ANOTHER DIVISION 7A SLEEPER

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The only certainty about Div 7A of the ITAA 1936 at the moment is probably its uncertainty where there is a transaction involving a trust.

Section 109XI

A new and widespread uncertainty has emerged regarding the operation of s 109XI and its interrelationship with Subdiv EA generally and, more particularly, s 109XA(2).

The following is an extract from NTLG agenda item 8, from the recent 18 October 2010 meeting:

"Section 109XI essentially provides that a private company is taken to become entitled to an amount of net income of a trust (called T1, for ease of reference) where the private company is or has become entitled to net income of another trust (called T2, for ease of reference) in certain circumstances. These circumstances are where:

(a) a reasonable person would conclude that the entitlement of the private company arises solely or mainly as part of an arrangement involving an entitlement to an amount from the target trust; and

(b) T2 is or becomes presently entitled to an amount from the net income of T1, or another trust interposed between T1 and the company from the net income of T1."

To summarise - where T1 creates an unpaid present entitlement (***UPE***) in favour of T2 and T2 creates a UPE in favour of a private company beneficiary, assuming for a moment that both amounts of UPE are the same (say $10), the private company is regarded as having become entitled to 2 amounts of $10, once actually from T2 and once notionally from T1.

It would be fair to say that the creation of 2 UPEs in this manner has been a common scenario for many years prior to 30 June 2010.

An example

In order to illustrate the potential ramifications, let us assume that the 2 amounts of $10:

- were distributable with respect to the year ended 30 June 2008;
- remain outstanding; and
- constitute grandfathered UPEs for the purposes of TR 2010/3 and PS LA 2010/4.

One of the reasons for using the year ended 30 June 2008 is to highlight that s 109XI (which was introduced as part of a series of amendments in the year ended 30 June 2010) operates with retrospective effect.

Broadly, whilst those amendments apply in respect of loans, payments and debt forgiveness's arising on or after 1 July 2009, in the context of s 109XI, the UPEs may have come into existence years earlier.

Let us now assume, as is probable, that on or after 1 July 2009, T1 lends $6 to a shareholder or an associate of the private company where that associate is not itself a private company and that the loan remains outstanding.

The combined operation of ss 109XA(2) and 109XB is such that if a trustee makes a loan to a shareholder or an associate of a shareholder of a private company (except a shareholder or associate that is a company), whilst the private company is presently entitled to an amount from the net income of the trust estate at the time of the loan (and assuming that the loan has not been repaid), there is the potential for a deemed dividend for the purposes of Div 7A. This would arise if the amount to which the private company is presently entitled has not been paid to the company before *the earlier of* the due date for lodgment and the date of lodgment of the trustee's return of income for the trust for the year of income of the trust in which the loan takes place, assuming that the loan has not been placed on compliant Div 7A terms on or by that date.

Solutions

Returning to our example:

- Section 109XI has operated such that the private company has a notional unpaid present entitlement due to it from T1 of $10;
- T1 has made a loan of $6 to a shareholder or an associate thereof (the ***borrower***) of a private company.

In this example, how does one mitigate the operation of Div 7A? There appear to be 3 possible options:

1. The borrower repays the loan by the due date.

A practical issue here is how the borrower funds this repayment. In particular, if the borrower borrows a second amount from the private company or a trust with an unpaid distribution (real or notional) due to the private company, there is a real prospect that the interposed entity provisions in s 109T or s 109XG will apply.

2. T1 puts the loan on compliant Div 7A terms by the relevant date.

A practical issue here is that, other than in the simplest of groups, Div 7A management becomes spread all over the group.

3. T1 discharges the ***notional*** amount to which the private company is presently entitled before the relevant due date.

The practical issue here is as to how you discharge a notional amount.

The legislation is completely silent in this respect.

Surely it cannot have been intended that the notional amount cannot be discharged. To think otherwise would mean that T1 would forever be subject to Div 7A.

- Logic suggests that: The intention was that T1 could discharge the amount due to T2.

