Division 7A

No Distributable Surplus, no tax, no worries?

Damian O’Connor
Tax Principal

and

Stephen Clarke
Solicitor

August 2014
“The Spartans answered by saying they had forgotten the beginning and could not understand the end so (we) had to try again”

Herodotus “The Histories” c. 450 BC.

Background

For all its considerable complexity Division 7A had a relatively simple genesis – private company owners often treated company funds as their own, benefiting along the way by using money taxed at the lower company tax rate (or not taxed at all) for their private purposes. The usual answer when the ATO made enquiries was that the cash taken from the company represented loans that would be repaid in the fullness of time.

Division 7A was introduced to attack this practice with a particular focus on documenting loans and requiring “commercial” terms. Where the legislation found amounts that would be subject to tax, the amount of the “deemed dividend” was capped at the distributable surplus of the company at the end of the financial year. The distributable surplus mechanism in Division 7A is a rough proxy for the “out of profits” concept that identifies a dividend.

The Distributable Surplus calculation is important because it may mean which amounts that would otherwise be Division 7A deemed dividends are not taxed under those provisions.

Legislation - Division 7A

The Taxation Laws Amendment Act (No. 3) 1998 introduced Division 7A to the Income Tax Assessment Act 1936 (ITAA 1936) in order to:

“ensure that payments and loans made by a private company to a shareholder or a shareholder’s associate are treated as assessable dividends to the extent that there are realised or unrealised profits in the company. The provisions contain exclusions from this treatment for repayments of genuine debts, payments and loans to other companies, payments that are otherwise assessable, ordinary business loans made on the company’s usual terms for arm’s length loans of that type and loans meeting minimum interest rate and maximum term criteria”. (Second reading speech).
Working out the Distributable Surplus

The Distributable Surplus calculation is set out in section 109Y (ITAA 1936) and looks relatively straightforward:

Net assets + Division 7A amounts non-commercial loans – paid-up share value
– repayments of non-commercial loans = Distributable Surplus

Net Assets

Net assets are defined to mean:

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

(a) The present legal obligations of the company to person's other than the company; and

(b) The following provisions (according to the company's accounting records):

   i) Depreciation

   ii) Annual leave and long service leave

   iii) Amortisation of IP and trade marks

   iv) Provisions prescribed in regulations

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

Division 7A Amounts

Division 7A Amounts are defined to mean “the total of any amounts the company is taken under section 109C or 109F to have paid as dividends in the year of income apart from this section.”

Section 109C deals with payments section 109F is concerned with debt forgiveness.

Non-Commercial Loans and Repayments

Broadly, these parts of the Distributable Surplus calculation look at loans that have been treated as dividends in earlier years and which are still shown in the company accounts as assets.
Why does the Distributable Surplus matter?

Section 109C(2) ITAA 1936 (for example) provides that the amount of a deemed dividend is taken to be “the amount paid, subject to section 109Y”.

The table below is an example of how section 109Y can operate to cap deemed dividends in real life:

<table>
<thead>
<tr>
<th>Deemed Dividend Calculation</th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amounts disallowed as deductions to company; taken to be paid to director/shareholder as dividends under section 109C(2)</td>
<td>$111,500</td>
<td>$609,508</td>
<td>$781,731</td>
</tr>
<tr>
<td>Distributable Surplus</td>
<td>$352,322</td>
<td>$112,948</td>
<td>$332,922</td>
</tr>
<tr>
<td>Reduced Deemed Dividend under section 109Y</td>
<td>$111,500</td>
<td>$112,948</td>
<td>$332,922</td>
</tr>
</tbody>
</table>

This example is taken from the AAT decision in 3D Scaffolding (2008 ATC 10-009) and shows that of the $1.5m in cash apparently received by the director/shareholder over this period, $557,370 was taxed as deemed dividends, leaving almost $1m cash not caught by Division 7A.

It should come as no surprise that the Tax Commissioner is very concerned about outcomes like this, and his interpretation of the relevant provisions and the litigation he has undertaken all show that he is very unhappy with the possibility that the operation of Division 7A can lead to tax free windfalls.

Where there is a question about the quantum of any distributable surplus the Commissioner is always going to look at the value of company assets and whether he should exercise his discretion to substitute different values, as well as the quantum of liabilities that are permitted to be taken into account in arriving at the Distributable Surplus amount.

Value of Company Assets - MV versus Book Value TD 2009/5

Taxation Determination TD 2009/5 concerns itself with the Commissioner’s discretion under section 109Y(2) to substitute a different value for company assets than the values shown in the company accounts (the book values).

The Commissioner accepts that the starting point is the book value of assets, and that “generally” the book values will be accepted where accounting standards have been applied.

The significant qualification to the Commissioner’s position, however, is that if some Division 7A mischief results from the application of accounting standards, or otherwise, the Commissioner “…generally will substitute (the assets) true value”, as “…the discretion is there to protect the integrity of the Act, and it will be exercised when it is necessary to do so..."
for that purpose.” “The focus must be on whether it is necessary to exercise the discretion to tax what is in substance an informal distribution of earnings, not simply whether asset values are understated.”

Now, that is not quite what the words in section 109Y(2) say:

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

It will often be the case that an undervalue of assets will produce an anomalous Division 7A outcome that may attract the operation of the Commissioner’s discretion to substitute an “appropriate value,” but there may be some question about whether section 109Y empowers the Commissioner to use this discretion under the banner of system integrity as an “anti-avoidance catch all” where assets have been correctly valued.

**Present Legal Obligations – Tax Liabilities - TD 2012/10**

This determination sets out the Commissioner’s view of when income tax is a “present legal obligation” for the purposes of the Distributable Surplus calculation.

In short, the Commissioner accepts that income tax levied in respect of a particular income year is a present legal obligation at 30 June, notwithstanding that the due date for payment of tax will be after the end of that financial year. The Commissioner also accepts that a debit amended assessment is a present legal obligation at 30 June of the relevant year.

Example 4 of the determination deals tax liabilities in the following circumstances:

12. A private company (C Pty Ltd) derives assessable income during the 2007-08 income year of $100,000 which is taken as a loan by the majority shareholder (Sam) and not returned as assessable income by C Pty Ltd. The loan was not made under a written agreement that met the criteria of section 109N of the ITAA 1936. On completion of an audit in the 2009-10 income year, an amended assessment issued to C Pty Ltd increasing assessable income for the 2007-08 income year by $100,000 and resulting in additional tax payable of $30,000. This was paid by C Pty Ltd on 30 September 2010.

13. As a result of the audit, the Commissioner also issued an amended assessment to Sam to include an amount taken to be paid as a dividend under Division 7A of Part III of the ITAA 1936 in his assessable income for the 2007-08 income year. In determining the amount taken to be a dividend, the amount payable under the amended assessment by C Pty Ltd on 30 September 2010 is a present legal obligation for the purposes of the distributable surplus calculation under subsection 109Y(2) of the ITAA 1936 at 30 June 2008.

In practice, these tax liabilities commonly arise where cash takings of a private company are pocketed by a principal for his or her own private use and simply not returned as company income. In this example, the Commissioner has assumed that the cash involved has been
lent to the majority shareholder (ie there is an obligation on the shareholder to pay the money back) notwithstanding that there is no written loan agreement.

For Distributable Surplus calculation purposes, if the dealings between the company and the shareholder are in fact a loan, the amounts taken by the shareholder remain assets of the company. Different outcomes may arise where the cash is treated being paid (rather than loaned) to a shareholder or associate.

The Commissioner’s acceptance that tax payable by the company comes off the Distributable Surplus calculation reflects the decision in Commissioner of Taxation v H [2010] FCAFC 128.

**PAYG instalments**

Tax liabilities are net of PAYG instalments paid or payable. PAYG instalments unpaid at 30 June are separately counted as present legal obligations.

