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Mythbusting Division 7A

DIVISION 7A STILL CAUSES ACCOUNTANCY PRACTITIONERS MAJOR HEADACHES BECAUSE OF THE WAY THEIR FINANCIAL STATEMENTS ARE PREPARED. DEALING WITH THE ATO COULD BE EASIER IF TRANSACTIONS ARE PROPERLY ACCOUNTED FOR.



Since the introduction of Div 7A into the *Income Tax Assessment Act 1936* (“ITAA36”) in 1997,¹ there has been some misconception about the intended effect of its operation.

Too often, I see experienced accountancy practitioners, after having endured an initial review and subsequent audit by the Australian Taxation Office, faced with the prospect of being issued with amended assessments simply because the practitioner was unaware that a loan by a company to a related trust, for example, would invoke the provisions of Div 7A.

I also see correspondence which passes between the practitioner and the ATO during the audit process, but prior to the issuing of amended assessments. Usually, the correspondence goes something like this:

“My client is a hardworking person who would never dream of defrauding the tax office ...”;

“Whilst we admit that the taxpayer took loans from his company, such loans were for private purposes only ...”;

“I did not know that the lending of money from a company to a trust would be taxable ...”

In each of these cases, apart from admissions being made which supports the raising of amended assessments by the Commissioner, there must be some grave misunderstanding about the way that Div 7A operates and its policy intention and effect.

Given that it has been nearly a decade since the introduction of Div 7A, such ignorance of even the basic rules that would trigger Div 7A is inexcusable. Remember, accountancy practitioners are expected to be “tax experts”!²

Although punitive to some extent, the policy underpinning Div 7A is that if any form of economic benefit is extracted by a shareholder or associate from a private company that is not

assessable income, then that amount is deemed to be a dividend in the hands of the recipient. The punitive aspect is that the dividend is unfrankable,³ and yet the company’s franking account is debited, as though it had made a frankable distribution.⁴ Obviously Div 7A is designed to discourage such activity.

This paper examines some of the underlying reasons why there is some misunderstanding about the way in which Div 7A operates, but also examines some of the “myths” surrounding the operation of Div 7A, particularly in an accounting context. Unfortunately, accountants, as registered tax agents, are at the coal-face when dealing with uneducated clients and the ATO. Some of the issues in this article should provide some salutary lessons, and if not, then perhaps some food for thought!

Possibly explaining the misconception

Prior to the introduction of Div 7A, the Commissioner could only rely on s 108 of the ITAA36 to assess shareholders or their associates on any dividends that were deemed to have been paid by a private company.

The operative clause of s 108 is subs 108(1) which says that: “if a private company pays an amount ... or by way of advance or loan ... in the opinion of the Commissioner...”

In other words, unless an ATO auditor reviewed a private company’s financial statements, and after having seen a debit balance, either as a loan or as an expense, and formed an opinion that the amount was paid out of profits, then s 108 could not apply.

Not unexpectedly, s 108 was heavily litigated, particularly the concept of “out of profits”.⁵ Nevertheless, the prevention of extracting wealth from private companies in the form of

non-assessable payments or loans was difficult to enforce under s 108.

Realistically, the primary reason for this must have been because the ATO simply did not have the resources to review every private company's financial statements to form the requisite opinion. As time passed, it is likely that accountancy practitioners who were not subjected to any ATO presence would have simply ignored, or even forgotten, the operation of s 108 because the Commissioner could not, and did not, form an opinion.

Now consider the present extracts from Div 7A:

"A private company is taken to pay a dividend to an entity at the end of the private company's year of income if the private company pays an amount to the entity during the year and either";⁶ and,

A private company is taken to pay a dividend to an entity at the end of one of the private company's years of income (the "current year") if:

- (a) the private company makes a loan to the entity during the current year; and
- (b) the loan is not fully repaid by the end of the current year; and
- (c)
- (d)

In this paragraph the following contradistinctions can be drawn against the present provisions of Div 7A which superseded s 108:

- For the purpose of giving effect to the operation of Div 7A, there are separate provisions for payments and loans. In particular, a loan to an entity is not a payment to the entity;⁸
- Div 7A operates "automatically" in the sense that if the preconditions are satisfied, and there is a distributable surplus, the recipient of the dividend must include that amount as his or her assessable income. That is why it says: "... taken to pay ..."