This could be by way of an actual payment or the parties agreeing that it has been discharged in satisfaction of a loan. The decision in *East Finchley Pty Ltd v FCT* (1989) 90 ALR 457; 20 ATR 1623 is clear authority that a payment can be effected in that way.

In this event, Div 7A continues to have considerable scope for operation because T2 continues to have an amount due to the private company.

If T2 were to make a loan to any party associated with the private company (and assuming that that party is not itself a private company), Subdiv EA would apply to that loan with the same alternatives for the mitigation of Div 7A as are set out above.

- The intention was that T2 could discharge the amount due to the private company.

  As a matter of policy, if not construction, one would have thought that the loan from T1 should not be exposed to the operation of Div 7A if the amount due by T2 to the private company was discharged.

  How can there be any potential for the operation of Subdiv EA when no amount is actually due to a private company?

Division 7A was designed to prevent private companies from providing funds/benefits to their shareholders or associates thereof where the income which gave rise to those funds/benefits is being sheltered at the prevailing company tax rate. In particular, Subdiv EA was introduced to prevent trustees from providing funds/benefits to shareholders or associates thereof of private companies where those funds/benefits were, in effect, provided by the private company by virtue of having a UPE from the trust.

Under either of the above discharge alternatives, it should be clear that the loan from T1 to the shareholder has not, in effect, been provided by the private company and accordingly should not be exposed to the operation of Div 7A and Subdiv EA.

In addition, Subdiv EB, and s 109XI in particular, was specifically enacted as a technical amendment to Div 7A to remedy the deficiency which allowed Subdiv EA to be circumvented as a result of interposing one or more entities between the trust making the loan and the private company. As a technical amendment, it should be inferred that s 109XI was not intended to apply to arrangements that would not have been subject to Subdiv EA but for the interposition.

Once T1 has discharged the amount due to T2, or alternatively once T2 has discharged the amount due to the private company, logic would dictate there should no longer be an interposition which could potentially circumvent the operation of Subdiv EA.

Consequently, any loan made by T1 to the shareholders or associates thereof of the private company would not ordinarily be subject to Subdivision EA and should not be dragged into Subdiv EA by operation of s 109XI.

If legislation is to be construed using a purposive approach, the above are compelling reasons why the discharge of one or the other UPE and not both should have the effect that Subdiv EA no longer has application as regards the loan from T1.

The ATO

However, neither of these alternatives presently seems to be favoured by the ATO.

The following is a further extract from NTLG agenda item 8, from the recent 18 October meeting:

"Using the example provided, the ATO's initial view is that payment of the UPE by the target trust to the interposed trust (UPE 1) and payment of that amount (which could be all or part of UPE 2) by the first interposed trust to the private company by lodgment date will not result in the private company being taken to be or to become entitled to an amount from the net income of the target trust.

The ATO is currently assessing the section 109XI implications for other arrangements, including but not limited to:

- payment by lodgment date of UPE 1 (as per example) only, and
- payment by lodgment date of UPE 2 (as per example) only.

There are a number of issues associated with these scenarios that need to [be] better understood before an ATO view can be determined. Further consultation on these, and other scenarios, will occur as part of the consultation process on the proposed Tax Determination or other ATO view product.

As part of the process of developing an ATO view product, we will engage with relevant stakeholders to seek their comment and feedback. We will also raise this matter at relevant ATO consultative forums, such as the *ATPF SME working group* and the *Division 7A working group*."

Thus the ATO's first position is that both T1 and T2 must discharge the amounts due.

The ATO is currently assessing whether either of the alternatives proposed above are to be permitted.

Thus, it would seem at this time that:

- T2 will be required to pay the amount due to the private company. On the assumption that the moneys are otherwise tied up in the group, the probability is that this will be satisfied by bringing into existence a compliant Div 7A loan between the private company and T2; and
- T1 will be required to pay the amount due to T2. On the assumption that the moneys are otherwise tied up in the taxpayer group, the probability is that this can be satisfied by bringing into existence a non-compliant Div 7A loan between T1 and T2. As T2 will be paying interest to the private company, it will probably be necessary for T1 to pay interest to T2 on this loan.