
Chapter #
Improving fairness and integrity in the tax system — tightening the non-commercial loan rules

Outline of chapter

1.1 Schedule # amends the non-commercial loan rules in Division 7A of the *Income Tax Assessment Act 1936* (ITAA 1936) to prevent a shareholder of a private company (or an associate of the shareholder) accessing tax-free dividends through the use of company assets, under a lease, licence or other right to use, for less than their market value.

1.2 Other technical amendments have also been made to strengthen the non-commercial loan rules to ensure that they operate in accordance with their original policy intent and cannot be circumvented by the use of a corporate limited partnership.

1.3 All of the legislative references in this chapter relate to the ITAA 1936 unless otherwise specified.

Context of amendments

1.4 The non-commercial loan rules in Division 7A are integrity provisions that treat all payments, loans, and other credits by private companies to shareholders (or their associates) as assessable dividends (unless they come within specified exclusions), to the extent that there are realised or unrealised profits in the company. Division 7A also ensures that a trustee cannot shelter trust income at the prevailing company tax rate by creating a present entitlement to a private company without paying it and then distributing the underlying cash to a shareholder of the company (or their associate).

1.5 The definition of ‘payment’ for the purposes of Division 7A is contained in subsection 109C(3). A payment includes:

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- a payment to the extent that it is to the entity, on behalf of the entity, or for the benefit of the entity; and
- a credit of an amount to the extent that it is:
 - to the entity; or
 - on behalf of the entity; or
 - for the benefit of the entity; and
- a transfer of property to the entity.

1.6 For a payment to arise under a ‘transfer of property’, the ownership of an asset needs to pass from the private company to the shareholder (or their associate), or there must be a lease of real property in existence. Broadly, therefore, the following are not payments and are not covered by Division 7A:

- a licence or other right to use real property; and
- a lease, licence or other right to use other company assets.

1.7 Some shareholders of private companies (or their associates) are utilising arrangements involving leases, licences and other rights to use in order to circumvent the operation of Division 7A and access disguised tax-free dividends from private companies. As a result, such shareholders may not be subject to tax on their use of company assets. In contrast, if an employee of a private company makes use of the same assets, their use may be subject to fringe benefits tax payable by the private company as their employer.

1.8 As part of the 2009-10 Budget the Government announced that it would tighten the non-commercial loan rules to prevent private companies from making ‘payments’ of disguised tax-free dividends to their shareholders (or their associates). The Government also announced that it would make a number of other technical amendments to Division 7A ensure that it operates in accordance with its original policy intent.

1.9 After consulting with small business and farming communities, the Assistant Treasurer announced the final details of the measure in Press Release No.51 of 14 September 2009. The final details of the measure include the introduction of an otherwise deductible rule and an exception for the use of certain residences, in addition to the exception for minor use

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of certain company assets. These exceptions are limited in their application and only apply to payments that arise because of the operation of paragraph 109C(3)(d).

1.10 These amendments allow Division 7A to apply to payments made through a lease, licence or right to use a company asset and ensure that use of company assets by shareholders (or their associates) is treated in a similar way to the use of those assets by employees. These amendments do not impact upon any of the existing payments in subsection 109C(3).

1.11 These amendments also correct a number of other technical deficiencies that provide taxpayers with the opportunity to structure their affairs to circumvent the application of Division 7A.

Summary of new law

1.12 These amendments treat arrangements where a shareholder of a private company (or their associate) uses the assets of a private company under a lease, licence or other right to use (other than a transfer of property which is already covered by paragraph 109C(3)(c) of the ITAA 1936) as a payment for the purposes of Division 7A.

1.13 There are three exceptions to this treatment. They include an exception for:

- the minor use of company assets;
- certain payments that would otherwise be allowable as a once only deduction to the user of the asset; and
- the use of certain residences.

1.14 These amendments also ensure that where an entity is interposed either between the trust making a payment or loan to a shareholder of a private company (or their associate) or between a trust and the private company that holds an unpaid present entitlement to an amount from the net income of the trust, the interposed entities cannot be used to circumvent the operation of Division 7A.

1.15 Other technical amendments have also been made to strengthen the non-commercial loan rules to ensure that they operate in accordance with their original policy intent and that Division 7A cannot be

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circumvented by the use of a corporate limited partnership, which is a partnership taxed as a company.

