



Nexia Tax Alliance Division 7A loan repayments

Wednesday, 19 May 2021

12:30–1:30pm (AEST)



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Nexia Australia

What we do for clients...

- Put money in your pocket
- Prevent money leaving your pocket
- Help you sleep well at night
 - And practitioners, too

Introduction

Div 7A loan repayments

- Almost never paid by transferring money
 - Set-off
 - Round-robin by journal
- Payment legally effective?
- When not effective:
 - Division 7A risk
 - Commercial risk
 - Practitioner risk
- Service offering

Today's session

- Brief recap on why Div 7A exists
- Loan repayments by set-off against a dividend
- Effectiveness of loan repayments made by a round-robin of journal entries
- Div 7A interest deductible? Don't assume so
- Won't cover all technical points
- Practical examples

Div 7A

Brief history

- In 1997:
 - Company tax rate 36%
 - Top personal rate: 48.5%
- 51.5c (dividend) vs 64c (loan)
- Your estate will owe the 64c
 - Do you care?

Div 7A

Brief history, cont

- No intention of repaying loan
 - In-substance dividend
 - No top-up tax collected
- From 4 December 1997, Div 7A applies:
 - Deemed dividend, self-executing
- Motivates behaviour to prevent this
 - All stick, no carrot
- Payments, forgiven debts as well

The stick

Deemed dividend

- Private company makes loan to shareholder/assoc
- If:
 - Not fully repaid **before** lodgement day, or
 - Not one of the exempt types of loans, then
 - Deemed dividend, full stop
- Note, no *actual* dividend paid:
 - Fiction created by law
 - Still legally a loan, on company's bal sheet
- Trust with corporate beneficiary

The stick

Deemed dividend

- Limited to distributable surplus
 - Do not assume DS is just retained profits
- If Div 7A triggered:
 - Cannot “fix”. Too late
 - s109RB
 - Do not repay loan

Exempt loan

Complying loan agreement

- Main type of exempt loan
- Loan agreement executed **before** lodgement day
- 7- or 25-year term
- Div 7A's ultimatum:
 - Repay with P&I, or be assessed on a deemed dividend
 - Stick motivation
- Benchmark interest rate
- Minimum annual repayment

Exempt loan

Complying loan agreement

- Template facility agreements (7- & 25-year)
 - Covers all future advance to particular borrower
- Execution service only – no contribution to authoring

Complying loan agreement

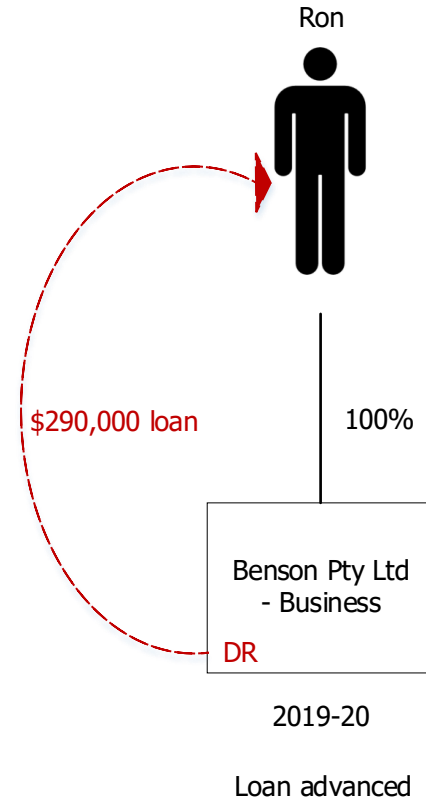
Minimum annual repayment (MAR)

- Almost never made by transferring money
- Set-off against actual dividend declared by company
- Clears out retained profits
- Top-up tax collected over loan term

Loan repayment by set-off

Example 1: MAR by set-off

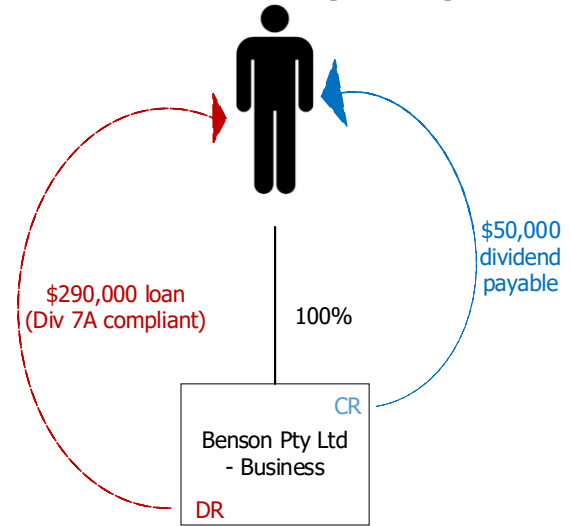
- Our client personally owns their company
 - Unrealistic; foundation for later examples
- Took money as a loan
- Complying loan agreement executed before 2019/20's lodgement day
- Interest starts from 1 July 2020
- MAR of \$49,249 due 30 June 2021



