

The Tax Summit

Session 19.1: Demystifying Division 7A – Common misunderstandings and challenges

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1. Current ATO activity relating to Division 7A

While the deemed dividend rules in Division 7A have been in place for many years, it continues to be a major area of focus for the ATO in relation to private businesses and family groups and a key risk area for advisors.

So much so that the ATO has recently embarked on a 12-month education campaign starting with the first webinar held on 28 February 2024. The recording and transcript of the webinar can be found [here](#).

The ATO's position is clear from the title of the webinar "Private Companies & Division 7A – avoid the common mistakes!" and from comments by Assistant Commissioners Kasey Macfarlane and Anthony Marvello throughout their presentation, for example:

"Another interesting insight is that the breaches and those fundamental breaches that we've been talking about are common across the board. So, from very small business all the way up to some of the largest and private wealth groups, there's no concentration of issues in any particular industry or any particular sector of the business community. It's evenly dispersed across, and they're common across the board."

They also comment that, to the surprise of many in the ATO, the breaches are generally not highly technical but arise from a lack of understanding of or attention to the most fundamental elements of the Division 7A rules.

"...these are actually based on what we see in relation to the majority of Division 7A breaches and errors. They are those basic fundamental issues that we see."

Amongst the most common issues highlighted by the ATO are:

- Clients paying private expenses from their company's bank account without any consideration of the potential tax consequences.
- Clients failing to have complying loan agreements in place.
- Failing to make the required minimum repayments, which can arise due to:
 - A miscalculation of the minimum repayment required.
 - A lack of awareness of the minimum repayment requirements.
 - Not applying the correct benchmark interest rate.
 - Making loan repayments late.

These issues are mirrored in the ATO's reported findings from their major review programmes including the Top 500 and Next 5,000 compliance reviews, where poor record-keeping and a lack of documented governance procedures showed a clear correlation between common errors in key areas including a lack of compliance with Division 7A – see link to the ATO's Next 5,000 findings report [here](#).

The ATO also highlighted that their data shows in the vast majority of cases clients rely on their tax agent to manage their Division 7A obligations. This is why educating advisors is a key ATO priority.

The other common mistakes identified by the ATO in the webinar include:

- A failure by clients to recognise that a company is a separate legal entity, i.e. shareholders treating a company's funds as their own, often with a complete lack of awareness of Division 7A.
- Not maintaining appropriate records that explain payments taken from the company – the ATO will generally assume that such payments create a Division 7A issue unless the client can show otherwise.
- The client "wearing different hats", i.e. the individuals have transactions in their own name as well as being shareholders and directors of their private company and they often don't pay enough attention to the capacity in which they are acting at a particular time. This can result in payments not being treated correctly.

The ATO went to great lengths to make the point that *“there is (generally) no such thing as an obligation-free or tax-free payment/benefit from a private company.”*

Another important point for advisors to remember is that there is a label on the Company Tax Return (Label N at Question 8) requiring disclosure of any debit loan balance owing to a shareholder or associate at year-end. The ATO’s experience has been in many situations the relevant label is incorrectly not completed when there is in fact a debit loan balance owing to a shareholder or associate of a shareholder (e.g. a family trust).

Of course the failure to disclose a debit loan balance in the company tax return does not necessarily mean that there is a Division 7A issue in these cases. It would be very common for a shareholder to have a debit balance as at 30 June for which the appropriate action is taken (e.g. repayment of the loan balance in full or entering into a complying loan agreement) prior to the earlier of lodgement date or due date for the company’s tax return such that no deemed dividend arises.

