TD 2010/D10 - Income tax: Division 7A - payments and loans through interposed entities - factors the Commissioner will take into account in determining the amount of any deemed payment or notional loan arising under section 109T of the Income Tax Assessment Act 1936

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Draft Taxation Determination

Income tax: Division 7A – payments and loans through interposed entities – factors the Commissioner will take into account in determining the amount of any deemed payment or notional loan arising under section 109T of the *Income Tax Assessment Act 1936*

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This publication is a draft for public comment. It represents the Commissioner's preliminary view about the way in which a relevant taxation provision applies, or would apply to entities generally or to a class of entities in relation to a particular scheme or a class of schemes.

You can rely on this publication (excluding appendixes) to provide you with protection from interest and penalties in the following way. If a statement turns out to be incorrect and you underpay your tax as a result, you will not have to pay a penalty. Nor will you have to pay interest on the underpayment provided you reasonably relied on the publication in good faith. However, even if you don't have to pay a penalty or interest, you will have to pay the correct amount of tax provided the time limits under the law allow it.

Ruling

1. Where section 109T of the *Income Tax Assessment Act 1936* (ITAA 1936)[1] operates to treat a private company as having made a payment or loan to a shareholder (the target entity), in determining the amount of that deemed payment or notional loan under section 109V or 109W, the Commissioner will take into account relevant factors occurring before the earlier of the due date for lodgment and the date of lodgment (lodgment date) of the private company's return for the income year in which the company is taken to have made the deemed payment or notional loan.

2. The relevant factors that the Commissioner will take into account immediately before the lodgment date for the private company's return for the year in which it is taken under subsection 109T(1) to have made a deemed payment or notional loan include:

(a) the amount that an interposed entity referred to in that subsection (an 'interposed entity') loaned or paid the target entity referred to in that subsection (target entity) under the arrangement described in that subsection (the arrangement);

[1] All legislative references in this draft Determination are to the ITAA 1936 unless otherwise stated.

(b) how much (if any) of the amount loaned or paid to the target entity by an interposed entity under the arrangement the Commissioner believes represented arm's length consideration payable to the target entity by the private company or an interposed entity for anything;

(c) the extent to which any actual loans made as part of the arrangement have been repaid by that time;

(d) the extent to which any actual payments made as part of the arrangement were converted into loans pursuant to subsection 109D(4A) that have been repaid by that time;

(e) the extent to which any loan made from the private company to an interposed entity as part of the arrangement meets the criteria set out in section 109N (that is, is 'a section 109N compliant loan') at that time;

(f) the extent to which any payment made from the private company to an interposed entity as part of the arrangement was converted, pursuant to subsection 109D(4A) into a section 109N compliant loan by that time;

(g) the extent to which the above factors reflect genuine transactions that are not designed to avoid the application of Subdivision E otherwise than as envisaged within the scheme of Division 7A (such as genuinely and in substance repaying loans in a manner that would not attract section 109R if it applied, or making the loan a section 109N compliant loan by the relevant lodgment date and after that time making appropriate minimum yearly repayments as worked out under subsection 109E(6)).

