

TAX RETREAT NEW CALEDONIA

24 – 25 MAY 2017

Chateau Royal, Noumea

Division 7A – Status Quo

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Session 2



Introduction

Division 7A of Part III of the *Income Tax Assessment Act 1936* (ss 109B to 109ZE) operates to treat certain transactions by private companies on or after 4 December 1997 to be the payment of an unfranked dividend by that company. Those transactions fall into three categories:

- certain loans from a private company;
- certain payments from a private company;
- forgiveness of a debt owed to a private company.

Loans

- Section 109D operates to treat certain loans made by private companies on or after 4 December 1997 to be dividends.

How to approach Division 7A – Loans

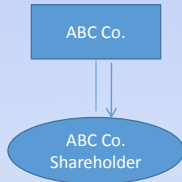
- *Step One* - Has the private company made a "loan" to an entity during the current year?
- *Step Two* - Is the entity to which the loan has been made a shareholder or associate of a shareholder?
- *Step Three* - Has the loan been fully repaid by the lodgement day?
- *Step Four* - Is the loan specifically excluded under Subdivision D?
- *Step Five* - What is the deemed dividend amount?
- *Step Six* - What is the impact on the company's franking account?
- *Step Seven* - Does the loan give rise to an FBT liability?

Step One - Has the private company made a "loan" to an entity during the current year?

- With effect from 1/7/09 a "private company" for purposes of Div 7A includes a corporate limited partnership (CLP)
- What is a "loan"?
- Under s 109D(3) a "loan" includes:
 - an advance of money;
 - a provision of credit or any other form of financial accommodation;
 - a payment of an amount for another person where there is an express or implied obligation to repay that amount; and
 - any transaction which is, in substance, a loan.
- Loan includes direct loans and indirect loans from interposed entities

Step One - Has the private company made a “loan” to an entity during the current year? (continued)

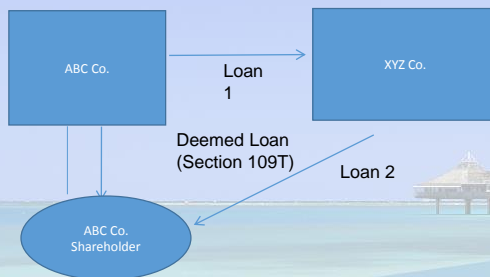
Direct loan to shareholder



- Loan can be repaid or converted to arm’s length loan before tax return due date
- If not repaid or converted, loan becomes Div 7A deemed dividend

Step One - Has the private company made a “loan” to an entity during the current year? (continued)

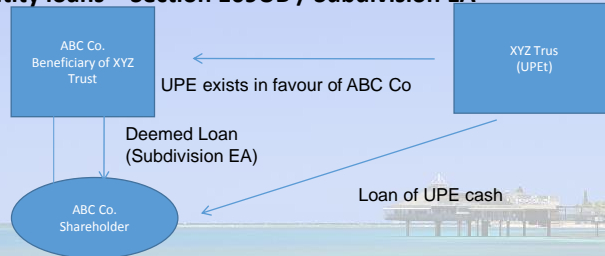
Interposed entity loans – Section 109T



- Deemed loan arises as a result of interposed entity loan
- Deemed loan is repaid or converted to arm’s length loan before tax return due date
- If not repaid or converted, deemed loan becomes Div 7A deemed dividend

Step One - Has the private company made a “loan” to an entity during the current year? (continued)

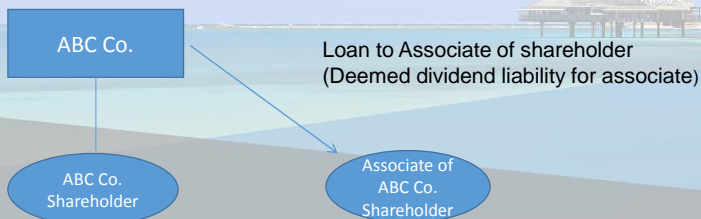
Interposed entity loans – Section 109UB / Subdivision EA



- Deemed loan arises due to UPE in XYZ Trust and loan to ABC Co. shareholder
- Deemed loan is repaid or converted to arm's length loan before tax return due date
- If not repaid or converted, deemed loan becomes Div 7A deemed dividend
- With effect from 1/7/09 interposing additional trust(s) to separate the UPE holder and lender of loan will not avoid the operation of Subdiv EA

Step Two - Is the entity to which the loan has been made a shareholder or associate of a shareholder?

