Division 7A Loans and Family Law

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It is difficult to think of a less riveting title for an article than the one I've come up with. However, in the last year or so I've regularly come across the concept of Division 7A loans. A recent seminar I attended presented by accountants, had the presenter bemoaning their experience of family lawyers who "did not get" Division 7A loans.

This may be a hard concept to grasp as it is an issue in the arena of tax accountants who get to spend many (delightful) years studying the intricacies of tax legislation. As family lawyers we can, for the most part, get away with only a working knowledge of tax law. Further, it is only a small proportion of clients who are financially sophisticated enough to have set up their finances to include Division 7A loans – given that only 10.9% of separating couples have net assets over $500,000[1].

So what is a Division 7A loan?

Division 7A is a section of the *Income Tax Assessment Act 1936* (Cth) (the ***ITA Act***) that contains anti-avoidance provisions which are aimed at preventing private company owners and their associates from avoiding dividend taxation.

Generally speaking, a payment, or loan made, or debt forgiven to a company shareholder or shareholder's "associate" (mostly the spouse in our work) attracts the attention of Division 7A by deeming this money to be a "dividend".

The *ITA Act* provides that a dividend is taxed at a parties' personal income marginal tax rate (47% if in the highest tax bracket) rather than the company tax rate (30%). Further, the dividend is "unfranked" meaning there are no franking credits available to the recipient.

To avoid the money/loan made/debt forgiven being taxed as a dividend in the recipient's hands, a party needs a Division 7A complying loan deed made on a commercial basis. Where a Division 7A loan agreement is in place between a private company and a shareholder or shareholder's associate, the terms of the loan agreement will negate the operation of Division 7A and the relevant amount will be treated as a loan by the company to the shareholder. This loan will be subject to interest and repayments must be made in accordance with the terms of the Division 7A loan agreement, which must comply with the provisions of the *ITA Act*. For example, it requires the payment of 1/7 of the total loan amount each

[1] Qu, Weston, Moloney, Kaspiew and Dunstan, "Post-separation parenting property relationship dynamics after five years", Australian Institute of Family Studies 2014, pg. 92-93.

year, as well as minimum interest set by the government and a maximum loan term of 7 years.

The other point to note is that whilst a Division 7A loan is on a purported commercial footing (due to the operation of the legislation) the reality is that the loans are in essence between a party and themselves and is done so to minimise or defer tax.

Are Division 7A loans a liability to factor into an asset pool?

I encountered the question of how to treat a Division 7A loan in a recent property negotiation. There was no question in this property negotiation that my client, being the business owner, was the only party in a position to take the liability on and the question arose as to how this issue was to be taken into account.

The Full Court of the Family Court decision of *Rodgers and Rodgers* [2016] FamCAFC 68 looked at this very issue. This was an appeal from a decision of Crisford J and central to the appeal was whether her Honour was correct in refusing to deduct future taxation payable by the parties' corporation arising from a number of Division 7A loans. Crisford J had considered the liability pursuant to section 75(2) rather than as a "line item" in the asset pool. The Husband's counsel (being the party liable for the future liability) argued on appeal that in failing to deduct the tax liability her Honour had made an error in law.

In this case the tax liability of the Division 7A loan could not be exactly quantified and the accountant gave evidence that it was in the "range of $438,552 to $718,401", depending on how it was dealt with in future.

The Full Court analysed the issue of liabilities in general and acknowledged that the norm was that the value of the property pool was achieved by identifying and valuing the parties' assets and then deducting from this the value of the parties' liabilities - but that this was not a hard and fast rule. In examining this concept, the Court quoted Dr Dickey QC[2] when he wrote:

> "*...in proceedings for an alteration of property interests there is no rule that the court must deduct liabilities* unless *these fall into one of the exceptional categories. Instead, in property cases it is simply a matter of discretion how the court treats liabilities.*"

In considering the alternate view, the Full Court referred to the decision of *Campbell v Kuskey* (1998) FLC 92-795 per Baker, Lindenmayer and Maxwell JJ where the Full Court said at 84-917:

> "*...it is inappropriate in most cases to use s75(2) as a means of bringing to account in a general way a liability, or potential liability, which has not*

[2] Anthony Dickey QC, "A Question of Priorities: Wives or Unsecured Creditors?" (1992) 6 AJFL 229 at p 232.

otherwise been brought to account as a liability when determining the overall net pool of assets. The reason for this is that by doing so, a trial Judge may produce a result that works an injustice as against one party or the other."

