Australian Government
Australian Taxation Office

Continuing the focus on Division 7A:

Answers to frequently asked questions

Presenters:

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Welcome

Acknowledgment of country

"We would like to respectfully acknowledge the traditional owners and custodians of the land on which we meet throughout Australia and the continuing connection to land, waters, and community. We pay our respects to them and their cultures, and elders past, present and emerging."

Introduction

Every payment and benefit from a private company to its shareholders and their associates has tax consequences, e.g. salary and wages, PAYG, Super, STP, director's fees, fringe benefits or dividends.

In our webinar earlier this year, we shared with you the common Division 7A mistakes we are seeing.

The majority of Division 7A breaches are in relation to the fundamental aspects of Division 7A and can be easily avoided by taking some simple steps:

- recognising that companies are separate legal entities
- keeping and maintaining adequate records that explain payments, loans and other benefits provided from the private company to its shareholders and their associates
- planning ahead and undertaking basic annual checks to ensure complying loan agreements are in place, you are using the correct benchmark interest rate and minimum yearly repayments are made by required dates.

We shared with you that we are concerned that fundamental issues continue to be overlooked.

It is expected that a tax professional with private company clients would be aware of the core provisions of Division 7A and they should actively seek sufficient information from clients to form a view on how it applies to the client’s specific circumstances.

Don't assume you will be able to rely on the Commissioner exercising a discretion in your favour if you trigger an unfranked dividend.

Today's session

Today we are:

- answering some frequently asked questions on:
  - the section 109RB discretion
  - what loans are in the scope of Division 7A
  - complying loan agreements
  - minimum yearly repayments
  - distributable surplus
  - interposed entities
- discussing what to look out for heading into tax time to help you and your clients get Division 7A right.

All references are to the *Income Tax Assessment Act* 1936

Division 7A - the basics

- Is an integrity rule that prevents profits from being provided to shareholders or their associates tax-free.
- Division 7A may apply to a loan, payment or other benefit (including the use of a company asset, debt forgiveness given) to one of its shareholders or their associates.
- Where it applies the recipient of the loan, payment, or other benefit is deemed to have received an unfranked dividend, that is included in their assessable income.
- Some payments and loans from private companies are excluded from being taken to be a deemed dividend, including loans on complying Division 7A terms or otherwise assessable payments like salary and wages and dividends.
- Division 7A can apply when a company provides loans or payments to shareholders or their associates through another entity(s) (e.g. other companies, trusts and individuals).

What if you make a mistake? Commissioner's discretions

Discretion	What does it allow the Commissioner to do?
Section 109RB	Disregards a deemed dividend, or allows a deemed dividend to be franked, if the relevant breach resulted from an *honest mistake or inadvertent omission* **and** the circumstances support the exercise of the discretion.
Section 109Q	Disregards a deemed dividend under section 109E, where the minimum yearly repayment (MYR) shortfall occurred because of circumstances beyond the loan recipient's control **and** the recipient would suffer undue hardship if the private company were taken to pay them a dividend under section 109E.
Section 109RD	Disregards a dividend deemed under section 109E and allows an extension of time to make a MYR where the loan recipient is unable to pay an MYR because of circumstances beyond their control.
Subsection 109G(4)	Debt forgiveness not treated as a section 109F dividend where the repayment of the debt would have caused undue hardship to the recipient **and** they had the capacity to repay the debt at the time it was incurred **and** lost the ability to repay the debt as a result of circumstances beyond their control.

TR 2010/8 – section 109RB discretion

What is an honest mistake or inadvertent omission?

