The Tax Institute

The Tax Summit

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Session 14.1: Deep dive on ATO application of 109T

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1. Overview

With Division 7A of the *Income Tax Assessment Act* 1997 (Cth) (**ITAA36**) having been in play for close to 30 years, its provisions and their application continue to catch advisers and their taxpayer clients out. This paper assumes a more than basic understanding of the Division and is intended to canvass two factual scenarios that explore the operation of the interposed entity provisions in two different taxpayer circumstances.[1]

It is worth pointing out that neither scenario should be considered a planning opportunity. While the author's view is that there are robust arguments to put forward as why the starting point for the interposed entity provisions to operate is different to the one advanced by the Commissioner, the nature of disputes with the Commissioner is that it is unlikely most taxpayers would welcome the review or audit. There are also positions that could be advanced in respect of Part IVA and dividend stripping that could be applied though depending on circumstances, it would be difficult to maintain those positions. Again, most taxpayers will lack the willingness and resources to test these positions.

This paper will provide an overview of the interposed entity provisions, set out the taxpayer scenarios and apply the provisions to those scenarios and cover off on advantages and disadvantages of those positions

[1] If you're minded to partake in some pre-reading as a refresher of Division 7A basics and concepts – see 'Division 7A and The Raven' presented at the 2022 Tax Summit, authored by Kaitlin Lowdon and Mark Macrae.

2. Division 7A

2.1 Background

Division 7A was introduced as an anti-avoidance regime to eliminate arrangements that allowed access to corporate profits other than by way of dividend. It broadly captures loans, payments and debt forgiveness that are used to allow access by shareholders and their associates (collectively **Shareholders**) of company profits. While the primary provisions contemplate Shareholder access directly from the target company, the interposed entity provisions extend their operation to arrangements where a step or entity is interposed between the target company and Shareholders as a mechanism to break that nexus.

Unlike the primary provisions, the interposed entity provisions require a determination by the Commissioner in respect of the application of the interposed entity provisions. In other words, the interposed entity provisions are not self-executing.

Where the interposed entity provisions apply, the Shareholder is treated as having accessed corporate profits from the target entity and the intervening steps and/or entity are disregarded. The basis for the Commissioner making such a determination is a consequence of him concluding that a reasonable person would have concluded that the target company intended to make the payment or loan solely or mainly as part of the arrangement that allowed the Shareholders access.

Many arrangements that purport to sever the nexus rely on the 'first step' being the step that moves corporate profit from the target company to a 'Division 7A-free' environment as being one that is disregarded in its entirety or being 'protected' from Division 7A so that the amount considered under the interposed entity provisions is nil.

A common example that could be cited and was prolific prior to the 2009 suite of amendments to Division 7A was the use of corporate limited partnerships (**CLP**) and dividend access shares issued by the target company to the CLP. Prior to 2009, closely held CLPs were deemed companies but not private companies for the purposes of Division 7A. This provided the 'Division 7A-free environment. The dividend access share allowed the corporate profits of the target company to be moved to the CLP under the auspices of the position that an actual dividend was not a 'payment' on which the interposed entity provisions could operate therefore the starting position was the CLP for any analysis. More on that later.

To counter that position, the Commissioner developed a view to counter the thinking that an actual dividend could not constitute a payment from which the provisions could operate by raising the potential application of the dividend stripping provisions. This is set out in Taxpayer Alert TA2023/1 and sets out a circumstance where an individual shareholder interposes a newly incorporated company between itself and the target company relying on a Subdivision 122-A rollover[2]. The nature of the rollover allows the interposed company to issue share capital to the individual shareholder equal to the market value of the shareholding in the target company. This allows the interposed company to eliminate its distributable surplus so that when the target company declares a dividend, non-complying loans can purportedly be made to Shareholders. If a dividend can constitute a payment for the purposes of the interposed entity provisions, then Shareholders can be treated as taking a loan (or payment depending on circumstances) from the target company. If not, then the starting position is the interposed company being a 'Division 7A-free' environment; hence the alternative argument of it being a purported dividend strip. Again, more on that later.

Therefore, many of these arrangements rely on similar concepts.

[2] Contained in the *Income Tax Assessment Act 1997* (Cth).

2.2 The provisions

Section 109T(1)[3] operates to treat a target company as having made a payment or loan to a target entity as described in s109V or s109W if the target company makes a payment or loan to an interposed entity and a reasonable person would conclude the target company made the payment or loan solely or mainly as part of an arrangement.