Loan repayment by set-off

Example 1: MAR by set-off

- Company declares \$50,000 FF dividend on 30 June 2021 (Tx 1)
- Now we have mutually opposing obligations
- Agree to make payments by set-off (Tx 2)
 - Express or implied



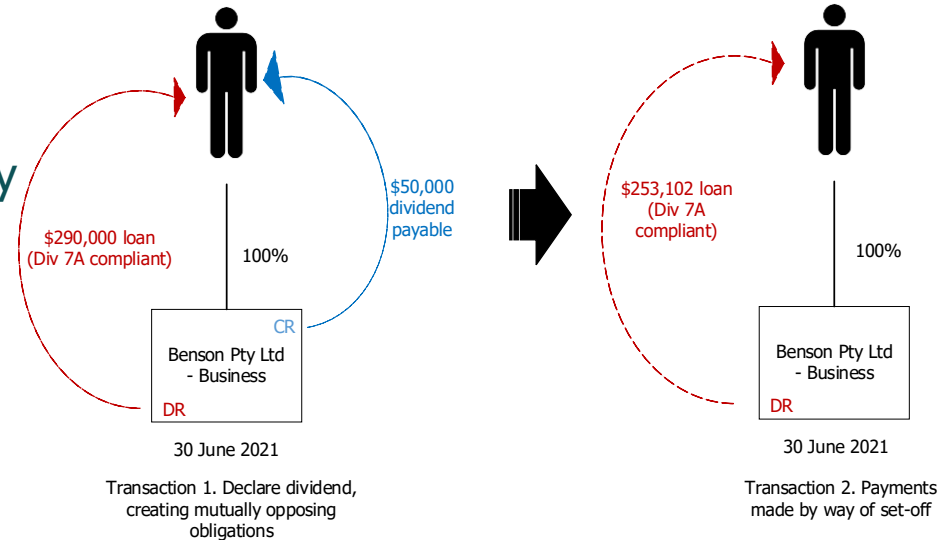
30 June 2021

Transaction 1. Declare dividend,
creating mutually opposing
obligations

Loan repayment by set-off

Example 1: MAR by set-off

- Agree to set off (Tx 2)
- Legally effective payments:
 - Company pays \$50k to client
 - Client pays \$50k MAR to company
- \$50k MAR comprises:
 - \$13,102 interest
 - \$36,898 principal
- Closing loan bal: \$253,102
- Top-up tax bill for client



Loan repayment by set-off

Example 1: MAR by set-off

- Journal entries in company
- Long way:

Benson Pty Ltd				
Records this transaction	Date	Account	DR \$	CR \$
1. Creation of liability owing to Ron	30 June 2021	Dividend paid	50,000	
		Dividend payable to Ron Benson		50,000
<hr/>				
2. Payments by way of setting off mutually opposing obligations	30 June 2021	Dividend payable to Ron Benson	50,000	
		Interest income		13,102
		Loan to Ron Benson (Div 7A)		36,898

Loan repayment by set-off

Example 1: MAR by set-off

- Journal entries in company, cont
- Short cut:

Date	Account	DR \$	CR \$
30 June 2021	Dividend paid	50,000	
	Interest income		13,102
	Loan to Ron Benson (Div 7A)		36,898

- Journal entries do not execute transactions, merely record them
 - Declare dividend (Tx 1)
 - Set-off (Tx 2, implied)

Loan repayment by set-off

Timing of dividend declaration

- Dividend for MAR set-off usually declared 1 July, not 30 June
 - ie, start of year, not end
- MAR comprises less interest, more principal reduction
- Less interest, lower tax cost
- Can't work out forthcoming year's MAR on 1 July
 - Why not?
- Ensure estimate well

Valid dividend declaration?

- Successful outcome in Eg 1 turns on creation of \$50k Co. liability
- Requires dividend declaration to be valid
 - Constitution
 - Corporations Act
- Board/sole director resolution
- Evidencing above resolution actually made

Valid dividend declaration

Evidencing resolution

- If cannot evidence resolution
 - Risk Commissioner takes view no resolution made; no div declared
- Triggers chain reaction:
 - Co. \$50k liability to client not created
 - No mutually opposing obligations
 - Set-off has no application
 - No payments made
 - 100% shortfall in MAR
 - Deemed dividend of \$49,249

Valid dividend declaration

Evidencing resolution – minutes

- s251A Corps Act
 - Must be prepared and filed in co. register within one month
 - Must be signed within reasonable time
- If they weren't?
 - \$6,660 fine, per time
 - Lose evidentiary status
- Automatically invalidate dividend declaration?
 - No

Distribution statement

Private companies

- 30 June y/e, must provide to shareholders by 31 October
- Backdating a document is never acceptable
 - But distribution statements are not required be signed
 - Issue of backdating does not arise
- Simply a matter of whether or not given to shareholders by 31 October
- If weren't?
 - \$4,440 fine, first offence, on conviction
- Invalidate dividend?
 - No