Oddly enough, s 108 applies to an "associated person", meaning either a shareholder or an associate of a company,⁹ but Div 7A is expanded to apply to non-share equity interest holders as well as shareholders and their associates.¹⁰

DIVISION 7A MYTHS – LOANS AND PAYMENTS

Is there a loan?

Let's put it like this:

An accountancy practitioner is primarily trained to deal in debits and credits when preparing financial statements. Practitioners, particularly those that deal with SME's, have difficulty

in dealing with transactions where a private company pays an amount to a controller.¹¹ In many cases, by default, the transaction is recorded by debiting a "loan" account, being in the company's balance sheet, rather than expensing the amount through the profit and loss statement.

I have often asked a simple question of such controllers of SME's when I review the financial statements of a private company: "Do you ever intend to repay the money you 'borrowed'?". Invariably, the answer is "of course not!"

Now where does that leave the hapless accountancy practitioner? After all, the financial statements he or she has prepared are then incorrect, because a receivable called a "loan" which necessarily implies the existence of a debtor-creditor relationship is shown as an asset, when in fact, it is not realisable and should be not be shown as such. That means that if a proper recording of the transaction had occurred at the time of the payment, then perhaps, the company's profit and loss account should have shown a non-deductible expense.¹² It also means that the company's retained earnings brought forward, and its "distributable surplus"¹³ would be depleted.

Given that for the purposes of Div 7A, a loan to an entity is not a payment to the entity,¹⁴ then there must necessarily be a delineation between the two, so the question then becomes – is an "outgoing" a payment or a loan?

A "payment" as distinguished from a loan, connotes a singular transaction, ie it cannot be reversed by being repaid. A "gift" for example happens when one person does everything he or she can to perfect the gift so that there may not be any ability for the donor to reclaim the gift.¹⁵

A "payment" for Div 7A purposes is exclusively defined¹⁶ to include a payment, a crediting of an amount,¹⁷ or a transfer of property.¹⁸

Therefore, an expense of a private company that is debited to its profit and loss account, and claimed as an allowable deduction, but is in reality non-deductible, would fall into the concept of a "payment" for Div 7A purposes and be deemed to be a dividend, and assessable to the extent of the company's distributable surplus in the income year in which the payment is made.

On the other hand, payments made by a private company that are debited by an accountancy practitioner to its balance sheet as a receivable shouldn't simply be accepted as giving rise to a "loan".

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Technically, a loan is in fact a limited concept. For example in Taxation Ruling TR 93/28, the definition of a “loan” is as follows:

34. For there to be borrowed money there must exist a legal relationship of lender and borrower. In addition, an obligation of repayment by the borrower is essential to a loan transaction (cf. *Inland Revenue Commissioners v. Rowntree and Co. Limited* (1948) 1 All ER 482 at 486; *Ferguson v. O’Neil* (1943) VLR 30 at 32). Money is lent where there exists in one party a right to repayment of principal and to payment of interest accrued on the principal. Money lent (the principal) constitutes a debt owing by the borrower (debtor) to the lender (creditor). Interest is the payment which becomes due because the creditor has not had his money at the due date (cf. *Humes Limited v. Comptroller of Stamps (Vic)* 89 ATC 4656 at 4651, (1989) 20 ATR 860.

So, a loan in a technical sense is a creature of contract, but can also arise by court judgment, by statute or other legislative process, or in some cases as the result of a trust, however it is fundamentally different to a trust because the borrower is not a trustee of the creditor, and no fiduciary duty attaches to the money borrowed, subject to any contractual terms.