Subsection (2) provides that (1) will operate regardless of:

- timing or
- amounts,

but the section does not operate if the payment or loan to the first interposed entity is treated as a dividend.

The qualification in subsection (2) regarding the treatment as a dividend is expanded on by subsection (3) which provides the Division does not operate as described in subsection (1) if the target company is taken under Subdivision B to pay a dividend (so when a payment, loan or debt forgiveness is deemed a dividend) as a result of the payment or loan to the first interposed entity.

For completeness:

- Section 109V allows the Commissioner to determine the amount treated as paid by the target company to the target. In determining the amount, the Commissioner must take account of the amount the interposed entity paid the target and how much of that (if any) the Commissioner *believes* represented consideration payable to the target by the target company or any of the interposed entities (assuming that the consideration payable equals that for similar transactions at arm's length);
- Section 109W similarly deals with loans though is reduced by way of treating it as repaid where an amount is treated as a dividend under s109D.

From the Commissioner's perspective, what can be taken into account by him is extended by the matters outlined in Taxation Determination TD2011/16 and set out below for ease of reference in paragraphs 2 and 3 respectively:

(a) the amount that an interposed entity referred to in subsection 109T(1) (an 'interposed entity') loaned or paid the target entity referred to in that subsection (target entity) under the arrangement described in that subsection (the arrangement);
(b) how much (if any) of the amount loaned or paid to the target entity by an interposed entity under the arrangement the Commissioner believes represented arm's length consideration payable to the target entity by the private company or an interposed entity for anything (other than its right to receive repayment of the loan and any relevant interest);
(c) the extent to which any actual loans made as part of the arrangement have been repaid by that time;
(d) the extent to which any actual payments made as part of the arrangement were converted into loans pursuant to subsection 109D(4A) that have been repaid by that time;
(e) the extent to which any loan made from the private company to an interposed entity as part of the arrangement meets the criteria set out in section 109N (that is, 'a section 109N compliant loan') at that time;
(f) the extent to which any payment made from the private company to an interposed entity as part of the arrangement was converted, pursuant to subsection 109D(4A) into a section 109N compliant loan by that time;
(g) the extent to which any actual loans made as part of the arrangement would be covered by section 109M (loans in the ordinary course of the private company's business made on its usual terms applicable to arm's length parties); and
(h) the extent to which the above factors reflect genuine transactions that are not designed to avoid the application of Subdivision E otherwise than as envisaged within the scheme of Division 7A (such as making a section 109N compliant loan to an entity that has an intention and capacity to repay a loan [in respect of which to the extent expected at the time when the Commissioner is determining the amount of deemed payment or notional loan, appropriate minimum yearly repayments have been made] or genuinely and in substance repaying loans in a manner that would not attract section 109R if it applied).

[3] All references are to ITAA36 unless otherwise indicated

3. For the purpose of paragraph 2(h) of this Determination, in determining whether the factors reflect genuine transactions the Commissioner will take into account related facts and circumstances within the Commissioner's knowledge at the time the Commissioner determines the amount of the deemed payment and notional loan. Examples of arrangements designed to avoid the application of Subdivision E otherwise than as envisaged within the scheme of Division 7A include loans to interposed entities entered into on section 109N compliant terms in respect which:

- appropriate minimum yearly repayments are not made;
- the loan is then forgiven; or
- the interposed entity has no obvious intention or capacity to repay the loan (such as may be the case where it has no distributable surplus).

Further, Taxation Determination TD 2018/13 outlines the Commissioner's position that the first payment/loan can only be ignored where it *is treated as a dividend* and from his perspective this only arises where it is a deemed dividend[4].

Presumably reliance is made on the use of *treated*. If the intention was actual dividends not being included, the Commissioner would argue that the legislation would say as much. The opposite is equally true though in that carving out actual dividends is not necessary given the framework of Division 7A is to deem things that are not dividends to be dividends where they leave the corporate environment and find their way to a non-corporate associate. In addition, the qualification to s109T(2) would be superfluous if the Commissioner's position is correct. Subsection (3) is clear that the Division does not operate where the first transaction is a loan or payment that has been deemed to be a dividend. The purpose of the qualification in subsection (2) is to highlight that an actual dividend cannot also act as the first transaction.

