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PRACTITIONER ARTICLES

[1067] Determining amount of a deemed dividend under "interposed entity" rules in Div 7A – some concerns about *Howard* case

by Nicole Sammel, Nicole Sammel Tax Lawyers

Where a deemed dividend arises under the "interposed entity" rules in Division 7A, how do you determine the **amount** of the deemed dividend? This question was addressed in the recent case of *Howard and FCT [2019] AATA 1910*, reported at 2019 WTB 32 [1056].

This article provides a brief refresher on how the "interposed entity" rules in Division 7A operate; summarises what *Howard* says about how to determine the amount of a deemed dividend under the interposed entity rules; and raises a concern about the potential implications of *Howard*.

"Interposed entity" rules in Division 7A – a refresher

Under the "ordinary" rules in Division 7A, if a private company ("**PC**") makes a payment or loan to a shareholder or an associate of a shareholder ("**Related Party**") and the payment or loan is not an *actual* dividend, the amount of the payment or loan can nevertheless be included as an unfranked *deemed* dividend in the hands of Related Party. These rules aim to discourage arrangements that allow Related Party to benefit from PC's profits without incurring liability to "top-up" tax on the profits (where liability to top-up tax *would* have arisen had PC distributed the profits via an actual dividend).

Next, the "interposed entity" rules in Division 7A ensure that PC cannot avoid the operation of the "ordinary" rules in Division 7A by making a payment or loan to Related Party via an *interposed entity*. Under the "interposed entity" rules, an unfranked deemed dividend can be included in the hands of Related Party even where PC does not make a payment or loan to Related Party; but instead makes a payment or loan to an interposed entity and the *interposed entity* directly or indirectly on-pays or on-lends an amount to Related Party.

Specifically, under the "interposed entity" rules, an unfranked deemed dividend can arise for a Related Party of PC (referred to as "Target") including where (s 109T):

- PC makes a payment or loan to a second entity ("**Interposed Entity**") which payment or loan is not caught as a deemed dividend under the "ordinary" rules in Division 7A [**TRANSACTION 1**];
- Interposed Entity makes a payment or loan to Related Party ("**Target**") [**TRANSACTION 2**]; and
- a reasonable person would conclude, having regard to all the circumstances, that PC made the payment or loan to Interposed Entity solely or mainly as part of an arrangement involving a payment or loan to Target.

A deemed dividend can arise for Target even if Transactions 1 and 2 occur at different times and/or involve different amounts (subs 109T(2)); and, significantly, even if the payment or loan from PC to Interposed Entity in Transaction 1 *is included in the assessable income of Interposed Entity* (subs 109X(1)(b)).

Amount of deemed dividend – legislation

Given that there are at least 2 separate transactions in an "interposed entity" arrangement (ie, (i) the payment or loan from PC to Interposed Entity; and (ii) the payment or loan from Interposed Entity to Target) and that these transactions could well involve different amounts, it is not immediately obvious what should be the amount of the deemed dividend in Target's hands.

The legislation merely states that the amount of the deemed dividend is "determined by the Commissioner" (subss 109V (1) and 109W(1)); and that, in determining the amount of the deemed dividend, the Commissioner must take account of (a) how much Interposed Entity paid or lent to Target; and (b) whether the amount Interposed Entity paid or lent to Target was consideration payable to Target for anything (subss 109V(2) and 109W(2)). This wording ***leaves open the question of what, if any, other factors, the Commissioner may or must take into account*** in determining the amount of the deemed dividend in Target's hands.

Amount of deemed dividend – *Howard*

In *Howard*, the Applicant argued that, in determining the amount of a deemed dividend in Target's hands, the Commissioner should take into account whether the payment or loan by PC to Interposed Entity (ie, the Transaction 1 amount) has been included in the assessable income of any taxpayer. Specifically, the Applicant argued that if the payment or loan from PC to Interposed Entity (under Transaction 1) has been included in the assessable income of Interposed Entity or some other entity, then the amount of the deemed dividend in Target's hands should be nil.

