SME Loans
06/02/2024

CCH Learning:

Hi, everyone. Welcome to today's webinar regarding SME Loans. I'm Alison Wood from Wolters Kluwer CCH Learning and I'll be your moderator for today. Just a few quick pointers before we get started. If you're having sound problems and if you can hear this, then please talk in between audio and phone, but hopefully you can see the screen regardless. If you're looking for your PowerPoint for today's session, it's just saved in the handout section. Shortly after the session today, you will receive an email letting you know the e-learning recording is ready to be viewed. You can ask questions at any point during the presentation today. Simply send them into the questions box. I will collate those questions and ask them at the Q&A at the end of today's presentation.

CCH Learning also offers a subscription service, which many people have termed Netflix for Professionals. It provides members with access to our entire library of recordings, as well as live webinars for a very competitive flat fee. That's for over 500 hours of content, and 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. So without any further ado, I will pass you over to Carlo to commence today's presentation.

Carlo Di Loreto:

Thank you very much, Alison. Hello, everyone, and welcome to our session today. As Alison's pointed out, it's about SME loans. So before we get started, firstly, welcome back. I hope everyone had a great break over Christmas on the holidays. I know I did. I feel like I really needed it this year, and I hope you've all come back refreshed and ready to learn a little bit about tax today.

So just by way of overview, I've picked SME loans because I think there are so many different areas that are impacted when we start thinking about loaning within a small to medium enterprise group. Part of the problem is they involve combinations of different entities. So just because it's an SME, it doesn't mean the law is simple. Quite often, SMEs have really complex laws. They're very confusing, and I thought today would be a good opportunity to cover as many of the provisions as we can.

So it's not a detailed session, so please don't think you're going to learn everything about SME loans today. We can't do that in 45 minutes, but treat this presentation as a checklist. So while it won't give you all the answers, it will alert you to where you need to look and to the issues that you perhaps may not have seen. If I can achieve that today, then I think I've done my job. Sometimes we don't have a proper understanding of the provisions, so I'm hoping today this will shed some light on some of those, and it's really to give you some practical guidance, so point out things that you perhaps need to look at.

So on this slide here, you'll see what we're going to cover today. The first part of the presentation will cover private company loans, so Division 7A is the thing we really have to worry about there. Included in that will be loans from trust, so subdivision EA. Now, I'm going to cover UPEs today as well because we know that in the past year or so, the ATO's view on that has changed and we're all probably really familiar with Bendel's case, and there's some really optimistic commentary about Bendel. I don't want to be a bearer of bad news, but I'm not so optimistic that Bendel will be successful on appeal, but we'll cover that later.

We'll also touch on some commercial debt forgiveness issues, interest deductibility, personal use assets. That's a real sleeper, and one that's often overlooked in relation to loans, and especially interest-free loans. Just touch briefly on debt equity and then just a note about international dealings, Forex, and withholding taxes to finish off. So as you can see, something as simple as SME loans brings in a lot of different areas of legislation.

So let's start off with Division 7A. You probably remember, look, if you've been around for as long as me, you probably remember this day, 4th of December '97. It's the day that the old Section 108 was put to bed and a new set of rules about loans made by private companies to shareholders was brought in. So just the basics, there's a few things you need to worry about. When you're dealing with a private company, are you making a payment loan or forgiving a debt to a shareholder or their associate? So just remember, when you are looking at the definition of associate, it goes to the CFC rules, so Section 318 of the 36 Act, very, very broad definition. So in SME groups, I would say that any loan that a private company makes to any related entity is going to be caught by Division 7A, so just be aware of that.

The thing to watch out with loans is triggering a deemed dividend. So what you need is a loan to be made by the private company and it's not repaid by the lodgement date, and that is the lodgement date of the private company. So it's got to be paid before that date, it's its due date or if you lodge earlier, it's that earlier date. So be very careful of that. If you don't have an excluded loan, then you might be triggering a deemed dividend, an excluded loan you'll find in Section 109N of the 36 Act, and the shareholder or associate requirement there again. Just be aware that if your private company is a foreign company, Division 7A can still apply, and that's because the main impact is on the shareholder or associate. So it's the person receiving the loan that really bears the consequences of that.

I mentioned Section 109N, very important that you have a proper written agreement. Doesn't necessarily have to be a contract per se, but it does have to be in writing. I would get one prepared by a solicitor because then you know that all the right conditions are in there. Be aware the seven-year maximum term, 25 years if you have it secured by way of a registered mortgage over real property, and you've got to meet that 110% valuation requirement as well, and be very careful of the benchmark interest rate because as you know, that changes every year.

So very simply, they're the only things you have to worry about in terms of a Section 109N loan. If your loan agreement has the right term and the requirement to pay interest at the benchmark rate of return or interest rate and it provides for minimum yearly repayments, and typically you would have that formula in the contract or agreement, then you're generally going to be fine. The main issue you're going to have is make sure you get that minimum yearly repayment calculated correctly.

Now, the other thing that we often get wrong is this whole concept of distributable surplus. So you'll find it in Section 109Y. If you do happen to trigger a deemed dividend, your distributable surplus could reduce that deemed dividend amount. So this is the formula for it. You start off with the net assets at the end of the particular year that the loan or the deemed dividend arises, and then you add any Division 7A amounts and you deduct non-commercial loans, paid up share value, and repayments of non-commercial loans. So Division 7A amounts are the ones that the companies made as a payment. So they're the Section 109C triggers or a debt forgiveness under 109F. So you can see that they add to your net assets, so it increases your distributable surplus.