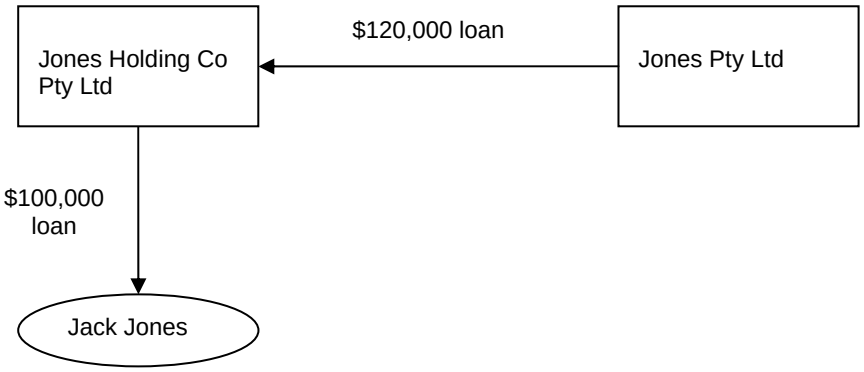
Example 1

3. The Jones family conduct their business and investment activities through a number of corporate entities.

4. On 15 September 2010 Jones Pty Ltd makes a loan of $120,000 to Jones Holding Co Pty Ltd. This loan does not comply with the requirements of section 109N at the time the loan is made as the interest rate is below the benchmark interest rate prescribed in subsection 109N(2). The accounts indicate the $120,000 loan funds were deposited in a bank account and not used to fund the activities of Jones Holding Co Pty Ltd.

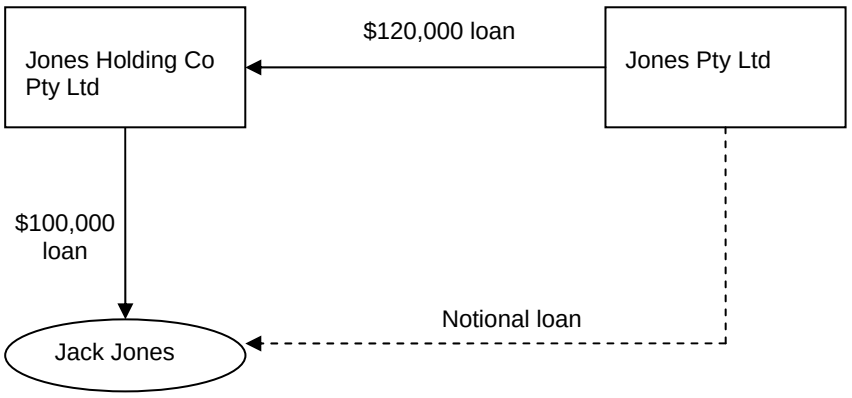
5. On 30 April 2011, Jones Holding Co Pty Ltd, in turn, withdraws $100,000 from its bank account which it lends to Jack Jones, a shareholder of Jones Pty Ltd (see Diagram 1). Jack uses the $100,000 for private purposes.

Diagram 1



6. Having regard to all the circumstances, a reasonable person would conclude that Jones Pty Ltd loaned $120,000 to Jones Holding Co Pty Ltd solely or mainly as part of an arrangement involving a loan to Jack Jones. Accordingly, subsection 109T(1) will apply to treat Jones Pty Ltd as having made a notional loan to Jack Jones (see Diagram 2).

Diagram 2

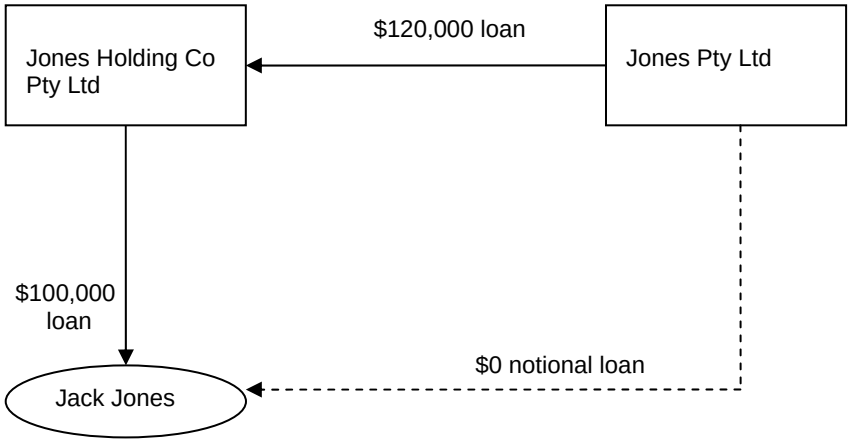


7. On 2 July 2011, prior to Jones Pty Ltd's 2010 lodgment date, Jones Pty Ltd and Jones Holding Co Pty Ltd enter into a compliant section 109N loan agreement in respect of the loan of 15 September 2010. They do this by varying their loan agreement to confirm a 7 year term and to specify that interest will be charged at the benchmark interest rate, with minimum yearly repayments to be paid as required by subsection 109E(6). The variations the loan agreement are made effective from 15 September 2010.

