that potentially could be the 14th of May 2030 in terms of an option one agreement or the 14th of May 2033 in term if it was an option two agreement.

Just as an aside, it's worth bearing in mind that loans under particularly option one or option two, that they were considerably beneficial for the borrower because normally with a Division 7A compliant loan agreement, it's necessary to make a minimum yearly repayment which consists of both interest and capital.

However, under these arrangements it's possible to simply pay interest and leave the capital outstanding. Having said that, obviously with interest rates having gone up recently over the past year or two, the benchmark interest rate for Division 7A is currently 8.27%. It's likely to go up again next year. Therefore, potentially the borrowing costs do actually far outweigh the interest income which the trust can earn.

Now those arrangements lasted until the 30th of June 2022, at which point, the ATO changed its position and thereafter issued a new tax determination TD 2022/11 to apply to trust entitlements that arise on or after the 1st of July 2022.

Now, for trust entitlements that arose on or before the 30th of June 2022, that previous tax ruling TR 2010/3 and the previous law administration practise statement PSLA 2010/4 continue to apply. However, from the 1st of July 2022, those documents are withdrawn and they're replaced with a new TD which has actually greatly toughened the ATO's position.

TD 2022/11 does state that the company does provide a financial accommodation to the shareholder or the associate where that amount is set aside by the trustee and held on sub-trusts, and the company consents to those funds being used by the shareholder or associate. And therefore in those situations, Division 7A will arise.

Now according to TD 2022/11, a private company beneficiary with a UPE will provide a financial accommodation to the trustee when the company has knowledge of an amount that they can demand immediate repayment of from the trustee but does not do so. Therefore, the company has consented to the trustee retaining the funds for continued use for trust purposes.

Now, how is knowledge actually defined? Well, a Division 7A loan is basically given when the same directing mind, so bear in mind we've got a trust and a company and typically they will have the same directing mind, has calculated the trust law income and knows the amount to be distributed to the company.

Now that will usually be when the accounts for the year have been prepared. For example, say we're looking at the 30th of June 2023, the accounts might be prepared on the 31st of October 2023 and therefore that will be the date of the Division 7A loan.

Just a quick example of that, say on the 30th of June 2023, the company becomes presently entitled to 80% of the trust income. Now on the 30th of October 2023, the trust income is determined to be $200,000 at which basically on completion of the trust's accounts. And therefore, the company's taken to provide financial accommodation to the trust resulting in a Division 7A loan to the trust of $160,000, which is 80% of that figure.

That is in the year ended the 30th of June 2024, and therefore by the 14th of May 2025, which is the day before the company's lodgement day for the 2024 income year, the company and the trust need to enter into a complying loan agreement for $160,000. Or in the alternative, the trust needs to repay the $160,000 to the company prior to the 15th of May. Then on the 30th of June 2025, assuming that they did actually enter into a compliant loan agreement, then the first minimum yearly repayment is due.

Now, as I say, this is a much more robust view of the law than previously the ATO had expressed. Under the old PSLA, option one or option two sub-trusts could have been entered into and often were, where the amounts which ended up in the sub-trusts were basically invested in the main trust and used for example, for working capital, plants and equipment, or real property acquisitions. We basically enabled trading trusts to finance the business on purely interest only terms.

Now going forward, the ATO considers that Division 7A will apply to those arrangements unless the unpaid distributed funds are put onto a sub-trust with the sub-trust funds not mixed with the main trust funds and invested solely for the benefit of the company.

Now, that's a much more stringent requirement than the one expressed in the earlier tax ruling and in the earlier PSLA, which allowed sub-trust funds to be mixed with the main trusts funds without triggering a Division 7A loan.

And therefore, the requirement the funds on sub-trust be held for the exclusive benefit of the corporate beneficiary and not used by a shareholder or associate of that corporate beneficiary, including crucially by the main trust, has made this arrangement altogether less desirable and increased the chances of Division 7A applying.

Basically, this new TD does represent a material change for present entitlements arising on or after the 1st of July 2022, and it's a material change greatly for the worst because the ATO have tightened the noose and defined a UPE which Division 7A much more stringently.

Now, we might've assumed that TD 2022/11 was the final word on this subject. However, we were very quickly disabused of that because in, well very recently within the last two months, we've had the Bendel case. On the 28th of September 2023, the AAT handed down its decision in the Bendel case. This case dealt with a group of entities that carried on a suburban accounting and tax agent practise. The relevant entities were the Steven Bendel 2005 Discretionary Trust and Gleewin Investment Proprietary Limited. And the basic situation was that during the four years between 2013 and 2017, Gleewin became entitled to the income of the 2005 trust, which therefore resulted in UPEs owing to Gleewin.

