# Division 7A – Legislative Amendments

***On 4 January, the Government released Draft legislation aimed at tightening the Division 7A rules.***

Further to the ATO releasing Draft Ruling 2009/D8 regarding the application of Division 7A to unpaid present entitlements owed by Trusts to private companies (as discussed in our December 2009 Newsletter), on 4 January 2010, the Government released draft legislation also aimed at tightening the Division 7A rules.

Division 7A prevents private companies from making tax-free distributions of profits to shareholders by treating payments to shareholders or their associates as assessable dividends, and both the draft ruling and proposed legislative changes aim to increase the reach of the Division 7A provisions.

The most significant changes prevent private companies from allowing shareholders to use company assets, such as holiday houses and cars, for less than market value, and bring Trusts with present entitlements owing to private companies within these rules.

The changes were first proposed in the 2009/10 budget announcements and are intended to apply from 1 July 2009.

## *Use of Assets*

Amongst the many proposed changes, it is the intention to include the grant of a lease, licence or right to use assets such as cars, boats and real estate that are owned by a company within the deemed dividend provisions. Essentially, any use of such assets by shareholders (or associates) for less than market value becomes a 'payment' and a deemed dividend that is assessable to the shareholder (or associate) if there is a distributable surplus.

In certain circumstances, this extends to situations where the assets are owned by a discretionary trust which owes beneficial entitlements or other loaned amounts to a private company. It would appear there is limited application to such trusts as it will only apply to where there is a distribution of an unrealised gain usually resulting from an asset revaluation.

There is uncertainty as to how the proposed provisions will value payments constituting the right to use an asset. In particular, whether the right will be valued based on actual use or potential use. For example, in the case of a residential property that is available for shareholders to use at any time during the year it may be the case that the new provisions deem the value of the payment to be the market rent of the property for the entire year rather than only the rent for the nights actually used.

**Exceptions**
There are three proposed exceptions to the above 'use of assets' provisions:
(i) minor use of certain assets;
(ii) certain payments that would otherwise be allowable as a once only deduction; and
(iii) the use of certain residences.

***Minor benefits***
Benefits that are worth less than $300 and are infrequent and irregular, are excepted from the definition of 'payments' for the purposes of Division 7A.

It is likely the infrequent use requirement will result in many taxpayers falling out of this exception and having to pay tax on a deemed dividend unless they pay an arm's length fee for the use of the asset.

***Otherwise Deductible Payments***
If the shareholder or associate had outlaid expenditure in relation to the lease, licence or right and a once-only deduction would have been allowable to the shareholder for the expenditure, the use of the asset will be disregarded for the purposes of Division 7A.

This exception therefore, in theory, will not be available to lifestyle assets and is only relevant to business assets used as part of a business.

***Dwelling Owned by a Private Company***
The third exception relates to the situation where a dwelling owned by a private company (or trust with unpaid beneficial entitlement owed to a private company) is used privately by a shareholder or associate. A number of criteria must be met in order to access the exception as follows:

- The shareholder must be carrying on a business;
- The shareholder 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;
- The shareholder 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.

This exception is aimed at taxpayers such as farmers and other small business owners whose residences are owned by private companies, where that residence is also located on or used for the business premises.

***For example:***
*Farm Pty Ltd owns a farm. During the 2010 income year, the shareholders of Farm Pty Ltd (Aaron and Liz), run a farming business on the farm 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.*

*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 Division 7A.*

However, this exception as currently drafted is likely to have limited application as in more likely cases the business would be carried on by a Trust or Private Company rather than in the name of the individual shareholder using the property in part as a home.

***For example:***
*Following on from the above, consider a situation with the same facts except that the business is carried on by Farm Pty Ltd as well as owning the land, rather than Aaron and Liz.*

*In this case the exception would not apply as the shareholder (Aaron and Liz) is not carrying on a business and therefore was not granted the licence to use the land on carry on the business.*

These changes are effectively retrospective as they apply to the use of assets granted since 1 July 2009 and existing assets acquired well before 1 July 2009.

