

ATO CONFIRMS DIV 7A REQUIREMENTS

The ATO has released a final determination (TD 2008/8) on the formal requirements for a complying loan agreement for the purposes of Div 7A.

Previously, the ATO accepted that a company's constitution, which contained the necessary parts of Div 7A, could constitute a loan agreement in writing for the purposes of the Act. It has been common practice to-date for companies to rely on this and simply minute each loan to a member.

The ATO has now made it clear that such loan agreements must be in writing and be agreed by the company and its borrower. As such, it is now essential that each Div 7A loan agreement accurately records the loan terms in accordance with the ATO determination, and that it may not be acceptable to rely solely on the company's constitution for the Div 7A loan terms.

Users should be aware that, following the change in ATO practice, loan packs distributed by **ACIS** have been updated (see attached) to take this into account. Accordingly, older versions of the loan pack (prior to 16 June 2008) may need to be updated to make sure that loans documented in accordance with them fully comply.

TD 2008/8 requires that the entire agreement between the parties must be in writing including:

- the names of the parties;
- the loan terms (i.e. the amount of the loan and the date the loan amount is drawn, the requirement to repay the loan amount, the period of the loan and the interest rate payable);
- that the parties named have agreed to the terms; and
- when the written agreement was made, for example the date it was signed or executed,

For the purposes of the Act, an agreement that is partly oral and partly in writing is not an agreement in writing.

The ATO has recognised that the requirement for the agreement to be in writing would also be sufficiently satisfied if there is written confirmation of the existence of the agreement and the essential elements. For example, an exchange of letters, emails, faxes, or other means of communication would be sufficient if they are dated and provide written evidence of the terms of the agreement and the parties' acceptance of those terms.

ACIS recommends that, in all cases, a formal loan agreement be prepared and signed by the company and the borrower to ensure that each Div 7A loan complies with the ATO's requirements.

For further information, please call us toll-free on 1800 773 477.

COMPANY LOAN PACK

Dear Sir/Madam,

Company loans have recently been the subject of considerable legislative attention.

We have prepared this Loan Pack to help you to ensure that any loans made by your company comply with the strict guidelines set down by the Income Tax Assessment Act ("the Act").

The included Explanatory Memorandum summarises the requirements of the Act in this regard and should be read carefully before proceeding to transact a loan. Naturally, your accounting or legal adviser should be consulted.

You should note that your company's constitution contains provisions that allow loans to be made by the company (by the authority of the directors). For your reference, we have included a sample minute and sample loan agreement, both of which are necessary to document Div 7A loans made by the company.

Please do not hesitate to contact our office should you have any queries or require any assistance.

Yours faithfully,



Matt Neibling
Director.



EXPLANATORY MEMORANDUM

Loans made by private companies – the application of Division 7A and Section 108 of the Income Tax Assessment Act.

Drawn by:

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Background.

Prior to the introduction of Division 7A into Parliament, Section 108 was the key provision in the Income Tax Assessment Act ("the Act") dealing with private company dividends that had been disguised as loans. Section 108 deemed such loans made to shareholders or their associates to be dividends, but has since been found to contain flaws.

Division 7A has been inserted into the Act in order to rectify those flaws. The Division automatically deems to be an assessable dividend (to the extent that there are realised and unrealised profits in the company) any advances, loans, or the crediting of amounts by private companies to shareholders (and their associates), unless they come within a defined class of excluded loans.

These amounts are included in the assessable income of the shareholder or associate under Section 44 of the Act.

The legislation is effective from the date of introduction into Parliament – i.e. 4 December 1997.

The Structure of Division 7A

Division 7A applies to all payments or loans made on or after 4 December 1997.

Division 7A will also apply to any forgiveness of debts on or after the introduction date, regardless of when the debts were created. Where the terms of the existing loan are significantly altered after the date of introduction, the new measures will deem such loans to be new loans from the day the terms are varied. A significant alteration in a loan covers such things as an increase in the amount or term of the loan.

