Australian Government
Australian Taxation Office

Private companies and Division 7A – avoid the common mistakes of taking money and benefits from the business

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Presenters:

Assistant Commissioner Kasey Macfarlane | Private Wealth

Assistant Commissioner Anthony Marvello | Small Business

OFFICIAL: EXTERNAL

Welcome

Acknowledgment of country

"We would like to respectfully acknowledge the traditional owners and custodians of the land on which we meet throughout Australia and the continuing connection to land, waters, and community. We pay our respects to them and their cultures, and elders past, present and emerging."

Introduction

- There are a range of issues and rules for small business and private groups to navigate when taking money and benefits from their private companies.
- A concern we have shared with your professional associations is that a number of businesses and their advisers are not sufficiently focussed on getting the basics right – until it is too late!
- Throughout 2024 we will be working in partnership with your professional associations to raise awareness of these issues and concerns.
- Division 7A has been a part of the Australian tax law for 25 years. Despite this, it is among the top issues we regularly see.
- We are concerned that fundamental issues continue to be overlooked.

Over the next year

March to May

Division 7A – avoid the common mistakes:

- what the ATO is seeing
- the different ‘hats’ of private company shareholders
- taking money or benefits from a private company – the range of tax consequences
- Division 7A – common issues and mistakes and how to avoid them.

June to August

Division 7A – foundational topics including:

- payments and benefits
- loans (e.g. complying loan agreements, benchmark interest rate)
- minimum yearly repayments (including section 109R)
- discretions.

Sept to Nov

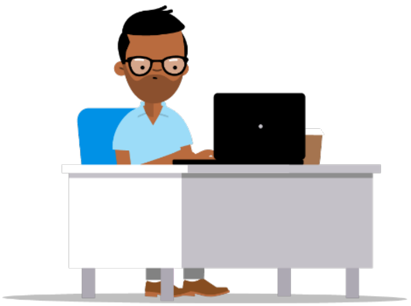
Division 7A – intermediate topics including:

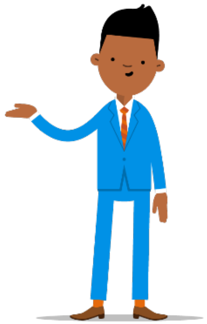
- interposed entities
- forgiveness of debts
- unpaid present entitlements, Bendel Full Federal Court appeal
- use of company assets.

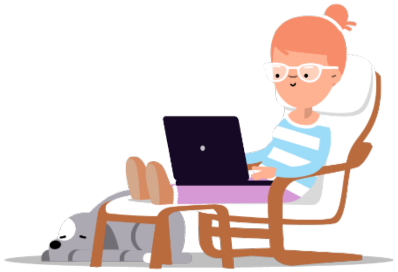
What we are seeing

- Most of the market relies on their agent to get Division 7A right.
- Division 7A breaches are common across all industries and segments from small one person companies to largely privately held groups and with all types of agents.
- Many of the issues we see can be avoided by taking some simple steps, including
  - recognising that companies are separate legal entities
  - keeping, maintaining and retaining adequate records that explain payments
  - planning ahead when it comes to payments to and/or the use of company assets by shareholders and their associates
  - maintaining separate bank accounts and loan accounts for individual entities
  - undertaking basic annual checks to ensure complying loan agreements are in place, and minimum yearly repayments are made by required dates.

The hats that owners can wear in relation to their private companies







Employee

Director

Shareholder

Taking money or benefits from a private company

Salary and wages and directors’ fees

- The private company has obligations including:
  - pay as you go withholding (PAYGW)
  - superannuation
  - Single Touch Payroll (STP) reporting.
- The private company can claim a deduction for the cost of salary and wages, and directors’ fees.
- The recipient includes the salary and wages or directors' fees in their tax return and gets a credit for the PAYGW.

Fringe benefits

Fringe benefits tax (FBT) is payable by employers if they provide certain benefits to their employees, the employee’s family or other associates.

- The employer must lodge an FBT return and pay any FBT liability.
- The employer can claim an income tax deduction:
  - and GST credits for the cost of providing fringe benefits
  - for the FBT they pay.
- Fringe benefits are tax free to the recipient.

Taking money or benefits from the company

Dividends	Debtor/creditor
The private company: ▪ pays tax on its profit at the company tax rate. ▪ can issue a franked or unfranked dividend. ▪ must give the shareholder a dividend statement. The shareholder: ▪ includes the dividend with any attached franking credit in their tax return. ▪ receives a credit for the tax already paid by the company.	▪ Loans from private companies to shareholders and their associates must comply with Division 7A if they're not repaid in full by the company's lodgment day. ▪ Interest derived on loans is income of the lender. ▪ Interest isn't deductible for the borrower if the money borrowed is used to pay for personal, not business expenses. ▪ Interest is deductible for the borrower if it's incurred in gaining or producing their income or in carrying on their business.

Division 7A – the basics

- Is an integrity rule that prevents profits from being provided to shareholders or their associates tax-free.
- Division 7A may apply to a loan, payment or other benefit (including the use of a company asset, debt forgiveness given) to one of its shareholders or their associates.
- Where it applies the recipient of the loan, payment, or other benefit is deemed to have received an unfranked dividend, that is included in their assessable income.
- Some payments and loans from private companies are excluded from been taken to be a deemed dividend, including loans on complying Division 7A terms or assessable payments like salary and wages and dividends.
- Division 7A can apply when a company provides loans, payments or other benefits to shareholders or their associates through another entity(s) (e.g. other companies, trusts and individuals).