- Div 7A applies to loans for current or past shareholders if reasonable to assume loan is made because of shareholding relationship
- Div7A does not apply to loans for future shareholders
- Loan to associate imposes Div 7A liability on associate not shareholder

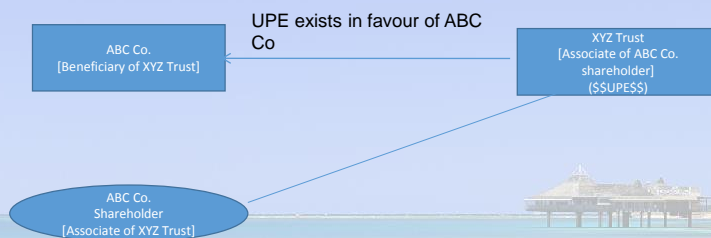


Step Two - Is the entity to which the loan has been made a shareholder or associate of a shareholder? (continued)

- An associate of an individual includes:
 - relative of individual;
 - partner of individual;
 - trust where individual, or an associate benefits under the trust; and
 - company in which individual (either alone or together with associates) holds a majority voting interest.
- An associate of a trust includes:
 - entity that benefits under the trust; and
 - entity which is an associate of another entity which benefits under the trust.
- An associate of a company includes:
 - partner of the company or a partnership in which the company is partner;
 - trust where company, or an associate of company, benefits under the trust; and
 - entity which holds a majority voting interest in the company (either alone or together with associates).

Step Two - Is the entity to which the loan has been made a shareholder or associate of a shareholder? (continued)

Taxation Ruling TR 2010/3 & PSLA 2010/4 – UPE Treatment

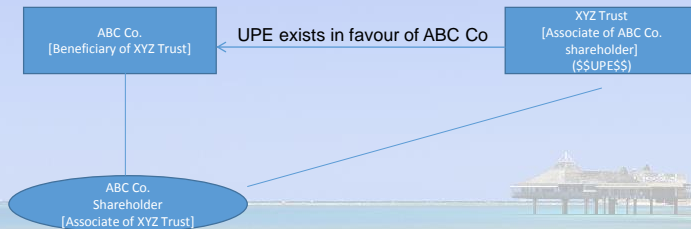


TR 2010/3 - Section 2 Loans

- UPE becomes Section 2 loan if both ABC Co and XYZ Trust treat UPE as loan in accounts (i.e. treated as actual loan)
- Section 2 loan is immediate Div 7A deemed dividend from time treated as loan
- Section 2 loan can be deemed dividend **retrospectively from period before 16 December 2009**
- Section 2 loan can be fixed by repayment or making UPE arm's length loan before tax return lodgement

Step Two - Is the entity to which the loan has been made a shareholder or associate of a shareholder? (continued)

Taxation Ruling TR 2010/3 & PSLA 2010/4 – UPE Treatment

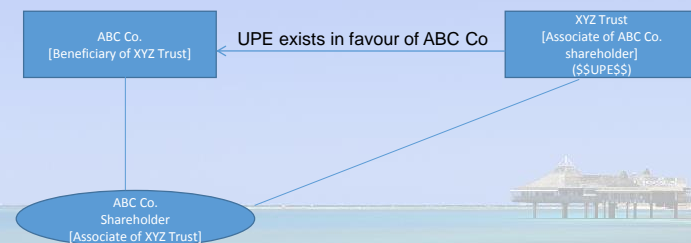


TR 2010/3 – Section 3 Loans

- UPE treated as Section 3 loan if inferred as a loan because of treatment of UPE funds by XYZ trust
- Section 3 loan only Div 7A deemed dividend after 12 months – not immediate deemed dividend
- Section 3 loan provide extra 12 months to repay or make arm'slength