We go over the page. The other important aspect of this formula is net assets. So what do we mean by this? Well, you start off with the accounting records of the company. So it's the total of the company assets, and then from that, you get to deduct present legal obligations. So that is very similar to present legal obligations that you would think about for, say, Section 81 purposes. So whereas a presently existing obligation to pay something, that could be included, and then only certain provisions, so depreciation leave and IP and trademark amortisation. Other forms of depreciation cannot come into it.

Now, the other thing that you should be aware of is if the asset values are perhaps overstated or understated, whichever way, the commissioner can substitute his own value. Now, he generally doesn't do that as long as the accounts are prepared on a reasonable basis, but the starting point is the financials, but it's not the net asset that you see on your financial statements. It's only the net assets as calculated on this slide. So be very careful about that. I've seen people get this horribly wrong. I've seen people claim they have no distributor surplus and, therefore, have no problem with a deemed dividend, but on reflection and on review, we've found that they've actually misunderstood how the distributor surplus calculation works.

Another element of the formula is non-commercial loans. So these are loans that basically have been treated as deemed dividends already in a prior year, either under the old Section 108 or under Division 7A. Also, repayments, you adjust the distributor surplus amount for any repayments, again, of loans that have already been triggered by Division 7A or its predecessor 108.

So we've already talked briefly about 109N agreements. Now, some of the problems we find here, generally, incorrect calculation of the distributable surplus. One of the things we've seen recently in a prudential tax review that we've just completed is the client trying to argue that their net asset is negative, and you cannot have that. You cannot have that under these rules. The net assets can either be zero or positive, but not negative because the definition talks about the assets in your financials to the extent that they exceed your liabilities as defined in this particular section. So it doesn't really suggest in the wording that you can have a negative asset position, but you can have zero.

The other problem we often find is the interest rate is not wrong, sorry, incorrectly or using the wrong rate, sorry, should I say, from year to year and just not complying with the minimum yearly repayments, and with secured loans, be very careful with the valuation. Make sure you have enough support to show that the property is at least 110% by value of the loan amount. So be very careful there.

In terms of company to company, you generally don't have a problem there, but be aware of Section 109T. So best way to do this is have a look at a diagram, which I'll show you in a minute, but if you have a look at TD 2018/13, there is no defence to 109T by saying that your transaction is an ordinary commercial transaction. So this is an example of how 109T might apply, and this is taken from the TD. So you might have a private company and it's got two different classes of shareholders. Company A pays a dividend to Company B and then extends a notional loan to ... It then extends a loan to the class A shareholder of Company A and 109T operates to disregard that dividend paid from A to B and deems a notional loan to be made to the shareholder. So it's like a look through. This is often done to take advantage of maybe using an interpose entity that may not have a distributor surplus. So 109T, it's a bit, I would call it, an integrity provision. So just be aware that that exists.

Trust borrowings from companies has gone through a lot of change recently. Now, you might remember the first upheaval of UPEs happened in December 2009. Prior to that date, the ATO had a very, very beneficial view of UPEs and they just thought that they weren't loans for Division 7A purposes. However, from 16th of December onwards, they changed their view on that and they decided that this would constitute a financial accommodation. So we did things like put in place a complying loan agreement at the right time. We also did things like utilise under the PSLA 2010/4 one of three investment options that you could use in respect of that UPE.

Unfortunately, all of that now has come to an end, and that's because in 2022, TD 22/11 came out, and this completely changed the ATO's view about UPEs. So now what the ATO is saying in their minds, there is no doubt that if a UPE is owed to a company, private company buyer trust, that becomes a loan for Division 7A purposes, and it's a financial accommodation loan. So it's a specific part of the definition in 109D. So the only way around this now really is to either pay out that UPE by the lodgement date of the company or put in place a 109N complying loan agreement.

Just a word of note, those investment options that were available under that PSLA are no longer available because the old taxation ruling and that PSLA are both withdrawn from 1 July 2022. So we're just probably finishing our 2023 work at the moment for our private groups or are well-advanced into it. So for the 2023 year, TD 2022/11 applies to you. So just be very aware of UPEs owing to private companies when you're doing your 2023 accounts and the potential need to put in place a 109N agreement soon or to pay out the UPE altogether.

So the TD talks about when an unpaid present entitlement is also held on sub-trust. Now, if you can set up a proper sub-trust under a trust distribution, then that won't be a financial accommodation. So it generally occurs. So 109D3B is the area you want to look at for your definition. So you've got a UPE to a private company, and that company has knowledge of the UPE and it doesn't demand payment. Basically, that's when you will have a financial accommodation arising and a loan arising. So that's the definition there. I thought it might be worthwhile for you to have a look at that so you can see the precise wording.

Financial accommodation itself is not really defined. You just have to go back and look at case law in other areas because there's not even a lot in the income tax sphere on that, but it's a very broad and general term, and we'll talk about Bendel's case shortly because that was about whether or not it was a financial accommodation, and I don't know that the court perhaps of being, in my view, a little bit too optimistic in saying that it wasn't financial accommodation in that case.

