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BENEATH THE SURFACE

DIV 7A UPDATE

The main part of this paper deals with the new Division 7A rules for unpaid trust entitlements of private company beneficiaries, then briefly alerts you to the new Division 7A rules in relation to the 'use' of company assets by a shareholder (or their associate), and finally covers other key technical amendments to the rules in Division 7A.

BACKGROUND OF DIV 7A

Division 7A of Part III of the *Income Tax Assessment Act 1936* (ITAA 1936) is a measure aimed at preventing private companies from making tax-free distributions of profits to shareholders (or their associates). In particular, advances, loans and other payments or credits to shareholders (or their associates) are, unless they come within specified exclusions, treated as assessable (unfranked) dividends to the extent that the private company has a distributable surplus (see formula below).

Division 7A also includes rules in Subdivision EA designed to ensure that a trustee (of a trust) cannot shelter trust income at the prevailing company tax rate by creating a present entitlement to an amount of net income in favour of a private company without paying it, and then distributing the underlying cash to a shareholder (or their associate) of the company.

BACKGROUND OF DIV 7A & TRUST ENTITLEMENTS

Traditionally, companies (aka bucket companies) have been used by discretionary trusts to "cap" the rate of tax payable on their income to the corporate rate (currently 30%). Typically, once present entitlements to other beneficiaries have taken those beneficiaries (usually individuals) to the limit of their 30% marginal tax rate bracket, the balance is "allocated" to a corporate beneficiary by way of a present entitlement. Normally the trust retains this net (after company tax) income and uses the funds as working capital and/or to acquire an income-producing asset thus reducing its reliance on external finance. These unpaid funds are known as "unpaid present entitlements" (UPEs).

NEW TR 2010/3: DIV 7A & TRUST ENTITLEMENTS

The question that arises where a trust distributes to a bucket company is whether the UPE is a "loan", either within its *ordinary meaning* of under its *extended definition* under Division 7A.

On 2 June 2010 the tax office released Taxation Ruling 2010/3 which details their view as to when a UPE from a related trust to a company beneficiary amounts to a loan from the company to the trust for the purposes of Division 7A.

We can now confirm:

- ◊ Division 7A can be avoided by holding the UPE for the sole benefit of the company, via the operation of the sub-trust exception (see below)
- ◊ UPEs that were in existence prior to 16 December 2009 are carved-out and not subject to these new rules provided:
  - ∗ they are not converted to a loan within the ordinary meaning of that term
  - ∗ the (trust's) financial accounts indicate the UPE arose < 16 Dec 09 and the amount is recorded as a UPE and not a loan

- ◊ **Tax Warning for pre-16 Dec 09 UPEs:**

  Division 7A can still deem a dividend to arise where the trust:

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- makes a loan to a shareholder (or associate) of the company beneficiary
- forgives a debt owed by a shareholder (or associate) of the company beneficiary, or
- makes a payment (of an unrealised gain) to a shareholder (or associate) of the company beneficiary

HOW THE SUB-TRUST ARRANGEMENT WORKS

Div 7A can be avoided where the funds representing the UPE are invested (by the trust) for the company beneficiary's sole benefit (and not for the benefit of the trust). The trust can demonstrate a sub-trust as follows:

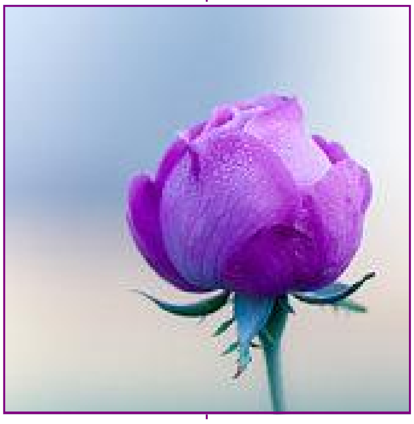
◊ the UPE is held on sub-trust (documentation **vital,** see your accountant)

◊ evidence of a sub-trust can be demonstrated and

◊ proof that all the benefits from the investment of the UPE flow back to the sub-trust and hence the company beneficiary

⇒ where a specific asset is purchased with the UPE, the entire net return (income and capital) flows back to the sub-trust

⇒ where it is not possible to show a direct return on the investment of the UPE, the terms of the investment of the UPE into the main trust (from the sub-trust) are documented, include an obligation to pay the principal (ie the UPE) back to the sub-trust, and include either an agreed rate (option 1) or a method of calculating the return (option 2) – your accountant will help determine best option for you



