VIC Tax Forum

Session 4A: Division 7A

How well do you think you know the provisions?

Presented at VIC Tax Forum 21-22 March 2024

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Acknowledgements

I would like to acknowledge the assistance of my colleague, Leo Gouzenfiter, Director at Pitcher Partners Advisors Proprietary Limited, for the countless hours spent in debating these issues with me. I would also like to acknowledge the assistance provided by my National Tax team for reviewing the contents of this paper and for providing their support. I would also like to acknowledge Archana Manapakkam, Special Counsel Velocity Legal, for her assistance in considering Section 2 (***Bendel***) of this paper and for providing her invaluable insights.

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1. Overview

The purpose of this paper and presentation is to explore some interpretive issues with Division 7A. These issues are not new and almost all of these items were raised in the final report of the Board of Taxation's review of Division 7A released on 12 November 2014 (**Division 7A report**).

Having been a member of the panel that assisted with the Division 7A report, it is somewhat disappointing that a lot of uncertainty has not been resolved via legislative amendment (as recommended by the Board). Without legislative amendment, we are left with a number of provisions that are somewhat broken and difficult to apply in practice.

The AAT decision in *Bendel and Commissioner of Taxation* [2023] AATA 3074 (***Bendel***) is a clear example of this potential issue, where the Tribunal or the Courts have been used to clarify the meaning of the term "loan" as used in Division 7A. It has been well known that this issue has been contentious, and this issue could have been addressed by legislative change (which would have removed all doubt a long time ago).

In some cases, there has been little guidance provided by the ATO (e.g., the interaction of section 109T with section 109R) or there is currently no guidance provided on a particular aspect of Division 7A (e.g., the treatment of partnerships). Given that Division 7A has been around for over 25 years, we need to question why this is the case and why there is currently significant uncertainty with the application of Division 7A in basic cases.

Historically, it is believed that the ATO were able to address questions on Division 7A in a timely manner through its NTLG Division 7A working group and technical forums. These forums enabled the ATO to explore issues with tax advisors in real time, with an aim of providing non-binding views on certain questions, or by providing appropriate public advice and guidance (**PAG**) to taxpayers on issues of significant importance. The ATO also had the ability to provide timely technical guidance through ATO IDs, especially around Division 7A. Throughout its lifetime, the ATO issued approximately 44 technical ATO IDs on various aspects of Division 7A. These documents helped to promote greater certainty in the application of the provisions – a key aspect that is missing today.

There also appears to be a significant disconnect between the ATO view and the view of tax practitioners in many cases (simply because the ATO view is unknown). A clear example of this, which is covered in this paper, is contained in the ATO's Private Binding Ruling (**PBR**) 1052129530678. This PBR outlines a significant change in the ATO view of partnerships in a Division 7A context. Whether this is a one-off view or a considered view is difficult to ascertain based on a single PBR. There appears to be no public commentary on this topic provided by the ATO other than the PBR. Accordingly, the majority of taxpayers would be unaware of this potential view held by the ATO, making it extremely difficult for many taxpayers to comply with an unknown ATO view.

In my view, it is very easy to fall foul of the Division 7A provisions. Whether you are a sole practitioner, or partner in a large accounting or legal practice. The issue does not need to be complex, and non-compliance can occur in the simplest of cases. While it is understandable why the ATO has not taken a broad approach to "self-correction" under the Commissioner's discretion (section 109RB), I would strongly advocate that the new Commissioner consider an ability for taxpayers to self-correct Division 7A issues identified in many cases (for example in a PCG).

All statutory references in this paper are to the Income Tax Assessment Act 1936 (Cth) (**ITAA 1936**), unless otherwise stated.

2. Considering the decision in Bendel

2.1 Background and assumptions

2.1.1 Unpaid entitlements to a corporate beneficiary

The *Bendel* case involved a discretionary trust (**the 2005 Trust**) that made distributions to a corporate beneficiary (**Gleewin Investments**) during the 2013 to 2016 income years. The distribution amount that remained unpaid (also known as an ‘unpaid present entitlement’ or **UPE**) by the lodgment date for each income year is outlined in the following table. It is noted that the Trustee of the 2005 Trust did not place the UPEs on a sub-trust and recorded the UPEs as a liability of the trust.

Income year	Entitlement	UPE at the lodgement day
30 June 2013	236,251	181,601
30 June 2014	164,242	164,242
30 June 2015	807,417	807,417
30 June 2016	229,955	229,955
Total	**1,437,865**	**1,383,285**

2.1.2 Loans to an individual beneficiary

At the same time, Mr Bendel borrowed money from the 2005 Trust through (what they refer to as) his beneficiary current account. The current account was recorded as an asset of the 2005 Trust. The balance of the current account at the end of each of the relevant income years was as follows.

Income year	Balance	Increase from prior year	Reduction from prior year
30 June 2013	1,400,000	574,820	-
30 June 2014	741,288	-	658,712
30 June 2015	1,663,561	922,273	-
30 June 2016	1,973,170	309,609	-
Total		**1,806,702**	**658,712**

As shown in the table, but for the 30 June 2014 income year, Mr Bendel's current account increased from year to year.

2.1.3 Character of the advances to Mr Bendel

The AAT did not discuss the nature of Mr Bendel's current account with the 2005 Trust, in particular the quantum of the increases and whether the current account constituted a single loan or whether each advance to Mr Bendel would be regarded as separate loans.

It appears to be accepted that the current account consisted of a single loan by the 2005 Trust to Mr Bendel. While this appears to have no bearing on the decision in Bendel (as the AAT was only concerned with the tax treatment of the UPE for the purposes of section 109D relating to loans made by private companies), the nature of the arrangement can have implications when analysing the application of Subdivision EA (relating to UPEs to corporate beneficiaries).

For completeness it is noted that some guidance has previously been provided on this question in the Federal Court decision of *Ashton Mining Ltd v Federal Commissioner of Taxation* [2000] FCA 590, where the Court held that advances in respect of an undocumented intercompany loan were each taken to be separate loans (rather than being part of a single loan under a single contract).

> *25 The Commissioner did not dispute the transactions recorded in the inter-company loan accounts between Ashton Mining and Ashton Gold. Rather, he contended that a running account was established pursuant to a contract between the 2 companies which came into existence prior to 10 May 1989. Accordingly, it was submitted that, although the advances said to constitute the relevant loans were made after 10 May 1989, they were acquired when the establishment of the running account was agreed to. Thus, so it is said, when each advance was made after 10 May 1989 it resulted in a new balance outstanding, from time to time, in respect of the "security" established by the pre-existing contract.*
>
> *26 The Commissioner relied on 2 decisions to support his submission. In Joachimson v Swiss Bank Corporation [1921] 3 KB 110 at 126-7 Atkin LJ observed that the contractual relationship between a banker and customer was governed by the terms of the contract entered into between them in the ordinary course of business when a current account was opened. Accordingly, advances made in the course of that relationship were held not to be simple loans made with each advance but, rather, were advances made pursuant to the terms of the original contract. The second decision was Hart (Inspector of Taxes) v Sangster [1957] 1 Ch 329 at 337 where Lord Goddard CJ agreed that, whether the account established between a banker and a customer is a deposit account or a current account, there is a continuing contract, rather than a new contract, every time money is paid into the account.*
>
> *27 Neither decision assists the Commissioner in the present case. The inter-company loans made by Ashton Mining to Ashton Gold were not governed by the terms of any initial contract entered into between them. Rather, Ashton Mining retained a discretion to make loans to its subsidiary upon such terms as it saw fit when each loan was made. Although Ashton Mining may have intended to make the loans interest free and repayable on demand, it was open to it to determine whether those terms, or any other terms, were to govern each particular advance. In the present case, unlike the situation with banker and customer, there was no*

> *pre-existing agreement establishing the inter-company loan account and the terms upon which advances to or from that account were to be made. Accordingly, there was a new unsecured loan made each time an advance was made by Ashton Mining to Ashton Gold.*

Without further analysis of this issue, and for the purposes of this paper only, it is assumed that the annual increase in the loan is to be treated as a separate loan for that income year to Mr Bendel. Accordingly, for the purposes of analysing Subdivision EA, we have assumed that Mr Bendel has been lent an amount of money (as shown in the table) in the 30 June 2013, 30 June 2015 and 30 June 2016 income years.

2.2 Applying Division 7A to UPEs

2.2.1 The Commissioner's contention on section 109D

Consistent with the Commissioner's view in the public ruling that applied at the time, *Taxation Ruling TR 2010/3: Income tax: Division 7A loans: trust entitlements* (**TR 2010/3**), the Commissioner contended that the UPEs payable to Gleewin Investments from the 2005 Trust were loans as defined under section 109D(3). In particular, he contended that by allowing the amounts to remain unpaid and intermingled with the funds of the 2005 Trust, the UPEs became a form of financial accommodation provided to the trust and also that it effected in substance a loan of money[1].

It is noted for completeness that TR 2010/3 has now been withdrawn and has been replaced by *Taxation Determination 2022/11: Income tax: Division 7A: when will an unpaid present entitlement or amount held on sub-trust become the provision of 'financial accommodation'?* (**TD 2022/11**).
TR 2010/3 was limited to UPEs that had not been placed on a sub-trust. TD 2022/11 goes further, holding that almost all UPEs will now constitute financial accommodation.

> *6. The "phrase 'financial accommodation' in paragraph 109D(3)(b) has a wide meaning. It extends to cases where an entity with a trust entitlement has knowledge of an amount that it can demand and does not call for payment.*

While the ATO originally stated that this view was limited to UPEs (see the compendium of response to TD 2022/11), we note that the Commissioner has now extended this view to loans and equity provided to partnerships in PBRs. Further detail on this issue is discussed at paragraph 4.3.3 below.

2.2.2 The taxpayer's contention on Subdivision EA

Given the background facts, it was open to the Commissioner to apply Subdivision EA. That is, section 109XA(2) can broadly apply where:

1. A trustee makes a loan to a shareholder (or their associate) of a private company; and

2. Either:

[1] Refer to paragraphs 64 to 86.

a. At the time of the trustee making the loan, the company has an existing UPE that remains unpaid at the lodgement date[2]; or

b. The company becomes entitled to a UPE after the making of the loan by the trust where the UPE remains unpaid at the lodgement date[3].

Based on the assumptions made in section 2.1.3 above, it would appear that the first condition would have been satisfied (i.e. as loans of approximately $1,806,702 had been advanced to Mr Bendel). At the time of each advance to Mr Bendel, UPEs were owing to (and became owing to) the corporate beneficiary Gleewin Investments. Accordingly, the conditions for section 109XA(2) would appear to have been satisfied.

It is noted that section 109XA(4) contains a capping rule, where the actual transaction (the loan to Mr Bendel) would have been capped at the lesser of the actual transaction amount and UPE less previous transactions. This is likely to have produced a deemed dividend similar to the amount that the ATO had assessed to the 2005 Trust. The key difference may have been that the amount for the 2014 income year may have been nil (assuming no loans were made during that period to Mr Bendel).

Given this similar outcome that would have occurred, it is unclear why (at paragraph 30 of the decision) the Commissioner contended that Subdivision EA did not apply to this case. The taxpayer contended that a UPE to a company was not a loan from the company under the extended definition contained in section 109D(3). The taxpayer contended, at paragraph 61, that regard had to be had to the legislative history, extrinsic material and context of the provisions and that UPEs were to be dealt with under Subdivision EA and did not fall within the meaning of a loan for Division 7A purposes.

2.2.3 AAT decision

Separate trust requirement

One key aspect of the AAT decision was whether a UPE was required to form a separate trust in order for Subdivision EA to apply. It is noted that the Commissioner and the taxpayer both contended that a separate trust existed for the purposes of their argument.

With reference to the High Court decision in *Fischer v Nemeske Pty Ltd (2016)* 257 CLR 615 (**Fischer**), the AAT held that a separate trust did not arise for Subdivision EA to have application.

> *79. In the present circumstances, where it is not possible to identify any asset or property held on any separate trust as conventionally understood, notwithstanding the acceptance of the parties that a separate trust was created, what was created upon passing resolutions to distribute Gleewin's income was a right or entitlement for the beneficiary coupled with the corresponding obligation of the trustee of a nature contemplated by what Gageler J said in Fischer v Nemeske.*
>
> *80. Accordingly, the Tribunal does not accept contentions that a separate trust in fact arose in any conventional sense that had the effect of discharging or*

[2] Lodgement date for this purpose is the time before the earlier of the due date for lodgment and the date of lodgment of the trustee's return of income.
[3] As above

replacing the obligation to pay entitlements to income. Those entitlements to be paid shares of Gleewin's income continued to exist.

…

84. At the outset, the Tribunal does not accept a number of the Commissioner's contentions. (a) First, and for two reasons, the Tribunal cannot accept the contention that Subdivision EA does not apply in the present circumstances because the relevant unpaid present entitlements were held on a separate trust, with the entitlement to Gleewin's income being satisfied or paid.

(i) As noted above, the Tribunal is not satisfied that there was any separate trust in the conventional sense.

(ii) Secondary trust circumstances are specifically contemplated as within the Subdivision EA ambit: they referred to in the EM.[59] Even in a secondary trust circumstance, the party intended to be taxed is the party in receipt of the in-substance loan funds, here Mr Bendel, through the Subdivision EA mechanism because, in substance, corporate profits are being provided by way of loan to a shareholder via the trust.

The Tribunal went further to note that where an entitlement arose which was not reflected in an absolute beneficial entitlement to the whole or part of an asset, the beneficiary's interest was thus an equitable obligation of the trustee. It is noted that this conclusion is not only supported by the decision in *Fischer*, but also appears to be supported by decisions such as *Gusdote Pty Limited v Ashley; In the Matter of Gusdote Pty Limited [2011]* FCA 250 *(**Gusdote**)* and *Chianti Pty Ltd v Leume Pty Ltd [2007]* WASCA 270 (***Chianti***).

For example, in Chianti's case, the trust deed required that amounts be set aside in separate trust, which was not adhered to by the Trustee. The Court did not hold there to be a separate trust but appeared to acknowledge that there had been an apparent breach of trust and that the obligation to pay the entitlement remained that of trustee of the original trust.

67. It is established, by the financial statements of the SJRF Trust and the evidence of Stephen Frederick Ryan (a director of the appellant) that, in apparent breach of cl 3.5 of the SJRF Trust deed, the amounts distributed to the respondent were not held by the appellant as a separate trust fund. Further, it is established, by that evidence, that the appellant did not invest the distributed amounts pursuant to cl 3.5 and cl 5(e) and in consequence no income was derived from those amounts.

…

77. In the present case, I am of the opinion that the financial statements of the SJRF Trust and the evidence of Stephen Frederick Ryan, which I have mentioned at [27] - [30] and [32] above, when considered in the context of the relevant factual and legal background including cl 3.5 of the SJRF Trust deed and the resolutions, constitute admissions by the appellant that the distributed amounts were owing by the appellant to the respondent, for the purposes of the principle referred to in Gummow J's reasons in Roxborough [67]. The latest financial statements before Judge Eaton, namely, those for the year ended 30 June 2003, described the distributed amounts as an 'Unpaid Beneficiary Entitlement'. When that description is read with cl 3.5, the resolutions and Stephen Frederick Ryan's evidence, the *proper conclusion is that the appellant's admission was of an obligation to pay on demand. Although it is unnecessary to determine this point, my examination of Edwards v Lowndes and the other cases in the line of authority referred to in Meagher, Gummow & Lehane's, Equity Doctrines & Remedies (4th ed, 2002) [1 215] and Gummow J's reasons in Roxborough [67], does not indicate that it is essential, for there to be a binding admission in relation to an amount owing by a trustee to a beneficiary, that the relevant amount is held as, or represented by, cash at bank or some other monetary sum when the alleged admission is made.*

Accordingly, the Tribunal in *Bendel* held that it was not important to identify a UPE that is found in a sub-trust in order for Subdivision EA to apply to transactions entered into by the trustee and that the provisions only requires that the "company is presently entitled to an amount from the net income of the trust estate … and the whole of that amount has not been paid to the company". With reference to Example 4 of the Explanation Memorandum, the Tribunal stated the following:

94. Former s 109UB and Subdivision EA particularly focus on a situation with two features: am entitlement to trust income vested in a corporate beneficiary and a contemporaneous loan to a shareholder (or an associate of a shareholder) of the corporate beneficiary made by the trustee bearing the outstanding obligation to the corporate beneficiary.

Accordingly, the Tribunal rejected both the arguments of both the taxpayer and the Commissioner on the basis that a separate trust existed.

80. Accordingly, the Tribunal does not accept contentions that a separate trust in fact arose in any conventional sense that had the effect of discharging or replacing the obligation to pay entitlements to income. Those entitlements to be paid shares of Gleewin's income continued to exist.

81. Each party's contentions that were based on the concept of a separate trust having the effect that the entitlements to income were discharged or paid are not accepted.

This is a very important part of the AAT decision. It does not read down the potential application of Subdivision EA where a trust simply has an amount of a present entitlement that remains unpaid at a particular time (irrespective of whether the amounts have been placed on a separate trust). The words of the legislation (i.e. with reference to present entitlements that remain unpaid) do not appear as restrictive as what has been contended by the ATO. The logic and analysis provided by the Tribunal appears to be reasonable with respect to this point. It will therefore be interesting to see what the Full Federal Court has to say on this matter.

Context of the provisions

The AAT acknowledged that a wide reading of the meaning of the term "loan" could result in a UPE falling within the meaning of the defined term contained in section 109D. In *Re Montgomery Wools Pty Ltd (As Trustee for Montgomery Wools Pty Ltd Super Fund) and F. C of T.* (2012) 87 ATR 282 (**Montgomery**), the AAT held that a UPE was financial accommodation for the purposes of the superannuation provisions. In respect of the *Montgomery* decision, the AAT in *Bendel* stated that, without more, the term financial accommodation could cover an arrangement such as a UPE.

82. The definition of a loan in s 109D(3) of the 1936 Assessment Act uses very wide language. Similar language has been used in other statutory settings, and the authorities concerning those settings give a generous and wide construction to

> *the term. [58] Without more, a similar approach and construction could be expected in relation to s 109D(3).*

However, having regard to the construction of the provisions contained within Division 7A, that is the operation and interaction of Subdivision EA with section 109D, the legislative history and the relevant extrinsic material, the AAT held that a similarly broad definition of loan was not warranted in the case of Division 7A as drafted.

> *101. Having regard to … the necessary conclusion is that a loan within the meaning of s 109D(3) does not reach so far as to embrace the rights in equity created when entitlements to trust income (or capital) are created but not satisfied and remain unpaid. The balance of an outstanding or unpaid entitlement of a corporate beneficiary of a trust, whether held on a separate trust or otherwise, is not a loan to the trustee of that trust.*

The AAT appear to have performed a very thorough and comprehensive analysis of the history of the provisions and considered the context in a significant amount of detail. I note that many of the same points were raised in a submission that I provided to the ATO dated 24 September 2009 (see Appendix B).

Perhaps the only other key piece of extrinsic material that was missing from the AAT decision was the drafting instructions, which were released by the Treasury publicly through a Freedom of Information request that I had made at the time of drafting the above submission. I have attached those drafting instructions as Appendix A to this paper. The drafting instructions are consistent with the AAT analysis of the amendments at the time, and broadly support the conclusions of the AAT.

2.3 Appeal process and interim decision impact statement

The Bendel case is currently on appeal in the Full Federal Court, and it is understood that the case had not been heard at the time of writing this paper. On 15 November 2023, the ATO released an interim decision impact statement (**IDIS**) pending the decision of the Full Federal Court being handed down. In the IDIS, the Commissioner holds that the ATO will administer the law in the following manner until the appeal process is finalised:

- The Commissioner does not intend to revise its current views and will continue to administer the law in accordance with TD 2022/11.
- The Commissioner does not propose to finalise objection decisions where the decision turns on whether or not a UPE was a subsection 109D(3) loan.
- Any decision required to be made will be based on the existing ATO view of the law.
- UPEs may have implications under other taxation laws, such as section 100A.

2.4 Comparing Subdivision EA to section 109D

There can be material differences that occur from applying Subdivision EA versus section 109D. The following outlines a number of those key differences.

The time of assessable dividends

Section 109D treats a private company as being taken to pay a dividend to an entity at the end of a year of income, which then, may be assessed under section 44. To the extent that a complying loan is put in place, section 109E treats the private company as being taken to pay a dividend to an entity at the end of the year of income where there is a shortfall in a minimum yearly repayment (for subsequent years).

Compare this to section 109XB, which is drafted in a substantially different manner. Subsection 109XB(1) requires that an amount be included, "as if it were a dividend <u>paid by the company at the end of the year of income of the company in which the actual transaction took place</u>, in the assessable income of the shareholder or associate referred to in subsection 109XA(1), (2) or (3) if:

- had the actual transaction been done by a private company (the notional company); and
- had the shareholder or associate been a shareholder of the notional company at the time the actual transaction took place;

an amount (the Division 7A amount) would have been included in the shareholder's or associate's assessable income because of a provision of this Division outside this Subdivision." <u>[emphasis added]</u>

However, this raises a critical question – what is the 'actual transaction' for the purpose of section 109XB? Section 109XA defines the term 'actual transaction'. For example, with respect to loans, section 109XA(2) defines an actual transaction as being a transaction where "a trustee makes a loan (including a loan through an interposed entity as described in section 109XG) to a shareholder or an associate of a shareholder of a private company (except a shareholder or associate that is a company)". If the term 'actual transaction' takes its meaning from section 109XA, then 109XB(1) would seem to operate at the end of the private company's year of income in which the loan was made to the relevant shareholder or associate of the shareholder of the company.

It is noted that the timing (i.e. the underlined words above) were added through *Tax Laws Amendment (2010 Measures No. 2) Act 2010*. Supposably, by having regard to the EM, those words appear to have been inserted to work together with amendments made to section 109Y (distributable surplus rules) to ensure that prior year 109XB deemed dividends could be used to reduce the distributable surplus of the company (i.e. via amendments to section 109Y(2)(b)). However, this drafting raises a number of practical issues. This can be demonstrated by an example.