- The honest mistake or inadvertent omission must be genuine. The belief relating to the purported mistake must be actually held by the entity that made it.
- Ignorance, lack of due diligence or reasonable care will alone generally not constitute an honest mistake or inadvertent omission. Circumstances surrounding the ignorance need to be considered.
- Deliberate indifference, wilful blindness and actions or omissions made to circumvent Division 7A cannot satisfy the requirements of honest mistake or inadvertent omission.
- Inadvertence implies a degree of pre-existing knowledge and can include a failure to observe, or failure to pay attention. *Inadvertence does not cover a case where in the immediate duty which they are performing, they ought to have a full knowledge of the law.*
- If the tax professional's conduct caused the result produced by the operation of Division 7A but that conduct does not amount to an honest mistake or inadvertent omission, it would be difficult for the taxpayer to demonstrate that another entity's (be it the recipient or the private company) honest mistake or inadvertent omission is the cause of the result produced.
- If there is not enough evidence to establish an inadvertent omission or honest mistake, the Commissioner cannot exercise the discretion.

The Commissioner's discretion – section 109RB

Is the Commissioner’s discretion available if the taxpayer relied on an adviser?

The availability of the Commissioner’s discretion for Division 7A breaches under an adviser would depend on the individual facts and circumstances of each case.

The actions of the adviser must have contributed to the breach and the reliance on the professional advice for Division 7A must be reasonable. Relevant factors would include the disclosures made to the adviser, the nature of the advice and whether the adviser made an honest mistake or inadvertent omission.

It will be difficult to demonstrate that the client has reasonably relied upon professional advice for Division 7A where no Division 7A advice is obtained or where the adviser has not turned their mind to the application of Division 7A to the client’s circumstances.

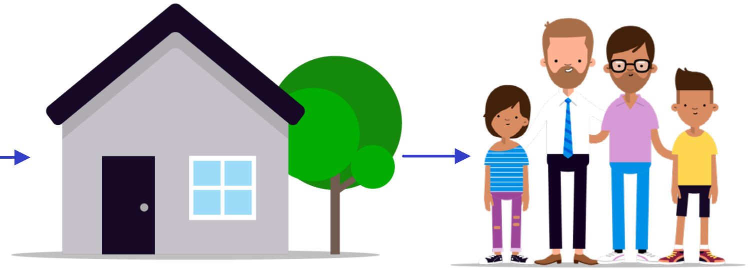
It is expected that a tax practitioner with private company clients would be aware of the core provisions of Division 7A and they should actively seek sufficient information from clients to form a view on how it applies to the client’s specific circumstances.

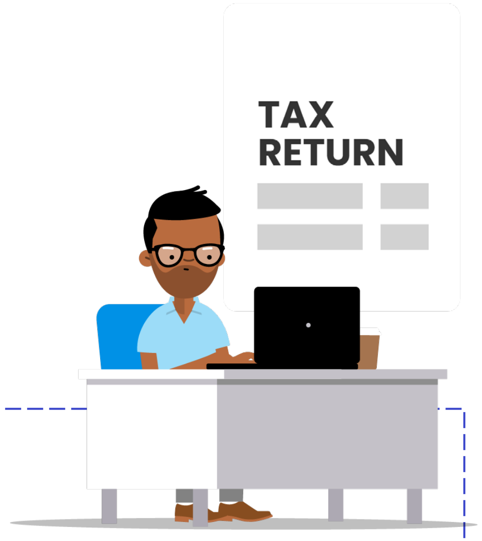
Whether the client made an honest mistake or inadvertent omission for reasons other than reliance on a tax professional would depend on consideration of all the facts and circumstances.

Section 109RB example

Is the breach a result of an honest mistake or inadvertent omission?

Beach Escape Pty Ltd





- Beach Escape has been operating a holiday accommodation business for the past 10 years and owns multiple holiday homes.
- The shareholder uses one of the holiday homes for 2 months a year during school holidays for no consideration.
- The shareholder is not an employee of the company.

- Beach Escape has used the same tax agent for the last 5 years.
- The tax agent had discussed the application of Division 7A with his client in prior years, including the use of company assets like the holiday homes.
- When preparing Beach Escape's income tax return, the tax agent did not enquire about private use of the holiday homes.
- The shareholder did not advise the tax agent of the private use.
- No Division 7A benefit is recorded.

What loans are in scope of Division 7A?