Other key areas of concern that the ATO raised in the webinar include:

- Using a journal entry to offset a debit loan balance, including by recognising payment of a dividend to a shareholder which is then applied to repay a debit loan balance is fraught with danger and must be mere recognition of a transaction that has already happened, ideally supported by documentation.
- The “strategy” of repaying loans and reborrowing in the following year is still alarmingly common and in many circumstances is likely to attract Section 109R which has the effect of negating the repayment such that the Division 7A issue will not have been resolved and a deemed dividend may arise.
- As noted above, the due date for repaying a loan in full to avoid Division 7A is the earlier of lodgement date or due date for the company’s tax return, so delaying lodgement will not overcome the issue.
- The Commissioner’s discretion under Section 109RB to ignore the application of Division 7A due to “an honest mistake or inadvertent omission” has been relied upon too heavily by taxpayers and tax agents alike and is not intended to be a “get out of jail free card” whenever a Division 7A breach arises.

The ATO also makes some important observations that are worth considering:

- A common scenario is where a tax agent picks up a new client and identifies a Division 7A issue that was not adequately addressed by the previous tax agent. In the past this has often been accepted as a sufficient reason but the ATO is starting to take a tougher stance on this point and will generally require more specific reasons.
- It was noted that in the majority of applications the “honest mistake” was attributed to the tax agent, and the ATO’s expectation going forward is that tax agents know and correctly apply the rules.
- Finally, the closing message in the webinar is not to ignore an issue or “bury your head in the sand”, rather the ATO expects taxpayers and tax agents to be proactive in identifying and addressing Division 7A issues and taking any required corrective action as soon as possible.

2. Section 109RB – Commissioner’s Discretion

This is an important provision as it allows the Commissioner to exercise his discretion where there has been a breach of Division 7A so that either:

- A deemed dividend that would otherwise arise under Division 7A should be disregarded¹; or
- A deemed dividend that would normally be unfranked may be franked².

The Commissioner may exercise his discretion under Section 109RB when the deemed dividend arises because of an “honest mistake or inadvertent omission” by the recipient of the relevant payment or loan, the company, or “any other entity whose conduct contributed to that result” (e.g. a tax agent).³

At this point it is worth noting that a decision by the Commission whether to exercise his discretion under Section 109RB is a “reviewable decision” for which an application can be made to the Administrative Review Tribunal⁴, previously the Administrative Appeals Tribunal (AAT).

An example of a Section 109RB decision that was reviewed by the AAT is Case 8/2012⁵ in which the taxpayer argued that an honest mistake was made by his tax agent Mr M in respect of loans to the taxpayer by his company BuildCo in the 2005, 2006 and 2007 years. In that case a loan agreement was drawn up by the tax agent in June 2006, although the agreement was not fully compliant with the requirements of Division 7A.

The factors that led to the Tribunal member accepting on balance that there had been an honest mistake by the tax agent such that it was appropriate to exercise discretion in respect of the 2006 and 2007 loans (but not in respect of the 2005 loan) included:

- The circumstances that led to the mistake were “quite benign” in that Mr M made an attempt to draft a compliant loan agreement although his attempt “fell short of the mark”. The circumstances were regarded as neutral, weighing neither in favour of or against the taxpayer.
- In terms of the nature and timing of any corrective action “to try to correct the mistake”, the AAT member notes that the shortcoming in the loan agreement came to the notice of the taxpayer and Mr M during the ATO audit of BuildCo that commenced in November 2007 and was finalised in November 2009. The fact that during this period no attempt was made to correct the shortcomings in the loan agreement was seen as weighing against the exercise of discretion.
- The fact that Division 7A had not operated previously was a factor in favour of exercising the discretion.
- The extent and timing of repayments totalling \$434,000 towards the loans was considered to be a relevant matter in terms of Section 109RB(3)(d) and overall weighed in the taxpayer’s favour. This is despite the fact that the rule in Section 109R concerning repayments to be ignored had some relevance due to certain additional borrowings from BuildCo during the period.
- Not surprisingly, the ATO decision impact statement states that the case was decided on its own facts.

