

TAX TALKS

Australia's Tax News Podcast - The Podcast for Australian Tax Professionals

The following information is only of a general nature and should not be taken as professional advice.

50 | Div 7A Loans

Div 7A loans result in a deemed dividend. But not all loans from private companies to their shareholders fall under Div 7a. There are ways around it.

Div 7A Loans

A loan from a private company to a shareholder or associate is treated as a dividend, unless repaid in time or subject to an exclusion.

That is an outline of Div 7A loans in one sentence. Let's break this apart. There is a lot to cover.

Loan

A loan per s109D(3) includes an advance of money and provision of credit. It also includes any form of financial accommodation, when in substance it is like a loan of money. This includes the payment of an amount on behalf of or at the request of a shareholder or their associate. But there is only a loan if there is an obligation to repay the amount. This obligation can be express or implied. If there is no obligation to repay, then there is no loan.

Shareholder or Associate

A loan falls under Div 7A if a reasonable person would conclude that the company made the loan because the recipient is or has been a shareholder or associate of a shareholder – s 109D(1)(d)(ii). TD 2008/14 states that the reason must be real and substantial.

Repayment

Div 7A only applies if the shareholder or their associate doesn't fully repay the loan in time. But what means in time? Before the due date or actual lodgement date of the company's income tax return – whichever is earlier. So if the shareholder repays the loan after the tax return's due date, it is too late.

Amount

The amount of the dividend is the loan amount still outstanding (s 109D(1AA)), subject to s 109Y ITAA36.

Distributable Surplus

s 109Y limits the dividend to the amount of the company's distributable surplus.

Distributable surplus per s 109Y(2) is net assets plus Div 7A amounts less non-commercial loans less paid-up share value less repayment of the non-commercial loans.

Net Assets

Net assets is the amount by which the company's assets exceed the sum of present legal obligations of the company to a person other than the company and certain listed provisions including annual leave, long service, depreciation and amortisation.

The basis for the calculation of net assets is usually the company's accounts. However, the Commissioner may substitute another amount where he considers that the accounting records significantly undervalue assets or overstate liabilities.

Present Legal Obligation

The Full federal Court decided in FCT v H[2010] FCAFC 128 that the obligation of a private company to pay income tax for an income year is a present legal obligation at the end of that income year. This is despite the amount not being a quantified obligation in the sense of being "due payable" until sometime after the end of the year of that relevant income year.

The Commissioner also stated in the decision impact statement that an amended assessment is a present legal obligation of the year to which it relates, rather than the year of amendment.

The statement also stipulates that a liability to a general interest charge is a present legal obligation on each day it accrues.

However, a tax shortfall penalty is not a present legal obligation until the date of the actual assessment of that shortfall penalty.

Non-commercial Loans

Non-commercial loans are basically deemed dividends of earlier years.

Written Statement

When the distributable surplus reduces a deemed dividend, the company needs to provide a written statement to every shareholder and associate in receipt of the dividend. The written statement should set out the company's distributable surplus and the total amount of dividends that would apply but for s 109Y. With this statement, the relevant shareholders and associates can calculate how much to include in their assessable income.

Subdivision D

Subdiv D of Div 7A lists a number of exclusion. When these apply, the Div 7a loan is not treated as a dividend. s 109D(1)(c) excludes the loan from the application of Div 7A if the loan is made:

- By the company to another company, unless it is to a company in its capacity as trustee (s 109K ITAA36); or
- In the ordinary course of the company's business and on usual terms used for similar loans to parties at arm's length (s 109M ITAA36); or
- As part of a liquidator's distribution (s 109NA ITAA36); or
- To enable a shareholder or associate to acquire qualifying shares or rights under an employee share scheme (s 109NB ITAA36); or
- Included in a recipient's assessable income other than Div 7A (s 109L ITAA36); or
- Requiring minimum interest rates and terms pursuant to s 109N ITAA36.

s109N

The exclusion under s109N is the most common way around a Div 7A loan. s109N requires the loan agreement to:

- Be in writing; and
- Stipulate a rate of interest equal or exceeding the benchmark rate for the year. This is the Reserve Bank's most current indicator lending rate – bank variable housing loans interest rate; and
- Stipulate a loan term not exceeding 7 years, or 25 years where secured by a mortgage over real property and the value of the property is at least 110% of the amount of the loan.

