INCOME TAX:
DIVISION 7A
AN INTRODUCTION

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1. Introduction

The provisions of Division 7A of the tax act are relatively new. The original provisions were enacted in 1998 to give effect to an announcement in the 1997 budget.

Since then it has undergone many amendments and in turn, the ATO has clarified its interpretation of the various provisions to create the complex web of law we currently have.

It has also been a hot topic for the ATO in their compliance activities and once again we see Division 7A listed as a priority in the small to medium enterprise sector.

2. Why Division 7A?

The policy intention of Division 7A when originally enacted was to attack attempts to avoid tax on distributions disguised as loans or other forms of credit.

Arguably the provisions do much more than this in their current form and thus no longer match the original intention of the then Government in 1997.

The Division 7A provisions replaced one provision of the old tax act which by 1997 had been rendered largely ineffective. Section 108 of the 1936 act sought to tax the distribution of private company profits through the guise of advances or loans to associated persons.

3. The Purpose Of This Paper

The purpose of this paper is not to give an in-depth analysis of the principles and provisions of Division 7A.

This paper is intended as an introduction to Division 7A for bookkeepers and small to medium business owners. It has been designed and written to:

- Briefly explain the major concepts of Division 7A
- Briefly explain the ways the problem can be rectified
- Discuss as examples some of the very common situations where Division 7A applies

It is the belief of Mobility Accounting Solutions that if the client and the bookkeeper who is involved in the affairs of the business understand some of the basic principles of this legislation, they will be able to either identify or seek advice on transactions or activity which may be caught by the provisions.

This early identification is vital. As readers will see later in this paper, the earlier a problem can be identified, the easier it is to fix in many situations.

4. Division 7A & Companies

a) Payments Treated As Dividends

"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:

i. ***The payment is made where the entity is a shareholder in the private company or an associate of such a shareholder or,***
ii. ***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."***

SOURCE: ITAA 1936 Section 109c(1)

Whilst this may seem to be a fairly innocent statement, it is very far-reaching in its application when one considers the meaning of the key terms of that definition. Those key terms are Payment, Entity and Associate.

A payment is defined in the law to mean:

- A payment on behalf or for the benefit of the entity
- A credit of an amount on behalf of or for the benefit of the entity
- A transfer of property to the entity

Further to this, in 2009 another amendment was put through to amend the definition of payment to include the use of an asset by the entity.

Entity is defined to include virtually all types of legal entities including:

- Individuals
- Body corporates
- Partnerships
- Unincorporated associations
- Trusts
- Superannuation funds

The term Associate is also a widely defined term. The full definition of the term is quite complex and is contained in Section 318 of ITAA 1936. For a full definition of Associate, see Appendix 1 to this paper, however for the purposes of this discussion, assume that if a person or an entity is somehow related to the company directly or indirectly, they will mostly likely be an associate of the company.

<u>Example 1 – Bob The Builder</u>

Bob, a builder of international reputation is the 100% shareholder of Bob Enterprises Pty Ltd. Bob also has a passion for speed boats and as such he directs the company to pay $30,000 for a new engine for his speed boat. Because Bob is a shareholder in the company, the payment to an external party is on his behalf and therefore subject to the Division 7A rules.

<u>Example 2 – Wendy</u>

Wendy is Bob the builder's de-facto spouse. During the 2011 financial year, Bob Enterprises Pty Ltd transfer some building materials purchased by the company at trade prices to Wendy so she can build her private residence next to Bob.

This transaction would qualify as a payment for the purposes of Division 7A.. Whilst the payment is not made to Bob, Wendy is his associate and therefore caught under the law.

<u>Example 3 – The Holiday House</u>

Bob has been super successful in building the construction empire of Bob Enterprises Pty Ltd such that the company purchases a house for the use of Bob and Wendy in the quaint Whilstler region.

Because Bob and Wendy have the ability to use the holiday house for their personal benefit, the transaction would be subject to the rules of Division 7A as a payment.

It is worth noting with Example 3 that there are some exceptions to the rule such as the main residence exemption if the house was purchased prior to July 2009.

In all of these examples, a dividend will be taken to be paid at the end of the income year (June 30 in that financial year) unless some action is taken. These will be discussed later. The amount of the dividend (in most situations but not all) is equal to the amount of the payment and the ATO can treat the amount as unfranked.

b) Loans Treated As Dividends

A private company is taken to pay a dividend to an entity at the end of a year of income if:

1) ***The private company makes a loan to the entity during the current year and***
2) ***The loan is not fully repaid before the last day for lodgement of the company income tax return for that year and***
3) ***The provisions of the Act do not prevent the company from being taken to pay a dividend and***
4) ***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***

SOURCE: ITAA 1936 Section 109b (1)

Once again to fully understand the ramifications of this provision, you will need to understand the key terms of the wording. In this area, it is the term 'Loan'.