We've covered earlier on that a private company's going to be taken to have paid a deemed unranked dividend if it makes a loan to a shareholder or associate and you don't repay that by the company's lodgement date or alternatively, you haven't put in place an excluded loan agreement. Then the TD goes on to describe, well, what is a financial accommodation? So the UPE remains unpaid, that's the first thing. Also, the UPE can be satisfied by holding on a new sub-trust for the benefit of the private company. This creates perhaps an opportunity, but I think that it's very difficult for most of us to actually put in effect a really good sub-trust arrangement.

This, again, talks about financial accommodation. Again, the key thing is that the company must have knowledge. So typically, that is going to happen after year end. So you'll make your trustee resolution say on or before 30th of June for a particular year. So typically, a beneficiary can't really know their entitlement until the accounts are prepared or are well-advanced. So that, by necessity, takes place in the following year anyway. So the company has knowledge in the following year, and then that sets the timing from when things have to happen by. So in these situations, if that UPE remains in the trust, that is the loan, that is the financial accommodation that is provided.

So a sub-trust is one area we could think about using. So if you look at most typical trust deeds, especially discretionary trust deed, they do often contain a statement in there that says that the trustee will hold the UPE on sub-trust, but it's got to do so for the exclusive benefit of that private company. So these sub-trusts, they form corpus. So the UPE is the corpus of the sub-trust. So the UPE comes to an end and you've got this new thing that arises, which is a sub-trust, which is essentially a separate trust.

So the ATO is saying in the TD that if you can set up a sub-trust so that UPE remains for the sole benefit of the private company, there will be no financial accommodation in the original or main trust. So there's a glimmer of hope there, but I would say that it's very difficult to achieve that because if the private company can sense to the trustee of the sub-trust allowing those funds to be used in the main trust, even if you pay a commercial return on those funds, that's going to be a financial accommodation.

So I think the only way that this can possibly work is if that sub-trust receives the money or an asset equivalent to that UPE and that money or asset is invested independently outside of that main trust and the return on those investments go only to the private company. I'd say that's the only very limited situation where you can achieve a sub-trust arrangement that doesn't trigger a deemed dividend. So very difficult to achieve that I think. So be very, very careful with your UPEs for the FY '23 year and onwards.

Now, Bendel is the case I was referring to earlier. So this did not go well for the ATO. So this is an AAT decision so it doesn't really carry much weight. The AAT held that the UPEs in this particular case didn't constitute loans for Division 7A purposes. So little comment there in italics from the case that a loan for Division 7A purposes doesn't go as far as covering rights created when you have an entitlement to trust income that hasn't been satisfied and remains unpaid. I think that's a pretty broad statement. I think it's optimistic. I think there's been case law in other areas that have a much wider definition of financial accommodation.

So look, it just remains to be seen. This matter is on appeal. So it's going to go probably now to the federal court. Whether it's single judge or full bench, I haven't seen any updates yet, but in the interim, be aware there is a decision impact statement that the ATO put out on the 15th of November. Until the appeal process is finished, the ATO are not wavering. They are going to keep on applying the views in TD 2022/11. So be very careful if you're going to take a contrary position. I think the results of the appeal could earn out very badly for you.

So unfortunately, none of us have a crystal ball. You may want to play it conservatively until then. If the federal court agrees with the AAT, then going forward, great, but at the moment, the ATO is still sticking with their views. So anything you do in that regard, just be aware. The ATO are not going to agree with you if you want to go contrary to TD 22/11. So things like objection decisions for past year assessments, they're not going to finalise those unless they absolutely have to. So they're just waiting on a higher court decision. Sorry, that was a little bit long-winded, but I think it's just an important element of Division 7A to really emphasise. It is a significant change, and I think what's even more significant is the removal of those three administrative investment options that we had under the old PSLA, which are now no longer available to us. So it does really limit the options going forward.

The other area that affects trusts and UPEs is what we call subdivision EA loans. Now, given the ATO's views under TD 2022/11 and the difficulty with maintaining a true sub-trust arrangement, there's going to be less situations with subdivision EA will apply. So if your financial accommodation is caught under TD 2022/11, you don't have to worry about EA, but EA generally applies. Well, you've got to trust and they make a payment that's related to an unrealized gain or they make a loan or they forgive a debt to shareholder or associate of a private company, and that trust also has an unpaid present entitlement owed to that company, then a deemed dividend can arise unless you put in place a loan agreement or what have you.

So just to be clear, these are loans and forgivenesses from a trust to a shareholder of a private company. So I think, however, given the ATO's views in TD 2022/11, that's going to override EA, but there might be situations where you do have a genuine sub-trust in place and then you're going to have potentially subdivision EA issues to worry about. This is a diagram of how it works. So you've got a private company ABC. It's owed a UPE from the ACB trust and the trust loan amount to Mr. A who is either a shareholder or associate of a shareholder of ABC. There is a deemed loan that is made from the company in that particular case. So just be aware that that still exists.

Also, again, you have 109T to worry about. So this is that integrity provision, and it can apply where a private company uses, say, an interpose entity like a trust to get either interest-free loans or out to a particular person. So I'll leave this diagram here for you to have a look at in your own time. TD 2018/13 also explains this example in a bit more detail.