Fact or Myth?

Facts

- Applies to a wide range of benefits. Except amounts that are otherwise assessable to the shareholder (including; dividends, salary and wages or director's fees), or exempt (e.g. fringe benefits).
- Company funds are not the shareholder's personal funds – it isn't a single pool of funds.
- An amount may be treated as a Division 7A dividend even if it's paid or lent by the private company to the shareholder or their associate through one or more other entities.
- You can't borrow money from the company to make your minimum yearly repayments.
- You are required to complete Division 7A income tax return labels.

Myths

- Tax can be avoided by taking money out of a company informally, or by way of having the company provide benefits to its shareholders and their associates.
- If the money is taken out to fund another business, Division 7A doesn't apply.
- A journal entry in the annual accounts for a dividend liability can offset a loan repayment on its own.
- Division 7A doesn't apply to payments or loans to trusts.
- You can avoid Division 7A if you repay the loan before lodgment date and reborrow the same amount in the next income year.

Division 7A – complying loan agreements

- To avoid a deemed dividend a loan must be either repaid in full or put on a complying loan agreement before the company’s lodgment date (sections 109D / 109N).
- A payment can be converted to a loan before the company’s lodgement date.
- A section 109N complying loan agreement must be in writing, and include:
  - the identity of the parties
  - an interest rate for each year of the loan at least equal to the Division 7A benchmark interest rate (currently 8.27% for 2023-24 income year)
  - a maximum term of 7 years for unsecured loans (25 years for certain secured loans)
  - the amount of the loan
  - the requirement to repay
  - a signature and dated by the parties.

Division 7A – repayments

- Minimum yearly repayments (MYR) must be made by the end of the income year for complying loans made in earlier income years that have not been repaid in full.
- A shortfall in a MYR on a complying loan may be a deemed dividend (section 109E).
- Some repayments may not be taken into account when working out whether the minimum yearly repayment or how much of the complying loan has been repaid, including reborrowing’s from the same private company (section 109R).
- Some repayments will always be taken into account, for example if they are made by offsetting a shareholder's entitlement to a dividend declared by the company, or salary and wages or directors fees payable to a shareholder or their associate.

Staying ahead of Division 7A

By the end of the income year (e.g. by 30 June)

- Early in the income year, plan how company money will be accessed (e.g., salary and wages, dividends, complying loan agreement).
- Ensure account allocations are correct and substantiated.
- Identify any payments (including use of company assets), loans and debt forgiveness to shareholders or their associates.
- Make the minimum yearly repayments required for prior year Division 7A loans.
- Take any required action if you plan to offset a company liability to pay dividends, salary and wages or directors' fees to a shareholder against their minimum yearly repayment obligation.

By lodgment date

- To avoid a Division 7A deemed dividend, before the company tax return is due or lodged (whichever comes first):
  - payments not repaid or offset by the end of the income year must be converted to a Division 7A complying loan
  - loans must be repaid in full, or put on Division 7A loan with complying terms.
- Report interest from any Division 7A loans as income for the company.
- Deemed dividends must be included in the shareholder or shareholder's associate's assessable income.
- Plan ahead for next year – how will company money be accessed?

The Commissioner's discretion

- The Commissioner is able to exercise discretion under section 109RB to disregard the operation of Division 7A or to allow a deemed dividend to be franked.
- The discretion can **only** be exercised if the relevant breach resulted from an honest mistake or inadvertent omission **and** the circumstances support the exercise of the discretion.
- Ignorance, lack of due diligence or reasonable care will generally not constitute an honest mistake or inadvertent omission.
- Timely and appropriate corrective action will weigh in favour of exercise of the discretion.

Common Division 7A errors

Most of the errors we are seeing are simple in nature:

- loans made without complying loan agreements or not in place by lodgment day
- loan agreements not between the right entities
- incorrect calculation of minimum yearly repayments
- a lower than benchmark interest rate applied on Division 7A loans
- late or underpayment of minimum yearly repayments
- reborrowing from the private company to make repayments on the Division 7A loan.

Key messages

- A company is a separate legal entity, company money is not your money.
- Every payment and benefit from a private company to its shareholders and their associates has tax consequences, e.g. salary and wages, PAYG, Super, STP, directors fees, fringe benefits or dividends.
- Other benefits taken from the company need to be treated *as if the shareholder was borrowing from a bank*. Otherwise, they are borrowing from the Australian community and there is a cost to that – Division 7A.
- Don't assume you will be able to rely on the Commissioner exercising a discretion in your favour, if you trigger an unfranked deemed dividend.
- Keep accurate and timely records.
- Your professional association and the ATO have numerous resources to assist.
- The ATO is here to help.

Resources

- Private company benefits – Division 7A dividends – QC 17861
- Using your business money and assets – QC 67807
- Division 7A calculator and decision tool – QC 21036
- Division 7A – benchmark interest rate – QC 17928
- Issuing distributions statements – QC 47309
- Tax control frameworks for medium and small corporations – QC 46292
- Managing Division 7A risks, and corrective action – QC 45061
- Essentials to strengthen your small business