Valid dividend declaration

Summary

- Distribution statement provided late has no impact
- Dividend declaration not *automatically* invalid if:
 - Minutes filed late
 - Minutes not signed within reasonable time
- Penalties can arise, Div 7A chain reaction risk
 - Low risk

Penalties; Chain reaction

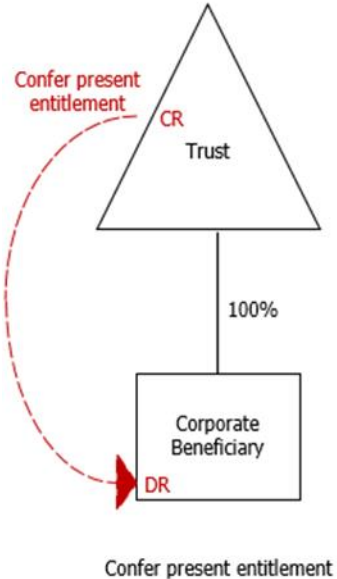
Why low risk?

- ASIC has higher priorities
- Div 7A achieving policy objectives
 - Top-up tax being paid
 - No tax leakage
- Why would Commissioner challenge minutes/distribution statement, disrupt above?

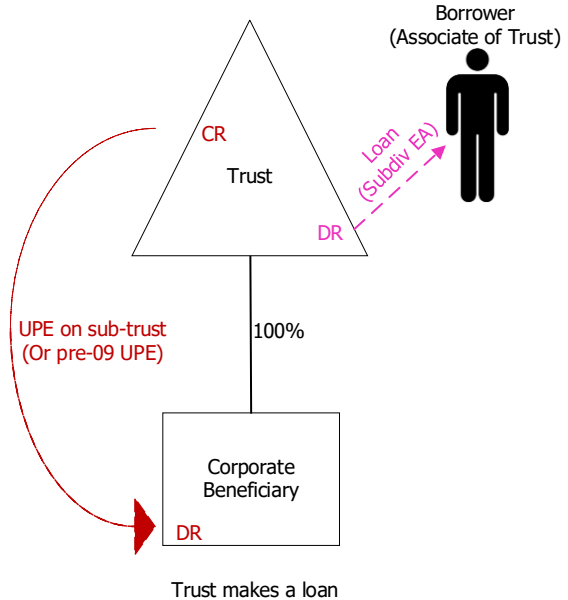
Naturally occurring mutually opposing obligations

Other examples

Example 2



Example 3

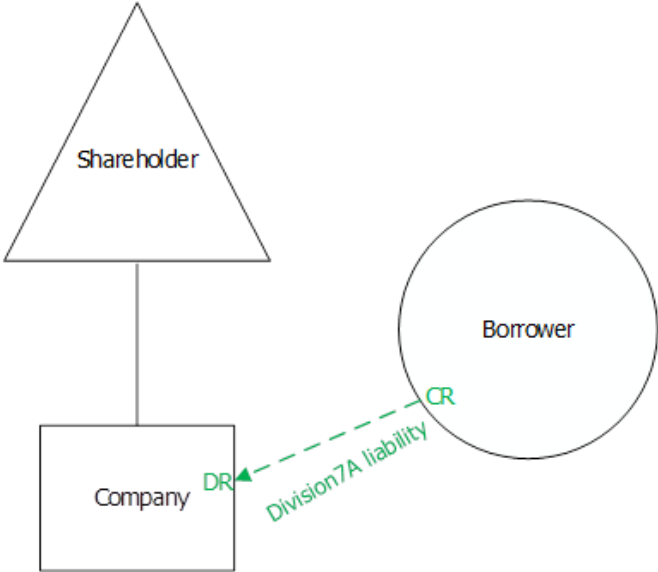


Mutually opposing obligations

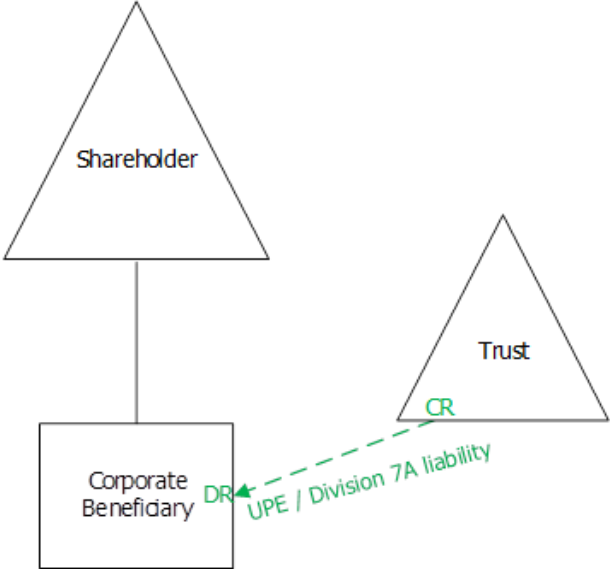
- In Examples 1-3, mutually opposing obligations arise naturally
- Some things need to be done
 - But do-able within normal processes for those structures
- But what if mutually opposing obligations don't arise naturally?

