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 **IPA** INSTITUTE OF PUBLIC ACCOUNTANTS

## Solving Inherited Problems – Division 7A

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## Solving Inherited Problems – Division 7A

### Objective of this Presentation

- To identify payments, loans, amalgamated loans and forgiven debts that may be treated as deemed dividends under Division 7A ITAA36.
- To identify the role that the concept of “distributable surplus” has in determining whether a deemed dividend exists.
- To clarify how unpaid present entitlements (UPEs) (amounts owing by trusts to companies) may be classified and managed in the context of Division 7A.
- Managing existing and inherited Division 7A problems.
- Identify strategies by which existing Division 7A loans can be reduced or eliminated in a tax effective manner.



## Solving Inherited Problems – Division 7A

### Deemed Dividends – The Starting Point

Division 7A treats 3 kinds of amounts as dividends paid by a private company:

- Amounts **paid** by the company to a shareholder or shareholder's associate [Section 109C ITAA 36](#)... See also [Section 109CA ITAA 36](#).
- Amounts **lent** by the company to a shareholder or shareholder's associate [Section 109D ITAA 36](#) and [Section 109E ITAA 36](#)
- Amounts of debts owed by a shareholder or shareholder's associate to the company that the company **forgives** [Section 109F ITAA 36](#)
- Division 7A applies to non-residents [Section 109BC ITAA 36](#)
- An associate is defined in [section 318 ITAA 36](#).
- Deemed dividends are generally un-frankable whereas deemed dividends arising from a family law obligation may be franked, [s 109RC ITAA36](#).



## Solving Inherited Problems – Division 7A

### Payments as Dividends – Some Points

- A private company is taken to pay a dividend to an entity at the end of the private company's year of income if the private company pays an amount to the entity during the year and either:
  - (a) the payment is made when the entity is a shareholder in the private company or an associate of such a shareholder; or
  - (b) a reasonable person would conclude (having regard to all the circumstances) that the payment is made because the entity has been such a shareholder or associate at some time, [s 109C ITAA36](#).
- Payment to an entity includes the provision of an asset for use by the entity which can include the provision of property under a lease or licence, [s 109CA ITAA36](#) – exceptions exist.
- Value of Payment - the amount that would have been paid for the provision of the asset by the parties dealing at arm's length less any consideration given for the provision of the asset by the entity, [s 109CA\(10\) ITAA36](#).



## Solving Inherited Problems – Division 7A

### Loans as Dividends – Some Points

- A private company is taken to pay a dividend to an entity at the end of one of the private company's years of income (the current year ) if:
  - (a) the private company makes a loan to the entity during the current year; and
  - (b) the loan is not fully repaid before the lodgment day for the current year; and
  - (c) [Subdivision D](#) does not prevent the private company from being taken to pay a dividend because of the loan at the end of the current year; and
  - (d) either:
    - (i) the entity is a shareholder in the private company, or an associate of such a shareholder, when the loan is made; or
    - (ii) a reasonable person would conclude (having regard to all the circumstances) that the loan is made because the entity has been such a shareholder or associate at some time, [s 109D ITAA36](#).

The amount of the dividend is the amount of the loan that has not been repaid before the lodgment day for the current year, subject to [s 109Y ITAA36](#).

A loan includes an advance of money, a provision of credit or any other form of financial accommodation or a transaction (whatever its terms or form) which in substance effects a loan of money, [s 109D\(3\) ITAA36](#).



## Solving Inherited Problems – Division 7A

### Loans as Dividends – Minimum Payments

- [Taxation Determination TD 98/22](#) demonstrates how the benchmark interest rate is used in calculating the minimum yearly repayment.
- To calculate the minimum repayments you can access an [ATO Online Calculator](#)
- The Commissioner has the discretion under [s 109Q ITAA36](#) to disregard a Division 7A dividend if the minimum yearly repayment was not made because of circumstances beyond the entity's control and the entity would suffer undue hardship if the loan was taken to be a deemed dividend.
- The Commissioner has the discretion to disregard a deemed dividend that arises because of an honest mistake or an inadvertent omission, [s 109RB ITAA36](#) and to extend the period for repayments of an amalgamated loan, [s 109RD ITAA36](#).
- Some repayments of loans are disregarded, [s 109R ITAA36](#).



