

Appendix III

NO. 11

SENATOR  
THE HON. **ROD KEMP**

ASSISTANT TREASURER

# PRESS RELEASE

## TAXATION OF DISTRIBUTIONS DISGUISED AS LOANS FROM PRIVATE COMPANIES

I am announcing today additional amendments to proposed Division 7A of the Income Tax Assessment Act 1936 which was introduced into the House of Representatives in Taxation Laws Amendment Bill (No-7) 1997 on 4 December 1997.

The new Division 7A is intended to ensure that payments, loans, or debts forgiven by private companies to shareholders (and associates of shareholders) are treated as assessable dividends to the extent that there are realised or unrealised profits in the company (unless they come within specified exclusions).

On 9 March 1998 I announced the Government's intention to amend the Bill to ensure that the proposed legislation will not apply to payments by private companies to, or on behalf of, shareholders in their capacity as employees. I also announced that the Government was considering representations received on other aspects of the proposed legislation. In response to those representations the Government will make further amendments to the proposed legislation to ensure that the provisions operate as intended.

Accordingly, the following amendments (which are attached to this press release) will be moved when the Bill is debated in the House of Representatives.

*Loan guarantees:* The proposed legislation currently provides that, where a private company guarantees a loan made by a third party to a shareholder (or their associate), the amount of the loan will be treated as a dividend. The proposed guarantee provision may have unintended consequences. Accordingly, it will be amended so that, generally, the mere provision of a guarantee will not result in a deemed dividend. Rather, the creation of a liability to make a payment upon default under a guarantee will be the triggering event for a deemed dividend.

In addition, the guarantee provisions will be amended to give a discretion to the Commissioner of

Taxation to exclude an amount treated as a dividend as a result of a liability arising under a guarantee if it would cause undue hardship to the shareholder (or associate). This will allow the Commissioner a discretion in circumstances where, for example, a shareholder is financially unable to meet loan repayments through no fault of their own, or where a shareholder technically defaults under a loan agreement by failing to make a payment by the due date, but makes that payment within a short period of time thereafter.

If a guarantee is provided by a private company as part of an arrangement involving, either directly or indirectly, a payment or loan to a shareholder of that company (or their associate) by another company, the loan will be treated as a payment to the shareholder (or associate) to the extent that the payment or loan made to the shareholder (or associate) by an interposed company exceeds the interposed company's distributable surplus. This will ensure that Division 7A cannot be avoided by a profitable company guaranteeing a loan to an interposed company with no profits simply to allow that company to make a payment or loan to a shareholder (or their associate).

Guarantee for the purposes of Division 7A will be defined to include the provision of security. This is to ensure that the provisions cannot be circumvented merely by providing security for a loan rather than a guarantee.

*Loans for employee share scheme purchases:* The proposed legislation will be amended so that loans made solely for the purpose of allowing a shareholder or associate of a shareholder to acquire qualifying shares or qualifying rights in the company under an employee share scheme, to which Division 13A of the *Income Tax Assessment Act* applies, will not be treated as dividends,

*Distributions by liquidators and winding up loans:* The proposed legislation may have the effect of treating payments by liquidators, or loans made during the winding-up of a private company, as dividends. The legislation will be amended so that liquidators' distributions will not be treated as dividends. The legislation will also be amended so that loans made during the course of winding-up a company will not be treated as dividends to the extent that they are either repaid or

offset by a distribution by the end of the year of income following the year in which the loan is made.

*Trust distributions to corporate beneficiaries:* It has been argued that the proposed legislation does not apply to arrangements where a corporate beneficiary has become presently entitled to net income of a trust and the amount is not paid by the trustee to the corporate beneficiary, but continues to be held by the trustee who then provides a loan to a shareholder (or their associate) of the corporate beneficiary. These sorts of arrangements should be caught by Division 7A because, in substance, a loan of money from the private company to the shareholder (or their associate) has been effected via the trust. The proposed legislation will be amended to deal with this situation.

*Amounts that are not otherwise assessable treated as dividends:* The proposed legislation ensures that where a payment or loan would be included in the assessable income of a shareholder (or their associate), it will not be treated as a deemed dividend under Division 7A. It is also possible that a payment or loan made to a shareholder (or their associate) will be specifically excluded from their assessable income by virtue of an exempting provision in the income tax law. The proposed legislation will be amended to ensure that such a payment or loan will not be treated as a dividend under Division 7A.

*Written loan agreements:* The proposed legislation currently provides that a loan satisfying maximum term and minimum interest rate criteria will not be treated as a dividend if there is a written agreement in place before any amount is advanced to the shareholder (or their associate). The proposed legislation will be amended so that the requirement for the written agreement to be in place before the loan is made will be regarded as satisfied if the written agreement is put in place by 30 June 1998. This measure will apply only for loans made during the company's 1997-98 year of income.

