Is your client Division 7A compliant?

Carmen Vassallo of Collins & Co analyses common traps when it comes to private company loans to shareholders.

Division 7A of Part III of the Income Tax Assessment Act 1936 (ITAA36) is an integrity measure which was designed to prevent companies from making tax-free distributions to shareholders or their associates. This can occur where distributions of profit are disguised as loans or other transactions. This effectively allows the shareholder or their associate to have access to the corporate tax rate.

A consequence of Division 7A applying to certain loans and transactions is that an unfranked dividend is taken to be paid to the shareholder or associate in the year the loan is made or the transaction occurs.

In particular, it can apply to the following transactions involving a company:

- loans
- payments
- debts forgiven
- use of company assets (such as a holiday home)
- unpaid present entitlements from a trust, and
- guarantees and indemnities.

The definition of “loan” under Division 7A is quite broad and includes a “provision of financial accommodation”.

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Each transaction posted through a loan account should be carefully analysed to determine what the underlying transaction relates to.

For example, the ATO has adopted the position that unpaid present entitlements arising after 16 December 2009 by a trust that are not paid or held on sub-trust for the sole benefit of the private company beneficiary amount to the private company providing financial accommodation to the trust.

Generally, transactions involving unrelated parties will not be subject to Division 7A. However, as noted, if the transaction involves a shareholder of a private company, or an associate of a shareholder, it will be subject to Division 7A. An “associate” is very broadly defined by s318 ITAA36. It can, amongst others, include:
- a spouse, child or relative of the shareholder
- a trust in which the shareholder or associate is a beneficiary, and
- a company under the control of the shareholder or their associate, or a partner in partnership with the shareholder.

If the shareholder in the private company is a trust, a beneficiary of the trust is also an associate of the private company, regardless of the beneficiary’s level of control over the trust.

COMMON DIVISION 7A TRAPS

Typical situations we encounter when dealing with Division 7A in practice include:

Loans to associated trusts
Loans from a private company to a trust which is an associate of the company are subject to Division 7A regardless of how the loan proceeds are applied.
It is common for trusts to borrow funds for the purchase of income producing assets. In this scenario, the loan is still subject to Division 7A, notwithstanding the interest would be ‘otherwise deductible’ to the trust.

Managing loans to avoid Division 7A
There are a number of strategies that can be adopted to ensure loans do not unintentionally result in deemed dividends:
- repay the loan to the company in cash before the company’s lodgment day
- declaring dividends from the company to the shareholder
- transferring property to the company valued at or greater than the loan balance
- entering into a Division 7A complying loan agreement, or
- set off of mutual obligations between the company and the shareholder or associate.

Minimum loan repayments must be made by the 30th of June each year where a Division 7A complying loan agreement is in place. Where minimum loan repayments are not made in relation to a loan, a deemed dividend is taken to be paid in the income year where the shortfall occurs. Note however that the amount of the deemed dividend cannot exceed the shortfall with respect to the unpaid minimum loan repayment.

Analyse drawings and loan accounts carefully
It is not uncommon for loan accounts to contain a range of different entries based on cash transactions, credit card purchases, journals or dividends. Each transaction posted through a loan account should be carefully analysed to determine what the underlying transaction relates to.

Consider Case Study 1 on the following page.

Significance of “before” lodgment day
Once a loan has been made to which Division 7A applies, a deemed dividend can be avoided if the loan is repaid before the lodgment day of the company’s tax return for the year in which the loan was made.
For example, for loans made in the year ending 30 June 2015, the deadline for repayment of the loan or putting in place a complying loan agreement is the day before the company’s tax return is due – which is 14 May 2016, if the due date is 15 May 2016.

Beware of back-to-back loans
A “back-to-back loan” arrangement will arise in situations where the shareholder or associate has an existing loan from a private company which is repaid from funds obtained from a new loan. Under Division 7A, any repayments made against a loan in such an arrangement will be disregarded.
Consider Case Study 2 on the following page.
Case Study 1: Analysing loans and drawings

During the year ending 30 June 2015, The Sample Family Trust borrowed $100 from Example Pty Ltd. The loan is repaid by declaring a dividend of $100 on 30 June 2015, which is credited to the loan account. However, the shareholder of Example Pty Ltd is not The Sample Family Trust – it is another related entity – The Demo Family Trust.