## Solving Inherited Problems – Division 7A

### Payments and Loans – Not Dividends

- Payments of genuine debts (arm's length basis) ([Section 109J](#));
- Payments and loans to other companies other than in the capacity as trustee ([Section 109K](#)), See *Di Lorenzo Ceramics Pty Ltd v FCT* (2007) 67 ATR 42;
- Payments and loans that are otherwise assessable or that are specifically excluded from assessable income ([Section 109L](#));
- Loans made in the ordinary course of business on ordinary commercial terms ([Section 109M](#)) see also [Taxation Determination TD 2008/1](#);
- Loans that meet criteria for minimum interest rate ([benchmark interest rate](#)) and maximum term ([Section 109N](#)) – for a complying loan agreement see [Taxation Determination TD 2008/8](#);
- Certain loans and distributions by liquidators ([Section 109NA](#)); and
- Loans that are for the purpose of funding the purchase of certain ESS interests under an employee share scheme ([Section 109NB](#)).





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### Forgiven Debts – Some Points

- Under [s 109F ITAA36](#) a private company is taken to pay a dividend to an entity (at the end of the company's income year) if all or part of a debt owed to the company by the entity is forgiven during the year, [TD 2008/14](#).
- A debt is also taken to be forgiven if the private company will not insist on the entity paying the debt or rely on the entity's obligation to pay the debt, [s 109F\(6\) ITAA36](#).
- A deemed dividend may arise if a shareholder dies and the debt is forgiven during administration of the deceased's estate, [ATO ID 2012/77](#).
- The amount of the dividend equals the amount of debt forgiven, subject to [s 109Y ITAA36](#).
- Whether a debt is "forgiven" is determined in accordance with the commercial debt forgiveness provisions in [Division 245 ITAA97](#).



## Solving Inherited Problems – Division 7A

### Distributable Surplus

- [Section 109Y ITAA 36](#) provides that there is a proportional reduction of deemed dividends so they do not exceed the distributable surplus.
- A private company's distributable surplus for its year of income is the amount worked out using the formula:  
 Net Assets + Division 7A amounts  
 Less:  
 Non-commercial Loans + Paid up share value + Repayments of non-commercial loans
- "Division 7A amounts" is the total of any section 109C or 109F dividends in the year of income.
- "net assets" means the amount (if any), at the end of the company's year of income, by which the company's assets (according to the company's accounting records [ID 2009/5](#)) exceed the sum of:
  - the present legal obligations of the company (see [TD 2012/10](#)) and provisions for depreciation, provisions for annual leave and long service leave, provisions for amortisation of intellectual property and trademarks and other provisions prescribed under the regulations.