The definition of loan for the purposes of Div 7A is quite broad and is an inclusive one.¹⁹ It includes:

- (a) an advance of money; and
- (b) a provision of credit or any other form of financial accommodation; and
- (c) a payment of an amount for, on account of, on behalf of or at the request of, an entity, if there is an express or implied obligation to repay the amount; and
- (d) a transaction (whatever its terms or form) which in substance effects a loan of money.

That explains why commercial loan agreements to avoid the operation of Div 7A must now be in writing,²⁰ so that as a matter of evidence, it ensures that a debtor must expressly acknowledge the existence of a debt owed to a creditor.

Therefore, in reconsidering the question whether a debit balance in a balance sheet is a receivable or a loan, consider if there is in fact a debtor. For example, if there is no debtor, then the relevant balance should be reversed to the company’s profit and loss statement as an expense (non deductible). This would have the effect of reducing the company’s distributable surplus, because the net assets value will decrease by the corresponding amount of the payment.

It also implies that at some earlier time there was, in fact, a payment. This amount should have been brought to account as assessable income in the hands of the recipient.²¹ In terms of timing, that payment may have been made far earlier than the relevant time limits for amending assessments, and in the absence of fraud or evasion, may mean the Commissioner is unable to issue an amended assessment unless he treats the amount written off as a forgiven debt.²² The point of this is that the financial statements of a private company should reflect its obligations to external parties such as creditors and the resources available to discharge those obligations. Showing a non-existent asset as a resource is misleading to the users of those financial statements.

Payment v Loan

All other things being equal, there is little comfort to a recipient²³ of a payment who initially may have tried to disguise the extraction of wealth from a private company as a loan. That amount will be a payment because of the express delineation between loans and payments.²⁴

Obviously if an amount is paid as a dividend, meaning that it has been declared by the directors of the company by way of resolution, and in accordance with any requirements prescribed in a private company’s constitution, it would generally be a frankable distribution and Div 7A would be precluded from operating.²⁵

Anything else would thus be caught as a payment, and once made, subject to the company’s distributable surplus, means that Div 7A will apply, with no ability to reverse or “undo” the transaction.

The problem is further compounded because of the effect of the “market value substitution rule”²⁶ in subs 109C(4). That subsection says:

The amount of a payment consisting of a transfer of property is the amount that would have been paid for the transfer by parties dealing at arm’s length less any consideration given by the transferee for the transfer. (The amount of a payment is nil if the consideration given by the transferee equals or exceeds the amount that would have been paid at arm’s length for the transfer.)

So, consider the following scenario:

The controllers of a private company restructured their affairs by having the company transfer its very profitable business to a partnership of trusts structure of which each controller’s respective family were the ultimate beneficial owners.

No money changed hands because the private company disposed of its business to another

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All other things being equal, there is little comfort to a recipient of a payment who initially may have tried to disguise the extraction of wealth from a private company as a loan.

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entity for no consideration. For accounting purposes, the transaction was treated by way of journal entry, with a net debit entry to the existing loan account of each shareholder who had now acquired a partnership interest.

The deemed market value rule in subs 109C(4) is not widely known or understood, unlike its counterpart in Div 116 of the ITAA97, which would also have applied, but the 2 sections operate quite independently.

The term “property” is not defined in Div 7A,²⁷ and so takes its meaning from the general law. Goodwill is property, albeit intangible property.²⁸

In this case there is a “payment” because there is a transfer of property,²⁹ and the market value of the goodwill is the amount of the payment, subject to the company’s distributable surplus. The disposal of property will not have reduced the calculation of the distributable surplus, but in fact increased it, because the goodwill will generally not have been recorded, but the loans that arose in the books because of the journal entry will reflect an increase in the value of the company’s net assets.

Now here’s where it gets interesting!