Also, just to wrap up Division 7A, you're probably wondering what's happened to all the changes that have been announced quite a while ago on Division 7A. There's a bit of a history there, but the last thing that really happened was consultation way back at the end of 2018. There were some delays. The last announcement was a delay to 1 July 2020. Since then, we've had a change of government, and this government and treasury has been very quiet on Division 7A ever since. There is no draught legislation. At this stage, we really can't say which and if any changes will be carried out.

Some of the things that they have talked about is removing this idea of distributable surplus, just having a single 10-year loan rather than a seven and a 25-year. Interest rate, just simply using interest rates published by the Reserve Bank of Australia and no requirement for formal loan documents, but you need to have some written evidence that a loan was entered into, so some of the things that they're hoping to achieve.

Then there was some talk of transitional rules for existing loans. So there would be, obviously, seven and 25 and pre-loans in place that there would be special transitional rules to bring them into the new 10-year requirement, and also some transitional rules for UPEs. Now, this, of course, this guidance hasn't been updated for TD 2022/11. So all we can do is keep watching and see if there's any progress. Alison, I'll hand over to you now to run our first poll question for today.

CCH Learning:

Thank you very much, Carlo. All right, everyone, I'll just read this question and then launch it up for you all to vote. So where minimum repayments have not been made on a complying loan agreement during a year, the amount of the deemed dividend would be? I'll just launch it up for you all. So A, the entire value of the loan, B, the shortfall in minimum repayments or, C, being nil. If you're looking for how to participate in these polls, just click the blue flower icon on the bottom of your screen. Then you'll be able to see GoToWebinar in its entirety and just click in one of the three radio buttons for this first poll question. We just have two polls in our session today. All right. Slowly getting up to majority there. Thank you for getting in your votes, everyone. I'll just give you a couple more seconds, and let's compare these results. So we had 55% A, 44% B. Thanks, Carlo.

Carlo Di Loreto:

Thanks, Alison. Well, I'm not sure I like those results, but look, let's go straight to the answer. It is B. It's the shortfall in the minimum repayments, not the entire value of the loan. Those who said A, look, you'd be right. That used to be the case many years ago. So when the introduction of Division 7A was made, if you got your minimum repayments wrong, the entire value of the loan would be a deemed dividend. They realised that that was just grossly unfair. So now, if you failed to make a minimum yearly repayment in a year, your deemed dividend is only that minimum yearly repayment. So thank you for having a go at that, but some of you need to brush up on your Division 7A knowledge.

Let's go quickly now to have a look at another part of loans which often creates problems, and that's commercial debt forgiveness. So CDFs is what we call them. It basically applies to commercial debts. So what is that? So it's a debt that if interest was paid on, that would be an allowable deduction, and that's it. That's the primary test. The borrower of the debt, so the recipient of the loan in other words, is the entity that's subject to these rules where that commercial debt is forgiven. It can apply to individuals and trusts, but only if it's not subject to Division 7A or FBT. So those areas take precedence.

If you're a lender, so if you lend the money to someone, then if you forgive that, then there might be some ordinary income tax consequences, so potentially a deduction or you might have capital gains applying, so potentially capital loss, but depending on market value rules and what have you.

Now, CDF won't apply if there's bankruptcy or forgiveness through a will or for reasons of natural love and affection. Now, there was a view of the ATO many years ago that if a loan was made by a company to an individual and that loan was forgiven, say, because the director had a relationship with that person, then that was a natural love and affection forgiveness. TD 22/1 basically hits that on the head now. So you can only have a forgiveness of natural love and affection if it's by a natural person. So you can't have a company making such a forgiveness. So the ATO had turned their view around on that in recent years.

There are five ways you can trigger a forgiveness. So you can waive or otherwise extinguish the debt, the right to recover in. So every state typically has a statute of limitations, which it might vary from state to state, but let's just say it's six years in your state. That can trigger a debt forgiveness. You could enter into an agreement to forgive a debt in the future. Well, that agreement triggers a debt forgiveness. Now, you can assign a debt to an associate of the debtor. That's called a debt parking or you can do a debt for equity swap. So any of these things you need to be very careful.

One thing I will say is that you actually need to do something to evidence of forgiveness. Just writing it off in the account is not a debt forgiveness. So typically, what we would do to forgive a debt, you've got to implement some kind of a deed. We often call these a deed of forgiveness or a deed of release to actually affect the forgiveness. Just a journal entry, that's not going to be a forgiveness. That debt is still owing.

Then the other thing you need to think about is the timing of that deed of release because that determines things like your capital or tax losses when they can be deducted in the correct year. So the timing of that forgiveness is critical, especially from a CDT perspective. There's also rules about the amount forgiven. So you'll have to go to the provisions, but if you look at 245C, the amount forgiven is a formula. It's the value of the debt minus any consideration you receive. The value of the debt is typically the market value at the time of forgiveness, assuming that at the time the debt was incurred, the debt was able to be repaid and the debtor was solvent when the loan was advanced or forgiven. So that sets the debt amount. Typically, that would be the face value of the debt in most cases, but be aware of the solvency requirement.

Now, for arm's length transactions, the debtor would have the capacity to repay the loans when borrowing the funds, but then it can get a bit complicated when you're dealing with related parties because you could be advancing funds to entities that really are not able to repay but you lend them anyway. So you can't rely on that rule about at the time the debt was incurred, the debtor was able to pay the debt for non-arm's length transactions. So be very careful of related party transactions because that'll affect the formula of what the forgiven amount is, and the forgiven amount may actually be zero in some cases where there's non-arm's length dealings going on.

