Division 7A Update

Mark Chapman

Wednesday 22 November 2023

Wolters Kluwer

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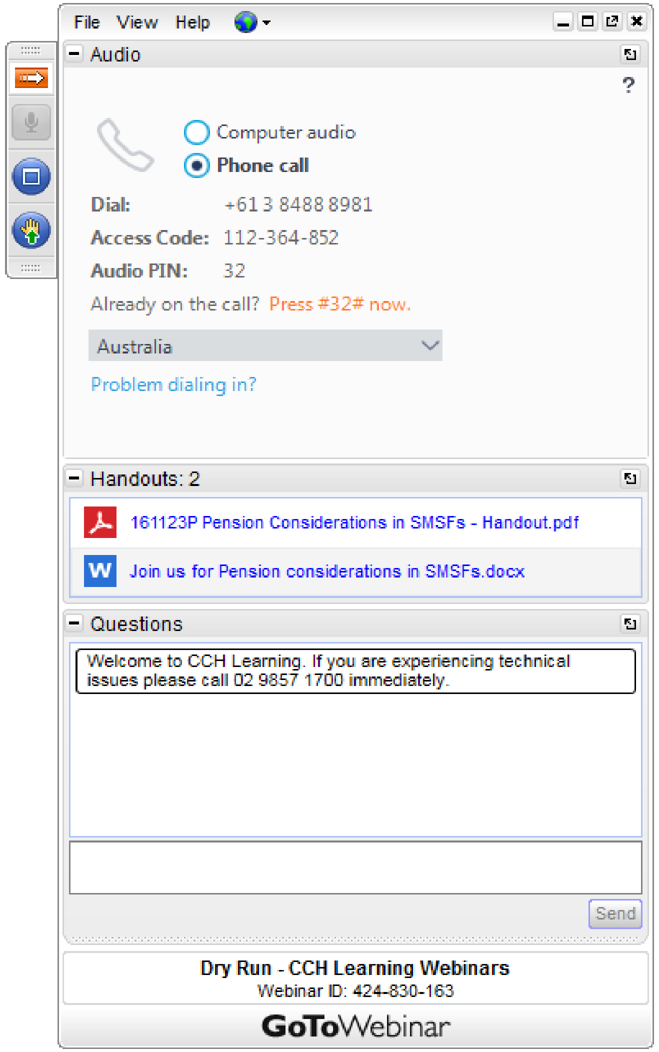

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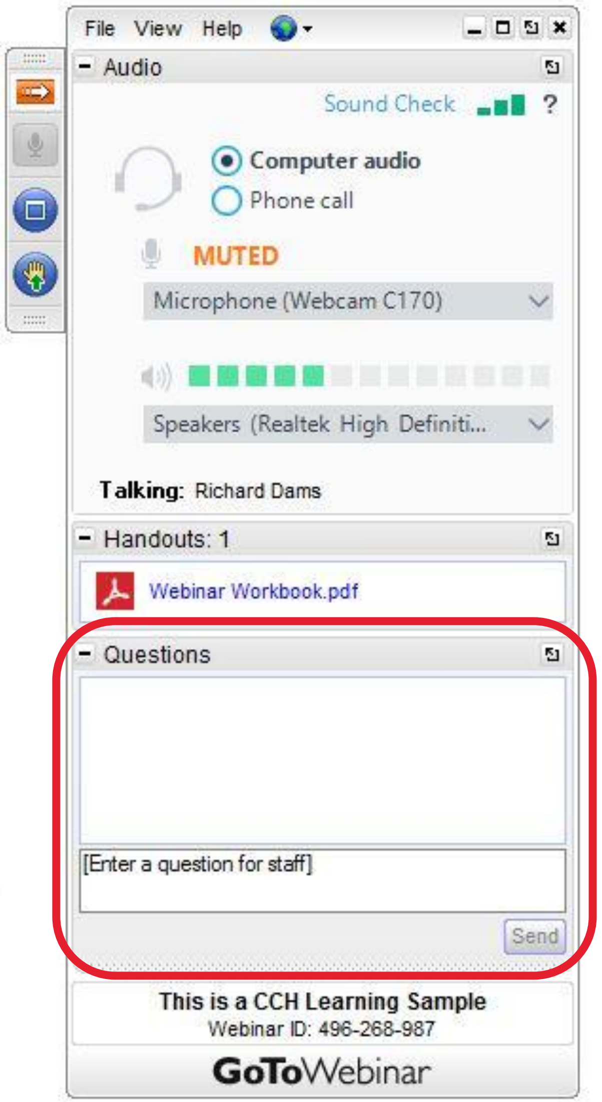