Comparison of key features of new law and current law

<i>New law</i>	<i>Current law</i>
Division 7A applies to closely held corporate limited partnerships in the same way as it applies to private companies.	Section 94N excludes corporate limited partnerships from the operation of Division 7A.
<p>The meaning of 'payment' includes a licence or other right to use real property (other than a transfer of property within the meaning of subsection 109C(3)(c)); and a lease, licence or other right to use other company assets.</p> <p>The minor use of company assets, certain payments that would otherwise be allowable as a once only deduction and the use of certain residences are not included in this extended definition of payment.</p>	<p>The meaning of payment in subsection 109C(3) includes a transfer of property to an entity, which entails the ownership of an asset passing to a shareholder or their associate such as a lease of real property.</p>
<p>A payment made by an entity in relation to a loan from a private company must not be taken into account in determining whether a loan has been repaid in whole or in part in the year in which it was made, or in determining whether a minimum yearly repayment has been made, if a reasonable person would conclude that:</p> <ul style="list-style-type: none">• when the payment was made the entity intended to obtain a loan or loans from	<p>A payment made by an entity in relation to a loan from a private company must not be taken into account in determining whether a loan has been repaid in whole or in part in the year in which it was made, or in determining whether a minimum yearly repayment has been made, if a reasonable person would conclude that when the payment was made the entity intended to obtain a loan from the private company of an amount</p>

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<p>the private company of an amount similar to or larger than the payment; or</p> <ul style="list-style-type: none"> in order to make the payment 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 payment. 	<p>similar to or larger than the payment.</p>
<p>The requirement under subsection 109XA(1) that a payment is a discharge of, or a reduction in, a present entitlement of a shareholder (or their associate) does not apply where a shareholder of a corporate beneficiary of a trust (or their associate) receives a distribution of an amount that is attributable to an unrealised gain, which is subject to the application of subsection 109XA(1) and all or part of the amount is subsequently loaned back to the trust.</p> <p>Any loan repayments made by the trustee to the shareholder (or their associate) in subsequent years may then give rise to a deemed dividend for the purposes of Division 7A, where there is an unpaid present entitlement.</p>	<p>No equivalent.</p>
<p>A company or trust (whatever the case may be) withholding an amount from an employee's salary or bonus and offsetting these amounts against the loan can be a repayment by an entity, in relation to a loan.</p>	<p>A company withholding an amount from an employee's salary or bonus and offsetting these amounts against the loan can be a repayment by an entity, in relation to a loan.</p>

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<p>Where a loan which has previously been included in the assessable income of a shareholder of a private company (or their associate) under section 109XB is forgiven by the trustee, the forgiven amount does not give rise to a deemed dividend.</p>	<p>Where a loan that has previously been included in the assessable income of a shareholder of a private company (or their associate) under section 109XB is forgiven by the trustee, it may give rise to a deemed dividend.</p>
<p>Where an entity is interposed between a trust and the shareholder of a private company (or their associate), the trust will be treated as having directly paid or loaned an amount to the shareholder of the private company (or their associate) for the purposes of Subdivision EA of Division 7A, where a reasonable person would conclude that the trustee made the payment or loan as part of an arrangement involving the target entity.</p>	<p>An entity interposed between a trust and a target entity (that is, a shareholder of a private company or their associate) may circumvent the operation of Subdivision EA of Division 7A.</p>
<p>If a reasonable person would conclude that a private company is entitled to an amount from a trust estate that is interposed between the private company and a trust (target trust) making a payment, loan or forgiving a debt to a shareholder of the private company (or their associate) as part of an arrangement involving that target trust, the private company is taken to be entitled to an amount from the net income of the target trust.</p>	<p>When a private company is presently entitled to an amount from the net income of a trust estate that is interposed between the company and a trust making a payment, loan or forgiveness of a debt to a shareholder of the private company (or their associate) Subdivision EA may not apply.</p>
<p>Any amounts that result in a payment because of section 109C or a forgiveness of debt because of section 109F are recognised in the distributable surplus formula</p>	<p>Payments under section 109C or a forgiveness of debt under section 109F are not currently recognised in the distributable surplus</p>

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in section 109Y.	formula in section 109Y.
Amounts that are included in the assessable income of a shareholder of a private company (or their associate) under section 109XB, in an earlier year of income, are reflected in the non-commercial loans component of the distributable surplus formula in section 109Y.	Amounts included in the assessable income of a shareholder of a private company (or their associate) under section 109XB, in an earlier year of income, are not reflected in the distributable surplus calculation in section 109Y.
If a loan from a trustee to a shareholder of a private company (or their associate) is included in their assessable income under section 109XB, and a later dividend is received by the shareholder (or their associate), and offset against that loan, the offset amount is excluded from their assessable income to the extent that the dividend is unfranked.	If a loan from a trustee to a shareholder of a private company (or their associate) is included in their assessable income under section 109XB and a later dividend is received by the shareholder (or their associate), that dividend cannot be offset against the loan from the trustee.
The law will put beyond doubt that Division 7A applies to arrangements that involve a non-resident private company making a payment, loan or forgiveness of debt to a resident shareholder (or their associate).	No equivalent.

Detailed explanation of new law

Payment that arises by the granting of a licence or right to use

1.16 The definition of ‘payment’ in section 109C does not currently extend to a licence or other right to use real property or a lease, licence or other right to use other company assets.

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1.17 These amendments extend the meaning of payment to include a lease, licence or other right to use an asset (other than a transfer of property which is already covered by paragraph 109C(3)(c) of the ITAA 1936). There are, however, exceptions for the minor use of certain company assets, certain payments that would otherwise be allowable as a once only deduction and the use of certain residences. The amendments do not change the meaning of transfer of property under paragraph 109C(3)(c).