If there was a loan account in the private company’s books with each trust, that was in credit and the balance of that account exceeded the market value of the goodwill and other assets transferred, then there should not be any Div 7A consequences because the transfer would have been to discharge an obligation of the company on an arm’s length basis.³⁰ Other issues can also arise, putting to one side the issue of whether a credit loan account is non-share equity, because if the credit loan account is in favour of another entity, say an individual, and the transfer is to a trust, then arguably, there is also a debt forgiveness issue that may need to be considered.

Now assume that there were no loan accounts, but the transfer gave rise to debit loan accounts.

The recognition of the receivable, assuming that the respective trusts agreed to pay the amounts, represents an asset, being a chose in action, that can be recovered by the private company. As the value of the chose is equivalent to the business transferred, then there is no “payment” because subs 109C(4) has not been satisfied. In other words, the amount of the payment is nil because the consideration given by the transferee (being the chose) equals or exceeds the amount that would have been paid at arm’s length for the transfer.

But that means that there are debit loan accounts, which if not repaid or put on a commercial footing, and Div 7A will apply.

DIVISION 7A MYTHS – FORGIVEN DEBTS

Prior to the introduction of Schedule 2C in the *Income Tax Assessment Act 1936* (“ITAA36”) the forgiveness of debts has long been seen as a way of avoiding any adverse taxation consequences. Typically, a debt incurred for which the debtor was able to claim an allowable deduction would not generally give rise to assessable income upon the forgiveness of the debt.

The effect of Schedule 2C is to reduce the tax attributes of assets held by the debtor as a consequence of any debt forgiveness. Typically, this meant that revenue and capital losses would be reduced as well as other tax attributes in a particular order.

With the introduction of Div 7A into the ITAA36, debts that a private company forgave a shareholder or an associate could be subject to the deemed dividend rules. Note that with the introduction of the debt/equity rules, a person having an equity interest in a private company is also subject to Div 7A.³¹ This is a far cry from having one’s tax attributes of assets affected, to the potential inclusion of the amount in that person’s assessable income.

Schedule 2C

In order to understand debt forgiveness for Div 7A purposes, an understanding of Schedule 2C is required.

Broadly, Schedule 2C operates as set out in the map to Div 245.³² The purpose of that division is to identify:

- when a debt satisfies the conditions of being a commercial debt;
- the ways in which forgiveness of commercial debts can occur;
- what is the gross forgiven amount;
- what is the net forgiven amount;
- how the net forgiven amounts reduce the debtor’s tax attributes; and
- special rules in relation to certain entities.

In order for Schedule 2C to operate, there must be a debt,³³ the debt must be a commercial debt³⁴ and the commercial debt must be forgiven within the meaning of Schedule 2C.³⁵

Debt

A debt is defined as an enforceable obligation imposed by law on a person to pay an amount to another person.³⁶



Commercial Debt

A debt is a commercial debt if the whole or any part of interest that has been paid or payable in respect of the debt is or would be allowable as a deduction to the debtor.³⁷ The debt is still a commercial debt, even if no interest is paid, but would have been a deduction had it been paid.³⁸ Finally, a non-equity share is taken to be a commercial debt under the debt forgiveness rules.³⁹

Forgiven

For the purposes of Schedule 2C, a commercial debt is forgiven if:

- the debtor's obligation to pay the debt is released or waived, or is otherwise extinguished;⁴⁰
- a statute of limitations period within which the creditor is entitled to sue for the recovery of the debt ends without the debt having been paid;⁴¹
- if the debtor and creditor agree that the debt is to be forgiven in the future;⁴²
- debt parking;⁴³ and
- subscription for shares by and issue to the creditor to repay a debt owed by the debtor (debt/equity swap).⁴⁴

Debt forgiveness – Division 7A

Division 7A is only concerned with the first 2 points above in a private company context, namely:

- where there is a debt to a shareholder or an associate in existence; and
- the ways in which forgiveness of debts can occur;

Section 109F is the provision that determines the ways in which forgiveness occurs and provides the operative provision that brings the amount of the forgiven debt to account as assessable income, subject to the distributable surplus.⁴⁵

However, there are some important exceptions. Unlike, the strictly objective test in Schedule 2C, s 109F imports a “reasonable person” test.

