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Session 9: Division 7A – Some things you may not know

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1. Introduction

Division 7A is an area of the tax law that private clients and practitioners in the private client space will generally have an awareness of. In particular, the core concept that loans, payments and forgiveness from a private company to a shareholder or their associate can have adverse tax implications if not appropriately managed.

However, beyond an understanding of the core of Division 7A, there are many subtleties within the Division that can have material impacts on the tax outcomes that arise for the particular situation (and often in an adverse manner).

This paper considers some of the subtleties within Division 7A, while the practical application of these issues is considered further in the accompanying presentation.

Unless otherwise noted, all references in this paper are to the provisions of the *Income Tax Assessment Act 1936 ("ITAA 1936").*

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2. When is a repayment not a 'repayment'?

2.1 Section 109R

Section 109R is an anti-avoidance provision within Division 7A, designed to ensure that only certain repayments are treated as repayments for Division 7A purposes. Essentially the provision is designed to prevent many situations where there has been a further borrowing from the company to repay the loan, or an intention to borrow again from the company after the repayment has been made.

While such an anti-avoidance measure may seem reasonable to ensure credibility of Division 7A, the subtleties of the provisions, and the unintended consequences, are crucial to understand.

2.1.1 Which parts of Division 7A does s.109R apply to?

Section 109R applies for particular payment purposes in respect of loans and minimum repayments, and treats the repayment as though it wasn't made:

> *(1) This section provides for some payments to a private company in relation to a loan the private company made to an entity not to be taken into account for the purpose of working out:*
>
> > *(a) how much of the loan has been repaid for the purposes of sections 109D and 109E (which treat amounts of loans that have not been repaid as dividends); or*
> >
> > *(b) the minimum yearly repayment for the loan under subsection 109E(5).*

2.1.2 When are repayments not taken into account?

While s.109R can apply in respect of loans and repayments, it only applies in particular circumstances:

> *(2) A payment must not be taken into account if:*
>
> > *(a) a reasonable person would conclude (having regard to all the circumstances) that, when the payment was made, the entity intended to obtain a loan or loans from the private company of a total amount similar to, or larger than, the payment; or*
> >
> > *(b) both of the following subparagraphs apply:*
> >
> > > *(i) the entity obtained, before the payment was made, a loan or loans from the private company of a total amount similar to, or larger than, the amount of the payment;*
> > >
> > > *(ii) a reasonable person would conclude (having regard to all the circumstances) that the entity obtained the loan or loans in order to make the payment.*

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There are a number of aspects within subsection 2 which are relevant to consider in order to determine if a repayment will not be taken into account for the s.109D and s.109E purposes noted above, being:

- The amount of the loan(s)
- Intention
- Subtleties of whether the loan(s) is made before or after the repayment
- All the circumstances
- Reasonable person

The amount of the loan(s)

For s.109R to apply, the amount of the 'new' loan taken out needs to be similar to, or larger than, the repayment. Hence, if the additional loan is considerably smaller than the repayment amount, it should not trigger the application of s.109R.

Intention

Where a 'new' loan is taken out after the repayment has been made, s.109R can only apply where there was an intention at the time the repayment was made that such 'new' loan (of a similar or larger amount than the repayment) would be taken out. If there is no intention at that time, this requirement will not be met and hence s.109R should not apply.

Where a 'new' loan is taken out prior to the repayment being made, it is necessary for a reasonable person (discussed below) to conclude that the entity obtained the loan(s) in order to make the repayment. Absent this link between the 'new' loan and the repayment, s.109R should not apply.

All the circumstances

A core part of the s.109R analysis is that regard needs to be had to all the circumstances. This implies a wider reaching consideration of the situation than merely the particular loan or repayment in isolation.

Reasonable person

A core aspect of s.109R is the 'reasonable person' test. This requires the conclusions within s.109R(2) to be made through the eyes of a 'reasonable person'. When combined with the intention aspect mentioned above, it is clear that s.109R(2) is only intended to be applied in particular circumstances, not merely every time there is a loan made by the company in a subsequent year.