[Schedule #, item 60, paragraph 109C(3)(d)]

Example 1.1

Ben is a shareholder of private company that manufactures luxury yachts. The company owns a luxury yacht that it uses for sales demonstration purposes. Every second weekend during the 2009-10 income year the company allows Ben to use the yacht for free.

Ben is not an employee of the company so Ben's use of the luxury yacht is not subject to fringe benefits tax. Ben's use of the yacht is however considered to be a payment for the purposes of paragraph 109C(3)(d).

Under these amendments, Ben is required to pay for his weekend use of the yacht (at market value rates) or the use will result in the company being treated as paying a deemed dividend (subject to the private company having a distributable surplus). Ben will then be liable to pay tax on the amount of the deemed dividend, if the payment is not converted to a loan and either repaid before the lodgment day of the private company, or a loan agreement complying with Division 7A requirements is made.

Example 1.2

Peter is a shareholder of a private company that owns a number of cars for company use. Every second weekend Peter takes one of these company cars home for private use and returns the car to the company's premises on Monday.

Peter is not an employee of the company so his use of the car is not subject to fringe benefits tax. Peter's use of the car is however considered to be a payment for the purposes of paragraph 109C(3)(d), even though Peter may not drive the car on both days of the weekend. The fact that the car is made available to be Peter means that Peter has a licence or right to use the car for the purposes of paragraph 109C(3)(d).

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Peter is required to pay for his weekend use of the company car (at market value rates) or his use will result in the company being treated as paying a deemed dividend (subject to the private company having a distributable surplus). Peter will then be liable to pay tax on the amount of the deemed dividend, if the payment is not converted to a loan and either repaid before the lodgment day of the private company, or a loan agreement complying with Division 7A requirements is made.

Exceptions to payments made by the provision of a lease, licence or right to use (other than a transfer of property)

1.18 These amendments include three exceptions to when a payment through a lease, licence or other right to use an asset (other than a transfer of property), may come within the operation of Division 7A.

Minor benefits

1.19 The first exception is in subsection 109C(3B), which provides that paragraph 109C(3)(d) does not apply to a lease, licence or other right to use an asset (other than a transfer of property), if the lease, licence or other right to use the private company's asset, if provided to an employee in respect of their employment, would be a minor benefit under section 58P of the *Fringe Benefits Tax Assessment Act 1986* (FBTAA 1986).

1.20 Section 58P of the FBTAA 1986 sets out when a minor benefit provided in, or in respect of a year of tax is an exempt benefit and hence not subject to fringe benefits tax. Paragraph 58P(1)(e) of the FBTAA 1986 provides that the notional taxable value of a minor benefit in relation to the current year of tax must be less than \$300. In addition paragraph 58P(1)(f) of the FBTAA 1986 sets out a number of other matters such as the infrequency and irregularity of the benefit which may lead to a conclusion that it would be unreasonable to treat the minor benefit as a fringe benefit for the current year of tax.

1.21 This exception will reduce compliance costs for taxpayers as they will not have to treat minor payments made to shareholders of a private company (or their associates) as payments that could give rise to deemed dividends.

[Schedule #, item 65, subsection 109C(3B)]

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Example 1.3

John is a shareholder of a private company that hires out trailers for \$250 per day. The company owns a number of trailers, one of which John has used once during the 2009-10 income year to move furniture and other household items.

John is not an employee of the company. His one-off use of the trailer would therefore be considered to be a payment for the purposes of paragraph 109C(3)(d).

However, because the notional value of his use of the trailer is less than \$300 and it would be unreasonable to treat the benefit as a fringe benefit given the one-off nature of the use, his use of the trailer would be treated as a minor benefit under section 58P of the FBTAA 1986.

As John's use of the trailer would be treated as a minor benefit under section 58P of the FBTAA 1986, his use of the trailer is disregarded for the purposes of paragraph 109C(3)(d).

Otherwise deductible payments

1.22 The second exception is in subsection 109C(3C), which provides that if the shareholder of a private company (or their associate) had paid expenditure in respect of the lease, licence or other right and a once-only deduction would have been allowable to the shareholder (or their associate) paragraph 109C(3)(d) does not apply.

1.23 In determining whether an amount is otherwise deductible, the appropriate test is whether the payment for the use of the asset (under a lease, licence or other right to use) would otherwise be deductible to the user of the asset, not whether the user would be able to deduct the amount had they purchased the asset themselves.

[Schedule #, item 65, subsection 109C(3C)]

Example 1.4

Shop Pty Ltd owns a shopping centre. Audrey is a shareholder of Shop Pty Ltd and at various times during the 2009-10 income year she is granted a right to use part of the property to run a gift wrapping service. Under her arrangement with Shop Pty Ltd, Audrey is not required to make payments to Shop Pty Ltd for the right to use that part of the property.

Had Audrey made payments for the use of the property she would be able to deduct those payments, as they would have been part of the

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expenses she incurred in running her business. Therefore, while Audrey's use of the property is within the scope of paragraph 109C(3)(d), it is disregarded, as Audrey would have otherwise been able to deduct any payment made for the use of the property.

The exception would not operate if it was established that Audrey had in fact a lease of real property (that is, a transfer of property to an entity within the meaning of paragraph 109C(3)(c)). The exception only applies to the extended meaning of payment in paragraph 109C(3)(d).

Dwelling owned by a private company

1.24 The third exception contained in subsection 109C(3D) relates to where a dwelling is being used by a shareholder of a private company (or their associate) and the use would not meet the otherwise deductible rule (that is, because the use was for private purposes). This exception requires that a number of conditions are met before the use of a residence by a shareholder of a private company (or their associate) is disregarded for the purposes of paragraph 109C(3)(d). These conditions are that the shareholder (or their associate):

- is carrying on a business;
- was granted a lease, licence or other right to use the land or water on which the dwelling is situated or adjacent to, or the building in which the dwelling is situated, for the primary purpose of carrying on that business;
- was granted the licence or other right to use the dwelling for the purpose of enabling the entity to utilise the lease, licence or other right used to carry on that business; and
- the dwelling is less than 10% of the area of the land, water or building used to carry on that business.

1.25 This exemption has been included to ensure that the use of certain dwellings is not captured inadvertently by the introduction of paragraph 109C(3)(d).

[Schedule #, item 65, subsection 109C(3D)]

Example 1.5

Farm Pty Ltd owns a farm. During the 2009-10 income year, the shareholders of Farm Pty Ltd (Aaron and Liz), run a farming business

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on the land owned by Farm Pty Ltd under a licence arrangement (Aaron and Liz do not have exclusive possession of the farmland). Due to the remote location of the farm, Aaron and Liz would not be able to utilise the farm to run their business without accommodation on the farm. In addition to the licence to use the farmland, Farm Pty Ltd therefore provides Aaron and Liz with the right to use a farmhouse that is situated on the farmland.

Aaron and Liz do not make payments to Farm Pty Ltd for either the use of the farmland or the farmhouse.

The use of the farmland by Aaron and Liz is not a payment for the purposes of paragraph 109C(3)(d). This is because if they had made a payment during the income year for the use of the farmland an once-only deduction would have been allowable. However, the use of the farmhouse by Aaron and Liz is of a private nature and hence does not come within the exception provided for in subsection 109C(3C).

As Aaron and Liz are carrying on a business on the land on which the farmhouse is situated, the right to use the farmhouse was granted to enable them to utilise their licence to use the farmland and the farmhouse is less than 10% of the area of the farmland, their use of the farmhouse is disregarded for the purposes of paragraph 109C(3)(d).

Example 1.6

Rebecca is a shareholder of a private company Health Pty Ltd. She is also a doctor who runs a surgery. Rebecca runs her surgery in a house owned by Health Pty Ltd under a licence agreement. The surgery takes approximately up 40% of the area of the house. Health Pty Ltd has also granted Rebecca a right to use the remaining 60% of the house to live in. She does not pay any rent to Health Pty Ltd under either arrangement.

Rebecca's licence to use the part of the house to run her surgery is not a payment for the purposes of paragraph 109C(3)(d). This is because if she had made a payment for her use of part of the house a once-only deduction would have been allowable.

However, Rebecca's use of the remainder of the house is a payment for the purposes of paragraph 109C(3)(d). This is because the area used as her dwelling is greater than 10% of the area of the house used to carry on her business.

Closely-held corporate limited partnerships

1.26 Division 7A does not currently apply to corporate limited partnerships due to the operation of section 94N, which states that a

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reference to a private company in relation to the year of income does not include a reference to a corporate limited partnership.

1.27 Under these amendments, corporate limited partnerships that satisfy the requirements outlined in section 109BB are subject to the operation of Division 7A. Section 109BB sets out that a corporate limited partnership will be considered to be closely held for the purposes of Division 7A where it has fewer than 50 members or an entity has, directly or indirectly, and for the entity's own benefit, an entitlement to a 75% or greater share of the income or capital of the partnership.

[Schedule #, item 55, section 109BB]

Example 1.7

Kariba L.P is a limited partnership that has one general partner and three limited partners. Kariba L.P is a corporate limited partnership under section 94D. As Kariba L.P has less than fifty members, it is subject to the application of Division 7A from the 2009-10 income year.

Interposed entities

Payments and loans made by a trustee through interposed entities

1.28 Under the current law, where an entity is interposed between a private company and a target entity, a payment or loan from the private company will be treated as being made directly to a target entity, namely the shareholder of the private company (or their associate) if certain conditions are met. There are currently no corresponding rules that apply for the purposes of Subdivision EA, where an entity is interposed between a trust and a target entity.