Does Division 7A apply to:

- **loans from a private company to directors and employees?**
- **loans from company to company?**
- **loans from shareholders to the company?**
- **loans from trusts?**

Yes, Division 7A will apply to loans made by the private company to directors and employees if they are a shareholder of the company or an associate of a shareholder (Section 109D). To avoid double taxation, such benefits are not subject to FBT.

Division 7A does not apply to loans or payments:

- from the private company to another company (Section 109K), except in their capacity as a trustee of a trust
- to the company from other entities, for example from a shareholder
- made by a trust (unless the interposed entity rules apply or in certain circumstances where the trust has an unpaid present entitlement owing to a company).

What loans are in the scope of Division 7A?

Can multiple drawdowns or loans in the same income year be covered under one loan agreement?

Yes. Broadly, for the purposes of Division 7A, all the loans made by the private company to the shareholder or their associate in an income year that have the same maximum term are treated as one loan. (Section 109D)

An amalgamated loan (section 109E) is when a private company makes one or more loans to a particular shareholder or associate during an income year, and each loan:

- isn't repaid before the company's lodgment day
- would be treated as a dividend, except it's under a complying loan agreement
- has the same maximum term.

Each of the individual loans are known as 'constituent loans'. The amount of the amalgamated loan is the sum of the constituent loans that have not been repaid before the lodgment day for the year of income in which the amalgamated loan is made.

What loans are in the scope of Division 7A?

Can present entitlements owing from a trust to a company be subject to Division 7A?

Yes. Our view on how Division 7A applies to trust entitlements created on or after 1 July 2022 is outlined in TD 2022/11.

In summary, a private company beneficiary, that is presently entitled to income from a trust, is considered to have provided a loan for Division 7A purposes to its shareholder or their associate if either:

- the private company beneficiary has knowledge of its entitlement but doesn't demand payment from the trust; or
- the trustee holds an amount from the main trust fund on a new separate trust (a sub-trust) for the sole benefit of the private company beneficiary, and
  - all or part of the sub-trust fund is used by (or for the benefit of) the private company beneficiary's shareholder or their associate (the amount used is the amount of the loan)
  - the private company beneficiary is aware of this use.

What loans are in the scope of Division 7A?

Can you give an update about the AAT decision on the application of Division 7A to UPE's in Bendel[1]?

Yes. The Commissioner has appealed the Tribunal's decision in respect of the Primary Issue.

> Pending the outcome of the appeal process, the ATO is administering the law in accordance with the published views relating to private company entitlements and trust income in TD 2022/11.

In addition to the application of section 109D, the basis on which private company beneficiaries deal with unpaid present entitlements (UPE) to trust income may have implications under other taxation laws, such as section 100A.

Until the appeal process is finalised, the Commissioner does not propose to finalise objection decisions in relation to objections to past year assessments (for which no settlement was reached) where the decision turns on whether or not a UPE was a subsection 109D(3) loan. However, if a decision is required to be made (for example, because a taxpayer gives notice requiring the Commissioner to make an objection decision), any objection decisions made will be based on the existing ATO view of the law.

[1] Interim Decision Impact Statement on *Bendel and Commissioner of Taxation* [2023] AATA 3074

Division 7A – complying loan agreements

When does a complying loan agreement need to be in place and what needs to be included in the loan agreement? Does the ATO have a template?

A section 109N complying loan agreement must be in writing before the company's tax return lodgment day and should include as a minimum :

- an interest rate specified for each income year of the loan at least equal to the Division 7A benchmark interest rate (currently 8.27% for 2023-24 income year)
- a maximum term of 7 years for unsecured loans (25 years for certain secured loans).

The ATO does not have a template. There is no prescribed form for the written agreement. However, as a minimum, the agreement should:

- identify the parties
- set out the essential terms of the loan
- be signed and dated by the parties.

TD 2008/8 provides further guidance on what is required in terms of a formal loan agreement.

Division 7A – complying loan agreements

Do you need a new loan agreement for each income year or for each withdrawal/loan made in the one income year?

No. A written agreement can be drafted to cover multiple loans which will be made to a shareholder or their associate and can cover a number of income years in the future.