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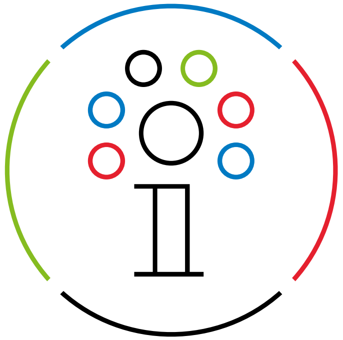
Your Presenter

Mark Chapman
Director of Tax Communications
H&R Block

Today's session will cover



Division 7A: Latest Developments

- Overview of the existing Division 7A rules
- What needs to be done to put in place a complying loan agreement to avoid Division 7A, including documentation and timing requirements?
- ATO's treatment of unpaid present entitlements (UPE's) arising before 30 June 2022
- When will post 30 June 2022 UPE's become subject to Division 7A? Overview of the ATO's latest position, highlighting key differences to previous draft guidelines and possible impact on "bucket companies".
- ALERT: Overview of the recent Bendel case – what does this mean for UPE's?
- Sub-trusts: do they still have a role in Division 7A planning?
- New ATO warning highlights arrangements where a holding company is interposed to access company profits tax free, with clear Division 7A exposure.
- Where are we up to with the proposed government changes to Division 7A, including new simplified loan rules? Will these changes ever take effect? What should clients do?

Division 7A overview

- Under ITAA36 Pt III Div 7A (s 109B to 109ZE), amounts paid, lent or forgiven by a private company to certain associated entities (including individuals) are treated as unfranked dividends.
- Div 7A applies where the recipient of the payment, loan or forgiven amount is
  - a shareholder
  - an associate of a shareholder
  - a former shareholder or former associate.
- A Div 7A deemed dividend is 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

Division 7A overview

- So what sort of transactions is Division 7A looking to catch? Here are a few examples:
  - Paying private expenses out of company funds
  - Lending company funds to shareholders without a loan agreement, possibly at no interest or a reduced interest rate
  - Giving private use of company assets for free or at less than market value (such as a home owned within the company or a boat).
  - Unpaid present entitlement issues, if the company is a beneficiary of a family trust (but see later slide…).

Division 7A overview

- A payment or other benefit that is potentially subject to Division 7A isn't treated as a Division 7A dividend if it's repaid or converted to a complying loan by the company's lodgment day for the income year in which the payment occurs.
- A company's lodgment day is the actual day on which the company lodges its income tax return or the due date for lodgment, whichever is earlier.
- A complying loan agreement must have the following features:
  - It must be in writing
  - It should identify the names of the lender and borrower
  - 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 (benchmark interest rate set by the ATO)
    - the term of the loan
  - The loan agreement must be signed and dated before lodging the income tax return.

Division 7A overview

- There are 2 types of complying Division 7A loan agreements:
  - An unsecured loan, which has a maximum term of 7 years; or
  - A secured loan, secured by a mortgage over real property (where the market value of the property is at least 110% of the loan amount), which has a maximum term of 25 years.
- Minimum loan repayments must be made by 30 June each year.
- Some payments made by a private company to a shareholder or its associate are not treated as unfranked dividends. These include:
  - A repayment of a genuine debt owed to a shareholder or its associate.
  - A payment to a company (but not a company acting as a trustee).
  - A payment that is otherwise assessable under another provision of the Act.
  - A payment made to a shareholder or shareholder’s associate in their capacity as an employee or an employee’s associate.
  - A liquidator’s distribution.