Subtleties of whether the loan(s) is made before or after the repayment

As noted above, the intent of s.109R remains consistent irrespective of whether the 'new' loan(s) is drawn down before or after the repayment. However, the subtleties of the wording of the provisions do vary slightly depending on whether the loan is drawn down before or after the repayment.

2.1.3 Exclusions from s.109R(2)

Offsetting

Certain situations where there is an offsetting of amounts against a loan are specifically excluded from having s.109R apply to them (i.e. there is an exclusion to s.109R(2)).

> *(3) Subsection (2) does not apply to a payment made by setting off against an amount payable in relation to the loan:*
>
> > *(a) a dividend payable by the private company to the entity; or*
> >
> > *(b) work and income support related withholding payments and benefits payable by the private company to the entity; or*
> >
> > *(ba) payments covered by section 12-55 in Schedule 1 to the Taxation Administration Act 1953 ; or*
> >
> > *(c) if the entity has transferred property to the private company--an amount equalling the difference between:*
> >
> > > *(i) the amount that a party at arm's length from the entity would have paid for the transfer of the property to the party; and*
> > >
> > > *(ii) the amount that the private company has already paid the entity (by way of set-off or otherwise) for the transfer.*

Hence, a borrower who is making the repayment by offsetting their dividend or salary (an amount subject to PAYGW) from the company against their loan from the company can do so without the potential application of s.109R. However, as noted below, beware of whose dividend, salary or loan it is.

Assessable payment made by another

In certain circumstances, a specific exclusion from s.109R applies to situations where another party has made the repayment on behalf of the borrower:

> *(4) Nor does subsection (2) apply to a payment made on behalf of the entity (the borrower) by another entity paying to the private company an amount that:*
>
> > *(a) is payable by the other entity to the borrower; and*
> >
> > *(b) is assessable income of the borrower for the year of income in which the payment was made or an earlier year of income.*

This exclusion in s.109R(4) is relatively narrow, given that (b) requires the amount to be, or have been, assessable income of the borrower during that year or an earlier income year. A mere use of someone else's credit loan balance would generally not be expected to meet this requirement.

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Switching from 7 to 25 year loans

In some instances, a Division 7A loan may be refinanced from a 7 year loan to a 25 year loan (or vice versa). In such instances particular exclusions from s.109R applying are contained in ss.(6) and (7) of s.109R.

Offsetting loan accounts

Within groups of entities, it is not uncommon for the parties to want to 'tidy up' loan balances such that only one entity in the group has loans with the shareholders (or associates). While this may make sense from a commercial and accounting perspective, care needs to be taken from a tax perspective, including Division 7A.

As well as s.109R, the interposed entity provisions in s.109T, s.109V and s.109W (discussed further in subsequent sections of this paper) need to be carefully considered and navigated when offsetting loans within groups. While a mere offsetting of a credit loan owed to a shareholder from one entity with a debit loan that shareholder has with another entity shouldn't on its own trigger an adverse Division 7A implication, the underlying transactions which led to the loans and the amount of offsetting within the group to achieve the outcomes needs careful consideration.

Where debit loans from multiple entities in a group are being 'merged' into a single debit loan from one company to the shareholder, particular care needs to be taken to ensure that s.109T and s. 109W don't apply, and that the repayment isn't disregarded under s.109R(2). While there are the 'reasonable person', 'intention' and 'all the circumstances' aspects to consider (as noted above), it shouldn't be automatically assumed that they will allow for loans within a group to be 'tidied up' free of Division 7A implications. It should also be remembered that even if Division 7A can be technically navigated, Part IVA can still apply to relevant circumstances.

When taking on new clients with existing Division 7A loans, it is crucial to gain a full understanding of the underlying composition of the loans to ensure that you appropriately address the Division 7A implications in the period you are engaged to attend to tax matters for. Don't just assume that positive actions (such as physically making a repayment on a loan) will always be accepted for Division 7A purposes (for example if s. 109R applied to not take that repayment into account).