Typical round-robin scenarios

LOAN TO NON-SHAREHOLDER



CORPORATE BENEFICIARY

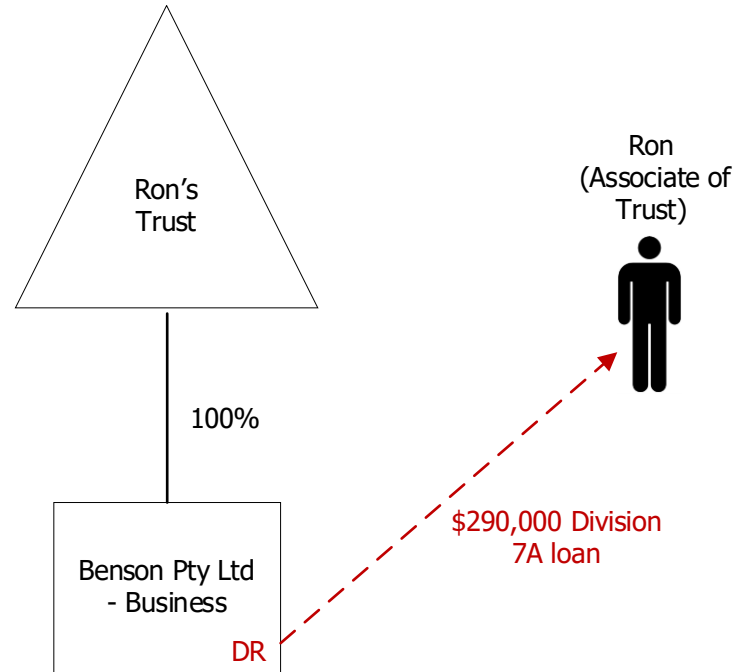


No mutually opposing obligations

Example 4: Loan to non-shareholder

- Variation of Eg 1
- More realistic structure
- 2019/20 loan
- Ron must make MAR of \$49,249 in 2020/21
- Now what?

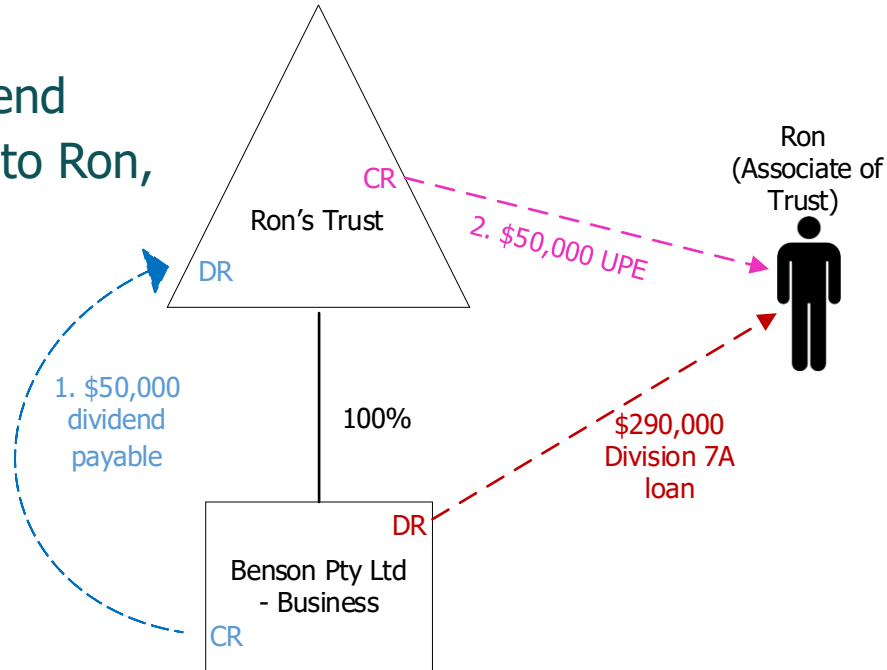
- Same issues arise if lend to an entity (except a company)



No mutually opposing obligations

Example 4: Loan to non-shareholder

- What is typically done:
 - Co. declare \$50k dividend
 - Trust appoints income to Ron, creating UPE owing