Division 7A overview

- Common traps to avoid falling into:
  - Entering into a 25 year agreement related to property but forgetting to register a mortgage or leaving it too late to register a mortgage in time for the tax return lodgement date
  - Keeping poor records of amounts paid, lent or repaid so you can't accurately establish Division 7A balances at a point in time
  - Failing to put in place a complying loan agreement by the deadline
  - Failing to abide by the terms of the complying loan agreement (eg, setting the interest rate too low)
  - Failing to make the necessary loan repayments in accordance with a complying loan agreement

Relief from the operation of Division 7A

- The Commissioner may **disregard** a failure to make a MYR (and resultant deemed dividend) if he is satisfied the failure was due to circumstances beyond the shareholder's control and the inclusion of the deemed dividend in their assessable income would cause undue hardship. (S.109Q).
- The period for making a MYR may be **extended** by the Commissioner in cases where the failure to make the MYR was due to circumstances beyond the shareholder's control. (S.109RD).
- The Commissioner also has a discretion to **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 (S.109RB).

Honest mistake or inadvertent omission (s109RB)

- The Commissioner has the discretion to 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. Two-step process to obtain relief:
  - Was Division 7A triggered because of either an honest mistake, or an inadvertent omission?
  - If yes, the Commissioner then determines whether the discretion should be granted, taking into account a number 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, and if so, the circumstances in which this occurred; and
    - Any other matters that the Commissioner considers relevant.

Honest mistake or inadvertent omission (s109RB)

- The terms ‘honest mistake’ and ‘inadvertent omission’ are not defined.
- Per 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 is a failure to take action that is relevant to or affects the operation of Division 7A (and such an omission must be inadvertent).
- A mistake, or an omission arising as a result of ignorance can attract relief under the section, provided the state of being ignorant, or the reasons for it, are honest or inadvertent.
- 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, would not constitute an honest mistake or inadvertent omission.

Proposed changes - background

- Treasury Consultation Paper 'Targeted amendments to the Division 7A integrity rules'.
- Follows Board of Taxation reviews and subsequent discussion papers in 2012 and 2014
- Originally intended to apply from 1 July 2019
- In 2019 Federal Budget, start date for new measures shifted to 1 July 2020
- On 30 June 2020, the Government announced that the new rules will now apply from income years commencing on or after the date of royal assent of the enabling legislation.
- Since then, there has been no further word on what's happening (and there's been a General Election since).

Division 7A proposed changes to loan agreements

- 7 year and 25 year loan model is replaced with a new 10 year loan model
- Increased interest rates.
- Revised method for calculating repayments:
  - Principal amount is written off in equal annual instalments over the term of the loan
  - Interest calculated on the opening balance of the loan each year using the benchmark interest rate
- No requirement for a formal written loan agreement

Other key changes

- Concept of ‘distributable surplus’ is removed
- Self-correction mechanism introduced
- Interaction between Div 7A and FBT – if the payment is made to a shareholder in their capacity as an employee but is not subject to FBT, Division 7A applies
- Optional safe harbour formula to be introduced to simplify the market valuation of private company assets used by shareholders.
- Extended period of review for Division 7A:
    - 14 years after the end of the year of income in which the loan, payment or debt forgiveness gave rise to, or would have given rise to, a deemed dividend
    - Applies from commencement date

UPE’s: Background

- Since December 2009, the ATO has taken the view that the Div 7A provisions apply if there is a UPE from a trust to an associated private company and the company does not call for the payment or investment of the UPE.
- *Note: this treatment does not apply to pre-16 December 2009 UPE’s, where the ATO accepted that a UPE was not a loan for Div 7A purposes.*
- In effect, the company is "agreeing" that the funds representing the UPE can be used for trust purposes (see TR 2010/3).
- Practice Statement PS LA 2010/4 states that a UPE will not be treated as a Div 7A loan if the funds are held on sub-trust for the sole benefit of the corporate beneficiary, with taxpayers determining the appropriate terms of the investment or adopting one of the 3 safe-harbour investment options:
    - Option 1: invest the funds on an interest-only 7-year loan at the Div 7A benchmark interest rate
    - Option 2: invest the funds on an interest-only 10-year loan at a prescribed interest rate; or
    - Option 3: invest the funds in a specific income-producing asset or investment.