There's also the market value substitution rule. You'll find that in the CGT provisions, which will substitute the value forgiven to market value at the time the loans were funded. So what that might mean is you may not have a capital loss to claim. So again, make sure you check out all of these provisions if you are faced with A CDF for debt forgiveness. So let's just say you've triggered a debt forgiveness, you have got a forgiven amount, and that it's significant. This is what happens. So to the person or entity who has borrowed the money, they must reduce their tax balances in this order. So you start with revenue losses, then capital losses, then deductible expenditure. Things like, for example, depreciating assets could fall under that, and then finally, reduction of the cost base of CGT assets.

If your debt forgiveness amount is greater than the total of all of these, well, it doesn't matter. There are no further issues that you need to worry about and the excess just disappears. It doesn't carry forward or anything, but just be aware that a debt forgiveness can wipe out a lot of these tax balances.

So here's a simple example that I've got here. We've got a proprietary limited. There's a commercial debt of 15,000 that's been forgiven, and we'll just assume that that gives rise to a $15,000 net forgiven amount. The column there, pre-forgiveness balances, are the losses and capital allowances and CGT cost basis. You can see that the total of those is only 12,000. So we've absorbed all of those. We've wiped out all of our tax balances. We have an unapplied amount of $3,000, but that doesn't matter. There are no further consequences from that. Just be aware if you're in a partnership, it can, but we won't complicate things with that today.

So when a lender forgives a debt, you then need to think about the tax treatment for the lender. So that is the person who has lent money to someone. So you may have a C2 event under the CGT rules. So that talks about when the ownership of an asset that you own and that would be the loan you've advanced is cancelled. That's what generally happens under a forgiveness. So you could have a CGT event, but just be aware of the market value rules. So you'll need to calculate your capital gain or loss. You may have a cost base, but you may have a deemed market value depending on the circumstances. If the lender is in the business of money lending, then that's a different story. They may be able to claim a tax deduction. So for example, like a bad debt deduction but limited to entities in that money lending business.

There is a common ownership exclusion. So companies under common ownership you could ignore. You can enter into an agreement between the debtor and credit company to do that. If you have a tax consolidated group, you generally don't have to worry about it if the forgiveness is within the group, but just be aware of this common ownership exclusion. It can mean that within groups it's a tidy way of clearing loans that have perhaps become a problem over time.

The other area that we want to also touch on today is just interest deductions. So when we're talking about interest deductions, we're really just looking at Section 81. There's no specific provision to deduct interest per se, but this is generally the one we are most concerned with. So the two things there, one thing I will say is interest can never be capital in nature. So the only question is, has it been incurred in producing assessable income or in carrying on a business or has it been incurred for some non-business or non-income producing purpose or private purpose? So that's the only thing you have to decide with interest. It's never a question of whether it's capital or not.

Deals case from many years ago, a high core decision has basically clarified all of that. So you've just got to show that there's a connection between the interest expense and the gaining or producing of assessable income, and that it can't be incurred too soon before the commencement of a business activity. That's what Steele is also primarily about. So the big issue that you'll often find with the ATO is they'll try and knock out expenses or deductions in a review or audit on the basis that you've incurred them at a point too soon in time. So the income earning activities may not have started yet or the business may not have been established yet. So be aware of that timing rule.

The use test is critical. So Monroe is a good case about that. In deciding whether interest is deductible, you look at the use to which the borrowed funds have been put. So very simple but very practical rule. There's also a few special rules there. You can have a look at TR 2000/2 about line of credit and redraw facilities. So where you have a loan that's used for multiple purposes, the ATO expect you to really keep those purposes well-documented to support the interest deduction because some of those purposes may be private and not income-producing. So be very careful with these sorts of facilities. Redraws can get very complex. I've seen a lot of people misuse them, especially line of credit type mortgages. So needs good documentation in order to make sure you maximise your interest deductions.

We've touched on vacant land deductions recently in an update, but I thought worthwhile noting that there is this very specific exclusion. You cannot claim an interest deduction where you hold vacant land. So there is no structure on the land. It doesn't apply to the extent that the taxpayer is carrying on a business. So that was one exclusion to this rule. So if you're carrying on a business, then this should be fine, but again, just refer to Steele. Are you incurring your activities too soon? That can still be a problem. You can still get a deduction if it's in connection with an affiliate or a connected entity that's carrying on a business on that vacant land.

So a couple of exclusions there, but be very careful about this vacant land. It denies deductions. So this denial doesn't apply. So the vacant land rule doesn't apply to corporate tax entities. So companies and public super funds are generally okay, but be aware. SMSFs, manage investment trusts, public unit trusts are actually still caught by this rule. So if you've got a private trust and you're holding vacant land, the only way you can really claim a deduction is you've got to be carrying on a business in relation to that land. Of course, with SMSFs, they cannot carry on a business. So it'd be very difficult for an SMSF to borrow hold vacant land and claim an interest deduction for that.

