Division 7A evolution: where are we heading?

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Notwithstanding the maturity of Div 7A of the *Income Tax Assessment Act 1936* (Cth) as an integrity measure, it still results in ongoing confusion and mistakes for practitioners. As the reform promised almost a decade ago has since evaporated, it is timely to revisit and examine where we are with Div 7A, and also consider where it may head into the future.

This article seeks to take a stocktake of Div 7A and shine a light upon areas of confusion or common non-compliance.

Introduction

It is with some astonishment that some 28 years after the introduction of Div 7A of the *Income Tax Assessment Act 1936* (Cth) (ITAA36), it continues to provide so much fertile ground for mistakes, disputes and ongoing aggravation for the tax profession. I am therefore not surprised that the ATO appears to have lost patience with non-compliance. In a recent ATO dealing, I could not help but notice the officer's frustration regarding what was quite a simple Div 7A matter being improperly dealt with by a former adviser.

When it comes to the long-awaited reforms of Div 7A, my astonishment turns to disappointment as more than 10 years after the Board of Taxation post-implementation review into Div 7A, we are no closer to positive changes to remove the unnecessary complexity. In fact, the *Bendel* case highlights the need for reform and clarity more than ever.

Notwithstanding the lack of reform, the thrust of this article is to examine the ongoing operational complexity of Div 7A that continues to cause issues for the tax profession and its clients.

I will not be addressing the proposed reforms to Div 7A, as I think it is safe to assume these will not be proceeding any time soon.

Is it really a repayment?

As accountants would be aware, we spend an inordinate amount of time working with our small to medium enterprise (SME) clients on making the necessary repayments for their Div 7A loans. The process at our firm would resemble that followed in most firms across the country. The procedure is as follows:

1. Sometime from July to May, you do the year-end work for the client. During that process, new Div 7A loans are identified and the balances of old loans are determined at the previous 30 June. We check that the minimum yearly repayments (MYRs) were properly made, and appropriate interest is recognised.
2. In the year-end letter sending out the returns and financial statements, the client is informed of the MYR for their Div 7A loans for the coming 30 June.
3. Hopefully (assuming time permits) as part of tax-planning for the coming 30 June, the client is reminded of the MYR. Recommendations are made regarding cash payments or dividends required before 30 June.
4. "Rinse and repeat" for the following year.

A good proportion of SME clients regard the above as the "how the sausage is made" part of the process. They just want to know what they need to do/sign or whatever to comply. Other client's level of care does not even rise to that level. There is certainly a lack of appreciation from our clients on the efforts the accounting profession puts into this "compliance", which inevitably leads to the client not accepting the "value" of such work.

Because of their importance, Div 7A repayments are the focus of a lot of time for accountants, but all that work will be for nothing if the repayment is not in fact a repayment. This leads us to s 109R ITAA36.

Section 109R: what is the rationale?

If we did not have s 109R, Div 7A itself for loans would be rendered toothless. It could be avoided by repaying loans each June, and then the company advancing new loans in July (more on that strategy later).

At its core, s 109R is an anti-avoidance provision within the Div 7A integrity measures to ensure that repayments are "true" repayments.

To the extent that a purported repayment is not a true repayment under s 109R, it will be disregarded for *certain* Div 7A purposes. Those purposes are limited to whether an MYR had been made (s 109E ITAA36) and whether a loan has been repaid by lodgment day (s 109D ITAA36).

Base case: the reborrowing

The heading of s 109R(2) gives us fair warning regarding what the provision is about—"Intention to obtain loan". In simple terms, a repayment will be disregarded where, when the repayment was made, the borrower intended to reborrow that amount back.

This intention is viewed through the prism of a "reasonable person"—if a reasonable person would conclude (having regard to all of the circumstances) that when the purported repayment was made, the borrower intended to obtain a loan of an amount similar to, or larger than, the repayment.[1]

In addition, the provision applies where *both* of the following apply:

1. the borrower obtained a loan before the repayment was made of an amount similar to, or larger than, the purported repayment; and
2. a reasonable person would conclude that the borrower obtains the loan/loans in order to make the repayment.

There are specific exclusions from s 109R(2) that are discussed below in more detail.

Let's apply 109R(2) to a simple scenario.

Example 1

Baker Pty Limited is a client of your firm. In the 2024 year, Justin Baker (controller of the company) took out a loan from the company for $250,000 to repay the remaining balance of his home loan. He executes a complying loan agreement provided by your firm.

You then tell Justin he needs to make an MYR of approximately $50,000 prior to 30 June 2025. Justin tells you he will deposit the $50,000 into the company's bank account prior to 30 June 2025.

When you are preparing the 2025 financial statements, your staff confirm from the Xero file that the repayment was made on 28 June 2025. Your inquisitive staff member also can see that Justin withdrew $50,000 on 2 July 2025.

I guarantee you that the above scenario plays out in every firm in Australia on a regular basis. How does s 109R play out here?

What is not known is whether, from a reasonable person's perspective, Justin intended to reborrow the $50,000 repayment on 28 June when it was made. I would contend that unless there was some intervening event or set of facts between 28 June and 2 July, then it would be very difficult to mount an argument that there was no intention to reborrow the existing on 28 June.

Example 2

Following on from Example 1. You contact Justin and he confirms that all you told him was to make a repayment by 30 June, and that you did not tell him he could not reborrow the money, so he did. He also informs you that the money is better off in his mortgage offset account than in the operating account of the company, owing to the non-deductibility of his home loan.

Fast forward 12 months. Justin makes a repayment of $45,000 on 15 June 2026. He reborrows the $45,000 on 1 August 2026.

Is s 109R(2) still a problem?

Of course it is! Changing the dates and leaving a longer period between them does not distract from the fact that the intention to reborrow exists at the time of the repayment.

It is very common when explaining the concept of s 109R to SME clients that they quickly get the issue of a late June/early July set of repayment and reborrowings. The penny drops quite easily since it is a pretty easy concept. However, a very common question following that initial discussion is, what if I just did slightly different amounts and mixed the dates around a little?

The strategy was identified in a Board of Taxation 2012 discussion paper, where it was noted that the use of "similar amount" may allow some scope for avoiding the application of s 109R by making sufficient variations to the reborrowed amounts.

The following is from the ATO website addressing the reborrowing strategy:[2]

"**Example: indefinite reborrowing arrangement**

Sam is the sole director and shareholder of Plant Pty Ltd. He is told by a mate about a way he can save money on his mortgage by borrowing the profits made by his company, without having to pay any additional tax on the amount of profit he borrows. He is also told he won't need to enter into a complying loan agreement, and so he won't have to pay interest to his company, if he temporarily repays the amounts he borrows by the end of the income year. Under this arrangement Sam understands that:

- In the first income year of the arrangement
  - he would borrow profits from Plant Pty Ltd that it doesn't need and put them in his mortgage offset account, saving non-deductible interest on his personal mortgage
  - on 30 June he would repay the total amount he borrowed to plant Pty Ltd.
- In following income years
  - on 1 July, Sam would reborrow the amount he repaid Plant Pty Ltd the day before and put it back in his personal mortgage offset account
  - he would then borrow additional amounts of profit made by Plant Pty Ltd throughout the income year that it doesn't need to run its business and deposit them into his personal mortgage offset account
  - Sam will repay the total amount he has borrowed during the income year on 30 June.
- He will repeat this arrangement indefinitely year after year, until it is no longer possible, or he doesn't need to.

Before starting the arrangement, he decides to get advice from his tax agent first.

Sam's tax agent correctly warns him that this reborrowing arrangement would result in him being deemed to be paid an unfranked dividend by the company in each income year he undertakes it equal to the amount borrowed (subject to the amount of the company's distributable surplus for that income year).

> This is because the repayments he makes on the loan are disregarded by section 109R, because a reasonable person would conclude that, when he made the repayment, he intended to reborrow a similar or larger amount from the company.
>
> Sam's tax agent advises him that he will need to include the amount of any deemed dividend he is taken to be paid as a result of the arrangement in his assessable income.
>
> Sam follows his agent's advice and decides not to enter the arrangement and warns his mate about the tax consequences of the arrangement."

In my experience, and anecdotally, Sam (the client) does not usually react the way the ATO describes. What generally happens is that Sam wants to know why his mates' accountant told him this was an acceptable strategy, and that he does it all the time with great financial effect. He has an almost permanent offset account running.

That is the problem here—the reborrowing strategy is so widely used, its very existence is being used to give it credibility (they might refer to that as confirmation bias). There are some firms I am aware of where this is the "go-to" strategy for Div 7A management, or the "don't ask a question that you don't want to know the answer to" strategy or merely turning a blind eye altogether.

Reborrowing: ATO approach

Naturally, if the ATO was to encounter a client using the reborrowing strategy either pre-30 June or pre-lodgment date, they would apply s 109R(2) and disregard the purported repayments. For an existing complying loan, it would be expected that the ATO would assess the recipient on the shortfall in MYR under s 109E.

If the strategy was used for new loans such that they were never recognised for Div 7A purposes, it may result in the ATO deeming the entire loan amount as a deemed dividend under s 109D as the loan was not repaid by lodgment day. I am aware of instances where the ATO has sought to apply this outcome over several years where the reborrowing occurred and the same amount was subject to Div 7A in successive years.

Section 109R was briefly considered in an Administrative Review Tribunal (AAT) decision in 2012, *Building Company Owner v FCT*.[3] The provision was not a core issue of the particular case, but counsel for the ATO raised it during the case. The shareholder made two repayments and reborrowed the same amounts 14 days later. In evidence, he admitted for one repayment, there was an intention to reborrow, but not the other repayment. On that repayment, the shareholder testified that "I just happened to need it two weeks later". That evidence was considered not convincing by the AAT.

The lesson here is that this strategy needs to stop since it is dangerous to encourage it and the client will merely blame the adviser if detected.

What repayments are immune from section 109R(2)?

First, the way in which s 109R has been drafted does not allow it to be applied when the reborrowing is made by a *different* entity that made the repayment. Leaving aside the interposed entity provisions (discussed below) s 109R can be avoided, for example, where a husband shareholder repays a loan and sometime later his spouse borrows the same amount.

Adopting a reborrowing strategy with different rotating entities would certainly result in consideration by the Commissioner in seeking to apply Pt IVA ITAA36 to such strategies.