A loan for this purpose retains its ordinary meaning and then is extended to include various situations.

In its most basic meaning, a loan is a payment of money to or for someone on the condition that it will be repaid on demand or on a fixed date whether interest is charged or not.

The definition is further expanded to also include the following situations:

- An advance of money
- The provision of credit or any other form of financial accommodation
- A payment of any amount for, on account of, on behalf of or at the request of an entity if there is an express or implied obligation to repay the amount and
- A transaction which in substance effects a loan of money

Loans are the most common form of Division 7A problem, particularly when the extended definition is considered.

<u>Example 4 – Bedrock Enterprises Pty Ltd & Bedrock Trust</u>

Fred Flintstone is the local slate mining magnate in the township of Bedrock. Fred's success is unparalleled in the area and he decides to pay cash for new palatial premises.

To purchase the property, Fred establishes the Bedrock Trust and transfers $3M to the trust from his company Bedrock Enterprises Pty Ltd to allow the trust to complete the settlement. The trust accounts for this amount as a creditor in its financials.

Because Fred controls the Bedrock Trust, the trust will be an associate of the company. The amount transferred to the trust is an advance of money. The result is that the company has made a Division 7A loan to an associate.

Example 5 – Bedrock Trust & Slate Holdings Pty Ltd

Fred Flintstone owns another company Slate Holdings Pty Ltd which receives a $300,000 distribution at 30 June 2011 from the Bedrock Trust.

The distribution is effected by journal in the books but not paid to the company. Fred controls both the Bedrock Trust and Slate Holdings Pty Ltd.

The distribution or unpaid present entitlement from the trust is a form of financial accommodation (according to the ATO) and therefore within the extended definition of a loan. The amount of $300,000 is subject to the rules of Division 7A.

Once again in these examples, a dividend will be taken to be paid if no action is taken. The amount of the dividend is equal to the amount of the loan and subject to a company's distributable surplus. Any dividend will be unfranked.

c) Forgiven Debts Treated As Dividends

A private company is taken to pay a dividend to an entity at the end of the private company's year of income if all or part of the debt owed to the private company is forgiven in that year and:

1) **The amount is forgiven when the entity is a shareholder in the private company or an associate of such a shareholder or**
2) **A reasonable person would conclude having regard to all the circumstances that the amount is forgiven because the entity has been a shareholder or associate at some time.**

   SOURCE: ITAA 1936 Section 109f (1)

This section is relatively easy to understand and mirrors the other two previously discussed. If a company forgives a debt owing to it, the amount will be taken to be a dividend subject to various exceptions and other rules to be discussed.

Example 6 – Klampett Oil Pty Ltd & Jethro Klampett

Klampett Oil Pty was established with the accidental discovery of oil on the Klampett family farm. The company makes a loan of $500,000 to Jethro Klampett a member of the family to establish a fast food franchise using the recipes of his grandmother. In the 2011 financial year, the company forgives the debt owed by Jethro.

Because Jethro is a shareholder of Klampett Oil Pty Ltd, the forgiven amount of $500,000 will be treated as a dividend.

The amount of the dividend is equal to the amount of the loan and subject to the company's distributable surplus. Any dividend paid in this way is unfranked.

5. <u>Exclusions From Division 7A</u>

In the previous section, the basic rules were presented as to how Division 7A will work in various situations. However, there are some exceptions to the rules.

Although minor in operation, in certain circumstances they can be used to exclude various situations from Division 7A

These rules include:

- Exceptions to the use of asset rules for minor benefits (less than $300), otherwise deductible expenditure and certain dwellings including a principal place of residence
- Exclusion from the rules where the amounts are between companies
- Exclusion from the rules where the amounts are converted to loans within the meaning of the law
- Exclusion if the amount is treated as assessable income by the payee
- Loans repaid before the company's tax return lodgement day
- Loans in the ordinary course of business

6. <u>Rectification Under The Law</u>

Rectification of a Division 7A issue can take many forms and will be dependent upon the nature of the item in question. Indeed some Division 7A problems such as debt forgiveness cannot be rectified at all and so the best action possible is to reduce the impact of the law.

Any rectification generally needs to occur on or before the lodgement day of the company's tax return for that year. Depending on the classification of the company with the ATO, in 2012 this will generally be one of three dates – January 15, March 31 or May 15 for Division 7A problems arising in the year to 30 June 2011. If the company's financial year end is not 30 June, then a different date may apply.

Also where rectification is possible, some thought will need to be given to the distributable surplus. Any deemed dividend under these provisions is limited to a company's distributable surplus. This term is used to define the amount able to be distributed to members by a company.