The Tribunal rejected this argument. It concluded that the fact the Transaction 1 amount may have been included in the assessable income of the Interposed Entity and/or other entities "**does not enter into the determination of the amount of** [the deemed dividend in Target's hands]". The Tribunal based its conclusion on the following factors:

- The legislation expressly states (in subs 109X(1)(b)) that a deemed dividend can arise for Target even where the payment or loan from PC to Interposed Entity (under Transaction 1) is included in the assessable income of Interposed Entity.
- The legislation does not expressly state (in subs 109W(2)) that the Commissioner should or can take into account, in determining the amount of the deemed dividend in Target's hands, that the Transaction 1 amount has been included in another entity's assessable income.
- The wording in subs 109W(2) (re how the Commissioner is to determine the amount of the deemed dividend in Target's hands) can be contrasted with the wording in s 109RB (re how the Commissioner is to determine whether to disregard a breach of Division 7A which has arisen due to an honest mistake or inadvertent omission). For the purposes of the Commissioner determining whether to disregard a breach under s 109RB, subs 109RB(3) requires the Commissioner to have regard to certain stipulated matters, as well as to "**any other matters that the Commissioner considers relevant**". By way of contrast, for the purposes of the Commissioner determining the amount of a deemed dividend under s 109W, subs 109W(2) merely requires the Commissioner to take account of certain stipulated matters (see above) – it says nothing about the Commissioner taking account of other matters he considers relevant.

The Tribunal also noted the ATO's submission that "it was not intended, in determining the amount of [the deemed dividend in Target's hands], that the Commissioner should have to cast around to see what the interposed entity, and less still its shareholders or beneficiaries, might have included in their assessable income". However, the Tribunal seems to have placed less weight on this factor in coming to its conclusion than it did on the other three factors above.

Implications of *Howard*

The Tribunal seemed to be suggesting that, as a matter of statutory construction, in determining the amount of a deemed dividend in Target's hands under the interposed entity rules, the ATO is not to take into account that the Transaction 1 amount has been included in an entity's assessable income.

While the Tribunal's statutory interpretation may be correct, I query whether this interpretation will always give rise to appropriate outcomes.

To achieve appropriate outcomes, the ATO *should* be permitted, in my view, to have regard to whether the Transaction 1 amount is included in the assessable income of any entity; and if it is, also to **whether the entity is liable to "top-up" tax** in respect of the amount.

Where Transaction 1 does NOT give rise to "top-up tax" liability

It is certainly possible for the Transaction 1 amount to be included in the assessable income of an entity without *giving rise to any top-up tax liability* for the entity. This could occur, for example, if Transaction 1 is the payment by PC of, say, a $3 million franked dividend and Interposed Entity is a trust that resolves to distribute the franked dividend to another group company.

If Interposed Entity trust then makes an interest-free loan or pays $3 million to an individual Target (who would have been liable to top-up tax had PC paid the $3 million franked dividend directly to Target or if the trust had resolved to distribute the $3 million franked dividend to Target), the effect (ignoring the interposed entity rules) is that Target benefits from the $3 million dividend amount but no entity is liable to top-up tax on the $3 million. Since this is precisely the outcome the interposed entity rules are designed to prevent, the fact that the Transaction 1 amount has been included in the assessable income of another entity should not be taken into account in determining the amount of the deemed dividend in Target's hands under the interposed entity rules – in other words, in this particular factual situation, the deemed dividend amount in Target's hands under the interposed entity rules should be $3 million, not nil.

Thus, the application of *Howard* to this particular factual situation (where the Transaction 1 amount is assessable but does **not** give rise to a top-up tax liability) results in an appropriate outcome.

Where Transaction 1 DOES give rise to "top-up tax" liability

On the other hand, one can imagine a situation where the inclusion of the Transaction 1 amount in an entity's assessable income does give rise to a "top-up" tax liability for the entity. Consider, for example, the situation where PC pays a franked dividend of $3 million to its sole shareholder, a parent (who is liable to top-up tax on the franked dividend) ("**Parent**"); and Parent then loans the $3 million, interest free, to their adult child ("**Adult Child**"), in order that Adult Child can, say, purchase a property. This arrangement is caught under the "interposed entity" rules because (i) PC has made a payment to an Interposed Entity (Parent), which payment is not a deemed dividend under Division 7A (because it is an actual dividend); (ii) Interposed Entity (Parent) has made a payment to Adult Child who is an associate of PC's shareholder; and (iii) a reasonable person would conclude that PC made the payment to Parent solely or mainly as part of an arrangement involving a payment to Adult Child. When the ATO determines the amount of the deemed dividend in Adult Child's hands, one would expect the appropriate outcome to be a deemed dividend of **nil** – because it would be outrageous if Adult Child were required to pay tax on the $3 million gift from Parent given that Parent is liable to top-up tax on the franked dividend from PC.