Less dangerously, there are specific exclusions from s 109R for the following repayments that are set off against the loan:

- a dividend payable to the borrower by the lender;
- assessable payments for work (PAYG income) payable to the borrower;
- payment subject to voluntary withholding under s 12-55 of Sch 1 to the *Taxation Administration Act 1953* (Cth) payable to the borrower; and
- the market value of property transferred to the lender company by the borrower entity, less amounts paid by the company for that property.

The logic of the above is that the above repayments are either assessable to the borrower in the case of the dividend/salary payments set off or capital gains tax (CGT) in the case of a property transfer. As a result, it would be inequitable for s 109R to apply for any amounts reborrowed given the cost to the borrower in making the repayments.

Repayments made by others for borrower

Section 109R(4) contains a further specific narrow exclusion when a repayment is made by an entity other than the borrower.

The exclusion is limited only where the repayment by that other entity was in fact assessable income of *the borrower.*

Further exclusions

In addition to the above, s 109R(5) to (7) contain further specific exclusions from s 109R. These are:

- where a Div 7A loan is subordinated to another loan; and
- where a Div 7A loan is refinanced from a 7-year unsecured loan to a 25-year secured loan (and vice versa).

Repayments by "set-off" in practice

In practice, repayments are made by clients most commonly by the set-off of dividends, rather than cash payments. Ideally, cash payments are cleaner, but in reality, not practical for many clients.

Where borrower is a shareholder?

As noted above, where the borrower is the shareholder and a dividend is set off against the loan as a repayment, s 109R

will not apply to any subsequent reborrowings. However, the real issue is to ensure that the set-off is actually a repayment.

For a set-off to be effective, the parties must *agree* to set off the presently due mutual liabilities owing between them. That agreement can be expressly made or implied.

I would hope that in an ATO review, this issue is not agitated, but to avoid that possibility, it is important that when it is planned for, a dividend is to be used as a repayment, and that there is a set-off agreement signed by the borrower and company where the parties agree to apply and set off the dividend entitlement against the loan.

Merely journaling the impact of the application of the dividend against the loan is, by itself, not sufficient to make an effective repayment, although accountants love journal entries—they represent the evidence or aftermath of a transaction, rather than the actual transaction.

In a recent ATO website addition to *Division 7A myths debunked,* the following was noted:[4]

> **"Using journal entries to record offsets**
>
> Myth: I can record a dividend in a journal entry, after an income year has ended, and use that to effectively offset my minimum yearly repayment obligation for that income year.
>
> Fact: a journal entry, without other supporting evidence and contemporaneous action, won't be effective to offset a minimum yearly repayment obligation on a complying loan.
>
> The dividend and minimum yearly repayment obligations must exist at the time of the offset and the borrower and the company must have agreed to the offsets. The agreement and offsets must be made by the end of the income year, usually 30 June."

Clearly, the warning above is targeting the backdating of a dividend repayment subsequent to 30 June and just "journaling" the repayment. Its message is equally related to the importance of having an agreement for the set-off to demonstrate the purported repayment transactions.

Setting-off dividend when shareholder not the borrower

The mechanics of a set-off repayment is more troublesome where the dividend needed to make the Div 7A repayment is payable to an entity that is *not* the Div 7A borrower.

The set-off doctrine referred to above does not apply, since there are most likely not be mutual presently owing liabilities between the parties.

In my experience, many firms effect the above through journal entries only. However, for the Div 7A repayments to be effective, more is needed.

What is required is a tri-partite deed where the shareholder effectively assigns the dividend entitlement to the borrower, and the company agrees to set off the dividend against the loan as a repayment.

I was involved in an ATO review where this was raised as an issue (journals moving repayments), but in the end (thankfully) was not pursued by the ATO officer, since there was a genuine attempt to comply and no other compliance issues. That does not necessarily mean it will not be an issue pursued by the ATO in the future.

It would be prudent that your firm engages a solicitor to assist in such assignment/set-off deeds to legally implement these transactions.

Interposed entity provision (section 109T) in practice

Background

The interposed entity rules often do not get the attention they deserve in practice. This is likely due to either their perceived (and actual) complexity or a lack of awareness. The purpose of the provisions is to remove planning opportunities to structure common Div 7A transactions outside of Div 7A through the use of an entity whose features displace the operation of Div 7A.

At its core, s 109T ITAA36 is designed to ensure that Div 7A will be taken to apply where loans or payments are made by a private company through interposed entities where a shareholder/associate of the private company is the ultimate recipient of the funds sourced from that private company.

Section 109T contains the following core conditions:

- a private company makes a payment or loan to an entity (the first interposed entity);
- the first interposed entity makes a payment or loan to a shareholder/associate of the private company (the target entity) directly or through one or more other interposed entities; and
- 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 payment or loan to the target entity.

The wording of s 109T then makes it clear that certain factors do not matter in forming the above conclusion, these factors are:

- whether the payment by the private company occurs before the eventual payment to the target entity or after it; and
- whether the amounts of the transactions to which s 109T directs its attention are the same or not.

One would assume when the drafters of Div 7A wrote the core provisions that they then considered how the core provisions could be easily circumvented. The most obvious transaction would be to have a private company with a distributable surplus to make a loan to a company with no distributable surplus (say a company established for this purpose and no other assets). That loan would of course be excluded from Div 7A owing to the operation of s 109K.

The company with no distributable surplus would then make a loan to the shareholders. Such a transaction would be an easy access to the profits of the private company by its shareholders, skirting around Div 7A.

Once s 109T is applied to a set of transactions, its impact is to deem that the private company has made a notional loan or payment to the target entity. The interposed entities and the transactions in the chain are effectively ignored for these purposes.

The only statutory exclusions to s 109T are:

1. where the target entity is a company (other than in capacity as trustee)—refer to TD 2001/2 for confirmation; and
2. where the payment or loan from the private company to the interposed entity is deemed to be a dividend because of the application of Div 7A itself.

In relation to the second exception, it is very important to note that this exception only applies where the initial payment or loan is deemed to be a dividend and does not apply where the initial loan is put on complying terms within s 109N ITAA36. This is confirmed clearly by the Commissioner in TD 2011/16, which is discussed directly below:

> "37. If the loan between the private company and the interposed entity is a section 109N compliant loan (or the payment from the private company to the interposed entity is converted into a section 109N compliant loan) before the private company's lodgment date for the income year in which that loan or payment was made, the private company will not be taken to have paid a dividend to the interposed entity. In this situation the exception in subsection 109T(3) will be insufficient to itself prevent Division 7A from otherwise applying to the deemed payment or notional loan made by the private company to the target entity (the shareholder (or their associate))." (emphasis added)

Factors the Commissioner considers

In TD 2011/16, the Commissioner addresses the relevant factors it will consider in determining the amount of a deemed dividend or notional loan under s 109T in conjunction with s 109V (payments) and s 109W (loans) ITAA36.

The relevant factors include (reproduced directly from TD 2011/16):

> "(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)."

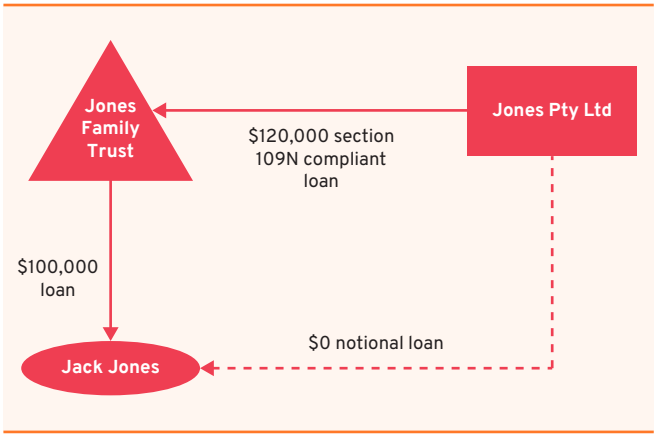
There is a small number of connected examples in TD 2011/16 to illustrate how the factors are considered.

In Example 1, a private company, Jones Pty Limited, makes a loan of $120,000 to a related Family Trust and places that loan under a s 109N compliant agreement. Some months after the initial loan, the trust then makes a loan of $100,000 to a shareholder of Jones Pty Limited, Jack Jones.

The Commissioner concludes that, given that the loan to the interposed entity was compliant with Div 7A, it would conclude that the notional loan arising from the application of s 109T from Jones Pty Limited to Jack would be reduced to $nil:

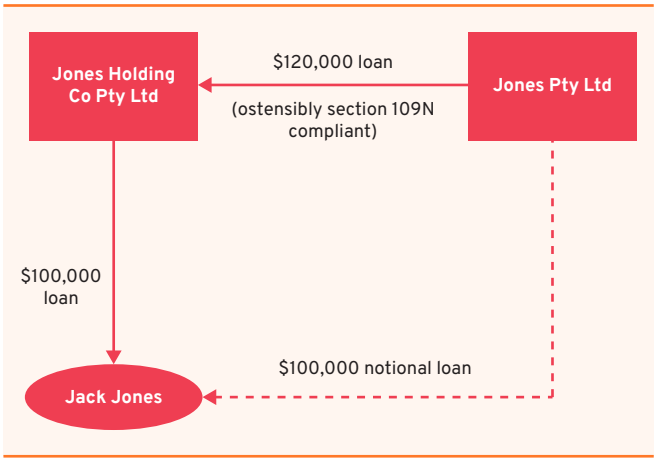
> "11. For the purposes of determining the amount of the notional loan under subsection 109W(1) the Commissioner will have regard to the fact the loan between Jones Pty Ltd and Jones Holding Co Pty Ltd as trustee for the Jones Family Trust complies with section 109N. As such the amount that would otherwise have been the amount of the notional loan, for section 109W purposes, will be reduced by $100,000 and resulting in a notional loan with a value of nil [see Diagram 1]."

Diagram 1



In Example 2, the Family Trust is replaced with a company with no distributable surplus. In the example, the loan between Jones Pty Limited and the interposed company is also put on complying s 109N terms (despite it being a loan between companies). The TD concludes that there would be a notional loan between Jones Pty Limited and Jack, as shown in Diagram 2.

Diagram 2



Sections 109V and 109W: other considerations

Sections 109V and 109W set out other considerations in determining the amount of the payment or loan, respectively, that arises where the interposed entity provisions apply. These provisions require that, in the determination of the respective amounts, the Commissioner must consider:

- the amount that the interposed entity paid or loaned to the target entity; and
- 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 (arm's length consideration for something).

Can section 109T apply to commercial transactions?

Many years ago, one of my partners and I were faced with a scenario that did not sit right with us. A client's company was investing into an unrelated unit trust. The units were being issued at market value and all looked above board. However, at some point, it became evident that the plan also involved the unit trust making loans back to our client on favourable (not compliant with s 109N) terms. It appeared to be a scheme to use the unit trust to access the profits of the company without having to comply with Div 7A.