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3. Where did that loan really come from?

The reach of Division 7A can go beyond the initial entity in a chain, and instead operate in such a way that the eventual recipient of the payment or loan (the target entity) is the one to which adverse Division 7A implications may apply. However, this deeming only operates in certain instances, with the core starting point being a consideration of section 109T.

3.1 Section 109T

Section 109T states:

> *(1) This Division operates as if a private company makes a payment or loan to an entity (the target entity) as described in section 109V or 109W if:*
>
> > *(a) the private company makes a payment or loan to another entity (the first interposed entity) that is interposed between the private company and the target entity; and*
> >
> > *(b) a reasonable person would conclude (having regard to all the circumstances) that the private company made the payment or loan solely or mainly as part of an arrangement involving a payment or loan to the target entity; and*
> >
> > *(c) either:*
> >
> > > *(i) the first interposed entity makes a payment or loan to the target entity; or*
> > >
> > > *(ii) another entity interposed between the private company and the target entity makes a payment or loan to the target entity.*
>
> *This section operates regardless of certain factors*
>
> *(2) For the purposes of this section, it does not matter:*
>
> > *(a) whether the interposed entity made the payment or loan to the target entity before, after or at the same time as the first interposed entity received the payment or loan from the private company; or*
> >
> > *(b) whether or not the interposed entity paid or lent the target entity the same amount as the private company paid or lent the first interposed entity.*
>
> *This section does not operate if the payment or loan to the first interposed entity is treated as a dividend*
>
> *(3) This Division does not operate as described in subsection (1) (and sections 109V and 109W) if the private company is taken under Subdivision B (as it applies apart from this Subdivision) to pay a dividend as a result of the payment or loan to the first interposed entity.*

There are various aspects that can be gleaned from the above, including:

- An interposed entity(ies)
- When the loan is made, and its amount
- Reasonable person
- All of the circumstances
- Intention

Interposed entity(ies)

For s. 109T to have application, there needs to be a chain of entities, whereby there is an eventual recipient of the payment or loan (the target entity), and there was a private company which initially made a payment or loan that made it's way to the target entity. How many entities are in between (i.e. interposed entities) is not of direct relevance other than in respect of subsection 3 whereby s. 109T does not operate if the initial loan or payment from the company to the first entity already resulted in the payment of a dividend under Division 7A.

When the loan is made and its amount

Section 109T is clear that for the purposes of whether the section applies, it doesn't matter the amount or timing of the loan from the interposed entity to the target. This contrasts to s. 109R(2)(b) whereby the timing and amount of the loans are relevant to the s. 109R conclusion. Hence, the potential application of 109T could have a notable breadth to it. Notwithstanding this, if s. 109T does have application, the amount of the potential deemed dividend under s. 109V or s. 109W does need to have regard to the circumstances and flow from the company to the target entity.

All the circumstances

A core part of the s.109T analysis (similar to that in s. 109R) is that regard needs to be had to all the circumstances. This implies a wider reaching consideration of the situation than merely the particular loan or payment in isolation.

Reasonable person

A core aspect of s.109T is the 'reasonable person' test. This requires the conclusions within s.109T(1) to be made through the eyes of a 'reasonable person'. When combined with the intention aspect mentioned below, it is clear that s.109T is only intended to be applied in particular circumstances, not merely every time there is a loan made by the company.

Intention

The intention of the private company making the payment needs to have a sufficient link to the payment or loan to the target entity. As s.109T(1)(b) states, the payment or loan needs to be made by the company "solely or mainly as part of an arrangement involving a payment or loan to the target entity". If the loan or payment from the company is merely incidental to an interposed entity making a loan or payment to a target, s. 109T should not be enlivened.