Now, we've talked about incurring interest too soon, but there's also a rule about commencement and cessation. So if you have a look at TR 2004/4, the ATO accepts the decision in Steele, that interest is not capital in nature and really can't be because there's no enduring benefit to interest. Interest is the time cost of borrowing money and it's calculated from time to time, but it has a very short-term benefit for each interest payment that you make.

So if you are about to commence a business, you can still claim a deduction for interest if the intention is to produce assessable income and it's not incurred too soon. Again, be very careful with that rule and have a look at this ruling if this is a concern to you. Also, if you've ceased a business, it can still remain deductible, and there's been a couple of really interesting cases on this many, many years ago now, but it's pretty well-established law.

So even though your business has ceased, if you've still got an outstanding loan that you're paying off, you can potentially still claim a deduction for that interest, unless of course you keep the loan for unassociated purposes and the taxpayer keeps that loan for an ongoing commercial advantage. So something to be aware of if you've got clients who have closed down their businesses, for example.

Penalty interest, I'll leave this here for you to have a look at. TR 2019/2 sets out the deductible of penalty interest, so could be deductible under 81 or potentially as borrowing cost discharge, CGT, cost base, et cetera, and 40-880. So this just basically sets out a cascading set of provisions that you might want to have a look at and some examples taken from that ruling about penalty interest.

Then this slide here, again, I'll leave it for you to have a look at, but total holdings is a really interesting one because it talks about interest free on lending. So Total Holdings was a holding company. It borrowed funds from a parent and it lent to a subsidiary on an interest-free basis. So the holding company had an interest expense and the whole issue was, well, can you claim a deduction if you're not earning interest on those funds? In the case of a corporate group, well, the answer was yes you can because interest-free on lending enables a subsidiary to be more profitable, so it increases the expectation of dividends. So there's your income, and the court found that yes, a deduction is available in these corporate group style arrangements.

The other thing to consider about interest-free on lending is where you have discretionary trusts and you can't borrow money and then on lend it to a trust or contribute it to a trust because under a discretionary trust, you have no entitlement or expectation of income. It's a bit different if it's a unit trust, but with a discretionary trust, typically everything's at the discretion of the trustee from year to year and you have nothing more than a mere expectancy that you'll receive income from that trust.

I've got an example here that I'll leave you to have a look at in your own time, but just very simple and just illustrates the situation with lending to trusts and then trust borrowings lending or borrowing money to pay off beneficiaries, that there is a real risk here, that you just won't be able to claim any interest costs in the trust to do this. Again, it always comes down to showing a sufficient connection with assessable income being generated from that fund. So be aware of borrowing to do things like paying out UPEs. Okay, Alison, I'll hand over to you now to run our second poll question, please.

CCH Learning:

Thank you very much, Carlo. So I've just realised GoToWebinar's cut off the end of this sentence, so hopefully you can still see it on the PowerPoint slide, but I'll read through what I do have. So Company A's a creditor has forgiven a debt totalling $100,000 during the 2018-'19 financial year and the company has carried forward. So A was 100,000, B, 15,000, C, 50,000 or D, 65,000. All right. Thank you for getting those votes in. So this is our second and final poll question for the webinar today. Couple of questions coming through. Thank you for those. So we will add those to our Q&A at the end of the webinar today.

All right. How are these votes going? So we are slowly getting up to majority. I'll just give you a couple more seconds and then we can compare everyone's results together. All right. Let's have a look at these answers. Thank you very much, everyone. So we had 67% with 100,000. Thank you, Carlo.

Carlo Di Loreto:

Oh, thank you. Again, we're not having a good run with these questions today, are we, Alison? So the debt forgiveness is 100 and it occurs in the '19 financial year, but the carry forward losses were 50,000 at the end of the '18 year, so the previous year, and then there was a further 15 incurred in '19. So it can really only be 50 or 65, and we'll assume no other balances exist. The correct answer is actually C, 50,000.

So the trick with commercial debt forgiveness is you always go back to your tax balances at the start of the year in which the forgiveness occurs. So in our case, let's just assume that the debt was forgiven on the 30th of June 2019. We go back to the tax losses at the beginning of the '19 year. So that would be $50,000. So the 15,000 that were incurred during '19 do not come into it, so only the 50,000 is impacted. So hopefully, that clarifies things for you, but more hopefully you don't actually have to get into any debt forgiveness situations because I think that's a far worse problem to have.

So just to finish off the presentation today, we've got a few slides left, I'll just take you through very quickly a hodgepodge of other issues that you might want to consider. So the first one is the debt equity rules as they apply to small business. So what these rules do is they tell you whether an arrangement is a debt or it's equity. That's really important because if you've got a debt interest, then the interest payable or paid on that could be deductible. However, if you've got an equity interest on which you have an interest expense, then that won't be deductible, but it could be a dividend. So very important.

It basically is a set of rules which classifies things. It doesn't tell you whether something is deductible or not. It's like an interpretation provision. So the thing we always want to do is when we have a loan arrangement, we want to make sure it qualifies as a debt interest. So it can be a debt interest if you have a requirement to repay the loan within 10 years. If the term exceeds 10 years, be very careful because then you have to calculate a present value of the repayments on those loans, and it gets very difficult because a present value requires you to know what a benchmark interest rate is to apply to that loan.