The thing that we struggled with was whether s 109T is to be used when the first transaction by the private company (in this case, an investment in units at market value) is a legitimate commercial transaction. At the time, it just felt too good to be true that s 109T could be circumvented through a commercial transaction in the set of transactions, and we warned the client of such.

The Commissioner's view of this particular question became known only in 2018 with the release of TD 2018/13. Not surprisingly, the answer was affirmative—"yes", s 109T can apply where the first transaction in the transactions is a commercial transaction. However, I was surprised by the extent to which this approach reached.

Conveniently for me and our earlier concerns, the TD specifically references investments in unit trusts at para 78:

> "78. If subsection 109T(1) did not apply where the payment or loan from the private company to the first interposed entity was a transaction ordinarily seen in commercial dealings, the application of Division 7A could also be overcome by the private company subscribing for an equity interest in another entity (for example, units in a unit trust or an interest in a partnership) as part of an arrangement involving a payment or loan from an interposed entity to the target entity." (emphasis added)

Example 1 of the TD confirms that the Commissioner even considers that when the transaction between the private company and the interposed entity is an assessable dividend, s 109T can be applied. In that example, the private company in question has two classes of shares on issue. One class is owned by an individual, and the other by Company B (that has no distributable surplus). The private company declares a dividend to Company B. Company B, in turn, makes an interest-free loan to the individual. The Commissioner considers that a notional loan arises between Company A and the individual, as shown in Diagram 3.

There is naturally an assumption that Company B has no distributable surplus after the receipt of the fully franked dividend from Company A.

Example 2 is where the Commissioner's view takes an interesting turn, as it extends s 109T to intersect with s 100A ITAA36 (for example). In the example, Company C is wholly owned by the S Family Trust. Company C pays a fully franked dividend to the Family Trust, who makes non-resident Mrs T presently entitled to the dividend income. Upon receipt of the dividend, the Family Trust makes a loan to Mr S (also a non-resident), who is not the spouse of Mrs T. The Commissioner considers a notional loan would arise as shown in Diagram 4.

Diagram 3. Example 1 from TD 2018/13

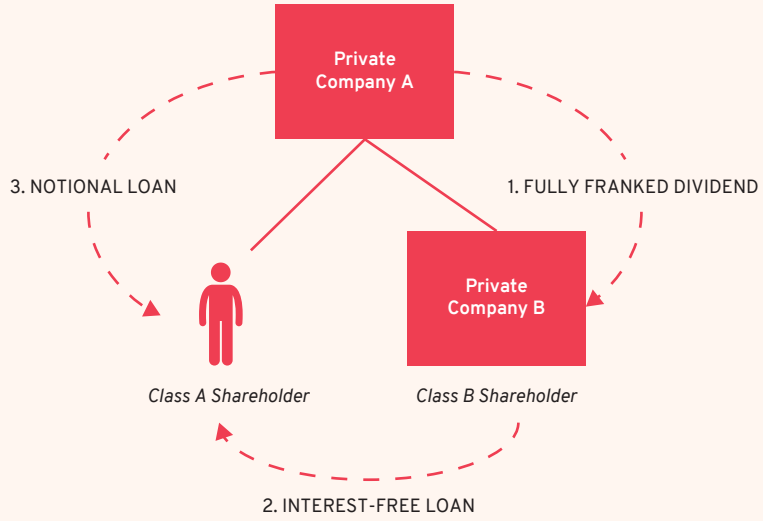
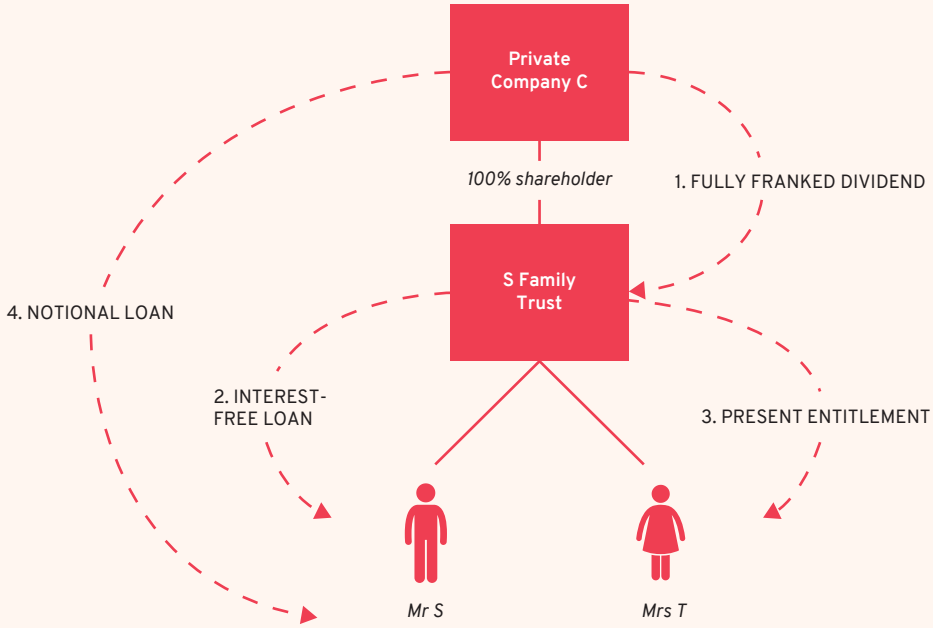


Diagram 4. Example 2 from TD 2018/13



Example 3 is a variation on my unit trust client query of some 20 years ago. It is shown in the determination in Diagram 5.

The most concerning examples in the determination are Examples 6 and 7 in my view. In Example 6, it is a variation of Example 2 with a trust owning shares in Private Company Z. The trust receives a fully franked dividend from Company Z, and then makes resident Mrs Z presently entitled to the income. However, Mrs Z directs the trustee to make a payment to Mr Z, who is her spouse. In the Commissioner's view, there would be a deemed payment from Company Z to Mr Z, despite the fact that Mrs Z has returned the dividend as assessable income (through s 97 ITAA36). An illustration of this example is provided in Diagram 6.

It is comforting to know that in the determination, the Commissioner confirms that, for Example 6, although s 109T will apply, it would reduce the deemed payment (s 109V) to $nil because the funds were retained in the same family unit and the present entitlement was subject to marginal tax rates.

This outcome is explained in the compendium to TD 2018/13 (Item 5), where the Commissioner confirms that it would consider the overall tax payable on the assessable transaction as a factor to determine the amount of the notional loan or payment in ss 109V and 109W. It states:

> "While the reasonable person test in paragraph 109T(1)(b) requires that every case be considered having regard to its facts and circumstances, the Commissioner agrees

Diagram 5. Example 3 from TD 2018/13

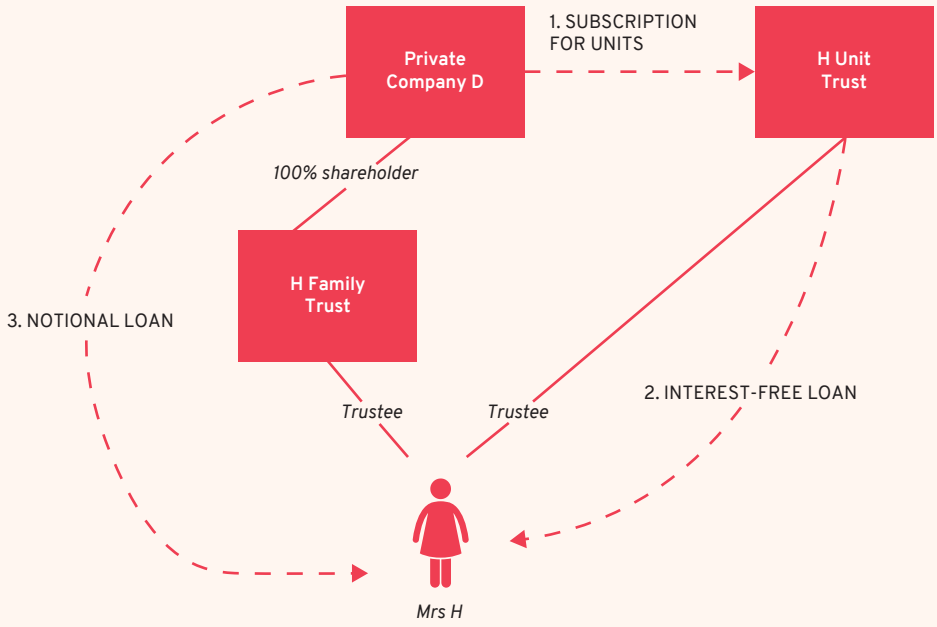
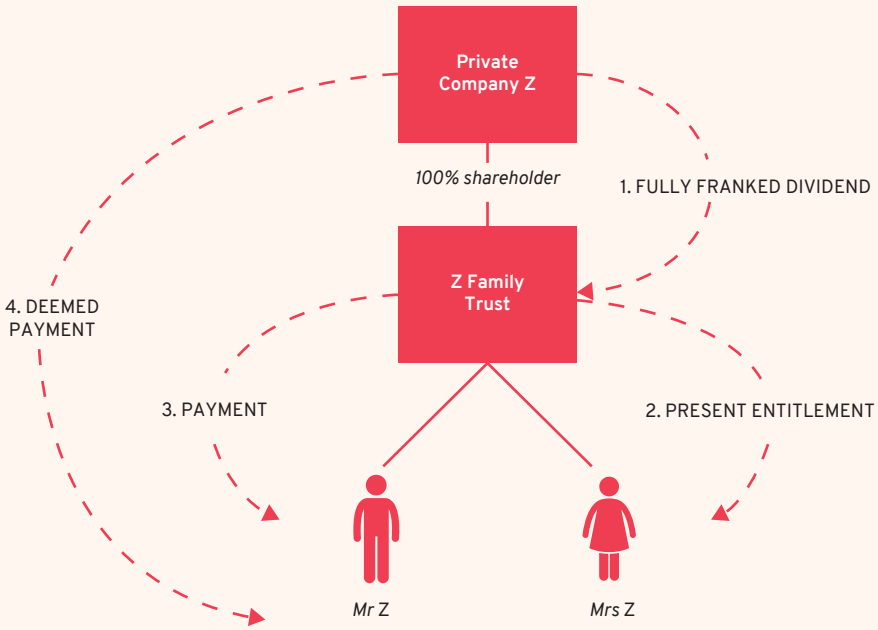