While the ATO is unlikely to pursue Adult Child for tax re the $3 million gift in this situation (given that the arrangement does not involve any tax mischief and doing so would result in double taxation), the ***decision in Howard leaves open the possibility that the ATO could pursue Adult Child for tax on the $3 million gift***, and may in fact be obliged to do so. This is because *Howard* seems to say that, in determining the amount of the deemed dividend in Adult Child's hands, the ATO is not to take into account that the dividend from PC to Parent has been included in Parent's assessable income.

Thus, the application of *Howard* to this particular factual situation (and likely also to various other scenarios where the Transaction 1 amount both is assessable and gives rise to a top-up tax liability) results in an inappropriate outcome.

Conclusion

In light of *Howard*, the Government should perhaps seek to amend ss 109W and 109V of Division 7A to allow the ATO to take into account "any matters it considers relevant" in determining the amount of a deemed dividend under the interposed entity rules in Division 7A. Such an amendment would mean that, in determining the amount of the deemed dividend in Target's hands, the assessability of the Transaction 1 amount could be taken into account *where appropriate* (eg, where it gives rise to a top-up tax liability), but need not otherwise be taken into account.

Unless and until that happens, tax advisers should be cautious in how they couch advice about the tax implications of payments or loans sourced from private company profits which ultimately end up (after passing through an intermediary) in the hands of a related party of the private company. The profits may technically be an unfranked deemed dividend in the related party's hands *even if* the intermediary is liable to tax on the profits.

[1068] DPNs to extend to cover GST - Directors and shadow directors exposed!

by Jack Stuk, National Tax Principal, KHQ Lawyers, President NTAA and Angelo Mazzone, Trainee Lawyer, KHQ Lawyers

Snapshot: the changing landscape

The ATO has, following the passage of amending legislation (see below), recently extended its ability to hold a rogue director accountable for unpaid tax liabilities of their company (which would include a company acting as trustee of a trading trust). This has been achieved through the strengthening of the suite of recovery legislation at its disposal. It's illustrative of the ATO's ever-broadening but proper focus on tax compliance. The "Phoenix Industry" has been allowed to flourish for far too long. In this article, we explore the sweeping implications of Director Penalty Notices (DPNs), particularly with respect to increasingly common 'shadow director' arrangements and how innocent but inadvertent directors can be exposed to this fiscal fracas.

Under the long standing PAYG withholding scheme and its predecessors, the ITAA 1997 requires companies to withhold a portion of employee wages to meet tax liabilities. Similarly, companies have an obligation to pay a superannuation guarantee charge (SGC) under the *Superannuation Guarantee (Administration) Act 1992* (SGA Act). Failure to meet PAYG and SGC obligations by the relevant respective due dates exposes company directors to personal liability equal to the unpaid amount, unless there has been proper reporting and the timely placement of the impecunious company into liquidation or administration or establishing, what case law has demonstrated to be difficult to prove, statutory defences.

On 13 February 2019, the *Treasury Laws Amendment (Combatting Illegal Phoenixing) Bill 2019* (***Phoenixing Bill***) was introduced into Parliament. Provisions in Schedule 3 of the Phoenixing Bill propose to extend existing director liability and DPN provisions for unpaid PAYG withholding amounts and SGCs to GST debts. As a result, directors of both public and private companies will also become personally liable for outstanding GST debts in the event of non-compliance, generating even greater disincentive for directors to defer GST payments.

The House of Representatives was dissolved on 11 April 2019 ahead of the Federal election. Thus, all Bills that had not passed Parliament at that time lapsed, including the *Phoenixing Bill* and will need to be re-tabled if the newly elected coalition Government is to proceed with the measures, which appears likely.

The status of the relevant legislation is provided below:

