Division 7A issues of transferring property after relationship breakdown

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1. **INTRODUCTION**

1.1 Most property settlements following a relationship breakdown involve one or more of the following:

   (a) A transfer of assets:

      (i) between the parties to the relationship; or

      (ii) from an entity (for example a company or trust) to a party to the relationship (or an entity that is nominated by them).

   (b) One of the parties being removed from any association with an entity. This generally involves:

      (i) resigning as officeholder of a company;

      (ii) resigning as a trustee and/or appointor of a trust;

      (iii) dealing with loans owing to or by the company and/trust to the spouse.

1.2 Generally, a property settlement can be structured in such a way that a transfer of assets will result in:

   (a) automatic roll-over relief from any tax implications on the transfer (under capital gains provisions or Division 40 which relates to deprecating assets) provided that transfer occurs:

      (i) from an individual to their spouse (or former spouse);

      (ii) from a company or trust to a spouse (or former spouse); and

   (b) an exemption from duty.

1.3 However, there is no corresponding relief from the application of Division 7A of the 1936 Tax Act.

1.4 This paper will outline the application of Division 7A as it is relevant to relationship breakdowns, including:

   (a) When Division 7A may apply?

   (b) The Commissioner’s view on the application of section 109J of the 1936 Tax Act.

   (c) The ability of the parties to agree to frank a dividend which may occur due to the application of Division 7A.

1.5 In this paper a reference to:

   (a) 1936 Tax Act means *Income Tax Assessment Act 1936* (Cth);

2. DIVISION 7A

2.1 When does Division 7A apply?

Division 7A:

(a) only applies to private companies;

(b) may apply to trustees who have unpaid present entitlement (UPE) to a private company;

(c) applies automatically (it does not require the Commissioner to form an opinion).

2.2 What is a private company?

(a) A ‘private company’ is a company that is not a public company for income year (section 995-1 of the 1997 Tax Act)

(b) Public company is defined in section 103A of the 1936 Tax Act.

(c) Note that under the 20/75 rule some public companies are taken to be private companies.

(d) From 1 July 2009, Division 7A applies to some corporate limited partnerships in the same way which it applies to private companies.

The corporate limited partnerships to which Division 7A applies are those which have fewer than 50 members or which have any entity that has directly or indirectly an entitlement to at least 75% of the income or capital of the partnership

2.3 There may be Division 7A implications where a company on or after 4 December 1997:

(a) makes a payment for the benefit of a shareholder or an associate; or

(b) makes a loan to a shareholder or an associate; or

(c) forgives a debt owed to the company by a shareholder or associate.

2.4 There may also be Division 7A implications under Subdivision EA where a trustee, on or after 12 December 2002:

(a) either:

(i) makes a loan to a shareholder or associate;

(ii) forgives a debt which is owed by a shareholder or associate to a trustee; or

(iii) makes a payment to a shareholder or associate and the payment is a discharge of the present entitlement attributable to an amount that is an unrealised gain; and

(b) either:

(i) the UPE has not been paid to the company before the lodgement of the trustee’s income tax return; or

(ii) the company becomes presently entitled to an amount after the payment is made, but before the lodgement (or due date for lodgement) of the trustee’s income tax return and the amount is not repaid by that date.

2.5 An ‘associate’ is defined in section 318 of the 1936 Tax Act. The definition is extremely wide.

2.6 Division 7A applies regardless of what the shareholder or associate used the funds for.
2.7 This means that even if the shareholder or associate uses the funds for ‘income producing’ purposes, there may be Division 7A implications. If the funds are used for ‘income producing’ purposes, any interest paid may be deductible.

2.8 Generally, Division 7A will not apply where the payment, loan or debt forgiveness occur in relation to a shareholder or associate who is a company (except a company in its capacity as trustee).

2.9 Impact of Division 7A

(a) The company may be deemed to have paid an unfranked dividend to the shareholder or associate unless:

(i) there is a written loan agreement in place which meets the criteria of section 109N prior to the lodgement of the company's tax return (or due date for lodgement) and the minimum repayments are made each year; or

(ii) the loan is repaid prior to the lodgement of the company's tax return (or due date for lodgement).

(b) The amount of the deemed dividend is subject to the amount of the company’s distributable surplus (if any) at the end of the year.

3. PRIVATE COMPANY PAYMENTS

3.1 When are payments treated as dividends?

(a) Applies

(i) only to private companies.

(ii) where the company make a payment during the year; and

(iii) where the payment is made:

- to an entity that is a shareholder or associate of the shareholder; or

- a reasonable person would conclude that the payment is made because the entity has been such a shareholder or associate at some time.

(b) What does “because the entity has been such a shareholder or associate at some time” mean?

(i) Draft Determination TD 2008/D2 – paragraph 1 ‘the reason must be a real and substantial reason for the payment, loan or forgiveness concerned, even if it is not the only reason or not the main reason for the transaction’.

(ii) The Commissioner does not consider that ‘because’ means that the reason need to be the sole or dominant reason.

(iii) In a property settlement, even though the transferee former spouse may not be an associate at the time of the transfer (because they are no longer a spouse), the reason for the payment is because at some time they were a spouse.

(c) A payment means:

(i) a payment made to a shareholder or an associate;

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1 Section 109C of the 1936 Tax Act
(ii) a payment made on behalf of a shareholder or an associate;

(iii) a payment made for the benefit of a shareholder or an associate;

(iv) an amount credited to a shareholder or an associate;

(v) an amount credited on behalf of a shareholder or an associate;

(vi) an amount credited for the benefit of a shareholder or an associate;

(vii) a transfer of property to a shareholder or an associate; or

(viii) a grant of a lease, or a licence or other right to use an asset, to entity shareholder or an associate.

(d) The amount of the payment will be the market value of the property transferred, lease, licence or other right less any consideration given by the transferee for the transfer, lease, licence or other right.

(e) A dividend equal to the amount of the payment is taken to have been paid at the end of the year:

(i) unless the payment is converted to a loan and a complying Division 7A loan agreement is put in place; and

(ii) will be equal to the amount of the payment or the company’s distributable surplus (whichever is less).

(f) A loan is not a payment.

3.2 From 1 July 2009, a payment includes a grant of a lease, or a licence or other right to use an asset, unless one of the exceptions applies:

(a) Exception one – minor benefits.

(b) Exception two – once-only deduction.

(c) Exception three – right to use a dwelling (subject to certain requirements).

3.3 Section 109J

(a) Section 109J provides that a private company is not taken under section 109C (about payments) to pay a dividend because of the payment of an amount, to the extent that the payment:

(i) discharges an obligation of the private company to pay money to the entity; and

(ii) is not more than would have been required to discharge the obligation had the private company and entity been dealing with each other at arm’s length.

Example

The company is a party to a court order or financial agreement. Under the orders or agreement, the company is obliged to pay the husband $2 million in cash and transfer an asset to the husband worth $3 million. The company later pays the $2 million and transfers the asset to the husband.

Is the payment of $5 million a dividend for the purpose of section 109C or does it come within section 109J?
(b) Commissioner’s previous position

In a private ruling (number 85828) the Commissioner had indicated that such an arrangement would not trigger a deemed dividend under Division 7A because the payment was made to discharge the financial obligation imposed by the court order and was therefore within the scope of the exemption in section 109J.

The obvious advantage of this interpretation was that the payments would not be taxable as a deemed dividend under Division 7A (although the payment may still have been treated as a dividend under the general provisions in the 1936 Tax Act if the recipient spouse was a shareholder at the time of payment).

(c) Commissioner’s revised interpretation – Taxation Ruling TR 2014/5

In TR 2014/5 the Commissioner has reversed his position and indicated that a payment from a private company to a spouse pursuant to a court order will not satisfy the requirements for exemption under section 109J and will be a deemed Division 7A dividend.

This taxation ruling reflects the views in a more recent private ruling (number 1012508158267),

The basis of the revised view is that the Commissioner considers the second requirement of section 109J is not satisfied, because the payment will generally be more than would have been required to discharge the obligation had the parties been dealing with each other at arm’s length.

In the context of a property settlement, the ATO considers that:

(i) the parties are not dealing at arm’s length; and

(ii) had the parties been dealing at arm’s length, the company would not have made a ‘gratuitous’ payment.

4. PRIVATE COMPANY LOANS

4.1 When are loans treated as dividends?

(a) Applies:

(i) only to private companies;

(ii) where the company makes a loan during the year which is not repaid by the end of that year;

(iii) where the loan is made:

- to an entity who is a shareholder or associate of the shareholder; or
- a reasonable person would conclude that the loan is made because the entity has been such a shareholder or associate at some time.

2 Section 109D of the 1936 Tax Act
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(b) A dividend equal to the amount of the loan unpaid at the lodgement day:

(i) unless subdivision 109D applies (when payments and loans are not treated as dividends); and

(ii) limited to the amount of the loan or the company’s distributable surplus as calculated in subdivision 109Y (whichever is less).

(c) A loan will be treated as having been made to a shareholder or associate if an interposed entity makes a loan to the shareholder or associate.

4.2 What is a loan?

A loan includes:

(a) an advance of money;

(b) a provision of credit or any form of financial accommodation (includes provided goods and services on credit terms for e.g. 30 day accounts);

(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 which in substance is a loan of money.

4.3 Loans which are covered by a complying section 109N loan agreement will not be taken to be dividends

(a) Criteria for loan agreements (all criteria must be satisfied):

(i) the loan is made under a written agreement prior to the lodgement date of the company’s income tax return;

(ii) the interest rate on the loan must be at least equal to the benchmark interest rate; and

(iii) the term must not exceed the maximum term.

(b) Lodgement date is the earlier of the date the tax return is lodged or the due date for lodgement.

(c) The maximum term is:

(i) 25 years provided that 100% of the value of the loan is secured by a mortgage over real estate and when the loan is made, the market value of the real estate (less the amounts of any other liabilities secured over the property in priority to the loan) must be at least 110% of the amount of the loan; or

(ii) 7 years.

5. FORGIVEN DEBTS TREATED AS DIVIDENDS

5.1 When are forgiven debts treated as dividends?

(a) Applies:

(i) only to private companies;

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3 Section 109E of the 1936 Tax Act
(ii) where the company forgives some or all of a debt owed by an entity to a private company;

(iii) either:

- the amount is forgiven when the entity was a shareholder or associate of the shareholder; or
- a reasonable person would conclude that the amount is forgiven because the entity has been such a shareholder or associate at some time.

(b) The amount of the dividend is equal to the amount of the debt forgiven limited to the company’s distributable surplus.

(c) A debt is forgiven if and when the amount would be forgiven under section 245-35 of Schedule 2C of the 1936 Tax Act (about the Forgiveness of Commercial Debts) or a reasonable person would conclude that the private company will not insist on the amount being repaid.

6. PAYMENTS, LOANS AND DEBT FORGIVENESS BY A TRUSTEE TO A SHAREHOLDER (OR ASSOCIATE) OF A PRIVATE COMPANY WITH AN UNPAID ENTITLEMENT

6.1 Section 109XB will apply where a loan is made, payment is made or debt is forgiven (actual transaction) after 11 December 2002, and:

(a) it is made to a shareholder or an associate of a private company; and

(b) the shareholder or associate is not a company; and

(c) if a payment, the payment is a discharge of a shareholder’s or associate’s present entitlement, and that present entitlement is wholly or partly attributable to an amount that is an unrealised gain; and

(d) either:

(i) a company has an unpaid entitlement at the time the actual transaction was made and the unpaid entitlement has not been paid to the company before the earlier of the due date for lodgement and the date of lodgement of the trust’s tax return for the year of income in which the actual transaction takes place; or

(ii) the company becomes presently entitled to an amount after the actual transaction takes place, but before the earlier of the due date for lodgement and the date of lodgement of the trust’s tax return for the year of income in which the actual transaction takes place, and the whole of the amount has not been paid to the company before the earlier of those dates (applies from 19/02/04).

6.2 The phrase 'net income' in the context of subsection 109XA(1) of the ITAA 1936 is the accounting income or the income less expenses of the trust for the income year as determined by the trustee in accordance with the trust deed and applicable accounting standards (ATO ID 2005/297).

6.3 In relation to a family law context where there is a transfer of property from a trustee to a spouse (or their entity), the ATO’s view in Private Binding Ruling number 1012456849173 appears to be that section 109XB will not apply. This is because the amount is not attributable to an unrealised gain.

The transfer of property will result in a gain being realised, but it may be disregarded under Subdivision 126-A (about transfers because of a family law obligation).
6.4 If however, the orders provide for a loan owing to a trustee being forgiven and there is a UPE owing to a company, section 109XB will apply.

7. DISTRIBUTABLE SURPLUS

7.1 The amount of the Division 7A dividend is limited to the company distributable surplus.

7.2 The distributable surplus is calculated as:

- (a) the company assets (according to the company’s accounting records\(^4\)) at the end of the company’s year of income; less
- (b) the present legal obligations of the company to persons other than the company at the end of the company’s year of income; and
- (c) the following provisions (according to the company’s accounting records\(^5\)) at the end of the company’s year of income;
  - (i) depreciation;
  - (ii) annual leave and long service leave;
  - (iii) amortisation of intellectual property and trademarks; less
- (d) non-commercial loans (being amounts which have been taken to be dividends because of Division 7A); less
- (e) the paid-up share capital of the company at the end of the company’s year of income; less
- (f) the repayment of any amounts taken to be dividends under Division 7A plus
- (g) the amounts the company is taken to have paid as dividends in the year of income (or would have had the company had a distributable surplus) under:
  - (i) section 109C (about payments being taken to be dividends); and
  - (ii) section 109F (about debts forgiven being taken to be dividends).

7.3 This means that the market value of any assets transferred out of the company or loans forgiven will be added back to determine the company’s distributable surplus.

8. DIVIDEND MAY BE FRANKED IF TAKEN TO BE PAID BECAUSE OF A FAMILY LAW OBLIGATION

8.1 Generally, an amount taken to be dividend under Division 7A is an unfrankable distribution (section 202-45(g)(i) of the 1997 Tax Act).

8.2 However, if an amount is taken to have been a dividend (such as a transfer of property or debt forgiveness) made to an entity because of a family law obligation, the dividend may be franked only if:

- (a) the dividend is franked at the private company’s benchmark franking percentage; or

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\(^4\) However if the Commissioner considers that the assets or provisions are overvalued or undervalued, he may substitute a value which he considers appropriate.

\(^5\) However if the Commissioner considers that the assets or provisions are overvalued or undervalued, he may substitute a value which he considers appropriate.
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8.3 Family law obligation is defined in section 109ZD to mean an order, agreement or award mentioned in Subdivision 126-A of the 1997 Tax Act (about CGT roll-over relief for relationship breakdowns).

This includes court orders made by the Family Court and binding financial agreements (BFA).

8.4 If the entity is not a shareholder, they will be treated as a shareholder for the purposes of franking the dividend.

8.5 Care will need to be taken that the company has sufficient franking credits to pay a franked dividend:

(a) If the company has not paid a dividend in the income year it will not have a benchmark franking percentage – which will mean that the dividend will be franked to 100% if the parties have agreed to frank the dividend. This may result in the company having franking deficit issues.

(b) If the company does not have sufficient franking credits to pay a fully franked dividend, it could pay a dividend prior to the end of the year to obtain a benchmark franking percentage (below 100%).

If the parties intend that the dividend will be fully franked and the company has not paid a dividend for the financial year, the company should pay a dividend (even if $100) fully franked. This will lock in the benchmark franking percentage at 100%.

9. COMMISSIONER’S DISCRETION UNDER SECTION 109RB

9.1 The Commissioner is unlikely to exercise his discretion under section 109RB to disregard a Division 7A dividend as a result of a transfer under a property settlement.

However, in the course of negotiating property settlement, previous Division 7A issues may be discovered. The parties will generally want to deal with these issues and may choose to apply to the Commissioner to exercise his discretion under section 109RB of the 1936 Tax Act.

9.2 The Commissioner has the ability to exercise his discretion under section 109RB of the 1936 Tax Act to either:

(a) disregard any amounts which will be taken to be dividends under Division 7A; or

(b) allow that any amounts which are taken to be dividends under Division 7A to be franked.

9.3 The relevant factors which the Commissioner will consider in determining whether to exercise his discretion are set out in section 109RB(3) as:

(a) the circumstances that led to the mistake or omission

(b) the extent to which any of the entities have taken corrective action, and if so, how quickly

(c) whether Division 7A has applied previously to any of the entities, and

(d) any other relevant matters.

9.4 Practice Statement PS LA 2011/9 outlines the factors which tax officers must have regard to in determining whether the discretion should be exercised. At paragraph 23:

In considering the subject matter, scope and purpose of Division 7A and section 109RB, tax officers should have particular regard to the following:

(b) if the private company does not have a benchmark franking percentage – 100%.
Division 7A is an integrity measure aimed at preventing private companies from making tax-free distributions of profits to shareholders (and their associates) in the form of payments, loans or debt forgiveness (see paragraph 9.2 of the Explanatory Memorandum to Taxation Laws Amendment Bill (No. 3) 1998 and paragraphs 1.3 and 1.78 of the Explanatory Memorandum to Tax Laws Amendment (2007 Measures No. 3) Bill 2007). In other words, **Division 7A aims to prevent disguised distributions of profit.**

9.5 The discretion in subsection 109RB(2) was included to relieve the unintended effects of Division 7A from taxpayers that were not aiming to otherwise distribute profits. The Commissioner also states at [23] that:

> The discretion in subsection 109RB(2) is an exception to an integrity provision. Generally speaking it will not be appropriate to make a decision if in the circumstances it is clear that loans and other payments have been made as a means of avoiding tax on dividends. It should not be applied in a manner inconsistent with the integrity aims of Division 7A.

9.6 The Commissioner also acknowledges that, because Division 7A is self-executing, the discretion in section 109RB was introduced “to reduce the extent to which Taxpayers can trigger a deemed dividend inadvertently”. The Company and Trust submit that, while they have triggered a deemed dividend inadvertently, this is not a case where the original advance could be characterised as a quasi-dividend. The funds were used by the Trust to either acquire assets or reduce debt. Any interest charged would have been deductible to the Trust. PS LA 2011/29, at [6], states:

> In forming an opinion under section 109RB, tax officers must adhere to administrative law principles. The main obligations are as follows:

- **Tax officers must not apply this practice statement in a rigid or inflexible way.**
- **Each case must be considered on its merits, having regard to the object of the provision.**
- **Tax officers must take into account all relevant considerations, and must not take into account any irrelevant considerations. In the context of the Commissioner's discretion under subsection 109RB(2), there are specific matters outlined in subsection 109RB(3) that must be considered in each case. Paragraph 109RB(3)(d) allows the Commissioner to consider 'any other matters that the Commissioner considers relevant'. In determining whether a matter can be considered under paragraph 109RB(3), tax officers should have regard to the subject matter, scope and purpose of the Act.**
- **The decision must be made in good faith and without bias.**
- **The decision must be made independently and must not be made at the direction of another person.**
- **The decision must not be so unreasonable that no reasonable person could have reached the same decision.**

9.7 **Existence of Honest Mistake or Inadvertent Omission**

(a) **Taxation Ruling TR 2010/8 outlines what constitutes an honest mistake or inadvertent omission as follows:**

(i) In determining whether a person has made an honest mistake or an inadvertent omission, that person’s actual state of mind or belief is in issue [10].

(ii) A mistake in the context of subsection 109RB(1) is an incorrect view or opinion or misunderstanding about how Division 7A operates; about facts that are relevant to
its operation; or about other matters that affect its operation. Such a mistake must be honestly made [11].

(b) PS LA 2011/29, at [37] provides examples of relevant facts and circumstances which may favour a finding that the application of Division 7A has been caused by an honest mistake. These include:

(i) The applicable Division 7A provisions involved are complex.

(ii) The prevailing understanding and interpretation of Division 7A provision among the tax profession at the time the mistake was made, as evidenced by misunderstanding.

(iii) The party can demonstrate genuine attempts to comply with Division 7A both in general and in respect of the specific matter.

(iv) The relevant transactions are commercial in nature, albeit that they cause an application of Division 7A.

The practice statement lists examples of common mistakes at [49] of PS LA 2011/29, including:

- “loans from [a] private company to associated trusts for business purposes.”
- “misunderstanding of unpaid present entitlements from trusts to private company beneficiaries and subsequent breaches of Division 7A in relation to unpaid present entitlement.”