Example

◊ Trust makes distribution to a private company beneficiary on 30 June 2010 of $25,000 – UPE created and recorded as UPE, not a loan

◊ To the extent this amount remains unpaid, a *loan* (under Section 3 of the ruling) comes into existence on 30 June 2011

◊ **What options are available for a UPE in this example?**

⇒ **sub-trust** (documentation **vital,** see your accountant, **early**)

⇒ **no sub-trust -** pay out the UPE by the 'lodgement date' **or** the company and trust enter into a written S.109N Division 7A loan agreement by the 'lodgement date' with first annual loan payment due on 30 June 2012

⇒ **do nothing** and the UPE will be a deemed dividend (subject to the extent of the company's distributable surplus) and taxable to the main trust in the 2011 year (being the year the loan arose)

DIVISION 7A APPLIES TO 'USE' OF COMPANY ASSETS!

As part of the 2009-10 Federal Budget, the Government announced its intention to extend the operation of Division 7A generally to the use of private company assets such as holiday homes, artwork, cars, boats etc by a shareholder (or their associate) of the company. However the amount of the deemed dividend is reduced by any payments made by the shareholder (or their associate) in relation to the use of the asset/s.

How to avoid a deemed dividend arising on the provision of company assets to a shareholder (or their associate)

◊ check whether an exception applies (ie minor benefits, otherwise deductible, or certain dwellings)

◊ company can charge an arm's length amount for the 'actual use', or for 'exclusive availability for use', of the company asset

◊ company can sell or transfer asset to the shareholder, associate or to a third party (be acutely aware of income tax, GST, capital gains tax and stamp duty ramifications)

◊ company pays franked dividend which is set-off against payment from provision of asset

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- ◊ company stops providing assets for use
- ◊ convert payment from provision of asset into a "loan" repayable at a later time (either fully repay loan or enter into Div 7A loan agreement by lodgement day of the company's tax return)
  - ⇒ **Note 1:** the use of a company asset by an *employee* rather than a *shareholder* will attract fringe benefits tax
  - ⇒ **Note 2:** there is no carve-out for assets held pre-1July 2009

OTHER KEY TECHNICAL AMENDMENTS TO THE RULES IN DIVISION 7A

Announcements made in the 2009-10 Federal Government Budget and applicable from 1 July 2009, ***if enacted***, include:

Distributable surplus – formula changed, commencing 1 July 2009:

Where Division 7A is triggered, the deemed dividend amount is limited to the private company's distributable surplus:

Old Formula:

- ◊ net assets (includes value for internally generated goodwill and Commissioner can substitute market value for some assets)
- ◊ **less** non-commercial loans
- ◊ **less** paid-up share value
- ◊ **less** repayments of non-commercial loans

New Formula – increases exposure:

- ◊ all as above
- ◊ **plus Division 7A amounts**

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Definition of 'non-commercial loans' expanded to include loans made through trusts:

Non-commercial loans (including any repayments) reduce the distributable surplus of a company on the basis that they have already been treated as a deemed dividend in a prior year. However, the definition of non-commercial loans does not "back-out" deemed dividends that arise in relation to loans made by trusts. The definition of "non-commercial loans" is to be amended to remove this anomaly.

Payment disregarded if existing company loan is repaid by obtaining a new loan from the company:

Generally, a loan made by a private company to a shareholder (or their associate) is treated as a deemed dividend unless either of the following occurs before the earlier of the due date for lodgement of the company's tax return for the income year in which the loan was made, or the actual lodgement day:

- ◊ the shareholder (or associate) fully repays the loan, or
- ◊ the shareholder (or associate) enters into a loan agreement that complies with S.109N, which includes a requirement to make minimum yearly loan repayments.

However, to prevent a shareholder (or their associate) from never repaying a loan, a repayment of an existing loan is disregarded if a reasonable person would conclude that, having regard to all the circumstances, the shareholder/associate *intended* to re-borrow a similar or larger amount from the company at the time of making the payment.

A strategy often used to avoid Division 7A involves the re-borrowing occurring ***before*** the repayment is made. Proposed amendments will put this matter beyond doubt and remove any ambiguity. A repayment of an existing loan will be disregarded where:

- ◊ before the payment was actually made, the entity obtained a loan from the private company, of an amount that is similar to, or larger than the amount of the payment, and
- ◊ a reasonable person would conclude that the entity obtained the loan(s) to make the payment.