All the essential elements of a loan agreement may be in writing even though the actual amount drawn down is not specified in the formal written agreement.

However, there must be some written evidence before the private company's lodgment day that a payment or crediting of an amount to the shareholder or associate on a particular date was made under the terms of the formal written agreement. For example: where a formal written loan agreement sufficiently identifies the transactions it applies to. See TD 2008/8.

Private companies with more than one Division 7A loan will need to maintain separate records for each Division 7A loan.

Division 7A - repayments

When do you need to start calculating interest and making minimum yearly repayments?

You must make minimum yearly repayments (MYRs) comprised of principal and interest each year, starting from the income year after the loan is made.

Example: Coffee Pty Ltd makes a loan of $20,000 to its shareholder on 8 August 2022 on a complying loan agreement, during the income year ended 30 June 2023.

Coffee Pty Ltd's 2023 company tax return due date is 15 May 2024. They lodge on 31 Jan 2024.

Complying loan agreement must be entered into before 31 Jan 2024.

→

Interest on the loan is calculated from 1 July 2023

→

First MYR due 30 June 2024
(then by 30 June each year until 30 June 2030 or the loan is repaid)

Division 7A – repayments

Does the benchmark interest rate change each year?

Yes.

- One of the requirements of a complying loan agreement is an interest rate for each year of the loan at least equal to the Division 7A benchmark interest rate.
- The benchmark interest rate used to calculate the MYR changes annually. The rate for the current income year ending 30 June 2024 is 8.27%.
- The ATO's Division 7A calculator and decision tool can be used to calculate the minimum yearly loan repayment.

Division 7A – repayments

Does Division 7A apply if the shareholder or associate repays the loan before lodgment day and then reborrows? *For example, the shareholder transfers the company funds each year into their personal offset account and repays them before the end of the income year.*

Yes it can. Repayments will be disregarded if a reasonable person would conclude, on the basis of all relevant circumstances, that the shareholder or associate either:

- when making the payment, intended to obtain a loan (directly or indirectly) from the private company of an amount similar to, or larger than, the payment, or
- before making the payment, obtained a loan from the private company (directly or indirectly) of a total amount similar to, or larger than, the repayment in order to make the payment.

See Example – 'Interposed entity arrangement' under '<u>loan repayments not taken into account</u>' for how this rule may apply to borrowing amounts indirectly from the private company.

Division 7A – repayments

Can a shareholder or associate make repayments on the complying loan agreement using an offset of another liability the company owes them? For example, paying a dividend to a shareholder which is then offset against their complying loan.

Yes. Repayments of the complying loan can be made by effectively offsetting the borrower's entitlement to an amount payable to them from the private company.

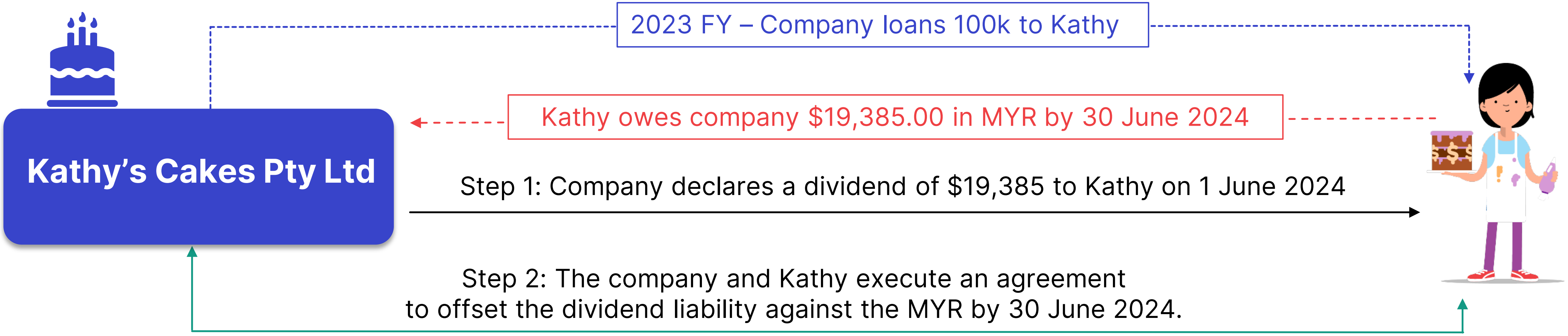
A repayment on a complying loan will always be taken into account, even if there is an intention to reborrow, to the extent that the repayment is effectively offset by the borrower's entitlement to an amount payable to them from the private company, such as a dividend payable to them as a shareholder of the private company, salary and wages or directors' fees (subsection 109R(3)).