In coming to the conclusion that her Honour had not made an error in law by treating the Division 7A loan liability as an adjustment factor rather than a crystallised liability, the Full Court noted at paragraph 40:

> *"[w]hat emerges from the authorities is that while there might be a "rule" the application of which is appropriate in the vast majority of cases, the manner in which a particular liability should be treated is, ultimately, depended upon the nature of the liability, the circumstances surrounding the liability and the dictates of justice and equity shaped by each."*

In this case, the Full Court decided it was open to her Honour to conclude that, given she was unsure how the Division 7A loan would be dealt with in the future and at what amount, to not give it an exact dollar figure as a liability but recognise it by way of an adjustment. However, the Full Court did find that her Honour did not "pay due regard" to this issue by not considering in real terms the impact of the tax "impost" on the Husband[3]. The matter was thus re-determined by the Full Court and the Husband given a greater adjustment in recognition of the Division 7A tax liability, with the Wife having to repay him $116,000 that she had already received from him – a pretty disappointing result for the Husband given the likely costs of the appeal.

A review of this decision led me to the conclusion that my client's Division 7A loan had little chance of being recognised in full and this indeed proved to be the case when we negotiated the matter. However, whilst I negotiated a 5% "future needs" adjustment in my client's favour, I cannot help but think this decision had an unfair impact on my client as his asset pool was far more modest than in the *Rodgers* case[4]. Further, whilst my client's accountant gave a range of estimated tax liability on the Division 7A loan, this range was far smaller than that provided in *Rodgers*. It thus remains to be seen whether a finely balanced decision such as *Rodgers* will be followed or whether subsequent decisions will be able to be distinguished by Courts on the basis of the accounting advice presented to it and the factual matrix of the parties' finances. Until then, the wisest course of action would be to advise clients that their Division 7A loan liability is unlikely to be recognised in full and, in the meantime, to gather as much concrete accounting evidence as possible.

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[3] *Rodgers* at [82]

[4] My client's net asset pool was around $600,000 versus the near 5 million asset pool in *Rodgers*.

Any other Division 7A issues to consider?

For the sake of completeness, I thought it was useful to include reference to two excellent articles that my friend and trusts guru Adjunct Professor Dr Brett Davies sent to me about Division 7A loans[5]. These articles, both written by taxation specialists, show that the short answer to the above question is "yes".

A couple of potential issues that came to my attention are as follows.

1. Where, under an order of the Family Court, a private company was required to make a payment to an associate of the shareholder, for example, a spouse of the shareholder, that payment was previously considered to be excluded from Division 7A. Due to this, it was common practice to join private family companies in property settlement proceedings, as any payment from the company to a former spouse under Court order had no detrimental tax consequences. The Commissioner of Taxation has now changed their ruling in this regard and such a payment will now trigger Division 7A with no exclusion applicable. TR 2014/5 is a fundamental change in the ATO's position regarding the application of Division 7A to family law settlements. The ruling provides that monetary payments or transfer of property from private companies to individuals will be treated as dividends from those companies.

2. Jorgensen notes[6] in his article that:

   > *"Since the Court may not adjust for potential tax liabilities, there is a strategic tension between deferring the tax point to not diminish the property available for distribution and realising the tax liability to ensure it is properly adjusted as part of the property settlement."*

   This upshot of this is that where family law proceedings involve private companies, alternative settlement arrangements may need to be looked at and a lot of expert taxation advice received.

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[5] *The increased impact of Division 7A on family law settlements*, Tamara Cardan, Senior Associate, K & L Gates, Taxation in Australia, Volume 51(5) at 253 and *Division 7A & divorce – Two certainties – Divorce & taxes* by Ron Jorgensen, Partner, Rigby Cooke Lawyers, delivered on 22 November 2016.

[6] Jorgensen (above) at page 9.