Historic loans

As noted above, there may be no mischief intended when funds flow within a group, or loans are offset within a structure, however care needs to be taken to not inadvertently trigger adverse Division 7A issues. Section 109R has the ability to effectively ignore (for Division 7A purposes) certain repayments, while s. 109T can trace through a chain of entities in certain instances to deem a dividend to be paid from an entity different to the one which the ultimate borrower physically borrowed their funds from.

Importantly, sufficient understanding of all the circumstances, which may include aspects arising in other years, is needed to accurately consider the potential application of s. 109R and s. 109T. Hence, when taking on new clients, it may be necessary to look at prior period items in some detail in order to correctly attend to the Division 7A implications during the period in which you are engaged for.

4. Division 7A or FBT?

On face value, Division 7A and FBT both seek to impose tax implications on some overlapping types of items; loans, payments and forgiveness. While FBT may be targeted at situations where these items are provided to employees (or associates), and Division 7A where they are provided to shareholders (or associates), what happens where an individual is both an employee and a shareholder of the company? Does Division 7A or FBT have taxing rights in that instance, or do they both?

4.1 The type of item matters

The priority system for Division 7A or FBT having first taxing rights depends on the type of item involved.

4.1.1 Loans and forgiveness

Section 109ZB contains certain clarification in respect of whether Division 7A or FBT has priority in respect of loans and forgiveness, granting Division 7A priority as follows:

> *(1) This Division applies to a loan of an amount to an entity by a private company, even if the loan is made:*
>
> > *(a) to the entity in its capacity as an employee (as defined in the Fringe Benefits Tax Assessment Act 1986) or an associate of such an employee; or*
> >
> > *(b) in respect of the employment of an employee (as defined in that Act).*
>
> *Note: This helps ensure that a loan is not a fringe benefit for the purposes of that Act.*
>
> *(2) This Division applies to a private company's forgiveness of a debt owed by an entity to the private company, even if:*
>
> > *(a) the entity owed the debt in its capacity as an employee (as defined in the Fringe Benefits Tax Assessment Act 1986) or an associate of such an employee; or*
> >
> > *(b) the forgiveness occurs in respect of the employment of an employee (as defined in that Act).*
>
> *Note: This helps ensure that the forgiveness of a debt is not a fringe benefit for the purposes of that Act.*

4.1.2 Payments

A payment for Division 7A purposes is broad, and can include the use of a company asset. Notwithstanding this, s.109ZB states:

> *(3) However, this Division does not apply to a payment made to a shareholder, or an associate of a shareholder, in their capacity as an employee (as defined in the Fringe Benefits Tax Assessment Act 1986) or an associate of such an employee.*

4.2 Is that it?

Whilst the intent of having loans and forgiveness dealt with under Division 7A and payments under FBT may be evident, there are still aspects of the provisions which are not entirely clear.

In Treasury's consultation paper from October 2018, *Targeted amendments to the Division 7A integrity rules*, a number of aspects of the Division 7A/FBT interaction were flagged as requiring clarification, which has yet to be provided. The paper noted the following:

> *To improve the clarity and integrity in relation to the interaction between Division 7A and the FBT provisions, amendments will be made to clarify that:*
>
> - *the exception in subsection 109ZB(3), which provides that Division 7A does not apply to payments made to shareholders (or their associates) in their capacity as an employee (or an associate of such an employee), only applies where that payment would constitute a fringe benefit. In determining if a payment is a fringe benefit within the meaning of subsection 136(1) of the Fringe Benefits Tax Assessment Act 1986, paragraph (r) should be disregarded;*
> - *former shareholders (or their associates) should be treated consistently with current shareholders. The exception in subsection 109ZB(3) will be extended to ensure that Division 7A will not apply to payments to former shareholders or associates of former shareholders in their capacity as an employee if the payment was a fringe benefit; and*
> - *FBT will not apply to payments to former shareholders and their associates that are otherwise captured by Division 7A.*
>
> *These amendments will clarify and provide integrity in relation to the interaction between Division 7A and the FBT provisions.*

5. 25 year loans

Although Treasury's 2018 consultation paper flagged the possibility of introducing a single 10 year loan arrangement for Division 7A, we continue to have two core loan terms under the current provisions, a 7 year or 25 year loan. While the 7 year arrangement is by far the most commonly used of the two, is the 25 year loan underutilised?