In order for a forgiven debt to be a deemed dividend, the forgiveness must occur when the debtor is a shareholder or an associate. Furthermore, a reasonable person must conclude (having regard to all the circumstances) that the amount is forgiven because the debtor entity has been such a shareholder or associate at some time.⁴⁶

For the purposes of Div 7A, the debt is automatically assumed to be a commercial debt.⁴⁷

Although the amount forgiven is usually the amount of the deemed dividend, the section is

subject to the “distributable surplus” rule in s 109Y.⁴⁸

The term “forgiveness” for Div 7A purposes is defined as occurring when a debt would be forgiven under s 245-35 of Schedule 2C. There are 3 important qualifications to this general rule:

- 1) there is a different debt-parking test;
- 2) there is a presumption that the debt is a commercial debt, even if it is for private or domestic purposes where interest could never be an allowable deduction;⁴⁹ and,
- 3) there is a “reasonable person” test.

Interestingly, a discharge of a debt can occur by the transfer of property, without invoking the debt forgiveness rules.⁵⁰ This differs to the position in Schedule 2C where the extinguishment of a debt can only be by payment in cash.⁵¹

For the purposes of Div 7A, debt parking, and therefore “forgiveness” occurs if the private company creditor assigns a debt owed by any entity to another entity, which is an associate of the debtor and a reasonable person would conclude (having regard to all of the circumstances) that the new creditor will not insist on the debtor repaying the amount of the debt.⁵²

Dealing with “latent” debt forgiveness

A dormant loan account can be a problem because it can be deemed to be a debt that is forgiven. This is because a period within which the trust is entitled to sue for the recovery of the debt ends due to the operation of a statute of limitations without the debt having been paid.

Reference should also be made to the recent Victorian Supreme Court decision in *V L Finance Pty Ltd v Legudi*.⁵³ The relevant statute of limitations period in Victoria is generally 6 years by which a debt could be statute barred.⁵⁴ However a debt is not statute barred if the debtor expressly acknowledges that the debt is still on foot.

It should also be noted that if “at-call” debit loans that were advanced by a trust many years previously could still be caught under the debt forgiveness, even if the debt has not gone bad. In this case, a reasonable person must conclude, having regard to all the circumstances, that the trust will not insist on the debtor paying the amount or rely on the entities obligations to pay the amount. Under the debt forgiveness rules in Div 7A, the amount would be forgiven when a reasonable person would first reach that conclusion.

Subs 109F(6) says:

An amount of debt an entity (the “debtor”) owes a private company is also “forgiven” for the purposes of this Division if a reasonable person would conclude (having regard to all the circumstances) that the private company will not insist on the entity paying the amount or rely on the entity’s obligation to pay the amount. (The amount is forgiven when a reasonable person would first reach that conclusion.)

For the purposes of subs 109F(6), a reasonable person must conclude that the company will not insist on the debtor repaying the loan. This is a prospective test, and essentially requires the reasonable person to make a prediction about the company’s future behaviour. Although difficult to conceptualise, in practice I suspect that an inactive debit loan account or where there is no evidence of repayment of any loan may invoke this rule, because there has not been any insistence.

Mythbusting pre-4/12/97 Loans

These loans are usually dismissed by accountancy practitioners who treat them as still being on-foot with no prospect of being repaid. Putting aside s 108 and subs 109F(6), and assuming that the loans are, in fact loans, and are not statute barred, it still means that the Commissioner may pay attention. After all, the acknowledgment of a loan that is 20 years old, but with no or minimum loan repayments doesn’t sound too commercial!

However, in my view, subs 109F(6) cannot be ignored. There has been little information released into the public domain about the way such a form of debt forgiveness is intended to operate, but it is reasonable that as law, the Commissioner is bound to administer and enforce it.