Step Two - Is the entity to which the loan has been made a shareholder or associate of a shareholder? (continued)

Taxation Ruling TR 2010/3 & PSLA 2010/4 – UPE Treatment

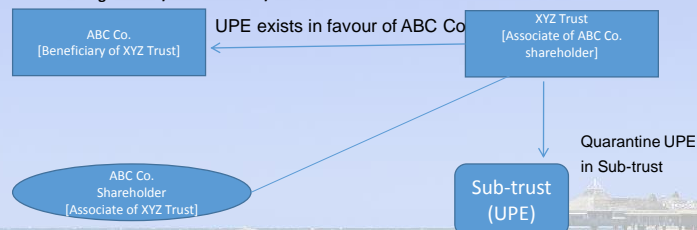


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Step Two - Is the entity to which the loan has been made a shareholder or associate of a shareholder? (continued)

Taxation Ruling TR 2010/3 & PSLA 2010/4 – UPE Treatment



TR 2010/3 – Preservation of UPE status

- Div 7A treatment can be avoided by preserving UPE status
- UPE status preserved by transferring and quarantining UPE in Sub-trust
- Preservation effective if UPE in Sub-trust held only for benefit of ABC Co.
- Return on UPE funds require minimum annual repayment distribution to ABC Co.
- Minimum annual repayment distribution can be based on section 109N benchmark interest rate and section 109NA minimum repayment formula

Div 7A & UPEs

- [TR 2010/3](#) states that where a private company has an unpaid present entitlement (UPE) from an associated trust but the trust uses the monies for its own purposes, Div 7A can have application. Can avoid by
 - fully paying the UPE to the corporate beneficiary before the lodgement day for the trust's income tax return
 - putting a Div 7A loan agreement in place, or
 - putting a sub trust in place – [PS LA 2010/4](#)
- [TD 2015/20](#) states a private company that releases all, or part, of its unpaid present entitlement is making a payment for Div 7A purposes to the extent that the release represents a financial benefit to an entity.

Step Three - Has the loan been fully repaid by the lodgement day?

- A loan is only treated as a dividend if the loan is not fully repaid by the following time:
 - loans in 2003-04 or earlier - end of the year loan was made; and
 - Loans in 2004-05 year or later - the earlier of date on which company lodges income tax return and due date for such lodgement.
- Repayments must be made by way of actual cash repayment or dividend
- Repayments made by way of journal entry, i.e. by capitalising the repayment onto the loan balance, are not accepted.
- Anti-avoidance provision in s109R - application to same or similar loans
- Repayment by way of salary and wages or dividend not subject to s109R

Step Four - Is the loan specifically excluded under Subdivision

The following loans are **excluded** from being dividends under Div 7A:

- A loan to another company (not acting in its capacity as trustee) - 109K
- A loan, included in the entity's assessable income or made exempt - 109L
- A loan made in the ordinary course of business on same terms and conditions as loans made to other parties at arm's length - 109M
- An excluded loan that meets interest rate (7.4%), term (7/25 years) and repayment criteria - 109N (issues – written agreements, converting loans, not making minimum repayments, Commissioner's discretion)
- A loan made in the winding up of a company by liquidator - 109NA 109D(1A)
- A loan to acquire shares under qualifying ESS - 109NB
- Amalgamated loan not treated as dividend in year in which made – subject to Commissioner's discretion - s109P / s109Q

Step Five - What is the deemed dividend amount?

- Deemed dividend cannot exceed **distributable surplus** of the company at **year end** (s 109Y(1)).
- From 1 July 2009 distributable surplus formula is:

Net assets + Division 7A amounts – Non-commercial loans – Paid-up share value – Repayments of non-commercial loans

- **Net assets** - amount by which company's assets exceed sum of:
 - the present legal obligations of the company; and
 - provisions for depreciation, annual leave, long service leave, and amortisation of intellectual property and trademarks
- **Div 7A amounts** – C/Y payments / forgiven debts – previously excluded
- Accounting basis – cannot over/under value - Commissioner can re-state
- *Fresta v FCT* 2002 ATC 2061 - provision for income tax is a “present legal obligation”, as company is liable for income tax at year end notwithstanding that it is not due and payable until assessed.