When we're talking about SMEs and related party borrowings, that interest rate is very, very difficult to ascertain. So for SME businesses, very important to perhaps on a very practical level keep your debt agreements to 10 years or less. So what this means is debt equity is the opposite of Division 7A. So these are loans that you might make to a private company. So just to be clear, so the exact opposite of what happens on the Division 7A. So if you're lending money to a company in the group, you have debt equity to worry about. So 10 years would be the maximum that I'd want to do because I think you're going to not be able to work out a benchmark interest rate for a loan that goes for greater than 10 years.

At call loans for small businesses are also a good idea. So you can make a loan to a company at call and that can be interest-free. The only thing you have to make sure is that the GST turnover of that company, that private company, is less than 20 million or doesn't exceed 20 million. So for SMEs, generally, that's what we do. We have a lot of these. If we have a company that needs funding, we generally tend to do it at call interest-free, and provided the GST turnover is below 20 million, that's a pretty nice situation, very simple to administer.

Then repayments can be made by the company at any time without any administration. So be aware of that. Be very careful with that call loans if your company has GST turnover, excuse me, exceeding $20 million because this carve out would not apply if you have a company greater than 20 mil GST turnover that you've advanced an at call loan to, that will be an equity interest. The problem with that is you need to keep a non-share capital account, but more importantly, the ATO will seek to apply a very, very harsh anti-avoidance provision if you try to make repayments of those at call loans from these large companies, and that's section 45B, where they can treat a repayment of an at call loan by a large company as a deemed dividend. So be very, very careful of managing credit loans to large companies, but for less than 20 mil, at call is fine and can be repaid quite easily.

Also, another one which we often are not aware of, personal use assets. That's the definition there from the legislation. I'll draw your attention to paragraph D. A personal use asset is a debt arising other than in the course of gaining, producing assessable income or from carrying on a business. So be very careful with interest free loans that you make. If it's a personal use asset, then any capital loss that you might make is disregarded. So again, be very aware. That's a bit of a sleeper which we often forget about.

Just a note regarding UPEs. UPEs are not commercial debts, so they're not subject to CDF, but interest-free loans could be considered personal use assets. So just be very careful there. In terms of international issues transfer pricing for loans, we covered this in an update late last year. There are some simplified transfer pricing rules which you can use. So international issues transfer pricing, it's basically pricing that is applied between related parties that one of them might happen to be offshore. So in a lot of SMEs these days, do venture offshore in expanding their business or vice versa. It might be offshore businesses expanding into Australia. If you've got them as clients, be aware, pricing between those related international parties need to be done on an arm's length basis, which is very costly and complex to establish. So the ATO have these simplified rules. You'll see it in a PCG 2017/2.

In terms of loans, you can forego all that transfer pricing analysis if you're happy to use the interest rate that the ATO suggests. So for 2024, they're saying 5.81% and that's for both in and outbound loans, and last year, it was 5.65. So they update these rates every year. However, just be aware you may get a better result if you actually carry out a proper transfer pricing study, but as I mentioned, that can be complex and it can be quite expensive to carry out.

Also, be aware of thin capitalization, again, with international type situations. The thin cap rules are currently going through a change. The senate just reported back yesterday they're happy for these changes to proceed and we've covered these changes previously, but it amends the way that you apply the thin cap rules, and they're going to use a new method where you use tax EBITDA to work out the maximum allowable debt deduction under these rules, but if you've got international groups, thin cap is only going to be a concern for you, however, if your debt deductions are two million or more. If they're below 2 million, you don't have to worry about thin cap at all.

Then final word, just on withholding taxes, if you're paying interest to a foreigner, a non-resident, be aware of withholding tax because you can only get a deduction for that interest if the withholding tax is being paid. There are all the obligations of remitting that withholding tax to the ATO. So again, be very careful, very mindful of this if your clients have borrowed from unrelated parties overseas. That's the section there, 2625, which can deny you an interest deduction if you fail to withhold correctly.

Also, be aware, international dealing schedule. If you have related party transactions exceeding $2 million, you need to complete this schedule as part of the tax return. That can be either a company, a partnership, a trust or some investment fund. So just be aware, look at aggregate dealings. So it's all dealings, including loans and what have you. If it's over 2 million, you will have to complete this. We already touched on the simplified way of charging interest between related party international loans.

Another thing which we often forget about is foreign exchange. If you've got foreign exchange debt, you need to consider the Forex rules, but you can disregard these if your balance is less than 250,000. These rules apply to individual trusts and companies as well. So just be aware of those. I've just outlined here some of the realisation events that might apply. So number two happens if you cease to have an obligation. So that's when you have a loan repaid to you or four when you've repaid a loan. So just be aware, Forex can be an issue, but if you've got a low amount less than 250,000 in Forex, you don't have to worry about that.

This slide here really just reminds us of the relationship between Division 7A and FBT. Typically, Division 7A takes precedence. However, if you've got a loan to someone who is not a shareholder or associate, then be aware, you may have a loan fringe benefit to take into account if the recipient of that loan is an employee. So just be very careful there of that interaction, but typically, if Division 7A applies to a loan, FBT doesn't. Typically, there's also debt waiver of fringe benefits that can arise as well, but if Division 7A applies because it's a debt forgiveness, then these debt waiver rules and the FBT legislation won't apply.