No mutually opposing obligations

Example 4: Loan to non-shareholder

- Journal series 1 – *Records* above two *executed* transactions

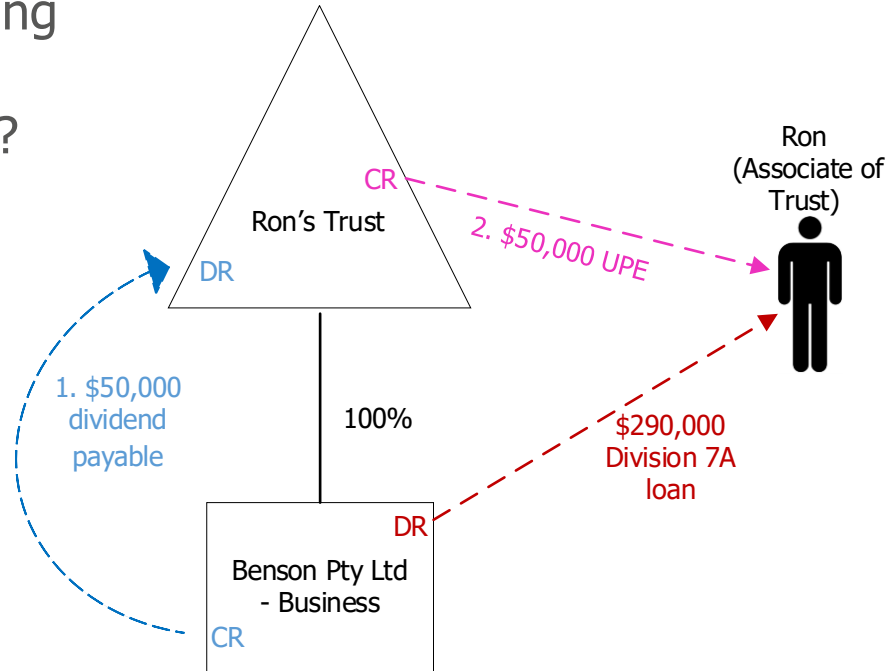
Benson Pty Ltd				
Records this transaction	Date	Account	DR \$	CR \$
Declare dividend	30 June 2021	Dividend paid	50,000	
		Dividend payable to Ron's Trust		50,000

Ron's Trust				
Records this transaction	Date	Account	DR \$	CR \$
Dividend receivable	30 June 2021	Dividend receivable from Benson Pty Ltd	50,000	
		Dividend income		50,000
Appoint trust income to Ron	30 June 2021	Distribution	50,000	
		Ron – UPE		50,000

No mutually opposing obligations

Example 4: Loan to non-shareholder

- **But**, no mutually opposing obligations
- So, what's typically next?
 - Journal series 2



No mutually opposing obligations

Example 4: Loan to non-shareholder

- Journal series 2:
 - Round-robin of “payments”
- Purportedly, three payments made:
 - Co. paid liability owing to the Trust
 - Trust paid out UPE owing to Ron
 - Ron made \$50k payment to Co (MAR)
- Payments legally effective?

Ron's Trust			
Date	Account	DR \$	CR \$
30 June 2021	UPE – Ron	50,000	
	Dividend receivable from Benson Pty Ltd		50,000

Benson Pty Ltd			
Date	Account	DR \$	CR \$
30 June 2021	Dividend payable to Ron's Trust	50,000	
	Interest income		13,102
	Loan to Ron Benson (Div 7A)		36,898

No mutually opposing obligations

Example 4: Loan to non-shareholder

- Legally effective payments?
 - No
 - Journals do not execute transactions
- MAR not actually made
 - Div 7A breach
- \$49,249 deemed dividend to Ron for 2020/21
- As tax agent, we sign:
 - Ron's return, knowing omits assessable income
 - Co. return, knowing omits required deemed dividend disclosure

What's the risk?

Example 4: Loan to non-shareholder

- Outcomes:
 - Div 7A complied with on paper
 - Top-up tax being paid
 - No revenue leakage
 - Policy objectives achieved
- Probably why Commissioner not made an issue in the past
- Hints position changing
 - Anecdotal from audits
 - Sleeper deemed dividend risk

Asset protection risk

Example 4: Loan to non-shareholder

- On paper, Co. debit loan reducing
 - But, repayments actually not legally effective
- Therefore, debit loan actually *not* reducing
- Original amount of debit loan still an asset of the company
 - If successful claim against company, loan can be called in
- Exposes client's personal assets more than everyone thought

Div 7A & asset protection risk

How much?

- Div 7A deemed dividend risk: $\$3\text{m} \times \sim 47\%$
= $\sim \$1.4\text{m}$ (amendment limits)
- Asset protection risk: $\$3\text{m}$ (not $\$560\text{k}$)

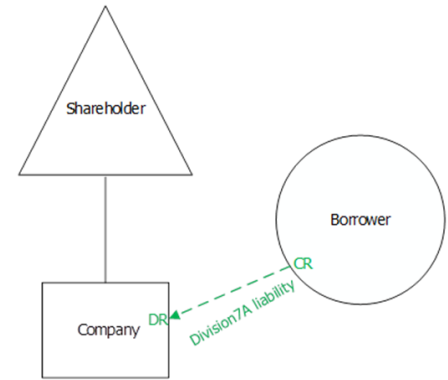
Company Pty Ltd Balance sheet (Extract)		
	As appears now	Plaintiff claims it's actually this
	\$	\$
ASSETS		
Loans to client	560,000	3,000,000
		(back to 1997)
LIABILITIES		
Dividend payable to shareholder	-	3,000,000 (back to 1997)