8. There are no other relevant facts and circumstances.

9. For the purposes of determining the amount of the notional loan under subsection 109W(1) the Commissioner will have regard to the fact the loan between Jones Pty Ltd and Jones Holding Co Pty Ltd complies with section 109N. As such the amount that would otherwise have been the amount of the notional loan, for section 109W purposes, will be reduced by $100,000 and resulting in a notional loan with a value of nil (see Diagram 3).

Diagram 3



Date of effect

10. When the final Determination is issued, it is proposed to apply both before and after its date of issue. However, the Determination will not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Determination (see paragraphs 75 to 77 of Taxation Ruling TR 2006/10).

Commissioner of Taxation
15 December 2010

Appendix 1 – Explanation

This Appendix is provided as information to help you understand how the Commissioner's preliminary view has been reached. It does not form part of the proposed binding public ruling.

Explanation

Background

11. Division 7A is an anti-avoidance or 'integrity' provision directed at preventing private companies from making tax-free distributions of profits to shareholders (or their associates) in the form of payments, loans or forgiven debts.

12. In particular, where a private company:

- has paid an amount to a shareholder (or their associate); or
- loaned an amount to a shareholder (or their associate) that is not repaid before the company's lodgment date for the income year in which the loan was made,

that amount is, unless it comes within specified exclusions, treated as an assessable dividend to the extent that, broadly speaking, there are realised or unrealised profits in the company.[2]

13. If a loan made by a private company to a shareholder (or their associate) is a section 109N compliant loan, it will not be treated as an assessable dividend. Subsection 109N(1) requires that:

(a) the loan agreement is set out in writing before the company's lodgment date for the year of income in which the loan is made;

(b) the rate of interest payable on the loan for the years of income after the year in which the loan is made equals or exceeds the benchmark interest rate; and

(c) the term of the loan does not exceed the maximum term for that kind of loan – that is, no more than 25 years for a loan secured by way of registered mortgage over real property and, for all other loans, no more than 7 years.

14. A payment made by a private company to a shareholder (or their associate) will also not be treated as an assessable dividend if it is converted to a section 109N compliant loan before the end of the company's lodgment date for the year of income in which the payment was made.[3]

Deemed payment or notional loan

15. Division 7A contains, in Subdivision E, interposed entity provisions.

[2] Subsections 109C(1) and 109D(1).
[3] Subsection 109D(4A).

16. Subdivision E is an anti-avoidance provision and is concerned with back-to-back arrangements under which a private company pays or loans an amount to an interposed entity on the understanding that the interposed entity or another interposed entity will pay or loan an amount to the shareholder of the private company or an associate of the shareholder (the 'target entity'). In these circumstances, subsection 109T(1) may apply to treat the private company as having made:

- a payment (deemed payment) to the target entity if the target entity is paid an amount by the interposed entity; or
- a loan (notional loan) to the target entity if the target entity is loaned an amount by the interposed entity

17. Specifically, subsection 109T(1) provides that Division 7A will operate as if a private company makes a deemed payment or notional loan, as described in section 109V or 109W, to the target entity if:

(a) the private company makes a payment or loan to another entity (the *first interposed entity*) that is interposed between the private company and the target entity; and

(b) a reasonable person would conclude (having regard to all the circumstances) that the private company made the payment or loan solely or mainly as part of an arrangement involving a payment or loan to the target entity; and

(c) either:

(i) the first interposed entity makes a payment or loan to the target entity; or

(ii) another interposed entity between the private company and the target entity makes a payment or loan to the target entity.