**Present Legal Obligations v Balance Sheet Liabilities**

The Commissioner explains the difference between these concepts in Appendix 1 of TD 2012/10:

The distributable surplus calculation looks at the book value of assets but not liabilities – for liabilities the calculation is concerned with “present legal obligations” not the book value of liabilities, except for the specific provisions listed in section 109Y (provisions for leave, amortization of IP, etc).

The Commissioner’s view is that treating liabilities this way leaves less room for the liability side of the accounts to be manipulated as part of the Distributable Surplus calculation.

Accordingly, a Distributable Surplus calculation and profits determined in accordance with accounting standards may not be the same, because liabilities generally will not be recognised under the Division 7A rules until they are present legal obligations.

**Changes to Division 7A**

The concept of “Division 7A Amounts” was introduced into the Distributable Surplus formula in 2010, with effect from 1 July 2009.

Division 7A Amounts mean “the total of any amounts the company is taken under section 109C or 109F to have paid as dividends in the year of income apart from this section.”

It is worthwhile looking at the explanatory memorandum introducing this change to understand what the Commissioner was targeting:

Rockwell Olivier
Inclusion of Division 7A Amounts in distributable surplus calculation

1.84 The current law does not include 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 in the distributable surplus calculation made under subsection 109Y(2).

1.85 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.

1.86 These amendments correct this anomaly by including a reference to Division 7A Amounts in the distributable surplus formula in subsection 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, are included in the distributable surplus of a private company under subsection 109Y(2). [Schedule 1, item 27, subsection 109Y(2)]

Example 1.22

On 29 June 2005, a private company has real property valued at its historical cost in the company's accounting records of $500,000, which it acquired before 1985. The real property has a market value of $1,500,000 and the private company has liabilities of $400,000 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 makes 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 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 is $100,000 and the private company's distributable surplus after deducting paid up share capital of $100,000 is nil before these amendments. 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 after these amendments, 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 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.

It seems that before this amendment the same outcome could have arisen where an amount was paid to shareholder or associate as a loan and forgiven before year end. While an outstanding debt remains an asset of the company, debt forgiveness removes that asset so that the distributable surplus calculation is less than it would otherwise be.

From 1 July 2009, payments and debt forgiveness amounts (but not loans) that would have been deemed dividends without the capping effect of section 109Y are now added back into the Distributable Surplus calculation.

Importantly, the EM expressly states that:

“The current law does not include 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 in the distributable surplus calculation made under subsection 109Y(2)”

On the face of it, the Distributable Surplus rules are relatively straightforward:

1. Deemed dividends are capped by the Distributable Surplus;

2. Net Assets reflect book values, subject to the Commissioner’s discretion to substitute “appropriate” amounts;

3. Liabilities must be present legal obligations (or specified provisions in accounts) in order to be deducted in the calculation;

4. Tax, PAYG instalments and interest are all present legal obligations; and

5. From 1 July 2009 the amount of deemed dividends arising from payments or debt forgiveness must be added back into the calculation.

Of course, in real life things are not all as tidy as this, and remainder of this paper will look at the way these rules apply in practice. In particular we will look at how these matters have been argued in court and how the Commissioner has changed the way he seeks to tax private company cash in the face of the “tax free” windfalls that can result from the Distributable Surplus formula.

**Continuing Problems for the ATO with the Distributable Surplus calculation**

The obvious problem for the revenue is that, on the face of it, if there is no Distributable Surplus there is no tax cost for the shareholder, or associate.

The Commissioner’s early approach to this was to argue that the calculation of Distributable Surplus must include the deemed dividend amounts themselves where they arise from payments or debt forgiveness. Having received mixed results in court, the Distributable Surplus formula was amended (effective from 1 July 2009).
In the Waffles Case (discussed below) where amounts were paid to a related entity through which the cash ultimately found its way to the individual principal. The Tribunal held that the cash was no longer an asset of the company and the cash payments were not added back as part of the year end Distributable Surplus calculation.

This “loophole” was dealt with by introducing the requirement to add back Division 7A Amounts. The EM introducing the Division 7A Amounts concept acknowledged (at 1.84) that prior to the amendments to Division 7A, a payment would deplete the company assets for Distributable Surplus purposes.

It seems correct from a mechanical calculation point of view that money coming into a company (whether disclosed or not) that is subsequently paid out before 30 June is no longer an asset at 30 June. In other words, while the company’s assets increased when it received the cash (or should have received the cash) its assets went down by the same amount when that cash was paid out.

In practice, this legislative change only appears to get the Commissioner some of the way to where he wants to be. It will still be the case, in some circumstances, that the amount of the Distributable Surplus (after taking into account deemed dividend amounts) will not be enough to tax all of the payments made to shareholders or associates.

The cases discussed below show the development of the Commissioner’s position on how the Distributable Surplus calculation should work, particularly were company cash has allegedly been taken via bogus deductions or skimming of cash before it is returned as company income.

**Distributable Surplus - Cases**

**AAT proceedings - 3-D Scaffolding Pty Ltd & Anor v FC of T (2008) ATC 10-009**

The ATO formed the view that amounts claimed by the company for scaffolding hire were bogus and that the cash involved found its way to Mr D, a director and shareholder of the company. The company was denied the deductions and Mr D was assessed on the disputed amounts on the basis that they were Division 7A deemed dividends.

The objection decisions for both the company and Mr D were referred to the AAT in the first instance. The Tribunal affirmed the Commissioner's objection decisions.

153. In effect, Docherty treated 3-D as his own and took its money for his own use. I do not accept that it can be suggested that Docherty stole the money from 3-D. He was its controlling mind as its only director, and he plainly considered that he could do what he pleased in relation to 3-D. I do not consider, in other words, and to the extent that this aspect may be relevant (which is doubtful), that there is a relevant misfeasance aspect.

154. It is clear that Division 7A of the Act must apply.
55. In determining whether or not s 109C(1) applied, the critical question for the Tribunal was whether 3D Scaffolding "paid an amount" to James Docherty, **there being no dispute that he was in fact a shareholder** in the relevant tax years. **Section 109C operates in relation to payments to shareholders, not directors.** The Tribunal's findings of fact were entirely sufficient to justify its conclusion that 3D Scaffolding "paid an amount" to James Docherty in the relevant tax years and, therefore, that s 109C(1) and Div 7A applied.

The outcome of the 3D litigation was that taking company money, whether by misappropriation or otherwise, may attract the operation of Division 7A. 3D clearly illustrates that the Distributable Surplus calculation rules (in operation at the relevant times) can significantly limit the size of deemed dividends.

Note that while Mr D was a shareholder of the company there does not appear to be any suggestion that the funds taken by Mr D were anything other than a Division 7A deemed dividends.

**Case (2010) AATA 78 (Waffles Case)**

The Tribunal considered whether amounts wrongly claimed as deductions for payments made by the company (Waffles) to an associated company (D Co) should be added back to increase Waffles’s Distributable Surplus for Division 7A purposes. Some of cash involved eventually found its way via D Co back to Waffles and on to the taxpayer, who was a director and shareholder of Waffles.

The taxpayer explained that he had a personal relationship with Ms Smith, an accountant, whom he unreservedly trusted in financial matters. Ms Smith and the Company’s accountant set up an arrangement where money paid to an offshore entity as marketing expenses was repaid to Waffles as a loan and credited to H’s loan account. Both H and S used these funds.

Mr H instructed S that the arrangements were to cease after the first transaction. “Without his knowledge or authority” S continued with the offshore arrangements.

After H and S went their separate ways H became aware that Waffles had overstated its deductions (and H had understated his income) and he made a voluntary disclosure to the ATO.

On the distributable surplus point, the Tribunal concluded that even though the deduction arrangements were a sham, "there is no doubt that the funds moved from Waffles to Desert, and as a result Waffles assets were reduced" (Para 71). In these circumstances "the proviso in the definition of "net assets" had not been triggered and therefore there is no reason to "add back" the Desert payments for the purposes of the calculation in s109Y." (Para 72)

The further issue was whether the tax payable by the company as a consequence of the disallowed deductions could reduce the Distributable Surplus.
The Tribunal's conclusion was that tax obligations that were identified after year-end were still counted as present legal obligations at 30 June, for Distributable Surplus purposes.