Diagram 6. Example 6 from TD 2018/13



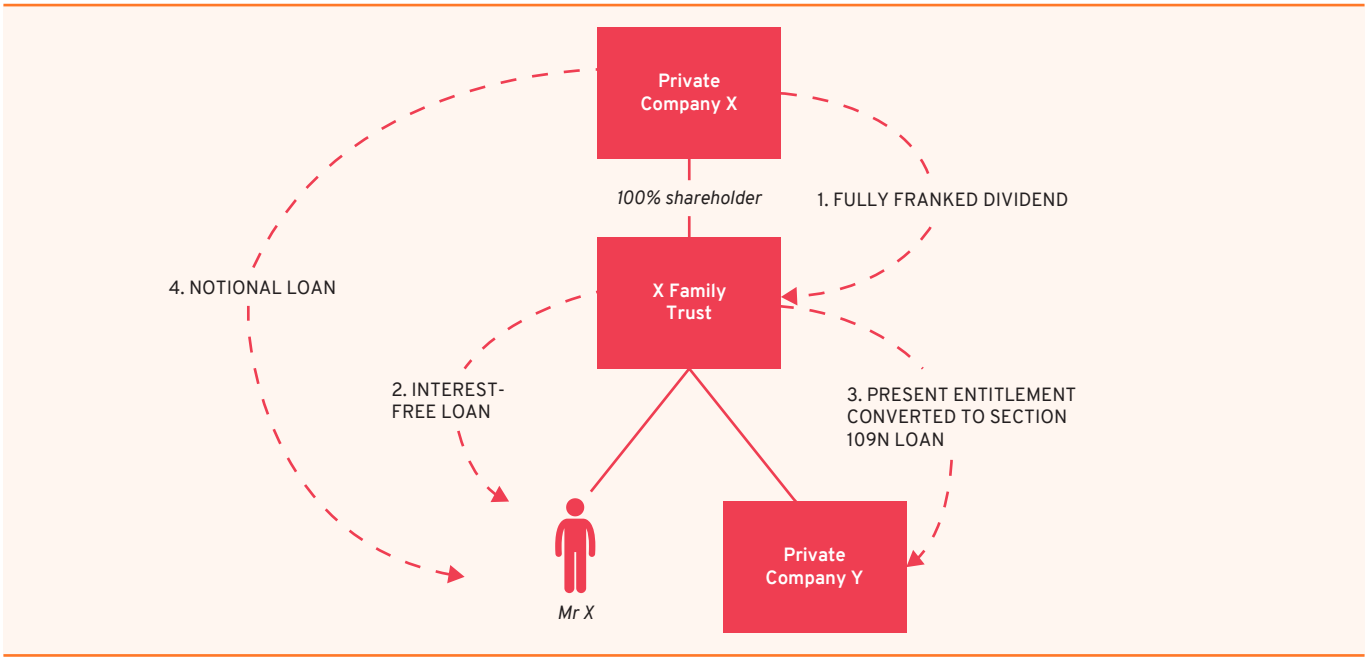
with the general proposition that the total tax payable on the relevant amount of private company profits should be limited to the amount payable if assessed at the target entity's marginal tax rate. However, the Commissioner reserves the right to apply Division 7A on a different basis depending on the nature of the arrangement under consideration."

Example 7 is another variation to the above, which most commonly occurs in practice. In this example, the Family Trust distributes the dividend income to Private Company Y and enters into a complying Div 7A loan agreement. The Family Trust then makes an interest-free loan to Mr X. Diagrammatically, it appears as in Diagram 7.

The Commissioner considers that the interest-free loan to Mr X would be a transaction to which s 109T would apply. However, it is noted that in determining the amount of the notional loan for the purposes of s 109W, the Commissioner would reduce it by the amount of the complying loan between the Family Trust and Private Company Y.

The above is a common outcome when a family trust shareholder receives a dividend, and the trustee seeks to utilise a corporate beneficiary. The conversion of the unpaid present entitlement owing to the company was required by the ATO (TR 2010/3 + PS LA 2010/4, and now TD 2022/11). Many trusts would then lend the funds to the controllers, often on an interest-free basis. It is comforting to note that

Diagram 7. Example 7 from TD 2018/13



provided the unpaid present entitlement (UPE) was placed on complying Div 7A terms, that would generally remove the risk of s 109T/109W being deployed.

The Commissioner has clearly formed the view in the determination that it does not matter whether, in the series of transactions to which s 109T is directed, an entity is assessable on that transaction outside of Div 7A. It is stated in the determination that just because an amount from the private company is assessable under s 44(1) ITAA36, it does not allow the exclusion in s 109T(3) to operate.

The justification of this approach (at para 75) is not unreasonable:

> "75. If subsection 109T(1) could never apply where the payment from a private company to the first interposed entity was a section 44 dividend, the application of Division 7A could be overcome by interposing a private company with no distributable surplus in an arrangement involving a payment or loan from the interposed private company to the target entity."

In the compendium to TD 2018/13, it was put to the Commissioner that the application of s 109T could not apply where the payment by the private company was an assessable dividend. The Commissioner respectfully disagreed with this position, indicating that the overarching object of Div 7A is attacking a disguised distribution of profits, and that this would include where a dividend is paid by the private company, but the funds from that dividend are accessed by a shareholder.

Timing matters

If I can return back to my unit trust example. Let's assume that my client's company invested into a unit trust with unrelated parties. The units are acquired at market value, and all is above board. The unit trust proceeds to undertake a venture such as a property development. Fast forward to when the development is completed and the profits distributed. Can s 109T apply if the unit trust used its capital from the issued units to lend to the individuals connected to each unitholder?

This would turn on the "reasonable person" test. Would a reasonable person conclude that the unit allotment was done as part of an arrangement involving the future loan to the shareholder/associate of the private company? It may be argued that, provided when the units were acquired, the future loans were not contemplated, it would be difficult for the Commissioner to deploy s 109T/109W in such a case, particularly where in the intervening period, the unit trust undertook a commercial venture.

Interposed entity provisions and guarantees

Included in the interposed entity provisions are also those dealing with the provision of private company guarantees. The relevant provisions are ss 109U and 109UA ITAA36.

Section 109U

This rule applies to deem a private company as making a payment to the target entity as described in s 109V if:

1. During a year, the private company guarantees a loan made by another entity (the interposed entity).
2. A reasonable person would conclude (having regard to all of the circumstances) that the private company gave the guarantee solely or mainly as a part of an arrangement involving a payment or loan to the target entity.
3. Either:
   a. the first interposed entity makes a loan to the target entity; or

b. another entity that is a private company, interposed between the private company and the target entity, makes a loan or payment to the target entity.

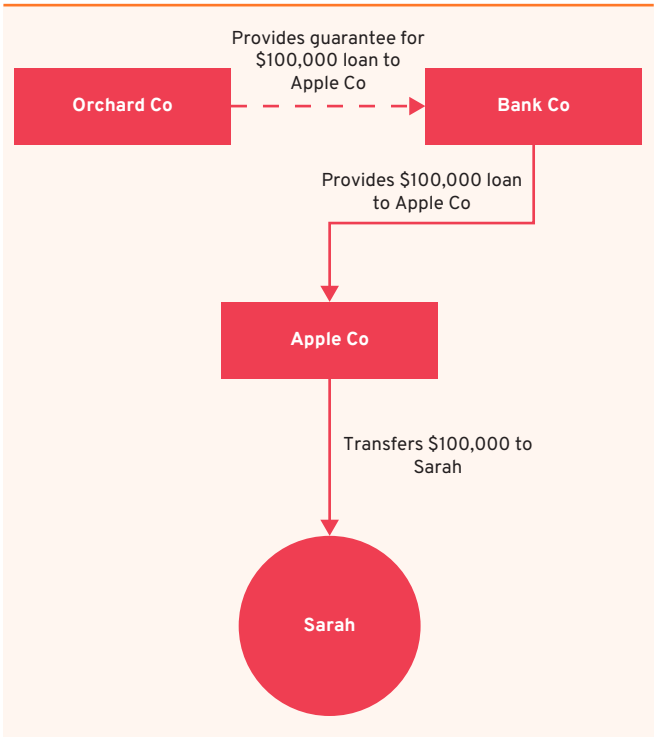
4. The amount of the payment or loan is greater than the amount worked out by the following formula:

Distributable surplus of interposed entity – section 109Y(3) amount

The s 109Y(3) ITAA36 amount is essentially any previous dividends taken to be paid by the interposed entity (excluding the loan guarantee rules).

In TD 2025/6, the Commissioner sets out its view of how s 109U can apply and confirms it does not only apply where the guarantee is provided to another private company. In the determination, a very good example is used that gets to the core of s 109U. The Fruit Family have several private companies in their group, Orchard Pty Limited and Apple Co Pty Limited. Apply Co is a new company with no distributable surplus, whereas Orchard has significant profits. In the example, Orchard provides a guarantee of $100k to a financial institution, who makes loan of $100k to Apple Co. Apple Co subsequently makes a payment of that loan to Sarah (see Diagram 8).

Diagram 8. Example 1 from TD 2025/6



Section 109U would deem there to be a payment of $100k from Orchard to Sarah, as calculated with reference to s 109V. The logic is that the financial resources of Orchard are being used to facilitate a bank loan to Apple, who in turn makes a payment to Sarah.

It is noted that where the loan from Apple to Sarah was placed under a complying s 109N loan agreement, the Commissioner would not dedicate compliance resources to the matter.

Section 109UA

Section 109UA applies where a private company has to make a payment under a guarantee it has made. The most likely example would be where a private company guarantees a bank loan for a shareholder and the shareholder defaults on the loan, causing the company to enforce the guarantee. The payment by the private company to the bank would be deemed to be a payment by the company to the shareholder (target entity). There is an exclusion where the shareholder and the private company enter into a complying loan agreement.

Section 109RB discretion

As most would be aware, s 109RB ITAA36 gives the Commissioner the discretion to disregard a deemed dividend that had arisen from the ordinary application of Div 7A. That discretion is to be exercised where the deemed dividend arose because of an "honest mistake or inadvertent omission" by either:

- the recipient;
- the private company; or
- any other entity that contributed to that result.

The discretion allows the Commissioner to either disregard the deemed dividend that arose because of Div 7A or allow the deemed dividend to be franked (only available where the recipient of the deemed dividend is a shareholder). Each of these options will be addressed separately below.