Now the ATO subsequently commenced a review of the Bendel group for the years in question and issued amended assessments contending that the UPE's comprised loans within the meaning of Section 109D3 of the 1936 Act. Objections were lodged against the amended assessments which were then disallowed by the commissioner. The whole matter was referred to the tribunal, which was required to answer the following question, did Gleewin make a loan within the meaning of section 109D3 of the 1936 Act to the 2005 trust on account of the UPEs owing to Gleewin? And the AAT answered that question, perhaps surprisingly no.

Now that really set the cat amongst the pigeons. The AAT actually noted that, just to quote them for a moment, the necessary conclusion is that a loan within the meaning of Section 109D3 does not reach so far as to embrace the rights inequity created when entitlements to trust income or capital are created but not satisfied and remain unpaid. The balance or an outstanding or unpaid entitlement of a corporate beneficiary of a trust, but are held on a sub-trust or otherwise is not a loan to the trustee of that trust. And they then went on to observe that UPEs are more specifically dealt with by Subdivision EA of Division 7A, not Section 109D.

Now, Subdivision EA applies to the specific circumstances where a trustee creates a UPE in a private company and transfers the underlying cash or property to a shareholder or an associate shareholder by way of payment or loan.

However, in situations where that doesn't apply such as this one which is a situation where the trustee retains the cash for use in the trust, Subdivision EA obviously can't apply. And therefore, there seems to be at least according to the judgement in Bendel v FCT a gap in the law because a UPE can be subject to tax on Division 7A on the Subdivision EA in situations where the resulting cash is paid out from the trust to a shareholder or to a shareholder's associate by way of payment or loan.

However, in this situation that we're primarily talking about here where the cash is retained within the trust, Subdivision EA doesn't apply. And according to Bendel v FCT, Section 109D3 also doesn't apply and therefore Division 7A doesn't apply.

And therefore, the AAT's decision in this particular case challenges the ATO's view that a UPE is generally a form of financial accommodation and falls within the definition of a loan in Section 109D. Now, it upset the apple cart because this has been the ATO's view for many years. Since at least 2009, it formed the basis of the 2010 tax ruling, the PSLA 2010/4, and it also formed the basis of the more recent ATO TD 2022/11, which actually tightened the rules surrounding UPEs.

Now obviously, this has all happened very recently. It's less than two months since the initial judgement and therefore at this stage, the 2022 determination remains in place unaltered, It hasn't been withdrawn. The commissioner has lodged an appeal against the Bendel case and therefore no real weight can be placed on the AAT's findings as the case is going to progress to a higher court and it may well progress beyond that indeed.

We're probably several months or possibly several years away from getting a specific answer to the question of whether UPEs are actually subject to Division 7A in this situation. And therefore, although it may be tempting to say that as well the AAT has found that these are UPEs but not within Division 7A, really you'd be better advised to refrain from advising clients that UPEs are not subject to Division 7A until the court and obviously, any higher courts in the case of appeal gives its final judgement .

Nevertheless, purely based on the wording of the judgement , we can see that this is a significant judgement that potentially changes the game for UPEs and incidentally changes the game not just going forward but retrospectively as well. Right back to 2009, it potentially throws into doubt any previous assessments which have been issued in relation to UPEs all the way back to 2009.

The ATO recently, very recently, it's only about a week ago, 15th of November, the ATO confirmed its position in a decision impact statement. The decision impact statement says that until the appeals process is finalised, the commissioner does not intend to revise the current ATO views relating to private company entitlements to trust income asset out in taxation determination TD 2022/11, so no real surprises there then.

However, one sentence at the end of that decision impact statement was slightly worrying. They said that in addition to the application of Section 109D, the basis on which private company beneficiaries deal with unpaid entitlements to trust income may have implications under other taxation laws such as Section 100A. And therefore, the ATO is obviously thinking to the future. If we lose this case, they're thinking, and Division 7A is thrown out as a way of attacking unpaid present entitlements.

What else can we do? And they're looking to Section 100A, which is as a reminder. Section 100A was a very obscure anti-avoidance, a bit of anti-avoidance legislation which nobody had really heard of, nobody really engaged with until about two or three years ago when the ATO brought it to the fore as a means of attacking what they saw as inappropriate tax behaviour within trusts.