> <u>*Example 1*</u>
>
> *The Arnold Trust loans of $100 to Mr Devito (**the actual transaction**) in year X0. At that time, the Arnold Trust has a UPE owing to Conan Company Pty Ltd (**Conan**) equal to $200. Mr Devito is a shareholder of Conan. Assume the loan to Mr Devito is placed on complying loan terms. In years X5, X6 and X7, Mr Devito is unable to meet his minimum loan repayments. Assume Mr Devito has lodged all tax returns on time.*

There is a first order question as to whether a failure (under section 109E) can be caught within section 109XB. The actual transaction in this case is a loan and not a minimum loan repayment. Given the loan was placed on complying terms in accordance with section 109N, arguably there would be no deemed dividend in respect of the actual transaction.

If we assume that this provision can extend to minimum loan repayments, then had the actual transaction been between Mr Devito and the company, section 109E would have assessed the shortfall to Mr Devito for each of the years X5 to X7. However, section 109XB(1) appears to result in a dividend being paid by the company at the end of the year of income of the company in which the 'actual transaction took place', being income year X0. Outside of fraud or evasion, this would be more than four years after the assessment period for income year X0. Accordingly, in this example, the Commissioner may be out of time to issue an amended assessment for this amount.

Corporate beneficiaries

Subdivision EA does not appear to preclude a trust from having a large outstanding UPE with a corporate beneficiary, where nothing else occurs.

> *Example 2*
>
> *Assume that the Tuco Trust has $10 million held in a bank deposit. Assume that at the end of year 1, the Tuco Trust derives $1 million of interest income and distributes all income to Bill Carson Pty Ltd. Assume the amount remains unpaid, and that the Tuco Trust reinvests the undistributed income in the bank deposit.*

In this case, as the Tuco Trust has not made a loan to a shareholder of Bill Carson Pty Ltd or an associate, Subdivision EA should not apply. This is a very different outcome compared to what would occur under the ATO's view contained in TD 2022/11. That is, the UPE would be treated as a loan under section 109D and subject to the operation of Division 7A.

Interposed payment rule

Subdivision EA has an interposed payment rule that is contained in section 109XA(1). The rule was first introduced to counter certain arrangements where trusts sought to revalue assets and distribute amounts equal to the asset revaluation reserve to individual beneficiaries (i.e. to create credit entitlements to such individual beneficiaries). A mischief occurred where the trust distributed its taxable income to a corporate beneficiary and used the 'cash' to instead repay the individual beneficiary's credit entitlement rather than pay the distribution to the corporate beneficiary. I refer to this rule as the interposed payment rule.

While the interposed payment rule was effective in stopping the mischief described above, the provision has significant limitations. The provision only applies where payments discharge or reduce a present entitlement of the shareholder or associate that is wholly or partly attributable to an amount that is an unrealised gain.

The term unrealised gain is not defined. ATO IDs 2005/359 and 2005/58 provide some guidance on the meaning of this term. The provisions contain a safe harbour to the extent the amount would be included in assessable income of the trust in the year before the payment, the year of the payment, or the year following the payment.

> *Example 3*
>
> *The Batman Trust resolves to distribute $1m of its net income to a related corporate beneficiary, Joker Pty Ltd. There is no difference between tax and accounting income. The Batman Trust satisfies $300,000 of the entitlement and retains $700,000 in a bank account. The Batman Trust later acquires residential premises. The residential premises are subsequently used by beneficiaries of the trust.*

In this example, while section 109C or 109CA may include the 'use of asset' as a payment, the payment does not discharge or reduce a UPE that was sourced in an unrealised gain. Accordingly, section 109XA(1) is unlikely to apply.

However, if the UPE to Joker Pty Ltd were regarded as loan, the payment to the beneficiary could fall within the scope of section 109T (i.e. a loan from a company to a trust followed by a payment from a trust to an associate of the shareholder of the company).

> *Example 4*
>
> *The John Wick Trust defines income in accordance with accounting principles. During the X1 income year, the John Wick Trust receives a trust distribution from an investment trust ($400,000). The taxable amount of the distribution is equal to $200,000 as it was reduced by capital works deductions under Division 43. The John Wick Trust also includes an accounting gain (unrealised profit) of $100,000 in its profit and loss statement for the X1 income year that will not be assessable for two years. Income of the trust estate is equal to $500,000 while taxable income is equal to $200,000. The whole of the income is distributed to Mr Winston Scott and is paid to him within three months of the distribution. At the time of the payment, the John Wick Trust owes a corporate beneficiary, Charon Pty Ltd, $700,000 being a UPE. Mr Scott is a shareholder of Charon Pty Ltd.*

It is important to note that subsection 109XA(6) outlines that the mere creation of a present entitlement does not give rise to a payment for the purposes of Subdivision EA. Accordingly, it is only the satisfaction of the UPE than could potentially give rise to the application of section 109XA.

In the example, Mr Scott has been paid an amount which arguably may have been sourced from unrealised gains. Section 109XA(7) defines 'unrealised gain' broadly as being any capital or income unrealised gain. The provision provides a safe harbour in that it excludes amounts that are (or would be) assessable income in the current income year, prior income year or subsequently income year.

There is a risk that the $300,000 does not meet the safe harbour contained in section 109XA(7) and may be regarded as being from an unrealised gain. Accordingly, there can be a risk that section 109XA(1) could apply in this circumstance.

However, if the UPE to Charon Pty Ltd were regarded as a loan, the Commissioner could seek to apply section 109D (for the loan to the interposed trust) or alternatively could seek to apply section section 109T in respect of any benefits provided to a target entity. In this case, section 109T could apply if a reasonable person would conclude (having regard to all the circumstances) that the private company made the $700,000 loan to the interposed entity (the John Wick Trust) solely or mainly as part of an arrangement involving a $500,000 payment to the target entity (Mr Scott). In this case, if the distribution and payment of the income to Mr Scott is unrelated to the prior year distribution to Charon Pty Ltd, it could be strongly arguable that the nexus between the loan and the payment would not be satisfied in this case. In making this determination, one would also need to look at the $100,000 unrealised gain and the source of the payment to Mr Scott[4].

The purpose of this example is not to determine whether section 109T is meant to apply. It is simply only to demonstrate the critical differences between how the two sets of provisions may operate to the same circumstance.

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[4] This is because the $400,000 is sourced from the trust distribution, while the $100,000 has been sourced from an unrealised profit and thus it may be important to trace the cash payment in considering the reasonable person test.

2.5 The overlap between Subdivision B and EA

One of the key items discussed in the AAT decision in *Bendel* is the lack of an anti-overlap provision as between Subdivision B and Subdivision EA. It is noted that Division 7A contains a number of anti-overlap provisions. For example:

- The provisions dealing with loans (section 109D) apply in priority to the provisions dealing with payments (section 109C) – see section 109C(3A)
- The provisions dealing with loans (section 109D) apply in priority to the provisions dealing with debt forgiveness (section 109F) – see section 109G(3)
- The provisions dealing with loans (section 109D) apply in priority to the interposed entity rules (section 109T) where the first leg of the transaction is taken to be a deemed dividend by the company to the first interposed entity – see section 109T(3)
- The provisions dealing with loans from trusts under Subdivision EA (section 109XA(2)) apply in priority to a forgiveness of the loan from the trust under Subdivision EA (section 109XA(3)) – see Section 109XD

In relation to the lack of an 'overlap' provision between Subdivision B and Subdivision EA, the AAT stated the following at paragraph 96.

> *Two people would be taxed, one through Division 6 and the other through Division 7A, where a trustee has an unpaid present entitlement to a corporate beneficiary of the trust and within the prescribed time frames the trustee has lent money to a shareholder of that corporate beneficiary (or to an associate of such a shareholder). If that same shareholder or shareholder's associate were the relevant beneficiary of the trust, and properly taxed under Division 6, that person would have two amounts included in assessable income, and, for the reasons set out in relation to Issue 2 below, would not be saved by s 6-25. There are known problematic or inappropriate outcomes with the Division 6 system of taxing trust income. [77] Those outcomes have been accepted as problematic, but a matter for the Government to fix. However, the Tribunal is not aware of any similar acceptance of problematic or inappropriate outcomes extending to permit the system to <u>tax two people as a consequence of events</u> starting in the same circumstance and <u>allowing the Commissioner to choose which taxpayer is assessed</u>, or to assess and collect from both. [78]*

While the Tribunal discussed the problem of section 6-25 in a general sense (in the context of distributions and Division 7A), a relevant observation was made at the end of paragraph 96 (emphasis added). The Tribunal observed that it is possible for two people to be taxed on the same amount under Division 7A and the interpretations offered by the Commissioner made it possible for the Commissioner to choose which taxpayer would be assessed (without an anti-overlap).

While not discussed as part of this case, this could be evident in other circumstances. For example, absent an overlap provision: (1) the section 109D 'deemed dividend' could be assessed to the Trustee (the 2005 Trust) where the UPE is treated as a loan (and would form part of the Division 6 income that would be attributed to the beneficiary); and (2) the section 109XB 'deemed dividend' would be assessed to the recipient of the loan (Mr Bendel) and would form part of his income. Furthermore, and as observed by the Tribunal, the original amount giving rise to the UPE would have been assessed to the corporate beneficiary in a previous year under Division 6.

This double (or triple) taxation issue in Division 7A is not unique to the UPE issue. This issue can also arise where the 'anti-overlap' rules do not appropriately interact. For example, the double counting nature of Division 7A was highlighted by the ATO in ATO ID 2005/298, where the ATO held that a single UPE to a corporate beneficiary could give rise to multiple deemed dividends of the same amount under section 109XA where loans were made to different shareholders by the interposed trust. This issue can also arise in many circumstances where section 109T applies.

While it is noted that this is possible, it is believed that some of these outcomes are due to some of the extreme interpretations being taken with respect to the provisions. As outlined by Dixon J in *Executor Trustee & Agency Co. of South Australia Ltd v Federal Commissioner of Taxation (1932)* 48 CLR 26 at 44:

> *"No interpretation of a taxing Act should be adopted which results in the imposition of double taxation unless the intention to do so is clear beyond any doubt."*

Lonsdale Sand and Metal Pty Ltd and the section 6-25 issue.

This outcome can also be compared to a potential lack of an overlap provision as between section 109C payments and section 109F debt forgiveness transactions. The Commissioner has also taken a broad view that a 'payment', as defined, can also capture a debt forgiveness in *TD 2015/20 - Income tax: Division 7A: is a release by a private company of its unpaid present entitlement a 'payment' within the meaning of Division 7A of Part III of the ITAA 1936?* (**TD 2015/20**).

TD 2015/20 is intended to apply to UPEs. The reason for the Commissioner releasing TD 2015/20 is due to the apparent shortcomings that exist with section 109F in respect to UPEs. That is, section 109F is limited to 'debts' rather than 'loans'. Accordingly, to the extent that a UPE is a loan but not a debt, arguably section 109F cannot apply to UPEs. This shortcoming has been overcome by noting that section 109C would apply to such debt forgiveness arrangements.

The view of the Commissioner appears to be supported by *Lonsdale Sand and Metal Pty Ltd v Commissioner of Taxation* [1998] FCA 155 (**Lonsdale**), where the Federal Court held that a debt forgiveness would constitute a payment under the predecessor provision (section 108).

> *The expression "pays or credits" in subclause (b) is clearly designed to have a wider range of operation. Although it may be that its scope may extend to payments or credits in favour of a third party rather than to the associated person, I see no reason why that is necessarily so. The contention, if correct, would not serve the apparent purpose of the section. <u>It would leave an irrational gap in its area of operation</u>. A 'crediting' transaction does not necessarily involve a third party at all. It may be on behalf or for the individual benefit of the associated person, without a third party being involved at all. It would be illogical to construe subclause (b) to limit its operation to circumstances where the payment or credit involves a third party where it is made on behalf of or for the individual benefit of the associated person. <u>[emphasis]</u>*

The interesting part of the decision in *Lonsdale* is that, in the ordinary sense, a loan by a company and a forgiveness of a debt consisting of that loan would (in almost all cases) be made in favour of the same debtor. Accordingly, the ATO appear to accept that the ordinary anti-overlap provision would apply.

> *This Determination does not apply to the extent that an amount is included in the assessable income of the entity in favour of whom the UPE is released because of*

> *the application of another provision of Division 7A in respect of the UPE (section 6-25 of the ITAA 1997). This Determination also does not apply to the extent that the UPE has been converted to a debt to which section 109F may apply.*

Furthermore, to the extent that there would otherwise be an ‘irrational gap’ in the application of section 109F (i.e. due to the use of the word ‘debt’ as compared to ‘loan’), there would appear to be support for the view taken by the Commissioner.

However, a similar issue arises in TD 2015/20 which is covered by the *Bendel* decision. The first is the scope of the word ‘debt’ versus ‘payment’ and whether the term payment was intended to cover a debt forgiveness taking into account the context of the provisions. While the Commissioner argued a broad meaning of the term in *Lonsdale*, the context was in respect of section 108.

Furthermore, Division 7A was introduced at roughly the same time as *Lonsdale* was being heard by the Federal Court. While the ATO had issued *IT 2437: Income tax: private companies: loans or advances which represent distributions of profits (withdrawn)* (**IT 2437**) which held that a debt forgiveness was a payment for section 108 purposes (see paras 17 to 20), there was some doubt in 1997 whether this view would be upheld by the Court. Accordingly, it is believed that section 109F was included in Division 7A to ensure that the position in relation to a debt forgiveness was explicit in the legislation.

Based on this, it may be arguable that the definition of payment contained in section 109C was not intended to cover a debt forgiveness and instead a forgiveness was intended to be explicitly covered by section 109F. However, section 109F goes further than what had occurred in the *Lonsdale*. That is, the decision in *Lonsdale* required a crediting to occur on the forgiveness. Section 109F goes further than this and covers debt parking scenarios and potentially statute barred loans. Accordingly, section 109F may be seen to have a purpose over and above section 109C.

That being said, the ‘double counting’ issue that is outlined in *Bendel’s* case could also potentially arise when applying the view in TD 2015/20. That is, assume that a UPE is not a loan under section 109D and that Mr Bendel was to be assessed under Subdivision EA (i.e. section 109XB) with respect to the loan that was made to Mr Bendel by the 2005 Trust. If the UPE owing to Gleewin Investments was subsequently forgiven in a later income year, this would have potentially given rise to a dividend under section 109F when applying the view in TD 2015/20. The double counting rule in section 109XD is limited to a forgiveness covered by 109XA (i.e. a forgiveness of the loan to Mr Bendel) and would not extend to the UPE. Accordingly, the same amount could potentially be taxed twice to two different taxpayers.

If the *Bendel* decision is upheld on appeal, this may raise doubts as to the potential application of TD 2015/20 and whether it is possible for the ATO to apply this view to UPEs, taking into account the context of the provisions. This issue would need to be explored further once *Bendel* is finalised.

2.6 What if the Taxpayer is successful in Bendel?

2.6.1 Current state of play

This position is probably an easier one to deal with. This is because, the outcome is probably not much different to how the majority of taxpayers have dealt with UPEs up to 30 June 2022. The following table summarises the expected outcomes for taxpayers in this case for different scenarios.

Arrangement	ATO Current treatment	Likely outcome if Bendel upheld
1. Pre-16 December 2009 UPEs	Treated as UPEs (not loans)	No change
2. PS LA 2010/4 UPEs	Treated as UPEs (not loans)	No change
3. UPEs converted to loans	Treated as loans	Silent (but likely to be a loan)
4. Section two[5] (implicit) loans	Treated as loans	Unclear where no explicit agreement
5. Section three UPEs	Treated as loans	Likely to be treated as UPEs
6. Post 1 July 2022 UPEs	Treated as loans	Treated as UPEs

From my experience, the majority of arrangements would be covered by scenarios 1 to 3. In those cases, the treatment by taxpayers and the ATO is likely to be consistent if the *Bendel* decision is upheld.

Scenarios 4, 5 and 6 are likely to be the ones that would result in a difference in treatment between what the ATO have outlined as their view and the actual treatment of the arrangement. In relation to scenario 4, these cases can involve UPEs which have been asserted to be loans under TR 2010/3 para 10, but there is no explicit agreement for the conversion of such amounts into loans (for example, this may be the case if financial statements recorded the amounts as loans without a real agreement between parties). Scenario 5 are those UPEs which were specifically covered by the facts in *Bendel's* case. The ATO have asserted that such UPEs are loans in accordance with TR 2010/3. If the decision in *Bendel* is upheld, then Subdivision EA would likely apply to such arrangements rather than section 109D. However, it expected that disputes on Section three loans are likely to be rare. In our experience, where taxpayers have sought to treat post-16 December 2009 distributions as UPEs, such UPEs have (more often than not) been placed on complying sub-trust agreements in accordance with PSLA 2010/4. Accordingly, these UPEs have likely been treated in accordance with Subdivision EA already.

Based on the above, there may be a small number of cases where the ATO have assessed UPEs as loans for certain taxpayers (i.e. Scenarios 4 and 5 above) where those taxpayers may still have rights to challenge those assessments on the basis that such UPEs still constitute UPEs and not loans. Scenario 6 relates only to the 30 June 2023 income year and thus *Bendel* is unlikely to have a material impact on arrangements under TD 2022/11 (as those tax returns have either just been lodged or will be lodged in the near future).

As many taxpayers have sought to comply with the ATO view in TR 2010/3 and TD 2022/11, most post-16 December 2009 UPEs have either been converted to loans (such that the decision in *Bendel* will not be relevant) or have been retained as UPEs under sub-trust arrangements. Accordingly, if the

[5] In particular, Category two loans referred to in the table are those covered by para 10 of TR 2010/3, where the ATO have asserted "10. The agreement between the private company beneficiary and the trustee may be an implied agreement. For example, if the private company has knowledge that the trustee has treated its UPE as having been satisfied and a corresponding amount borrowed back (as evidenced, for example, by crediting a loan account in the name of the private company beneficiary) and the private company acquiesces to that treatment, it will be inferred that it has consented to that loan being made."

Bendel decision is upheld, it is unlikely that many taxpayers will find that they have UPEs that have been treated in a manner that is inconsistent with the ATO views.

That being said, taxpayers would still need to assess their circumstances and confirm the treatment of each and every UPE. However, that being said, it is believed that this would be a relatively easier outcome as compared to the scenario where the Commissioner is successful, as outlined below.

Should the Government be unsatisfied with this outcome, they could revert to the 2018/19 Budget announcement that the law would be amended to treat UPEs as loans. The Budget announcement read as follows:

> *Tax Integrity — clarifying the operation of the Division 7A integrity rule*
>
> *The Government will ensure that unpaid present entitlements come within the scope of Division 7A of the ITAA 1936 from 1 July 2019. This will apply where a related private company is made entitled to a share of trust income as a beneficiary but has not been paid that amount, known as an unpaid present entitlement. Division 7A is an integrity rule that requires benefits provided by private companies to related taxpayers to be taxed as dividends unless they are structured as Division 7A complying loans or another exception applies. This measure will ensure the unpaid present entitlement is either required to be repaid to the private company over time as a complying loan or subject to tax as a dividend.*

While the measure was slated to start from 1 July 2019, the Government later changed this start date by 12 months in the 2019/20 Budget.

> *Tax Integrity — further consultation on amendments to Division 7A*
>
> *The Government will defer the start date of the 2018-19 Budget measure, Tax Integrity — clarifying the operation of the Division 7A integrity rule, from 1 July 2019 to 1 July 2020. This measure is estimated to have an unquantifiable impact on revenue over the forward estimates period.*

This was changed again in the 2020/21 Budget, where the Government announced that the start date would be deferred to the income year commencing after the date of Royal Assent. While this did not distinguish between the UPE issue and the rewrite of Division 7A, the announcement referred to the whole of the original announcement.

> *Revised Start Dates for Tax and Superannuation Measures*
>
> *The start date for the 2016-17 Budget measure Ten Year Enterprise Tax Plan — targeted amendments to Division 7A (as amended and modified by 2018-19 Budget measure Tax Integrity – clarifying the operation of the Division 7A integrity rule and the 2019-20 Budget measure Tax Integrity – further consultation on amendments to Division 7A) has been revised from 1 July 2020 to the income year commencing on or after the date of Royal Assent of the enabling legislation*

Accordingly, based on the above, if a legislative change is made, it would be interesting to understand whether the Government would respect their previous announcement (i.e. amendments would be prospective) or whether they would seek to make amendments from a retrospective date (i.e. to coincide with the view contained in TD 2022/11.

2.6.2 Potential amendment

An amendment to the legislation in this case may not be overly difficult, as it may simply require that section 109D is amended to include an ‘unpaid present entitlement created after a certain date’ in the definition of a loan. This would have a prospective effect for UPEs created after a certain date (e.g. from date of Royal Assent).

Perhaps the only difficulty would be whether an amendment would distinguish between pre-16 December 2009 UPEs and post-16 December 2009 UPEs (i.e. PS LA 2010/4 UPEs), with the former being ‘at call’ and the latter being on ‘complying’ UPE terms.

It is believed that consideration would need to be given as to whether this amendment would need to be accompanied with an additional amendment to clarify that UPEs prior to 16 December 2009 are not to be treated as loans. While the *Bendel* appeal will likely provide this clarity on whether a UPE is a loan, such an amendment would make it clear that Subdivisions EA and EB would continue to have application to transitional UPE arrangements that were created prior to that date.

2.6.3 What should taxpayers do about 30 June 2023 UPEs?

Given the uncertainty in respect of the *Bendel* appeal, many taxpayers will need to consider what they should do with respect to their 30 June 2023 UPEs.

The ATO holds the view, in paragraph 12 of TD 2022/11, that financial accommodation will generally occur for a UPE in the year following the creation of the present entitlement (i.e. during the 30 June 2024 year of income for a 2023 UPE). If a loan arises during the 30 June 2024 year of income, taxpayers will have until the lodgment date of the 30 June 2024 private company tax return to place the loan on complying Division 7A terms (being some time in 2025 for most taxpayers). Hopefully, *Bendel* will be decided by then.

However, if *Bendel* is not decided by then, it may be possible to place the 30 June 2023 UPE on terms that otherwise comply with section 109N. Where the conditions of being an amalgamated loan are otherwise satisfied, section 109N and section 109P provide an exclusion from section 109D. Accordingly, it is critical for a loan to satisfy the requirements of section 109N in order to be excluded from section 109D.