1.29 Under these amendments, where a corporate beneficiary has a present entitlement to an amount from the net income of a trust estate and the whole of that amount has not been paid, and an entity is interposed between that trust and a target entity (the shareholder of the private company or their associate), the trust will be treated as having directly paid or loaned an amount to the target entity for the purposes of Division 7A. Subdivision EA will then operate as if the trustee makes a payment or loan to the target entity.

1.30 However, the trust will only be treated as having directly paid or loaned an amount to the target entity if the trustee makes a payment or loan to an interposed entity and a reasonable person would conclude that

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the trustee made the payment or loan solely or mainly as part of an arrangement involving a payment or loan to the target entity and the interposed entity or another interposed entity makes a payment or loan to the target entity. *[Schedule #, item 125, subsection 109XF(1)]*

1.31 These amendments operate whether a single entity (the first interposed entity) is, or multiple entities are, interposed between the trust making the payment or loan and the target entity.

1.32 Additionally, it does not matter whether the interposed entity makes the payment or loan to the target entity at the same time as the first interposed entity receives a payment or loan from the trustee. The trustee will be considered to have made the payment or loan at the time the interposed entity makes the payment or loan to the target entity.
[Schedule #, item 125, subsection 109XF(5)]

1.33 The Commissioner of Taxation (the Commissioner) will be responsible for determining the amount of any payment or loan from the trust to the target entity as the amount received by the target entity may not be the same as the amount paid by the trustee. In determining this amount, the Commissioner will be required to take into account the amount the interposed entity paid or lent the target entity and how much of that amount represented consideration payable to the target entity by the trustee or any of the interposed entities.
[Schedule #, item 125, subsections 109XF(2), (3) and (4)]

1.34 Any repayments made by the target entity to the interposed entity will be taken into account in working out the amount that is included in the target entity's assessable income under section 109XB because of the notional loan between the trust and the target entity.
[Schedule #, item 125, subsection 109XF(7)]

Example 1.8

On 1 March 2010, Lush Trust enters into a transaction involving Lush Pty Ltd, Ngo Pty Ltd and Geoff, who is a shareholder of Lush Pty Ltd.

As part of this transaction, the Lush Trust declares a present entitlement of \$100,000 to Lush Pty Ltd. The present entitlement remains unpaid. Lush Trust then loans \$100,000 to Ngo Pty Ltd who makes a \$100,000 loan to Geoff, the shareholder of Lush Pty Ltd.

As Ngo Pty Ltd has received a payment from Lush Trust, and has made a loan to Geoff, the Lush Trust will be treated as having directly made a loan to Geoff where a reasonable person would conclude that

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the trustee of the Lush Trust made the loan to Ngo Pty Ltd as part of an arrangement involving a loan to Geoff.

Where this type of arrangement is established, having regard to all the circumstances, the Lush Trust is considered to have made a notional loan to Geoff. The Commissioner will then determine the value of the notional loan.

Geoff is assessable on the value of the loan determined by the Commissioner, subject to the normal operation of Subdivision EA.

Entitlements to trust income through interposed trusts

1.35 One of the requirements to satisfy subsections 109XA(1), (2) and (3) is that a private company is or becomes presently entitled to an amount from the net income of a trust estate that makes the payment, loan or debt forgiveness to the shareholder of the private company (or their associate), and the whole of that amount has not been paid.

1.36 Interposing one or more trusts between the private company that is or becomes presently entitled to an amount from the net income of a trust estate, where the whole of that amount has not been paid, and the target trust that makes the payment or loan to the shareholder of the private company (or their associate) may serve to circumvent the operation of Subdivision EA.

1.37 Under these amendments where one or more trusts is interposed between a private company and the target trust (the trust making the payment to the shareholder of the private company or their associate) the private company will be treated as holding a present entitlement to an amount from the net income of the target trust for the purposes of Division 7A, if a reasonable person would conclude that the private company is, or becomes entitled to, an amount from the net income of the interposed trust, solely or mainly as part of an arrangement involving an entitlement to an amount from the target trust.

[Schedule #, item 125, subsection 109XG(1)]

1.38 Subdivision EA will then operate as if the private company that is or becomes entitled to an amount from the net income of the interposed trust estate is in fact presently entitled to an amount from the net income of the trust estate of the target trust.

1.39 It does not matter whether the company became or becomes entitled to the amount from the net income of an interposed trust at the same time the interposed trust became or becomes presently entitled to an amount of the net income of the target trust. The company will be

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considered to be or become presently entitled to an amount of the net income of the target trust at the time the company is or becomes presently entitled to an amount from the interposed trust.

[Schedule #, item 125, subsections 109XG(2), (6)]

1.40 The Commissioner will be responsible for determining the amount that the company is taken to be or becomes presently entitled to from the net income of the target trust, as it may not be the same as the amount to which the interposed trust became presently entitled to. In determining this amount, the Commissioner must have regard to the amount the company is entitled to from the net income of the interposed trust and how much of that amount the Commissioner believes represents consideration payable to the company.