This paper is only intended as a general overview of issues relevant to the topic and is not legal advice. If there are any matters you would like us to advise you on in relation to this paper, please let us know.
APPENDIX – CASE STUDIES

1. CASE STUDY ONE – TOM AND SUE

1.1 Background:
(a) Tom and Sue have divorced and are finalising their property settlement.
(b) Tom is the sole shareholder of ABC Pty Ltd.
(c) ABC Pty Ltd:
   (i) owns real estate worth $6 million which will be transferred to Sue;
   (ii) has a debt of $2 million in relation to the property which will be taken over by Sue;
   (iii) is owed $200,000 by Sue;
   (iv) has sufficient franking credits to pay a $6 million dividend;
   (v) has net assets of approximately $20 million; and
   (vi) has not paid a dividend for the 2016 financial year.
(d) The transfer will occur in November 2015 under a BFA.

1.2 Are there any Division 7A implications?

Transfer of the real estate to Sue

1.3 Division 7A dividend?
(a) The only consideration to be given by Sue for the property is to take over the debt of $2 million.
(b) The transfer of real estate is a ‘payment’ for the purpose of Division 7A.
   (i) Although Sue is not a shareholder of ABC Pty Ltd, a reasonable person would assume that the reason she is receiving the real estate is because she was the wife (associate) of a shareholder at some time.
   (ii) This means that Sue will be deemed to receive a dividend at the end of the year of the transfer (that is, 30 June 2016) under Division 7A equal to the lower of:
       * the market value of the real estate ($6 million) less the consideration given of $2 million; and
       * the ABC Pty Ltd’s distributable surplus ($20 million).

That is, Sue includes a $4 million dividend in her assessable income for the 2016 year.

1.4 Can the dividend be franked?
(a) As the transfer is occurring because of a family law obligation, the dividend may be franked only if:
   (i) the dividend is franked at the private company’s benchmark franking percentage; or
   (ii) if the private company does not have a benchmark franking percentage – 100%.
(b) Although Sue is not a shareholder of the company, she will be treated as a shareholder for the purposes of franking the dividend.

(c) Issues to consider:
(i) You need to ensure that ABC Pty Ltd has sufficient franking credits to pay a franked dividend (which it has).

(ii) If the company does not pay a dividend in the income year it will not have a benchmark franking percentage. This means that the dividend will be franked at 100%.

(iii) If the husband pays a $200 dividend on April 2016 which is unfranked, then:

- the benchmark franking percentage will be Nil; and
- the $4 million will be franked to Nil.

That is, Sue will have an unfranked dividend to include in her assessable income of $4 million.

(iv) Therefore before signing the consent orders, Sue should insist that the company pays a $100 dividend franked to 100%.

(v) This means that the benchmark franking percentage is 100% and her dividend will be fully franked.

She will include $4 million plus the franking credit of $1,714,285 in her assessable income, but will get a tax offset of $1,714,285.

9.8 Sue's loan to company

(a) Division 7A applies where a company forgives some or all of a debt owed by an entity to a private company; and

(b) either:

(i) the amount is forgiven when the entity was is a shareholder or associate of the shareholder; or

(ii) a reasonable person would conclude that the amount is forgiven because the entity has been such a shareholder or associate at some time.

(c) The amount of the dividend is equal to the amount of the debt forgiven limited to the company's distributable surplus.

(d) As Sue was the spouse of the shareholder at some time, Division 7A will apply and she will be taken to have received an unfranked dividend of $200,000 (unless they agree to frank the dividend).

(e) An alternative would be for:

(i) Tom to give Sue $200,000;

(ii) Tom to direct company to pay Sue $200,000 which is to be applied against the amount she owes the company.

(iii) This means that Tom will now owe the company $200,000.

9.9 Capital gain on transfer of the property

(a) An automatic roll-over applies under Subdivision 126-A of the 1997 Tax Act:

(i) where there is a transfer:

(A) involving an individual and a spouse or former spouse;
(B) from a company or trustee to a spouse or former spouse; and

(ii) the transfer occurs:

(A) because of a court order under the Family Law Act 1975; or

(B) after 12 December 2006 because of a financial agreement, an award made in arbitration or a written agreement which is binding relating to de facto marriage breakdowns or marriage breakdowns.

(b) What are the tax implications?

(i) Generally ABC Pty Ltd will have a capital gain for the difference between the market value of the property and its cost base.

(ii) However, because the transfer will occur under a financial agreement to a spouse, Subdivision 126-A will apply, which means that:

(A) ABC Pty Ltd will disregard the capital gain;

(B) the first element of Sue’s cost base of the property is the cost base in the hands of the company.