Journalising round-robin Div 7A loan repayments

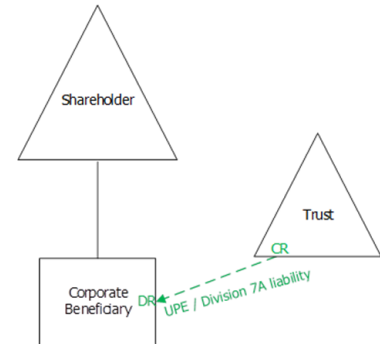
Solution

- Not legally effective payments
 - Emerging Div 7A risk; commercial risk
- Actually paying money virtually never an option
- Practical solution:
 - Service offering for clients

LOAN TO NON-SHAREHOLDER



CORPORATE BENEFICIARY



Journalising round-robin Div 7A loan repayments

Solution

- Different approaches posed for:
 1. Future:
 - Loans made by the company
 - Distributions to corporate beneficiary
 2. Existing Div 7A loans on foot
- Limits required work mainly to existing loans
 - Come to end when last loan cleared

Future loans

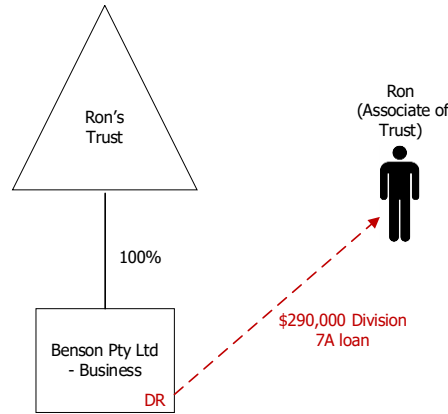
Constructive on-lend

- Company and Trustee each pass resolution
- Any future payment company makes to borrower is:
 1. Constructive loan by the company to the Trust; and
 2. Subsequent constructive loan by Trust to the borrower
- Exception is where specifically treated otherwise
 - eg, payment of salary

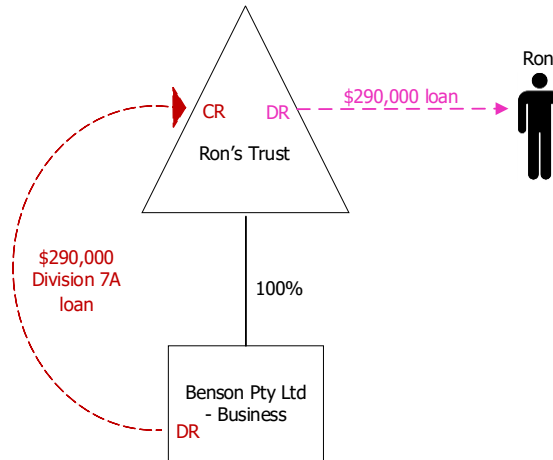
Future loans

Constructive on-lend

- This never happens in the first place...



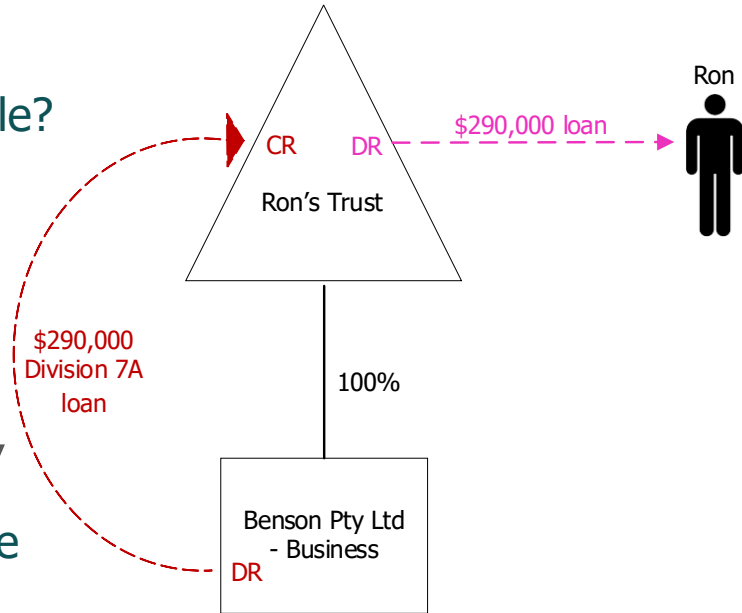
- ...instead, this does
 - Can create mutually opposing obligations