The requirements of section 109N are relatively straight forward. A private company that makes a loan to an entity must ensure (before the lodgment day for the year of income) that:

- the agreement that the loan was made under is in writing; and
- the rate of interest on the loan equals or exceeds the benchmark interest rate for the year; and
- the term of the loan does not exceed the maximum term (i.e., 7 years or 25 years as applicable).

It is possible that the repayment terms of the UPE could be put in place (in writing) in a manner that does not change the character of the UPE to a loan (in the ordinary sense), but instead requires that the trust repay the UPE on demand by the beneficiary or (at the very latest where there is no such demand) within a 7-year term. The agreement could also stipulate that interest is payable by the trust on the UPE balance at a rate equal to or greater than the benchmark rate. This would somewhat replicate the arrangements covered by PS LA 2010/4. Section 109N does not require the agreement to stipulate that it is an ordinary loan. Arguably, an agreement of this type may satisfy the requirements of section 109N and ensure compliance with Division 7A on the UPE if the ATO view is affirmed (i.e. the word 'loan' in that section should be taken to be a broader reference to loan under section 109D). The trust may seek to comply with section 109E (with respect to repayments) for any interim period until the case is decided. Compliance with section 109E simply requires that a minimum repayment would need to be made on the amount owing on an annual basis. With respect to the treatment of interest on a UPE, reference is made to Case V4 88 ATC 123 which provide some guidance on the potential treatment of such amounts[6].

The obvious risk of entering into such an agreement is that the agreement could constitute a loan within the ordinary meaning of the term contained in section 109D (i.e. to remain a UPE only, there should be no such agreement in place). There would also be an additional risk that the agreement could create a debt that may be subject to section 109F at a subsequent date.

That being said, if the decision in *Bendel* is upheld on appeal, and the agreement has not changed the UPE into a legal form loan, it is possible that the 30 June 2023 UPE will remain a UPE for the purpose of the provisions. If this action were taken, taxpayers would need to ensure compliance with Subdivision EA and EB in respect of that UPE (including the interim period).

The above is simply raised, as this could potentially be the outcome for 30 June 2023 UPEs. There are risks that can occur whichever way a 30 June 2023 UPE is to be dealt with. Each affected taxpayer should consider this issue and obtain appropriate advice in understanding what *Bendel* means for their UPEs before lodging their 30 June 2023 income tax return.

[6] Reference is made to paragraphs 27 to 30 of that decision. However, the treatment of the arrangement and any interest thereon is beyond the scope of this paper.

2.7 What if the Commissioner is successful in Bendel?

2.7.1 Current state of play

This section of the paper explores some of the outcomes that could occur if the Commissioner is successful in the *Bendel* appeal, that is, UPEs are treated as loans for Division 7A purposes under section 109D. Irrespective of my own personal views on the issue, this scenario appears to present significant challenges for the ATO, Treasury and taxpayers.

Arrangement	ATO Current treatment	Likely outcome if Bendel overturned
1. Pre-16 December 2009 UPEs	Treated as UPEs (not loans)	Loan. Is TR 2010/3 binding?
2. PS LA 2010/4 UPEs	Treated as UPEs (not loans)	Loan. Is TR 2010/3 binding?
3. UPEs converted to loans	Treated as loans	Treated as loans
4. Section two[7] and three UPEs	Treated as loans	Treated as loans
5. Post 1 July 2022 UPEs	Treated as loans	Treated as loans

As demonstrated by the above table, if UPEs are held to be loans in the appeal, this is likely to have an impact on those UPEs that are still being treated as UPEs for Division 7A purposes. Accordingly, items 1 and 2 are most likely to be the most significantly impacted arrangements. Accordingly, it would appear that the critical issue is whether TR 2010/3 would be binding on the Commissioner to treat those arrangements as UPEs.

Even if the ruling were binding, would taxpayers be required to continue to comply with TR 2010/3? This question is likely to give rise to significant compliance questions as outlined below.

2.7.2 The binding nature of TR 2010/3

TR 2010/3 outlines when the Commissioner will consider a UPE to be a loan for Division 7A purposes. The following are important parts of the tax ruling.

> ***Taxation Ruling Income tax: Division 7A loans: trust entitlements***
>
> *1. This Ruling expresses the Commissioner's opinion on the circumstances in which a private company with a present entitlement to an amount from an associated trust estate <u>makes a loan to that trust</u> within the meaning of subsection 109D(3) of Division 7A of Part III (Division 7A) of the ITAA 1936 (ITAA 1936), in*

[7] In particular, Category two loans referred to in the table are those covered by para 10 of TR 2010/3, where the ATO have asserted "10. The agreement between the private company beneficiary and the trustee may be an implied agreement. For example, if the private company has knowledge that the trustee has treated its UPE as having been satisfied and a corresponding amount borrowed back (as evidenced, for example, by crediting a loan account in the name of the private company beneficiary) and the private company acquiesces to that treatment, it will be inferred that it has consented to that loan being made."

circumstances where funds representing that present entitlement remain intermingled with funds of the trust.

Section three: Division 7A loans within the extended meaning

16. Note that this section of the Ruling does not apply to taxpayers in respect of all or part of any UPE that arose before 16 December 2009 – see paragraph 28 of this Ruling.

Date of effect

28. Section three of this Ruling (contained in paragraphs 16 to 26) provides the Commissioner's view of when a subsisting UPE may be a loan for the purpose of Division 7A. Section three of this Ruling does not apply to UPEs arising before 16 December 2009.

The words of the ruling expressly state the Commissioner's view in a positive manner, that is when a UPE will be regarded as a loan and not the other way around (i.e. when a UPE will not be regarded as a loan). The relevant text has been underlined above for completeness.

Furthermore, the ruling expressly states that it does not apply to a pre-16 December 2009 UPE. Accordingly, if the Commissioner is successful in the *Bendel* appeal and it is held (by the Courts) that a UPE is a loan, it is questioned whether taxpayers could continue to rely on TR 2010/3 in respect of their treatment of those pre-16 December 2009 UPEs. A public ruling is defined in section 385-5 of Schedule 1 to the *Taxation Administration Act 1953*.

358-5 What is a public ruling?

(1) The Commissioner may make a written ruling on the way in which the Commissioner considers a relevant provision applies or would apply to:

(a) entities generally or a class of entities; or

*(b) entities generally, or a class of entities, in relation to a class of *schemes; or*

(c) entities generally, or a class of entities, in relation to a particular scheme.

Note: Section 357-55 specifies the relevant provisions.

(2) Such a ruling may cover any matter involved in the application of the provision.

This will be an interesting question that would need to be addressed. Section 257-60 in Schedule 1 to the *Taxation Administration Act 195*3 outlines when a ruling is binding on the Commissioner.

357-60 When rulings are binding on the Commissioner

(1) Subject to subsection (5), a ruling binds the Commissioner in relation to you (whether or not you are aware of the ruling) if:

(a) the ruling applies to you; and

(b) you rely on the ruling by acting (or omitting to act) in accordance with the ruling.

> *Example 1: A public ruling is expressed to apply to a class of entities in relation to a particular scheme. Tim is a member of that class of entities and he is one of a number of taxpayers who enter into that scheme. The ruling applies to Tim.*
>
> *Tim relies on the ruling by lodging an income tax return that is in accordance with the ruling.*
>
> *Under the ruling, Tim's deductions in relation to the scheme are worked out to be a particular amount. Because Tim has relied on the ruling, the Commissioner must use that amount in making Tim's assessment (unless Tim stops relying on the ruling or the law is more favourable to him: see sections 357-65 and 357-70).*

For the ruling to be binding, the ruling must apply to the taxpayer, and you must rely on the ruling by acting in accordance with the ruling. Arguably, while the ruling does not positively state that a pre-16 December 2009 UPE is not a loan, it is implied that the Commissioner will not treat such UPEs as a loan in accordance with the public ruling. Most taxpayers would have acted in accordance with the implied nature of the ruling and would not have treated a UPE as a loan. Unfortunately, *Bendel's* case does not deal with a pre-16 December 2009 UPE and therefore this question may remain outstanding.

2.7.3 Do taxpayers need to apply TR 2010/3?

Even if it is held that TR 2010/3 is binding on the Commissioner, if the *Bendel* appeal is decided in favour of the Commissioner, taxpayers may seek to apply the decision in *Bendel* to their pre-16 December 2009 UPEs and PS LA 2010/4 UPEs. That is, they could reclassify such pre-16 December 2009 UPEs as loans.

There would seem to be nothing stopping taxpayers from subsequently altering their view in respect of the application of the law to those UPEs, based on the decision of the Court. The outcome is discussed in the following section.

2.7.4 Outcome if TR 2010/3 is not binding (or is no longer applied)

Treatment of the UPE

If TR 2010/3 is not binding on taxpayers (or if taxpayers choose to revisit their treatment of UPEs), there would be a question as to whether section 109D has already operated in respect of such pre-16 December 2009 UPEs to treat them as a dividend in respect of an earlier income year.

Assuming that the non-inclusion of the dividend amounts would not be due to fraud or evasion, it would seem that the Commissioner may have little success in trying to amend the majority of those prior year income tax returns, subject to the potential application of section 100A or Part IVA (which is discussed below). This also raises a number of questions as to how subsequent transactions in respect of the UPE would be treated.

A later dividend

If an unfranked dividend (**the later dividend**) were to be paid by the company and applied against the loan to the trust, it would seem that this latter dividend would arguably not be assessable income in accordance with section 109ZC(1A).

> *(1A) This section also sets out special rules for dealing with a dividend (also the later dividend) distributed by a private company if:*
>
> *(a) the private company distributes the later dividend to a shareholder in the company; and*
>
> *(b) the shareholder applies the amount of the dividend to repay all or part of a loan:*
>
> *(i) that was obtained from the private company by an associate of the shareholder; and*
>
> *(ii) in relation to which a dividend was previously taken under this Division to have been paid by the private company.*

Section 109ZC(1A) does not appear to be limited to a case where Division 7A resulted in the taxpayer including a dividend in their assessable income in their income tax return. The provision is worded in a way that looks at whether, objectively, the section applied to treat the loan as a dividend in a previous income year. It is noted that the Commissioner has appeared to apply this view in a section 99B context (refer to ATO ID 2008/155W and ATO ID 2010/211).

While not exactly the same, there are similarities with this issue and that in relation to the treatment of opening trading stock. Section 29(1) of the ITAA 1936 stated that the opening value of trading stock "shall be its value as ascertained under this or the previous Act at the end of the year immediately preceding the year of income". The question was whether this was an amount ascertained objectively, or whether it was an amount actually included in the taxpayer's assessment. This was particularly relevant where the opening balance was within the four-year amendment period, but the closing balance was not. In *Australasian Jam Co Pty Ltd v FCT* (1953) 88 CLR 23 (***Australasian Jam***), Fullagar, J stated at page 33:

> *On the other hand, the section is imperative in that it requires him to adopt for each article of his stock one or other of the three prescribed bases of valuation. He is not at liberty to adopt some other basis of his own. And s. 29 requires that the value at which his stock is brought into account at the beginning of a year <u>shall be the value at which it was brought into account at the close of the preceding year</u> ; in other words, the opening figure of any year <u>must be identical with the closing figure</u> of the preceding year.*

Without citing *Australasian Jam* the Full Federal Court came to a different conclusion in *FCT v Energy Resources of Australia Ltd [2003] FCAFC 314* (**Energy Resources**) (the Federal Court distinguished *Australasian Jam* on the basis that the chosen valuation method had been correctly applied while ERA had incorrectly applied its chosen valuation method. In the Full Federal Court, Ryan and Finkelstein JJ held at para 21[8]:

> *21 Even in the absence of any guidance from Parliament, we would reject the Commissioner's construction of s 29. As already indicated, the opening value of trading stock "shall be its value as ascertained under [the ITAA 1936] at the end of the [immediately preceding] year of income". According to the Commissioner this means that (i) the opening value must be the stock's value "as it was ascertained" at the close of the previous year; and (ii) the value is "ascertained" by the Commissioner. The Commissioner may "ascertain" that value either by accepting*

[8] Allsop J, delivered a separate judgment to the same effect.

> *the value adopted by the taxpayer (provided that it is undertaken in accordance with one of the methods mentioned in s 31(1)) or by undertaking his own determination, regardless of whether the result is correct. We do not agree. The word "ascertain" means to determine or establish with certainty. Section 29 does not provide for the determination to be made by the Commissioner. The section only provides for the value to be determined "under the [1936] Act". Problems are often encountered when one uses the passive voice: R Dickerson, The Fundamentals of Legal Drafting (1965), 116. Such a problem exists here. Speaking strictly, value cannot be determined by legislation; only a person can make the determination. On the other hand, s 31(1) specifies how an article of trading stock is to be valued, that is, at the taxpayer's option, by either its cost price, market selling value or its replacement cost. It follows, in our opinion, that when s 29 provides that the value is to be "ascertained" under the ITAA 1936 that means that the value must be determined in accordance with one of the 3 prescribed methods. Consequently, it is the correct value under the chosen method to which regard must be had. It makes no difference whether that value is determined by the taxpayer or by the Commissioner. Put another way, for the purposes of an income tax year the opening value of stock must be its actual value assessed by reference to one of the 3 available methods, whether or not any change is made to its value in the previous year. This conclusion negatives the possibility that the Commissioner can "ascertain" the value of the stock by ascribing to it a value based on the chosen method but calculated incorrectly.*

It is noted that the above is not completely on point and that this issue does not seem to have been explored by the Courts. However, for completeness, it is noted that a similar Division 7A issue was identified by the Board of Taxation in its report dated 12 November 2014, at para 6.45 to 6.50. Selected paragraphs have been included below.

> *6.45 However, the Board also notes that it may not encourage active compliance if the proposed anti-duplication rule was to apply on the basis that an amount was 'assessable in an earlier year' rather than 'assessed in an earlier year'. That is, it may also encourage taxpayers to argue that loans have been forgiven in earlier years (where that year is outside the amendment period) or encourage taxpayers to take no remedial action in the hope that the ATO will not discover the breach.*

> *6.47 Based on the above, the Board considers that the proposed anti-duplication rule would improve the current operation of Division 7A, but that it would be preferable to only extend this new rule to amounts that have been or will be assessed to the relevant taxpayer in respect of an earlier year. Dividends that arose at a prior milestone date, but had not been or could not be assessed, would not be subject to the anti-duplication rule.*

> *6.50 The Board notes that, under the current law, taxpayers are sometimes able to gain a tactical advantage by asserting that a payment was not subject to a complying loan. This position should not be reproduced in a reformed Division 7A. Accordingly, the Board recommends that, where the Commissioner is out of time to assess a deemed dividend arising from a payment, the rules should prevent the taxpayer from asserting that the payment was not subject to a loan. This could be achieved by deeming payments to be a loan if they have not been, or cannot be, assessed as a dividend from a payment for the relevant year.*

The Commissioner has not publicly outlined his view on the application of section 109ZC(1A). However, should the Commissioner be successful in the *Bendel* appeal, he may be forced to address this issue.

Subsequent debt forgiveness

Alternatively, a company could seek to forgive its pre-16 December 2009 UPE which was previously considered a loan (and subject to section 109D) in a previous year of income.

In such a case, section 109G(3) provides an exclusion which is worded in a similar manner to section 109ZC(1A). The exclusion effectively states that a private company shall not be taken to pay a dividend under section 109F if the private company was taken under section 109D to pay a dividend at the end of that year or an earlier one. Whether this exclusion will apply or not will be subject to similar considerations as outlined above.

Effect on distributable surplus

Assume that neither a subsequent dividend nor a debt forgiveness arises, but instead the company makes a new loan (equal to its retained earnings) to the shareholder. If the pre-16 December 2009 UPE is considered to be a prior year loan that should have been subject to Division 7A, arguably there will be a reduction in the distributable surplus of the company irrespective of whether the dividend has been assessed to the taxpayer.

That is, section 109Y(2) defines a Division 7A amount (i.e. a reduction to the distributable surplus) as being "the total of any amounts the company is taken under section 109C or 109F to have paid as dividends in the year of income apart from this section." Whether this adjustment applies or not will be also subject to similar considerations as outlined above.

Application of section 100A

Given the uncertainty of the above, it is not surprising that the Commissioner would refer to section 100A in his IDIS on *Bendel*. That is, the Commissioner stated:

> *In addition to the application of section 109D, the basis on which private company beneficiaries deal with unpaid entitlements to trust income may have implications under other taxation laws, such as section 100A.*

The key difference between section 109D and section 100A is that section 100A has an unlimited amendment period. Accordingly, to the extent that taxpayers attempt to close out pre-16 December 2009 UPEs without further tax consequence (e.g. by applying section 109ZC (latter dividend), section 109G (debt forgiveness) or section 109Y (a reduction in distributable surplus)), the Commissioner could seek to apply section 100A to the prior year distribution to the corporate beneficiary.

The problem with this approach is that it may not be consistent with the decision of the Full Federal Court in *Commissioner of Taxation v Guardian AIT Pty Ltd ATF Australian Investment Trust [2023] FCAFC 3* (**Guardian**). That is, it may be difficult for the Commissioner to contend that the present entitlement arose out of a relevant reimbursement agreement at the time of the distribution.

> *124. The inquiry in relation to the existence of a reimbursement agreement in s 100A is different. It requires the existence of an "agreement" (as defined in s 100A(10)) invoking, as it does, a requirement of consensus and adoption. The scope for attribution in that context is far more limited. In the absence of a finding*

> *that a communication had been made to Mr Springer or his agent of a plan or recommendation prior to 23 June 2013, it was necessary to find that Ms Burke or Mr Fischer had authorisation to act on or behalf of those entities in order to conclude that there was consensus or adoption by Guardian and Mr Springer. No such finding was made by the primary judge and, apart from relying on the general practice of Mr Springer to follow the advice of Pitcher Partners, the Commissioner did not press for such a finding before this Court. Mr Fischer's evidence was that Ms Burke worked under his supervision. There was no evidence that she had authority to act on behalf of Mr Springer or the entities in the Springer Group. Whilst the evidence supports a finding that Mr Springer generally followed the advice of Mr Fischer, there is no evidence that Mr Fischer was an authorised representative of Mr Springer or the Springer Group.*
>
> *125. For these reasons, it is concluded that, although the payment of a dividend by AITCS to the AIT as at 23 June 2013 was not "wholly conjectural", there was no "agreement" as at 23 June 2013 within s 100A(13) which involved the payment of such a dividend and, therefore, there was no "reimbursement agreement" for the purposes of s 100A.*

While the Commissioner could have more success with Part IVA, as evidenced in *Guardian*, Part IVA has a limited amendment period and may not be an option for the Commissioner for pre-16 December 2009 UPEs.

2.7.5 Interaction with PS LA 2010/4 and PCG 2017/3

PS LA 2010/4 (Withdrawn): Division 7A: trust entitlements (**PS LA 2010/4**) and *PCG 2017/13 Division 7A - PS LA 2010/4 sub-trust arrangements maturing in or after the 2016-17 income year* (**PCG 2017/3**) have administratively allowed for:

- A UPE (for distributions from 16 December 2009 to 1 July 2022) to have been placed on a complying sub-trust arrangement (PSLA 2010/4); and
- Certain sub-trust arrangements to be refinanced as Division 7A loans (**PCG 2017/3**).

Unfortunately, the sub-trust arrangements covered by PSLA 2010/4 and the refinancing provided for by PCG 2017/3 would unlikely be binding on the Commissioner. That being said, PSLA 2010/4 at least links into TR 2010/3 via paragraph 21 and 23 by outlining which arrangements would be accepted by the Commissioner as being those that would evidence "funds representing the UPE for the private company's sole benefit rather than their use for the benefit of the trust." Accordingly, there is at least some basis to be found in a binding ruling. The question that remains, however, is whether the ruling is binding on taxpayers or whether taxpayers can choose to change their treatment (if the Federal Court finds in favour of the taxpayer in *Bendel*).

2.8 Conclusion

The issues that arise due to *Bendel* are not new. These issues were highlighted in some detail in the Board of Taxation's Division 7A report but ultimately were never resolved.

Not only did the Board recommend that UPEs be treated as loans (under the legislation) but also made specific recommendations regarding the 'amendments' issue where a taxpayer sought to rely on a double counting rule. Perhaps a lot of these issues could have been avoided if the Government had followed the recommendations of the Board.

It is also interesting to again note that the Commissioner chose to challenge *Bendel* under section 109D rather than under Subdivision EA. Perhaps the issues raised in this paper could have been avoided if the ATO had instead issued assessments to the various taxpayers under both section 109D and Subdivision EA).

As unfortunate as the current position is (in terms of the uncertainty that it has now created), we nonetheless will be forced to consider the ramifications of the decision in *Bendel* once it is heard by the Federal Court. Furthermore, there is no guarantee the decision in the Federal Court will not be appealed. Accordingly, it may be some time before we know the real outcomes and consequences of the decision.

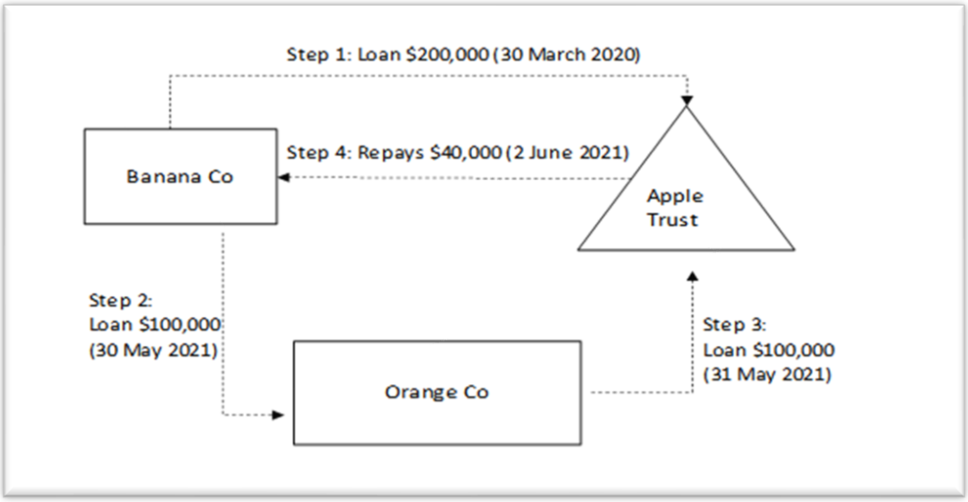
3. Section 109R and interposed entities

3.1 The ATO example

In 2023, the ATO published an example in their Division 7A web guidance, which provided a view that section 109T (the interposed entity rule) could potentially be applied when applying section 109R (the refinancing rule).