**Next Steps**
The proposed changes have been released as an exposure draft and submissions from Industry will be considered prior to releasing final legislation. Some potential issues that will hopefully be rectified via this process include clarification on:

(i) the valuation of payments constituting the rights to use assets; and
(ii) the allocation of payments amongst the shareholders (for example where assets are available for use by more than one shareholder.)

## *Interposed Entities*
Further, amendments are proposed to ensure that where a corporate beneficiary has an unpaid (or partly unpaid) present entitlement to net income of a trust and that trust makes a payment to the company's shareholder via an entity that is interposed between that trust and the shareholder, the trust will be treated as having directly paid or loaned an amount to the shareholder for the purposes of Division 7A.

The most significant impact of these proposed changes will be the typical scenario where:

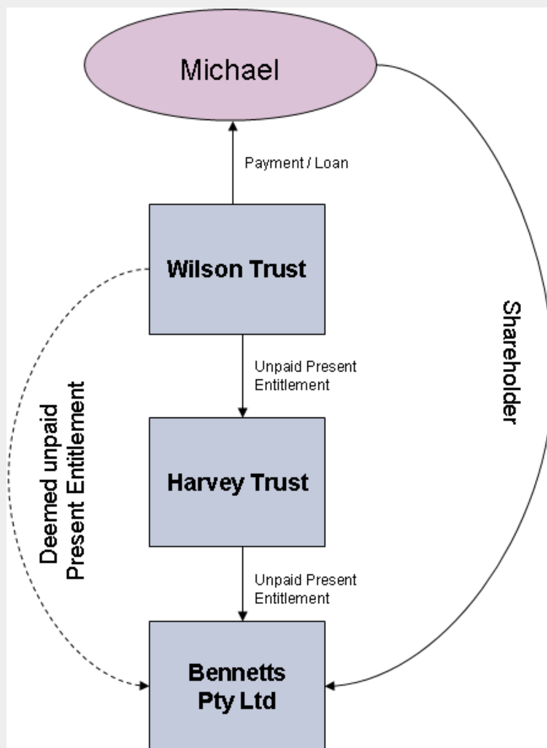
(i) A unit trust or partnership (usually the business operator) has a distribution owing to a discretionary trust, unit holder or partner; or
(ii) One trust distributes to a second trust;

- Which in turn has an unpaid distribution owing to a corporate beneficiary; and
- The original trust or partnership lends funds to shareholders of the corporate beneficiary (or their associates).

These typical scenarios have not previously fallen under the existing Division 7A provisions but will now be caught under the proposed inter-entity provisions.

***For example:***
*Michael is a shareholder of Bennetts Pty Ltd. In the 2010 income year, he receives a payment from the Wilson Trust. The Wilson Trust has an unpaid distribution owed to the Harvey Trust.*

*The Harvey Trust has in turn an unpaid distribution owed to Bennetts Pty Ltd.*




*For the purpose of Division 7A, Bennetts Pty Ltd is taken to be presently entitled to a share of income of the Wilson Trust where a reasonable person would conclude that the company 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. In this case, the payment or loan made to Michael by the Wilson Trust may be assessable to him personally as a deemed dividend.*

***Action Required***
The above proposed changes may have many unintended and inequitable outcomes. Ideally, the proposed changes should not be enacted without substantial review and perhaps narrowing the scope of the applications so that outcomes are more equitable.

Perhaps the Henry Review will contain recommendations where the above proposed changes become not required or irrelevant.

We expect there will be extensive discussion and feedback from the industry to Treasury regarding the above proposed changes whereupon we will keep you informed of developments.

In the meantime, it is recommended that structures containing private companies are reviewed in terms of investment ownership and assessing any actions required prior to 30 June 2010.

If you have any queries, or would like advice in relation to any matters relating to any of the above, please contact either Michelle Saunders or Marissa Bechta on (08) 6311 6900.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