TD 2011/16 - 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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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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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)[2], 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. The Commissioner will also take account of any relevant factors occurring after that date that are within the Commissioner's knowledge at the time of making a determination.

[1] All legislative references in this Determination are to the ITAA 1936 unless otherwise stated.
[2] For the purposes of this Determination it is assumed that subsection 109T(1) has been satisfied. However, in practice this is a question of fact and circumstance.

2. The relevant factors that the Commissioner will take into account include:

(a) the amount that an interposed entity referred to in subsection 109T(1) (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);

(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 (other than its right to receive repayment of the loan and any relevant interest);

(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, '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 any actual loans made as part of the arrangement would be covered by section 109M (loans in the ordinary course of the private company's business made on its usual terms applicable to arm's length parties); and

(h) 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 making a section 109N compliant loan to an entity that has an intention and capacity to repay a loan [in respect of which to the extent expected at the time when the Commissioner is determining the amount of deemed payment or notional loan, appropriate minimum yearly repayments have been made] or genuinely and in substance repaying loans in a manner that would not attract section 109R if it applied).

3. For the purpose of paragraph 2(h) of this Determination, in determining whether the factors reflect genuine transactions the Commissioner will take into account related facts and circumstances within the Commissioner's knowledge at the time the Commissioner determines the amount of the deemed payment and notional loan. Examples of arrangements designed to avoid the application of Subdivision E otherwise than as envisaged within the scheme of Division 7A include loans to interposed entities entered into on section 109N compliant terms in respect which:

- appropriate minimum yearly repayments are not made;
- the loan is then forgiven; or
- the interposed entity has no obvious intention or capacity to repay the loan (such as may be the case where it has no distributable surplus).

4. The following examples are illustrations of the way in which the above principles are applied. The determination of the amount of any deemed payment or notional loan depends on the circumstances of the particular case. Consequently the answers given in the following examples are not determinative of our views on cases with similar, but different, facts.

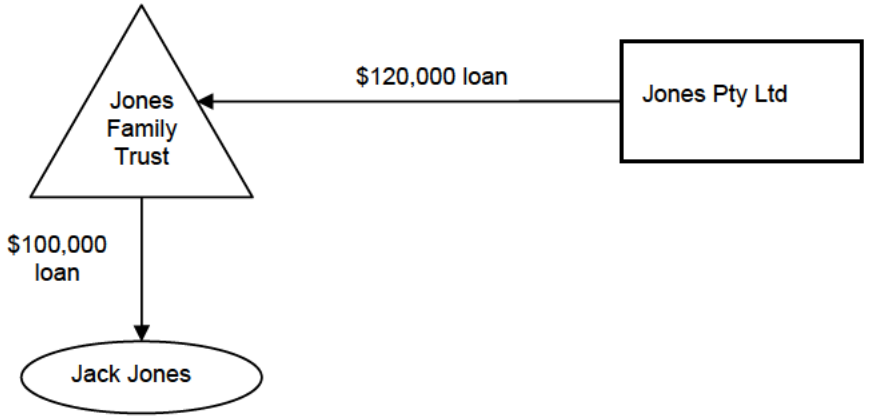
Example 1

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

6. On 15 September 2010 Jones Pty Ltd makes a loan of $120,000 to Jones Holding Co Pty Ltd as trustee for the Jones Family Trust. 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 general trust activities.

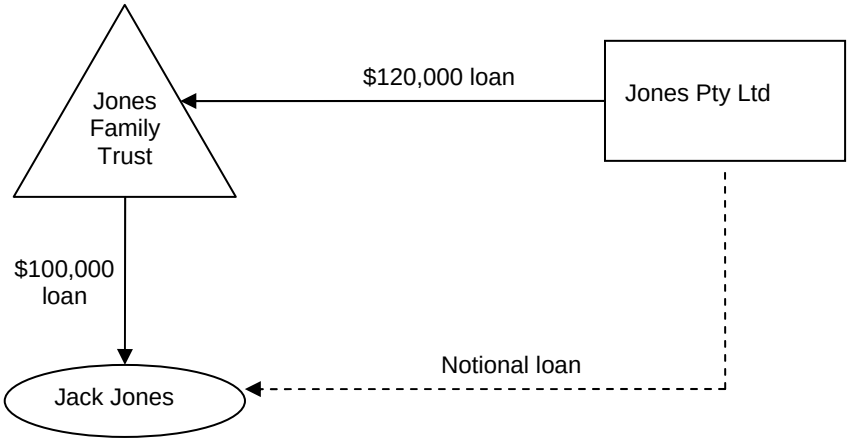
7. On 30 April 2011, Jones Holding Co Pty Ltd, withdraws $100,000 from the trust's bank account which it lends to Jack Jones, a shareholder of Jones Pty Ltd (see Diagram 1). Jack uses the $100,000 for private purposes.

