



***TD 2024/D3 - Income tax: Division 7A - does section 109U of the Income Tax Assessment Act 1936 only apply to arrangements where a private company gives a guarantee to another private company?***

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 For information about the status of this draft Determination, see item 4145 on our [Advice under development program](#).



Status: **draft only – for comment**

## Taxation Determination

Income tax: Division 7A – does section 109U of the *Income Tax Assessment Act 1936* only apply to arrangements where a private company gives a guarantee to another private company?

### **📌 Relying on this draft Determination**

This publication is a draft for public comment. It represents the Commissioner's preliminary view on how a relevant provision could apply.

If this draft Determination applies to you and you rely on it reasonably and in good faith, you will not have to pay any interest or penalties in respect of the matters covered, if this draft Determination turns out to be incorrect and you underpay your tax as a result. However, you may still have to pay the correct amount of tax.

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### **What this draft Determination is about**

1. Section 109U of the *Income Tax Assessment Act 1936* (ITAA 1936) forms part of Subdivision E of Division 7A which deals with payments and loans through interposed entities. Under section 109U, a private company is taken to make a payment to a shareholder or associate of a shareholder (target entity) if:

- the private company guarantees a loan made by another entity (first interposed entity)
- a reasonable person would conclude (having regard to all the circumstances) that the private company gave the guarantee solely or mainly as part of an arrangement involving a payment or loan to the target entity

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- another private company (which may be the first interposed entity or another interposed entity) makes a loan or payment to the target entity, and
  - the amount paid or loaned by the other private company to the target entity exceeds that company's distributable surplus.
2. The amount of any deemed payment is worked out by the Commissioner under section 109V of the ITAA 1936.<sup>1</sup>
3. This draft Determination<sup>2</sup> deals with the issue of whether the first interposed entity (that is, the entity to whom the guarantee is given) needs to be a private company in order for section 109U of the ITAA 1936 to apply.
4. All legislative references in this Determination are to the ITAA 1936, unless otherwise indicated.

### **Ruling**

5. The requirement in paragraph 109U(1)(a) that a private company guarantees a loan made by the 'first interposed entity' does not contain any restrictions on the type of entity the first interposed entity must be. The first interposed entity need not be a private company<sup>3</sup> and may be any entity (including, for example, a public company bank).
6. However, while any entity (including a public company) can be the recipient of a guarantee under paragraph 109U(1)(a), the entity making the ultimate payment or loan to the 'target entity' must be a private company pursuant to paragraph 109U(1)(c).
- Note 1: section 109U will only apply if all requirements of the provision are satisfied, including the 'reasonable person test'<sup>4</sup> and the 'insufficient distributable surplus' condition.<sup>5</sup>
  - Note 2: in determining the amount of any deemed payment that arises, the Commissioner will have regard to factors relevant to the exercise of the discretion in section 109V which includes (for payments that are taken to have been made under section 109U) the mischief to which section 109U was directed.

### **Date of effect**

7. When finalised, it is proposed that this Determination will apply to years of income commencing both before and after its date of issue.

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### **Commissioner of Taxation**

11 December 2024

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<sup>1</sup> In some circumstances the Commissioner may determine the amount to be nil.

<sup>2</sup> For readability, all further references to 'this Determination' refer to the Determination as it will read when finalised. Note that this Ruling will not take effect until finalised.

<sup>3</sup> As defined in subsection 6(1). This section states that a private company in relation to a year of income, means a company that is a private company in relation to that year of income for the purposes of Division 7 of Part III. Subsection 103A(1) provides that a company is a private company in relation to the year of income if the company is not a public company in relation to the year of income.

<sup>4</sup> Paragraph 109U(1)(b).

<sup>5</sup> Paragraph 109U(1)(d).

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## **Appendix 1 – Explanation**

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❶ ***This Explanation 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.***

8. Division 7A was inserted into the ITAA 1936 in 1998 to ensure that a private company could not make tax-free distributions of profits to its shareholders (or their associates) in the form of payments or loans.<sup>6</sup> It does this by deeming certain payments and loans to be dividends paid by a private company to a shareholder (or associate of a shareholder). However, if what would otherwise be the sum of the deemed dividends a private company is taken to pay at the end of an income year exceeds the private company’s ‘distributable surplus’ for that year, the amount of each dividend is proportionately reduced so that the sum is equal to the company’s distributable surplus.<sup>7</sup>

9. In explaining the rationale for section 109U, the Explanatory Memorandum to the Taxation Laws Amendment Bill (No. 3) 1998 which introduced Division 7A notes, at paragraphs 9.70 and 9.71:

... the intended effect of **new Division 7A** could be circumvented by structuring a loan to a shareholder (or associate) through a company which has no distributable surplus, the repayment of which is guaranteed or secured by a company with distributable profits. Under such an arrangement the loan or payment by the interposed company would not be treated as a dividend under **new Division 7A** because the company making the loan does not have a distributable surplus.