Although the taxpayer was a shareholder of the company there does not appear to be any consideration in the judgement of whether the amounts were ordinary dividends or other income.

On Appeal - Commissioner of Taxation v H [2010] FCAFC 128

The Commissioner appealed against the Waffles AAT decision in relation to counting tax liabilities in the Distributable Surplus calculation.

The Federal Court decided that “…the obligation to pay tax at the amount subsequently ascertained, assessed and determined, is a ‘present legal obligation’ as at the end of the financial year in which the income is derived and within the meaning of s 109Y(2) of the ITAA 1936”.

The Federal Court further accepted that general interest charge is a present legal obligation for 109Y(2) purposes “on each day on which the tax that should have been paid remains unpaid” notwithstanding the Commissioner’s power of remission.

The Federal Court decision is reflected in ATO Tax Determination TD 2012/10

Kocic & Anor v FC of T (2011) ATC 10-174

In this case, the Commissioner was of the view that undeclared sales of a Company should be treated as Division 7A dividends in the hands of the shareholders and that the calculation of the Distributable Surplus should include the undeclared sales.

The taxpayers submitted that the Waffles decision should apply so that even if sales had been excluded from company accounts, the fact that these sales amounts had been “paid” to the principals resulted in an offsetting reduction in company assets, and as a result the company accounts were correct, in that they reflected the current asset position.

The taxpayers pointed to the EM introducing the 2010 amendments (discussed above – Division 7A Amounts) however the Tribunal had this to say:

62. In Waffles, the Commissioner "added back" payments made by the company to a related company even though the payments were made and the assets of the company "were necessarily less than they were before the payments were made". The loss of value was properly reflected in the company’s accounting records and the Tribunal found that the proviso in the definition for net assets was therefore not triggered.

63. In the present case, the undisclosed sales, after taking into account deductions for wages, were assets of Ansetat in the relevant period but were improperly excluded from the company’s accounting records. The net assets of Ansetat were undervalued by failing to take into account those net sales and the proviso in s 109Y(2) was
triggered. It was therefore appropriate for the Commissioner to add back the undisclosed sales, although he should have deducted wages, when determining the value for net assets.

64. … counsel for Mr and Mrs Kocic referred to the explanatory memorandum and amending legislation passed in 2010 to close the loophole created by the facts of Waffles. Given the facts of this case can be distinguished from Waffles, we are of the view this material is irrelevant to the determination of the issue and does not assist either party."

As the EM expressly stated that “The current law does not include 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 in the distributable surplus calculation made under subsection 109Y(2)” it is unfortunate that we do not have a clearer explanation of how the Distributable Surplus calculation works in the common situation where company money has been applied for private purposes without being returned as company income.

ATO Decision Impact Statement

The ATO decision impact statement (below) comments that the Kocic decision reinforces the Tribunal conclusion in Waffles.

*Should the undisclosed sales be ‘added back’ when determining the net assets of Ansetat for the purposes of determining distributable surplus, calculated under s 109Y of the 1936 Act, for the income years 1998 to 2006?*

The Tribunal agreed with this submission. Under s 109Y, the net assets component shall be calculated in accordance with the company's accounting records. Yet this proposition can be displaced if the company's accounting records significantly undervalue or overvalue its assets. This reinforced what the Tribunal had concluded in the case of *Re Waffles and Anor v Commissioner of Taxation* [2010] AATA 78 (‘Waffles’). The Tribunal concluded that in the present case, the undisclosed sales of Ansetat less cash payments for wages were assets of the company in the relevant period and were improperly excluded from the accounting records. In such circumstances, the Commissioner may add back such amounts when determining net assets.

The decision in Waffles was that cash paid out to a related company which eventually found its way back to the principal of Waffles was not added back as an asset of Waffles for Distributable Surplus calculation purposes.