UPE’s: Background

- PCG 2017/13 allowed such arrangements to be extended via an administrative practice of allowing maturing Option 1 and/or Option 2 arrangements (where the trust has not repaid the UPE) to be placed on complying 7-year terms prior to the corporate beneficiary’s lodgment day.
- Originally, PCG 2017/13 applied to trustees who adopted Option 1 before 1 July 2011 and placed funds representing the UPE under a sub-trust on a 7-year interest only loan with the main trust. These arrangements matured in 2016-17 or 2017-18.
- Ultimately, PCG 2017/13 was extended so that it applies to both Option 1 and Option 2 sub-trust arrangements maturing in the 2022 income year and later.
- The updated PCG applies to UPEs arising during (but not after) 2021–22 until the maturity of the sub-trust arrangement, generally:
  - 14 May 2030 (Option 1)
  - 14 May 2033 (Option 2).
- In addition, if the principal amount is not fully repaid on maturity, the outstanding amount can be placed on complying loan terms, with the liability for the first minimum yearly repayment under the new 7-year complying loan arising on:
  - 30 June 2031 (Option 1)
  - 30 June 2034 (Option 2),
- and the entire arrangement concluding by 30 June 2037 and 30 June 2040.

UPE's: Background

- Loans under these arrangements (especially Options 1 & 2) have previously provided for better cash flow for the borrower than the principal and interest payments normally required to satisfy the terms of a complying written loan agreement.
- However, with interest rates rising, these arrangements are becoming increasingly challenging. The benchmark interest rate for the 2022–23 year was set at 4.77% pa in May 2022, but for 2023–24 the rate increased to 8.27% pa. Consequently, borrowing costs may now far exceed interest income.
- For trust entitlements that arose on or before 30 June 2022, Taxation Ruling TR 2010/3 and Practice Statement Law Administration PS LA 2010/4 continue to apply (with PCG 2017/13 interpreting).
- However, the ATO has withdrawn TR 2010/3 and PSLA 2010/4 with effect from 1 July 2022.
- The ATO changed its position and issued a new TD (TD 2022/11) to apply to trust entitlements that arise on or after 1 July 2022.

UPE's: TD 2022/11

- TD 2022/11 states that a company provides a financial accommodation to the shareholder/associate where:
  - that amount is set aside by the trustee and held on sub-trust; and
  - the company consents to those funds being used by the shareholder/associate.
- Per TD 2022/11, a private company beneficiary with a UPE will provide 'financial accommodation' to the trustee when the company has 'knowledge' of an amount that it can demand immediate payment of from the trustee, but does not do so. As such, the company has consented to the trustee retaining the funds for continued use for trust purposes.
- This will give rise to a Div 7A loan.
- How is "knowledge" defined?
- A Division 7A loan is given when the same directing mind has calculated the trust's 'trust law income' and knows the amount to be distributed to the company. This will usually be when the accounts for the year have been prepared (for example on 31 October 2023, for the year ended 30 June 2023).

UPE's: TD 2022/11

- Example:
- 30 June 2023: Company becomes presently entitled to 80% of trust income
- 30 October 2023: Trust income is determined to be $200,000. Hence, the company is taken to provide financial accommodation to the Trust, resulting in a Division 7A loan to the Trust of $160,000.
- 14 May 2025: The day before the company's lodgment day for the 2024 income year, the company and trust enter into a complying loan agreement for $160,000 (or alternatively, the trust repays the $160,000 loan to the company prior to 15 May 2025)
- 30 June 2025: first minimum yearly repayment due.