A similar result could also be achieved by using an interposed company with a distributable surplus that is less than the payment or loan made to the shareholder (or associate) of the first entity.

10. Under section 109U, a private company is taken (for the purposes of Division 7A) to make a payment to a shareholder, or associate of a shareholder (the target entity) if:

(a) during a year of income the private company guarantees a loan made by another entity (the **first interposed entity**); and

...

(c) either:

(i) the first interposed entity that is a private company makes a loan to the target entity; or

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

...

### **Guarantee must be given to another entity – paragraph 109U(1)(a)**

11. Under paragraph 109U(1)(a), the private company must provide a guarantee to ‘another entity’ (first interposed entity).<sup>8</sup> No qualification or limitation on the type of entity is given.

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<sup>6</sup> Paragraph 9.2 of the Explanatory Memorandum to the Taxation Laws Amendment Bill (No. 3) 1998.

<sup>7</sup> Section 109Y.

<sup>8</sup> Section 109ZD provides that a ‘guarantee’, in relation to a loan, includes providing security for a loan.

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12. For the purposes of Division 7A, 'entity' is defined under section 109ZD to have the same meaning as section 960-100 of the ITAA 1997, and includes a body corporate.<sup>9</sup>

13. It is clear, therefore, that there is no requirement that the entity receiving the guarantee (first interposed entity) be a private company to satisfy paragraph 109U(1)(a).

#### **The payment to the target entity – paragraph 109U(1)(c)**

14. Subparagraphs 109U(1)(c)(i) and (ii) provide for 2 types of arrangements intended to fall within 109U.

15. Subparagraph 109U(1)(c)(i) covers direct arrangements where the first interposed entity provides the loan directly to the target entity. These direct arrangements require that the first interposed entity be a private company.

16. Subparagraph 109U(1)(c)(ii) captures arrangements with multiple interposed entities. This provision requires that the entity that ultimately makes the payment or loan to the target entity be a private company. Under these arrangements, the entity receiving the guarantee will be a different entity to the one making the payment or loan to the target entity.

17. The term 'another entity', in subparagraph 109U(1)(c)(ii) is simply used to refer to an additional entity (other than the first interposed entity) in the chain of interposed entities. It would be wrong to construe the term 'another entity' in subparagraph 109U(1)(c)(ii) as meaning an entity in addition to 'the first interposed entity that is a private company' so as to import the requirement that the first interposed entity be a private company in subparagraph 109U(1)(c)(i) into subparagraph 109U(1)(c)(ii). Had the legislature intended that the first interposed entity be a private company, it could reasonably be expected that this would have been made clear in paragraph 109U(1)(a).

18. For completeness, the second reference to private company in subparagraph 109U(1)(c)(ii) is a reference to the private company that gave the guarantee to another entity in paragraph 109U(1)(a) and is not a reference to the private company mentioned in subparagraph 109U(1)(c)(i).

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#### **Example 1 – private company guarantees a loan made by a bank to a private company with no distributable surplus**

19. *The Fruit family wholly own several private companies, including Orchard Co and Apple Co.*

20. *On 1 November 2023, Orchard Co provides a guarantee to Bank Co for a \$100,000 loan to Apple Co. Bank Co is a publicly listed company.*

21. *On 4 November 2023 Apple Co transfers \$100,000 to Sarah for her personal use. Apple Co is a newly incorporated entity and has no distributable surplus for Division 7A purposes.*

