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Division 7A is an integrity measure that 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 house)
- 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". 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.

Transactions involving unrelated parties will not generally 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 can be subject to Division 7A. An "associate" is very broadly defined. It can, among 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.

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## Federal budget changes

Note that the May budget stated that the government will clarify the operation of Division 7A to ensure more clarity about when unpaid present entitlements (UPEs) come within its scope. A UPE arises where a related private company becomes entitled to a share of trust income as a beneficiary, but that amount is yet to be actually paid.

Division 7A requires benefits provided by private companies to related taxpayers to be taxed as dividends unless they are structured as "Division 7A loans" or another exception applies. The measure will ensure the UPE is either repayed before "lodgment date" of the relevant return (see below), required to be repaid to the private company over time as a complying loan, or taxed as a dividend.

Also announced in the May budget was that the start date of other Division 7A measures is to be deferred. These amendments (see below) will be deferred from 1 July 2018 to 1 July 2019, and include:

- a self-correction mechanism providing taxpayers whose arrangements have inadvertently triggered Division 7A with the opportunity to voluntarily correct their arrangements
- 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 Division 7A loans, including having a single compliant loan duration of 10 years and better aligning the calculation of the minimum interest rate with commercial transactions.

## Common Division 7A pitfalls

Typical situations encountered when dealing with Division 7A in practical terms can include the following.

Loans to associated trusts: Loans from a private company to a trust that 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. Note however that a genuine movement of cash to a business for legitimate purposes does not necessarily mean Division 7A applies.

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, and therefore Division 7A:

- 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 legitimate Division 7A complying loan agreement, or
- set off mutual obligations between the company and the shareholder or associate.

Minimum loan repayments must be made by 30 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.

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 2018, 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 2019, if the due date is 15 May 2019.

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 that 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.

## 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

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A company's distributable surplus is calculated using the formula: Net assets + Division 7A amounts – non-commercial loans – paid-up share value – repayments of non-commercial loans = distributable surplus.

When calculating the distributable surplus, it will pay to be mindful of the following:

### 1/ Assuming that a deficiency of net assets means a 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 (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 an addition to the formula for distributable surplus and has caught many by surprise. This was 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.

A common trap is for a loan to occur during the year, and then for the company to determine that it has no distributable surplus. As a result of there being no distributable surplus, the loan is forgiven and written off 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 that have already given rise to amounts of deemed dividends in the past.

It is common for companies that 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.

While 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 that is relevant and not the original face value of the loan.

### 4/ Don't forget to recognise all of the company's 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 ATO 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.