And therefore, the threat to potentially use Section 100A if the Division 7A case is lost does indeed appear to be worrying and it does appear to give cause for concern. Nevertheless, that is some way down the line. As I say, it'll take months, possibly years for this to wind its way through the court. And in the meantime, the position regarding UPEs is very much up in the air.

And finally, just to make you aware of a taxpayer alert which was issued on the 8th of February 2023 in respect of the interposition of a holding company to access company profits tax-free. Now taxpayer alerts are issued when the ATO becomes aware of a particular tax avoidance scheme out in the marketplace. And this particular alert arises because the ATO was concerned that individual taxpayers and private companies could be entering into arrangements to facilitate the extraction of profits tax-free from private companies with the dominant purpose of tax avoidance.

And they were doing this by abusing the commission 7A legislation. Specifically, an interposed holding company is put in place to receive dividends from an existing company, but the funds lent then to the shareholder of terms that don't comply with Section 109N.

To give an example of the sort of situation which the ATO is talking about, Jack is a sole shareholder and director of Austco Pty Ltd. He has 10 ordinary fully paid up shares in Austco of $1 each. Austco has an amount of cash on hand of a million dollars consisting of the $10 paid up share capital and accumulated profits of $999,990 for previous year's trust distributions. Austco has no other assets. Jack wants to access the retained profits for private purposes.

Now on the 7th of June 2023, Jack incorporates a company, Holdco Pty Ltd for which he's the sole director and shareholder holding one ordinary fully paid up share of $1. On the 20th of June 2023, Jack transfers his 10 ordinary shares in Austco valued at $1 million to Holdco. And in return, Holdco issues Jack with 1 million ordinary shares of $1 each fully paid. Both Jack and Holdco adopt the amount of $1 million as being the consideration for the transaction.

Jack makes a choice for rollover relief on the Subdivision 122A, meaning that the capital gain made by Jack from the disposal of his shares in Austco to Holdco is disregarded. On the 29th of June 2023, Austco declares and pays a fully franked dividend of $999,990 to Holdco. And on the following day, Holdco lends $999,990 to Jack on terms which are unsecured, interest-free and repayable at call.

The accounting records for both Austco and Holdco show distributable surplus of nil as at 30th of June 2023. That's significant because obviously Division 7A loans cannot exist where the company doesn't have a distributable surplus. Austco Pty Ltd is then wound up and the loan remains uncalled and outstanding.

In this situation, Jack has effectively taken out just less than a million dollars from the company apparently on some form of loan, which is unsecured, interest-free and repayable at call. In reality, who knows whether that will ever be repaid.

You can kind of see why the ATO has an issue with that, and the ATO very sensibly has pointed out that Jack could quite simply strip out the accumulative profits far more simply than setting up that arrangement. For example, the company called payment dividend or he could provide him with an interest-free unsecured loan, which also incidentally would be accessible as a deemed dividend under Division 7A.

Now it chose not to do either of those things, both of which would've resulted in a tax liability to Jack and therefore the arrangement appears to have the dominant purpose of avoiding tax and has therefore spawned this alert.

The alert actually states that such arrangements typically display all or most of the following features. Firstly, the original company is owned by individuals or a trustee and has retained profits with available franking credits to pay dividends. A company isn't deposed between a private company and the individual or trustee through the utilisation of CGT rollover therefore deferring any capital gains tax.

The original company pays a franked dividend to the new interposed company, which is paid by either cash, check or promissory note. The interposed company utilises dividend payment to provide a loan to the individual and the loan is not a complying Division 7A loan. For example, it say, it might be interest free. Neither the first company or the interpose company have a distributable surplus per the Division 7A provisions to deem a dividend payable to the individual.

The ATO really has three ways of attacking this particular arrangement. First of all, they can look at it on the Section 109C and they can ask whether there was any intention for the purported loan to the individual to be repaid, or if the amounts that could be taken to be an accessible deemed dividend paid to the individual on the other provisions of Division 7A relating to payments from private companies. That's probably the favoured way of attacking this arrangement. Alternatively, the arrangements could be dividend tripping, or alternatively again, the general anti-avoidance provisions in Part 4A could apply to the scheme.

Now where the ATO could argue that there's no intention to repay a purported loan as in this case, Section 109C will apply. Now, payments on the Section 109C change the distributable surplus calculation back upwards. In other words, they add back the $990,000, meaning that a deemed unfranked dividend may, after all, apply for $990,000. That is obviously an unfranked dividend. Therefore, the franking credits which were used in this situation in paying the dividend to Holdco will be lost.

