TD 2011/D7 - Income tax: Division 7A: do the exclusion rules in Subdivision D of Division 7A of Part III of the Income Tax Assessment Act 1936 (ITAA 1936) necessarily impact on the deemed circumstances arising from Subdivision E of the ITAA 1936 and the consequent operation of Subdivision B of the ITAA 1936?

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This document has been finalised by TD 2012/12.

There is a Compendium for this document: **TD 2012/12EC** .

Draft Taxation Determination

Income tax: Division 7A: do the exclusion rules in Subdivision D of Division 7A of Part III of the *Income Tax Assessment Act 1936* (ITAA 1936) necessarily impact on the deemed circumstances arising from Subdivision E of the ITAA 1936 and the consequent operation of Subdivision B of the ITAA 1936?

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Ruling

1. No. Whether or not the exclusion rules in Subdivision D of Division 7A of Part III of the *Income Tax Assessment Act 1936*[1] have an impact will depend upon the facts and circumstances of each case.

2. Division 7A treats three kinds of amounts as dividends paid by a private company. Under Subdivision B, private company payments or loans made directly to an entity that is a shareholder or an associate of a shareholder are taken to be a dividend paid to the shareholder or associate. Debts owed by the entity to a private company that are forgiven are also taken to be the payment of a dividend.

3. In this regard it may be said that Division 7A is an anti-avoidance or integrity measure aimed at ensuring that the profits of a private company are not effectively received in a non-dividend form.

[1] All legislative references are to the *Income Tax Assessment Act 1936* unless otherwise stated.

4. There may, of course, be occasions when it would be inappropriate to apply the broad rules in Subdivision B. Subdivision C sets out the rules that provide that a dividend does not arise under Subdivision B where certain debts are forgiven (for example, between companies). Subdivision D sets out rules about payments and loans that are also not treated as dividends under Subdivision B.

5. For example, payments of genuine debts to an entity, payments and loans to other companies and otherwise assessable payments or loans are excluded from the general rules in Subdivision B under sections 109J, 109K and 109L respectively.

6. Loans made in the ordinary course of a private company's business on an arm's length basis are also not taken to be dividends (section 109M).

7. A way of avoiding the operation of the primary rules in Subdivision B may be to cause an entity interposed between the private company and its shareholder (or their associate) to itself make a payment or loan to the shareholder (or their associate).

8. Subdivision E anticipates this kind of arrangement and sets out rules when payments and loans through interposed entities are to be taken as direct payments and loans under Subdivision B from a private company to a shareholder (or their associate) and therefore to be taken to be a dividend.

9. Sections 109T and 109V (for payments) and sections 109T and 109W (for loans) work in conjunction with each other to achieve this result.

10. The kind of situation under consideration is where a private company makes a payment or loan to the interposed entity and a reasonable person would conclude that this was done solely or mainly as part of an arrangement involving a payment or loan to the shareholder or associate (described as the target entity).

That is to say, the interposed entity receiving the payment or loan from the private company needs to have itself made a payment or loan to the target entity under the arrangement. There may be more than one interposed entity involved.

11. The fact that an arrangement may not have been entered into for the purpose of circumventing Division 7A is not relevant for the purposes of paragraph 109T(1)(b).

12. The exclusion rules in Subdivision D operate (or not) when the operation of the interposed entity rules in Subdivision E *deem* certain things to have taken place.

13. For example, in Taxation Determination TD 2001/2, the interaction between sections 109K, 109T and 109X is discussed. In effect, TD 2001/2 provides that no dividend is deemed to have been paid to a target entity under sections 109C or 109D where the target entity is itself a company. However, where the target entity is an individual, section 109K has no application.

14. Section 109J provides that a private company is not taken to pay a dividend under section 109C if the payment is in discharge of a pecuniary obligation and is not more than an arm's length amount. It is difficult to imagine a situation where there is any interplay between Subdivision D and Subdivision E in cases of the payment of genuine debts.

15. However, it is not so with section 109L. Notwithstanding that a payment or loan from a private company to an interposed entity is otherwise assessable income, the interposed entity rules may still apply to any arrangement involving a payment or loan from the interposed entity to a target entity.[2]

[2] See paragraph 109X(1)(b).