¹ Sec 109RB(2)(a) of the Income Tax Assessment Act 1936 (ITAA36)

² Sec 109RB(2)(b) of ITAA36

³ Sec 109RB(1)(b) of ITAA36

⁴ Sec 12(1) of Administrative Review Tribunal Act 2024

⁵ [2012] AATA 755

2.1 What is an “honest mistake” or “inadvertent omission”?

The requirements for obtaining an exercise of discretion under Section 109RB, in particular the meanings of honest mistake and inadvertent omission are discussed by the ATO in a taxation ruling TR 2010/8 and a practice statement PS LA 2011/29, each of which provides useful explanation and examples.

As neither term is defined in the legislation they will take their ordinary meaning.⁶

Also it is a person's “actual state of mind or belief” that is relevant when determining whether they have made an honest mistake or inadvertent omission and the ATO states that the available evidence can indicate this.⁷

This may arise due a mistake of law, a mistake of fact or a mixture of the two, noting that with a mistake of law the ATO will have regard to the level of knowledge and expertise of the person involved⁸ (which implies that a higher standard would be expected of a tax agent than of a client without such expertise).

A mistake in this context is “an incorrect view or opinion or misunderstanding” which must be honestly made⁹, while an omission is a “failure to take action” which must be inadvertent.¹⁰

The ATO acknowledges that a mistake or omission can arise from ignorance, but they would need to be satisfied that the ignorance led to the honest mistake or inadvertent omission which in turn led caused the breach of Division 7A. The ATO does not accept deliberate behaviour to remain ignorant of the requirements of Division 7A where the taxpayer is aware or is made aware of the provisions before that time, nor does it accept actions or omissions made to circumvent Division 7A, deliberate indifference or wilful blindness.¹¹

It is also worth noting that a mistake or omission that is common would not necessarily be accepted as honest or inadvertent, but in the absence of direct evidence this may be helpful. Similarly, a recurring mistake or omission may be accepted if it recurs for the same reason, including where an original mistake of law by a tax agent is accepted and then the same mistake is applied to other clients.¹²

The legislation specifies that in, making a decision whether to apply his discretion, the Commissioner must have regard to the following¹³:

- The circumstances that led to the mistake or omission.
- The extent to which the relevant entities have taken corrective action and how quickly it was taken.
- Whether any of the entities have previously been subject to Division 7A and in what circumstances.
- Any other matters that the Commissioner considers relevant.

Appropriate corrective action¹⁴ includes:

- Converting the payment, loan or debt forgiveness to a loan that complies with section 109N, and
- Making catch-up or shortfall minimum yearly repayments as if the transaction always complied with section 109N (plus interest compounded to reflect non-payment in earlier years).

Further explanation of relevant facts and circumstances is provided in paragraph 9 of PS LA 2011/29.

⁶ TR 2010/8, para 9

⁷ TR 2010/8, para 10

⁸ PS LA 2011/29, para 8

⁹ TR 2010/8, para 11

¹⁰ TR 2010/8, para 12

¹¹ TR 2010/8, para 13 - 16

¹² TR 2010/8, para 18 – 19

¹³ Sec 109RB(3) of ITAA36

¹⁴ PS LA 2011/29, para 14

2.1.1 Circumstances that support an honest mistake or inadvertent omission

- The relevant transactions were commercial, i.e. accurately and completely recorded and independently audited.
- The relevant entities involved in the arrangement can demonstrate a good Division 7A compliance history, i.e. genuine past attempts to comply with Division 7A generally and in the specific matter.
- The recipient or company has reasonably relied on professional advice or has adopted a position that is a common mistake or omission.
- Other contributing factors may include:
 - the complexity of the facts
 - novel or contentious issues of law
 - lack of ATO advice or guidance covering the facts or the law

Note – the ATO states that ignorance of the law is not in itself sufficient evidence to establish an honest mistake or inadvertent omission. The reason for that ignorance is equally important.

A rare recent example where the ATO has applied the 2-step process for granting discretion under Section 109RB set out in PS LA 2011/29 and been satisfied that the failure to comply with Division 7A arose from an honest mistake or inadvertent omission was a private ruling issued in June 2024¹⁵, specifically dealing with the failure of a previous tax agent to identify an address Division 7A issues arising from UPE's.