While the ATO counters this premise with a simple example at paragraph 75 of TD2018/13, if the ATO's position is correct, it renders the language of the legislation ineffective.

The second query to be addressed is whether s109J can operate to negate a payment otherwise being taken to be the first transaction against which s109T then operates. Section 109J sits within Subdivision D that sets out the types of payments and loans that are not treated as dividends.

Section 109D provides a simplified outline of the Subdivision by listing the types of payments and loans that are not treated as dividends.

Relevantly s109J provides that a target company is not taken under s109C to pay a dividend because of the payment of an amount to the extent the payment:

- discharges an obligation of the target company to pay money to the entity; and
- is not more than would have been required to discharge the obligation had the target company and entity been dealing with each other at arm's length.

The ATO view of whether Subdivision D impacts on the application of Subdivision E will depend upon the facts and circumstances of the case (TD 2012/12). The first example contained in TD 2012/12 provides that a profitable company, lending to a loss company that subsequently lends to a shareholder will fall afoul of s109T where there is no commercially justifiable reason to explain why the intercompany loan was made. It states further that s109K (company to company loans) will not prevent s109T from operating. This outcome follows given s109X(1) carves out s109K (and s109L) from the analysis.

Section 109J is not mentioned.

This would lend support to the circumstance that where the first transaction of s109T is a payment that is 'protected' by s109J, that payment could not form the first transaction of s109T to operate.

[4] Paras 71 to 76

From this analysis, it would seem to follow that the:

- dividends paid by the target company could not operate as the first transaction for s109T;
- assignments of receivables or payments by a target company for say the discharge of subscription monies required to be paid for an issue of ordinary shares (assuming the target company held all the issued capital) could not operate as the first transaction for s109T; and
- the starting entity for s109T analysis would not be the target company.

3. Taxpayer scenarios

3.1 Succession scenario

The first factual matrix concerns a private group. Historically, a primary source of funds was a private company (**Original Co**) that was controlled by the parents and the shareholders were five, non-fixed trusts that were controlled by the parents but earmarked for their five children. Retained profits at the time were $50m and were largely represented by receivables owed by related parties where those funds were utilised for income producing and investment activities.

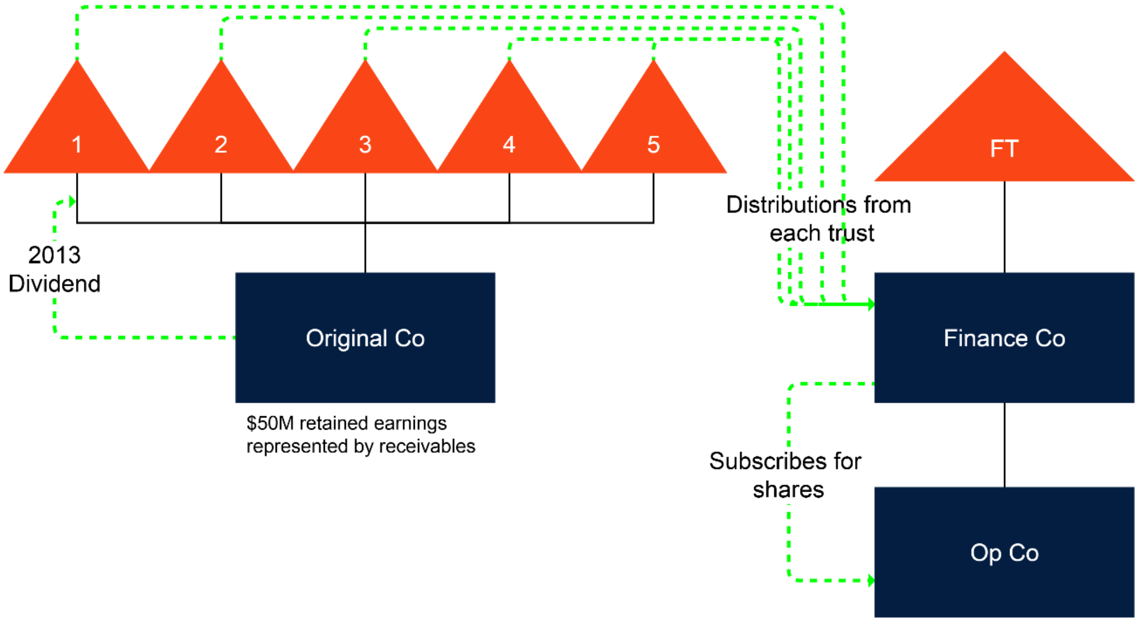
Original Co was one of several corporates in the family group. In, say, 2013, the patriarch had a growing concern in relation to his children who had come to an age where they were taking on long term partners and the patriarch had started to consider the impact of relationship breakdown on the family holdings. He sought and obtained advice on steps he could take to minimise that impact. A part of that advice included the children entering into binding financial agreements which he ultimately enforced. Some of that advice also flagged that the more of the value of the family group that could be compartmentalised for the benefit of particular children, the higher the risk of that compartmentalised value being exposed to a claim by an aggrieved spouse.