*Confidential v Commissioner of Taxation [2013] AATA 112*

Deputy President Forgie delivered a decision on 1 March 2013 which, amongst other things covered in its 281 pages, considered whether undisclosed cash of a business was correctly included in the income of the individual principals.

As a result of audit activities undertaken by the ATO, amended assessments were raised claiming income tax, GST and penalties.

The sums involved were significant. For the company additional amounts for income tax, GST penalties and interest exceeded $20m for the 2005 to 2008 years. For one of the
individuals the tax, penalties and interest charges for the same period were in excess of $7m.

Amended assessments had been raised against the individuals on these alternative bases:

- Unfranked dividends under section 44(1) of the ITAA 1936; or
- Deemed dividends under Division 7A; or
- Ordinary income under section 6-5 ITAA1997.

The taxpayers challenged the Commissioner's negative objection decisions on a variety of grounds, including that the amounts in question were properly to be dealt with under the FBT regime.

**Confidential – Deemed Dividends - Distributable Surplus**

The taxpayers argued that there was no distributable surplus at relevant times, that the Commissioner was not entitled to substitute alternative values (for s109Y purposes) and that the amounts were in any case fringe benefits (paragraphs 788-790).

The judgement (at Para 820) refers to the Commissioner's reasoning (set out in his final audit report) for increasing the distributable surplus amount:

"In this instance the company's assets have been deliberately and significantly stripped...and consequently the company’s assets have been significantly understated...the bank balances of the company’s business accounts have been considerably understated."

ATO calculation of distributable surplus was originally based on amended taxable income, however the Commissioner subsequently changed his position to look at operating profit (apparently giving a higher number).

The taxpayers submitted that counting "dividend" cash was:

"... an internally contradictory statement. If an amount is paid, it is not there to value. ... if an amount has been paid, it ceases to be an asset. There is no asset to value or undervalue. That view cannot be right. If it cannot be right, it means the exercise of the discretion had no basis in fact, and necessarily it must follow that the exercise of the discretion miscarried. ..."

The Tribunal referred to the purpose of the provisions:

"...to ensure that private companies will no longer be able to make tax-free distribution of profits to shareholders (or associates) in the form of payments or loans."

823. In a situation such as this in which Bert and Fred have diverted funds from Freanert for their own purposes, adding their value back to the asset basis is not only
not a contradictory position to take, it is a position in keeping with the object of Division 7A. It captures amounts that have been directed by the directors to themselves or to their associates for their benefit and that, given the assumptions that I have made in considering Division 7A in this case, would not otherwise be taxed.

The Tribunal also observed (at Para 823) that "In a situation such as this in which… (they) have diverted funds from (the company) for their own purposes, adding their value back to the asset base …is…in keeping with the object of Division 7A."

The decision of Deputy President Forg was that the taxpayers had not satisfied their onus of proof to show that the value given to the Distributable Surplus, and the adding back of the offending amounts by the Commissioner was excessive (paragraph 827) or that the "Commissioners assessment is excessive by reason of Division 7A" (paragraph 828).

**Current Position – Distributable Surplus**

None of these cases considered the operation of the Distributable Surplus Amount amendment which applies from 1 July 2009 to add-back payments (and debt forgiven) that would be deemed dividends, aside from the capping effect of section 109Y.

The EM introducing the add back of Division 7A Amounts clearly says that the existing law did not “include 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 in the distributable surplus calculation made under subsection 109Y(2).” With that in mind, it is not clear how the outcome in Waffles Case (where the cash came to the shareholder via an intermediary company) did not apply in the other cases, where the material differences were that no intermediary company was involved (see Ma, below), or the cash had not been returned by the company.

On the face of it, the reasoning applied in these cases could now result in the same cash being counted twice – as Division 7A Amounts, and also added back to the assets of the company.

**Taxation outside Division 7A**

Assuming that company assets are valued in some rational way, there will still be circumstances where the Distributable Surplus will be less than the cash in question, so that there is potentially a tax free bonanza for principals using company cash.