2.1.2 Circumstances that weigh against honest mistake or inadvertent omission

- The relevant transactions were uncommercial, i.e. the arrangement had a purpose of avoiding tax or involved fraud or evasion; the transaction was artificial, not accurately or completely recorded or was not subject to independent review.
- The behaviour and knowledge of relevant entities involved in the arrangement does not support a conclusion of honest mistake or inadvertent omission.
- The taxpayer or another party such as their tax agent had the relevant knowledge of Division 7A and the experience and expertise to properly comply with the requirements of Division 7A.
- Division 7A had previously applied in similar circumstances to an entity.
- A relevant entity has a poor tax compliance history.
- The entities involved consciously or unreasonably avoided obtaining advice in relation to the relevant application of Division 7A or unreasonably relied on or ignored professional advice.
- The trigger for Division 7A and associated transactions is straightforward or involve a straightforward application of the law
- The trigger for Division 7A involved transactions that are identified in publicly available and relevant ATO advice, or ATO advice provided to the entity.

2.2 Examples of honest mistakes or inadvertent omissions

As mentioned above, in TR 2010/8 the ATO outlines the requirement to be satisfied in order for the discretion in Section 109RB to be granted and provides several examples of situations that it believes can be considered to be an honest mistake or inadvertent omission.

¹⁵ ATO Private Ruling 1052227615407, issued 18 June 2024

2.2.1 Arithmetic error (example 2 of TR 2010/8)

A private company is taken to have paid a dividend to a shareholder because of a minimum yearly repayment shortfall.

The shortfall arose because the tax agent had made an error in calculating the minimum yearly repayment for one of the amalgamated loans. No similar errors were made in respect of other amalgamated loans, either in the current year or earlier income years. The error related to the remaining term used in the minimum yearly loan repayment formula. The term used was one year longer than it should have been.

The shareholder had made repayments based on the minimum yearly loan repayment advised by the agent. Both the taxpayer and tax agent were aware of the Division 7A obligations and had attempted to comply. There is no evidence to suggest that the error was anything other than an accidental oversight.

Outcome - in these circumstances, the arithmetic error is an honest mistake.

2.2.2 Mistake in the carrying out of the activities (example 3 of TR 2010/8)

Jack and Jill are the shareholders and directors of a private company.

During the year the company refurbished the company premises including the office.

It is Jack and Jill's practice to maintain separate business and private bank accounts and to pay business and private expenses from the appropriate account by cheque or direct debit. Jack and Jill are both signatories on each account and can sign solely. Jill does not take an active role in the company's business but is aware of the need to keep business and personal affairs separate. One day Jill goes shopping for new household furniture at a furniture store. As she is leaving the house she unwittingly takes the business cheque book with her instead of the personal cheque book. She pays \$10,000 for the private furniture using the business cheque book (again without realising her mistake) and writes "New Furniture — Furniture Store" on the cheque butt but does not otherwise indicate whether the cheque was for business or private purposes.

The amount paid for the private furniture was similar to amounts paid for office furniture.

Her error goes unnoticed by Jack or by Jill.

The company's income tax return was lodged and the company was taken to have paid a dividend under section 109C. During the preparation of the income tax return the company's general ledger entries were reviewed and the error was not discovered. The entry neither appeared unusual or inconsistent with other company transactions in terms of the nature of the transaction and the amount of the transaction.

Soon after the lodgement of the company's income tax return, as a result of a dispute with the supplier of the office furniture, Jack had cause to review the company's records and discovered the error. He took corrective action and repaid the money to the company from his personal bank account.

Jill's error is capable of constituting an honest mistake.

Outcome - the corrective action taken by Jack is relevant for the purposes of Sec 109RB(3)(b) when the exercise of the discretion is considered. It is irrelevant for the purposes of Sec 109RB(1).