Following from that, a restructure was undertaken that was not too dissimilar to the one outlined in TA2023/1. This comprised:

- a new company being established (**Finance Co**) that was owned by a single, non-fixed trust controlled by the parents;
- Finance Co establishing a wholly owned subsidiary (**Op Co**);
- Original Co declaring a fully franked dividend, equal to its retained earnings and paying that dividend to the five shareholders. That dividend was paid by way of assignment of the receivables;
- The five shareholders distributing the dividends to Finance Co, being an eligible beneficiary;
- Finance Co subscribing for shares in Op Co and paying the subscription price by a further assignment of the receivables.

The rationale for the restructure and each step were set out in a deed of which all relevant entities were a party to. Relevantly, the deed foreshadowed that loans would likely be made by Op Co moving forward.

A review by the Commissioner commenced in 2018 for that and later years. Unsurprisingly, issue was taken with the 2013 reorganisation, with the primary arguments being around whether the interposed entity provisions applied such that 2018 loans could be considered has having been made by Original Co instead of Op Co.



3.2 Employee share/loan funded scheme scenario

The second scenario is in the context of the recalibration of shareholdings in a company (**Trade Co**) that owns and operates several standalone (but complementary) businesses.

Trade Co had been originally established with unequal shareholdings (being a mix of companies that are owned by non-fixed trusts and the non-fixed trusts directly and respectively controlled by three individuals) that represented the fact that a particular shareholder was largely funding the operations of Trade Co. This was in say 2020. Fast forward to the present, there was an intention of the shareholders to equalise the shareholdings, but the dilemma was that Trade Co had been quite successful over the intervening period, and the underlying shareholdings had increased in value significantly.

The adviser proposed an equalisation[5] where:

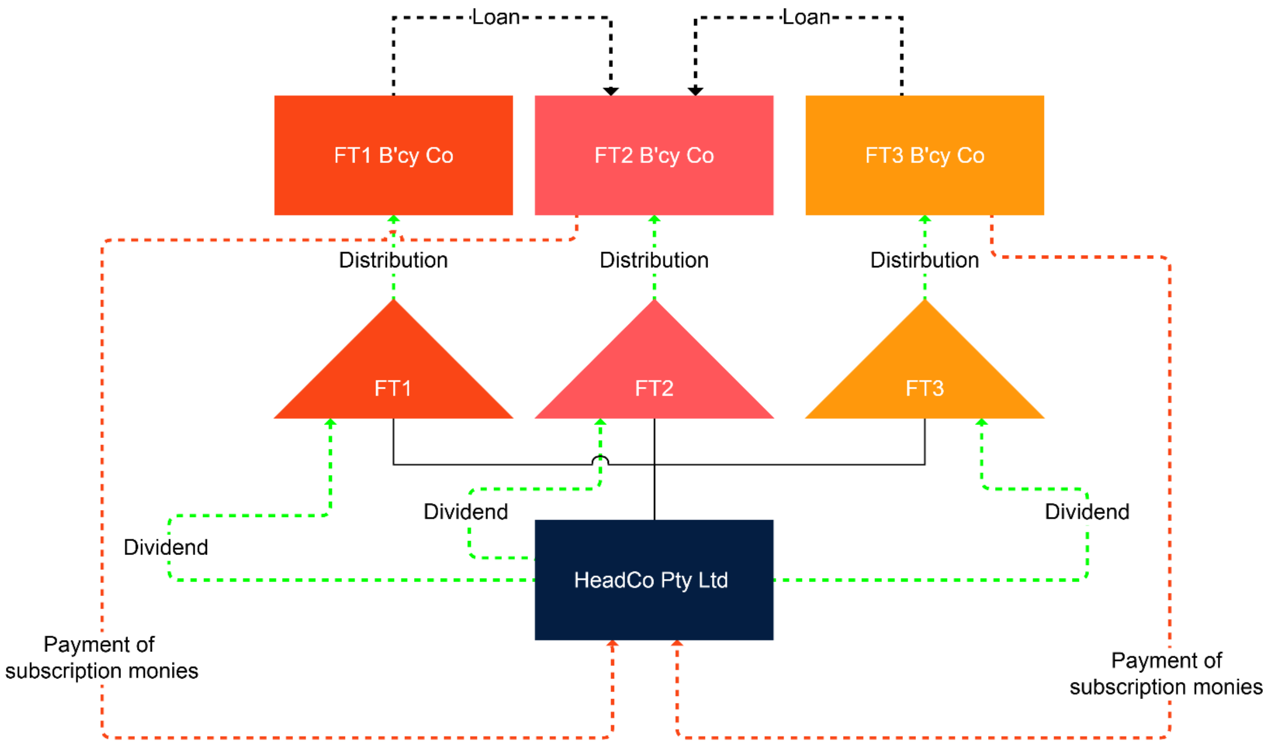
- Trade Co would declare and pay a dividend sufficient to facilitate the equalisation[6];
- that dividend be used by each shareholder to subscribe for an amount of shares (requiring payment of market value) sufficient to equalise them with the larger shareholder noting the larger shareholder would initially lend a part of their dividend to the others (their existing corporate shareholding entities) to allow them to subscribe for more shares.