The ATO has not provided detailed guidance on this, and instead have effectively stated that the provisions can be applied in conjunction with each other. The following is the example, which is taken from the ATO website section titled "Loans by private companies"[9], which is current at the date of writing this paper.

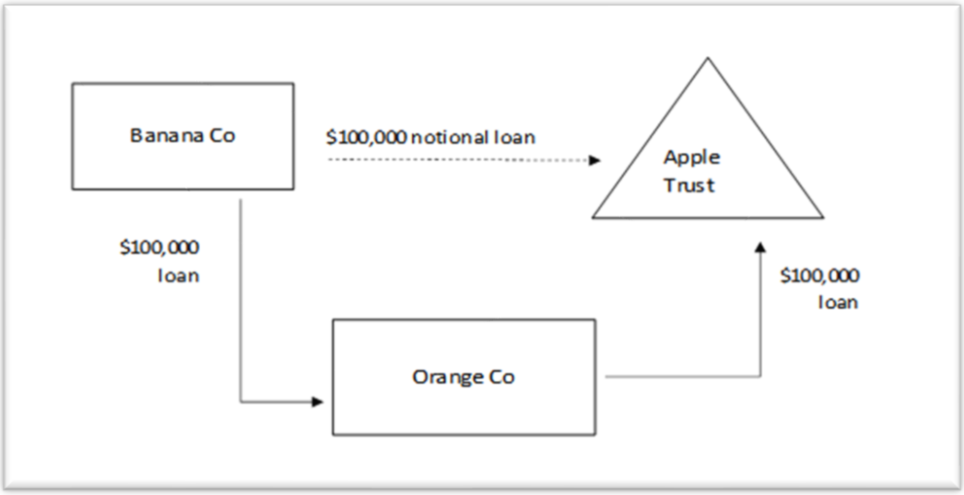
> *<u>Example – Interposed entity arrangement</u>*
>
> *Apple Trust requires a minimum level of working capital to operate its business. Banana Co is a private company that has significant retained earnings. Orange Co is a private company that has no retained earnings. Apple Trust, Banana Co and Orange Co are controlled by the same family group.*
>
> *On 30 March 2020, Banana Co lends $200,000 to Apple Trust. The parties enter into a complying loan agreement before Banana Co's lodgment day (being 15 May 2021). On 30 May 2021, Banana Co lends $100,000 to Orange Co. On 31 May 2021, Orange Co lends $100,000 to Apple Trust. On 2 June 2021, Apple Trust repays $40,000 to Banana Co.*
>
> *The loan between Orange Co and Apple Trust is not a Division 7A complying loan and Orange Co has no distributable surplus.*



> *Having regard to all the circumstances including the timing of payments and the relationship between entities, a reasonable person may conclude that Banana Co lent $100,000 to Orange Co solely or mainly as part of an arrangement involving a*

[9] https://www.ato.gov.au/businesses-and-organisations/corporate-tax-measures-and-assurance/private-company-benefits-division-7a-dividends/in-detail/division-7a-loans

loan to Apple Trust. Banana Co is taken to have made a notional loan of $100,000 to Apple Trust as follows:



Having regard to all the circumstances, a reasonable person may conclude that before the payment of $40,000 was made, the trustee of Apple Trust borrowed $100,000 (which is a larger amount to the payment) from Banana Co in order to make the payment. Apple Trust's repayment of $40,000 may not be taken into account for the purposes of working out how much the $200,000 loan has been repaid.

As seen from the example, the reference to 'notional loan' from Banana Co to the Apple Trust is a reference to the same term used in section 109W. We note that outside of the interposed entity rules, the term 'notional loan' is not a concept that is otherwise used in Division 7A. Accordingly, the example effectively demonstrates an ATO view on the interaction of section 109R with section 109T.

3.2 How does this work?

As noted above, the example assumes a straightforward interaction between section 109R and 109T. However, the application of the provisions is far from being as simple as that outlined in the example. Before examining the example in detail, it is important to consider how both section 109R and section 109T operate (on a standalone basis) and some of the potential complexities that would need to be addressed before coming to the conclusion contained in the ATO example.

3.3 Applying the refinance principal (section 109R)

Section 109R is essentially an 'anti-refinancing' rule. As outlined in the original Explanatory Memorandum at paragraph 9.60, the "provision is intended to prevent shareholders or associates from avoiding the operation of the Division by temporarily repaying a loan." Section 109R can apply in two circumstances (what we refer to as two limbs).

3.3.1 The first limb

The first limb is contained in paragraph 109R(2)(a). It covers a scenario where an entity repays a part or all of a loan to a private company and then subsequently reborrows from the same private company. The provision will be satisfied where:

> *a reasonable person would conclude (having regard to all the circumstances) that, when the payment was made, the entity intended to obtain a loan or loans from the private company of a total amount similar to, or larger than, the payment;*

Accordingly, in this case, it is critical to determine objectively (having regard to all the circumstances) that: (1) the entity intended to obtain a loan from the private company; and (2) the amount of the loan is similar to or larger than the original loan.

3.3.2 The second limb

The second limb is contained in paragraph 109R(2)(b). It covers a scenario where an entity obtains a loan from the private company in order to repay a part or all of the original loan from the private company. The provision will be satisfied where:

> *(i) the entity obtained, before the payment was made, a loan or loans from the private company of a total amount similar to, or larger than, the amount of the payment; and*
>
> *(ii) a reasonable person would conclude (having regard to all the circumstances) that the entity obtained the loan or loans in order to make the payment.*

Accordingly, in this case, it is critical to determine that: (1) the entity obtains a new loan or loans from the private company; (2) the amount of the loan or loas is similar to or larger than the amount of the payment; and (3) objectively (having regard to all of the circumstances) the entity obtained the loan to make the repayment to the private company.

3.4 Applying the interposed entity rule (section 109T)

3.4.1 Can 109T deem there to be a loan for 109R purposes?

There is a fundamental question as to whether the Commissioner can apply the ‘deeming’ rule in section 109T as a basis for applying section 109R. In particular, in the Full Federal Court decision of *FCT v Comber* (1986) 17 ATR 413 at 420 (**Comber**), Fisher J said:

> *... deeming provisions are required by their nature to be construed strictly and only for the purpose for which they are resorted to ....*
>
> *It is improper in my view to extend by implication the express application of such a statutory fiction. It is even more improper so to do if such an extension is unnecessary, the express provision being capable by itself of sensible and rational application.*

In other words, there is a limitation as to how far a deeming rule can go. Section 109T requires that the Division "operates as if a private company makes a payment or loan to an entity". However, section 109R does not use that term. Section 109R requires that the entity intended to "obtain a loan" and in fact "obtained a loan" from the private company. Accordingly, for the provisions to work in the manner asserted to by the ATO, the ATO would need to argue that the deeming rule results in the entity both intending to obtain such a loan from the private company and obtaining such a loan from the private company. Given the complexities that are outlined in the following paragraphs, it would be questionable whether the legislator intended for the deeming rule to go this far and accordingly there is a real question as to whether the ATO's interpretation would be held to be correct if reviewed by a Court.

3.4.2 Only section 109W is relevant

Section 109T is not a provision that deems there to be a dividend. Instead, where section 109T applies, Division 7A operates as if a private company makes a "payment" or "loan" to the target entity, as described in section 109V or 109W, for the purposes of the whole of the Division.

Section 109V covers a scenario where the target entity is paid an amount by the interposed entity. In that case, the Division operates as if the private company had paid an amount to the target entity. Section 109W covers a scenario where the target entity is lent an amount by the interposed entity. In this case, the Division operates as if the private company had made a loan of an amount to the target entity.

The first and the second limb of subsection 109R(2) can only operate where the private company has made a loan (or loans) to the entity (either before or after the repayment by the entity). Accordingly, if the interposed entity rules are used to determine whether a 'notional loan' has occurred, only section 109W would be relevant. Accordingly, section 109V should not be relevant for the purposes of this analysis.

3.4.3 Criteria when applying section 109T and 109W

Before analysing the interaction of section 109R with section 109T, there are some important ground rules that must be considered with respect to section 109T and 109W. Please note that the following comments are restricted to comments on sections 109T and 109W (and do not cover section 109V):

- Section 109T can deem there to be a loan for the whole of the Division.
- Section 109T has a reasonable person test and requires that a reasonable person would conclude (having regard to all the circumstances) that the private company made the payment or loan solely or mainly as part of an arrangement involving a loan to the target entity.
- While section 109T is self-executing, the quantum or amount of the loan is subject to a Commissioner's determination under 109W.
- Section 109W requires the Commissioner to make a determination as to the size of the notional loan, taking into account the amount of the loan actually made to the target entity by the interposed entity.
- Section 109W can reduce the amount of the loan by how much (if any) of that amount the Commissioner believes represented consideration payable to the target entity by the private

company or any of the interposed entities for anything (assuming that the consideration payable equals that for similar transactions at arm's length).

- The considerations that are to be taken into account by the Commissioner in section 109W are not limited to the two factors outlined in section 109W(2). This is the view outlined in *TD 2011/16: "Income tax: Division 7A - payments and loans through interposed entities - factors the Commissioner will take into account in determining the amount of any deemed payment or notional loan arising under section 109T of the ITAA 1936"*. The Commissioner must take into account those additional factors.
- TD 2011/16, para 2(e), requires the Commissioner to consider the extent to which any loan made from the private company to an interposed entity is placed on section 109N terms.
- TD 2011/16, para 2(h), requires the Commissioner to consider the extent to which the arrangement is 'genuine' and is not designed to avoid the application of Subdivision E.
- The AAT can stand in the shoes of the Commissioner in determining the amount of the loan to the target entity under section 109W.

3.4.4 What does 109W(2)(b) mean?

Section 109W(2)(b) states that the Commissioner must take into account how much (if any) of the loan to the target entity the Commissioner believes represented consideration payable to the target entity by the private company or any of the interposed entities for anything (assuming that the consideration payable equals that for similar transactions at arm's length).

The ATO has specifically stated, in TD 2011/16 para (2)(b), that the consideration payable to the target entity excludes the "right to receive repayment of the loan and any relevant interest". It is questionable whether this conclusion is technically correct.

Unlike section 109V which deals with payments that can be made as consideration for the provision of something by the target entity, section 109W simply deals with a loan to the target entity. Under a loan arrangement, a target entity agrees to make repayments of the loan. The target entity cannot provide any other consideration other than the rights under the loan agreement (otherwise the arrangement would not be a loan). The target entity simply agrees to repay the loan together with any interest. It is possible that the repayments could be by way of a transfer of goods or services over time, however this would simply be in satisfaction of the promise to repay the loan. Accordingly, it is difficult to identify an arrangement where the target entity provides consideration to the interposed entity or the private company other than agreeing to make repayments under the loan agreement (i.e. other than a promise to pay).

Arguably, this raises significant doubt as to whether the ATO are correct in their view contained in TD 2011/16 under para (2)(b) of that Taxation Determination. Arguably, section 109W(2)(b) allows the Commissioner to take into account consideration payable to the target entity for anything which would include the rights under the loan agreement provided to the company (provided that they were arm's length). That is, arguably, section 109W(2)(b) requires the Commissioner to take into account the 'promise to pay'.

In examining the words 'consideration' and the provision of 'anything', reference is made to the High Court decision of *Fadden v Federal Commissioner of Taxation (1945) 70 CLR 555*, which discussed the concept of a 'promise to pay' as real consideration.

In this case the documents imply a promise to pay, that is a promise to pay an amount of money which the case shows is the full value of the property. The promise to pay is immediately enforceable, although it has not been enforced for a period of about three years.

If the appellant were at any time to release the debt so that the promise would no longer be enforceable, a quite different set of circumstances would arise, because the release of a debt is included in the definition of disposition of property and may therefore be a gift. But the present position is that the consideration for the transfer of the shares is to be found in each case in a promise to pay the full value, such promise being immediately enforceable. In my opinion it is impossible to say that such a promise is an inadequate consideration, and it has not hitherto been suggested that a distinction should be drawn between such promises as consideration by reference to the financial capacity of the promisor to pay. Entry into such matters to determine the "real consideration" or the "adequacy" of the consideration under such provisions as those now under consideration would open up an entirely new field of inquiry, an inquiry which there appears to be no authority for making.

The decision in *Fadden's* case is still good law and has been followed in numerous subsequent cases. It is noted that a similar conclusion was provided by the ATO in an old Private Binding Ruling number 24571 which was released in 2003.

"Consideration is not defined in Division 7A, although the term also appears in paragraph 109V(2)(b) and paragraph 109W(2)(b) of the ITAA 1936. Neither the Explanatory Memorandum or the Second Reading Speech of the Taxation Laws Amendment Act (No. 3) 1998 provide any guidance.

'Consideration' is defined in section 9-15 of A New Tax System (Goods and Services Tax) Act 1999 to include any payment, act or forbearance in connection with a supply of anything and in response to or for the inducement of a supply of anything.

For the purposes of contract law, consideration has been defined as follows:

'An act or forbearance of one party, or the promise thereof, is the price for which the promise of the other is bought, and the promise thus given for value is enforceable.'

Source: Pollock on Contracts, 8th ed. P. 175 cited in Dunlop Pneumatic Tyre Company Ltd v Selfridge and Company [1915] AC 847 at 855.

Under the law of contract, compromise of a claim or a forbearance to sue may constitute good consideration (Seddon, N.C. & Ellinghaus, M.P., 2002, Cheshire and Fifoot's Law of Contract, 8th edn, LexisNexis Butterworths, Australia at [4.24] - [4.26]). The consideration must be capable of expression in terms of value however small (Seddon, N.C. & Ellinghaus, M.P. at [4.12]).

In Federal Commissioner of Taxation v Scully [2000] HCA 6; 2000 ATC 4,111, the majority of the High Court (Gaudron, ACJ, McHugh, Gummow and Callinan JJ, Kirby J dissenting) found that the term 'consideration' should not bear its technical meaning. In that case the Court found that a payment from a superannuation fund for the termination of employment on the grounds of total and permanent

> *disablement was not 'consideration of a capital nature for, or in respect of, personal injury to the taxpayer' and was therefore not an eligible termination payment. At paragraph 25, the majority said:*
>
> *'No doubt the full court was right in holding that, in the context of paragraph (n), 'consideration' should not bear the technical meaning that it has in the law of contract'.*
>
> *According to the Australian Oxford Dictionary, the ordinary meaning of consideration is 'compensation; a payment or reward'. The Dictionary defines compensation as 'something, esp. money, given as a recompense'."*

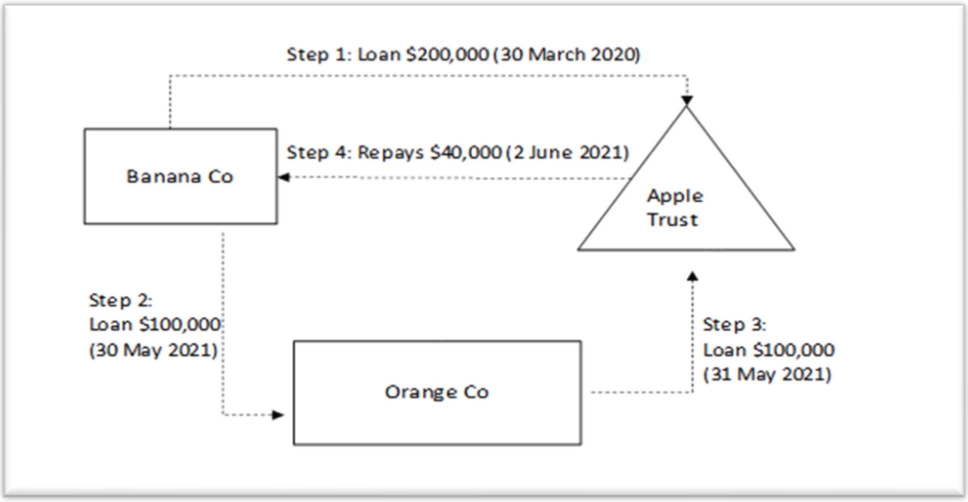
It is understandable why the ATO sought to exclude a 'loan' or a 'promise to pay' from being consideration in paragraph 109W(2)(b). Accepting a broad interpretation of the word 'consideration' and 'anything' would mean that section 109N loans could simply be replaced with arm's length loans through interposed entities. Accepting this proposition would have (administratively) resulted in many difficulties for the Commissioner in administering Division 7A, as section 109T is subject to a Commissioner's determination. In a round-about way, the Commissioner will potentially accept section 109N loans made by the interposed entity to the target entity provided that it does not otherwise circumvent Subdivision E (see TD 2011/16, para (2)(e) and (g)). In effect, this is broadly the same outcome. But it is questioned why a Division 7A loan should be acceptable (under the words used in the legislation), but an arm's length loan (which may, for example, have an interest rate higher than the benchmark rate) should not be.

Arguably, there may be no ability for the Commissioner to read down the plain words contained in paragraph 109W(2)(b). We note that the interposed entity provisions may apply where there are multiple interposed entities. The provisions were not intended to be self-executing and they require the Commissioner to make a determination in each case. As interposed entities (such as trusts) are not ordinarily subject to the operation of Division 7A, it could be reasonable to assume that paragraph 109W(2)(b) should take into account arm's length loans made to the target entity by those interposed entities in such circumstances. While this could be arguable, provided the Commissioner accepts 109N loans as being a factor to take into account under section 109W (where such loans are not intended to circumvent the operation of Subdivision E (as outlined above)), this is likely to be a reasonable compromise in many cases.

3.5 Reconsidering the ATO example

3.5.1 The background

The ATO example is reproduced again for the purpose of analysing the interaction between section 109R and section 109T, having regard to the background outlined above.



In the ATO example, the ATO suggest that the combination of Step 2 and Step 3 could constitute a 'notional loan' under section 109T and thus could potentially result in a loan for the purposes of applying section 109R. Accordingly, the ATO assert that first limb of section 109R may be satisfied. However, there is no further analysis provided by the ATO in the guidance material. So, let's explore this potential conclusion further.

3.5.2 Three deemed dividends?

Before examining the interaction issues further, it is important to note that the example asserts that both section 109E will apply to the Apple Trust (i.e. by not counting the 109R repayment of the first loan) and that section 109T will apply to the Apple Trust for the same amount (by treating that as a deemed loan under section 109D, which requires a conclusion that the notional loan is $100,000 under section 109W). In addition to this, Orange Co has made a loan to the Apple Trust which may also be caught by Division 7A where Orange Co has a distributable surplus. Accordingly, the example provided by the ATO could result in three deemed dividends to the Apple trust:

- Deemed dividend 1 – section 109E - $40,000 (from Banana Co)
- Deemed dividend 2 – section 109T - $100,000 (from Banana Co)
- Deemed dividend 3 – section 109D - $100,000 (from Orange Co)

There appears to be no anti-overlap that occurs in this case contained within Division 7A (for example, as section 109T(3) only applies if the deemed dividend occurs from the company to the first interposed entity). However, as Division 7A could operate to include three dividends to Apple Trust in respect of the same amount, there is a question as to whether section 6-25 could operate to ignore two of these deemed dividends. Section 6-25 can operate where more than one rule includes an amount in your assessable income. While the case of *Bendel* discusses section 6-25, that case dealt with the amount potentially being included in the assessable income of two different taxpayers. Accordingly, the comments in *Bendel* may not be relevant.

In TD 2015/20, paragraph 3, the ATO acknowledge that section 6-25 can potentially apply where two or more provisions contained in Division 7A apply to include an amount in the taxpayer's assessable income.

> *3. This Determination does not apply to the extent that an amount is included in the assessable income of the entity in favour of whom the UPE is released because of the application of another provision of Division 7A in respect of the UPE, (section 6-25 of the ITAA 1997).*

While section 6-25 may apply so that the amount is not included more than once, section 109Y is not framed in the same manner. In that provision, a reduction for a "Division 7A amount" for amounts the company is taken under section 109C or 109F to have paid as dividends in the year of income apart from this section. A reduction also occurs for a "non-commercial loan" for amounts the company is taken under former section 108, or section 109D or 109E, to have paid as dividends in earlier years of income. These provisions do not look at whether such dividends are assessable, but instead just looks at whether the Division 7A provisions have applied.

However, section 6-25 does not deem there to be no dividend paid. The provision simply states that "the amount is included only once in your assessable income for an income year and is then not included in your assessable income for any other income year."

In addition to this, section 109Y(3) has a reduction rule where there are multiple dividends paid (where the sum total of those deemed dividends exceed the distributable surplus of the company). The application of this provision can have the effect of reducing the deemed dividend amount.

So, this begs the question – If these interaction rules need to be applied, which of the three deemed dividends would need to be included in the assessable income of the Apple Trust and what would be the quantum of those dividends? Unfortunately, this issue is not discussed or considered in the guidance provided by the ATO.

3.5.3 Amount of the notional loan

From a technical perspective, the ATO example concludes that section 109T (through section 109W) would result in a notional loan of $100,000 from Banana Co to Apple Trust. In this example, if the actual loan to the Apple Trust (from Orange Co) were to have been placed on section 109N terms, then arguably this would be a consideration the Commissioner would need to take into account in determining the quantum of the loan under section 109W (in accordance with TD 2011/16, paragraph 2). The Commissioner may then point out that the effect of the new loan is to extend the term of the original $200,000 loan (which is also a factor the Commissioner would need to take into account under section 109W under TD 2011/16).