For example, if the cost base in the hands of the company was $4 million, ABC would disregard the capital gain of $2 million and Sue will calculate any future capital gains using a cost base of $4 million.
2. CASE STUDY TWO: JACK AND SAMANTHA

2.1 Background

(a) Jack and Samantha are married but have separated and are now in the process of negotiating a property settlement.

(b) Jack and Samantha each have 10 ordinary shares in Jones Company Pty Ltd.

Jones Company Pty Ltd is worth $30 million.

It has $20 million in cash.

(c) As part of the property settlement:

(i) Samantha will be required to transfer her shares in Jones Company Pty Ltd to Jack; and

(ii) Jack must pay Samantha $15 million.

(d) Jack suggests that the orders be structured to include Jones Company Pty Ltd as a party and that Jones Company Pty Ltd will pay Samantha $15 million.

2.2 Are there any Division 7A issues for Samantha?

(a) The payment of the cash to Samantha will be a deemed Division 7A dividend as:

(i) it is a payment made by a private company to a shareholder; and

(ii) section 109J will not preclude it from being a dividend.

This is because although Jones Company Pty Ltd has an obligation to pay the $15 million to Samantha, it would be more than what the company would pay to her if they were acting at arm’s length.

(b) Alternative

(i) Jack acquires Samantha’s shares in Jones Company Pty Ltd for $15 million.

(ii) Jack borrows $15 million from Jones Company Pty Ltd to buy the shares (there will be financial assistance compliance requirements under the Corporations Act).

(iii) Jack and Jones Company Pty Ltd enter into a Division 7A complying loan agreement to avoid any adverse Division 7A issues for Jack.

The interest on the Division 7A loan would be deductible for Jack as the purpose of the borrowings was to buy the shares.

(iv) Jack will need to make minimum repayments to comply with Division 7A which may result in dividends being required to be paid to him (and top up tax).

Therefore there may need to be an adjustment to the $15 million paid to Samantha to compensate Jack.
9.10 Capital gain on transfer of the shares

(a) An automatic roll-over applies under Subdivision 126-A of the 1997 Tax Act:

(i) where there is a transfer:

   (A) involving an individual and a spouse or former spouse;

   (B) from a company or trustee to a spouse or former spouse; and

(ii) the transfer occurs:

   (A) because of a court order under the Family Law Act 1975; or

   (B) after 12 December 2006 because of a financial agreement, an award made in arbitration or a written agreement which is binding relating to de facto marriage breakdowns or marriage breakdowns.

(b) What are the tax implications?

(i) Generally Samantha will have a capital gain for the difference between the market value of the shares and their cost base.

(ii) However, because the transfer will occur under an order to a spouse, Subdivision 126-A will apply, which means that:

   (A) Samantha will disregard the capital gain;

   (B) the first element of Jack’s cost base for the shares will be Samantha’s cost base.
3. CASE STUDY THREE: JANICE AND BRIAN

3.1 Background:

(a) Janice and Brian are divorcing and negotiating their property settlement.

(b) The trustee (Manning Holdings Pty Ltd) of the Manning Family Trust is to transfer the property at 2 Westbreeze Court to Janice.

(c) The property at Westbreeze Court is valued at $7 million with a cost base of $4 million.

(d) The trust has an unpaid present entitlement owing to Manning Investments Pty Ltd of $10 million.

Manning Investments Pty Ltd has a distributable surplus of $12 million.

(e) Janice also has a loan owing to Manning Family Trust of $500,000 under a complying Division 7A loan agreement.

It is contemplated that Manning Family Trust will forgive the loan.

(f) Any transfers will occur under consent orders.

Does Division 7A apply to the transfer to Janice?

3.2 Adopting the ATO’s view in Private Binding Ruling 1012456849173, section 109XB in Division 7A will not apply because the trustee will be making a payment (transfer of property) to a shareholder of Manning Investments Pty Ltd attributable to a realised gain (not an unrealised gain).

As the transfer is occurring under consent orders and the transfer is to a ‘spouse’, the trustee will disregard the capital gain (under Subdivision 126-A of the 1997 Tax Act).

Suggestion: May be prudent to apply for a private ruling from the ATO that Division 7A will not apply.

Will Division 7A apply to the forgiven loan?

3.3 Section 109XB

Division 7A will apply because the trustee for the Manning Family Trust:

(a) will forgive a loan owing by a shareholder or associate of Manning Investments Pty Ltd; and

(b) has a UPE owing to Manning Investments Pty Ltd.