3. Why the change of heart and how your client's problem might become your problem

As discussed above in relation to the ATO's current education campaign and with specific reference to the comments made in the ATO webinar in February 2024, it is clear that the ATO is stepping up its level of focus on Division 7A and will be less forgiving going forward when issues are identified.

A fundamental driver of the ATO's current approach is their concerns about the cost to the community of some taxpayers not meeting their Division 7A obligations – *"...benefits taken from (a) company and not being dealt with elsewhere, well, it's like the shareholder was borrowing from a bank being the Australian community and the consequence / cost of not getting that right is the application of Div 7A"*¹⁶.

Anecdotally it is clear that the ATO has become increasingly reluctant to apply Section 109RB to ignore the application of Division 7A for reasons including:

- The extent of non-compliance with Division 7A observed through its compliance activity.
- The fact that the vast majority of errors observed by the ATO arise from simple, fundamental aspects of the Division 7A rules that could have been easily avoided with greater care and attention.
- In many cases there appears to be genuine lack of knowledge and understanding of the requirements of Division 7A, which is quite concerning to the ATO and something they are keen to change.
- The consequences of the Division 7A breaches, i.e. significant difference in tax outcomes that can arise.
- The general increase in interest rates means that the tax implications of failing to charge interest on a shareholder loan (which in most cases would be assessable to the company but non-deductible to the shareholder, i.e. funds are used for private purposes) are much greater than was previously the case.
- Common incidences of the same taxpayer and/or the same agents making repeated Section 109RB applications, suggesting they have not learned their lesson and continue making the same mistakes.

It should not be lost on those of us that are tax agents that according to the ATO in most cases the party responsible for the honest mistake or inadvertent omission in Section 109RB applications is the tax agent. Often such errors come to light only when a client changes tax agent and the new advisor identifies an error that is attributed to the actions or omissions of the previous agent. As an aside, the latest Tax Practitioner Board requirements make it even more important for the new agent in such a situation to identify issues such as a Division 7A breach, raise it with the client and take appropriate action as soon as possible.

The key lesson here is that, whenever a tax agent takes on a new client, among the many steps in the onboarding process should be a careful review of the client's group with a view to identifying any potential unaddressed tax issues including Division 7A breaches.

Notwithstanding the ATO's apparent recent change of heart in being less willing to accept a lack of knowledge of the rules as a sufficient reason for obtaining Section 109RB relief, it is notable that the recent private ruling noted above, granted as recently as June 2024, still accepted that the conditions for applying the discretion had been met. It is reasonable to expect that the swift, proactive action by the new tax agent to identify and address the issue was a major factor in convincing the ATO to take a more lenient approach in that case.

If, by contrast, the new agent had not identified or addressed the issue promptly and there had been a significant delay before making the Section 109RB application, or even worse if the issue had instead been identified by the ATO in the course of a review of the client's affairs, it is likely that the outcome may have been much less favourable for the client.

¹⁶ Quote from the transcript of ATO Division 7A webinar held on 28 February 2024 – website link provided above.

Not only might the client then have taken action against its previous tax agent for neglecting to properly advise on their Division 7A obligations, but they may also have had cause to take action against the new agent for failing to identify and advise on the issue during the onboarding process.

A couple of further comments from the ATO webinar transcript are instructive in this respect:

“Don’t ignore it, don’t bury your head in the sand, take correction action as soon as possible.”

“...the discretion is not a get out of jail free card in every case where there is a Division 7A issue.”

“...we often see an agent come to us who’s just picked up a new client who have these Div 7A problems asking for us to exercise the discretion when there’s clearly been problems either at the client end or the previous adviser’s end, and they’re looking for us to exercise the 109RB discretion. Now, I don’t know what conversations they had. But clearly, that’s all things being considered would be unlikely to be, have the discretion exercised.”