Under the original loan, the minimum loan repayment for the 30 June 2021 income year would be equal to $33,965.00 (in accordance with section 109E and using the ATOs Division 7A calculator). Arguably, this is the only amount of the loan to the Apple Trust from the interposed entity that otherwise would result in a 12-month extension of the original loan. Based on this, it could be possible to argue that the Commissioner should only seek to quantify the 'notional loan' as being an amount of $33,965 for the purpose of section 109W, i.e., the amount giving rise to a perceived mischief in this case.

However, if that were the case, the first limb of section 109R(2) may not be satisfied. The provision requires that the loan (albeit the notional loan) must be an amount that is similar to or larger than the repayment made to the private company. While $33,965 is not larger than $40,000, it is questioned whether this amount is 'similar'. Again, this is not an issue that is considered in the ATO example or guidance material, as it simply assumes the notional loan is $100,000 in this case.

3.5.4 New interposed loan has a reduced term

Assume that Orange Co instead places the loan on section 109N terms, reduced by one year (i.e. taking into account the reduced term of the original loan from Banana Co, Orange Co reduces the term to 6 years on the new loan). In this case, arguably, the Apple Trust will continue to comply with Division 7A and the refinance is not intended to circumvent the operation of Division 7A. In this example, it is difficult to quantify the amount that the Commissioner would determine to be the 'notional loan' under section 109W and whether this would be $100,000 or a lesser amount.

Recently the ATO issued PBR 1052059888636 (24 November 2022). In this case, existing Division 7A loans that were in place with one company (the Old Holding Co) were repaid through new loans provided by another related group company (the New Holding Co). While edited PBRs do not always disclose all the facts, the facts in this PBR are relatively clear.

> *New Holding Company will agree to make loans to the Trustee and each Family member (severally) under complying Division 7A loan facility agreement,*
>
> *These loan advances are intended to enable the Trustee and each Family member to refinance their existing Division 7A loans with Old Holding Company as new 25-year loans with New Holding Company. The maximum terms of each new loan will be set according to the reductions required under s109N(3A) ITAA 1936 in relation to refinancing arrangements.*
>
> *The Trustee and each Family member will repay loans previously advanced to them by Old Holding Company.*

In this PBR, the ATO specifically did not seek to apply section 109R through section 109T. The following provides their view in the edited PBR.

> *Under the proposed arrangement:*
>
> - *the Trustee and each Family member will direct New Holding Company to pay the proceeds of each loan advance to Old Holding Company;*
> - *Old Holding Company will agree to accept each directed payment as a repayment in respect of the loans previously advanced to the Trust and each Family member; and*
> - *Old Holding Company and New Holding Company will agree to set off their mutual obligations to one another in relation to the Old Holding Company dividend and the New Holding Company directed payments.*
>
> *As a consequence of this, the former shareholders of Old Holding Company (now shareholders of New Holding Company) will now owe New Holding Company the outstanding amount instead of Old Holding Company.*
>
> *Neither section 109R of the ITAA 1936, nor section 109T, would not (sic) apply in these circumstances.*
>
> *The shareholders (and their associates) already had use of the monies in question. The mere replacement of Division 7A compliant loans from Old Holding Company with new Division 7A compliant loans from New Holding Company will not put more money in their hands.*

> *This refinancing will meet Division 7A of the ITAA 1936 requirements and the maximum terms of each new loan will be set according to the reductions required under s109N(3A) ITAA 1936 in relation to the refinancing arrangements.*

As can be seen, where the 'refinance' replaces the Division 7A loan and there is an appropriate reduction in the term of the refinanced loan, the Commissioner may be open to the argument that neither section 109R (through section 109T) should be applied. However, as this is an isolated PBR and given the website guidance does not discuss this, it is difficult to ascertain whether the view in the PBR coincides with the Commissioner's view on this matter, or whether this is a one-off case. Either way, the fact that the 'notional loan' is subject to section 109W considerations means that it should be difficult for the Commissioner to simply state that the notional loan in the example provided in the website guidance is simply $100,000.

3.6 Conclusion

The application of section 109T to section 109R repayments is quite novel and is probably not something that is easily understood broadly by taxpayers. The ATO example and their website guidance do not stipulate that the provisions will always work together. The example simply states that they provisions "may" operate to disregard a repayment. This, of itself, does not appear to be an incorrect statement on the ATOs website guidance.

Accordingly, the ATO have done the right thing by raising the issue and outlining this key risk for taxpayers. However, taxpayers (and ATO officers) are unlikely to understand the nuances of this issue and how the provision actually applies in complex case scenarios. The complexity of this issue is probably something that requires further consideration and further guidance by the ATO. Without this, there is a significant risk that the ATO and tax advisors may incorrectly apply the example to real life circumstances.

In many cases, the outcome applying the two provisions together can be significantly unfair, especially where there is more than one interposed entity within the group and more than one potential deemed dividend arising from the same amount. There is a therefore real question as to whether a Court would seek to read down the 'deeming' rule (in line with the decision in ***Comber***) which could avoid potentially anomalous outcomes.

While it is understood that the ATO consulted on the website guidance, we recommend that the ATO consider a more technical approach to consultation on this complex interaction issue. Should the ATO believe that the view is the correct application of the law, it is believed that it would be better for the ATO to issue a Public Ruling on the matter (or at the very least, more detailed guidance) which considers many of the issues raised in this paper.

4. The treatment of partnerships

4.1 Background

For income tax purposes, there are two types of partnerships[10], as defined in section 995-1. A general law partnership (being an association of persons (other than a company or a limited partnership) carrying on business as partners) and a tax law partnership (being an association of persons (other than a company or a limited partnership) in receipt of ordinary income or statutory income jointly).

At the time of writing this paper, there is no published view or guidance by the ATO on the treatment of partnerships for Division 7A purposes. However, in recent private binding rulings, the ATO has articulated a number of new concepts and principles that are being applied to partnerships. This paper will explore these concepts in more detail.

4.2 Former ATO view contained in website guidance

The ATO had previously issued an FAQ document on Division 7A, which included three questions on the treatment of partnerships. While not binding, the questions and answers appeared to provide a practical interpretation of the application of Division 7A to partnerships.

> ***Partnerships***
>
> ***Can capital contributed to a partnership by a private company partner give rise to a dividend?***
>
> *No, provided it is a bona fide capital contribution. By its nature, a capital contribution made by a private company partner to the partnership is not a loan to either the partnership or the other partners. Although it constitutes a payment to an entity for Division 7A purposes, it will not be treated as a dividend because it discharges an obligation of the private company to pay money to the partnership and is not more than would have been required in an arm's length dealing.*
>
> *(See subsection 109C(3) and section 109J.)*
>
> ***Can a private company partner's undrawn partnership profits be taken to be a dividend?***
>
> *No. A private company partner's undrawn partnership profits constitute neither a loan nor a payment by the private company to either the partnership or the other partners.*
>
> ***Where a private company and its shareholders or their associates are partners, what are the Division 7A consequences of excess drawings by a partner who is such a shareholder or associate?***

[10] Excluding limited partnerships

> *An excess drawing that is correctly characterised at law as a transaction on account of the partnership cannot be taken to be a dividend.*
>
> *However, an amount that may have been accounted for as a drawing may be beyond the terms of the partnership agreement, or it may involve a transaction that is properly characterised as being directly between the private company and the other partner in their own capacity and on their own account instead of their capacity as partners and on account of the partnership. In these instances, amounts shown as excess drawings by a partner who is a shareholder (or an associate of a shareholder) of the private company partner can satisfy the definition of a payment or loan under subsections 109C(3) or 109D(3). Such an excess drawing can give rise to a dividend, where it relies on either capital contributions by, or undrawn profits of, the private company partner.*

The FAQs have since been removed from the ATO website. Since that time, the ATO have not release any further guidance (publicly) on the treatment of partnerships for Division 7A purposes.

4.3 Recent ATO private binding rulings

There have not been many PBRs issued that specifically deal with partnerships and Division 7A. However, since 2018, there have been three PBRs that seek to address some of the key concepts with respect to the application of Division 7A to partnership. These key concepts include whether the partnership is an ‘entity’ for Division 7A purposes, whether the relevant entities are ‘associates’ as defined, and whether the transaction is one that would give rise to a payment (section 109C), a loan (section 109D) or the application of the interposed entity rules (section 109T).

4.3.1 PBR 1051393604802 (3 July 2018)

Background facts

This private binding ruling was relatively simple in terms of its facts. The question asked of the ATO was in respect of the treatment of partnership capital that was provided by a partner (who was a private company) to a general law partnership in accordance with the partnership agreement. The taxpayer asked whether the partnership contribution would be a deemed dividend under section 109C or 109D.

Section 109C payment

The ATO held that the proposed capital contribution constituted a payment for the purposes of Division 7A. Section 109J provides an exemption where the payment discharges an obligation of the private company to pay money to the entity and the amount paid is not more than would have been required to discharge the obligation (dealing at arm's length). The ATO concluded, in this case, that the exemption in section 109Jwould apply to the contribution of capital.

Section 109D loan

The ATO analysed whether the partnership capital was a loan consistently with TR 2010/3 (which has now been withdrawn). The ATO concluded that the proposed capital contribution was made in accordance with the Partnership Agreement and was consistent with the purpose of the Partnership.

Accordingly, the ATO concluded that the proposed capital contribution was not regarded as an ordinary loan (as it was bona fide capital) or a loan by virtue of the extended definition of the term for the purposes of Division 7A. As such, the ATO held that no deemed dividend would arise under section 109D.

Commentary

The view contained in the PBR was consistent with the view provided by the ATO in its website guidance (now withdrawn). However, the view was also based on the now withdrawn TR 2010/3. Given the ATO no longer hold the view contained in TR 2010/3 with respect to UPEs, it would be questionable whether this same conclusion could be held. This is discussed in further detail below, especially in PBR 1052129530678 where the ATO seek to apply their new view on 'financial accommodation (as contained in TD 2022/11) to partnership capital.

This PBR is also silent as to why the partnership is considered to be an associate of the shareholder of the company in this case. Some examples have been included in paragraph 4.9 of this paper that demonstrates that this will not always be the case.

4.3.2 PBR 7910152492401 (21 October 2022)

Background facts

This private ruling involved a private company (Cattle Company Pty Ltd) that was owned by Yellow. It is assumed that Yellow is an individual. Yellow was also a partner in a partnership carrying on business with three other partners. The company provided a loan to the partnership during an income year. The ATO was asked whether the loan from the private company would be subject to Division 7A.

Associate and entity

The ATO concluded that the partnership was an associate of Yellow (the shareholder) under section 318(1)(b). Furthermore, the ATO concluded that the partnership was an entity for Division 7A purposes in accordance with section 109ZD.

Section 109D loan

The ATO concluded that the loan was subject to section 109D and resulted in a deemed dividend to the partnership. Pursuant to section 92, each of the four equal partners were required to include an unfranked dividend as assessable income. In this case, the issue was identified by the new tax agent and the deemed dividend occurred outside of the amendment period. As there was no fraud or evasion in this case, the ATO concluded that in accordance with subsection 170(1) the Commissioner was out of time to amend the assessments of the partners.

Commentary

This PBR explores the associate rule and whether the ATO would regard the partnership as an entity. The associate rule appears quite straightforward in this case (assuming that Yellow was an individual) and this appears to be correctly applied. However, the concept of whether the partnership should be regarded as an entity requires some further consideration. It is noted that the treatment of the partnership as an entity in this PBR is inconsistent with the following PBR 1052129530678 where the ATO regarded the partnership as an entity, but choice to also ATO look through the partnership for Division 7A purposes (and not assess the partnership on loans provided to and through the partnership).

4.3.3 PBR 1052129530678 (14 June 2023)

Background facts

This private ruling involved a partnership that was comprised of two individual partners and one private company partner. There was no partnership agreement in this case, however the facts state that they carried on business activities on real property owned by Trust A. The ATO accept the fact that a general law partnership existed in this case despite there being no agreement. The two individuals were shareholders of the private company. They were also beneficiaries of the related trust, Trust A.

In this PBR, the individual partners had overdrawn their ‘partnership entitlement’ account, while the corporate partner had underdrawn their ‘partnership entitlement’ account. Furthermore, the partnership had made a loan to Trust A.

Partnership entitlement account and ATO website guidance

As outlined above in paragraph 4.2, the ATO had previously held that partnership entitlement accounts generally did not result in a loan for Division 7A purposes. However, that guidance was subject to the risk that an overdrawn account (that was not in accordance with terms of the partnership agreement) could be viewed as a loan. In this PBR, the ATO highlight that the “web guidance has been withdrawn and doesn’t reflect the ATO’s current view”.

Associate and entity

The ATO concluded that the partnership was an associate of the individuals (the shareholders) under section 318(1)(b). The ATO also concluded that Trust A was an associate of the shareholders under section 318(1)(d). This part of the ruling appears correct and uncontroversial.

Consistent with the previous ruling, the ATO concluded that the partnership was an entity for Division 7A purposes in accordance with section 109ZD.

Section 109D loan

The ATO’s analysis on section 109D (loans) in this PBR is very different to anything that they have publicly stated. In this PBR, the ATO adopt the view taken in TD 2022/11 in respect of the broad meaning of the term ‘financial accommodation’. However, the ATO appear to go further in its application in this case. The ATO state that the fact that the company did not call on its ‘undrawn’ entitlement’ and the fact that the company knew the partnership made a loan to Trust A and allowed individuals to overdraw on their entitlements resulted in ‘financial accommodation’ directly to those recipients. This view was held without the need to apply the interposed entity rule in section 109T. The ruling states:

> *20. Each loan will be treated as a dividend in the income years when the Partnership made the loans. When all loans were made, Company D's controlling*

> *minds would have had constructive knowledge of two things. First, Company D had a substantial underdrawn partnership entitlement. Second, its ongoing failure to demand payment would allow the Partnership to fund the loans. Therefore, the financial accommodation (or payments by direction) would arise in the income years when the Partnership provided the funds to Trust A.*
>
> *26… We think Company D was making loans through granting financial accommodation directly to Person B and Person C by consenting to Person B and Person C's overdrawings without demanding payment of its underdrawn entitlement.*

Section 109T

The PBR outlines that a partnership is an entity and thus the ATO could have also applied the interposed entity rules in this case. That is, the company had made a loan to the partnership (via its undrawn entitlement) and the partnership made loans or payments to the individual and Trust A. However, in a bizarre twist, the ATO conclude that section 109D was more appropriate than 109T, without citing any provision to give effect to this conclusion. The ruling states:

> *22. But we don't think it's appropriate to take either of these approaches on these facts. We think these transactions are best characterised as direct loans or payments to Trust A because all entities were controlled by Person B and Person C. The Partnership is simply an agreement between Company D and Person B and Person C. Since Person B and Person C controlled Company D, it should therefore be taken to have consented to a redirection of its entitlements to Trust A. It's unnecessary to characterise the arrangement as involving loans or payments to the Partnership. Further, we wouldn't need to consider the interposed entity rules where the underlying transactions can be appropriately characterised as direct loans or payments to the target entity.*

Commentary

There is so much to say about this PBR. Firstly, Pitcher Partners posed a question on TD 2022/11 in our submission on the draft determination (TD 2022/D1). We were concerned with the ‘look-through’ approach adopted by the ATO and whether the ATO would seek to apply this view more broadly (and ignore entities under section 960-100). The compendium summarises our question as the following (Item 7.2).

> *Our main concern with the ATO view in the draft Determination relating to 'circumstance two' is that it undermines the entity concept in sections 109ZE and 960-100 by ignoring the sub-trust and concluding that the corporate beneficiary provides the financial accommodation to the main trust (or user of the funds) directly, rather than indirectly through interposed entities. We are concerned that this view could have broader implications, such as where there is a corporate unitholder in a unit trust. If the unit trust makes a loan to a related party, one would normally have to rely on the application of 109T for a deemed dividend to arise (that is section 109C payment from company to unit trust for subscription of units (to which section 109J could apply) followed by a section 109D loan made by the unit trust to target entity).*

In particular, we queried whether the ATO would seek to apply their broad view where a corporate subscribed for units in a trust and the trust made a loan to an associate of the shareholder of the corporate (i.e. would this be regarded as financial accommodation and thus a direct loan from the corporate to the associate of the shareholder, ignoring the unit trust). The ATO suggested that this would not be the case and that their view was limited to bare trust or transparent trust type arrangements.

> *We have made changes to the final Determination at paragraphs 17, 34 and 74.*
>
> *A sub-trust is ordinarily going to meet the definition of a Transparent Trust as defined in PS LA 2000/2. As such, a sub-trustee who allows a third party to use the sub-trust funds in circumstances where the private company beneficiary consents or acquiesces to that use is not being financially accommodated, and the actions of that trust are effectively taken to be actions of the absolute beneficiary.*
>
> *It is the third-party entity who uses the funds who is being financially accommodated. When the beneficiary allows a third party to use its funds, this is a benefit being provided to that third party by the beneficiary. Where that third party is a shareholder (or shareholder's associate) of the private company beneficiary, Division 7A may apply.*
>
> *The broader implications of such a view are consistent with the overall policy intent of Division 7A. Where a private company allows a shareholder (or shareholder's associate) access to and use of its funds in a tax-free way, Division 7A should have cause to apply.*
>
> *We do not consider the rights of a beneficiary under a sub-trust as we have described it is analogous to a corporate unitholder in a unit trust.*
>
> *Where a sub-trust does not meet the definition of a Transparent Trust, whether financial accommodation is provided to the sub-trustee needs to be considered on a case-by-case basis.*

While the ATO dismissed our question with respect to its application to a unit trust, the ATO has sought to apply the exact same logic to a partnership (only 11 months after responding to our question and releasing the final determination TD 2022/11). We note that the recent High Court decision in *Rojoda* (discussed below) outlines that certain characteristics of a partnership are very similar to characteristics of a unit trust as described in the High Court decision of *CPT Custodian Pty Ltd v Commissioner of State Revenue* [2005] HCA 53. This is discussed further below in paragraph 4.4.2.

In this PBR, the ATO accepts the partnership is an entity under section 960-100, however the ATO then looked through the partnership for the purposes of applying section 109C, 109D and 109T based on TD 2022/11. While the overall outcome appears reasonable in this case, we believe that the ATO should have explicitly stated that this approach is achieved by ignoring the ‘partnership’ as an entity. The ability to do this is discussed further in paragraph 4.6 below.

While this PBR provides a reasonable outcome in the circumstances, from my perspective, it is disappointing that the ATO made this statement in the compendium with respect to unit trusts yet sought to apply the same logic to a partnership. It is also disappointing that one needs to trawl through PBRs to understand that this could potentially be the new view of the ATO in respect of partnerships. There needs to be a better way for the ATO to communicate a change in view, especially one as significant as this.

In addition to this, if the taxpayer is successful in *Bendel* in its appeal, the concept of 'financial accommodation' and its application to partnerships would need to be reconsidered. However, even if the taxpayer in *Bendel* is not successful, one would still need to explore the entity concept further to determine whether the transactions should be categorised as ones with the 'partnership' as an entity or ones with the underlying partners. That is, the concept of a loan can still potentially be satisfied in the case where a partnership is ignored and the transaction is analysed as a "look-through" transaction.

This PBR therefore leaves a lot of issues on the table for consideration. We will explore these concepts in further detail below.

4.4 What are the characteristics of a partnership?

4.4.1 Outline

Before exploring the interaction of Division 7A and partnerships, it is worth considering the nature of a partnership, both general law and tax law partnerships.

4.4.2 General law partnership

The nature of a general law partnership and a partner's interest was considered in the High Court decision of *Commissioner of State Revenue (WA) v Rojoda Pty Ltd* [2020] HCA 7 (**Rojoda**).

> *71. A partnership, of course, is not a legal entity. In the language of the Partnership Act 1895 (WA) ("the Western Australian Partnership Act"), it is a "relation which subsists between persons carrying on a business in common with a view of profit"[106], whose mutual rights and obligations are governed by their partnership agreement[107], each of whom is bound by acts and instruments relating to the partnership business done or executed by another in the name of the partnership[108], each of whom is jointly and severally liable with the others for loss or injury caused by the wrongful act or omission of any one of them in the ordinary course of the partnership business[109], and each of whom is liable jointly with the others for all debts and liabilities incurred in carrying on the partnership business[110].*
>
> *72. Partnership property comprises all property brought into the partnership or acquired on account of the partnership or for the purposes of and in the course of the partnership[111]. In respect of partnership property, each partner has two kinds of rights which it is important to keep conceptually distinct[112].*
>
> *…*
>
> *87. For so long as the partnership is carrying on business, or at least for so long as assets or liabilities of the partnership are turning over or are in prospect of turning over, the legal or beneficial interest of each partner in each item of partnership property necessarily remains unascertained. The share of each partner is not "a fixed proportion" that is "immediately ascertainable" but is rather "an indefinite and fluctuating interest, which at any given moment is in proportion to his share in the ultimate surplus coming to him if at that moment the partnership*

were wound up and its accounts taken"[140] and which might change from moment to moment. But even then, the share of each partner is "'an unascertained interest in every single asset of the partnership, and it is not right to regard him as being merely entitled to a particular sum of cash ascertained from the balance-sheet of the partnership as drawn up at the date of' dissolution"[141].

These key concepts can be summarised as follows: (1) a general law partnership is not a legal entity; (2) each partner is jointly and severally liable with the others for all debts and liabilities incurred in carrying on the partnership business; (3) each partner holds an unascertained interest in every single asset of the partnership.

As outlined earlier, these characteristics are very similar to those that were outlined in the High Court decision in *CPT Custodian*.

20. The beneficial interest in the fund was divided into units, each said to confer an equal interest in all property for the time being held by the trustee upon the trusts of the deed, but excluding that part of the fund credited to a distribution account for distribution to unitholders (cl 3.2). But no unit conferred "any interest in any particular part of the trust fund or any investment" and each unit had "only such interest in the Trust Fund as a whole as [was] conferred on a unit under the provisions contained in [the deed]" (cl 3.2).

51. In the present case, the unsatisfied trustees' right of indemnity was expressed as an actual liability in each of the relevant accounts at each 31 December date and rendered applicable the sense of the above words of Lord Davey. Until satisfaction of rights of reimbursement or exoneration, it was impossible to say what the trust fund in question was.