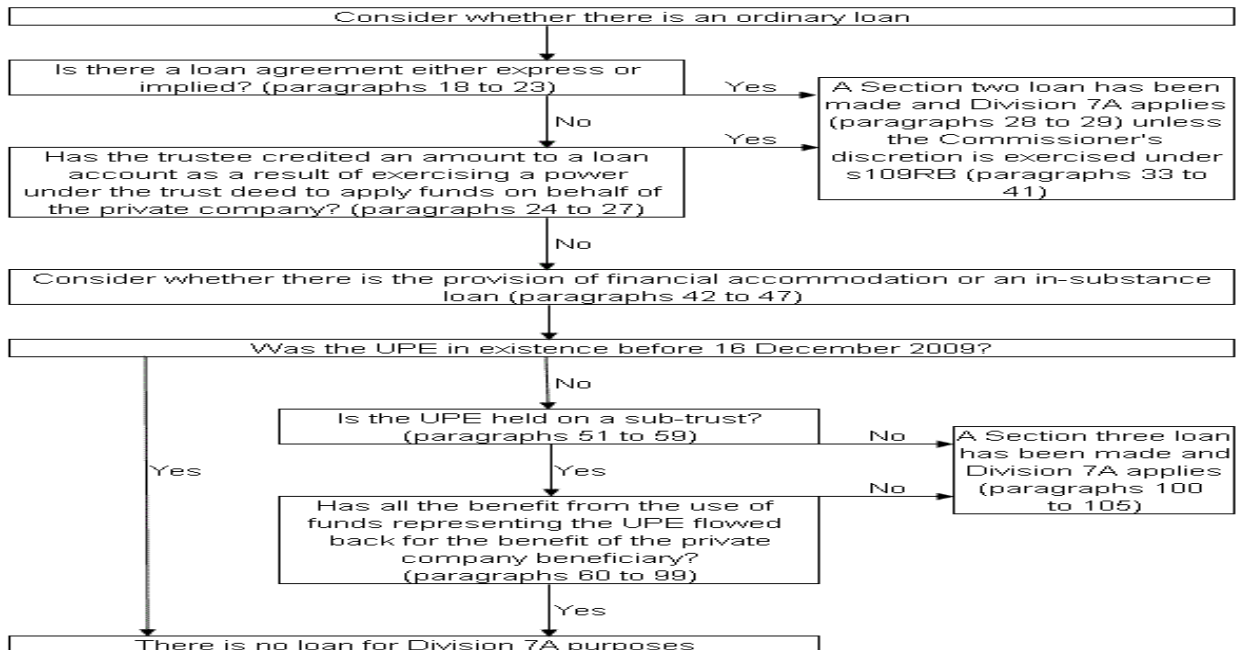


## Solving Inherited Problems – Division 7A

### Unpaid Present Entitlement

- The Commissioner has indicated he will apply Division 7A where there is an unpaid present entitlement (UPE) from a trust to an associated private company, [TR 2010/3](#).
- The rationale is that if a present entitlement is unpaid, it is at least a form of financial accommodation and therefore a loan as defined.
- If the trust is a shareholder or, as may be more common, an associate of a shareholder in the private company, then there is a direct application of [s 109D ITAA36](#).
- The mischief that the Commissioner's approach on this issue is directed to is that by creating a present entitlement – without a payment of funds – the trustee is avoiding tax on what would otherwise be accumulated income and taxed under [s 99A ITAA36](#).
- [PSLA 2010/4](#) describes “section three loans” which are essentially financial accommodation provided by the company to the trust.
- A trust can convert the financial accommodation to a “sub-trust”.

### Trusts and UPEs - [PSLA 2010/4](#) – Flow Chart



## PSLA 2010/4 – Section Three Loan Summary

	<b>Option 1 - interest only 7-year loan</b>	<b>Option 2 - interest only 10-year loan</b>	<b>Option 3 - invest in a specific income producing asset or investment</b>
<b>Amount of the annual return</b>	Main trust to pay interest calculated at the Benchmark interest rate to the sub trust.	Main trust to pay interest calculated at the Prescribed interest rate to the sub trust.	Sub trust is entitled to receive the share of net return (e.g. interest income or rental income) derived as a result of the specific asset or investment to the sub trust.
<b>Nature of the annual return</b>	Interest.	Interest.	Depends on the specific asset or investment.
<b>Repayment of the funds representing the UPE (the principal)</b>	The principal must be repaid at the end of the 7-year loan.	The principal must be repaid at the end of the 10-year loan.	The principal must be repaid by the lodgment day of the tax return of the private company beneficiary for the year in which the investment ends.
<b>Deductibility of the annual return</b>	Yes, the amount is deductible to the main trust provided that the trustee of the main trust satisfies section 8 1 of the ITAA 1997.	Yes, the amount is deductible to the main trust provided that the trustee of the main trust satisfies section 8 1 of the ITAA 1997.	No.
<b>Assessability of the annual return</b>	Yes, the amount is assessable to the private company beneficiary.	Yes, the amount is assessable to the private company beneficiary.	Depends on the specific asset or investment.
<b>Sub-trust tax return</b>	Not required.	Not required.	Required.



## Solving Inherited Problems – Division 7A

### Ongoing Division 7A Issues

- Prior to 2009 it was considered to be best practice to operate a business through a discretionary trust and make distributions to a corporate beneficiary so that the tax rate would be capped at 30%.
- With the advent of [TR 2010/3](#) and [PS LA 2010/4](#) clients that continue to distribute to corporate beneficiaries must either:
  - Cash flow distributions to corporate beneficiaries;
  - Enter into a sub-trust arrangement as set out in [PS LA 2010/4](#); or
  - Let the UPE convert into a section three loan (subject to Division 7A).
- Given that many businesses are unable to cash flow the distribution to the corporate beneficiary then the only options are to enter into a sub-trust (7 or 10 year interest only loan) or convert the UPE to a Division 7A loan.
- Where a trust continues to make distributions to a corporate beneficiary the potential future liability continues to accumulate... when/how will it end?