I have been involved in quite a few such applications and have a good deal of experience with them. I have sensed a shift in mood within the ATO over the past 12 months or so where the ability to obtain the discretion is more difficult than it has been historically.

In November 2024, the ATO hosted an excellent webinar on how they may approach a s 109RB discretion. It is a worthwhile watch that remains on the ATO website as of 29 January 2026. The presenters gave examples of matters the ATO is seeing where the discretion was not warranted. There was even a reference to "repeat offender" tax agents who are seeking the discretion for the same clients in successive years, suggesting that the agent has not learned from the earlier actions that led to the previous discretion.

I wanted to discuss the role of the discretion and overlay that with what is happening in practice in my experience. I will examine the role of the discretion in the context of a new client for a firm where the new tax agent encounters historical Div 7A issues. However, the analysis is equally relevant to a tax agent having to deal with a Div 7A problem caused by their own firm.

There are several approaches when a tax agent encounters a Div 7A historical breach:

- do nothing and ensure compliance moving forward. I refer to this as the "not my problem" approach;
- the "self-correction" approach, where the agent gets things back on track and ensures compliance moving forward. This is the "we are all good now approach"; and

- approach the Commissioner and seek the s 109RB discretion.

Anecdotally, most firms have a discussion with the client and land on the self-correct approach. There is general apprehension in voluntarily approaching the ATO for the discretion because of the possibility that the discretion will not be granted, and now the ATO is fully aware of the breach with amended assessments to follow.

As the ATO noted in the abovementioned webinar, the *only* way a deemed dividend that has arisen can be disregarded is through the s 109RB discretion. Self-correction may make the participants feel better, but it does not absolve the client from the Div 7A sin.

What about self-correction?

As noted above, in my experience, a majority of SME-focused accounting firms will do the following when they pick up a new client with some historical Div 7A issue within the client's amendment periods:

- contact the previous tax agent to ascertain the Div 7A problem. Normally, that enquiry is met with silence and delay;
- once the issue has been defined, discuss the issue with the client;
- recommend self-correction such as catch-up repayments, repay loans in full through current year dividends; and
- move on.

I would assume some clients may even resist this course of action because of the potential cost of doing so, but hopefully most clients will allow full self-correction.

Self-correction is widespread, but as already noted, it does not fix the issue if the ATO were to commence a review in relation to Div 7A or include such an enquiry in the context of a broader review.

I would expect that if an ATO review was commenced and the tax agent voluntarily disclosed the previous Div 7A compliance and the self-correction, it would likely depend on the ATO officer and what other issues the review encountered. The officer may take a dim view of the fact that no s 109RB discretion was sought prior to the review being commenced. It is also less likely that a late s 109RB discretion application would be successful, since timeliness of action is a material consideration for the ATO.

The presenters in the ATO webinar stated:

> "I mean, as we spoke about before, the only thing that can undo a deemed unfranked dividend is exercise of the discretion by the Commissioner. And that corrective action should be voluntary and undertaken sort of unilaterally by the taxpayer. *It's not, going to weigh heavily if sort of taxpayers bury their head in the sand and wait for the issue to be detected by the ATO as part of review or audit, and then undertake corrective action.* You need to be taking corrective action as soon as you identify that there is a Division 7A issue."

Pragmatically, appropriate self-correction is a solid middle ground for a tax agent trying to retain a new client and trying to get them to comply, but it comes with risks that should be explained (always in writing) to the client.

I would suggest that the issue is set out in writing, with the suggested course of action being the s 109RB discretion. With that recommendation, you need to inform the client of what self-correction action will be required and their cost, as well as the possibility that if the discretion is denied, what the impact of a deemed dividend will be. Many clients when faced with this option will be reluctant to proceed for obvious reasons.

If the new client instructs you that they do not wish to proceed with the discretion application, you need to convince them to, at the very least, self-correct by bringing the loans up to date as if they had been always compliant. That should also be done in writing.

If the client instructs you that they do not wish to do anything about the historical issues, you should inform them of the risks of that course of action and acknowledge the client decision in writing. Separately, you need to consider whether you are willing to continue with the client engagement.

TASA and Division 7A breaches

Although a comprehensive analysis of the Code of Conduct in the *Tax Agent Services Act 2009* (Cth) (TASA code) is beyond the scope of this article, it might be helpful for some commentary on what tax agents are required to do to comply with TASA.

Section 30-40 TASA requires that an agent has an obligation to notify the Tax Practitioners Board (TPB) of significant breaches of the code. That may be relevant where the inherited Div 7A issue is significant and perhaps the tax agent has encountered other similar Div 7A issues from the former tax agent. The unknown is determining what is a "significant" breach in the context of Div 7A.

A practitioner put to me a scenario recently, which I will assume was hypothetical. He told me that he had recently picked up a new client. It became clear that the former tax agent was eliminating Div 7A loans by a company by re-assigning them to a "capital loss reserve". He wanted my view on whether that was a reportable breach by the former tax agent. I thought it was a given that it was an obvious and deliberate attempt to circumvent Div 7A.

What then are our own obligations with the historical breach?

As far as I can determine, the process I have described above with offering the discretion, etc, to the client should satisfy your obligations under the code.

There is no positive obligation to correct the false statement made by the former tax agent. However, s 35 of the code requires that competent services are provided. A competent service would involve setting out the options for the client, as I have summarised above. In my view, the "do nothing" strategy would not represent a competent service.

If the client did not wish to remedy the issue and insisted that they wished to continue to not comply with Div 7A, the agent should consider withdrawing from the engagement to avoid making false statements to the ATO in the future.

It is important to also note that the Commissioner may also report a tax agent to the TPB where they consider that the agent has breached s 30-10 TASA regarding lack of competence.

Honest mistake/inadvertent omission

Section 109RB(3) sets out the relevant factors the Commissioner must consider in deciding to allow the discretion as:

- the circumstances that led to the mistake or omission;
- the extent to which any of the entities have taken corrective action, and if so, how quickly;
- previous Div 7A issues with the entity; and
- any other relevant matters.

PS LA 2011/29, sets out the steps the ATO officers should follow in determining the discretion application. TR 2010/8 is also a comprehensive ruling on how the ATO approaches the discretion.

Whether the deemed dividend arose because of an honest mistake or inadvertent omission will require an objective assessment of all the circumstances surrounding the failure to satisfy the requirements of Div 7A.

Ignorance can on same occasions contribute to a mistake or omission. In TR 2010/8, the ATO note:

> "***Ignorance***
>
> 59. A mistake or omission can be the result of ignorance. However, it would need to be established that the relevant entity's ignorance led to the honest mistake or inadvertent omission relevant to subsection 109RB(1) and that the result of the operation of Division 7A arose because of it. Whether or not this is the case will depend on the particular situation. For example, ignorance of the existence of Division 7A does not of itself establish that the loan itself was a mistake, the fact that it was not repaid was an honest mistake or inadvertent omission or that the absence of a complying written loan agreement was an inadvertent omission. It is necessary to make further enquiries about the circumstances surrounding the ignorance to determine whether an honest mistake or inadvertent omission in fact occurred and that it caused Division 7A to operate with the particular relevant result.
>
> 60. In corporate law cases such as *Nichol* v. *Fearby* [1923] 1 KB 480 and *Sanwa Australia Finance Ltd v. Ground-Breakers Pty Ltd (in liq)* [1991] 2 Qd R 456; (1990) 8 ACLC 852, the courts have held that ignorance of the law may amount to inadvertence; however, these cases do not go so far as to suggest that ignorance of the law always constitutes inadvertence.
>
> 61. The honest mistake or inadvertent omission must be genuine. The belief relating to the purported mistake must be actually held by the entity. An entity that deliberately ignores the operation of Division 7A does not make an honest mistake or inadvertent omission."

For most simple Div 7A problems (eg where a loan agreement was not put in place or MYR not made), it is probable that the reason for the non-compliance is either ignorance or deliberate non-compliance. Obviously, deliberate non-compliance will not bode well in a discretion application. The issue is determining the extent to which ignorance is still an honest mistake/or omission, particularly when the concept of a complying loan to comply with Div 7A is straightforward.

Recently, I assisted on a s 109RB discretion caused by the fact that the tax agent missed advising the client of the MYR for several years. The client was subject to an ATO review, and the missed repayments were voluntarily disclosed, together with the discretion application requesting that the ATO disregard the deemed dividend from the repayment shortfall (s 109E). As a corrective action, the agent had the client fully repay the loan well ahead of time. However, the ATO did not grant the discretion, citing the fact that calculation and making MYR is not a complex matter for a tax agent and referring the agent to the ATO website for further information on Div 7A.

Table 1 summarises the factors that would support or detract from the success of an application to the Commissioner.

Common areas of non-compliance and my estimate of a positive favourable discretion application is set out in Table 2.

In a 2019 AAT case, *Howard*,[5] the tribunal considered whether the s 109RB discretion should be granted in light of various controversial transactions to circumvent Div 7A. One main issue of the discretion application was that a 25-year loan was secured over a property that was already subject to a mortgage with NAB. The fact that this was missed was argued to be an inadvertent error by the taxpayer or tax agent.

The tribunal held that the applicant offered no evidence that the omission was an honest mistake or inadvertence. The fact that the taxpayer took advice on a series of deliberate transactions also weighed against the discretion being granted.[6]

Given the uncertainty of how the application will be considered by the ATO, I suspect the vast majority of SME tax advisers will be reluctant to lodge an application, and will be instructed by their clients to "roll the dice" with waiting out the review period when confronted with an historical issue. Self-correction will likely be done to fix the sin after the event.

What corrective action is required?

In Appendix A of PS LA 2011/29, the Commissioner provides a list of acceptable corrective action for different categories of non-compliance.