The following cases show some of the ways in which the Commissioner has looked outside Division 7A to achieve the taxation outcomes he is after.
Ma & Anor v FC of T 2012 ATC 10-232 – Ordinary Income

This matter involved deductions claimed for payments of wages to associates which were treated by the Commissioner as income of the business owners (the directors and shareholders of the company through which the business was conducted).

The issues addressed included whether amounts were received by the shareholders beneficially or on behalf of other family members who had performed work for the business, and relevantly, whether the Commissioner was correct in treating the amounts taken to have been beneficially received by shareholders as ordinary income, without applying Division 7A.

The Tribunal held that, to the extent that amounts were derived beneficially by the principals, they did not attract the operation of Division 7A, and fell to be taxed as ordinary income.

Confidential/Haritos – Section 44 Dividends

The taxpayers argued that there were no profits in the relevant years from which dividends could be paid, that the books correctly recorded the transactions as loans, that the FBT Act applied and that there were no resolutions authorising any relevant distribution.

After an exhaustive analysis of the various accounting records and expert reports which attempted to establish the correct financial position of the companies, the Deputy President concluded (at paragraph 681) that:

“Taking the three reports at face value and making allowance in the 2006 income year for the fact that none of them can be more than an approximation, I am satisfied that, on the balance of probabilities, there were profits in the 2005, 2006, 2008 and 2009 income years in the from which the amounts could have been paid to Bert and Fred. It is clear from the judgment of Fisher J in MacFarlane at [612(6)(c)] above that amounts do not have to be paid from post taxed money. It would be prudent to do so but prudence does not determine whether they have in fact been paid. As for the 2007 income year, I am not satisfied that Bert and Fred have discharged their burden of proof to establish that there were not profits from which the amounts assessed could not have been paid. This stems from their inability to prove the expenses on which the reports have been based …”

Once “out of profits” amounts were identified, the Tribunal accepted that cash amounts accruing to the shareholders were properly regarded as section 44 dividends.

Confidential/Haritos - Ordinary Income

The third alternative basis the Commissioner relied upon was that the cash involved was simply ordinary income. Amongst other things, the taxpayers argued that they had not derived any gain in relation to the relevant amounts as any gain accrued to others (paragraph 830) and in any case any benefits were in the nature of fringe benefits, which fell outside the scope of s6-5 (paragraph 832).
The Deputy President's conclusion was as follows:

837. Whether Bert and Fred, acting as directors, transferred funds from Freanert to their own accounts, to the accounts of their wives or children, as appears from the table derived from the Pitcher Partner report, or to pay a third party such as the ANZ to repay a loan and did so for purposes other than those connected with Freanert's business, they derived a benefit to themselves. They dealt with the funds as their own and that was enough to derive a benefit. It was a benefit in the form of money and so income in ordinary terms. It does not matter whether, ultimately, the money benefitted them directly by adding to their portfolios of assets or by paying their expenses or whether it benefited members of their families by adding to their portfolios of assets or by paying their expenses. The income was derived when they directed it to be paid from Freanert's accounts for reasons unconnected with its business.

The Tribunal's decision was that the relevant amounts were ordinary income of the taxpayers or section 44 dividends paid to them, and as the amounts were otherwise assessable Division 7A did not apply. If the amounts were not otherwise assessable, Division 7A would have applied, in the Deputy President's view.

**Haritos Appeal [2014] FCA 96**

The short answer of the Federal Court to the taxpayer's appeal from the Tribunal decision was that the appeal was incompetent and the applicants should pay the Commissioner's costs.

**No Distributable Surplus and Not Out of Profits so the Cash is Tax Free?**

As this brief consideration of these cases show, the idea that movements of cash could be an ordinary dividend was not directly considered in the earlier cases. In fact, some of the earlier judgements say that because a person was a shareholder, Division 7A applied to payments made to them.

The Commissioner's position has developed over time so that the questions of whether something is an ordinary dividend (outside Division 7A) or ordinary income are squarely on the table.