In this context it is clear that, whether we are advising our existing clients or evaluating ongoing and historical Division 7A exposures for new clients, it is critical that tax agents have a good understanding of the requirements and practical application of Division 7A. We must be able to identify and anticipate potential Division 7A exposures and “head them off at the pass”, advising clients what they should and should not do in order to remain fully compliant with Division 7A and its application to their various transactions.

Not only should tax agents pay close attention to payments, loans and debt forgiven in relation to dealings between private companies, individuals and related entities (including trusts) and notwithstanding any potential changes that may flow from the final washup of the Bendel decision¹⁷ it is also important to ensure Division 7A risks arising from UPE’s owing to private companies by trusts are also managed.

While the basic principles of Division 7A can be relatively straightforward and its underlying intent is quite clear, the ATO’s observations indicate that the level of compliance generally is still much lower than it would expect and as with most areas of tax law there are still numerous complexities in Division 7A once a situation varies from the simplest, plain vanilla cases, and clients expect their agents to manage these risks for them.

Given the extent to which clients tend to rely on their tax agents in these matters, it follows that an increase in ATO activity targeting Division 7A breaches and a growing reluctance to exercise the discretion in Section 109RB means that, if the client has a problem in this area, then their tax agent also has a problem. This is a place none of us want to be and highlights the importance of staying on top of potential Division 7A issues.

¹⁷ Bendel and Commissioner of Taxation [2023] AATA 3074 and Interim Decision Impact Statement issued 15 November 2023.

4. Alternatives to dealing with historical problems

Let's assume you have started acting for a client and your review of their structure and prior year transactions has uncovered a prior year Division 7A exposure that has not been properly addressed. This could be:

- A payment to a shareholder that is treated as a dividend under Section 109C.
- The use of a company asset as addressed by Section 109CA.
- A loan falling within Section 109D where the appropriate action has not been taken, including a UPE owing to a company by a trust that is treated as a loan under the ATO's current approach.
- An amalgamated loan from a previous year where the minimum yearly repayment has not been made by the end of the current year, triggering Section 109E.
- A debt owing to the company that has been forgiven in circumstances that trigger Section 109F.
- A payment by the shareholder that is ignored due to the operation of Section 109R.
- An arrangement involving a trust and a shareholder or associate of the company that falls within Subdivision EA of Division 7A.¹⁸

Previously, after the issue with the client, you may have established that their previous tax agent has not advised the client appropriately on their Division 7A obligations and therefore appropriate action has not been taken in relation to prior year transactions. You summarise the situation in an application to the ATO requesting that they exercise discretion under Section 109RB to disregard the deemed dividend and, on receiving confirmation from the ATO, hey presto, subject to some corrective action – problem solved.

Now that the ATO is becoming reluctant to exercise discretion under Section 109RB without more specific reasons that can establish an honest mistake or inadvertent admission that was the cause of the Division 7A breach, what other options do you have to help your new client?

4.1 What if the relevant assessment is out of time for amendment?

The ATO generally has the ability to amend a prior year assessment for an individual within 2 years of the date of the assessment¹⁹ unless the ATO believes there has been fraud or evasion²⁰ in which case there is no time limit or one of the following applies²¹ (in which case the time limit is 4 years):

- The individual carries on a business at any time during the year and is not a “small business entity”²² or “medium business entity”²³.
- The individual is a partner in a partnership that is not a “small business entity” or “medium business entity”.
- The individual is a beneficiary of a trust that is not a “small business entity” or “medium business entity”, whether or not they actually received a trust distribution in the relevant year.

Similar rules apply to amending assessments of other entities such as trusts, in that a trust that is a small business entity or medium business entity will have a 2 year amendment period and for others the period will be 4 years, again assuming that there has been no finding of fraud or evasion.

¹⁸ See sections 109XA – 109XD of ITAA36.

¹⁹ Item 1 of the table in section 170(1) of ITAA97.

²⁰ Item 5 of the table in section 170(1) of ITAA97.

²¹ Column 2 of item 1 of the table in section 170(1) of ITAA97.