5.1 The common criteria

Whether entering into a 7 year or 25 year loan, there are certain criteria common to both loans which must be satisfied. These are set out in s.109N as:

> *(1) A private company that makes a loan to an entity in one of the private company's years of income is not taken under section 109D to pay a dividend at the end of the year of income because of the loan if, before the lodgment day for the year of income:*
>
> > *(a) the agreement that the loan was made under is in writing; and*
> >
> > *(b) the rate of interest payable on the loan for years of income after the year in which the loan is made equals or exceeds the benchmark interest rate for the year; and*
> >
> > *(c) the term of the loan does not exceed the term (the maximum term) for that kind of loan worked out under subsection (3).*

Hence, the loan must:

- Be in writing
- Have an interest rate at or exceeding a particular benchmark
- Be of a maximum term (see below).

The benchmark interest rate is the indicator Lending Rates--Bank variable housing loans interest rate last published by the Reserve Bank of Australia before the start of the year of income. Practically this means the May rate, published early June. For the 2025 year the rate is 8.77%.

If the above criteria are met, it is important to then determine the maximum permitted term of the loan.

5.2 The 25 year loan

When thinking about the two types of Division 7A loans, many people refer to 7 year loans as unsecured and 25 years as secured. Whilst it is correct that a 25 year loan requires appropriate security (refer below) in order to be a complying 25 year Division 7A loan, Division 7A is silent on the security aspect for 7 year loans, meaning they could be secured (if the parties wanted) or unsecured. In practice, the 7 year Division 7A loans would typically be unsecured. S.109N(3) provides:

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The maximum term is:

(a) 25 years for a loan if:

(i) 100% of the value of the loan is secured by a mortgage over real property that has been registered in accordance with a law of a State or Territory; and

(ii) when the loan is first made, the market value of that real property (less the amounts of any other liabilities secured over that property in priority to the loan) is at least 110% of the amount of the loan; and

(b) 7 years for any other loan.

However, the maximum term for a loan is the period worked out under the regulations, if they provide for working out the maximum term for that kind of loan.

Hence, some points to note:

- The 25 year or 7 year terms are the maximum term
- The amount of security and when to consider the value of the security is specified in the legislation
- The type of acceptable security is set out in the legislation

25 years or 7 years?

While the legislation specifically mentions 25 years and 7 years, these are the maximum terms. It is possible to have a shorter term loan, for example if all other relevant aspects of a secured loan were addressed, a 15 year loan could be put in place rather than 25 years. Similarly, a 3 year rather than 7 year loan could be put in place for a loan that met all relevant aspects other than the security part. In reality, Division 7A is only generally capturing loans with related parties, so unless there is a commercial imperative to draft the loan arrangement with terms less than 25 or 7 years, the loan could be repaid faster than the maximum term if the parties agreed.

The amount of security

To meet the relevant security amount criteria, the entirety of the loan must be secured and the value of the security must be at least 110% of the amount of the loan when the loan is first made. Practically this translates to a loan-to-value ratio (LVR) of just over 90%.

Importantly, the value of the security does not need to be re-tested during the life of the facility, and there is no requirement for the security to be a first mortgage.

The type of security

The loan must be secured by a mortgage over real property. The security must be registered in accordance with a law of a State or Territory.

There is no requirement for the security to be owned by the borrower, however it must be real property.

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5.3 Use of 25 year loans in a private group

Where a private group structure allows for it, creating an investment company which is the 'banker' of the group can prove a useful strategy. The banker may lend funds to other entities in the group, such as trusts, to acquire growth assets. From a commercial perspective, the company holding secured passive style assets (in this instance loans) can be an effective asset protection mechanism, while the 25 year loan term can ensure that the principal of the loan is steadily paid off over time. Furthermore, with interest rates on Division 7A loans being in excess of 8% for the 2025 year, it can provide notable tax deductions for the borrower entity and a source of growth in the investment pot of the banker company.