Case Study - Div 7A

- On 1 January 2016 A Pty Ltd loaned \$15,000 to John, a shareholder of A Pty Ltd. No qualifying written agreement was in place, or repayments made, before the lodgment day of A Pty Ltd's 2016 income tax return.
- Assume no other payments or loans to shareholders or their associates for the income year ended 30 June 2016. Assume no Div 7A amounts and that in prior years there were no loans treated as dividends under Division 7A

Case Study - Div 7A

Balance sheet of A Pty Ltd as at 30 June 2016

Assets	
Cash	10,000
Stock	20,000
Plant	30,000
Loan to John	<u>15,000</u>
Total assets	75,000
Liabilities	
Creditors	<u>55,000</u>
Net assets	<u>20,000</u>
Shareholders' funds	
Paid-up share capital	12,000
Retained profits	<u>8,000</u>
Equity	<u>20,000</u>

Case Study - Div 7A

- On 30 June 2016 A Pty Ltd is taken to pay a dividend to John.

Distributable surplus formula

Net assets	\$20,000
Less: non-commercial loans (that is, loans treated as dividends in prior years)	\$0
Less: paid-up share capital	\$12,000
Less: repayments of non-commercial loans	\$0
Distributable surplus	\$8,000

Case Study - Div 7A

- Although \$15,000 was loaned to John, the amount treated as a dividend will be reduced to A Pty Ltd's distributable surplus of \$8,000. John includes \$8,000 in his 2016 tax return as an unfranked dividend
- The remaining \$7,000 is not treated as a dividend in the income year ended 30 June 2016, and will **not** be treated as a dividend in a future year even if the company has a distributable surplus in that future year

Step Six - What is the impact on the company's franking account?

- From 1 July 2006, no franking debit arises in a company's franking account as a result of the operation of Division 7A.

Step Seven - Does the loan give rise to an FBT liability?

- Loans that are Division 7A deemed dividends specifically excluded
- Effective 1 April 2007, a loan that complies with the requirements of Division 7A excluded loan is not a fringe benefit.

Commissioner's Discretion under Division 7A

- One-off opportunity to correct past mistakes - (*Practice Statement PS LA 2007/20*) until 30 June 2008
- However after 30/06/08, Commissioner can still apply discretion in cases of an honest mistake or inadvertent omissions (s 109RB).
- Formal request for discretion required after 30 June 2008.

ATO Backflip - ATO ID 2013/15: UPE and bad debt deduction

- This ATO ID considers whether a beneficiary of a trust, is entitled to a bad debt deduction for UPE amounts that have been written off as bad debts
- For bad debt deduction under section 25-35, debt must be actually written off and amount must have been included in assessable income previously
- ATO view – UPE is equity entitlement not a “debt”, so cannot be bad debt
- Even if structured as an equity debt, amount not the same as included in taxpayer’s assessable income previously
- No bad debt deduction available to taxpayer

Board of Taxation Recommendations - Consultation Paper (Dec 2012)

1. Division 7A Adjustment Model

- Address the individual issues and problems in Division 7A by way of specific legislative amendment.

2. Statutory Interest Model

- Impose requirement that loans to related entities carry a statutory rate of interest, but no requirement that principal be repaid prior to termination of the loan.

3. Distribution Model

- Allow the retention of profits within the private group for permitted purposes and to treat any profits not so used, and not distributed, as deemed dividends (which would be able to be franked).

Board of Taxation Recommendations - Consultation Paper (Dec 2012)

1. Division 7A Adjustment Model

Potential issues to be specifically fixed –

- UPE classification,
- distributable surplus quantification,
- interposed entity identification and treatment,
- loan and payment definitions,
- categorisation of exclusions,
- repayment compliance requirements, etc
- scope and effect of Commissioners discretionary powers

- Advantage - could deal with specifically known issues.
- However, has potential to be mere piecemeal solution and may fail to significantly simplify the law or its understanding.