A further approach that the Commissioner has taken in recent audits is to suggest that cash taken by company shareholders/associates is simply and plainly remuneration for services or employment income.

This approach is seen in Ma, where the Commissioner claimed that paying money into a joint husband and wife bank account was prima facie evidence that the cash was remuneration for each of them, particularly as it was paid on a regular basis (regularity of receipt being one indicator of income). On the face of it, this seems to be a weak argument, but as taxpayers have the onus of proof to establish the correct tax position, even a weak argument can be difficult to overcome.
We are aware of other cases where auditors have adopted a similar line, arguing that cash allegedly going to a director (who was also a shareholder) represented remuneration.

In this case, the auditors took the view that the offending amounts were sales income of the company and wages paid to the director. A deduction was allowed for these wages amounts, however as the company was in a loss position that deduction was of no immediate benefit.

The consequences of the Commissioner taking the remuneration route at audit were that the director/shareholder was assessed on the cash amounts, the company was charged GST and also assessed on the cash amounts on the basis they were undisclosed sales, a tax deduction was allowed for the cash “taken” as wages, and the company had PAYG withholding penalties of 75% imposed on the amounts the ATO said should have been withheld, calculated at the “No TFN” rate.

**What is the Commissioner’s Position?**

The Commissioner initially took a few different approaches to amounts falling outside Division 7A as a result of the distributable surplus calculation:

1. Firstly, he argued that the net assets of a company included cash taken by principals, and he amended s109Y to add-back Division 7A Amounts from 1 July 2009.
2. Secondly, the Commissioner has also argued (successfully in some cases) that amounts that are not taxed under Division 7A (because of the effect of section 109Y, or otherwise) are to be taxed as ordinary income, as ordinary dividends or perhaps as salary and wage income of the recipient.

In Confidential v FC, the Commissioner has had success with (or more correctly the taxpayers failed to satisfy their onus of proof to displace) alternative claims that the offending amounts were ordinary dividends, deemed dividends or ordinary income.

This outcome is some distance from the position in 3D Scaffolding, where the only taxing base when a shareholder took company money and applied it for private purposes was Division 7A.

**Onus of Proof**

Satisfying the onus of proof is likely to remain a high hurdle for taxpayers for a range of reasons, including a lack of documentary evidence and questions of credibility.

Very different tax outcomes may arise where cash is taken as a loan rather than a payment, or where a person receives cash as a shareholder, an associate, a director or an employee. Something as simple as having documentation to categorise a transaction may make a big difference to tax costs in the long run.
When faced with the almost overwhelming complexity of these rules it is easy to forget that when push comes to shove, the inability of taxpayers to satisfy their onus of proof by introducing appropriate evidence is probably the number one reason why they fail in disputes with the Taxation Commissioner.

**Conclusion**

The cases we have looked at make it very clear that the Commissioner will aggressively pursue private company owners where company funds are applied to private purposes. The Commissioner will be encouraged by decisions like Confidential v FCT.

The ATO will continue applying the blow torch to taxpayers by relying on the reverse onus of proof and using alternative assessment grounds to force taxpayers, and their advisors, to make some sense of how Division 7A, FBT, ordinary income, director’s remuneration and section 44 interact. There may also be other additional and severe consequences where company money finds its way into owner’s pockets.

As it currently stands, taxpayers will need to work through their own particular engagements with the ATO as best they can, understanding that the absence of a Division 7A Distributable Surplus is not a “Get out of Jail Free” card, but may simply encourage the Commissioner to look for new, exotic and even more complex ways of getting the tax outcomes he is after.

**Damian O’Connor**  
Principal - Taxation

Rockwell Olivier

D +61 3 8673 5523  F +61 3 8673 5599  
M +61 448 300 519  
E doconnor@ro.com.au  
Level 2, 189 Flinders Lane  
Melbourne VIC 3000  
rockwellolivier.com.au

**Disclaimer**

The material and opinions in the paper are of a general nature and should not be used or treated as professional advice and readers should rely on their own enquiries in making any decisions concerning their own interests.