Then just a quick word on borrowing costs. Again, more of a reminder here, 20-25 cost of borrowing, you deduct over a five-year period, and it includes things like loan establishment fees, mortgage insurance, stamp duty loan valuations, et cetera. So I'm sure you're all very familiar with this, but I thought might be nice just for completeness just to show it all in the presentation today. Sorry to rush the end bit there because I'm conscious we're over time, but a lot to cover today. So Alison, I'll hand over to you to run through any questions and to close the session.

CCH Learning:

Thank you very much, Carlo. So as mentioned, we have had a couple of questions come through. Anyone else who would like to quickly submit a question, please pop it into that questions pane and then we can add that to our Q&A. All right. In the interim, I will quickly mention our upcoming webinars. So tomorrow, we have a Q&A session regarding aged care, then kicking off our FBT season with salary packaging essentials. 8 Feb, looking at improving performance with clients, then contractors versus employees, and on 13 Feb, how to charge your worth. So jump on the CCH learning website via this link and you can check out all of our webinars.

All right, Carlo. Let's have a look at these questions here. So first one is from Sam, "Does a sub-trust share have all the same attributes of the trust it's contained in, i.e., trustee, appoint or beneficiaries, except it has its own deed?

Carlo Di Loreto:

That's a great question, Sam. Look, I think in a nutshell you've got it right. So typically, what happens is the main trust deed contains provisions for the sub-trust. So the sub-trust in most cases, and look, I want to be careful here, I don't want to say this as a blanket rule, but in most cases, it just inherits the clauses of the main deed. So that would include the trustee remains the same appoint or guardian and what have you. So the short answer is it inherits the deed.

What's really important about sub-trust though is that if you want to do it properly, then what you really should have is that sub-trust should be producing its own set of accounts, should have its own TFN, should be lodging its own tax returns. So if you want to really be strict about it, you'd have to do all of that, but from today's presentation, the main thing is in relation to Div 7A, and the main thing is making sure that the funds that the UPE represents are isolated and dedicated only for the benefit of that private company beneficiary.

I think, practically, that's the difficult thing to achieve because for the most part, and that's what we see in practise, most of our SME clients, they need those funds in the main trust anyway, especially if the trust is operating a business or activities that require funding, any activity requiring funding. There's just generally a commercial and practical requirement to have the funds there.

So I would say yes, Sam, you're broadly correct, but very difficult to set it up administratively correctly, but then also practically and commercially, can you isolate those funds for the exclusive benefit of the private company? I think that's where it gets tricky. So there can be a bit of risk in relying on that sub-trust structure to get you out of the application of TD 22/11. So thank you for that. I thought that was a really good question. Thanks, Alison.

CCH Learning:

Thank you, Carlo. Next one from Edward, "A sole director company pays director fees to its director. The director fees are not transferred yet to the director account. Can we offset the unpaid wages and director fees from the debt balance for director loan to bring it to a nil balance?"

Carlo Di Loreto:

That's also a really good practical question, and I believe you can. Yes, you can offset wages against a potential Division 7A loan. I think short answer to that one is yes, you can. Thank you. Alison.

CCH Learning:

I think Edward may have covered that in his follow up question. So he said, "If there is a complied loan agreement in place, is it possible to offset the Division 7A loan, minimum yearly repayment from unpaid wages, director fees? The director has signed a director minutes resolution."

Carlo Di Loreto:

I believe you can. I personally haven't ever done that with my clients. Most of them are in a little bit unique situations, but I believe that's a valid repayment, but I'm happy to hear from others if they have a differing view, but I think that that is a valid repayment provided you want to make sure you get your ... I think you've mentioned that you've got all the correct resolutions in place, but you really want to make sure that those salary and wages are correctly set and incurred and, obviously, picked up in the director's payment summary, withholding tax, all of the other admin requirements there. So with a lot of these things, while they sound simple when we're talking about it, just remember there's a lot of practical administration that needs to be done, but in principle, yeah, I think you can. Thank you.

CCH Learning:

Thank you, Carlo. Lucky last question here from Jason, "Regarding vacant land use for farming, the business of farming should be able to claim the interest and exclude those provisions. So should they, and does it matter who owns the land?"

Carlo Di Loreto:

Look, good question. We haven't really delved into the vacant land exclusion too deeply. I'm a bit reticent to say too much about that because everything is fact-specific, but if you're carrying on a business, then that is a valid exception from those vacant land rules. I think we did mention in the slide about if the business is being carried on by an affiliate or a connected entity. So those terms are defined terms. So yes, it does matter. It really does matter who is carrying on the business, but I would say you'd probably need to go away and have a look very closely factually at the situation, but it sounds like in your case, there could be a potential there to claim a deduction, but I think you need to go and investigate that one because it's very, very fact dependent, but good question. Thank you.

CCH Learning:

Thank you very much, Carlo. All right. That is all the questions that have come through for today, so appreciate you answering those, and we will just look at wrapping the session up here. So in terms of next steps, I'll just ask everyone to please take a moment to complete the feedback survey. It's important for us to hear your opinions. Shortly after the session today, you'll receive an email letting you know when the recording is ready. We'll also prepare a verbatim transcript, a CPD certificate and, of course, the PowerPoint presentation. So thanks again to Carlo for the session today, and thank you to everyone in the audience. We hope to see you back online for another CCH Learning webinar very soon.

Carlo Di Loreto:

Thanks, Alison.