For an offset to be effective to pay a MYR, mutual liabilities must exist at the time of the offset and by the end of the income year (usually 30 June):

- there needs to be an agreement to offset the liabilities which is the legal basis for discharging the liabilities between the parties. This agreement can be express or implied.
- the transactions to offset the liabilities are undertaken.

Division 7A – repayments - Dividend offset example

A private company made a loan to its shareholder in an earlier income year on complying Division 7A terms and plans to offset a dividend to the shareholder against their requirement to pay the MYR.



For the offset to be effective in paying the MYR, before the end of the income year (usually 30 June):

- the shareholder must have an existing legal entitlement to be paid the dividend, i.e. the company has declared a dividend, which could be evidenced in a resolution made by the company
- the shareholder and the company have a binding agreement to offset the shareholder's entitlement to the dividend against the balance of their complying loan with the company
- the liabilities are offset, which may be evidenced by the journal entries.

Division 7A – repayments

If a company has made a complying loan to a borrower (associate of its shareholder), can their MYR be made by:

- **the company paying a dividend to its shareholder (a trust)**
- **the trustee distributing the dividend income to the borrower (a beneficiary of the trust), and**
- **all parties agreeing to offset the amount owing to borrower against their complying loan with that company?**

Yes, a payment by another entity to the private company on behalf a borrower (shareholder or their associate) will be taken into account, regardless of any intention to obtain another loan, (subsection 109R(4)) if the amount of the payment is:

- payable by the other entity to the borrower, and
- included in the borrower's assessable income in the income year in which the payment is made, or in an earlier income year.

In addition, a payment or loan is not treated as a deemed dividend where the amount is included in the recipient's assessable income e.g. in this case the recipient's (borrower) assessable income will include the trust distribution (section 109L).

The interposed entity rules, depending on the circumstances, may apply where the company pays a dividend to its shareholder as part of an arrangement for the shareholder to **lend** the amount to its associate (the borrower) to make the repayment on the borrower's complying loan with that company.

Debt forgiveness

Does Division 7A apply if the company forgives a debt of a shareholder or their associate?

A private company will be taken to pay an unfranked dividend to a shareholder or their associate if all or part of a debt they owed the company is forgiven under certain circumstances, (section 109F) including:

- the shareholder's or their associate's obligation to pay the debt is released, waived or otherwise extinguished (other than as a result of fully paying the debt in cash or in property, with a value at least equal to the amount of the debt)
- the private company loses its right to sue for recovery of the debt due to the statute of limitations
- the shareholder or their associate enters into an arrangement with the private company, where their obligation to pay the debt will end at a future time without having to pay anything (other than a token amount)
- the shareholder or their associate enters into a 'debt parking' arrangement
- it is reasonable to expect that the private company will not insist or rely on the shareholder or their associate repaying the debt.

Distributable surplus

What happens if the company has no distributable surplus?

The total of all deemed dividends that a private company is taken to pay under Division 7A is limited to its distributable surplus for that income year. If the company does not have any distributable surplus, any deemed dividend will be reduced to nil.

A private company's distributable surplus for an income year is calculated at as the end of that year using the following formula (section 109Y). Each of its elements are defined.

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

If the Commissioner considers that the company's accounting records significantly undervalue or overvalue its assets or provisions, the Commissioner may substitute a value that the Commissioner considers is appropriate. See TD 2009/5 for guidance.

Distributable surplus – common mistakes

Company using a negative net assets figure to calculate its distributable surplus where the company's financial statements state their liabilities exceed their assets.