UPE's: TD 2022/11

- Under PSLA 2010/4, Option 1 and Option 2 sub-trust arrangements were often used where the amount in the sub-trust was invested in the main trust in working capital, plant and equipment, or real property acquisitions. This enabled trading trusts to finance the business on interest only terms.
- The ATO now considers that Division 7A applies unless the unpaid distributed funds are put under a sub-trust, with the sub-trust funds not mixed with the main trust funds, and invested solely for the benefit of the company.
- This is a more stringent requirement than under TR 2010/3 and PS LA 2021/4 which allowed sub-trust funds to be mixed with the main trust's funds, without it resulting in a deemed Division 7A loan.
- Therefore, the requirement that 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 by the main trust**, means that there are likely to be few takers for sub-trust arrangements under the TD.
- The TD represent a material change for present entitlements arising on or after 1 July 2022.

UPE's: The Bendel case

- On 28 September 2023, the AAT handed down its decision in the Bendel case.
- The Bendel Group consisted of entities that carried on a suburban accounting and tax agent practice. The relevant entities were the Steven Bendel 2005 Discretionary Trust (2005 Trust) and Gleewin Investments Pty Ltd (Gleewin).
- During the 2013 to 2017 years, Gleewin became entitled to the income of the 2005 Trust, which resulted in UPEs owing to Gleewin.
- The ATO subsequently commenced a review of the Bendel Group for the years in question and issued amended assessments contending that the UPEs comprised loans within the meaning of section 109D(3) of the ITAA 1936. Objections were lodged for the amended assessments which were disallowed by the Commissioner.
- The Tribunal was required to answer the following question:
  - "Did Gleewin make a loan within the meaning of section 109D(3) of the ITAA 1936 to the 2005 Trust on account of the UPEs owing to Gleewin?"
- The AAT answered that question: no.

UPE’s: The Bendel case

- The AAT noted: “[101]….the necessary conclusion is that a loan within the meaning of s 109D(3) does not reach so far as to embrace the rights in equity created when entitlements to trust income (or capital) are created but not satisfied and remain unpaid. The balance of an outstanding or unpaid entitlement of a corporate beneficiary of a trust, whether held on a separate trust or otherwise, is not a loan to the trustee of that trust.”
- The AAT went on to observe that UPEs are more specifically dealt with by Sudivision EA of Division 7A, not section 109D.
- Subdivision EA applies to circumstances where a trustee creates an UPE in a private company and transfers the underlying cash (or property) to a shareholder or an associate of a shareholder by way of certain payments or loans, or by the forgiveness of such loans.
- However, in the absence of those circumstances (eg, when the trustee retains the cash for use in the trust) Subdivision EA has no application!
- If the Parliament had intended that a UPE to a corporate beneficiary should be within the scope of section 109D, Subdivision EA would not have been enacted. Until such time that new Division 7A legislation is enacted to specifically include UPEs to companies as 109D loans, then the judgement in Bendel v FCT tells us that the correct statutory interpretation of this section should be that UPEs are not loans for Division 7A purposes.

UPE’s: The Bendel case

- The AAT’s decision in this case challenges the ATO's view that a UPE is generally a form of "financial accommodation" and therefore falls within the definition of a "loan" in s 109D(3).
- This has been the ATO’s view since at least 2009 and it formed the basis of TR 2010/3 and PSLA 2010/4, as amended (but not replaced) by TD 2022/11.
- At this stage, with the case just published, the 2022 Determination remains in place and has not been withdrawn.
- The issue of whether "an unpaid present entitlement to income (or capital) of a trust estate is a loan for the purpose of s 109D(3)" is complex however the outcome of this case tells us that there is a gap in the legislation and UPEs not caught by Subdiv EA may escape Division 7A altogether.
- As expected, the Commissioner has lodged an appeal.
- No weight can be placed on the AAT findings as the case is to be heard by a higher Court.
- Therefore, advisers should refrain from advising clients that UPE’s are not subject to Division 7A until the Court (and any higher courts, in the case of appeal) gives its final judgement. Nevertheless, this is a significant judgement that, if upheld, changes the game for UPE’s (not just going forward but retrospectively).