Distributable Surplus	=	Net Assets	+	Division 7A Amounts	-	Non-Commercial Loans	-	Paid -Vs- Share Capital	-	Non-Commercial Loan Repayments

Lastly, where a Division 7A amount arose in a prior year without any corrective action being taken, rectification is still possible. However the taxpayer will need to apply to the ATO and be granted a discretion to do so. It is the understanding of Mobility that only 40% of applications for discretion are being approved, therefore caution and careful preparation of the application documents are required.

Where possible, there are generally three forms of rectification:

- Repayment of the loan
- Declaring the dividend
- Entering into a Division 7A loan agreement

A. Loan Repayment

It is possible to avoid the application of the provisions where any loan or Division 7A amount (except debt forgiveness) is repaid on or before the company's lodgement day for income tax.

<u>Example 7 – Crazy Frog</u>

Crazy Frog Promotions Pty Ltd makes a Division 7A loan to its shareholder Mr CR Frog before 30 June 2011. The company's tax return is due for the 2011 year on 15 March 2012. On 29 September 2011, Mr CR Frog repays the loan in full.

Because the loan was repaid on or before lodgement day of the company's 2011 tax return, the Division 7A amount which existed at 30 June can be disregarded.

B. Declaring The Dividend

It is also possible to avoid the operation of the provision if the taxpayer declares the dividend before the amount is deemed to be a dividend under the law.

Sometimes on careful consideration of the circumstances, it is unlikely that the funds will ever be returned to the company. If that is the case, declaring and paying the dividend (the ATO Objective) will avoid the operation of the provisions. It would be better to take this strategy rather than letting it be deemed by the legislation. Deemed dividends cannot be franked.

<u>Example 8 – Cunningham Hardware Pty Ltd</u>

Howard is the director of Cunningham Hardware Pty Ltd which has lent him $100,000 to spend on some home renovations to build a granny flat for his aging tenant Arthur. The loan was granted on 29 June 2011. On 10 September 2011 the company pays a fully franked dividend of $100,000 to clear the loan. The company tax lodgement date is 15 May 2012.

Because the dividend was paid before the company tax lodgement date, the loan will not attract the Division 7A provisions of 30 June 2011.

C. Loan Agreements

The most common way to rectify a Division 7A problem is to enter into a loan agreement under the terms stipulated in the Tax Act.

Broadly speaking, there are only two types of loans possible under the law:

- Unsecured principal + interest over a 7 year period
- Secured principal + interest over a 25 year period

Other requirements for loan agreements to be viewed as complying are:

- The agreement must be in writing
- The rate of interest must be equal to or exceed the benchmark interest rate as set by the ATO

There is no need to charge interest or make repayments in the year in which the Division 7A amount is converted to a complying loan.

Recent benchmark interest rates are as follows:

Year Ended	Rate
30 June 2012	7.8%
30 June 2011	7.4%
30 June 2010	5.75%
30 June 2009	9.45%

Once in place, the borrower will be required to make repayments of at least the minimum amount. Failure to do so will be considered a contravention and application will be required to the ATO to rectify.

Any interest charged by the company is assessable in the year it is charged.

Special rules apply to the secured loans and in particular the amount of security required to satisfy the loans.

Any loan agreement must be entered into on or before the lodgement day of the company's income tax return for that year.

Example 9 – Laverne & Shirley

Laverne & Shirley are two former brewery employees who have created their own beer under the label 'Two Broads'.

The beer becomes successful and Laverne & Shirley loan themselves $400,000 from their company Two Broads Pty Ltd before 30 June 2011. The company's lodgement date is 15 January 2012 for the 2011 tax return.

To be treated as a complying loan, Laverne & Shirley will need to:

- Execute a written Division 7A loan agreement with the company before 15 January 2012 (see Appendix 2 for a sample loan agreement).
- Make the first payment of principal and interest before 30 June 2012. The minimum repayment is $76,304-23 being $31,200 of interest and $45,104-23 of principal (see Appendix 3 for this calculation).

7. <u>Other Issues & Comments</u>

This paper was designed to give the reader an introduction to the area of law that is Division 7A. It is not to be construed as formal advice on the matter.

When the reader believes there is a Division 7A problem, it is our suggestion that the issue be referred to an accountant for appropriate advice as the issue may be outside the scope of the reader.

Division 7A issues may also be more complicated than examples presented in this paper and can include multiple entities some of which may be interposed to mask the Division 7A problem. The interposed entity rules are considered to be outside the scope of this paper.

Also, Division 7A can apply to trusts as well with their interaction with companies, so care is required.

Lastly, given the complexity of Division 7A provisions, clients should consider either:

- A Division 7A management plan
- A change of structure

to minimise its impact.