The accountant prepares the following journal entries:

**Example Pty Ltd**

- 30/06/2015 Dividend paid $100 DR
- 30/06/2015 Loan: The Demo Family Trust $100 CR
  (being declaration and payment of dividend)
- 30/06/2015 Loan: The Demo Family Trust $100 DR
- 30/06/2015 Loan: The Sample Family Trust $100 CR
  (being offsetting of loans between related parties)

**The Sample Family Trust**

- 30/06/2015 Loan: The Demo Family Trust $100 DR
- 30/06/2015 Loan: Example Pty Ltd $100 CR
  (being offsetting of loans between related parties)

**The Demo Family Trust**

- 30/06/2015 Loan: Example Pty Ltd $100 DR
- 30/06/2015 Dividends received $100 CR
  (being dividend paid by Example Pty Ltd)
- 30/06/2015 Loan: The Sample Family Trust $100 DR
- 30/06/2015 Loan: Example Pty Ltd $100 CR

Whilst all the parties may have the same directors and have genuinely agreed for the dividend paid by Example Pty Ltd to be set-off against the Sample Family Trust loan account, the only evidence of this agreement is the back-dated journal entries.

The ATO takes the position that in these circumstances, the repayment is not legally effective as journal entries posted to loan accounts must represent an underlying transaction that has taken place. The ATO will not accept that there has been a repayment for Division 7A purposes unless the journal entries are supported by adequate evidence to show the transaction has taken place – such as a written agreement.

Case Study 2: Back-to-back loans

On 1 July 2014, Example Pty Ltd makes a loan of $100 to a shareholder, Bob. In the following financial year, Bob repays the loan before the lodgment day of Example Pty Ltd's tax return (i.e before 15 May 2016). This is done by Bob withdrawing an amount of $100 and using this to repay the 2015 loan by depositing the amount back into the company's bank account the following day.

The subsequent repayment of the 2015 loan will be disregarded under Division 7A. The consequences of this is a deemed dividend of $100 will be included in the assessable income of Bob for the year ended 30 June 2015.
4 traps with the “distributable surplus”

A company’s distributable surplus is a central element of Division 7A because the extent of any assessable deemed dividend is limited to the distributable surplus which is determined at the end of the relevant income year. A deemed dividend will therefore be reduced to nil if the company does not have a distributable surplus at the end of that year.

A company's distributable surplus is calculated using the formula under s109Y ITAA36 (laid out below).

When calculating the distributable surplus, consider the following:

1. Assuming that a deficiency of net assets = distributable surplus of nil

The “net assets” component of the distributable surplus formula is calculated based on the company’s financial position at the end of the financial year, ie on 30 June.

A common shortcut is to review the balance sheet and identify that the company has a substantial deficiency of net assets and therefore no distributable surplus, or a “negative” distributable surplus.

The net assets component of the formula can only ever be nil or a positive number. Also a deficiency of net assets doesn’t necessarily preclude the company from having a distributable surplus.

2. Ignoring Division 7A amounts

“Division 7A amounts” is a relatively new addition to the formula for distributable surplus and therefore may catch many by surprise. This was only introduced in 2010 to overcome a loophole in Division 7A which allowed a private company to forgive debts before the end of a financial year in order to avoid the operation of Division 7A.

The legislation describes Division 7A amounts as meaning “the total of amounts the company is taken to pay under s109C or s109F apart from this section”; which relates to payments and forgiven debts respectively.

A common trap is for a loan to occur during the year, and then to determine that the company has no distributable surplus. As a result of there being no distributable surplus, the loan is forgiven and written off from the books. However, the process of writing off the loan can in itself trigger a deemed dividend because the amount of the loan written off will be included in the distributable surplus formula as “Division 7A amounts”.

3. Quarantined non-commercial loans

The “non-commercial loans” component of the distributable surplus formula relates to amounts that are shown as loans in the company’s accounting records which have already given rise to deemed dividends in the past.

It is common for companies which have advanced loans to shareholders or their associates in a year in which there was no distributable surplus to “quarantine” these loans. A potential trap is to mistakenly classify such quarantined loans as “non-commercial loans” in a subsequent year.

Whilst the quarantined loan has technically given rise to a deemed dividend for Division 7A purposes in the past, it is the amount of the assessable deemed dividend which is relevant and not the original face value of the loan.

4. Don’t forget to recognise all company liabilities

Where provisions for annual leave and long service leave are not recognised in the company’s accounting records, these should be taken into consideration by subtracting them from the company’s net assets for the purposes of the distributable surplus calculation.

Further, the Commissioner of Taxation accepts that unpaid PAYG instalments and income tax liabilities amount to a “present legal obligation” and should be subtracted from the “net assets” of the company.

A company’s distributable surplus equals:

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