Board of Taxation Recommendations - Consultation Paper (Dec 2012)

2. Statutory Interest Model

- Related party loans at legislatively prescribed interest rate
- Progressive (actual) loan repayments may not be necessary and re-borrowings (of principal) would be permitted.
- Uncomplicated model - interest on the loans assessable to payee (whether paid or not) but not deductible to payer
- Interest only- principal not be repaid prior to termination of loan
- Interest rate to be at commercial rate – current Division 7A benchmark interest rate too low
- Allows for retention of loans over prolonged terms
- Issue – ignores that Division 7A also applies to “payments” and “forgiven debts”

Board of Taxation Recommendations - Consultation Paper (Dec 2012)

3. Distribution Model

- Allow retention of profits within the private group for permitted purposes
- Any profits not so used, and not distributed treated as deemed dividends (but frankable)
- Retained profits would be taxed at company tax rate
- Deemed dividends would be taxed at the personal tax rate of relevant shareholders.
- Permitted purposes - use of profits for working capital and other active business purposes of the private company or related entity
- Use of the profits for passive investment purposes not permitted,
- Acquisition of active assets used in an active business allowed

Board of Taxation – Div 7A recommendations - Supplement

- Set of common principles for loans, payments, debt forgiveness
- Simpler system in which asset revaluations will not be required and unrealised profits not taken to be distributed because company assets have been used, and company profits tested each year
- Single 10-year loan with flexibility for repayment of principal
- A 'tick the box' option for trading trusts to retain working capital funds taxed at corporate tax rate - trading trusts that make election denied 50% CGT discount except in relation to goodwill.
- Alternative system that removes uncertainty on the treatment of UPEs by clarifying that all UPEs are loans for Division 7A purposes.
- Self correction mechanism which would enable taxpayers to put in place complying loan agreements, reduce compliance and administrative costs

Board of Taxation Report – Division 7A Recommendations

Key Recommendations

- No requirement for formal written agreement if evidence of loan
- Statutory interest rate set at the start of the loan and fixed over the term of the loan and would be RBA indicator lending rate for small business immediately before start of that income year.
- The maximum loan term would be 10 years.
- Prescribed maximum loan balances during the term of the loan (including any accumulated interest) would be as follows:
 - – 75 per cent of the original loan by the end of year three;
 - – 55 per cent of the original loan by the end of year five;
 - – 25 per cent of the original loan by the end of year eight; and
 - – 0 per cent of original loan (i.e., fully repaid) by end of year 10.

Board of Taxation Report – Division 7A Recommendations

Key Recommendations

- Transitioning all other pre-existing Division 7A loans to the new 10-year loans from the application date of the new provisions.
- All existing complying seven-year loans would have their terms extended to the new maximum of 10 years;
- **All pre-1997 loans would be deemed to be new complying Division 7A loans, with a 10-year term starting from the application date of the new provisions**

Board of Taxation Report – Division 7A Recommendations

Key Recommendations

- Introducing a legislative amendment that allows trusts to make a once-and-for-all election for loans from companies (including UPEs owing to companies) to be excluded from the operation of Division 7A.
- ensuring that a trust that makes such an election (an excluded trust) forgoes the CGT discount on capital gains arising from assets other than goodwill and 'intangible assets inherently connected with the business carried on by the trustee'

Board of Taxation Report – Division 7A Recommendations

Key Recommendations

- Qualifying taxpayers can self-assess their eligibility for an exception to Division 7A that will operate to reverse the effect of a prior deemed dividend.
- Eligibility for the exception will be based on satisfying two criteria:
 - It is reasonable to infer, on the basis of objective factors, that the conduct that caused the deemed dividend was unintentional; and
 - Appropriate steps have been taken to ensure that affected parties are placed in the position they would have been in had the dividend not arisen.

Board of Taxation Recommendations - Consultation Paper

- Board of Taxation (Final) Report to Government
- Treasury - Exposure Draft (consultation) - June 2017

Federal Budget Announcement Changes recommended to Div 7A

- In the May 2016 Budget, the Government announced it is proposing to amend Division 7A with effect 1 July 2018 to include:
 - a self-correction mechanism providing taxpayers whose arrangements have inadvertently triggered Div 7A with the opportunity to voluntarily correct their arrangements without penalty;
 - new safe harbour rules, such as for use of assets, to provide certainty and simplify compliance for taxpayers; and
 - amended rules, with appropriate transitional arrangements, regarding complying Div 7A loans, including having a single compliant loan duration of 10 years and better aligning calculation of the minimum interest rate with commercial transactions.