²² As defined in Sec 328-110 of ITAA97, being an entity that carries on a business and has aggregated turnover of less than \$10 million.

²³ As defined in Sec 170(14) of ITAA36, being a business with aggregated turnover of between \$10 million and \$50 million.

The ATO discusses the concepts of “fraud or evasion” in PS LA 2008/6, starting with describing fraud as “making false statements knowingly or without belief in their truth, including when made recklessly, careless as to whether a matter is true or false”.²⁴ Fraud is extremely serious and could lead to criminal charges and in most typical Division 7A it should hopefully be possible to demonstrate that fraud is not involved.

A slight step down from fraud is evasion. It was described by Dixon J in *Denver Chemical Manufacturing v Commissioner of Taxation*²⁵ as a “blameworthy act or omission on the part of the taxpayer”. The ATO in PS LA 2008/6 suggests that this:

- Lies somewhere between innocent mistake and intention to defraud.
- Involves making a wrong statement or taking an incorrect position without a credible explanation.
- Involves culpable conduct, more than mere avoidance or supplying misleading information.

The material facts must be examined to assess whether the relevant conduct is “blameworthy”.

Evasion is to be assessed objectively, based on the standard of a reasonable person in the taxpayer’s position.

The ATO states that “amended assessments based on fraud or evasion are expected to be very much the exception to the rule”.²⁶

If either fraud or evasion has occurred then a Division 7A error is unlikely to have been caused by an honest mistake or an inadvertent omission, so applying Section 109RB will not be a realistic option.

As both fraud and evasion are extremely serious matters and involve an element of deliberate wrongdoing, it is to be hoped that very few simple Division 7A situations would attract an unlimited amendment period.

That being the case, it would be a matter of establishing the amendment period relevant to the particular taxpayer that would potentially be taxed on a deemed dividend. If the amendment period has passed it is possible no action need be taken in relation to the original transaction to which Division 7A could have applied. This is important as it is also likely that the ATO will not consider an application for Section 109RB discretion where the relevant amendment period has expired.

That said, it is also worth bearing in mind that in most situations the trustee of a trust that has distributed all of its income to beneficiaries will not have received an assessment from the ATO so the trustee will not have an amendment period despite the ATO administrative approach. Unless there has actually been a trustee assessment the amendment period of the trust will effectively be unlimited and the risk is that a potential deemed dividend under Division 7A could be taxed to the trustee. This in turn means that the window within which a request for Section 109RB discretion may be relevant will be longer than may initially be expected.

If, however, the trustee’s distribution resolution for the relevant year operates in such a way that one or more beneficiaries would be considered to have been presently entitled to a dividend that the trust is deemed to have received through the application of Division 7A then the relevant time limit for amending assessments will be that applying to the assessments of the beneficiaries rather than the trustee.

This still leaves the question of how the debit loan balance should be accounted for going forward. The simplest way to deal with the loan would be for the shareholder to repay the loan in full to the company. As the loan has not actually been placed under qualifying Division 7A terms, there would not necessarily have to be interest charged. The parties would not be in exactly the same position as they would have been if Division 7A had been complied with in the first place, but at least no outstanding loans would be carried forward.

²⁴ Paragraph 2 of PS LA 2008/6.

²⁵ (1949) 79 CLR 296.

²⁶ Paragraph 4 of PS LA 2008/6.

Another consideration is whether a historical loan that has not been dealt with has become “statute barred” meaning that the company no longer has the right to call for payment of the debt. In NSW, for example, this can happen if more than six years has passed since there has been any repayment made or any acknowledgment of the debt. This could result in the loan being treated as having been forgiven for the purposes of Section 109F, such that the borrower could be assessed on a deemed dividend.

It is also worth bearing in mind that even if Division 7A is not attracted a debt forgiveness in such situations could have consequences for the borrower under the commercial debt forgiveness rules in Division 245.