The Government also intends to make some other minor changes to the legislation. These will clarify the operation of certain provisions and assist taxpayer compliance.

The additional amendments, with the exception of the changes to the treatment of loan guarantees and trust distributions to corporate beneficiaries, will commence on 4 December 1997, the same commencement date as for the rest of Division 7A. The amendments in respect of loan guarantees and trust distributions will apply to loan guarantees and trust distributions made after 4.00 pm AEST on 27 March 1998. .

27 March 1998  
Canberra

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The Parliament of the  
 Commonwealth of Australia

HOUSE OF REPRESENTATIVES

## Taxation Laws Amendment Bill (No. 7) 1997

*(Amendments to be moved on behalf of the Government)*

- (1) Schedule 3, item 9, Page 7 (line 5), omit "it objectives", substitute "its objectives-".
- (2) Schedule 3, item 15, page 8 (line 5), omit "object", substitute "objectives".
- (3) Schedule 3, item 15, page 8 Line 14), omit "objects", substitute objectives-.
- (4) Schedule 3, item 15, page 8 (line 20), omit "object", substitute "objectives".
- (5) Schedule 3, item 17, page 12 (line 4), omit "15", substitute "1.5A, 1.51Y".
- (6) Schedule 8, item 6, page 79 Line 19), omit "16OAQCO". substitute '11160AQCNA
- (7) Schedule 8, item 15, page 82 (line 10). omit "At the end of Subdivision C of Division 2 of Part IIIA, substitute "After section 16OAQCNA
- (8) Schedule 8, item 1, page 82 (line 12), omit "**16OAQCP**", substitute `**16QAQCNB**'.
- (9) Schedule 9, item 1, page 95 (line 17) after "109N, insert "109NA, 109NB."

- (10) Schedule 9, item 2, page 96 (line 13) omit "16O AQCP", substitute '160AQCNC".
- (11) Schedule 9, item 2, page 97 (line 24) omit "includes" substitute "means".
- (12) Schedule 9, item 2, page 97 (Line 25), after "payment, insert "to the extent that it is".
- (13) Schedule 9, item 2, page 97 (line 27), after "amount', insert "to the extent that it is'.
- (14) Schedule 9. item 2. page 97 (after line 31), after subsection (3), insert:

***Loans are not Payments***

(3A) However, a loan to an entity is not a payment to the entity.

- (15) Schedule 9, item 2, page 98 (line 6), after "transferee', insert "equals or".
- (16) Schedule 9, item 2, page 98 (lines 8 and 9), omit "**at the end of the year the loans are made**".
- (17) Schedule 9, item 2, page 98 (Line 28), omit "section", substitute "subsection".
- (18) Schedule 9, item 2, page 98 (after line 32), after subsection (1), insert  
*Loans treated as dividend in year following that of making*

(1A) A private company is taken to pay a dividend to an entity at the end of the private company's year of income (the *current year*) if:-

- (a) the private company made a loan to the entity during the previous year of income; and
- (b) it made the loan in the course of a winding-up of the private company by a liquidator, and
- (c) the loan is not fully repaid by the end of the current year; and
- (d) either.
  - (i) the entity is a shareholder in the private company, or an associate of such a shareholder, when the loan is made; or
  - (ii) a reasonable person would conclude (having regard to all the circumstances) that the loan is made because the entity has been such a shareholder or associate at some time,

Subdivision D (other than section 109R) does not apply to loans covered by this subsection.

- (19) Schedule 9, item 2, page 101 (Line 25) omit the formula, substitute:

Amount of the loans not made by the .. Current years  
and of the previous year of income benchmark interest rate

remaining tax

I- 1+ Current year's  
benchmark interest rate

(20) Schedule 9, item 2, page 102 (lines 1 to 3), omit the definition of *previous year's benchmark interest rate*, substitute:

*current year's benchmark interest rate* is the benchmark interest rate, for the year of income for which the minimum yearly repayment is being worked OUL

(21) Schedule 9, item 2, page 102 (Line 23), omit "previous".

(22) Schedule 9, item 2, page 105 (lines 16 to 22), omit subsection (3), substitute-

*Forgiveness of 164n debt does not give rise to dividend if loan did give rise to dividend*

(3) A private company is not taken under section 109P to pay a dividend at the end of a year of income because of the forgiveness of an amount of a debt resulting from a loan if, because of the loan, the private company is taken:

- (a) under section 109D of 109E to pay a dividend at the end of that year or an earlier one; or
- (b) under subsection 108(1) to pay a dividend on the last day of that year or an earlier One.

(23) Schedule 9, item 2, page 106 (line 13), after "assessable, insert "or that are specifically excluded from assessable income".