There are a number of exceptions to this rule. Where a loan is an "excluded loan", money lent out by a company to its member can be classed as a genuine loan rather than an unfranked dividend. We therefore need to look at and understand what an excluded loan is and, more importantly for loans made to a company by a member, what a commercial loan is.

What are excluded loans and how do they work?

Subdivision D sets out the rules for determining when payments and loans are not treated as dividends. Its purpose is to ensure that "genuine" loans (or those that are assessable under another provision in the Act) are not taxed unfairly. A payment or loan is not treated as a dividend if:

1. it is made to another company (other than a company in the capacity of a trustee) and the recipient company does not pay or loan an amount to a shareholder or associate of the first company; or
2. the loan is made in the ordinary course of business on the usual terms that would apply to arm's length loans; or
3. a repayment of a debt owed by a private company to a shareholder or associate to the extent that the repayment is not more than the value the debt would have had if the private company and shareholder or associate had been dealing with each other at arm's length (this section ensures that such commercial dealings are not taxed unfairly, and that, for example, disguised distributions are not made by inflating the amount of a debt owed to a shareholder or associate by a private company); or

4. a private company makes a loan to a shareholder or associate in a year of income and that loan is repaid by the end of that income year; or
5. the payment or loan made by a private company to a shareholder or associate forms part of the assessable income of the shareholder or the associate by virtue of some other provision of the Act; or
6. the payment or loan meets the criteria of an "excluded loan" specified in this Subdivision. The requirements of an excluded loan are that:
 - (a) the loan is made under a written agreement;
 - (b) the rate of interest payable on the loan is equal to or exceeds the Indicator Lending Rate, that is, the Bank variable housing loan interest rate last published by the Reserve Bank of Australia before the end of the year of income (referred to as the "*benchmark interest rate*");
 - (c) the maximum term for a secured loan must be no more than 25 years, and for all other loans, no more than 7 years. For a secured loan, the amount of the loan cannot exceed 90% of the value of the property over which security is provided (less any other liabilities in respect of which the property provides security). Such loans must be secured by way of registered mortgage;
 - (d) loan repayments must be made which are equal to or greater than the *minimum yearly repayment* [Section 109N]. (See below under "Repayments").

Amalgamated loans

Loans on similar terms made during the same year of income (that are not treated as dividends at the end of the year) are brought together to form a single amalgamated loan at the end of that year. It will then be necessary to make a minimum yearly repayment in respect of this amalgamated loan. Repayments made towards any of the loans that a shareholder or associate received in the previous income year will be treated as a repayment of the amalgamated loan [Section 109E(4)].

Repayments

The Division 7 A provisions require that there be *minimum yearly repayments*. Should the shareholder or associate fail to meet the minimum yearly repayment, and the Commissioner has not exercised his/her discretion to disregard the failure to make the minimum yearly repayment, the outstanding amount of the loan will be deemed to be a dividend in the income year when the shareholder or associate defaults [Sections 109E(1) and (2)].

The Commissioner has a discretion to disregard the failure to make a minimum yearly repayment if the failure was caused by circumstances beyond the control of the shareholder or associate, and the inclusion of a dividend in the assessable income of the shareholder or associate would cause undue hardship to the shareholder or associate. In deciding whether to exercise the discretion, the Commissioner must have regard to the following factors:

- (a) whether the shareholder or associate had the capacity to repay the loan at the time it was granted;
- (b) any circumstances that reduced the capacity of the shareholder or associate to repay in the particular year of income;

- (c) whether the shareholder or associate has made a genuine attempt during that year to make the minimum yearly repayment;
- (d) whether the shareholder or associate has made the minimum yearly repayment in previous years [Section 109Q].

An example of a situation in which the Commissioner may exercise his or her discretion is where the shareholder or associate has been involuntarily retrenched from his or her employment.

A request for the exercise of the Commissioner's discretion to disregard the requirement to make a minimum yearly repayment may be lodged with the Commissioner at any time. There is no guarantee that the Commissioner would, in fact, exercise the discretion. Therefore, prior to the exercise of the discretion, any return lodged in respect of a year in which the minimum yearly repayment was not made would be on the basis that the outstanding amount of the amalgamated loan is treated as a dividend.