Diagram 1



8. Having regard to all the circumstances, a reasonable person would conclude that Jones Pty Ltd loaned $120,000 to Jones Holding Co Pty Ltd as trustee for the Jones Family Trust 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

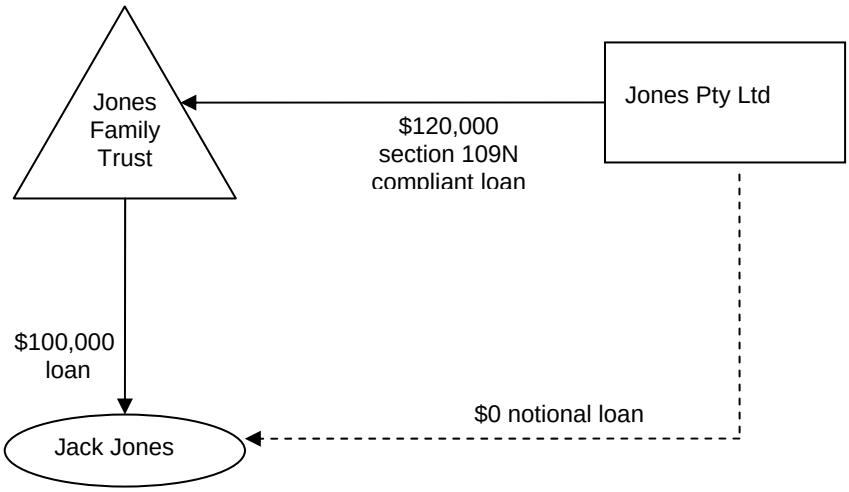


9. On 2 July 2011, prior to Jones Pty Ltd's 2011 lodgment date, Jones Pty Ltd and Jones Holding Co Pty Ltd as trustee for the Jones Family Trust enter into a compliant section 109N loan agreement in respect of the loan of 15 September 2010. They do this by varying their loan agreement to confirm a 7 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 to the loan agreement are made effective from 15 September 2010.

10. There are no other relevant facts and circumstances.

11. 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 as trustee for the Jones Family Trust 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



Example 2

12. Assume the same facts as in Example 1 except that Jones Holding Co Pty Ltd:

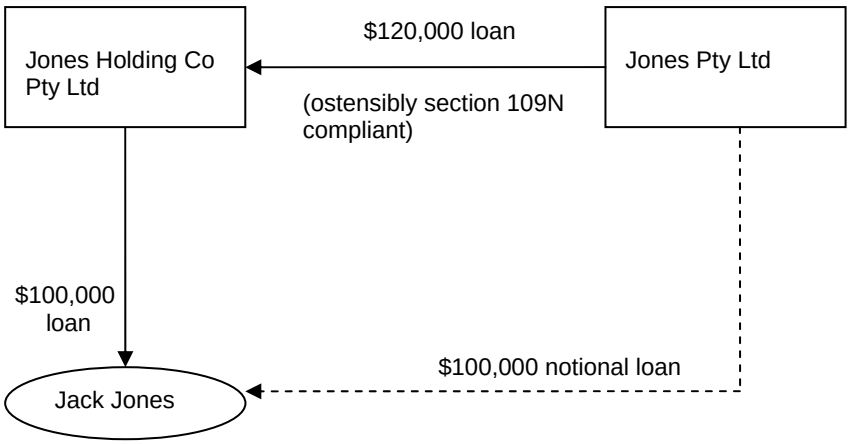
(a) is not acting in the capacity of a trustee and is therefore the interposed entity; and

(b) had no distributable surplus and no apparent capacity to repay the loan.[3]

13. 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.