The myth here is that a pre-4/12/97 loan can stay as a receivable in a private company’s balance sheet forever, provided it does not become statute-barred without any adverse taxation consequences. The reality is that it may already have been forgiven and that Div 7A has already applied automatically.

The lesson then is simple – review all of your clients’ private company financial statements. If there are pre-4/12/97 loans, consider either freshening-up the loans and have them repaid in accordance with Div 7A, or write-them off by declaring dividends which would be assessable and frankable.⁵⁵ In any event, discuss the issues with your clients who need to understand that loans need to be repaid, because if a client chooses not to do anything about it, then surely the Commissioner will!

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Reference notes

- 1 *Taxation Laws Amendment Bill (No 7) 1997*
- 2 *Walker v Hungerfords (1987) 19 ATR 745 per King CJ at p747 – “The very purpose of engaging tax advisers and accountants is to ensure that the returns are prepared upon a correct basis. Any calculation submitted by the taxpayer to his tax expert is necessarily submitted upon the basis that its conformity with tax law and correct tax and accounting practice will be verified by the expert.”*
- 3 *Paragraph 202-45(g)(i) Income Tax Assessment Act 1997 (“ITAA97”)*
- 4 *Section 205-30Item 8 ITAA97*
- 5 *For example, see MacFarlane v FCT (1986) 17 ATR 808*
- 6 *Subsection 109C(1)*
- 7 *Subsection 109D(1)*
- 8 *Subsection 109C(3)*
- 9 *Paragraph 108(3)(c)*
- 10 *Section 109BA*
- 11 *This anecdotal proposition is respectfully made.*
- 12 *Obviously, this would have other implications. The relevant amounts could be income according to ordinary concepts, or assessable under s 44 or be subject to FBT*
- 13 *Section 109Y*
- 14 *Subsection 109C(3A)*
- 15 *For example, see Corin v Patton (1990) 169 CLR 540*
- 16 *Section 109C(3)*
- 17 *For example, see Temple Wholesale Flower Supplies Pty Ltd v FCT (1990) 21 ATR 556*
- 18 *For example, see Ord Forrest Pty Ltd v FCT (1974) 4 ATR 230*
- 19 *Subsection 109D(3)*
- 20 *Paragraph 109N(1)(a)*
- 21 *Assumed to be a member or associate*
- 22 *Section 109F – although it becomes a circular argument, because debt forgiveness presupposes the existence of a debt to be forgiven!*
- 23 *Again assumed to be a member or associate*
- 24 *Subsection 109C(3A)*
- 25 *Subsection 109L(1)*
- 26 *My terminology*
- 27 *Section 109ZD*
- 28 *FCT v Murry (1998) 39 ATR 129*
- 29 *Paragraph 109C(3)(c)*
- 30 *Section 109J*
- 31 *Section 109BA*
- 32 *Section 245-3*
- 33 *Section 245-15*
- 34 *Section 245-25*
- 35 *Subdivision 245-B*
- 36 *Section 245-15*
- 37 *Subsection 245-25(2)*
- 38 *Subsection 245-25(3)*
- 39 *Subsection 245-25(4)*
- 40 *Subsection 245-35(1)*
- 41 *Subsection 245-35(2)*
- 42 *Subsection 245-35(3)*
- 43 *Subsection 245-35(4)*
- 44 *Subsection 245-35(5)*
- 45 *Subsection 109F(2)*
- 46 *Subsection 109F(1)*
- 47 *Subsection 109F(3)*
- 48 *Subsection 109F(2)*
- 49 *Subsection 109F(3)*
- 50 *Subsection 109F(4)*
- 51 *Subsection 245-245(1) – definition of “extinguish”*
- 52 *Subsection 109F(5)*
- 53 *[2003] VSC 57*
- 54 *Limitation Of Actions Act (Vic) 1958*
- 55 *Subject to section 109R*

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