The most common corrective action involves the "catch-up" of repayments that should have been made had the loan complied with Div 7A from inception. PS LA 2011/29

Table 1. Analysis of factors in a section 109RB discretion application

Supporting discretion	Against favourable discretion
Genuine attempt to comply with Div 7A	Lack of objective evidence to support intended compliance
Minor mistake—arithmetic error, typographical error in agreement	Deliberate steps taken to avoid Div 7A based on tax advice received. Also, if no advice was taken, was taxpayer wilfully blind to the issue?
Complex area of Div 7A (novel or contentious area of the law or lack of ATO guidance on the area)	Law misapplied is simple and generally understood in tax profession. In PS LA 2011/29, this is referred to as "core provisions"
Historical compliance with Div 7A (have not previously applied for discretion)	Past loans were not compliant with Div 7A (but outside amendment period) shows previous non-compliance that did not have consequences
The taxpayer (and agent) acted promptly when the instance of non-compliance was first detected	The discretion applied in the shadow of a review commenced by the Commissioner or unexplained delays between detection and application
Appropriate corrective action undertaken	
Former tax agent error—this is an anecdotal observation that the Commissioner appears to be more understanding where the application is made by a new tax agent acting promptly. This may not remain in light of statements made by the ATO (the above webinar for example)	Current tax agent error

Table 2. Assessment of prospects in section 109RB application

Issue	Comments on prospects
No loan agreement in place but repayments and interest all made as if loan was complying	Argument would be that there was intent to comply, but for some reason, no loan agreement was executed. Only corrective action would need to be executing a loan agreement reflecting historical loan
No loan agreement and repayments not in line with Div 7A	Unlikely to be granted. Loan agreement and repayments over 7 years are core provisions. A competent tax agent should be fully aware of the need for a written agreement and repayments
Missed repayment (single year)	Will depend on circumstances. If only one year and there was a supporting reason explaining why it was missed, corrective action is simple. Leaning favourable
Missed repayments (multiple years)	Unfavourable outcome likely. Likely roll of the dice and will be influenced by circumstances of missed repayments
Loan from trust subject to Subdiv EA, owing to pre-2009 UPE remaining owing by trust to corporate beneficiary	Leaning favourable—more complex area of law. Segments of tax profession has lost contact with Subdiv EA and its role with pre-2009 UPE. Throw the *Bendel* uncertainty into the application and a favourable outcome should be received
Section 109D loan to a trust	Still an area of confusion with smaller firms but not a complex area of Div 7A compliance. I lean towards unfavourable, absent supporting factors
Interposed entity loan not dealt with	Although a complex area of Div 7A, the application's prospects will depend on the relevant circumstances (was the loan deliberately diverted through the interposed entity or where the transactions were commercial?)
Company forgives a loan to a shareholder that was complying with Div 7A, without seeking tax advice	Forgiving a complying loan without seeking tax advice may constitute wilful blindness to the law. Probable unfavourable outcome

and the ATO website also states that interest on the missed repayments is compounded to reflect the non-payment of earlier years.

The ATO website provides a detailed example calculation of how the catch-up repayments and compounded interest are determined.[7]

It is a somewhat surprising outcome that once the compounded interest is considered, the cost of the corrective action is more than one might expect.

If the application sets out corrective action that is conditional upon the grant of the discretion (say the company will declare a dividend to make the required repayments), this will not weigh against the exercise of the discretion in cases where a timely application has been made. However, the parties must have a genuine and reasonable belief that the corrective action should be conditional on the discretion being granted, rather than delaying the corrective action for the sake of it.

In my experience, the Commissioner is willing to grant the discretion conditional upon the occurrence of certain transactions and events (cash repayments, declaring dividends and inclusion of interest income in the company's assessable income). Naturally, any positive discretion outcome will be subject to the proposed corrective action being implemented.

What is the process for the application?

There is no prescribed form or application format for the discretion request.

When made outside the confines of a current ATO review, it is best done as a private binding ruling application. Where it is done during an ATO review, a letter to the officer in charge of the review requesting the discretion with the proposed corrective action should suffice.

If the client is unsuccessful in their application, they may object to the assessment on the grounds of failure to properly exercise a discretion. The client also retains the normal review options to the Administrative Review Tribunal or Federal Court in relation to the discretion also.

Distributable surplus issues (section 109Y)

There have been a few times in my professional career where a supposed Div 7A issue has been "solved" because the relevant private company did not have a distributable surplus. It is the gatekeeper provision after the self-executing provisions do their work to ensure that the deemed dividend is, in effect, out of profits of the company.

For the vast majority of SME companies, the outcome of the distributable surplus formula in s 109Y(2) will be the accounting retained profits of the company.

For completeness, the formula is:

1. net assets of the company at end of year (book value per financial statements); plus
2. Div 7A amounts; less
3. non-commercial loans; less
4. paid-up capital; less
5. repayments of non-commercial loans.

Net assets

Net assets are defined as the amount that the book value of the assets of the company exceeds the sum of:

1. Present legal obligations owed to entities other than the company.
2. Provisions for depreciation. Annual/long service leave and amortisation of intellectual property.

Because it is phrased in this manner, the net assets component of the formula can never be less than $nil as it is limited by the "excess" of assets over the listed liabilities of the company. For a company with a deficiency of liabilities over assets, the net assets for this purpose will be $nil.

Division 7A amounts

These amounts are added to the net assets.

A Div 7A amount is an amount that arose during the current year that would be deemed to be a dividend under s 109C (payment) or s 109F (forgiveness) ITAA36 if the company had a distributable surplus.

Logically, these amounts need to be added back as the amounts have depleted the net assets (being a payment or a forgiveness). If they weren't, the distributable surplus would be artificially lowered by the very transactions that are deemed dividends in that year.

Non-commercial loans

Non-commercial loans are the amount that has been taken to have been paid as a dividend because of Div 7A applying to the amount that is shown as an asset in the financial records (loan still on balance sheet). This is a ny loans still on the balance sheet of the company that have previously been treated as deemed dividends in a prior year. It matters not whether the deemed dividend was included in the assessable income of the recipient.

Most commonly, this would occur when the company has a non-complying loan in an earlier year that was not recognised as a deemed dividend in that earlier year, and that is now out of time to amend. The fact that the loan was not included in the assessable income of the recipient does not impact the inclusion of that amount as a subtraction item as a non-commercial loan. This is a known deficiency and was due for amendment in the proposed revamp to Div 7A.

Where an amount that had previously been treated as a deemed dividend by the company because of the application of s 109XB (Subdiv EA) ITAA36, that amount is also allowed to be a subtraction amount but only where such amounts were included in the assessable income of a shareholder/associate.

Accounting records understate the net assets

The Commissioner has the power to substitute values into the assets/liabilities component of the net assets of a company where the accounting records "significantly" understate (for assets) or overstate (for liabilities) the value of those items.

In TD 2009/5, the Commissioner sets out the manner in which it will deploy this power. Specifically, the ATO notes that they would only do so where there has been a "deliberate, significant understatement of the value of assets (or overstatement of provisions) in the accounting records *with a view to circumventing Div 7A*".

It is also noted that where a company is not allowed to book the market value of assets, owing to accounting standards that apply to it, that would be indicative that there was no attempt to circumvent Div 7A, and the power to substitute values would not be exercised.

At para 28 the ATO states:

> "28. However, as a matter of practice, the Commissioner would not adjust the book value of assets shown in properly prepared accounts merely because the value of internally generated goodwill is omitted, and, more generally, would respect book values shown in proper accounts in the absence of matters pointing to an attempt to circumvent the Division. When, however, it is plain that the company, its shareholders and directors have acted in a way that treats the real and higher value of assets as the true value, regardless of the books, and that the mischief against which Division 7A is directed is present, the Commissioner will substitute those values. In other words, the discretion is there to protect the integrity of the Act, and it will be exercised when it is necessary to do so for that purpose."

Where I am seeing this emerge as an issue is in the preparation of financial statements for SME companies using the tax basis for depreciation, rather than booking normal accounting depreciation with a tax adjustment to reflect the accelerated tax depreciation. This has become more evident post-TFE (temporary full expensing) and IAWO (instant asset write-off) during the COVID-19 years. Many firms only apply tax depreciation in their financial statements, so that the book value of the equipment acquired during the previous 5 years is negligible. As a result, the distributable surplus of these companies may be understated because of the way the company prepares its financials on a tax basis. If a company then took advantage of this outcome to advance loans without consequences from Div 7A, (owing to a $nil distributable surplus), there is a real risk that the Commissioner would invoke the substitution power in s 109Y(2). I am not aware of the Commissioner adopting this approach as yet.

In TD 2009/5, it is clear that the Commissioner seeks to look at the circumstances surrounding the loan and how it may interact with the understatement of the net assets in the financial statements.

The examples in TD 2009/5 are illustrative to a point, but not overly helpful for a real-life client scenario.

Example 1 involves the non-recognition of internally generated goodwill of a company. The goodwill is assessed at market value, and that is disclosed to third parties (such as a financier). The shareholders take out interest-free loans for private purposes. The Commissioner concludes that the power to substitute a value for goodwill is necessary, as the shareholders have had regard to the goodwill and are then accessing the available surplus in the form of a loan.

Example 2 in TD 2009/5 refers to an example where a company owns a property that has increased in value. That increased value has been disclosed to third parties (assuming a financier). When the building is recorded at its cost (common accounting basis of reporting the asset), the company does not have distributable surplus but would do if the market value was substituted onto the balance sheet. In the example, the shareholders borrow funds from the company on an interest-free basis "at-call" loan. The Commissioner concludes that this example would be an appropriate exercise of the market value substitution power.

It appears from the only two examples in TD 2009/5 that the recognition and disclosure of the market value of the understated assets to third parties results in the substitution power being exercised.

In a small number of private binding rulings (PBR; see Table 3), the Commissioner's opinion is more helpful than in the above rulings.

If we combine the Commissioner's statements in TD 2009/5 and various PBRs, the key issues are whether the company is operating on the basis that it has an asset that is worth more than its book value and disclosing such to third parties, and also the use of the loaned funds. An interest-free loan for private use will likely invite attention from the Commissioner. One would think that if the company has not sought to rely on a market value balance sheet, the discretion may not be exercised, but that is far from clear and leaves practitioners in the position of making a "call" for a client with little guidance or seeking their own PBR.

In the Board of Taxation's second discussion paper in its post-implementation review of Div 7A, it noted that the potential inclusion of unrealised gains in the distributable surplus calculation was inequitable where the purported transfer of value (such as a loan) was not permanent. It proposed that unrealised gains were excluded from the calculation or are only included when there is a permanent transfer of value from the company (transfer of asset or forgiveness). As we now know, that proposal was not accepted, and rather, the Treasury proposal in 2018 was to remove the concept of distributable surplus entirely.

Table 3. Binding private rulings dealing with section 109Y(2) discretion

PBR reference	Outcome/comments
1052171363625 (2023)	Internally generated goodwill not recognised. Loan was to fund a share plan. Company had accounting losses. Owing to circumstances of loan (fund a share purchase), it is not an informal distribution of profits. No substitution to market value.
1051781843991 (2020)	Internally generated goodwill not recognised. Market value loan plan for ESS. No disclosure of market value to third parties. Loan to incentivise employees and loans could not be used for private use. No substitution to market value.