Future loans

Trust Div 7A interest expense

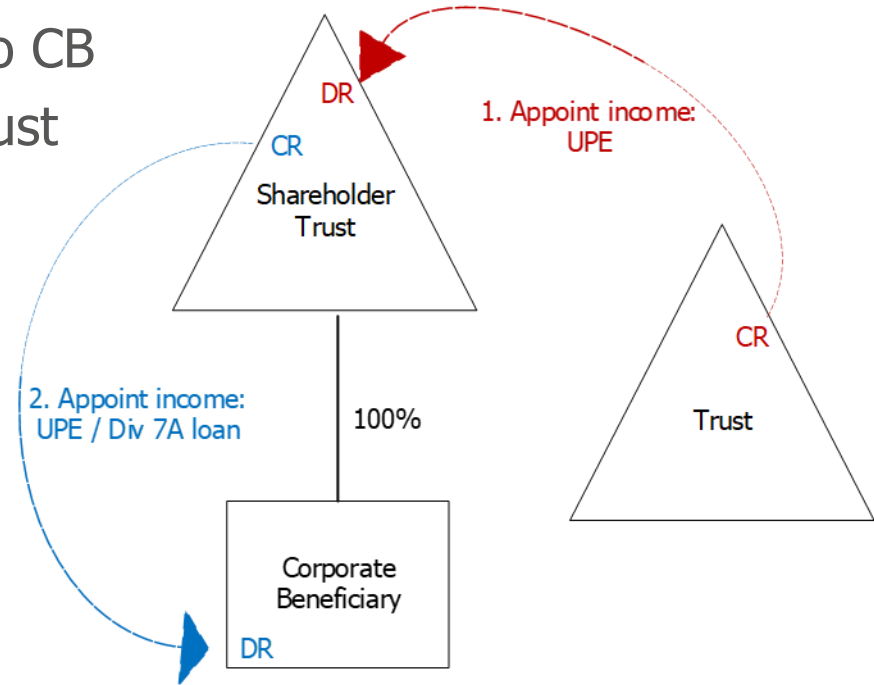
- Question:
 - Div 7A interest Trust incurs – deductible?
 - s8-1 ITAA97
 - Use test; purpose
- If loan to Ron interest-free, answer:
 - No
- If Ron uses funds for private purposes, that's okay
 - If use for income-producing, on-charge
 - Online agreements



Future distributions

Corporate beneficiary

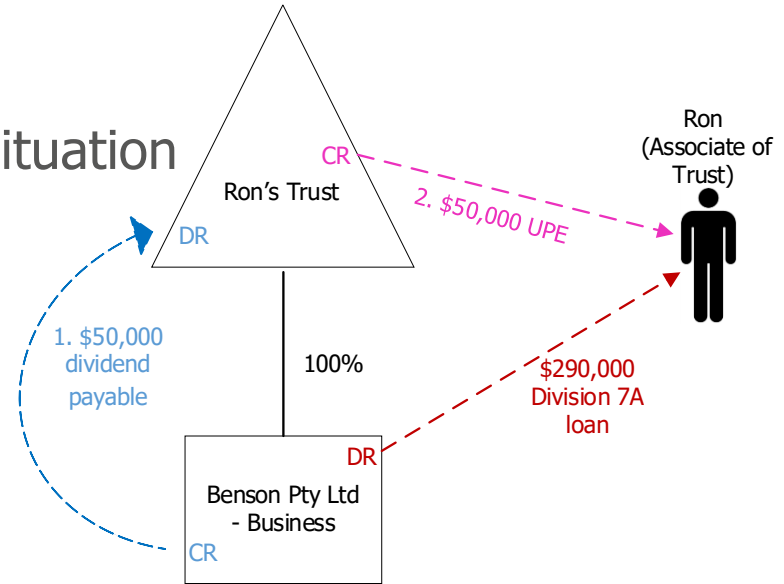
- Trust no longer appoints directly to CB
 - Instead, appoint to shareholder trust
 - S/h trust appoints to company
-
- Div 7A compliance via mutually opposing obligations
 - Address deductibility of interest expense in s/h trust



Existing loans

Effecting payments

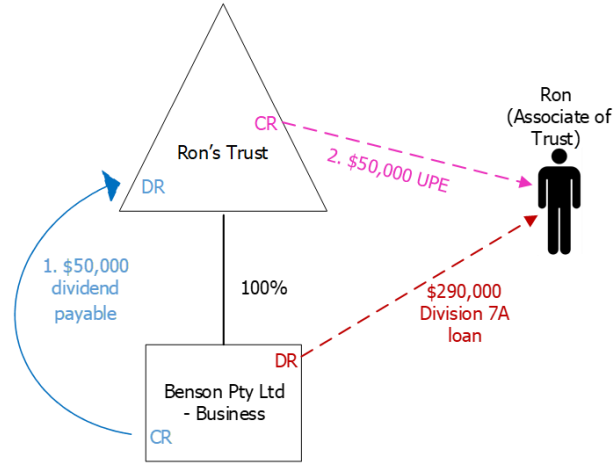
- Need to deal with as they are
- Applicable for any circular obligation situation
 - Mostly the two scenarios in slide 40
- Again, refer Eg 4
- Do one additional thing each 30 June
- After declare div/appoint income:
 - **Trust assigns \$50k receivable to Ron**



Existing loans

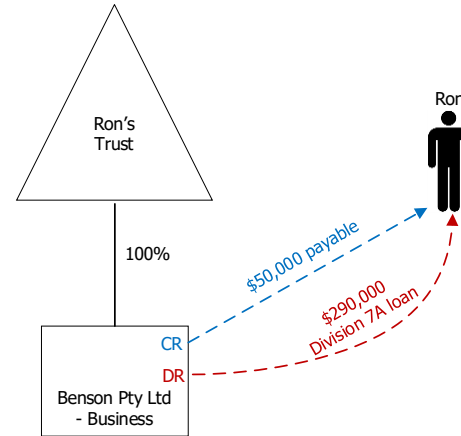
Effecting payments

- We go from this...