[Schedule #, item 125, subsections 109XG(4), (5)]

Example 1.9

Michael is a shareholder of Bennetts Pty Ltd. In the 2009-10 income year, he receives a payment from the trustee of the Wilson Trust, which is attributable to an unrealised gain. He receives this payment because of his shareholding in Bennetts Pty Ltd.

Bennetts Pty Ltd is not and has not become presently entitled to an amount from the net income of the Wilson Trust. However, the Harvey Trust is presently entitled to an amount from the net income of the Wilson Trust. This amount remains unpaid.

Bennetts Pty Ltd is presently entitled to an amount from the net income of the Harvey Trust. The amount of this entitlement is equal to the unpaid present entitlement that the Harvey Trust has with the Wilson Trust, but remains unpaid.

For the purpose of section 109XA Bennetts Pty Ltd is taken to be presently entitled to a share of income of the Wilson Trust as, in this case, a reasonable person would conclude that it solely or mainly became presently entitled to a share of the income of the Harvey Trust estate as part of an arrangement involving a present entitlement to an amount of net income of the Wilson Trust.

Loan agreements related to the distribution of an unrealised gain

1.41 The amount involved in an actual transaction under Subdivision EA, that may be included in a shareholder's (or their associate's) assessable income under section 109XB, is limited to the unpaid present entitlement amounts mentioned in paragraphs 109XA(1)(c), (2)(b) and (3)(b). Paragraph 109XA(1)(b) includes an

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additional limitation in that a payment must also be a discharge of, or a reduction in, a present entitlement of the shareholder (or their associate) that is wholly or partly attributable to an amount that is an unrealised gain.

1.42 In an attempt to exploit this limitation and circumvent the operation of Division 7A, taxpayers have been entering into arrangements whereby the amount of the payment received by a shareholder of a private company (or their associate) from the trustee of a trust, is significantly more than the unpaid present entitlement held by the private company, that is attributable wholly or partly to an unrealised gain of the trust.

1.43 Under these arrangements, the shareholder of the private company (or their associate) then loans back to the trust the amount of the payment that exceeds the unpaid present entitlement, held by the private company.

1.44 In a subsequent income year, where the private company holds an unpaid present entitlement from the trust, the trustee then makes a repayment of the loan to the shareholder of the private company (or their associate). The repayment of the loan to the shareholder (or their associate) is not caught by the operation of Division 7A as the payment is no longer a discharge of, or a reduction in, a present entitlement of the shareholder (or their associate) that is wholly or partly attributable to an amount that is an unrealised gain within the scope of subsection 109XA(1).

1.45 In order to prevent this type of arrangement being used to circumvent the operation of Division 7A, these amendments ensure that the operation of paragraph 109XA(1)(b) will be disregarded where the conditions contained in subsection 109XA(1A) are satisfied.

1.46 Section 109XA(1A) sets out that paragraph 109XA(1)(b) will be disregarded when:

- subsection 109XA(1) has previously applied because the trustee made a payment to the shareholder (or their associate) in an earlier income year; and
- the shareholder (or their associate) makes a loan back to the trustee and a reasonable person would conclude that the shareholder (or their associate) made or intended to make the loan or loans to the trustee at the time of, or before, the original transaction took place; and
- the trustee makes a repayment of all of or part of the loan.

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[Schedule #, item 90, subsection 109XA(1A)]

1.47 Section 109J which provides that a private company is not taken to pay a dividend because of payments, to the extent that they discharge an obligation of the private company to pay money to the entity on an arm's length basis does not apply where subsection 109XA(1A) applies. This is to ensure that the loan agreement between the trust and the shareholder of the private company cannot be used to avoid the application of subsection 109XA(1A).

[Schedule #, item 90, subsection 109XA(1B)]

Example 1.10

In the 2009-10 income year Trust A re-values an asset and makes a distribution of \$5 million to Lucas who is a shareholder of Willis Pty Ltd. Willis Pty Ltd holds a \$500,000 unpaid present entitlement to an amount from the net income of Trust A. Lucas will be required to include \$500,000 of the payment he receives in his assessable income for the 2009-10 income year, subject to the distributable surplus of Willis Pty Ltd.

When Lucas receives the payment from Trust A he immediately enters into a commercial loan agreement with the trust for \$4.5 million. The trust is obliged to repay the loan over successive income years.

In the 2010-11 income year, Willis Pty Ltd holds an unpaid present entitlement of \$500,000 from the net income of Trust A. The trustee of Trust A again makes a payment of \$500,000 to Lucas. However, this payment now represents a repayment of the outstanding loan to Lucas rather than a payment in relation to an unrealised gain.

Before the 2009-10 income year, Lucas would not have been required to include this payment in his assessable income under section 109XB. However, from the 2009-10 income year the subsequent payment made by the trustee (the repayment of the loan) is treated as the discharge of a present entitlement of the shareholder (or their associate) that is wholly or partly attributable to an amount that is an unrealised gain.