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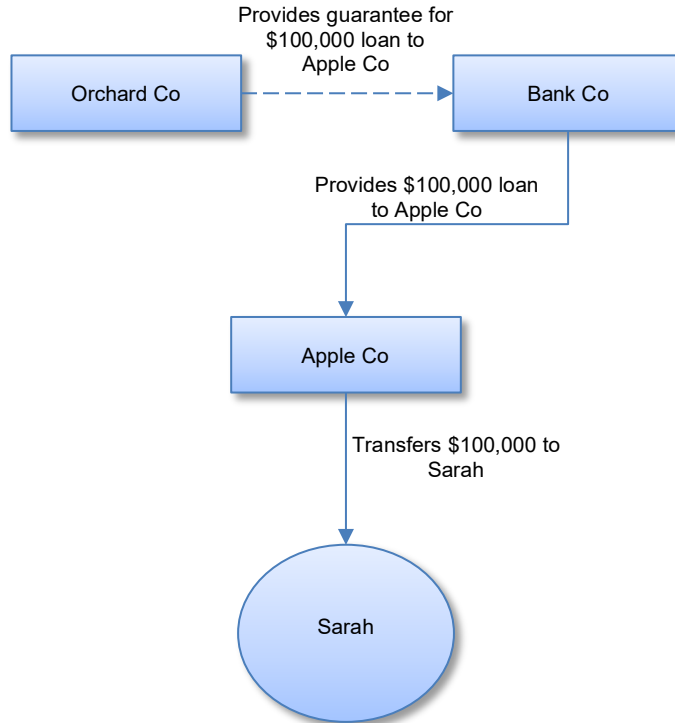
<sup>9</sup> A body corporate is not a defined term but extends to any company including an entity that is a public company.

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Diagram 1: private company guarantees a loan made by a bank to a private company with no distributable surplus



22. Orchard Co provides a guarantee to Bank Co (first interposed entity). Bank Co subsequently provides a loan to Apple Co. As Apple Co is a private company and ultimately pays the amount to Sarah, subparagraph 109U(1)(c)(ii) is satisfied. Having regard to all circumstances, section 109U applies to deem Orchard Co to make a payment to Sarah. The amount of the payment is calculated with reference to section 109V.

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## **Appendix 2 – Compliance approach**

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**①** *This Appendix sets out a proposed practical administration approach to assist taxpayers in complying with relevant tax laws. When this Determination is finalised, provided you follow the advice in this appendix in good faith and consistently with the Ruling section, the Commissioner will administer the law in accordance with this approach.*

23. We recognise that it is common for banks and other financial institutions to seek guarantees from related entities when providing loans to private companies.

24. We will focus the application of compliance resources concerning the application of section 109U to high-risk arrangements that display clearly artificial or contrived elements. For example, this will be the case where, on an objective assessment, one or more of the private companies involved in the arrangement entered into or carried out the arrangement with a view to circumventing Division 7A, including through the exploitation of one or more private companies with no distributable surplus.

25. To avoid doubt, our decision to apply compliance resources in this manner:

- only applies in respect of section 109U, with the result that if the private company which gave the guarantee was to pay an amount to the third-party lender (or to the private company borrower) which results in a deemed dividend arising under another provision in Division 7A<sup>10</sup>, we may have cause to devote compliance resources to applying that other provision, and
- applies regardless of whether the third-party lender is or is not a private company.

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<sup>10</sup> This may, for example, include sections 109C, 109D, 109T or 109UA.

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## **Appendix 3 – Your comments**

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26. You are invited to comment on this draft Determination including the proposed date of effect. Please forward your comments to the contact officer by the due date.

27. A compendium of comments is prepared when finalising this Determination, and an edited version (with names and identifying information removed) is published to the Legal database on [ato.gov.au](http://ato.gov.au)

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

**Due date:** 31 January 2025

Contact officer details have been removed as the comments period has ended.



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## References

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*Related Rulings/Determinations:*

TD 2011/16; TR 2006/10

*Legislative references:*

- ITAA 1936 6(1)
- ITAA 1936 Division 7 Pt III
- ITAA 1936 Division 7A Pt III
- ITAA 1936 Subdivision E
- ITAA 1936 103A(1)
- ITAA 1936 109C
- ITAA 1936 109D
- ITAA 1936 109T
- ITAA 1936 109U
- ITAA 1936 109U(1)(a)
- ITAA 1936 109U(1)(b)

- ITAA 1936 109U(1)(c)
- ITAA 1936 109U(1)(c)(i)
- ITAA 1936 109U(1)(c)(ii)
- ITAA 1936 109U(1)(d)
- ITAA 1936 109UA
- ITAA 1936 109V
- ITAA 1936 109Y
- ITAA 1936 109ZD
- ITAA 1997 960-100

*Other references:*

- Explanatory Memorandum to the Taxation Laws Amendment Bill (No. 3) 1998
- TA 2024/2

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ATO references

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