Section 109ZC: later dividends

If an amount that has been taken to be a deemed dividend is later partly or wholly set off by an unfranked dividend (an actual dividend), the dividend is not assessable to the recipient.

The provision also applies where a loan is made to an associate of a shareholder that was deemed to have been a dividend is then set off by an unfranked dividend to a shareholder.

This provision is important to ensure that the recipient of the unfranked dividend is not subject to tax twice on the same amount of profits.

I have not seen this provision operate in practice; a practitioner would not declare an unfranked dividend to a recipient of a loan that has been subject to Div 7A and deemed to be a dividend in an earlier year. I feel that the preferred course of action would be a forgiveness of that loan, relying on the exclusion in s 109G(3) ITAA36 addressed above.

There is a corresponding provision that deals with later dividends to repay a loan arising from the application of Subdiv EA (refer s 109ZCA ITAA36).

The interest "rabbit hole"

I wanted to share an issue I have grappled with for some years where an acceptable solution continues to evade me.

Section 109D(1) sets out the conditions for a loan made during a year that results in a deemed dividend. One of the key features of s 109D (and Div 7A generally) is that the amount of the loan that can be potentially dealt with under Div 7A is the amount of the loan that has not been repaid by lodgment day for the company.

Therefore, if a loan is made in the 2025 year of income and the loan is fully repaid by 30 November 2025 (2025 return not lodged until 31 March 2026), Div 7A is not an issue for the loan under s 109D. For completeness, s 109D(6) defines "lodgement day" as the earlier of the actual lodgement date or due date for that year's return.

This theme is continued in s 109E to determine the MYR for the loan. The formula for the calculation of the MYR in any year is shown in Diagram 9.

ATO ID 2010/82 sets out how the MYR is made in the second year of a loan, and in particular, how repayments made before lodgment day are treated.

In the ATO ID, the example below (with more current dates) is examined.

A company made two loans during the 2025 year to a shareholder:

- Loan 1: $50,000; and
- Loan 2: $25,000.

Both loans were placed under complying loan agreements.

After 1 July 2025, the shareholder made the following repayments:

- $20,000 against the $50,000 loan—*before* lodgment day; and
- $8,000 ($4,000 against each loan)—*after* lodgment day.

The ATO concluded the following:

- in the MYR formula, the amount not repaid by the end of the previous year of income was $55,000, being the loans made in 2025 less the repayments made before lodgment day; and
- the full $28,000 repayments are allowed to be used as the repayment.

Generously, it appears that repayments made before lodgment date assist on two fronts. First, they lower the MYR, and second, they are treated as a repayment. The ATO note that the definition of "amalgamated loan" in s 109E(3) contains only constituent loans not fully repaid by lodgment day.

They then conclude that the reference to an amount of the loan in the s 109E(6) formula is a reference to an amalgamated loan:

> "In the context of section 109E of the ITAA 1936, the reference to 'loan' in the subsection 109E(6) of the ITAA 1936 formula must be a reference to the 'amalgamated loan'. As already noted, the quantum is determined at the private company's lodgment day for the year in which the constituent loans were made. In the present case, the quantum is determined at 15 May 2010.
>
> The apparent tension in terms of whether an amalgamated loan can have an 'amount of loan not repaid by the end of the previous year of income' when calculating the initial minimum yearly repayment, is resolved by subsection 109E(3) of the ITAA 1936. That subsection amongst other things treats the amalgamated loan as having been made during the income year in which the constituent loans were made. It must follow that the quantum at the end of that income year is the amount subsection 109E(3) tells us it is, which is determined at the private company's lodgment day. In the present case, this means the amount of the

Diagram 9. Minimum yearly repayment formula

$$\frac{\text{Amount of loan not repaid by the end of the previous year of income} \times \text{Current year's benchmark interest rate}}{1 - \left[\frac{1}{1 + \text{Current year's benchmark interest rate}}\right]^{\text{remaining term}}}$$

amalgamated loan not repaid by the end of the 2008-09 income year is $55,000."

Good news as far as I can tell. However, that is not my issue.

My issue is the role of interest when the loan is fully repaid by lodgment day. If we change the above example, and the shareholder fully repays the loan before lodgment day, the formula in s 109E(6) will produce an MYR of $nil and the loan is not affected by Div 7A.

However, when you use the ATO MYR calculator and repay the loan before lodgment day, it calculated interest on the running balance of the loan from the subsequent 1 July until the loan is repaid. A copy of the ATO calculation is provided in the Appendix to this article. I assumed a $250,000 loan made in the 2025 year and fully repaid the day prior to lodgment (28 February 2026).

The results of the calculator confirm that the MYR has been satisfied, but that the loan has an outstanding balance of $13,873 (representing daily interest on $250,000 for 123 days before the loans is fully repaid).

It is my understanding that the ATO calculator was amended in or around 2015 to include interest on a loan fully repaid by lodgment day, whereas prior to the change, no interest was recognised. I would suggest that perhaps the change was inadvertent, but given you provide the dates of repayments and also lodgment day in the calculator, it appears a deliberate interpretation.

For those firms that use the calculator, this matter is likely never to arise because there is no need to use the MYR calculator when a loan has been fully repaid in the first year after the loan was made. I submit that I don't think the ATO's calculator correctly reflects s 109E and the logic applied in ATO ID 2010/82.

It may make a significant difference for larger loans.

"Out of time" deemed dividends

It is essential when you discover an historical Div 7A issue in a prior year that you consider the relevant amendment period that may apply to the recipient of the deemed dividend before you unnecessarily panic.

Although there has been extensive discussion of the amendment periods that might apply to a particular client, it is important to realise that the 2022 amendments to the *Income Tax Assessment (1936 Act) Regulations 2025* (Cth) (refer reg 14) have extended the number of taxpayers with a 4-year amendment period. It is prudent to adopt a starting point of 4 years, and then see whether you can work your way through elimination to a 2-year period.

Regardless, once you have determined that the historical Div 7A foul occurred in a year where the amendment period has elapsed, you have several options on how to manage the loan.

Where a client has a non-complying loan and the amendment period for approaching the ATO has genuinely expired, the following options are available:

- have the client repay the loan; or
- have the company forgive the loan.

Section 109G(3) excludes a forgiveness of a loan from being a deemed dividend under s 109F where the private company is taken to have paid a dividend in relation to that loan in an earlier year. The way the provision was drafted does not require that the amount was included in the assessable income in an earlier year, but rather that it was taken to be a deemed dividend. When there is a loan that was not dealt with properly in an earlier year, a deemed dividend did actually arise, so this provision applies. The fact that the recipient of the loan did not include the deemed dividend in their assessable income is of no relevance to the application of s 109G(3).

This apparent shortcoming was identified in the Board of Taxation's 2012 discussion paper:

> "4.50 Under subsection 109G(3) the private company is not taken to have paid a dividend because of the forgiveness of an amount of a debt resulting from a loan if, because of the loan, the private company is taken under section 109D to pay a dividend at the end of the income year or an earlier one. The private company only needs to have been taken to have paid a dividend under section 109D with no reference to the amount of the dividend taken to have been paid which could be $nil if no distributable surplus."

The same analysis may apply (as the Board of Taxation note above) where a loan was advanced when the company did not have a distributable surplus in the year the non-complying loan was advanced. Such a loan (assuming it was not placed on complying terms) would trigger s 109D, but the amount of the dividend would be reduced to nil. That would allow a future forgiveness to be covered by the exclusion in s 109G(3).

Naturally, it would be advisable for a detailed review of the matter before proceeding to forgive the loan. In addition, one should consider whether the forgiveness is subject to fringe benefits tax and the commercial debt forgiveness rules (if applicable).

Death of the borrower and MYR

I recently had a call from a colleague. The call came in mid-June, and she was quite concerned about a Div 7A issue she was faced with prior to 30 June.

The issue was that her client had passed away in the 2025 financial year. At the time of his death, he had significant Div 7A loans owing to his private company. She was concerned about how to make the MYR before 30 June 2025, and the executors were concerned about a deemed dividend arising to the estate.

I shared with her ATO ID 2002/741, in which the Commissioner confirmed a few matters with regard to a Div 7A loan owed by a person who passes away during the year:

- The ATO confirmed that death does not trigger a deemed dividend to the estate where the deceased had not made the minimum repayments prior to death.
- The ATO also confirmed that there was no deemed dividend even where the estate did not make the MYR for several years after the debtor's death.

The logic applied by the Commissioner is that s 109E (shortfalls in MYR) can only apply to the same entity to whom the loan was made. In the case where the loan was made to a person who passes away, it is executor who becomes the debtor at law.

The result is that once a person dies, the obligation to make MYR is removed and s 109E cannot apply to the shortfall in MYR.

Recent ATO rulings/alerts

The ATO continue to issue rulings, determinations and alerts that deal with Div 7A matters. I thought it would be helpful to briefly address some of the more recent developments.

TD 2025/5: role of section 109R and notional loans

This very recent TD (released 20 August 2025) addresses the interaction between the disregarded repayments power in s 109R to cases where there is a notional loan owing to the interposed entity provisions, rather than an actual loan.

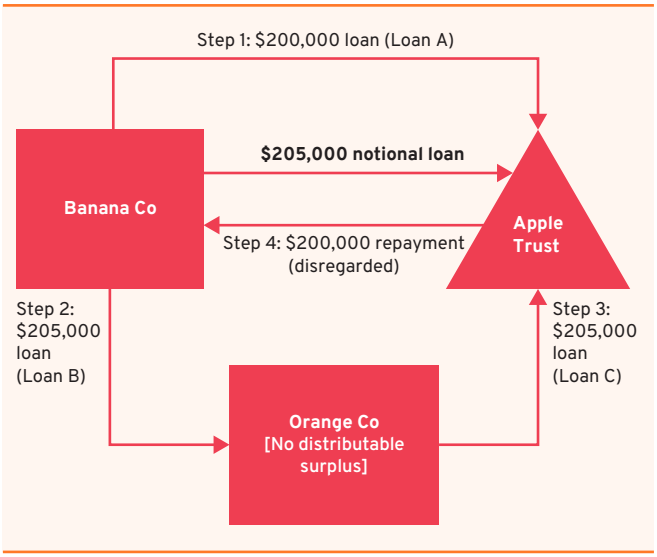
Not surprisingly, it is the Commissioner's view in the TD that:

- s 109R can be applied to disregard certain loan repayments made to a private company where the repaying entity is taken to have obtained a loan from a private company because of s 109T and s 109W; and
- where a private company is taken to have made a notional loan because of s 109T and s 109W, s 109R can apply to disregard certain repayments when determining how much (if any) of that loan was been notional repaid.