UPE's: The Bendel case – Decision Impact Statement

- The ATO's position was confirmed by the Decision Impact Statement issued on 15 November 2023.
- This DIS states that "until the appeal process is finalised, the Commissioner does not intend to revise the current ATO views relating to private company entitlements to trust income, as set out in Taxation Determination TD 2022/11"
- However, they also state (worryingly) "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."
- The (never-before voiced) threat to use s100A instead of Division 7A appears worrying.....

TA 2023/1

- The ATO issued Taxpayer Alert TA 2023/1 on 8 February 2023 in respect of the interposition of a holding company to access company profits tax-free.
- This alert arises because the ATO is concerned that individual taxpayers and private companies under their control may be entering into arrangements to facilitate the extraction of profits tax-free from private companies, with the dominant purpose of tax avoidance.
- Specifically, an interposed holding company is put in place to receive dividends from an existing company, with the funds then lent to the shareholder on terms that don't comply with s109N

TA 2023/1

- Example:
- Jack is the 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 $1 million, consisting of the $10 paid-up share capital and accumulated profits of $999,990 from previous year trust distributions. Austco has no other assets. Jack wants to access the retained profits for private purposes.
- On 7 June 2023, Jack incorporates a company, Holdco Pty Ltd, for which he is the sole director and shareholder, holding one ordinary, fully paid-up, share of $1.
- On 20 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 roll-over relief under ITAA97 Subdiv 122-A, meaning that the capital gain made by Jack from the disposal of his shares in Austco to Holdco is disregarded.
- On 29 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 a distributable surplus of nil as at 30 June 2023.
- Austco Pty Ltd is then wound up. The loan remains uncalled and outstanding.

TA 2023/1

- Austco could have provided its accumulated profits to Jack by far simpler means, such as by paying him a dividend or providing him with an interest-free, unsecured loan (which would also be assessable as a deemed dividend under ITAA36 Div 7A). This did not happen and, therefore, the arrangements appear to have the dominant purpose of avoiding tax (and is therefore the reason for the Alert).

TA 2023/1

- TA 2023/1 states that such arrangements typically display all or most of the following features:
  - The original company is owned by individuals/trustee and has retained profits, with available franking credits to pay franked dividends
  - A company is interposed between a private company and the individual/trustee through the utilisation of a CGT rollover – deferring any capital gains tax
  - The original company pays a franked dividend to the new interposed company, which is paid by either cash, cheque or promissory note
  - The interposed company utilises the dividend payment to provide a loan to the individual and the loan is not on a company division 7A loan, such as interest free or repayable at call
  - Neither the first company or the interposed company have a distributable surplus per the division 7A provision to deem a dividend payable to the individual

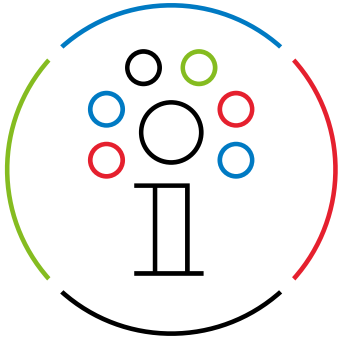
TA 2023/1

- Aspects of these arrangements that concern the ATO include whether:
  - there is any intention for the purported "loan" to the individual to be repaid, or if the amount may be taken to be an assessable deemed dividend paid to the individual under other provisions of Division 7A relating to payments from private companies (s.109C)
  - the arrangements comprise a "dividend stripping" scheme or operation, and
  - the general anti-avoidance provisions in Part IVA of the Income Tax Assessment Act 1936 may apply to the scheme