18. The test in paragraph 109T(1)(b) is approached from the perspective of a reasonable person and applies having regard to the prevailing circumstances at the time when the interposed entity makes the payment or loan to the target entity.

Exception to section 109T creating a Division 7A dividend

19. Subsection 109T(1) will not operate to treat the target entity as having received a payment or loan from a private company if the private company is taken (under Subdivision B) to pay a dividend as a result of the actual payment or loan to the first interposed entity.[4]

20. That is, if an actual payment or loan made by the private company to an interposed entity results in the private company being taken to have paid a dividend to that interposed entity, then the private company will not be taken to have also made a payment or loan to the target entity.

21. If the loan between the private company and the interposed entity is a section 109N compliant loan (or the payment from the private company to the interposed entity is converted into a section 109N compliant loan) before the private company's lodgment date for the income year in which that loan or payment was made, the private company will not be taken to have paid a dividend to the interposed entity. In this situation the exception in subsection 109T(3) will be insufficient to itself prevent Division 7A from otherwise applying to the deemed payment or notional loan made by the private company to the target entity (the shareholder (or their associate)).

[4] Subsection 109T(3).

22. However, if, on the other hand, the agreement under which the actual loan from an interposed entity to the target entity is a section 109N compliant loan, the notional loan will also be treated as being a section 109N compliant loan, and will therefore not be treated as an assessable dividend.[5]

Amount of deemed payment or notional loan determined by the Commissioner

23. Where subsection 109T(1) applies, the amount of the deemed payment the private company is taken to have paid the target entity or the notional loan the private company is taken to have made to the target entity is the amount (if any) determined by the Commissioner.[6]

24. In determining the amount of the deemed payment or notional loan that the private company is taken to have made, the Commissioner must take account of:

(a) the amount the interposed entity paid or loaned to the target entity; and

(b) how much (if any) of that amount the Commissioner believes represented arm's length consideration payable to the target entity by the private company or any of the interposed entities for anything.[7]

25. Subsections 109V(2) and 109W(2) do not exhaustively describe the factors which the Commissioner can consider when quantifying the payment or loan. In particular, it is also relevant to have regard to the commerciality of the loan from the private company to the interposed entity.

26. Whether or not the loan from the private company to the interposed entity complies with section 109N and repayments are made pursuant to section 109E are relevant factors when determining the commerciality of the originating loan.

Other relevant factors for Commissioner to take into account

27. Division 7A is directed at preventing private companies from making tax-free distributions of profits to shareholders (or their associates) in the form of payments, loans or forgiven debts. Within the policy framework of Division 7A, it is acknowledged that loans made by private companies that are either repaid or that meet minimum interest rate, maximum term and minimum yearly repayment requirements (that is, section 109N compliant loans) by the relevant lodgment date should not be treated as dividends. These loans are on an acceptable commercial footing such that it would be inappropriate to treat them as being disguised distributions of profits to shareholders or their associates.[8]

28. Separately, subsection 109T(3) in the interposed entity provisions of Subdivision E recognises that where a payment or loan from a private company to an interposed entity has already been dealt with under Division 7A, it would be inappropriate for that dealing to also attract the interposed entity provisions.

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[5] Subsections 109X(2) and 109X(3).
[6] Subsections 109V(1) and 109W(1).
[7] Subsections 109V(2) and W(2).
[8] This is acknowledged in paragraph 9.6 of the Explanatory Memorandum to the Tax Laws Amendment (2004 Measures No. 7) Bill 2004.