- Net assets is defined as the amount **(if any)** by which the company's assets **exceed** its present legal obligations and certain provisions.

The net assets will be ZERO if the company's net assets do not exceed the company's present legal obligations and certain provisions.

For example: if the company had assets of $1,000,000 and liabilities of $3,000,0000, their **net assets would be zero**, not -$2,000,000 ($1,000,000-$3,000,000).

Failing to add back Division 7A amounts:

- Division 7A amounts is the total of any amounts the company is taken under section 109C (payments) or 109F (debt forgiveness) to have paid as dividends in the year of income apart from this section.

Distributable surplus – example

Can a company forgive a debt to its shareholder or their associate if it is in a loss or has no distributable surplus?

If the debt forgiveness results in a deemed dividend under section 109F, the amount of that dividend (apart from section 109Y) will be added as 'Division 7A amounts' in calculating the company's distributable surplus. Any deemed dividend will then be limited to the amount of the company's distributable surplus.

Coffee Pty Ltd

Assets of $2,000,000

Liabilities of $3,000,000

Share capital of $10

Coffee Pty Ltd has substantial carried forward losses. The company forgives a debt owed by its shareholder of $20,000 (109F dividend).

The distributable surplus calculation would be:

Net Assets of <u>zero</u> + Division 7A amounts of $20,000 (109F) - $10 paid up share capital = $19,990

The section 109F dividend would be $19,990.

Interposed entity rules

What are the interposed entity rules?

A private company is taken to make a payment or loan to the target entity where (section 109T):

- the private company makes a payment or loan to an interposed entity (called the 'first interposed entity')
- the first interposed entity or another interposed entity makes a payment or loan to the target entity, and
- a reasonable person would conclude 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 rules apply even if the payment or loan made by a private company to the first interposed entity is an ordinary commercial transaction.

The rules do not apply if a payment or loan made by a private company to the first interposed entity itself results in Division 7A treating the amount as a dividend to the first interposed entity.

See TD 2011/16 and TD 2018/13.

Interposed entity rules - example

The Jones family conduct their business through a number of corporate entities.

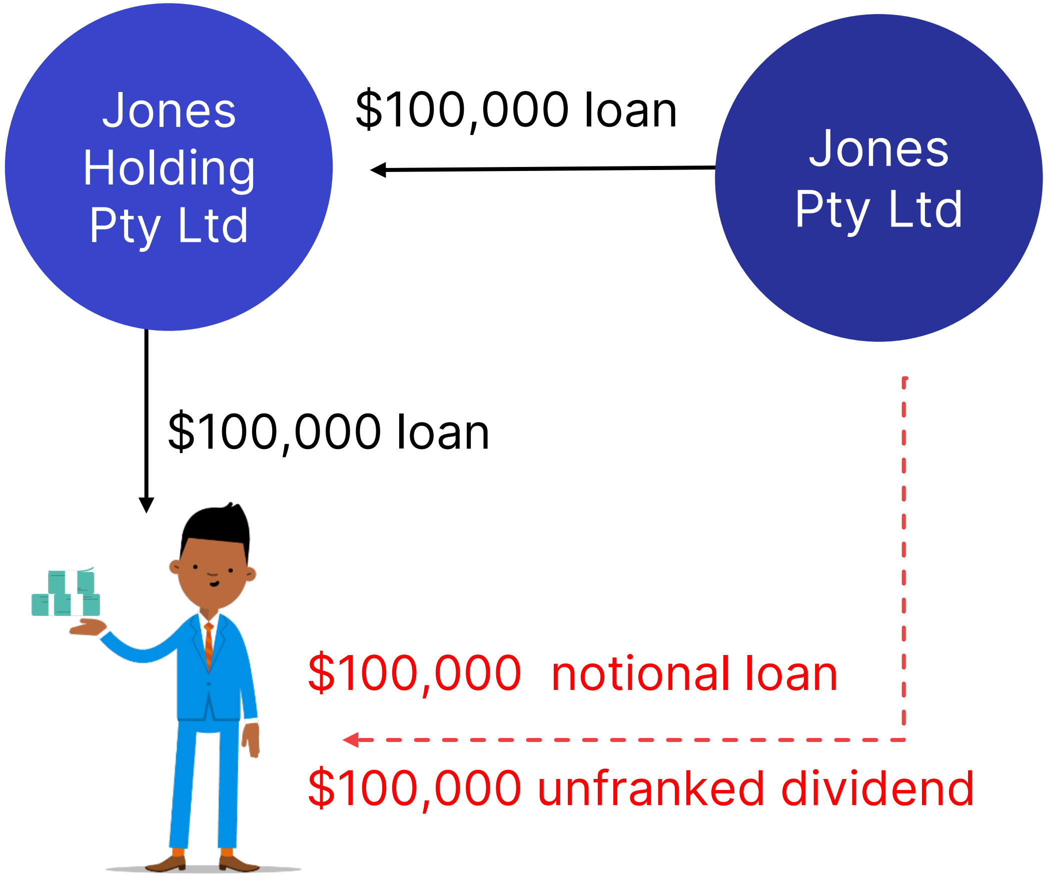
Jack wishes to borrow $100,000 from his family group.