Definition of non-commercial loans

1.48 The definition of non-commercial loans in section 109Y currently includes the amounts that are shown as assets in the company's accounting records at the end of the year of income that have been taken under section 109D, section 109E and former section 108 to have been paid as dividends in earlier years of income.

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1.49 These amendments allow amounts that have been included in the assessable income of a shareholder (or their associate), under section 109XB, to be taken into account when determining the amount of non-commercial loans under section 109Y.

[Schedule #, item 140, subsection 109Y(2)]

1.50 Where an amount is included in the non-commercial loan calculation because of section 109XB, it will be reduced by the total of the unfranked parts of any later dividends received by a shareholder (or their associate) which have been set off under section 109ZCA. Subsection 109Y(2A) ensures that the amount of any non-commercial loans, for the purpose of section 109Y, does not result in an underestimate of an entity's distributable surplus. *[Schedule #, item 150, subsection 109Y(2A)]*

Loans which have been treated as a deemed dividend that are forgiven by a trustee

1.51 Section 109G sets out that a private company is not taken to pay a dividend at the end of a year of income because of the forgiveness of an amount of a debt resulting from a loan, where the loan has already given rise to a deemed dividend. Currently, there is no equivalent provision in the law to allow a similar amount to be forgiven if the loan is made by a trustee rather than a private company.

1.52 These amendments introduce section 109XD, which allows an amount of a debt, resulting from a loan, to be forgiven and not be included in the assessable income of a shareholder (or their associate) of a private company (where the loan has previously resulted in an amount being included in the assessable income of the shareholder (or their associate) under section 109XB.

[Schedule #, item 120, section 109XD]

Example 1.11

Anna is a shareholder of Elliot Pty Ltd. In a previous income year, Anna received a loan from the Dawson Trust that was included in her assessable income under section 109XB.

In the 2009-10 income year, the Dawson Trust forgives the amount of the loan made to Anna. As the loan has already been included in Anna's assessable income under section 109XB, she is not required to include it again in her assessable income.

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Offset of later dividends against loans made by trustees

1.53 The current law sets out special rules which allow a later dividend, distributed by a private company to a shareholder (or their associate), to be set off against some or all of an amount that has already been taken to be a deemed dividend, previously paid by a company.

1.54 However, where an amount is instead included in the assessable income of a shareholder (or their associate) under section 109XB, there is no corresponding provision in the law to allow a later dividend from a private company to be set off against this amount.

1.55 These amendments allow for later dividends, distributed by a private company to a shareholder (or their associate), to be set off against some or all of an amount received from a trustee, where that amount has already been included in the assessable income of the shareholder (or their associate) under section 109XB. *[Schedule #, item 155, subsection 109ZCA(1)]*

1.56 As a later dividend could be part of a general dividend paid by the private company, and the dividend could be either fully or partly franked an exception is provided, so that a later dividend is still considered to be assessable income to the extent that it is franked. *[Schedule #, item 155, subsections 109ZCA(2),(3)]*

1.57 This exception means that the franking credit attached to a later dividend is still available to shareholders, to be applied against income tax liabilities, where that franked dividend is used to offset an earlier amount treated as a dividend. *[Schedule #, item 155, subsection 109ZCA(4)]*

Repayment of a loan by withholding amounts from an employee's salary or bonus

1.58 Under section 109R some repayments made to a private company, in relation to a loan the private company made to an entity, are not taken into account for the purpose of working out how much of the loan has been repaid for the purposes of sections 109D, 109E and the minimum yearly repayment amount in subsection 109E(5).

1.59 Subsection 109R(2) determines which payments will not be taken into account, subject to the exceptions contained in subsection 109R(3).

1.60 Paragraph 109R(3)(b) provides an exception for a payment made by setting off a loan amount against work and income support related withholding payments and benefits payable by the private

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company. Paragraph 109R(3)(ba) provides an exception for payment covered by section 12-55 of Schedule 1 to the *Taxation Administration Act 1953*. Currently, the exceptions in paragraphs 109R(3)(b) and 109R(3)(ba) cannot be accessed if the repayment being made is for a loan from a trustee, due to the operation of subsection 109XC(8).

1.61 These amendments allow a loan made by a trustee to be repaid by setting off the payments outlined in paragraphs 109R(3)(b) and 109R(3)(ba) against the outstanding amount of the loan.

[Schedule #, item 115, subsection 109XC(8)]

Example 1.12

In the 2009-10 income year, Aaron who is an employee of the Bell Trust but also a shareholder of Evans Pty Ltd. Evans Pty Ltd has an unpaid present entitlement to an amount from the net income of the Bell Trust.

During the 2009-10 income year, the Bell Trust makes a loan of \$100,000 to Aaron. Aaron arranges for the Bell Trust to set off Aaron's yearly bonus against the outstanding loan as a repayment.

The amount that has been set off is treated as a repayment for the purposes of section 109D, 109E and subsection 109E(5).