That is, the High Court consistently recognised that: (1) the trust was not a legal entity (it was the Trustee that was the legal proprietor of the property); (2) the unit holders only held an interest in the trust fund as a whole; and (3) had no interest in the assets until certain liabilities had been satisfied and it was possible to determine what the trust fund in question was.

There are perhaps three key differences (in my view). The first is that partners are jointly and severally liable for the debts of the partnership. Unless otherwise provided for by the trust deed, this is not generally the case for unit holders. The second is that there is sufficient case law that considers 'self-dealings' (i.e. between a partner and the partnership) which are generally to be ignored. Again, this is different to a unit trust, where dealings between a unit holder and the trustee are generally respected. Thirdly, for a trust to exist, there needs to be a trustee holding property for the benefit of the beneficiaries. While the *Rojoda* decision outlines that it is possible that each partner holds property on trust for each other partner, the partners still remain the legal owner of the property (which is different to the ordinary case involving a trust).

These similarities and differences are very important, especially when considering whether a partnership should be regarded as an entity for Division 7A purposes (see paragraph 4.6 below).

4.4.3 Tax law partnership

Where a general law partnership does not exist, a tax law partnership will generally only exist where the parties receive income jointly. This will usually occur where the parties hold property or provide services other than in conducting business in common.

Recognising a partnership as an entity in this case could result in unintended consequences, as the relationship in this case is simply one involving a joint holding of assets. Furthermore, while section 960-100 extends the 'entity' concept to this relationship, it is interesting to note that the participants are not deemed to be partners under the ITAA 1997. Reference is made to section 960-130 which uses the concept of a member who is a "partner", however the term "partner" does not appear to be defined in the ITAA 1997. In a general law sense, a joint owner of property is unlikely to be considered to be a partner.

Furthermore, section 318 has its own definition of 'entity' (as contained in section 317) which is independent of the ITAA 1997. The reference to a partnership in section 318 arguably is defined in section 6, which makes a reference to the term in section 995-1 of the ITAA 1997. Again, section 318 refers to partners in a partnership, and there is a real question whether joint owners can be found to be partners in such a relationship (without anything more).

Accordingly, there appears to be a stronger case for looking through the partnership concept for tax law partnerships in Division 7A. That is, arguably the provisions should look-through the deemed 'partnership' to the underlying joint holders of the property. To the extent that the parties have jointly borrowed from a company, each individual party should consider their own Division 7A consequences under a look-through approach. Similarly, if each joint owner has borrowed in their personal capacity, the Division 7A consequences should be considered from this perspective.

It is submitted that the underlying legal nature of the relationship between the entities and the borrowing is an important consideration that should be taken into account when properly considering Division 7A. However, that being said, the ATO have not explicitly accepted the above proposition and there is no guarantee that they would not seek to apply the 'entity' concept to a 'tax law partnership'.

4.5 Critical questions to address

Taking into account the above initial commentary, there are generally three key questions require some further discussion and analysis when considering the interaction of Division 7A with partnerships.

#	Question to consider
Question 1	Is the partnership an associate of the shareholder of the relevant private company?
Question 2	Should a partnership be regarded as an 'entity' for Division 7A purposes?
Question 3	Which provisions can apply to the transaction (section 109C, 109D, or 109T)?

4.6 Is the partnership (or the partners) an associate of the shareholders?

Where a company provides a benefit to a partnership (e.g. a payment or a loan) or to its partners, it is important to determine whether the partnership, or the partners, are associates of the shareholder of the relevant company providing those benefits.

Section 109ZD defines the term associate with reference to section 318 of the ITAA 1936. Section 318 is a very complex provision to apply, and it is easy to incorrectly determine that parties are either associates or not associates. The key to applying section 318 for Division 7A purposes is to first identify the shareholders (and in some cases, former shareholders) of the relevant company and then to apply section 318 to that shareholder in order to determine the breadth of the associates of that shareholder under section 318.

For the purposes of this paper, I will examine two types of shareholders and their interaction with section 318:

- **Individual shareholders**: - Where the shareholder is an individual, the associates of the shareholder will be limited to those covered by subsection 318(1). This would include relatives of the individual, partners or partnership in which the individual is a partner, the spouse or child of a partner of the individual, any trust where the individual (or an associate under subsection (1)) benefits under the trust (including indirectly through any other interposed entities)[11], and any company that is sufficiently influenced by the individual and their subsection (1) associates or is controlled (through voting) by the individual and their subsection (1) associates. As demonstrated by the examples in paragraph 4.9, the associate rule contained in subsection 318(1) is generally not as broad as the remaining provisions of section 318.

- **Trust shareholders**: - Where the shareholder is a trust, subsection 318(3) can apply. This provision is drafted quite broadly and can include any person that can benefit under the trust. The provision also extends to any subsection (1) associates of individual beneficiaries, and any subsection (2) associates of a corporate beneficiary. Due to this extension (to subsection (1) and (2) associates), a trust shareholder can (in some instances) result in a significantly broader scope of associate for the purposes of Division 7A. This is further demonstrated in Example 2 in paragraph 4.9.3 of this paper.

As outlined in the examples in paragraph 4.9 of this paper, the outcomes of applying section 318 are not always intuitive and are case specific. It is not enough to assume parties will be associates or not associates. It is always important to work through the provisions carefully in each case.

4.7 The entity concept and contrary intention

Section 109C (payments) and section 109D (loans) requires one to identify a relevant entity in order to determine whether an entity has received a benefit from the company. This is outlined in the following table.

Section	Provision requires	Outcome of application
Section 109C(1)	The private company <u>pays</u> an amount to the **entity**	A private company is taken to pay a dividend to an **entity**
Section 109D(1)	The private company <u>makes</u> a loan to the **entity** during the current year	A private company is taken to pay a dividend to an **entity**

[11] Refer to section 318(6)(a) of the ITAA 1936

Section 109ZD contains the defined terms for Division 7A purposes. In particular it states that the term “entity” has the meaning given by section 960-100 of the ITAA 1997. In addition, section 109ZE states that the rules in section 960-100 of the ITAA 1997 about entities apply to Division 7A. It seems that section 109ZD simply provides for the definition of an entity (as contained in subsection 960- 100(1)), and section 109ZE provides for the application of the additional rules (for example by ensuring that a company trustee is not regarded as a company under section 960-100(4) for the purpose of the section 109K exception).

Paragraph 960-100(1)(d) recognises a partnership as an ‘entity’. There is no distinction between a general law or tax law partnership in section 960-100. A partnership can comprise of one or more partners that are companies. Section 109K provides an exemption to section 109C or 109D where a private company makes a payment or loan to another company.

If a partnership is required to be recognised as an entity in accordance with sections 109ZD and 109ZE, it is unlikely one could apply the section 109K exception where benefits are provided to the partnership by a company. This could potentially result in the partnership being deemed to receive an unfranked dividend, which would be allocated to the partners under section 92 (being companies). If this were the outcome, Division 7A could produce a result that would not appear to be in line with the purpose or objects of the provision (i.e. where the benefit is provided to another company and all partners in the partnership were companies).

In considering whether a partnership should be regarded as an entity for Division 7A purposes, reference is made to the decision in *White v Commissioner of Taxation* [2009] FCA 880 (**White**). *White’s* case involved the small business CGT concessions and whether the net asset value test required the inclusion of connected entity ‘partnerships’ as covered by section 960-100. If the word ‘entity’ included a partnership, the taxpayer would have been required to include all of the assets of the partnership in the maximum net asset value test (rather than their partnership interest). The Federal Court held that the word ‘entity’ did not include a partnership and that a contrary intention could be evidenced in respect of Division 152.

> *4 By order made 29 May 2009 Gordon J ordered that the following preliminary question be determined: “Is a partnership an ‘entity’ within the meaning of that term as used in s 152-15(a)(ii) of the ITAA 1997?”*
>
> *12 Section 995 contains a large number of definitions which apply “except so far as the contrary intention appears.” One of them is the word “entity,” which has the meaning given by s 960-100.*
>
> *36 Thus, what is not clear from the provisions of the ITAA 1997 themselves, is made clear by the 1999 memorandum, namely that the “other entities” with which s 152-30 is concerned are companies and trusts.*
>
> *45 As I have said, the board proceeded on the basis that a partnership could be an entity for s 152 purposes because the definition in s 960-100(1) included a partnership. That is the very question in issue here. It cannot be resolved by resort to the board's opinion based as it was on the definition the applicability of which is said in this case to be excluded by a contrary intention.*
>
> *50 Accordingly, while I accept that the Guide to s 106 shows that the capital gains scheme does, when appropriate, treat partnerships as entities, I do not accept the generality of the submission that the scheme expressly treats partnerships as entities, in the sense that whenever the word “entity” appears it*

can be replaced by "partnership." In particular I do not accept that the fact that the Guide to s 106 identifies a partnership as an entity leads to the conclusion that a partnership is an entity for the purposes of ss 152-15(a)(ii) and 152-30.

54 Aided by the 1999 memorandum, I have determined that the entity referred to in s 152-30(2)(a) as "the other entity" does not include a partnership. Since s 152-30 defines when one entity is connected to another for the purposes of s 152-15(a)(ii), a partnership is not an "entity" for the purposes of para (a)(ii). It follows from the determination that a partnership is not an entity for the purpose of those provisions, that it was not the intention of the legislature that para (d) of the definition of 'entity' in s 960-100 should apply to those provisions. Accordingly, a contrary intention appears for the purposes of s 995.

55 I answer the preliminary question: "Is a partnership an 'entity' within the meaning of that term as used in s 152-15(a)(ii) of the ITAA 1997? No." [emphasis added]

Similar to the case with Division 152, the Explanatory Memorandum for the introduction of Division 7A does not contemplate 'partnerships' in the context of applying Division 7A.

It has been suggested that *White's* case cannot be used as a precedent for Division 7A due to the difference in the drafting of the provisions. That is, *White's* case specifically discussed the definition of 'entity' as contained in section 995-1 (which contains a requirement to determine whether there is a contrary intention) as compared to the definition of 'entity' in section 109ZD (which makes a direct reference to section 960-100 without reference to a contrary intention). However, I do not necessarily agree with this argument when the structure of the ITAA 1997 is properly considered.

While the term entity is defined in section 995-1 (as identified by *White's* case), it is a term that is used throughout the ITAA 1997 without an asterisk. Where such a term is used, Item 4 of subsection 2-15(3) of the ITAA 1997 operates. This provision states the following.

(3) The following basic terms used throughout the Act are not identified with an asterisk. They fall into 2 groups.

Key participants in the income tax system		
Item	**This term:**	**is defined in:**
1.	Australian resident	section 995-1
2.	Commissioner	section 995-1
3.	company	section 995-1
4.	entity	section 960-100
4A.	foreign resident	section 995-1
5.	individual	section 995-1
6.	partnership	section 995-1

Key participants in the income tax system		
Item	**This term:**	**is defined in:**
7.	person	section 995-1
8.	trustee	section 995-1
9.	you	section 4-5

Core concepts		
Item	**This term:**	**is defined in:**
1.	amount	section 995-1
2.	assessable income	Division 6
3.	assessment	section 995-1
3A.	Australia	Subdivision 960-T
4.	deduct, deduction	Division 8
5.	income tax	section 995-1
6.	income year	section 995-1
7.	taxable income	section 4-15
8.	this Act	section 995-1

It is noted that subsection 2-15(3) is still in its original form (with respect to Item 4) and no change has been made to the provision since the introduction of the ITAA 1997. Section 2-15 is no different to section 109ZD. The provision makes a direct reference to section 960-100 for the defined term and thus any reference in the ITAA 1997 to the word entity is taken to be defined in section 960-100 (rather than section 995-1).

However, this is not how it was applied in *White's* case. That is, the decision in White still had regard to the defined term in section 995-1 and the use of the words “except so far as the contrary intention appears”.

Arguably, where a provision uses a defined term as contained in the ITAA 1997, the definition is given force through section 995-1 which states:

Definitions

(1) In this Act, except so far as the contrary intention appears: "entity" has the meaning given by section 960-100.

Unless the Federal Court overlooked this aspect in *White's* case (which we believe would be a significant assumption to make), the Federal Court in *White's* case explicitly stated (at paragraph 12) that section 995-1 was the starting point with respect to the defined term 'entity', rather than section 2-15(3).

12 Section 995 contains a large number of definitions which apply "except so far as the contrary intention appears." One of them is the word "entity," which has the meaning given by s 960-100.

We note that six items contained in the table in subsection 2-15(3) contain a reference to a provision other than section 995-1. However, we note that every single item contained in that table is also defined in section 995-1. An argument that such terms do not require one to consider "a contrary intention" as required by section 995-1 (due to a direct link) would be inconsistent with the decision in *White* and inconsistent with the structure of the ITAA 1997, which is based on the premise that all defined terms are contained in section 995-1.

Although section 109ZD and 109ZE contain a direct reference to section 960-100 for the term 'entity', it is believed that the definition of that term should be read in conjunction with section 995-1, which requires one to have regard to a contrary intention for the purposes of the whole ITAA 1997 (which itself gives effect to section 960-100). In other words, the terms in section 960-100 are to be read in conjunction with section 995-1.

While this may be arguable, the ATO have not provided their view on this issue. However, the conclusion contained PBR 105219530678 in respect of 'looking through' the partnership (and not treating a loan to a partnership as being subject to Division 7A) provides a consistent result with this premise and may demonstrate that, despite section 109ZE, there is a contrary intention to a partnership being considered an entity under Division 7A. Accordingly, the ATO may be open to this view.

4.8 Categorising transactions

While corporate entities may have many interactions and dealings with a partnership and the partners of a partnership, four broad transactions are considered in this paper. These transactions broadly follow those transactions considered in the PBRs outlined in paragraph 4.3 of this paper.

The characterisation of a transaction can depend upon whether the entity concept is applied to the partnership, or whether one is required to look-through the partnership to the underlying partners.

4.8.1 Capital contributed by a partner

Despite PBR 1051393604802, it is no longer clear whether capital provided by a partner to the partnership would be regarded by the ATO as being a payment under section 109C (to the partnership), that would otherwise be excluded under section 109J (that deals with payments that discharge arm's length pecuniary obligations).

Furthermore, to the extent that the ATO continue to hold a broad view of a loan under TD 2022/11, it is also not clear whether the arm's length capital provided by a partner would be regarded as partnership capital or whether the ATO would hold the view that such amounts are to be regarded as financial accommodation (and thus a loan to the partnership) for section 109D purposes.

To the extent that the partnership is regarded as an entity and to the extent that the partnership is an associate of the shareholder of the private company, a deemed dividend could then arise if the ATO were to hold that partnership capital contributions were either subject to 109C or 109D. A deemed dividend to the partnership from the private company would simply result in the same private company (being a partner in the partnership) receiving a share of the deemed dividend under section 92. Under this view, a corporate partner (that is say a 50/50 partner) contributing an arm's length amount of partner capital (say $100,000) may be assessed on 50% of that amount as an unfranked dividend (i.e. $50,000). This outcome does not appear to be an appropriate outcome where the transaction is at arm's length.

To the extent that a partnership is not regarded as an entity, one would also need to determine whether the partner's capital contribution (provided by one corporate partner) effectively results in a benefit to another partner in the partnership (who is required to equally contribute capital). Taking into account comments in *Rojoda*, there could be a risk that any contribution by one partner benefits all other partners (as a whole). Accordingly, there can be a risk that a benefit is provided by all partners to all the other partners of the partnership.

However, to the extent that all parties are dealing at arm's length such that no partner is receiving a greater benefit than the other (proportionately with respect to their capital contribution), it would seem reasonable to treat the arrangements as not being subject to Division 7A. How this is achieved and whether this coincides with an ATO view is something the ATO should be working on through PAG and the taxpayer community. With the website guidance having been withdrawn on this issue, there is currently no guidance provided by the ATO on this transaction and therefore this is currently significant uncertainty on how the ATO may view this transaction.

4.8.2 Current account of a partner

Where an individual has an overdrawn account that is supported by capital provided by a company (either a partner's capital account or a partner's current account), this transaction is likely to be one that is capable of falling within the scope of sections 109C (payments), 109D (loans) or 109T (the interposed entity rules). The latest PBR provided by the ATO (PBR 105219530678) on the matter held that all of these three provisions could potentially apply to the undrawn partner current account. While this view provided by the ATO may achieve a result that is expected where the undrawn current account benefits a shareholder or associate of the private company, this transaction requires one to properly consider the entity concept and the associate tests.

Essentially, this is not much different to the transaction outlined in paragraph 4.8.1. The same considerations outlined in that paragraph of this paper would equally likely apply to a partner current account. The key difference is that a partner's current account may be drawn unequally as between partners and therefore there is higher chance that the transaction would result in a benefit provided by the company to either the partnership or other partners in general. That being said, a pragmatic approach has previously been taken in ATO ID 2012/74 (now withdrawn), which held that proportionate UPEs to a unit trust by each unitholder did not result in financial accommodation.

Accordingly, understanding the ATO view with respect to this transaction and the interaction of the 'entity' concept is critically important.

4.8.3 Loans provided by the partnership

If the entity concept is respected and a partnership is regarded as an entity, a loan provided by a partnership that is funded by either a corporate partner's capital or current account could give rise to the interposed entity rules in section 109T being applied to the loan.

However, section 109T(3) excludes the interposed entity provisions from applying. Therefore, if the ATO holds that partnership capital or current account from a partner is either a loan or a payment, then the partnership would have a deemed dividend under section 109C or 109D rather than the target entity (as this would ordinarily take priority). That being said, with reference to Example 4 in paragraph 4.9.4 of this paper, there will be cases where the partnership will not be regarded as an associate of the shareholder. Accordingly, there will be limitations in applying section 109C or 109D to the capital provided by a corporate partner. In such a case, if the partnership makes a loan to the shareholder or an associate of the shareholder, this provides some scope for section 109T to apply (as outlined in that Example).

However, that being said, for the reasons outlined in paragraph 4.8.1 and 4.8.2, where the partnership is recognised as an entity, this can give rise to anomalous outcomes for partners that are corporate entities.

Alternatively, if the partnership is ignored, section 109D could be applied directly to the loan made to the target entity from the corporate partner. That is, the corporate partner would be regarded as having an unascertained interest in the loan asset. Ignoring the entity, the corporate partner is likely to be held to have made (together with the other partners) a loan to the recipient for the purposes of section 109D. However, one would still be required to determine the quantum of the loan. Complexities may arise where, for example, the loan from the corporate is smaller than the loan to provided to the relevant target entity. Furthermore, the partnership may be able to evidence that the corporate loan is used to source the acquisition of partnership assets, while at the same time demonstrating that the a third party bank loan is used to provide funding to a target entity.

While these difficulties exist, we believe that the ATO should be consulting on this issue more broadly to determine acceptable principles for dealing with partnerships and Division 7A. The outcome contained in PBR 105219530678 appears to be a reasonable outcome and it would be useful if the ATO were able to more broadly provide an interpretation in a ruling or other public guidance statement.

4.8.4 Loans provided to the partnership

A company may make a loan to the partnership consisting of partners that are individuals and corporate entities. The characterisation of the loan to the partnership will depend on whether the ATO will hold the partnership to be an entity for Division 7A purposes (as in PBR 7910152492401) or whether a look-through approach is required to determine whether the 'partners' have benefited from the loan (as in PBR 1052129530678). The result is subject to the partnership or the partners (whichever is relevant) being an associate of the shareholders of the company under section 318.

Where a look-through approach is applied, there will be questions about quantifying the amount of the loan that is made to an individual partner in a partnership. Consistent with decisions such as *Re Rudd & Son Ltd* [1984] 2 WLR 831[12] and *Woods v Hopkins* [2016] WASC 16[13], joint debts of a

[12] Per Nourse J
[13] At 77 and 91 per Gething AM

partnership would (in the first instance) be paid from the joint assets of the partnership. As stated in Woods v Hopkins at para 71.

> *The interest of an individual partner cannot be appropriated to his or her use whilst the partnership subsists, and even on dissolution is subject to payment of all the debts and liabilities of the partnership.*

Having regard to decisions such as *Rojoda*, a partnership is a "relation which subsists between persons … each of whom is liable jointly with the others for all debts and liabilities incurred in carrying on the partnership business”.

Accordingly, in the first instance, to the extent that the partnership owes a liability or debt, each partner is likely to be regarded as being jointly liable for the whole of the liability or debt (which first should be paid out of the assets of the partnership).

However, this is generally subject to a partner’s right to contribution from other partners. Where a partner pays more than their share of a partnership debt, the partner is generally entitled to a contribution from those persons who were in partnership with them when the debt arose. Reference is made to the High Court decision in *Burke v LFOT Pty Ltd* [2002] HCA 17 which discusses the concept of equitable contribution.

Having regard to these concepts, while each partner is jointly liable for the whole of the amount of a loan provided to the partnership by a company, it would seem reasonable to conclude that a partner should effectively only be liable for their share of the debt. This would ensure that there is not a duplication of the Division 7A loan (as between multiple individuals).

Other than inconsistent PBRs being provided, the ATO do not appear to have a public view on whether it is appropriate to apply the entity rule or the look-through rule in this case. We would submit that the look-through approach would help to ensure that the ‘share’ of the loan that benefits a corporate partner should allow the corporate partner to apply section 109K (which may not otherwise be available where the partnership is regarded as an entity).