Depending on the other sources of income of the banker company, its tax rate may be 25% or 30%. Either way, this is significantly lower than the top marginal tax rate.

In some instances, funds may be loaned from an existing trading company to another entity in the group, such as a trust. While this approach might have certain practical advantages such as minimising the number of entities in the group (i.e. not needing to setup a new company to act as the banker of the group), there are notable disadvantages from an asset protection perspective, and also from an active asset test perspective (the loan from the trading company is unlikely to be an active asset, which could impact on the ability to access small business CGT concessions on the sale of shares in the trading company).

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6. Deemed dividends

Most taxpayers and their advisors try to ensure that the requirements of Division 7A are complied with in such a manner that the adverse outcomes, in the form of the payment of a deemed dividend, does not happen. However, if a deemed dividend is triggered, who is taxed on it and is the payment of a deemed dividend always a bad thing?

6.1 Who is taxed on a deemed dividend?

A 'regular' dividend paid validly in accordance with the Corporations Act should be assessable in the hands of the relevant shareholder. However, under Division 7A, dividends are deemed to be paid for income tax purposes if certain criteria are met; an 'actual' dividend is not triggered.

Under s.109C(1):

> *A private company is taken to pay a dividend to an entity [emphasis added] at the end of the private company's year of income if the private company pays an amount to the entity [emphasis added] during the year and either:*
>
> > *(a) the payment is made when the entity is a shareholder in the private company or an associate of such a shareholder; or*
> >
> > *(b) a reasonable person would conclude (having regard to all the circumstances) that the payment is made because the entity has been such a shareholder or associate at some time.*

Thus, while subsection (a) requires the shareholder or associate relationship to the company in order for Division 7A implications to be triggered, the deemed dividend itself is paid for tax purposes to the relevant party who has received the payment (or the benefit of the payment). There is no requirement that such party is the actual shareholder of the company.

6.2 Franked or not?

The default position is that a deemed dividend is unfranked. However, in certain instances, the dividend may be able to be franked, such as:

- Under s.109RB where there was an honest mistake or inadvertent omission; or
- Under s.109RC where the dividend is taken to be paid because of a family law obligation.

When dealing with relationship breakdown situations, the ability to frank dividends can be a useful way of managing the tax implications that arise when dividing the assets of the separated couple.

6.3 Is the payment of the deemed dividend problematic?

The answer 'it depends' is generally appropriate to the question of whether the payment of a deemed dividend is problematic. In some instances, the deemed dividend will mean more tax payable for the relevant parties, but in other instances, it may actually result in less tax than a regular dividend situation.

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Consider the following scenarios:

1) Bob is the sole shareholder of his company, PrivCo Pty Ltd, but is not an employee of the company. PrivCo has significant amounts of retained earnings and franking credits. PrivCo pays certain private expenses of Bob's, totalling $15,000.

   Unless the requirements of Division 7A are otherwise addressed, an unfranked dividend of $15,000 is likely to be deemed for tax purposes in Bob's hands. This is likely to be less tax effective for Bob than if he'd received a 'regular' fully franked dividend of the equivalent amount (which was subsequently used to pay for the private expenses).

2) Consider the same scenario as 1), but assume the company has no franking credits. In that instance there may be no practical difference in tax outcomes for Bob whether PrivCo pays him an actual dividend of $15,000 (unfranked) or a deemed dividend of that amount under Division 7A.

3) Consider the same scenario as 1), but assume that the private expenses were actually those of Frank, Bob's grandson.

   If Division 7A is not appropriately addressed, Frank may be assessable on a $15,000 unfranked dividend. If Frank has no other income, while Bob is on a higher marginal tax bracket, Frank receiving a deemed dividend may actually be more tax effective than if PrivCo had paid Bob a fully franked dividend, with which he then gifted the money to his grandson.

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