14. For the purposes of determining the amount of the notional loan under subsection 109W(1) the Commissioner will have regard to the amount that Jones Holding Co Pty Ltd loaned to Jack Jones and the fact Jones Holding Co Pty Ltd is not likely to be able to make the minimum yearly repayments to Jones Pty Ltd as required under the varied loan agreement. For section 109W purposes the amount of the notional loan will be $100,000 (see Diagram 4).

Diagram 4



Example 3

15. Assume the same facts as in Example 1 except that:

(a) Jones Holding Co Pty Ltd is not acting in the capacity of a trustee and is therefore the interposed entity;

(b) the Commissioner had to determine the amount of the notional loan made to Jack Jones in the 2010-11 income year as a result of an audit of the taxpayer's affairs conducted during the 2013-14 income year; and

(c) no loan repayments were made by Jones Holding Co Pty Ltd to Jones Pty Ltd in either the 2011-12 or 2012-13 income years.

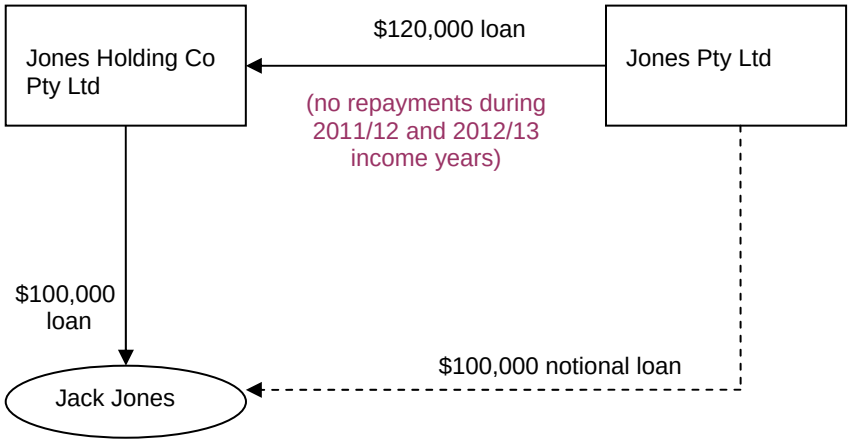
16. There are no other relevant facts or circumstances.

[3] Although Jones Holdings Co Pty Ltd may be taken to have paid a dividend to Jack Jones as a result of the loan made by that private company to Jack Jones the amount of the dividend is limited to the company's distributable surplus which is nil.

17. 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.

18. For the purposes of determining the amount of the notional loan under subsection 109W(1) the Commissioner will have regard to the amount that Jones Holding Co Pty Ltd loaned to Jack Jones and the fact Jones Holding Co Pty Ltd had the capacity to make loan repayments to Jones Pty Ltd but made no repayments during this time . For section 109W purposes the amount of the notional loan will be $100,000 (see Diagram 5).

Diagram 5



Example 4

19. Assume the same facts as in Example 1 except that:

(a) Jones Holding Co Pty Ltd is not acting in the capacity of a trustee and is therefore the interposed entity;

(b) the Commissioner had to determine the amount of the notional loan made to Jack Jones in the 2010-11 income year as a result of an audit of the taxpayer's affairs conducted during the 2013-14 income year; and