ATO factsheet common Div 7A errors

- The ATO has issued a factsheet highlighting common errors it encounters in relation to Division 7A. It covers:
 - Funds from a shared bank account
 - Intra-group loans for business purposes
 - Minimum yearly payment
 - Division 7A applies to associates of shareholders
 - A UPE can be considered a loan

Division 7A - Payments

A private company will be taken to pay a dividend where the company pays an amount to an entity during the year (s 109C).

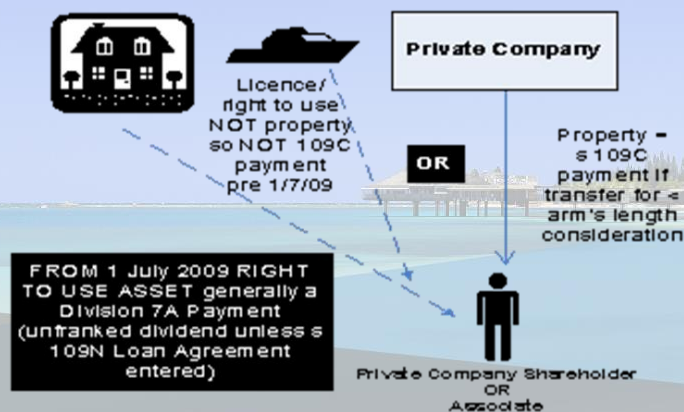
- *Step One* - Has the private company made a payment to an entity during the current year?
- *Step Two* - Is the entity to which the payment was made a shareholder or associate?
- *Step Three* - Is the payment specifically excluded under Subdivision D?
- *Step Four* - What is the deemed dividend amount?
- *Step Five* - What is the impact on the company's franking account?
- *Step Six* - Does the payment give rise to an FBT liability?

Step One - Has the private company made a payment to an entity during the current year?

Section 109C(3) provides that "payment" means:

- a payment to the extent that it is to the entity, on behalf of the entity or for the benefit of the entity;
- a credit of an amount to the extent that it is:
 - to the entity; or
 - on behalf of the entity; or
 - for the benefit of the entity; and
- a transfer of property to the entity
- Deemed payments through interposed entities
- Trust payments under Subdivision EA
- Payments are convertible into loans from 1 July 2006.
- From 1/7/09 use of assets are treated be Div 7A payments

Step One - Has the private company made a payment to an entity during the current year? (continued)



Step One - Has the private company made a payment to an entity during the current year? (continued)

Use of company assets by shareholders/associates – Exclusions:

- \$300 minor benefit exclusion
- Business real property exclusion
- Main residence exclusion
- “Otherwise deductible” exclusion

Step Two - Is the entity to which the payment has been made a shareholder or associate?

Section 109C - A private company will be taken to have paid a dividend to an entity, if the company pays an amount to an entity and either:

- the payment is made when the entity is a shareholder in the private company or an associate of such a shareholder; or
- 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.
- Div 7A liability resides with recipient of payment

Step Three - Is the payment specifically excluded under Subdivision D?

The following payments are not dividends under Div 7A:

- Payments of genuine debts - 109J
- Payments to other companies - 109K
- Payments that are otherwise assessable or that are specifically excluded from assessable income - 109L
- Exclusions for payment required under Law or Court judgement – exception for relationship breakdown

Div 7A Update - [TR 2014/5](#)

- When a private company pays money or transfers property to satisfy a court order in matrimonial property proceedings, the Ruling states
 - **Money or property to be paid or transferred to a shareholder** - to the extent paid out of the private company profits and is an ordinary dividend, it is assessable income of the shareholder under s 44
 - **Money or property to be transferred to an associate of a shareholder** - the payment of money or transfer of property is a payment for the purposes of s 109C(3). In addition, s 109J does not prevent the payment from being treated as a dividend under s 109C(1)
 - **Dividends frankable** – payments that amount to ordinary dividends are frankable. Where a dividend is taken to be paid to an associate of a shareholder under s 109C is franked, that associate is treated as being a shareholder

Step Four- What is the deemed dividend amount?