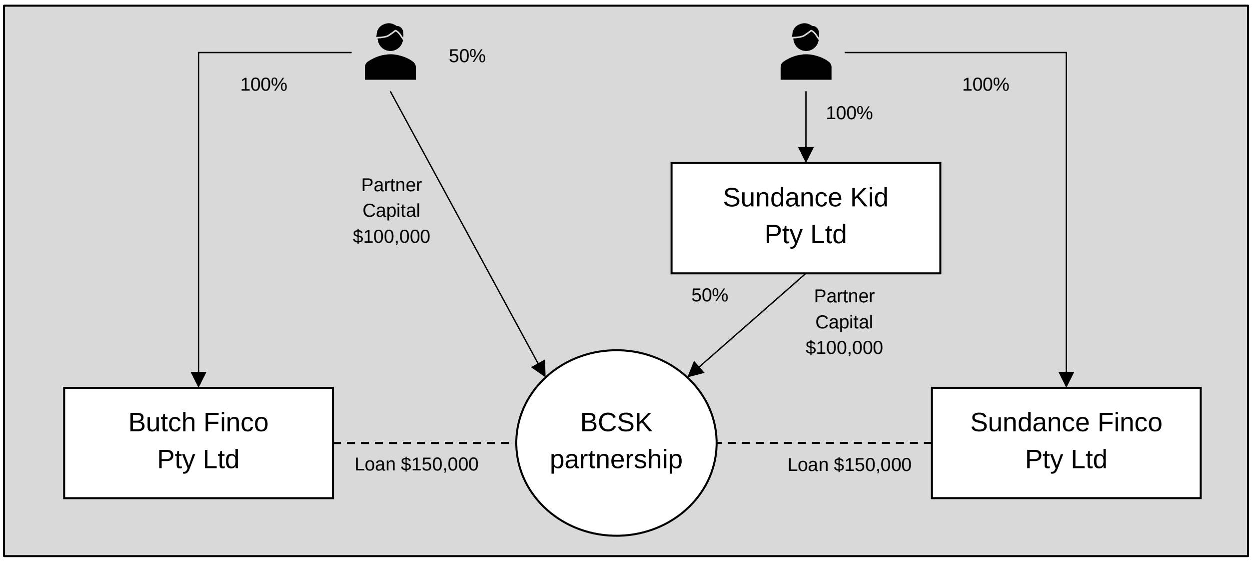
4.9 Examples exploring the entity concept further

The following examples have been put together to assist in considering the entity concept further. Discussion of this concept is contained in paragraph 4.7 of this paper. Whether the partnership is recognised or not can have significant implications for the conclusions, including whether the relevant entities are associates of the shareholder or whether exclusions may apply to the transaction (such as section 109K). The following examples are not intended to outline the preferred view, but rather to consider the differences that could occur in taking through interpretations. A more appropriate outcome could be obtained if the ‘partnership’ is ignored for Division 7A purposes and if an approach similar to that contained in PBR 1052129530678 is applied.

4.9.1 Example 1 – partnership with a natural person

This first example involves a partnership that consists of two unrelated partners, one being an individual partner and the other partner who is a corporate entity owned by an individual. The following diagram and background facts summarise this first example.

Background



*Mr Butch Cassidy and Mr Sundance Kid are two unrelated individuals. They form a 50/50 partnership (**BCSK**), which is in the business of selling train security systems. Mr Cassidy decides that he will be the partner in the partnership in his individual capacity. Mr Kid instead decides to incorporate a wholly owned company (Sundance Kid Pty Ltd) which will be the other partner in the partnership.*

The partnership is funded by: (a) partnership equity of $100,000 each; and (b) an interest free 'at call' loan of $150,000 provided by another company wholly owned by Mr Cassidy and Mr Kid respectively. Assume all companies have a substantial distributable surplus.

Assume the partnership is an entity

In Example 1, there are three companies that have provided benefits (payments and loans) to the partnership. Each company is owned by a sole shareholder. Subsection 318(1) provides the rules for determining whether an entity is an associate of an individual. The following table summarises these relationships.

Transaction	Shareholder	Is the Partnership an associate of the shareholder?
Loan from Butch Finco Pty Ltd ($150,000)	Mr Cassidy	Yes. Section 318(1)(b) includes a partnership of which Mr Cassidy is a partner.
Loan from Sundance Finco Pty Ltd ($150,000)	Mr Kid	No. Section 318(1)(e) should only treat Sundance Kid Pty Ltd and Sundance Finco Pty Ltd as associates of Mr Kid. It should not extend to the BCSK partnership in this instance.
Equity from Sundance Kid Pty Ltd ($100,000)	Mr Kid	No. Mr Kid is not a partner in the partnership. Section 318(1)(e) should only treat Sundance Kid Pty Ltd and Sundance Finco Pty Ltd as associates of Mr Kid. It

		should not extend to the BCSK partnership in this instance.

Where the partnership is regarded as an entity in this example, the loan from Butch Finco to the partnership could result in Division 7A applying to the partnership. This could result in a deemed dividend of $150,000, of which both partners would share under section 92. This would mean that the company-to-company loan (i.e. the share of the loan borne by Sundance Kid Pty Ltd) would not be excluded by applying section 109K. This outcome would not seem to provide a fair outcome for the partners in general (especially those partners that are corporate partners).

Assume the partnership is not an entity

If the partnership were ignored and a look-through approach were to be applied, each loan or payment made to the partnership would need to be examined separately (to determine whether a benefit is provided to a shareholder or associate of the relevant company). Any benefit provided to a company should be capable of being excluded under section 109K. Accordingly, prima facie, it should be unnecessary to consider transactions that have benefited Sundance Kid Pty Ltd, as these should be capable of being excluded under section 109K.

However, as Mr Cassidy is an individual, it is important to consider each of these transactions again to determine whether the transactions have provided some form of benefit (payment or loan) to Mr Cassidy (from a Division 7A perspective) as a shareholder (or associate of the shareholder) of the relevant company.

Transaction	Shareholder	Is Mr Cassidy a shareholder or an associate of the shareholder?
Loan from Butch Finco Pty Ltd ($150,000)	Mr Cassidy	Yes. This transaction could potentially be regarded as a loan indirectly to Mr Cassidy who is a shareholder of Butch Finco. Taking into account the commentary at 4.8.4, the amount of the loan borne by Mr Cassidy could be $75,000 or $150,000, depending on the view taken.
Loan from Sundance Finco Pty Ltd ($150,000)	Mr Kid	No. Section 318(1)(e) should only treat Sundance Kid Pty Ltd and Sundance Finco Pty Ltd as associates of Mr Kid. It should not extend to Mr Cassidy.
Equity from Sundance Kid Pty Ltd ($100,000)	Mr Kid	No. Section 318(1)(e) should only treat Sundance Kid Pty Ltd and Sundance Finco Pty Ltd as associates of Mr Kid. It should not extend to Mr Cassidy.

Where the partnership is not regarded as an entity in this example, the loan from Butch Finco to the partnership could result in Division 7A applying to Mr Cassidy. The key difference in this example is that the corporate partner would not appear to share in the deemed dividend that could occur under Division 7A. In the writer’s view, this outcome appears to be more appropriate and more consistent with the overall policy of the provisions.

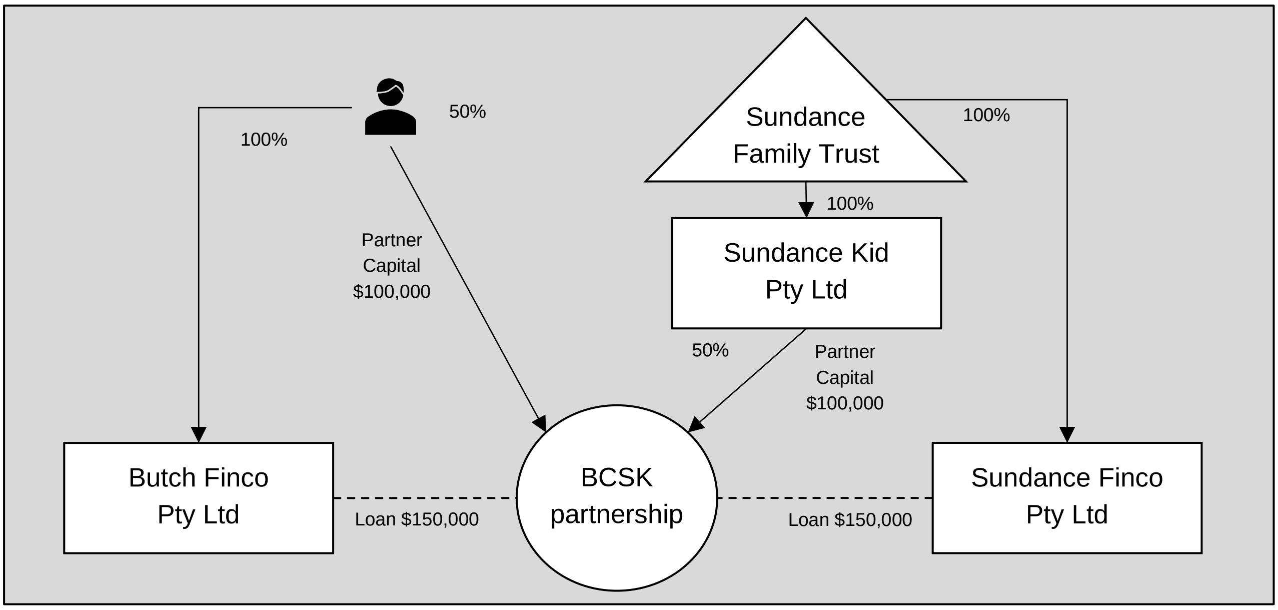
Observation

This example demonstrates that a more appropriate outcome would seem to occur if the partnership were not to be regarded as an entity for Division 7A purposes.

4.9.2 Example 2 – modification using a trust

This second example is essentially the same as Example 1, however the shares in Sundance Kid Pty Ltd and Sundance Finco Pty Ltd are instead owned by a discretionary trust controlled by Mr Kid. Assume that both Sundance Kid Pty Ltd and Sundance Finco Pty Ltd are eligible beneficiaries of the Sundance Family Trust. However, assume that the BCSK partnership is not an eligible beneficiary of the trust.

Background



Assume the partnership is an entity

Essentially this is the same as the previous example. However, the key difference here is whether the BCSK partnership can be regarded as an associate of Sundance Family Trust (being the shareholder of both Sundance Kid Pty Ltd and Sundance Finco Pty Ltd).

Section 318(3) would seem to be applicable in this case as the shareholder is a trust. The provision would prima facie include both of the Sundance companies as being associates of the trust under paragraph 318(3)(a), as they are both beneficiaries of the trust in this example. Where a company is an associate of the trust, paragraph 318(3)(c) also needs to be applied. This provision can include any associates of the company under subsection 318(2) as being associates of the trust. Section 318(2)(a) can include a partner of the company or a partnership in which the company is a partner. Applying this extension, it would seem that Mr Cassidy (being a partner in the partnership with Sundance Kid Pty Ltd) and the BCSK partnership (of which the Sundance Kid Pty Ltd is a partner) would be an associate of the Sundance Family Trust.

Based on this one change to Example 1, it would seem that the partnership would now be regarded as an associate of the shareholders of each of the three companies and therefore it is possible that all three transactions provided to the company could be within the scope of Division 7A (depending on the view of each transaction as discussed at paragraph 4.8 of this paper). Similar to Example 1, this conclusion could result in the corporate partner being allocated a deemed dividend under section 92 on its share of the payments or loans being made to the partnership.

Assume the partnership is not an entity

As outlined above, as Mr Cassidy is a partner in the BCSK partnership, it is likely that he would also be regarded as an associate of the Sundance Family Trust by virtue of section 318(3)(c). If transactions are to be examined by ignoring the partnership as an entity, it is possible that all three transactions could be seen to create a section 109C or 109D issue for Mr Cassidy. This would be dependent on the characterisation of each transaction as outlined in paragraph 4.8.

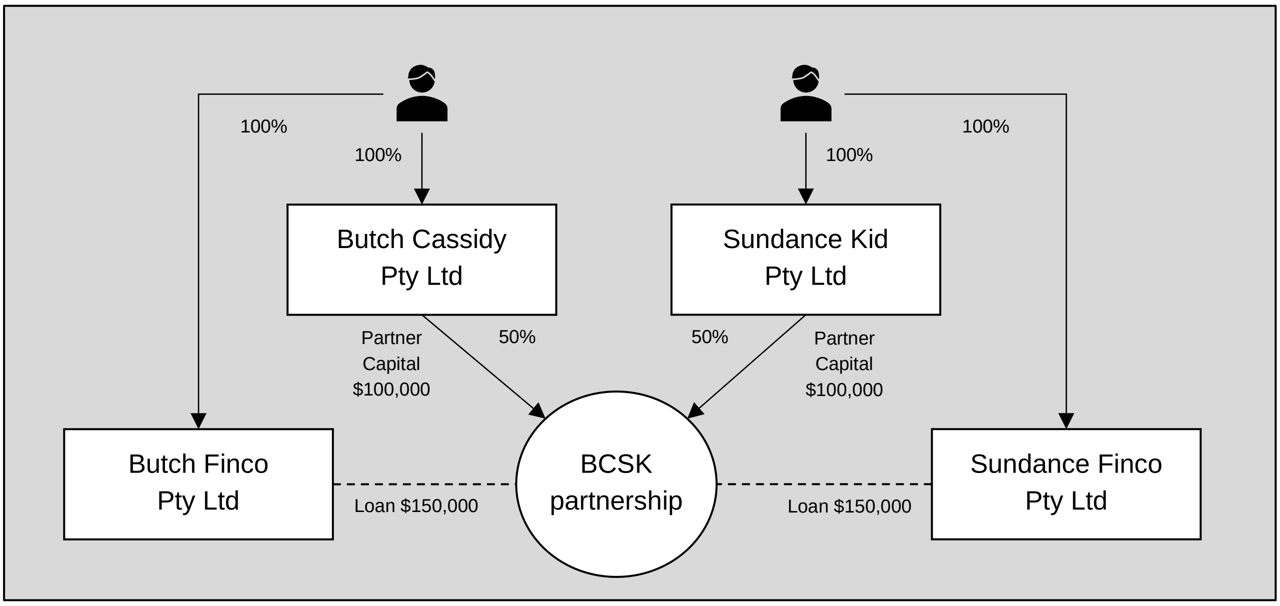
Observation

Similar to Example 1, by ignoring the partnership, Division 7A would better target the mischief in question – that is, whether any benefits have been provided to non-corporate entities. Accordingly, it is believed that this example again demonstrates that disregarding the partnership as an entity for Division 7A purposes provides a more consistent outcome from a policy perspective.

4.9.3 Example 3 – corporate partner (only)

This third example is a modification of Example 1, whereby all partners in the partnership are corporate entities which are owned by individual shareholders.

Background



Assume the partnership is an entity

In this example, the partnership should not be regarded to be an associate of the shareholders of the four companies under section 318(1). The associate rule does not appear to extend that far. Accordingly, Division 7A should not apply to any of these transactions if the partnership were an entity receiving payments or loans from these corporate entities.

With reference to the conclusions in Example 2, the outcome in this example could be very different if just one of the shareholders of the corporate partners were a trust. In this alternative scenario, the partnership could potentially be an associate of the shareholder trust under section 318(3)(c) (provided the corporate partner were a beneficiary of the shareholder trust). This small change in facts could result in a significantly different outcome for Division 7A if the partnership were regarded as an entity.

Assume the partnership is not an entity

On a look-through approach, there are only companies that have benefited from either payments or loans from other companies. Irrespective of which entities may be regarded as associates of the relevant shareholders of the companies, the section 109K exclusion (company to company exclusion) should be capable of applying to all arrangements that may otherwise be subject to Division 7A in this case).

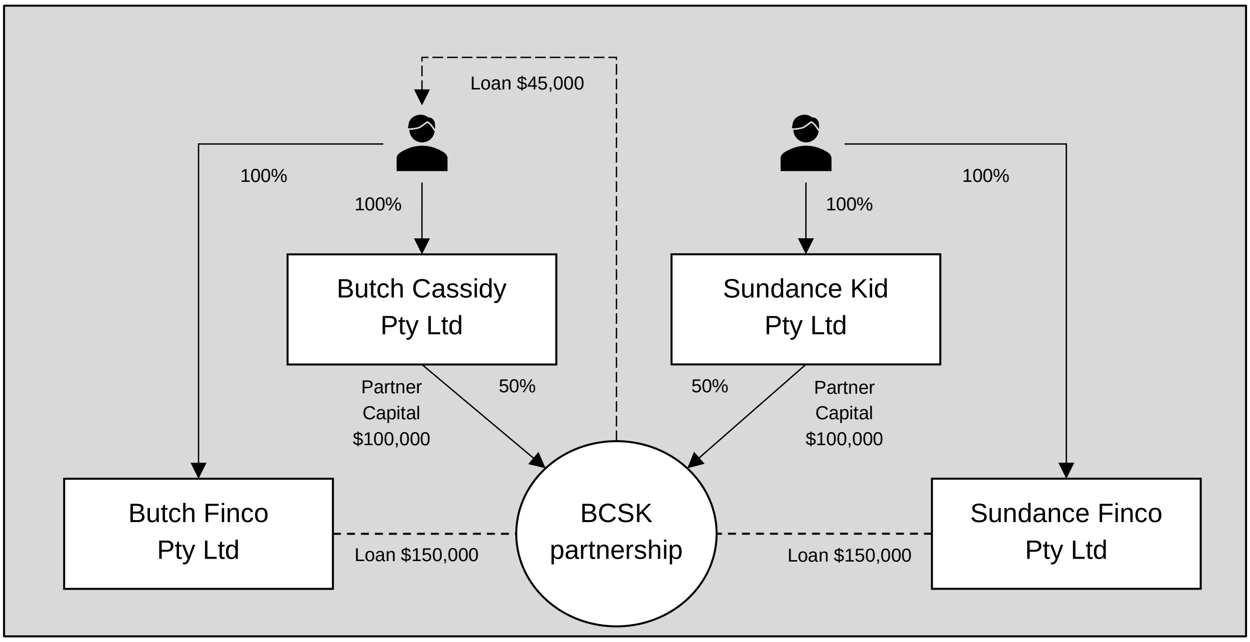
Observation

Again, this example demonstrates a more consistent and clearer policy outcome from a Division 7A perspective where the partnership is not regarded as an entity.

4.9.4 Example 4 – corporate partner (only) with a loan to a shareholder

This fourth example is the same as Example 3, however the partnership provides a loan to Mr Cassidy for $45,000.

Background



Assume the partnership is an entity

As outlined in Example 3, the BCSK partnership is unlikely to be considered an associate of Mr Cassidy or Mr Kid in this case. However, if the partnership is considered to be an entity, this example could result in section 109T applying. That is, in respect of the loan provided to Mr Cassidy.

As Mr Cassidy is unlikely to be an associate of the Mr Kid under section 318(1), it is unlikely that payments ($100,000) or loans ($150,000) provided by Sundance Kid Pty Ltd and Sundance Finco Pty Ltd respectively would result in a payment or loan within the scope of section 109C or 109D for Mr Cassidy. However, as Mr Cassidy is the shareholder of Butch Cassidy Pty Ltd and Butch Finco Pty Ltd, this condition would likely be satisfied with respect to the payments ($100,000) and loans ($150,000) provided by those two companies respectively. Accordingly, it is possible that section 109T could apply in respect of the loan provided to Mr Cassidy from the BCSK partnership.

Prima facie, it would seem possible that either of these two companies could be taken to have made a loan to Mr Cassidy under section 109T. However, the reasonable person test in section 109T and the Commissioner’s determination in section 109W would likely help resolve this issue to ensure that the loan is not otherwise double counted.

Assume the partnership is not an entity

A similar conclusion would occur in this case with respect to Mr Cassidy. Ignoring the partnership, Butch Cassidy Pty Ltd or Butch Finco Pty Ltd may be regarded as having provided a loan directly to Mr Cassidy. It is difficult, however, to ascertain the extent to which each entity would be regarded as having provided a loan to Mr Cassidy. This is because the loan to Mr Cassidy ($45,000) is less than each amount provided by the two companies.

Again, this could potentially result in a double counting of the loans and benefits provided to Mr Cassidy (i.e. from either Butch Cassidy Pty Ltd and Butch Finco Pty Ltd). That is, if both companies are held to have provided “financial accommodation” to Mr Cassidy, essentially this could mean that the arrangement is counted twice from a Division 7A perspective from the perspective of both companies, without an anti-overlap provision. This may require a tracing of the funds to the relevant corporate entity that provided the finance to Mr Cassidy and an apportionment between the two companies. Tracing will not always be a simple task. Furthermore, it is questionable whether the ATO will seek to apply the provisions in this manner in a live case.

4.10 Conclusion

The purpose of this paper was not to provide a definitive view on how partnerships should be treated from a Division 7A perspective. However, given that Division 7A has applied for over 25 years and given the large number of partnerships that would exist, it is important that these issues are considered by the ATO and that some meaningful form of guidance on the treatment of such entities is provided to the public at large. I encourage the ATO to consult with tax advisors in the near future on these important issues.

Appendix A: Drafting instructions obtained under Freedom of Information

Subdivision E – Payments and loans through interposed entities

Section 109T – Payments and loans by a private company to an entity through one or more interposed companies

Trust distributions to corporate beneficiaries

14. A variation on the interposed entity scenario involves a trust interposed between a private company and shareholder/associate.

15. The definition of *loan* in subsection 109D(3) includes 'a transaction (whatever its terms or form) which in substance effects a loan of money'. There is some doubt whether this phrase covers the situation where income of a trust estate to which a private company beneficiary had become presently entitled is not actually paid over by the trustee but instead is lent by the trustee to a shareholder of the private company beneficiary. There is persuasive opinion that such an amount is held by the trustee under a separate trust for the benefit of the corporate beneficiary. Accordingly, it is arguable that Division 7A would not apply to the amount held in the subtrust if it is lent by the trustee to a shareholder of the corporate beneficiary. This is because the amount held in the subtrust has not actually been lent by the private company to the trust.

16. To remove this uncertainty, a new provision is needed so that if:

- a private company is or has been made presently entitled to an amount from a trust's net income; and
- this amount has not been paid over by the trustee; and
- the trustee has subsequently made a loan to a shareholder/associate of the private company;

then the amount lent by the trustee, up to the value of the amount held separately on trust for the private company beneficiary, is to be treated as a loan paid by the private company to the shareholder/associate.

Appendix B: Original submission on the history of section 109UB / XA (24/09/2009)

History of section 109UB / XA
Review of documents supporting policy and understanding on the application of the provisions

1. Purpose of document

1.1. On 17 July 2009, the ATO held a meeting with members of the National Tax Liaison Group Division 7A working party [the NTLG subgroup] to outline its view on the potential application of section 109D to unpaid present entitlements [the ATO view]. At that meeting, the ATO requested feedback as to “how a situation had evolved” where members did not appreciate this ATO view.