4.2 Issues arising from a debt forgiveness

If instead the company was to forgive the loan *prima facie* Section 109F would apply to the forgiven amount, assuming other Division 7A conditions such as having a sufficient distributable surplus have been met. Importantly, Section 109F applies in the year that the debt is forgiven, meaning that the prior year Division 7A issue has become a current year Division 7A issue, and a deemed dividend could arise at that point.

It is worth noting at this point Section 109G, which is designed to ensure that situations where a deemed dividend has arisen for a loan under Section 109D do not also create a deemed dividend under Section 109F on forgiveness of the debt²⁷, which would result in the shareholder being double taxed on the same amount.

A strange quirk of the way Section 109G is currently drafted is that, where a loan would cause a shareholder to be taxed under Section 109D but the relevant assessment cannot be amended as it is out of time, Section 109G would still operate to negate the application of Section 109F on the forgiveness of the debt. This has the unintended effect that the shareholder would not be taxed under either provision, so in that situation the debt could be forgiven by the company without adverse tax consequences for the shareholder.

As noted above, even if Division 7A does not apply the borrower may still suffer consequences under the commercial debt forgiveness rules in Division 245.

This outcome is not one that can, or should, be planned for, but it is something to be aware of and can be a useful way to clean up an inherited Division 7A issue to minimise the tax implications for the client. That said, it should also be noted that forgiving the debt in this way will also generally reduce the company’s retained earnings which could be a problem down the track if it leaves the company with excess franking credits that cannot be distributed, trapping them in the company.

That may not arise to the extent that the capital loss that results from the debt forgiveness can be used by the company to offset future capital gains, but it is clear that this situation is far from straightforward so any debt forgiveness should not be undertaken lightly.

Was there a distributable surplus in the relevant year?

Every case is different so it will be important to carefully analyse your client’s specific situation when advising them on the associated risks and recommending possible actions that they might take.

Another important issues to consider is whether the company had a distributable surplus either for the year that the payment or loan was originally made or for the year in which a debt is forgiven and if so, whether it was equal to or greater than the relevant amount that would be subject to Division 7A. Any shortfall in the distributable shortfall would reduce or potentially eliminate the level of the client’s Division 7A exposure.

²⁷ Section 109G(3)(a).

5. Conclusion

There are many ways in which Division 7A issues can arise, and while the rules have been in place for many years, it remains a key area of focus for the ATO and a major risk area for private client groups. The ATO continues to see a wide range of fundamental errors in applying Division 7A. This includes a lack of compliance with the rules and in many cases a failure to correctly disclose debit loan balances in company tax returns.

For these reasons, and because the vast majority of clients rely heavily on their tax agents to identify and address Division 7A risks, the ATO has embarked on a 12-month education campaign to raise the level of understanding and compliance with the Division 7A rules. At the same time the ATO has become much less inclined to exercise its discretion under Section 109RB to allow companies and shareholders to take corrective action in relation to a Division 7A mistake whilst limiting adverse tax consequences.

It is therefore more important than ever that tax agents and their clients remain vigilant in identifying and addressing potential Division 7A exposures before they become a problem. If, however, you or your client identifies a prior year Division 7A issue that has not been properly addressed it is critical that the issue is carefully analysed and appropriate corrective action is taken as soon as possible. This is the case for both new and existing clients and regardless of who was at fault.

It may still be worth considering an application for the Commissioner's discretion under Section 109RB. Before you do this you must consider and discuss possible alternatives as there is a strong chance that the ATO will deny the request for discretion.

Finally, while circumstances may exist to minimise the extent of the issue for a particular client, having a Division 7A exposure is not a good situation to be in.

As a tax agent it is strongly advised that you:

- Put quality control processes in place to catch such issues before they become a problem;
- Ensure that all staff undertaking work for private groups are fully educated on Division 7A; and
- Undertake a detailed review of all new clients to identify any potential prior year Division 7A issues.

This will better allow you to advise the client on the potential consequences and to recommend the best course of action to "clean things up", managing the client's risks and your own.