Jones Holding Pty Ltd has no distributable surplus and no cash available. Jones Pty Ltd has the available cash and a distributable surplus of $500,000.

On 1 May 2024, Jones Pty Ltd makes a loan of $100,000 to Jones Holding Pty Ltd.

On the same date, Jones Holding makes a loan of $100,000 to Jack which does not comply with the requirements of section 109N.

Jones Pty Ltd is taken to have made a notional loan to Jack, resulting in an unfranked dividend of $100,000.



Staying ahead of Division 7A this tax time

By the end of the income year (e.g. by 30 June)

- Early in the income year, plan how company money will be accessed (e.g. salary and wages, dividends, complying loan agreement).
- Ensure account allocations are correct and substantiated.
- Identify any payments (including use of company assets), loans and debt forgiveness to shareholders or their associates.
- Make the MYR required for prior year Division 7A loans based on the benchmark interest rate (changes annually).
- Take any required action if you plan to offset a company liability to a shareholder or their associate (e.g. salary and wages, dividends) against their MYR obligation.

By lodgment day

- To avoid a Division 7A deemed dividend, before the company tax return is due or lodged (whichever comes first):
  - payments not repaid or offset by the end of the income year must be converted to a Division 7A complying loan
  - loans must be repaid in full, or put on Division 7A loan with complying terms.
- In the company tax return, report interest income from Division 7A loans and complete label 8N - Loans to shareholders and their associate.
- Deemed dividends must be included in the shareholder or shareholder's associate's assessable income.
- Plan ahead for next year.

Key messages

- We are concerned that clients and their advisers are not sufficiently focussed on getting the basics right and that fundamental issues continue to be overlooked.
- You should talk with your clients early. When they are deciding how to extract money from a private company make sure they know their tax, record keeping and reporting obligations. This will help them keep on top of their obligations from the beginning.
- Don’t assume your client will be able to rely on the Commissioner exercising a discretion in their favour if a Division 7A unfranked deemed dividend is triggered.
- Relying on advice from a professional adviser will not always constitute an honest mistake or inadvertent omission.
- If you are seeking the exercise of a discretion, make sure you have sufficient information to be able to demonstrate you qualify for it, and that your client has, or will take necessary corrective action.
- The Commissioner will be thoroughly scrutinising requests for the section 109RB discretion and ensuring the conditions are satisfied and supported by sufficient evidence.

Resources

Topic	Page ref.
Private company benefits – Division 7A dividends	QC 17861
Using your business money and assets	QC 67807
Division 7A calculator and decision tool	QC 21036
Division 7A – benchmark interest rate	QC 17928
Issuing distributions statements	QC 47309
Tax control frameworks for medium and small corporations	QC 46292
Essentials to strengthen your small business	

Thank you for attending

Survey is available at the end of the session

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