As with many Div 7A matters, the mechanics are best illustrated by an example. Below is Example 1 from TD 2025/5:

> "***Example 1 – a trust obtains a notional loan from a private company to repay a loan from the same private company***
>
> Apple Trust, Banana Co and Orange Co are controlled by the same family group. Apple Trust has minimal liquid assets and requires working capital to operate its business. Banana Co is a private company with a distributable surplus of $400,000. Orange Co is a private company that has no distributable surplus. Banana Co's lodgment day for the 2023 income year is 15 May 2024.
>
> The following transactions occur:
>
> - 30 March 2023: Banana Co lends $200,000 to Apple Trust – Loan A
> - 10 May 2024: Banana Co lends $205,000 to Orange Co – Loan B
> - 11 May 2024: Orange Co lends $205,000 to Apple Trust – Loan C
> - 14 May 2024 (the day before Banana Co's lodgment day for the 2023 income year): Apple Trust repays Loan A in full."

The diagram from the example shows the above transaction flow:



You can see the mischief here. The loan at Step 1 (loan 1) is an actual loan of $200k. However, it is repaid via a loan via Orange Co (with no distributable surplus). Sections 109T and 109W would operate to treat the Apple Trust has having a notional loan, with the funds from the notional loan being used to repay the actual loan. The actual loan was replaced by a notional loan. The Commissioner considers that s 109R could be applied to disregard the repayment at Step 4 so that the actual loan would remain on foot and would be a deemed dividend (given the loan was not repaid by lodgment day).

TD 2025/6: guarantees and section 109U

This TD is discussed above under the heading "Section 109U", concerning guarantees being provided to third parties.

TA 2023/1: use of holding company to access profits tax-free

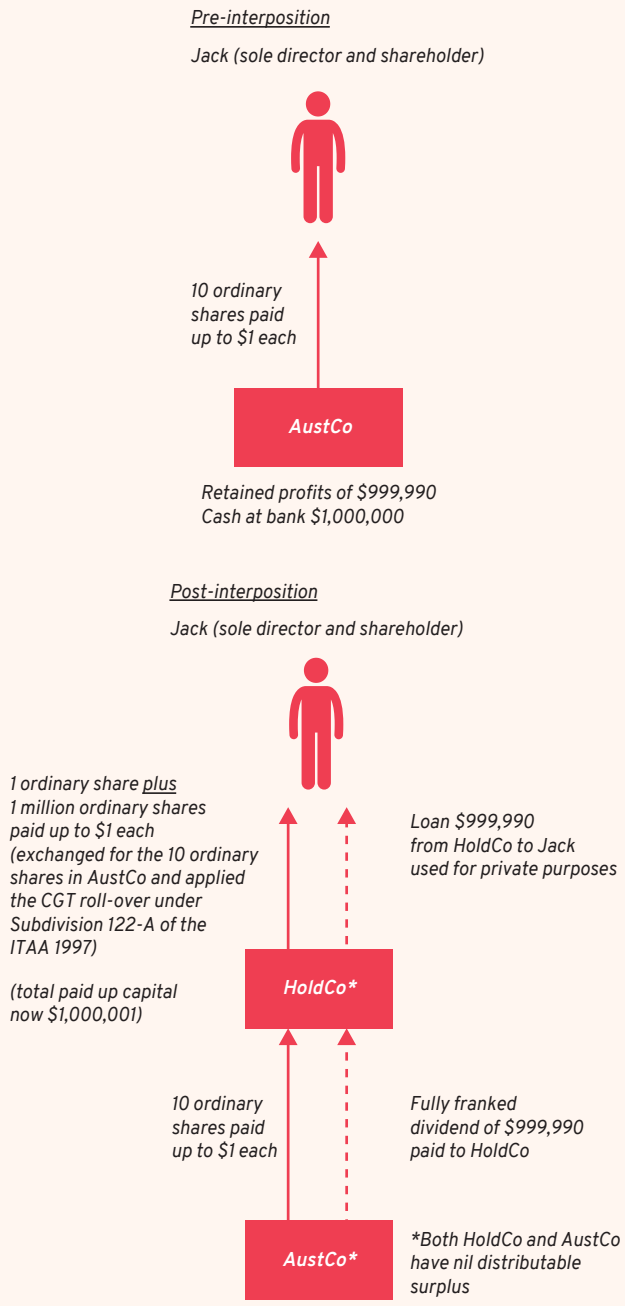
This alert relates to the purported extraction of company profits by using a CGT roll-over (Subdiv 122-A or Div 615 of the *Income Tax Assessment Act 1997* (Cth)) and interposing a holding company between the shareholders and the private company with retained profits.

The ATO sets out this scheme as shown in Diagram 10.

The concept revolves around the accounting entries for the interposed entity. In the above example, it is argued that the interposed company's balance sheet would be:

- cash on hand $1;
- investment in Sub $1,000,000; and
- issued capital $1,000,001.

Diagram 10. From TA 2023/1



When the dividend is received for $999,990, the holding company would apply against the investment in Subsidiary (as pre-acquisition profits).

As a result, Hold Co has no distributable surplus, and it is positioned that Div 7A does not apply to the loan to Jack (which was originally sourced from profits of Austco).

Naturally, the Commissioner feels there are a number of areas where this strategy could offend the tax laws.

TA 2024/2: third party guarantees

This alert addresses the above situation (refer "Section 109U" heading) where a private company provides a guarantee to a financial institution who lends a related private company with no or limited distributable surplus. That company then provides a loan to the target entity.

Post-Bendel crystal ball

I have a little secret to share—the vast majority of tax practitioners in the SME or private business space don't share an interest in the nuances of the *Bendel* case as some of us do. I don't imagine that the average accountant is reviewing the transcripts from the High Court hearing recently, as I was keen to do.

The average "reasonable" accountant simply wants to know what they need to do to be compliant. There is a general feeling that the position we have been taking post-2009, of converting the unpaid distributions owing to companies into Div 7A loans in the subsequent year, works extremely well. Clients understand that the process, and importantly, the rigour, of making MYR on those loans encourages clients to start thinking of their corporate beneficiary as an investment vehicle and accumulating wealth in the companies.

In the period from 2010 until 2021, I was brave enough to recommend, to a small number of clients whose affairs warranted it, the use of the sub-trust investment agreement (7 or 10 years). However, in hindsight it merely achieved two things:

1. just deferred the issue of transferring wealth to the corporate beneficiary; and
2. confused the client beyond belief, and now has them wondering why we are still paying interest on a 2015 sub-trust.

What we have had since 2022 is a consistent approach—UPEs turn into loans. I contend that it really has worked. Therefore, secretly, I have been hoping the ATO prevails, despite the judicial odds being stacked against it to date.

I often verbalise when training accountants on Div 7A that this whole mess and uncertainty could have been avoided by a simple amendment to s 109D to include unpaid distributions as a loan or financial accommodation in 2009 or 2010. The fact that it was not done is disappointing.

I remember in 2010 learned tax experts expressing concern that the ATO's position in TR 2010/3 and PS LA 2010/4 was based on a falsity that a UPE automatically became a loan, absent any action by the parties involved. This litigation was a long time coming!

I have been asked to cover what I think the post-*Bendel* landscape will look like. This is my best assessment:

- the ATO prevails in the High Court. The court holds that a UPE is in fact a form of financial accommodation and subject to s 109D. We go back to the way things were from 2010 until 2024; or

- the court dismisses the ATO's appeal and accepts the Full Federal Court's decision. A UPE is not a form of financial accommodation. The ATO will likely lobby for prompt legislative amendments (which should have occurred 15 years ago) or if that process is not achievable, revert to threatening the use of s 100A and deploying Subdiv EA to the extent that the trust makes loans or payments relevant to that subdivision.

In an intellectual sense, the *Bendel* case is extremely important, but on a day-to-day basis, it is more than likely from a simplicity and client discipline perspective that the conversion of UPEs to Div 7A loans, consistent with the ATO's position, makes a lot of sense.

The main client type that may benefit from a "win" in *Bendel* would be trusts that re-invest the company UPE in the trust's business with no leakage of loans/payments to the controllers such that Subdiv EA is not triggered. However, with the spectre of s 100A (however correct), it may be best to see where this lands and what the ATO do before committing to the UPE/Subdiv EA pathway.

I would respectfully ask the ATO officers who might read this article to spare a thought for us accountants, trying to navigate through this uncertainty with clients who don't share our level of interest. If we have chosen to apply Mr Bendel's position after the Full Federal Court's decision and that is soon overturned by the High Court, I hope that you provide us with the ability to self-rectify and move forward, without penalty or adverse action against our clients.

Stephen Holmes, CTA
Partner
WMS Tax & Advisory

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Disclaimer

The material and opinions in this article are those of the author and not those of The Tax Institute. The material and opinions in the article should not be used or treated as professional advice, and readers should rely on their own enquiries in making any decisions concerning their own interests.

References

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2 ATO, *Loans by private companies*. Available at https://www.ato.gov.au/businesses-and-organisations/corporate-tax-measures-and-assurance/private-company-benefits-division-7a-dividends/in-detail/division-7a-loans.

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5 *Howard and FCT* [2019] AATA 1910.

6 It was also acknowledged by the AAT that the loan agreement was not in fact executed prior to the lodgment date of the relevant return for the year in any event, making the discretion a moot point.

7 ATO, *What is corrective action*? Available at https://www.ato.gov.au/businesses-and-organisations/corporate-tax-measures-and-assurance/private-company-benefits-division-7a-dividends/in-detail/division-7a-exercise-of-commissioner-s-discretion-under-section-109rb#ato-Whatiscorrectiveaction.

Appendix

Result

Minimum yearly repayment met.

The amount of the loan not repaid at the end of income year 2025–26 is $13,873.56.

The amalgamated loan will not be taken to be a dividend because the total repayments made are equal to or greater than the minimum yearly replayment required for income year 2025–26.

Interest received by the private company must be included in the income tax return for 2025–26.

Minimum yearly repayment

$0

Benchmark interest rate

8.37%

Opening balance:

Date: 30/06/2025

Balance: $250,000.00

Days: 242

Interest: $13,873.56

Payments

Date: 28/02/2026

Amount: $250,000.00

Balance: $0

Days: 123

Interest: $0

Total repayments

$250,000.00

Total interest

$13,873.56

Total principal

$236,126.44

Closing balance

Date: 30/06/2026

Balance: $13,873.56