In Writing

What satisfies the requirement that the agreement is in writing? TD 2008/8 states that a clause in the company's constitution setting out the terms on which loans to shareholders are to be made can serve as a written loan agreement providing parties agree in writing that the loan was made on the terms set out in the clause. Similarly, written confirmation of the existence of an agreement by exchange of letters, emails or similar is also sufficient to serve as loan agreement.

Taxpayers have until either the lodgment or the due date for lodgment of the company's income tax return, whichever comes first, to make an agreement that satisfies s 109N.

s109E

When s 109N saves a loan from being a dividend in the year of issue, it will still be a dividend in a subsequent year under s 109E ITAA 36 if there is no minimum yearly repayment in that subsequent year.

So the loan doesn't require a minimum repayment in the year of issue. But it requires a minimum yearly repayment in all subsequent years in order to avoid Div 7A to apply.

The dividend is the amount of the shortfall in minimum yearly repayment. For income years before 1 July 2006, the dividend comprises the entire amount of the outstanding loan. But in all instances, the amount of the dividend is subject to the company's distributable surplus.

The shareholder or their associate can make a minimum repayment in cash or by crediting a dividend payment to the loan account. However, the Commissioner does not consider a repayment by way of journal entry as acceptable.

The minimum repayment is split into the principal and the relevant interest component. ATO ID 2011/8 states that a deemed dividend does not include the portion of the shortfall comprising unpaid interest. Accordingly, the closing balance of the constituent loan does not include such unpaid interest for the applicable income year.

Consequence

Where Div 7A applies to a transaction, the following consequences arise:

- a dividend is deemed to arise on the last day of the year of income to the extent of the company's distributable surplus. This dividend is assessable under s 44 ITAA36;
- the dividend is not frankable – see s 202-45 (g)(i) ITAA97; and
- the amount is not subject to withholding tax (s 109ZA ITAA36).

Div 7A applies in priority to FBT with respect to a loan, pursuant to s 109ZB(1) ITAA36.

Commissioner's modification of Div 7A

The Commissioner has the discretion to modify the operation of Div 7A in certain circumstances. This is possible under either s 109RB or s 109RD. The company needs to make a written application to the Commissioner with all the necessary information. There is no standard form.

If the Div 7A issue is due to an honest mistake or inadvertent omission, the Commissioner can disregard a deemed dividend otherwise arising from Div 7A. Or he can permit the deemed dividend to be a frankable dividend by virtue of s 109RB ITAA36. The later is only possible in the case of a shareholder, but not an associate.

TR 2010/8 sets out the necessary requirements before the Commissioner can make such a decision. It discusses s 109RB(1) in detail, including the meaning of "honest mistake" and "inadvertent omission".

The Commissioner has also issued a practice statement (PS LA 2011/29) which elaborates on various aspects of TR 2010/8. It gives a practical insight into how the ATO is likely to conduct investigations and evaluate a particular case.

If the shortfall arises as a consequences beyond the recipient's control, the commissioner can extend the deadline for a minimum yearly repayment under s 109E per s109 RD ITAA36. Such circumstances would include hospitalisation, a court freezing assets, or a bank subordinating the loan to prevent repayments.

MORE

[Div 7A Debt Forgiveness](#)

[Div 7A Payments](#)

[R&D Tax Incentive](#)

Disclaimer: Tax Talks does not provide financial or tax advice. This applies to these show notes as well as the actual podcast interview. All information on Tax Talks is provided for entertainment purposes only and might no longer be up to date or correct. You should seek professional accredited tax and financial advice when considering whether the information is suitable to your or your client's circumstances.

The information above is for general information only and should not be taken as constituting professional advice from Tax Talks. We are not a financial, legal or tax adviser. You should consider seeking independent legal, financial, taxation or other advice to check how the above information relates to your unique circumstances.