- ...to this

- Results:
 - Trust pays out UPE owing to Ron
 - Benson P/L and Ron now have mutually opposing obligations
 - Can now do set-off



Existing loans

Journals in the company

Benson Pty Ltd				
Records this transaction	Date	Account	DR \$	CR \$
Liability owing to Trust assigned to Ron	30 June 2021	Dividend payable to Ron's Trust	50,000	
		Liability owing to Ron Benson		50,000
Set-off of mutually opposing obligations	30 June 2021	Liability owing to Ron Benson	50,000	
		Interest income		13,102
		Loan to Ron Benson (Div 7A)		36,898

- In Trust, offset \$50k DR and CR accounts
- No CGT (capital proceeds = cost base)
- No GST (financial supply)

Existing loans

Repayments during year

- MAR already partially made
- Client's financial reporting systems
- Pre-30 June tax planning

Existing loans

Alternative

- Promissory notes

Existing loans

Consulting opportunity

- Template assignment deed
- Insert info only into unlocked fields
- Payments legally effective

- Do each June until existing loans cleared

Existing loans

Process

- Review client groups
- Identify clients per slide 40
- Conversation; education
 - Emerging deemed dividend risk
 - Asset protection risk
 - Mitigated by payments being legally effective
- Service offering
 - Assignment deed(s) each June
 - Sleep well at night

Existing loans

Process, cont

- Fee arrangement
- Yes/No
- Do work each June
- Invoice

Template assignment deed

Lark Lawyers

- \$1,400+GST, if commit to purchase by 7pm (AEST) Friday, 21 May
 - Cost of your firm (not disbursed to any client)
 - Includes template covering letter
- Tool you use in providing the service to clients
 - Use template over and over
- E-mail Liam McLagan (liam@larklaw.com.au):
 - Firm's legal name (will be named as licensee in locked part of deed)
 - Billing address
 - ABN
- Invoice issued on Monday, 24 May. Payable by Friday, 28 May
- Template assignment deed & letter e-mailed to you Monday, 31 May

Complimentary webinar

Deed purchasers only

- Tuesday, 1 June
 - 10:30am – 11:30am (AEST)
- Using the assignment deed in practice
- Multiple loans?
- Template letter
- Process for taking to clients
 - Conversation
 - Pricing guide
- Process for doing the work

Appointing trust's dividend income

Whom to?

- In Examples 2, 3 and 4, Trust receives dividend income
- To achieve desired outcomes, must dividend income be appointed to a specific beneficiary?

Example	Yes/No. If Yes, whom?
2	No
3	Yes; the borrower
4 – Future loans	No
4 – Existing loans	Yes; Ron

Appointing trust's dividend income

- Examples 2, 4 (Future loans)
- Must Trust appoint to individuals?
 - Trigger top-up tax
- Appoint back to the company? Another company?
 - No top-up tax
 - Breach s109R in Div 7A?
 - Can in some cases
 - "Offend" PS LA 2010/4?
 - s100A? (Dubious appointments of trust income)

Appointing trust's dividend income

- ATO's goal under TR 2010/3 & PS LA 2010/4 is to force triggering top-up tax
 - Even when profits reinvested
- If appoint to same/another company
 - Form of "machine washing"
 - Avoids top-up tax
- ATO likely seek to apply s100A
- Consensus practice is to appoint to individuals, trigger top-up tax

Part IVA

General observations

- Some actions causing assessable income to not arise get a free pass
 - Action resulting in no deemed Div 7A dividend is not one of them
- Eight factors
- Purpose is to effect legally effective payments
- Transparent, relatively uncomplicated
- Form and substance in alignment
- Outcomes as intended under tax laws
- Part IVA highly unlikely

Reforms to Division 7A

- Five years after intention announced, still waiting
- Requirement to make repayments likely continue

Conclusion

- Valid dividend declaration is key to MAR by set-off
- Round-robin payments by journal are ineffective
 - Div 7A breach
 - Asset protection compromise
 - ...and exposure for us a practitioners
- Consulting opportunity, solution

Conclusion

Consulting opportunities

- Slide 52-53 process
- Identify applicable clients
- Conversation
- Service offering
 - Yes/No
 - Do
- Invoice with confidence
- **** **Purchase the template deed** ****
- **** **Complimentary webinar 1 June** ****

Your feedback

You will soon receive an e-mail with a link to a short online feedback form

Please let us know what you think of this session

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Thank you

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