## Solving Inherited Problems – Division 7A

### Problems with repaying Division 7A loans

- The payment of a dividend by the company to the shareholder to enable the shareholder to make annual payments can give rise to top-up tax.
- Paying franked dividends will reduce the franking credits available for future distributions.
- Debt reduction can generally only occur out of after taxed funds... in other words a Division 7A loan could be considered to be just a temporary strategy which will have to be unwound eventually.
- Sub-trust loans which do not require principal payment defer the principle repayment problem for up to 7 to 10 years but we are now just 7 years since those sub-trusts commenced.
- Given that in many cases repayment of the loan will require top-up tax to be paid consideration should be given to just paying a franked dividend to the shareholder in the first instance rather than making a loan to the shareholder... a lot less administration!



## Solving Inherited Problems – Division 7A

### Problems with repaying Division 7A loans

- One option - Where sufficient unencumbered depreciating assets are present the trust could consider transferring/selling those items to the corporate beneficiary to partly or fully offset the sub-trust or Division 7A loan liabilities owing by the trust to the corporate beneficiary.
- The depreciating assets could then be rented back to the trust by the company at commercial rates. Actual rent would need to be paid or otherwise the non-payment of the rent may give rise to separate Division 7A concerns.
- Another alternative is the transfer of trading stock owned by the trust to the company and enable the corporate beneficiary to be the wholesaler to the trust.
- Another alternative would be for the trust to transfer the business or active assets of the business to the corporate beneficiary... note the small business roll-over restructuring from 1 July 2016... [Subdivision 328-G ITAA97](#).





## Solving Inherited Problems – Division 7A

### Division 7A – Changes on the Horizon

The Board of Taxation has proposed the following four guiding principles be used in amending Division 7A:

1. Ensuring that the private use of company profits attracts tax at the user's progressive personal income tax rate;
  2. Removing impediments to the reinvestment of business income as working capital;
  3. Maximising simplicity by reducing the compliance burden on business and the administrative burden on the ATO and other stakeholders; and
  4. The accumulation of passive investments funded by profits taxed at the company tax rate should not receive an advantage over the reinvestment of business profits in active businesses.
- Access can be made to the Board of Taxation's [review](#).

The Board developed a reform proposal it called the "Amortisation Model" where the maximum loan period would be 10 years.



## Solving Inherited Problems – Division 7A

### Division 7A – Proposed Changes

Amortisation Model (Preferred)	Interest Only Model (Alternative)
No formal written agreement, but some written/electronic evidence that loan entered by lodgment date	
Interest rate fixed at commencement of loan	Variable interest rate set annually
Statutory interest rate is RBA indicator lending rate for <a href="#">small business</a> ; <a href="#">variable</a> ; <a href="#">other</a> ; <a href="#">overdraft</a>	
Loans repayable over 10 years	No prescribed term for loan
No required annual repayments, but thresholds for % that must be repaid by end of years 3, 5, 8 and 10	No required principal repayments, and reborrowings of principal permitted (allows single pooled loan account)
Business income election to reinvest unpaid present entitlements without triggering div 7A if the trustee agrees to forgo the CGT discount concession on assets other than goodwill	No equivalent



## Solving Inherited Problems – Division 7A

### Division 7A – Proposed Changes

The prescribed maximum loan balances (including any accumulated interest) would be:

- 75% of the original loan by the end of year three
  - 55% of the original loan by the end of year five
  - 25% of the original loan by the end of year eight, and
  - 0% of the original loan (that is, fully repaid) by the end of year 10.
- Interest would be able to be accrued annually but would have to be paid by the end of years three, five, eight and 10.
  - If the fourth policy principle is omitted the Board has recommended an “interest only model”... interest only payments required during the period of the loan.
  - Proposed to apply from 1 July 2018.
  - Self-correction of breaches — replacing the general relieving provision in [s 109RB ITAA 36](#) with a self correction of unintentional breaches.