It is therefore necessary to determine how these minimum yearly repayments are calculated.

Calculating the minimum yearly repayment

The minimum yearly repayment is worked out using the formula in the Subdivision C [Subsection 109E(6)] the formula is as follows:

Amount of the loan not repaid by end of the previous year of income	x	Current year's benchmark interest rate
--	---	---

$$1 - \left(\frac{1}{1 + \text{Current year's benchmark interest rate}} \right)^{\text{Remaining term}}$$

where:

current year's benchmark interest rate is the benchmark interest rate for the year of income for which the minimum yearly repayment is being worked out.

benchmark interest rate is the rate last published by the Reserve Bank before the start of the year of income.

remaining term is the difference between:

- (a) the number of years in the longest term of any of the constituent loans that the amalgamated loan takes account of; and
- (b) the number of years between the end of the private company's year of income in which the loan was made and the end of the private company's year of income before the year of income for which the minimum yearly repayment is being worked out,

rounded up to the next higher whole number if the difference is not already a whole number.

The formula calculates the annual repayment of principal and interest required to repay the amalgamated loan over the term of the loan. The data necessary for the calculation are the value of the loan, the benchmark interest rate (as listed in the regulations), the original term of the loan and the remaining term of the loan. If the number for the remaining term of the loan is not a whole number, then it is rounded up. The term of the amalgamated loan is the longest of any of the loans, which make up the amalgamated loan.

For example:

- if the amount of the amalgamated loan is \$100,000;
- the term of the loan is five years;
- the remaining term of the loan is also five years;
- the benchmark interest rate is 8%;
- the minimum yearly repayment in the year immediately after the year in which the amalgamated loan comes into existence is calculated as follows:

$$\frac{100,000 \times 0.08}{1 - \left(\frac{1}{1 + 0.08} \right)^5} = \$25,045$$

In order to calculate the minimum yearly repayment for the second or subsequent year, the borrower has to know how much of the repayment made in the first year is attributable to interest and how much is applied to reduce the principal. To calculate this, the borrower may apply the relevant benchmark interest rate to the amount outstanding from time to time in the year calculated on daily balances [*subsection 109E97*]. The amount of the loan repaid during a year is obtained by deducting the amount of interest calculated under this formula from the actual repayment made during the year. The opening balance for the next year is the difference between the opening balance at the beginning of the previous year less the principle repaid during that year.

Some repayments are not taken into account

There are a few circumstances where a repayment will not be taken into account for the purpose of these provisions.

Repayments with the intention of reborrowing

A provision has been included [*Subsection 109R*] that is intended to prevent a shareholder or associate from avoiding the operation of Division 7A by temporarily repaying the loan.

Repayments of the whole or a part of a loan will not be taken into account if a reasonable person would conclude, on the basis of the relevant circumstances, that the shareholder or associate objectively intended to reborrow a similar or larger sum from the same private company.

A repayment *will* 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, even if there is an intention to reborrow, to the extent that the loan is offset by repayments sourced from:

- (a) a dividend payable to the shareholder or associate of the private company;
- (b) the PAYE earnings of the borrower; or
- (c) the difference between the arm's length value of property transferred to the private company and any consideration provided by the company for the property.

A payment made to a private company by a third party on behalf of a shareholder or associate will be treated as a repayment if:

- (a) the amount is owed by the third party to the shareholder or associate; and
- (b) the amount is included in the assessable income of the shareholder or associate.

Anti Avoidance – In Summary

As previously pointed out, it is important to note that certain repayments will be disregarded if a reasonable person would conclude, on the basis of all relevant circumstances, that the shareholder or associate intended to re-borrow a similar or larger sum from the same company.

Also, a payment made to the lender by a third party on behalf of a shareholder or associate will only be treated as a repayment if the amount paid by that third party is owed by it to the shareholder or associate and would be included in the assessable income of that shareholder or associate. Therefore, it is important for the shareholder or associate borrowing the money to make all repayments to the lender rather than have a third party make those repayments on his/her/their behalf.

Repayments by shareholders and associates may be sourced from dividends payable to that shareholder or associate by the private company.