Obviously, company to company loans are not subject to Division 7A but the adviser had suggested that, instead of the existing corporate shareholders borrowing, instead the larger shareholder loan funds to the non-fixed trusts

[5] Fringe Benefits Tax is also an issue but is not considered in this paper.
[6] Financial assistance under Part 2J.3 of the *Corporations Act* 2001 (Cth) is also required to be addressed but can be managed

and allow those to subscribe for the new shares given their ability to access the Discount Capital Gain. The reasoning was that:

- the smaller shareholders were not considered to be associates under s318 ITAA36 of the larger shareholder; and
- the starting position for s109T would be the larger shareholder and not Trade Co.



4. Taxpayer positions

4.1 Succession scenario

The first scenario is the more complex of the two given the factual matrix. There are a few facts that are worth bearing in mind. The first is that the retained profits of Original Co were a small fraction of the family's net worth when viewed overall. A finding against them may be more likely if say we were dealing with the same $50m years later as part of the review and audit. The reality though is that the family has generated and dealt with hundreds and millions of dollars in the intervening period between 2013 and the years in review. Considering the reasonable person test, is it in fact reasonable to take a view that the 2018 loans are in fact 'the same' as those made in 2013 when there is no evidence to support that finding?

The Commissioner's position is that a consequence of the deed foreshadowing the making of loans at some future point provides a necessary link between the 2013 restructure and the 2018 (and subsequent years) thereby causing a 'reasonable person' under s109T to determine that the transactions in 2013 were the source of funds for the 2018 (and subsequent years) loans - thus enlivening the interposed entity rules.

The alternative view is that:

- the dividend declared and paid by Original Co cannot be considered as a payment for the purposes of s109T as it is an actual dividend;
- Section 109J operates to disregard the first steps of the restructure (the movement of the dividend by assignment of the receivables from Original Co to Finance Co and then Op Co because the assignment of the receivables in each case was to discharge a pecuniary obligation of equivalent value);
- the starting position must be at Op Co at which time it would have no distributable surplus given the subscription paid by Finance Co resulting in Op Co having an amount of capital issued that was commensurate with its assets.

4.2 Employee share/loan funded scheme scenario

This scenario is a little simpler.

Strictly speaking, while it may be considered that the non-fixed trusts of the smaller shareholders are not considered to be an associate of the larger shareholder's corporate shareholder, there is an obvious risk that the Commissioner may consider applying the interposed entity provisions given the source of funds from Trade Co.

If actual dividends are not taken into account, then the starting position cannot be Trade Co and consequently, the interposed entity provisions have no role to play. On the other hand, if they are taken into account, then the interposed entity provisions are possibly enlivened to treat a loan as having been made by Trade Co to the smaller shareholding non-fixed trusts.

5. Alternative positions

Even if you can successfully navigate the interposed entity provisions, there is still Part IVA and the dividend stripping provisions in s177E and section 207-145 of the *Income Tax Assessment Act* 1997 (Cth) to contend with.