- The dividend is taken to equal the amount paid, subject to the distributable surplus of the company at year end.
- The basis and method for calculating distributable surplus is same as for Div 7A loans
- **Net assets + Division 7A amounts – Non-commercial loans – Paid-up share value – Repayments of non-commercial loans**

Step Five - What is the impact on the company's franking account?

- As with Div 7A loans, there is no impact on the company's franking account

Step Six – Does payment give rise to an FBT liability?

- Division 7A will not apply where a payment is made to a shareholder or associate in their capacity as employee (s 109ZB(3)).
- However, FBT may be payable in those circumstances.
- If FBT applies to the payment Div 7A will not operate to deem a dividend.

Division 7A – Debt Forgiveness

- A private company is taken to pay a dividend to an entity at the end of the company's year of income if all or part of a debt the entity owed the private company is forgiven (s 109F).
- *Step One* - Has the private company forgiven all or part of a debt owed to the company?
- *Step Two* - Is the entity which owed the debt a shareholder or an associate of a shareholder?
- *Step Three* - Is the debt forgiveness specifically excluded under Subdivision C?
- *Step Four* - What is the deemed dividend amount?
- *Step Five* - What is the impact on the company's franking account?
- *Step Six* - Does the debt forgiveness give rise to an FBT liability?

Step One - Has the private company forgiven all or part of a debt owed to the company?

- A debt is forgiven by a private company for the purposes of s 109F if:
 - the debtor's obligation to pay the debt is released, waived or otherwise extinguished
 - a creditor loses its right to sue the debtor for recovery of the debt because of the operation of a State or Territory statute of limitations
 - a debtor is effectively released from the obligation to pay the debt despite the existence of arrangements that continue the indebtedness for a period
- “Debt parking” also constitute debt forgiveness
- Statute barred debts
- Limitation can be stopped by:
 - a **written acknowledgment**, signed by debtor, that debt is still outstanding, is provided to the lender;
 - **part payment** of the loan principal or interest.
- PS LA 2006/2 GA – ATO not to pursue pre-4/12/97 statute barred debts
- Application of Subdivision EA

Step Two - Is the entity which owed the debt a shareholder or an associate of a shareholder?

- Shareholder and associate criteria same as for loans and payments.
- Div 7A liability resides with beneficiary of debt forgiveness

Step Three - Is the debt forgiveness specifically excluded under Subdivision C?

- The following forgiven debts are specifically excluded from the operation of Div 7A and therefore cannot be taken to be a dividend.
- Forgiveness of debt owed by another company (not acting in its capacity as trustee) - 109G(1)
- Forgiveness of debts under the *Bankruptcy Act* - 109G(2)
- Forgiveness of a loan which has already given rise to a dividend - 109G(3)
- Where the Commissioner treats the debt forgiveness as not giving rise to a dividend - 109G(4)
- The Commissioner may treat forgiveness as not being a dividend if:
 - the debt was forgiven because payment of the debt would have caused the entity undue hardship;
 - when the entity incurred the debt it had capacity to pay; and
 - the entity lost the ability to pay the debt in the foreseeable future as a result of circumstances beyond the entity's control.

Step Four- What is the deemed dividend amount?

- The amount of the dividend equals the amount of the debt forgiven, subject to the company's distributable surplus.
- Calculation of distributable surplus same as for loans and payments
- **Net assets + Division 7A amounts – Non-commercial loans – Paid-up share value – Repayments of non-commercial loans**

Step Five - What is the impact on the company's franking account?

- No impact on the company's franking account.

Step Six – Does the debt forgiveness give rise to an FBT liability?

- If Div 7A applies to deem a dividend where a private company forgives a debt, no FBT liability will arise (s 109ZB(2)).
- However, if the debt forgiveness is specifically excluded from the operation of Div 7A an FBT liability may arise if the forgiveness is in respect of the employment of the relevant employee.

THANK YOU



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