TA 2023/1

- Where the ATO can argue that, as here, there is no intention to repay a purported “loan”, ITAA36 s 109C will apply. Payments under s 109C change the distributable surplus calculation upward (in effect, adding the $990,000 back), meaning that a deemed unfranked dividend may, after all, apply for $990,000.
- As s1909C treats it as unfranked dividend, the franking credits which were used by Austco in paying the dividend to Holdco will be lost.
- Penalties could also apply to any adviser that advised on the scheme, including:
  - promotor penalties under TAA sch 1 Div 290
  - penalties in breach of the *Tax Agent Services Act 2009* for registered tax agents promoting such arrangements.
- To avoid the operation of s 109C, Jack should enter into a complying loan agreement under ITAA36 s 109N.
- A failure to do so risks either ITAA36 s 109C or 177D applying.

Questions



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Or contact me via:

- Mark Chapman
- Director of Tax Communications
- H&R Block
- 0415 844 388
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Questions?

Susannah Gynther,
Moderator

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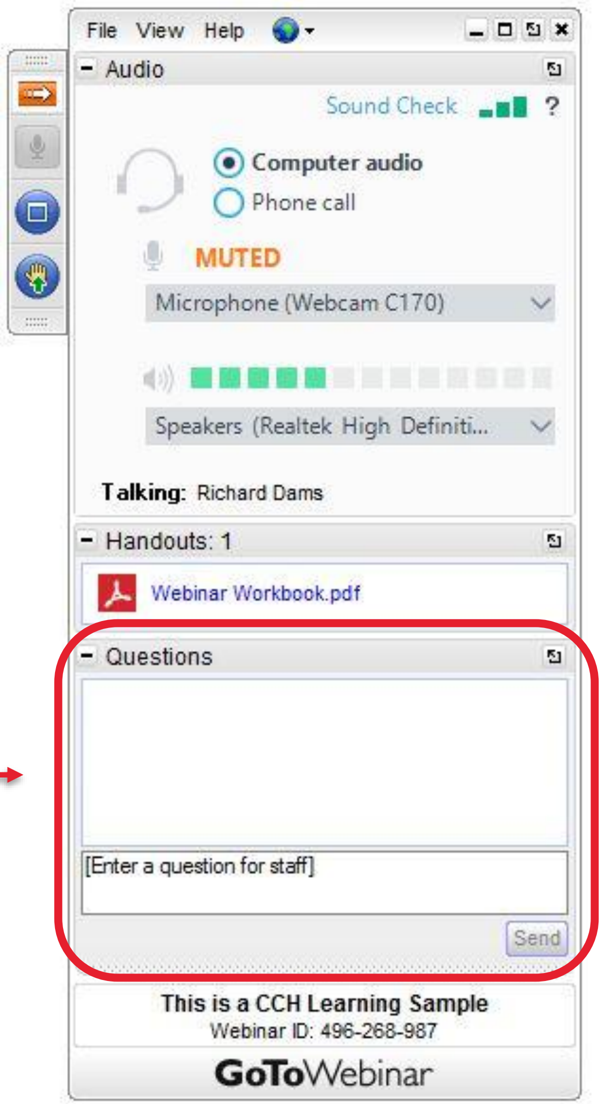

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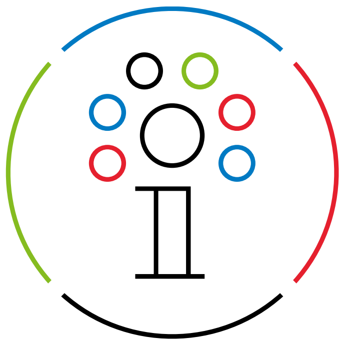

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Questions?

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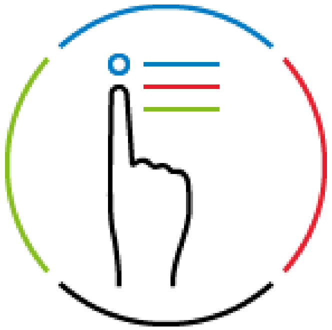

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