29. When these aspects of Division 7A are viewed together, it is evident that it is relevant for the Commissioner to have regard to how any payment or loan from the private company to an interposed entity has been dealt with by the lodgment date of the private company for the year in which the payment or loan was made. To the extent that a payment from the private company to the interposed entity is converted into a section 109N compliant loan or a loan that is then repaid by the relevant lodgment date, or the loan from the private company to the interposed entity is a section 109N compliant loan or is repaid by the relevant lodgment date, it has been dealt with in a manner which should not, without more, attract the provisions of Division 7A that treat a dividend as arising.

30. Accordingly, although the private company is taken to have paid or loaned the amount to the interposed entity at the time the interposed entity made the payment or loan to the target entity, the Commissioner will, before the lodgment date for the private company's year of income in which the deemed payment or notional loan arises, take into account:

- any repayments of the actual loans made as part of the arrangement described in paragraph 109T(1)(b);
- any repayments of any of the actual payments made as part of the arrangement described in paragraph 109T(1)(b) that were converted into loans pursuant to subsection 109D(4A); and
- whether or not the loan from the private company to an interposed entity is a section 109N compliant loan.

31. This is consistent with other provisions in Division 7A which enable a taxpayer's Division 7A outcome for a particular income year to be determined at any time up to the relevant lodgment date. Determining the Division 7A outcome at the lodgment date allows taxpayers to identify Division 7A issues and to take appropriate action (such as putting a section 109N complying loan agreement in place after a relevant loan is made) at any time before the relevant lodgment date.

32. In particular cases there may be other matters that need to be taken into account by the Commissioner to ensure that Subdivision E is not circumvented. For example, if the actual loans referred to in subsection 109T(1) are repaid in a manner that would be disregarded under section 109R if it applied to those repayments, it should not be taken into account by the Commissioner in determining the amount of any deemed loan under section 109W. Likewise, if an actual loan referred to in subsection 109T(1) is a section 109N compliant loan in circumstances where the Commissioner is aware that minimum yearly repayments as calculated under subsection 109E(6) are not being made, this loan should still then be taken into account for the purposes of determining the amount of any notional loan under section 109W.

Appendix 2 – Your comments

33. You are invited to comment on this draft Determination. Please forward your comments to the contact officer by the due date.

34. A compendium of comments is also prepared for the consideration of the relevant Rulings Panel or relevant tax officers. An edited version (names and identifying information removed) of the compendium of comments will also be prepared to:

- provide responses to persons providing comments; and
- publish on the Australian Taxation Office website at www.ato.gov.au

Please advise if you do not want your comments included in the edited version of the compendium.

Due date:	**4 February 2011**
Contact officer:	**Robert Mason**
Email address:	**Robert.Mason@ato.gov.au**
Telephone:	**(03) 6221 0428**
Facsimile:	**(03) 6221 0460**
Address:	**Australian Taxation Office** **PO Box 9977** **Hobart TAS 7001**

References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 2006/10

Subject references:

- deemed dividends
- disguised dividends
- dividends

Legislative references:

- ITAA 1936
- ITAA 1936 Pt III Div 7A
- ITAA 1936 Pt III Div 7A Subdiv B
- ITAA 1936 Pt III Div 7A Subdiv E
- ITAA 1936 109C(1)
- ITAA 1936 109D(1)
- ITAA 1936 109D(4A)
- ITAA 1936 109E
- ITAA 1936 109E(6)
- ITAA 1936 109N
- ITAA 1936 109N(1)
- ITAA 1936 109N(2)
- ITAA 1936 109R
- ITAA 1936 109T
- ITAA 1936 109T(1)
- ITAA 1936 109T(1)(b)
- ITAA 1936 109T(3)
- ITAA 1936 109V
- ITAA 1936 109V(1)
- ITAA 1936 109V(2)
- ITAA 1936 109W
- ITAA 1936 109W(1)
- ITAA 1936 109W(2)
- ITAA 1936 109X(2)
- ITAA 1936 109X(3)
- ITAA 1936 109X(4)

Other references:

- Explanatory Memorandum to the Tax Laws Amendment (2004 Measures No. 7) Bill 2004

ATO references

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