Disclaimer

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MINUTES OF MEETING OF DIRECTORS

OF:

HELD AT:

ON:

PRESENT:

CHAIRMAN: It was resolved that the following person be elected to act as Chairman of the meeting:

Print name

QUORUM: It was noted that a quorum was present at the meeting.

COMPANY LOAN: The Chairman noted that a loan had been made between the Company as the Lender and the Borrower as set out below ("the Loan"). The terms of the Loan are and the Loan will be made in accordance with the provisions contained within the Company's Constitution.

RESOLVED: The Loan was reviewed in detail and it was resolved that the Company accept the terms of the Loan and execute any relevant additional documentation required to give effect to the Loan.

Table with 4 rows and 2 columns: 1. Amount of Loan, 2. Borrower, 3. Date of Advance, 4. Secured/Unsecured(*) (•)

(*) delete whichever is not applicable
(•) insert details of security if secured or "N/A" if unsecured.

CLOSURE OF MEETING: There being no further business, the meeting was declared closed.

Signed as a correct record

Chairman, Dated:

**This Agreement should be completed and executed by both the
Lender and the Borrower**

LOAN AGREEMENT

This loan agreement ("Agreement") is made on the Agreement Date listed in the attached Loan Schedule between the Lender and the Borrower and incorporates the terms of the constitution of the Lender and all other documents recording the amounts loaned, advanced, granted or made available by the Lender to the Borrower.

1. The Borrower acknowledges that:
 - (a) by executing this Agreement that the Borrower has requested the Lender to lend, advance or make the Principal Sum available to or at the direction of the Borrower; and
 - (b) the Lender has loaned, advanced, granted or made the Principal Sum available to the Borrower or has agreed to lend, advance or make the Principal Sum available to or at the direction of the Borrower on the Commencement Date subject to the terms of this Agreement.
2. The parties have agreed to all of the provisions in this Agreement.
3. The parties agree that this Agreement evidences the granting of financial accommodation by the Lender to or at the direction of the Borrower and that the Borrower will comply with and fully perform its obligations under this Agreement.
4. The Borrower must repay the Principal Sum, or the amount then outstanding, to the Lender on or before the Final Payment Date.
5. The Borrower may pay the whole or part of the outstanding balance of the Principal Sum at any time prior to the Final Payment Date.
6. The Borrower must pay interest on the Principal Sum or on the amount then outstanding and upon any judgment or order in which this or the preceding clause may become merged.
7. Interest will be calculated at the Interest Rate and paid monthly in arrears until the Principal Sum is fully paid and satisfied.
8. During the Term, the Borrower will repay the Principal Sum and/or Interest in the manner agreed by the Lender and the Borrower.
9. In the absence of any other agreement, the Borrower must repay the Principal Sum to the Lender in accordance with the minimum yearly repayment requirements set out in the Act so that the loan constituted by the Principal Sum will not be deemed to be a dividend as a consequence of having failed to meet the minimum yearly repayment requirements.

LOAN SCHEDULE

Agreement Date:

The Lender:

Name:

Address:

The Borrower:

Name:

Address:

Commencement Date:

Principal Sum:

Term:

Interest Rate:

The benchmark interest rate for the purposes of Division 7A of the *Income Tax Assessment Act 1936* expressed as a rate per centum per annum or any higher rate of interest agreed in writing by the Lender and the Borrower.

Executed as an Agreement.

EXECUTED by)
)
)
as the Lender pursuant to Section 127 of)
the *Corporations Act 2001 (Cth)*:) _____
) *Director / *Sole Director
)
)
)
) _____
) *Director / *Secretary

If the Borrower is an individual:
SIGNED SEALED AND DELIVERED by)
)
)
as the Borrower in the presence of:) _____
Borrower

Witness
Name (printed):

If the Borrower is a company
EXECUTED by)
)
)
as the Borrower pursuant to Section 127 of)
the *Corporations Act 2001 (Cth)*:) _____
) *Director / *Sole Director
)
)
)
) _____
) *Director / *Secretary

* Strike out if not applicable