Therefore, the scheme doesn't work and the ATO has also said that the promoter penalty rules could apply or alternatively, or in addition, the Tax Agent Services Act 2009 could potentially involve the TPB in this arrangement if the advisor is found to have advised on the scheme. Basically, the ATO is telling you to avoid that particular scheme at all costs.

Now that's the end of the formal presentation. I might just hand back to Susannah to wrap up the session. Obviously we've got time for some questions, not much time because according to my watch, it's actually two o'clock. But nevertheless, we'll go on for a few minutes and take questions. If we don't get a chance to deal with all of your questions or if anything comes to mind afterwards, do please feel free to email me. My details are on the slide there. But for now, I'll just hand you back to Susannah briefly to wrap up.

CCH Learning:

Thank you very much for that, Mark. We will be spending the next few minutes taking questions, so just a reminder to please type them into the question's pane. To give you some time to type those up, I will mention some upcoming webinars. We're looking at preparing and participating in negotiations and also the tax technical update. We're also going to be thinking about insights on managing a termination of employment and if you are thinking about writing an app which had to be rescheduled.

Cybersecurity update in early December, we'll be looking at the ACSC report, top mitigations and expectations for 2024. And on the 7th of December, we'll be looking at navigating your clients through ATO compliance and debt collection activity in 2024. If you are interested in any of those, please head to wolterskluwer.cchlearning.com.au and see if any are right for you.

Let's have a little look at our questions. Mark, I have a question from Irene. Irene asks, "What if you don't have a loan agreement in place but still calculate interest and minimum repayments as per the ATO?"

Mark Chapman:

Well, it's not a complying loan agreement and Division 7A applies. Basically, the requirements are that you must have a written loan agreement in order for it to be a compliant loan agreement, and you must then go on to pay the minimum yearly repayments in accordance with that loan agreement. Now, if you don't have a loan agreement, then it isn't complying and Division 7A will apply to the amount. Basically, I think the client there is in a very awkward position.

CCH Learning:

Thank you very much for that, Mark. There you go, Irene. I have a question from Arthur. Arthur was asking, "Making a complying Div 7A loan agreement is legal work. How do accountants manage this in real life if they can't charge for it?"

Mark Chapman:

Well, it is legal work. Basically, the client needs to be advised to speak to somebody who is legally qualified to provide a written loan agreement. And if the client won't pay for the accountant's time, well you simply refer them on to a solicitor and let them get on with it. Really, the accountant's time should be paid for by the client, but that doesn't alter the fact that you have an obligation to provide that client with the necessary information in order to fulfil their legal obligations.

Whether the client then goes and does that is entirely up to them. And obviously if they're aware of the consequences, they can deal with them in conjunction with you for which you'll then no doubt charge them accordingly.

CCH Learning:

Thank you very much for that, Mark. There you go, Arthur. I have another question from Dave. Dave was asking, "Can a company loan money to a related trust without being caught under a Division 7A loan, i.e. there is a loan document but let's say for eight years and the interest rate is higher than the ATO benchmark?"

Mark Chapman:

Well, the maximum loan, a compliant loan agreement needs to be for seven years for a start. Therefore, if it's eight years, it's not complying. Even though the interest rate might be higher, that simply won't do, and therefore they've got Division 7A problems. What was the situation again? Just explain that to me again.

CCH Learning:

He was just asking, "Can a company loan money to a related trust without being caught under the Division 7A loan issues?"

Mark Chapman:

Well, no, they can't. Not in this situation because the maximum loan term is seven years for compliant loan agreement. This is non-compliant, therefore, Division 7A applies.

CCH Learning:

Thank you for that, Mark. There you go, Dave. Just a reminder that if... That sort of does bring us to the end of our questions for today. But just a reminder that if you do have further questions or you need further clarification, please reach out to Mark. His details are on the screen. I just have one very quick last one here. It's just asking from Arthur, "Is a Division 7A interest charged on the loan on a daily basis?"

Mark Chapman:

Yes. Yes.

CCH Learning:

That was an easy answer there, Arthur, so that was a yes. Thank you for that, Arthur. As I say, if you do have any further questions, please, Mark's details are there on the screen, so please reach out.

In terms of next steps, I would like to remind you all to please take a moment to provide your feedback when exiting. We have asked you a couple of questions about today's webinar, so it's really important for us to hear your opinions. It's also a reminder that within 24 to 48 hours, you will be enrolled into the e-learning recording which can be watched multiple times and have access to the PowerPoint, transcript, any other supporting documentation, and of course, a CPD certificate.

I would very much like to thank Mark 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. Please enjoy the rest of your day. Thank you very much.