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148 | Div 7A Concept

In this episode we will cover Div 7A concepts. We will cover the general concept of Div 7A and touch on UPEs to corporate beneficiaries.

Div 7A Concept

Div 7A is an anti-avoidance provision. It is to stop cash leaking from private companies to shareholders and associates in the form of loans, payments and debt forgiveness. The provision tries to stop this cash leakage by treating most loans, payments and forgiven debts as unfranked dividends in the hands of the recipients.

This episode is an edited and abbreviated extract of episode 50 to regig your memory.

In this episode Peter Adams explains the general concept of Div 7A and we have listed our key learnings below. But please listen in as Peter explains all this much better than we ever could.

To listen while you drive, walk or work, just listen through a podcast app on your phone.

Loan

A Div 7A loan is an advance of money, a provision of credit or any other form of financial accommodation. Anything which is in substance a loan – anything you and I think is a loan – would be a loan for Div 7A purposes.

So the definition of a loan in the context of Div 7A is very very wide. It does not just include direct loans to shareholders or associates of shareholders. But in also includes loans to interposed entities. And in return loans from those interposed entities to the target entity which is either the shareholder or the associate of the shareholder.

Loan Recipient

To trigger Div 7A the recipient of the loan would have to be the shareholder of that company out of which the loan emanates.

Shareholder is a member registered of that company, noted and recorded as a shareholder.

The person does not have to be a current shareholder to trigger Div 7A. The person can also be a past shareholder if made to them in that capacity.

Interposed Entity

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Div 7A also covers loans that run through an interposed entity. Interposed entities can either be a company or a trust.

Let's say a private company does not actually make a loan directly to a shareholder but instead makes a loan to another entity who is unrelated to the shareholder. That loan in itself would not trigger Div 7A.

But if that second entity – once it receives the loan from the first company – then passes on that cash to the shareholder of that first company, you got a Div 7A problem.

Div 7A will treat the second loan from the interposed entity to the shareholder as if it was a loan directly from the first company to the shareholder.

Three Div 7A Models

Div 7A operates through three models and only through these three models. You only have a Div 7A problem, if you have one of these three models present. Legislatively these are the only three models that trigger Div 7A.

Model 1

The first model is where the loan goes directly from a private company to its shareholder.

Model 2

The second model is when the loan goes from the primary company to an interposed entity – be it a company or trust – and from the interposed entity to the target shareholder of the first company. So there are two loans.

Model 3

In model three you also have an interposed entity but this interposed entity can only be a trust. You don't have an actual loan as such but a trust distribution that remains unpaid. The primary company is the corporate beneficiary of the interposed trust, which declares a distribution to the corporate beneficiary (primary company) but does not pass on the cash. So there is an unpaid present entitlement. The cash that does hasn't been paid to the corporate beneficiary does not remain in the trust but is passed on to the shareholder of the primary company as a loan. Now it triggers Div 7A.

Trading Trust

In recent years it has become common to use a trust as a trading vehicle. And use the benefit of the reduced corporate tax rate by using a bucket company for the distribution of trading profits from the trusts. Now that in itself is not an issue. That is within the law. But there are consequences for Div 7A purposes if the cash does not actually flow to the company but instead flows to the shareholder.

TR 2010/3

In 2010 there was a critical development within the regulatory framework around Div 7A.

The legislative model of Div 7A is simply the three models described above. But in 2010, the ATO took a particular view on something that is aligned with Model 3.

If you declare a UPE to a private company, you used to only trigger Div 7A if that cash went to the shareholder. So you are not going to do that. You are going to keep the cash in the trust. And if you pay it out, you are going to make sure NOT to pass it out to a shareholder or associate. If you don't have that second link, you don't have a Div 7A problem and so we thought. Until 2010 when the ATO issued Taxation Ruling TR 2010/3 .

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TR 2010/3 says that even if the cash that represents the UPE is not actually paid out to the shareholder you still have a Div 7A problem. How and Why?

The ATO argues that a trust and a shareholder are associates, if the shareholder is a beneficiary of that trust.

Div 7A doesn't just cover loans to shareholders but also to associates. The concept of an associate goes further than just individuals or people. It also includes a trust where the individual or the associate of that individual benefits under that trust. So according to the ATO the UPE scenario actually falls under Model 1. If a trust declares a distribution to a bucket company but doesn't pay the distribution, the resulting UPE is a Div 7A issue under Model 1 per TR 2010/3.

MORE

Div 7A UPE Issue

Subdiv 152-E

Div 7A Debt Forgiveness

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