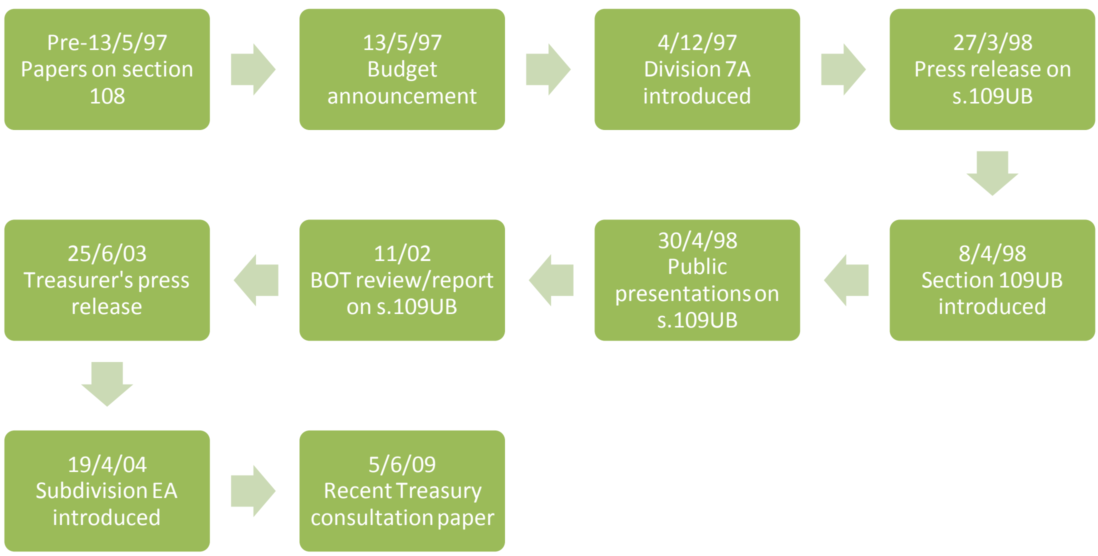
1.2. This memorandum has been prepared for the sole purpose of considering this “evolution” question posed by the ATO. From our analysis, the documents reviewed in this memorandum present a clear policy objective contained in Division 7A – that section 109D was not intended to cover unpaid beneficiary entitlements and that section 109UB was inserted as a measure to deal with the arrangement.

1.3. We note that this memorandum does not focus on any comments made publicly by the ATO on the current issue. Two documents prepared by Mr Theo Sakell of Pitcher Partners [reference numbers 135781_1 and 136335_1], which have been circulated to the NTLG subgroup, provide an excellent summary of those documents. I also refer to the letters circulated by Mr Mark Leibler [dated 01/9/09 and 21/09/09], which provides a critical review of the operation of Division 7A to unpaid present entitlements.

1.4. While this memorandum is not intended to revisit any of the findings contained in those documents, it is important to note that the findings and conclusions contained in this memorandum is both consistent with and supports those contained in the letters provided by both Mr Sakell and Mr Leibler.

2. Relevant time line

2.1. This memorandum considers documents that were publicly released at the times contained in the following time line.



3. Pre 13 May 1997: Before Division 7A

3.1. Prior to the introduction of Division 7A, section 108 was the main provision contained in the 1936 Act that dealt with loans to shareholders. A common issue, that was highlighted in a number of publicly available articles at the time, was whether section 108 could apply where there was an unpaid present entitlement from a trust to a corporate beneficiary.

3.2. We note, that this issue was raised publicly on numerous occasions by various commentators. For example, prior to the Government's announcement on Division 7A, the issue was discussed in the 1996 paper presented by Walker J Tieleman at the TIA State Convention WA Division. In this paper, the following statement was made[1]:

> A common predicament for taxpayers using corporate beneficiaries is the potential for the application of s.108 in the case where they do not draw trust distributions made in their favour. Can it be said in these instances that the undrawn distribution represents the payment of an amount to an associated person by way of advance or loan?

3.3. A number of additional articles at the time considered the potential application of section 108 to unpaid present entitlements[2], which are still available on the Tax Institute of Australia's database.

3.4. Having regard to the number of articles written on this issue at the time, it is reasonable to assume that these arrangements would have been considered at the time of drafting section 109UB.

4. 13 May 1997: 1997-1998 Budget announcement

4.1. On 13 May 1997, the Government made its budget announcement, whereby private company loans would be deemed to be unfranked dividends.[3] The budget measure was titled "Taxation of distributions disguised as loans from private companies".

4.2. It is noted that the budget paper did not specifically make reference to unpaid present entitlements and did not provide sufficient detail on the proposed definition of a loan. Accordingly, at this time, it was uncertain whether the proposed measures would apply to unpaid present entitlements.

5. 4 December 1997: Legislation introduced

5.1. *Taxation Laws Amendment (No.7) Bill 1997* was introduced into Parliament on 4 December 1997. The Bill as introduced did not contain section 109UB.

5.2. The definition of a "loan" as contained in section 109D(3) of the original Bill has not changed since its introduction in TLAB 7[4]. Despite public commentary provided on the

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[1] Tieleman, WJ., & Tieleman, M., "Section 108 – Deemed Dividends", TIA State Convention, Western Australian Division, 17 May 1996, page 7.

[2] Refer for example to Robertson, M., "Section 108 – existing and proposed legislation", 1997, which considers the application of section 108 to unpaid entitlements prior to the release of Division 7A. The TIA website contains numerous examples of such articles.

[3] 1997-98 Budget Paper No.2, page 173.

[4] Taxation Laws Amendment Bill (No. 7) 1997.

issue of unpaid entitlements, the legislation, as introduced, failed to address the treatment of unpaid entitlements under Division 7A.

6. 27 March 1998: Assistant-Treasurer Kemp's press release

6.1. On 27 March 1998, Assistant Treasurer Kemp announced additional amendments to Division 7A[5]. Specifically he stated that:

> It <u>has been argued</u> that the proposed legislation <u>does not apply</u> to arrangements where a corporate beneficiary has become presently entitled to net income of a trust and the amount is not paid by the trustee to the corporate beneficiary, but continues to be held by the trustee who then provides a loan to a shareholder (or their associate) of the corporate beneficiary [<u>emphasis added</u>].

6.2. There are a number of important statements made in the press release. The first is that press release begins with "it has been argued". The argument that Division 7A would not apply to the "arrangement" as described was highlighted in a number of articles written by the profession at the time. One noticeable article, by John Middleton in relation to the TIA Queensland State Convention, stated the following[6]:

> As originally drafted, the tax profession took some delight in pointing out that Div 7A would not apply to a "loan" to a discretionary trust by a corporate beneficiary (care is needed in the use of the term "family" trust due to the growing meaning that term is taking from the trust loss and dividend streaming provisions).

6.3. Accordingly, the first aspect of the press release acknowledges that section 109D would not apply to unpaid present entitlements. The press release then went on to appropriately describe the arrangement that would be covered by [the new] section 109UB. Importantly, the arrangement, as described, only appeared offensive if the "amount" was subsequently provided as a loan to a shareholder or associate of the corporate beneficiary. Implicit in this press release is the case that the arrangement would not have been offensive if the cash was retained on trust and used in (say) working capital of the trust.

6.4. A number of articles that were released at that time (and subsequently) also support this statement contained in the press release, being that the legislation would not apply to "unpaid present entitlements" where the underlying cash was retained in the trust. We note that the article by John Middleton also provided some commentary on the "sub-trust" approach as follows:

> **<u>The Sub-Trust approach</u>**
> There is no loan from a corporate beneficiary back to a discretionary trust where the discretionary trust distributes money to the corporate beneficiary. Where the distribution is not actually paid to the company, those monies are in fact held on a separate sub-trust for the benefit of the company, and are not treated as a loan at all. Of course, it is quite possible to turn it into a loan, and payment of interest on monies outstanding may well be sufficient to do this. However, for the most part, it will acquire something more than mere journal entries to create a loan in this circumstance.

6.5. In relation to the John Middleton article, we highlight that the article was written in response to the Open Forum of the Taxation Institute of Australia's 1999 Queensland

[5] Hon Rod Kemp, "Taxation of distributions disguised as loans from private companies, Press Release No.011, 27 March 1998

[6] Middleton, J., "Division 7A – is the corporate beneficiary dead?", ATP, Weekly Tax Bulletin, Issue 22, 24 May 1999.

State Convention. Interestingly, the ATO were present at the open forum and according to John Middleton provided feedback in relation to certain questions raised. In his article, John states:

> an ATO representative confirmed the ATO view that s 109UB (contained in Div 7A) is even harsher than originally thought, which has implications for all trusts with a corporate beneficiary.

6.6. The comment is made in relation to the ATO view provided on an example presented to the ATO. The example is repeated below:

> Since October 1996, a private company has been entitled to a distribution from a discretionary trust, but this distribution has never been paid. No further unpaid distributions have been made to the company since October 1996. On 1 June 1999, the discretionary trust makes a loan to a shareholder of the private company for $500,000. This loan is fully repaid to the trust within 2 weeks (and certainly by 30 June).
> In this situation, as far as the ATO is concerned, the shareholder has received a $500,000 unfrankable dividend. In the ATO's view, it does not make any difference if the present entitlement to the corporate beneficiary is fully paid by 30 June (ie the repayment of the monies to the trust is then paid by the trust to the company in satisfaction of the present entitlement).

6.7. We believe that it is important to note that the example presented to the ATO above highlighted a retention of trust funds for a period of three years. In the ATO response to the question, the only provision considered was the application of section 109UB. That is, section 109D was not raised as a concern in response to the example provided.

7. 8 April 1998: Introduction of revised Bill

7.1. On 8 April 1998, a revised Bill was introduced into the House of Representatives. The revised Bill contained section 109UB. The explanatory memorandum contained very little by way of background to the new provisions. However, the following comments were made:

> **Certain trust amounts treated as loans**
>
> 9.82 New section 109UB will apply if a private company, as a beneficiary of a trust estate, is or has been presently entitled to some or all of the net trust income which has not actually been paid. In such a situation the amount to which the company is presently entitled is held on a secondary trust for the benefit of the company. The provision applies to any subsequent loan by the trustee to a shareholder (or associate) of the company.
>
> 9.83 The loan from the trustee is treated as a loan by the private company to the shareholder (or associate) of an amount not exceeding the amount of income held on trust for the company, reduced by any amounts previously treated as a loan by new section 109UB in relation to the trust amount. [New subsection 109UB(2)]

7.2. It is noted that the discussion of the "subtrust" issue in the EM accords with many of the articles written at the time, whereby it was accepted that the subtrust relationship did not result in a loan under section 109D [see for example comments by John Middleton at paragraph 6.4 of this memorandum].

8. 30 May 1998: TIA New South Wales State Convention

8.1. The proposed application of Division 7A was discussed at the TIA's New South Wales State Convention on 30 May 1998, after the introduction of the new Bill containing the section 109UB amendments. At this convention, Patrick Mayes' made a number of observations on unpaid entitlements[7]:

> … the obvious weakness in the original legislation regarding advances by trusts to beneficiaries (quasi shareholders and their associates) out of funds which essentially relate to private company beneficiary entitlements have been brought within the ambit of the Division …
>
> Section 109UB at last recognises a previous total failure by the ATO to recognise the realities of the real world as it relates to the crediting of trust distributions to corporate beneficiaries where those corporate beneficiaries do not actually receive the trust distribution for which they are beneficially entitled but leave those funds in the Trust which then in turn advances the money to persons who may be shareholders or associates of shareholders of that corporate beneficiary. …
>
> It is interesting that this provision [section 109UB] may, in itself, acknowledge that the previous arrangement was ineffective insofar as its application under section 108 was concerned.

8.2. The TIA convention was one of the first conducted after the introduction of section 109UB. The presentation and paper provided a contemporaneous review of what was considered (at the time) to be the ATO view on the application of section 108 and Division 7A to unpaid present entitlements. The presentation covered the arrangement whereby funds would be retained in a discretionary trust where a corporate beneficiary was used. The paper covered commentary on the application of Division 7A, absent section 109UB.

9. November 2002: Board of tax review of section 109UB

9.1. During the next few years, many practitioners highlighted the inappropriate application of Division 7A in a number of circumstances. That is, many papers outlined the harsh consequences that would occur on applying section 109UB, as opposed to section 109D, to an interposed trust arrangement.

9.2. Subsequently, in November 2002, the Board released its report on the *Taxation of Discretionary trusts*[8]. Chapter 4 of this report discussed the application of section 109UB and, in particular, asked the following question[9].

> Should the existing rules preventing the use of corporate beneficiaries to allow individuals access to the lower company tax rate be made more effective?

9.3. In examining this issue, the Board report discussed the general application of Division 7A to unpaid entitlements. Importantly, paragraph 71 to 73 contained a description of arrangement that was the subject of section 109UB and Division 7A.

> 71 … The deemed dividend rules operate by deeming certain advances, loans and other benefits provided by private companies to shareholders (or associates) to be assessable dividends, to the extent that the company has a distributable surplus.

[7] Mayes, P., "The New Deemed Dividend Rules", TIA State Seminar NSW Division, 1998, page 2.
[8] Board of Taxation Report, "Taxation of Discretionary trusts", November 2002.
[9] Board of Taxation Report, paragraph 69.

> 72 The ambit of the deemed dividend rules is extended to trusts by section 109UB of the ITAA 1936, which applies to a private company that is a beneficiary of a trust estate. A trustee can make a company presently entitled to trust income without distributing cash to the company. This allows a trust to effectively accumulate income that has been taxed only at the company tax rate. Section 109UB deals with the case in which a trustee:
>
> - makes a company presently entitled to trust income (so as to access the company tax rate), and
> - then distributes the underlying cash to individual beneficiaries through loans (so that the beneficiaries avoid paying any 'top-up' tax that would be imposed on a distribution if the beneficiaries have a higher marginal tax rate).
>
> 73 Section 109UB deems the loan to have been made by the company, thus attracting the operation of the deemed dividend rules. [emphasis added]

9.4. The observation of the Board clearly highlights the practice and ability to "accumulate income" in the trust, without triggering the operation of Division 7A. That is, the report indicates that the provisions [i.e. Division 7A] were only extended to trusts where a subsequent loan was made to the shareholders or associates. This is made clear in paragraphs 74 and 75, where the Board report outlines the ineffectiveness of section 109UB.

> 74 Section 109UB, however, does not cover a case in which:
>
> - the trustee makes a private company presently entitled to trust income, but does not pay the income to the company; and
> - the trustee then distributes the underlying cash to trust beneficiaries, but not as a loan.
>
> 75 In such circumstances, the individuals are able to access, without further tax liability, trust income that has been taxed only at the company tax rate.

9.5. The reference to the use of the "underlying cash" and the description of the transaction by the Board is clear enough to establish that the Board review had considered the operation of Division 7A in the cases and examples that have been recently outlined by the ATO. The conclusion that only the "corporate tax rate" would apply is a clear indication that the Board concluded that Division 7A did not apply to the transaction. The discussion paper therefore strongly supports the view that both the [then] Government (who commissioned the Board to perform this review) and the Board did not consider that such an arrangement would be covered by a provision outside of section 109UB.

9.6. We highlight that the Board included representatives from both the ATO and Treasury, as well as external members. Accordingly, had there been some uncertainty in relation to the application of section 109D to the arrangements covered in Chapter 4 (and in particular paragraph 74), we are certain that the Board would have highlighted the possible application of section 109D. The integrity concern presented in the Board paper did not consider the possible application of section 109D to unpaid entitlements as a (specific) resolution to the issue.

9.7. However, in response to the integrity concern highlighted, the Board considered that changes were needed to section 109UB to "improve the effectiveness" of the deemed dividend rules so as to more effectively prevent beneficiaries accessing trust income that had borne tax only at the company tax rate.

9.8. To achieve this outcome, the Board put forward two recommendations. This first option was contained at paragraph 81. The option suggested an amendment to section 109UB to improve the effectiveness of the provision. We note that this first option resulted in the replacement provisions contained in Subdivision EA.

9.9. Importantly, the second option outlined a proposal to repeal section 109UB, to be replaced with a provision that would limit the use of unpaid entitlements (irrespective of the use of the underlying cash). The option was contained in paragraph 82, and is repeated below.

> Alternatively, section 109UB could be repealed, and replaced with a section setting out the consequences where a trustee makes a company presently entitled to the income of a trust, but does not pay the funds to the company within a reasonable period. The consequences could be either that the trustee would be assessed on the amount of the income as if there had been no distribution, or that the company would have to pay a top-up tax (which could create franking credits in the company).

9.10. From this, it is clear that the Board report considered the policy underlying the operation of section 109UB and section 109D. The alternative approach put forward by the Board makes it clear that an unpaid present entitlement (even when not paid in a reasonable period) did not trigger the operation of section 109D. This conclusion stands in stark contrast with the ATO's view about the operation of these provisions.

10. 25 June 2003: Treasurer's media release

10.1. On 25 June 2003, the then Treasurer, Peter Costello, announced details of the Government's amendments to section 109UB[10]. He stated that:

> On 12 December 2002, I announced, in response to the recommendation of the Board of Taxation, in its report on the Taxation of Discretionary Trusts, that the Government would improve the <u>effectiveness</u> and fairness of the deemed dividend rules contained in Division 7A of the *Income Tax Assessment Act 1936* [<u>emphasis added</u>]

10.2. It is clear from this press release, and the subsequent amendments to section 109UB (now contained in Subdivision EA), that the Government decided to proceed with the first recommendation of the Board – i.e. to amend section 109UB to improve the effectiveness and fairness of the section.

10.3. That is, the Government made a clear policy choice to allow trusts to retain the underlying cash in the trust by not proceeding with option two. Option two would have taxed the retention of funds to the trustee, while option one would only trigger a taxing point if the funds were later paid, loaned or distributed [by way of forgiveness] to the beneficiaries of the trust.

10.4. We believe that this choice made by Government further demonstrates a clear intention of the policy of Division 7A and Subdivision EA. We also believe that this policy choice by Government makes it relatively difficult for the ATO to argue that section 109D was intended and drafted to apply to unpaid present entitlements to corporate beneficiaries.

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[10] Hon Peter Costello, "Taxation of discretionary trusts – replacement of section 109UB", Media Release No. 055, June 2003.

11. 19 February 2004: TLAB (2004 Measures No. 1) Bill 2004

11.1. On 19 February 2004, *Tax Laws Amendment (2004 Measures No. 1) Bill 2004* was introduced into the House of Representatives. The Bill contained the amendments to section 109UB, being the introduction of Subdivision EA to the 1936 Act. The EM to the Bill provided an explanation of the purpose of the amendments. Importantly, the EM was consistent with the policy of the provisions as provided by the Board report in 2002.

> 8.2 The rules are designed to ensure that a trustee cannot shelter trust income at the prevailing company tax rate by creating a present entitlement to a private company <u>without paying it and then distributing the underlying cash</u> to a shareholder of the company. The rules replace the former section 109UB of the ITAA 1936 that had a similar, but more limited, application. [<u>emphasis added</u>]

11.2. The EM is consistent with the integrity issue identified in the Board report. It specifically refers to the arrangement (being the retention of the underlying cash and subsequent distribution of the underlying cash) that was the subject to the new provisions. Accordingly, the background and policy discussion contained in the EM clearly indicates that Subdivision EA was specifically introduced to deal with the treatment of an unpaid present entitlement under Division 7A in limited circumstances, and that an unpaid present entitlement of itself was not considered by the Treasury or Government to be an arrangement otherwise within the ambit of Division 7A outside of Subdivision EA.

12. 5 June 2009 – Treasury consultation paper

12.1. In the recently released Treasury consultation paper[11], Treasury includes a number of comments on the current operation of Division 7A, as it applies to unpaid present entitlements. Under section 3, Treasury states:

> The rules in this part of Division 7A are designed to ensure that a trustee <u>cannot shelter trust income at the prevailing company tax rate</u>. This could occur by the trust creating a present entitlement in favour of a private company as a beneficiary, not paying the amount to the company, and <u>then distributing the underlying cash</u> to a shareholder of the company.
>
> To prevent this, Subdivision EA deems certain payments, loans, or forgiven debts by a trustee of a trust estate to a shareholder (or their associate) of a private company to be included in their assessable income as if it were a dividend, in situations where the private company is presently entitled to an amount from the net income of the trust estate and that amount has not been fully paid. [<u>emphasis added</u>]

12.2. We believe that the consultation paper clearly highlights the Treasury view in relation to the current operation of Subdivision EA and its intended application to unpaid entitlements. If Treasury were of the view that section 109D was intended to apply to the above situation, we believe that Treasury would have included this comment in the Treasury paper.

12.3. To support this view, the Treasury paper provides two examples where (accordingly to the paper) Division 7A does not effectively capture certain arrangements. The examples contained in the Treasury paper are Examples 3.2 and 3.3. An analysis of the examples

[11] Treasury consultation paper, "Improving fairness and integrity in the tax system – tightening the non-commercial loan rules in division 7a of the income tax assessment act 1936", 5 June 2009.

is provided below, which we believe clearly demonstrates that Treasury is not of the view that an unpaid present entitlement is a loan for the purpose of section 109D.

12.4. Example 3.2 describes a situation where a second trust is interposed between the trust making the payment and the private company with the unpaid present entitlement. In this situation, the first trustee distributes an amount to the second trust, without paying the underlying cash to the second trust (i.e. creating an unpaid present entitlement). The second trust then distributes the amount to a private company, without paying the underlying cash to the private company (i.e. creating an unpaid present entitlement). In the paper, Treasury highlight a concern that Division 7A would not operate if the first trust then made a payment, loan or debt forgiveness to a shareholder or associate of the private company. Accordingly, amendments are suggested to cater for this arrangement.

12.5. However, we highlight that if Treasury were of the view that an unpaid present entitlement were a loan within section 109D, there would be no need for the proposed amendment. That is, the unpaid distribution from the second trust to the private company would be considered a loan from the company in question under section 109D. Furthermore, the loans between the various entities would also trigger the application of section 109T (the interposed entity provision).

12.6. A similar conclusion occurs in relation to Example 3.3, whereby the proposed amendment would not be required to Division 7A if the unpaid entitlements in the example were instead treated as a loan.

13. Disclaimer

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