3.4 Alternatives:

Although the $500,000 will be taken to be a deemed dividend paid by Manning Investments Pty Ltd to Janice at the end of the year, Brian and Janice could agree to frank the dividend.

(a) Brian gives Janice $500,000 to repay the loan.
4. CASE STUDY FOUR: DISTRIBUTABLE SURPLUS

4.1 XYZ Pty Ltd transfers a property worth $1 million in January 2016 to Sally Brown under a consent order.

4.2 The Balance Sheet of XYZ at 30 June 2016 shows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$10</td>
</tr>
<tr>
<td>Real Estate</td>
<td>$350,000</td>
</tr>
<tr>
<td>Plant and Equipment</td>
<td>$100,000</td>
</tr>
<tr>
<td>Total Assets</td>
<td>$450,010</td>
</tr>
<tr>
<td>Overdraft</td>
<td>$150,000</td>
</tr>
<tr>
<td>Trade Creditors</td>
<td>$50,000</td>
</tr>
<tr>
<td>Provision for Income Tax</td>
<td>$30,000</td>
</tr>
<tr>
<td>Loan to bank</td>
<td>$1,270,000</td>
</tr>
<tr>
<td>Total Liabilities</td>
<td>$1,500,000</td>
</tr>
<tr>
<td>Net Assets</td>
<td>($1,049,990)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Issued capital</td>
<td>$10</td>
</tr>
<tr>
<td>Retained Losses</td>
<td>($1,050,000)</td>
</tr>
<tr>
<td>Equity</td>
<td>($1,049,990)</td>
</tr>
</tbody>
</table>

4.3 Other information

(a) The real estate was acquired in 1995 for $350,000. The market value at 30 June 2016 is $900,000.

(b) The provision for employee entitlements which are not reflected in the balance sheet at 30 June 2016 is $90,000.

(c) The transfer of the property to Samantha would be a payment under section 109C of Division 7A for an amount of $1 million.

Are there any Division 7A implications for Samantha?

4.4 Will the amount be a dividend under Division 7A?

(a) A dividend will be taken to have been made at the end of the 2016 year equal to the lower of:

(i) the value of the property transferred to Samantha - $1 million; and

(ii) the XYZ’s distributable surplus at the end of the 2016 income tax year.
4.5 What is the distributable surplus of the XYZ at 30 June 2016?

(a) A private company’s distributable surplus for its year of income is the amount worked out using the formula:

(i) Net assets; less

(ii) Non-commercial Loans; less

(iii) Paid-up share; less

(iv) Repayments of non-commercial loans; plus

(v) Any payments under section 109C or debts forgiven under section 109F during the year will be added back to determine the distributable surplus at the end of the year.

(b) Net assets means the amount (if any), at the end of the company’s year of income, by which the company’s assets (according to the company’s accounting records) exceed the sum of:

(i) the present legal obligations of the company to persons other than the company; and

(ii) the following provisions (according to the company’s accounting records):

- provisions for depreciation;
- provisions for annual leave and long service leave; and
- provisions for amortisation of intellectual property and trademarks;

(c) If the Commissioner considers that the company’s accounting records significantly undervalue or overvalue its assets or undervalue or overvalue its provisions, the Commissioner may substitute a value that the Commissioner considers is appropriate.

(d) According to the balance sheet the distributable surplus is calculated as:

- XYZ’s assets $ 450,010
- Less present legal obligations of the company ($1,500,000)
- Less paid up capital ($ 10)
- Distributable surplus Nil

(i) However, XYZ’s accounting records significantly undervalue the assets and liabilities of XYZ. This means that the Commissioner will most likely substitute the current values of the assets and liabilities.

(ii) The distributable surplus should be calculated as follows:

- XYZ’s assets $ 450,010
- Add increase in value of real estate $ 550,000
- Less present legal obligations of the company ($1,500,000)
- Less provisions for employee entitlements ($ 90,000)
- Less paid up capital ($ 10)
- Plus Division 7A payment $1,000,000
- Distributable surplus $ 410,000
(iii) This means that XYZ will be taken to have paid an unfranked dividend to Samantha on 30 June 2016 of $410,000.

However the parties may agree to frank the dividend.