16. Section 109M excludes from section 109D any loans made by a private in the ordinary course of business on ordinary commercial terms. Such a loan could be made to a related company or, indeed, an individual shareholder (or their associate). However, where the terms of section 109T and 109W are satisfied, Subdivision E may operate to deem a notional loan to have been made by the private company to a target entity. However, it is difficult to imagine how section 109M could apply to a notional loan.

17. Section 109N excludes from section 109D loans that meet criteria for minimum interest and maximum term and the loan agreement is in writing. Subsections 109X(2) and (3) enable section 109N to apply to notional loans. The loan agreement between the interposed entity and the shareholder (or their associate) that meets the criteria of section 109N is treated as the agreement under which the notional loan was made.

18. As set out in Taxation Determination TD 2011/16 it would then be a question of determining the amount of the private company's deemed payment or notional loan under subsections 109V(2) and 109W(2) respectively.

19. The point to be made is that the deemed circumstances from the operation of the interposed entity rules in Subdivision E can give rise to deemed dividends under Subdivision B notwithstanding the exclusion rules in Subdivision D. This will be the case depending on the circumstances and the whole of the interaction of the various provisions of Division 7A need to be considered.

Example 1

20. *A private company with current year profits and a large retained profits reserve (and a large distributable surplus) lends money to a related company that has no current year earnings and several years of carried forward losses (consequently it has no distributable surplus for the purposes of section 109Y).*

21. *The loss company subsequently makes a loan to a shareholder of the profitable company.*

22. *The shareholder does not make any repayment on the loan during the year of income.*

23. *There is no commercially justifiable reason to explain why the inter-company loan was made.*

24. *It can be concluded that the company made the loan solely or mainly as part of an arrangement to make a loan to the shareholder. Accordingly under section 109W the Commissioner determines an amount of a notional loan as if the private company had made a loan to the target entity at the time the loan was made to the shareholder.*

25. *Section 109K does not prevent the private company from being taken to have paid a dividend in respect of the notional loan between the private company and the shareholder under section 109D because of the loan between the companies.*[3]

[3] See subsection 109X(1).

Example 2

26. *Private Company Pty Ltd makes a payment to Interposed Company Pty Ltd. Under an arrangement with Private Company Pty Ltd, Interposed Company Pty Ltd on loans that amount to one of Private Company Pty Ltd's shareholders – Aaron.*

27. *A loan agreement is in place between Interposed Company Pty Ltd and Aaron that meets the criteria in section 109N.*

28. *Subsections 109X(3) and (4) will treat the loan agreement between Interposed Company Pty Ltd and Aaron as the relevant agreement for the purpose of section 109N and a deemed dividend will not arise so long as minimum yearly repayments are made in accordance with section 109E in subsequent income years.*

Date of effect

29. 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 June 2011

Appendix 1 – Your comments

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

31. 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 ATO 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:	**15 July 2011**
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References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 2006/10; TD 2001/2; TD 2010/D10; TD 2011/16

Subject references:

- Deemed dividends
- Dividend income
- Shareholder debt forgiveness
- Shareholder loans
- Shareholder payments

Legislative references:

- ITAA 1936
- ITAA 1936 Pt III Div 7A
- ITAA 1936 Pt III Div 7A Subdiv B
- ITAA 1936 109C
- ITAA 1936 109D
- ITAA 1936 109E
- ITAA 1936 Pt III Div 7A Subdiv C
- ITAA 1936 Pt III Div 7A Subdiv D
- ITAA 1936 109J
- ITAA 1936 109K
- ITAA 1936 109L
- ITAA 1936 109M
- ITAA 1936 109N
- ITAA 1936 Pt III Div 7A Subdiv E
- ITAA 1936 109T
- ITAA 1936 109T(1)(b)
- ITAA 1936 109V
- ITAA 1936 109V(2)
- ITAA 1936 109W
- ITAA 1936 109W(2)
- ITAA 1936 109X
- ITAA 1936 109X(1)
- ITAA 1936 109X(1)(b)
- ITAA 1936 109X(2)
- ITAA 1936 109X(3)
- ITAA 1936 109X(4)
- ITAA 1936 109Y

ATO references

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