Repayment of a loan to a private company using a re-borrowing

1.62 Subsection 109R(2) currently states that a payment to repay a loan to a private company must not be taken into account if a reasonable person would conclude, after having regard to all the circumstances, that when the payment was made to the private company, the entity making the repayment intended to obtain a loan from the private company of an amount similar to or larger than the repayment.

1.63 These amendments extend the operation of subsection 109R(2) to ensure that where a reasonable person would conclude that an entity obtained a loan from the private company, of an amount similar to, or larger than the payment, before the payment was actually made, the payment will not be taken into account for the purpose of working out how much of the loan is repaid under sections 109D and 109E or the minimum yearly repayment amount under subsection 109E(5).

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1.64 In certain circumstances, it may already be possible to disregard these payments, however these amendments will put this matter beyond doubt and remove any ambiguity.

[Schedule #, item 75, subsection 109R(2)]

Example 1.13

Alicia obtains a loan of \$10,000 from Cleary Pty Ltd. Alicia has until the lodgment day to repay the loan. Two weeks before the lodgment day Alicia obtains a further \$10,000 from Cleary Pty Ltd. She then repays the original \$10,000 loan a week before the lodgment day.

The repayment of the original \$10,000 loan is not a repayment for the purposes of sections 109D. This is because Alicia has borrowed a similar amount from Cleary Pty Ltd and in this case a reasonable person would conclude that the loan was obtained in order to make the repayment of the original \$10,000.

The original \$10,000 loan is treated as a deemed dividend subject to the distributable surplus of the private company.

Inclusion of Division 7A amounts in distributable surplus calculation

1.65 The current law does not provide for amounts that have been paid out by a private company in the form of a payment or a forgiveness of debt, during an income year, to be included in the distributable surplus calculation made under subsection 109Y(2).

1.66 By excluding these amounts the current formula in subsection 109Y(2) understates the distributable surplus of a private company. This may lead to an artificial reduction in the amount of deemed dividends that a private company is considered to have paid during the relevant income year.

1.67 These amendments correct this anomaly by including a reference to Division 7A amounts in the distributable surplus formula in section 109Y(2). This reference ensures that amounts that have been taken to be payments under section 109C or the forgiveness of a debt under section 109F, before they are subject to the operation of section 109Y, are included in the distributable surplus of a private company under subsection 109Y(2).

[Schedule #, item 135, subsection 109Y(2)]

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Example 1.14

On 29 June 2005, a private company has real property valued at its historical cost in the company's accounting records of \$500,000. The real property has a market value of \$1,500,000 and the private company has liabilities of \$400,000 with no provisions and paid-up capital of \$100,000.

For section 44 purposes, the private company has 'profits' of \$1,000,000 which reflects the unrealised gain in the real property. If, on 29 June 2005, the private company made an in specie distribution of the real property to a shareholder, an amount of \$1,000,000 would be included in the shareholder's assessable income as a dividend under section 44.

However, if instead of making the in specie distribution, the private company sells the real property to the shareholder for \$500,000, the sale of the real property is a payment within the meaning of paragraph 109C(3)(c) of Division 7A of an amount determined under subsection 109C(4) – being \$1,000,000.

The private company's distributable surplus under section 109Y is determined according to the private company's accounting records as at 30 June 2005. As at that date, the private company has assets of \$500,000 (being the proceeds on disposal of the real property), liabilities of \$400,000 and paid-up capital of \$100,000. The net assets of the private company for section 109Y purposes, and therefore the private company's distributable surplus, are both nil. The end result is no amount is treated as a dividend under Division 7A.

By selling the real property to the shareholder at its historical cost, the private company has achieved a disguised distribution of \$1,000,000 to the shareholder tax free.

If this same transaction occurs from the 2009-10 income year the amount of the payment for the purpose of paragraph 109C(3)(c) will be included in the distributable surplus of the private company as a Division 7A dividend amount. Hence the company's distributable surplus will be \$1,000,000 and the shareholder of the company will be required to include a deemed dividend of \$1,000,000 in their assessable income.

Application of Division 7A to resident shareholder's or their associates

1.68 There has been some conjecture as to whether Division 7A applies to circumstances where a shareholder of a private company (or

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their associate) is an Australian resident and the private company involved in the arrangement is a foreign resident.

1.69 Section 109BC will put beyond doubt that Division 7A applies in relation to these arrangements and that the Australian resident will be liable to pay tax on any deemed dividends that arise under the operation of Division 7A.

1.70 Subsection 109BC(1) ensures that the relevant tax accounting period for a foreign company applies for the purposes of Division 7A. Subsection 109BC(2) ensures that where a company is resident in more than one foreign country the tax accounting period that ends first will be the relevant tax accounting period for the purpose of Division 7A.

[Schedule #, item 55, subsection 109BC]

Application and transitional provisions

1.71 The amendments made by this Schedule apply in relation to the 2009-10 income year and later income years. *[Schedule #, item 170]*