Both are often utilised by the Commissioner as alternatives in circumstances that are seen to circumvent Division 7A.

5.1 Part IVA

The nature of countering a Part IVA determination is not an easy one in practice and it is beyond the scope of this paper for a comprehensive analysis, save to say that some comfort may be taken from the appeal decision in *Minerva*[7]. As an oversimplification, a reorganisation was undertaken ahead of an initial public offering (**IPO**) that ultimately did not proceed.

That reorganisation delivered 'tax benefits' that the Commissioner took issue with. On appeal, the taxpayer succeeded largely because (in the author's view) the restructure that delivered the tax benefit endured notwithstanding the IPO did not proceed. This was important as the Full Federal Court (**FFC**) found that the Commissioner did not take into account the 'commercial advantages and consequences obtained by parties connected with the appellant and flowing from what was done[8]. The Commissioner instead had just focused on the tax consequences of the actual and counterfactual transactions.

There are nuggets of gold contained within the judgement that realigns the ambit of Part IVA with practitioner expectations. An example is the FFC's finding '[t]hat .. although Minerva obtained a tax benefit, nothing in the 'surrounding context' objectively supported a conclusion that any party to the schemes either entered into or carried out the schemes for a dominant purpose of enabling the taxpayer to obtain a tax benefit[9]. What will very likely become often quoted passages, the FFC has reminded us (and the Commissioner) that when considering Part IVA:

- For it to apply, it must be shown that having regard to the eight factors listed in s177D, 'it would be concluded that the person … who entered into or carried out the scheme or any part of the scheme did so for the purpose of enabling the relevant taxpayer to obtain a tax benefit in connection with the scheme'[10].
- The interpretation of the word 'scheme' extends well beyond its natural meaning and includes notions of agreement, arrangement and understanding. It can also include actions or courses of action taken by one party without the involvement of another party[11].
- It is the features of the scheme and surrounding circumstances which are examined in considering the s177D factors rather than an examination of the subjective purpose or motive of a party to the scheme[12].
- Section 177D does not require an inquiry as to whether a taxpayer would not have entered into the scheme 'but for' the tax benefit[13].

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[7] *Minerva Financial Group Pty Ltd v Commissioner of Taxation* [2024] FCAFC 28 (**Minerva Appeal Decision**).
[8] Minerva Appeal Decision at 121.
[9] Minerva Appeal Decision at 123.
[10] Minerva Appeal Decision at 60.
[11] Minerva Appeal Decision at 123.
[12] Minerva Appeal Decision at 63.
[13] Minerva Appeal Decision at 68.

- Where a taxpayer chooses between two transactions based on taxations considerations, it does not follow that the dominant purpose of the taxpayer was to obtain a tax benefit. Part IVA does not apply merely because the Commissioner can identify another means of achieving the commercial outcome which would have resulted in more tax payable[14].

That last point would have to be the pièce de résistance!

In respect of the s177D inquiry, the FFC held[15] 'The objective dominant purpose of a party to a scheme (such as an action or course of action) that has enabled a person to obtain a tax benefit is determined by regard to what has happened and evaluating why it has happened. Obtaining the tax benefit is not enough. Desiring the tax benefit is not enough. The obtaining of the tax benefit must have been the main object or aim of what is said to be the scheme when viewed objectively in its surrounding context.'

5.2 Dividend stripping

Pending the outcome of *Hayes*[16], it is not clear whether a Division 7A effective reorganisation that provides for loans from a 'Division 7A-free' environment amounts to a dividend stripping scheme. Historically, it could be said dividend stripping schemes were characterised by arrangements that resulted in capital sums representative of corporate profits being permanently liberated from a corporate environment and made available to shareholders or their associates in a tax free, capital form without having a further incidence of tax applied.

Arguments have been made that Division 7A arrangements that result in non-Division 7A loans being made from a source of funds that are still represented by tax paid reserves within a corporate environment do not fall within that concept.

Time will tell who is right.

[14] Minerva Appeal Decision at 60.
[15] Minerva Appeal Decision at 65.
[16] *Commissioner of Taxation* v *Michael John Hayes Trading Pty Ltd as trustee of the MJH Trading Trust* [2024] FCAFC 80, noting the FFC ordered that the matter be remitted to the ART for redetermination.