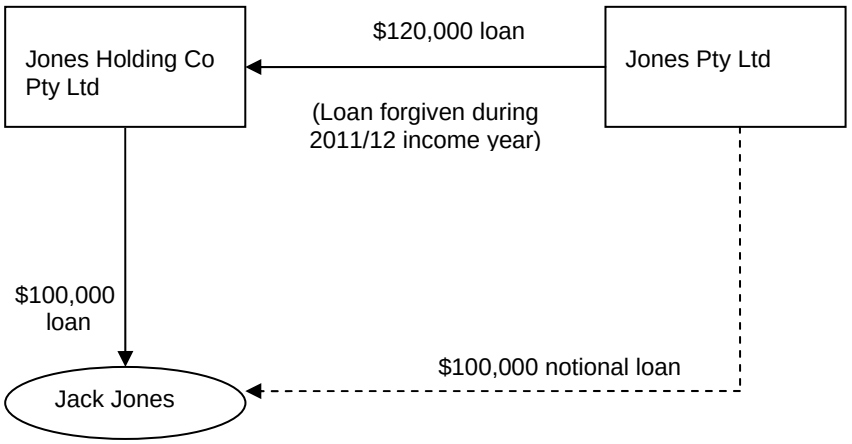
(c) the loan Jones Holding Co Pty Ltd owed to Jones Pty Ltd was forgiven in the 2011-12 income year.

20. There are no other relevant facts or circumstances.

21. 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.

22. For the purposes of determining the amount of the notional loan under subsection 109W(1) the Commissioner will have regard to the amount that Jones Holding Co Pty Ltd loaned to Jack Jones and the fact the loan Jones Holding Co Pty Ltd owed Jones Pty Ltd was forgiven during the 2011-12 income year. For section 109W purposes the amount of the notional loan will be $100,000 (see Diagram 6).

Diagram 6



Date of effect

23. This Determination applies to years of income commencing both before and after its date of issue. However, this Determination will not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of this Determination (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

Commissioner of Taxation
15 June 2011

Appendix 1 – Explanation

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

Explanation

Background

24. 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.

25. 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.[4]

26. 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.

27. 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.

28. 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 company's lodgment date for the year of income in which the payment was made.[5]

29. Other types of loans may also be excluded from being treated as a dividend, for example, loans made by a private company in the ordinary course of its business if made on its usual terms applicable to arm's length parties under section 109M.

Deemed payment or notional loan

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

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

31. 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.

32. 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) 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.

33. 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.

34. Paragraph 109T(1)(b) makes no reference to there being any purpose or intent of avoiding Division 7A. It merely refers to the need for a payment or loan from the private company to the interposed entity that a reasonable person would conclude was made as part of an arrangement involving a payment or loan to the target entity, that is a back-to-back arrangement. Nonetheless, such a purpose or intent may help establish such a reasonable conclusion.

Exception to section 109T creating a Division 7A dividend

35. 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.[6]

36. 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.

[6] Subsection 109T(3).

37. 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)).

38. 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.[7]

Amount of deemed payment or notional loan determined by the Commissioner

39. 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.[8]

40. 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.[9] The consideration 'for anything' here is a reference to anything other than the consideration properly received in respect of advancing loan funds, namely, the right to receive repayment of those funds (plus interest if relevant) according to the terms of the loan.

41. 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 relevant to have regard to the commerciality of the loan from the private company to the interposed entity

42. 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 the Commissioner to take into account

43. 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.

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[7] Subsections 109X(2) and 109X(3).
[8] Subsections 109V(1) and 109W(1).
[9] Subsections 109V(2) and 109W(2).

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.[10]

44. 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.

45. 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.

46. 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 take into account:

- any repayments made before the lodgment date for the private company in the year of income in which the notional loan arises of the actual loans made as part of the arrangement described in paragraph 109T(1)(b);
- any repayments made before the lodgment date for the private company's year of income in which the deemed payment or notional loan arises 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 would be subject to section 109M or is a section 109N compliant loan before the lodgment date for the private company's tax return for the year of income in which the notional loan arises.

47. 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.

48. In some instances the Commissioner will be asked to determine the amount of the deemed payment or notional loan after the lodgment date for the private company in the year of income in which the deemed payment or notional loan arises. The determination may occur in a subsequent income year. To the extent that other relevant factors after the lodgment date are relevant and in the Commissioner's knowledge then they may also be taken into account.

[10] This is acknowledged in paragraph 9.6 of the Explanatory Memorandum to the Tax Laws Amendment (2004 Measures No. 7) Bill 2004.

49. 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.

References

Previous draft:

TD 2010/D10

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 109M
- 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)
- TAA 1953

Other references:

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

ATO references

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