(24) Schedule 9, item 2, page 106 (Line 20), omit "section 109N).", substitute "section 109N)"

(25) Schedule 9, item 2, page 106 (after line 20), insert:

- certain loans and distributions by liquidators (section 109NA);
- loans that are for the purpose of funding the purchase of certain shares or rights under an employee share scheme (section IONB).

(26) Schedule 9, item 2, page 107 (lines 5 to 16), omit Section 109.1, substitute:

109J Payments discharging pecuniary obligations not treated as dividends

A private company is not taken under section 109C to pay a dividend because of the payment of an amount, to the extent that the payment:

- (a) discharge\* an obligation of the private company to pay money to the entity; and
  - (b) is not more than would have been required to discharge the obligation had the private company and entity been dealing with each other at arm's length.
- (27) Schedule 9, item 2, page 107 (line 7.3), omit 'Payments and loans that are otherwise assessable', substitute "Certain payments and loans".
- (28) Schedule 9, item 2, page 107 (line 27), omit "if", substitute "to the extent that"
- (29) Schedule 9, item 2, page 107 (line 28), omit 'section', substitute "Division.
- (30) Schedule 9, item 2, page 107 (after line 29), at the end of section 109L, add:
- (2) In addition, a private company is not taken under section 109C or 109D to pay a dividend because of a payment or loan that the private company made to an entity to the extent that a provision of this Act (other than this Division) has the effect that the payment or loan is not included in the entity's assessable income even though it would otherwise be included.
- (31) Schedule 9, item 2, page 108 (line 16), after "the loan", insert "for years of income after the year in which the loan is made,".
- (32) Schedule 9, item 2, page 108 (Line 23), omit 'end", substitute "start".
- (33) Schedule 9, item 2, page 109 (after line 18), after section 109N, insert:

### **109NA Certain liquidator's distributions and loans not treated as dividends**

A private company is not taken under section 109C or subsection 109D(j) to pay a dividend because of a distribution or loan made in the course of the winding-up of the company by a liquidator.

Note- However, if such a loan is not fully paid by the end of the following year of Income, the Company will be taken to have paid a dividend under subsection 109D(1A).

### **109NB Loans to purchase shares under employee share schemes not treated as dividends**

- (1) A private company is not taken under section 109D to pay dividend because of a loan made solely for the purpose of enabling the shareholder or an associate of the shareholder to acquire qualifying shares or qualifying rights under an employees share scheme.
- (2) Expressions used in this section that are defined in Division 13A have the same meaning as in that Division.

- (34) Schedule 9, item 2, page 112 (Lines, 11 and 12), omit 'and 109U'. substitute ". 109U, 109UA and 109UB".
- (35) Schedule 9. item 2, page 113 (lines 23 to 33), omit section 109U, substitute:

**109U Payments and loans through interposed entities relying on guarantees**

- (1) This Division operates as if it private company makes a payment to an entity (the target entity) as described in section 109V if.
- (a) during a year of income the private company guarantees a loan made by another entity (the *first interposed entity*); and
- (b) 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; and
- (r.) 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
- (d) the amount of the payment or the loan is greater than the amount worked out using the formula:

Distributable surplus - Subsection 109Y(3) amount

- (2) The amount of the payment from the private company to the target entity (as worked out under section 109V) is to be reduced by the amount worked out using the formula:

Distributable surplus - Subsection 109Y(3) amount

- (3) In the formulas in paragraph (1)(d) and subsection (2):

**distributable surplus** means the distributable surplus (worked out under subsection 109Y(2) for the interposed entity that made the payment or loan to the target entity for the year of income.

**Subsection 109Y(3) amount** means the total of any amounts calculated under subsection 109Y(3) in relation to that interposed entity for the year of income (apart from as a result of the operation of this section).

*This section operates regardless of certain factors.*

- (4) For the purposes of this section, it does not matter
- (a) whether the interposed entity made the payment or loan to the target entity before, or at the same time as the first interposed entity received the guarantee from the private company; or
- (b) whether or not the interposed entity paid or lent the target entity the same amount as the private company guaranteed.

### 109UA Certain liabilities under guarantees treated as payments

(1) Section 109T operates as if one entity (the first entity) makes a payment to a second entity if the first entity guarantees a loan the second entity makes a third entity (the target entity) and, as a result of the guarantee, the first entity has a liability (other than a contingent liability) to make a payment to the second entity.

Example: A private company guarantees a loan that a bank makes to a shareholder in the private company and the Shareholder defaults on the loan. As a result, the company has a presently existing liability to make a payment to the bank. Section 109T operates as if the private company had made a payment to the bank, so the company is treated by section 109V as making a payment to the shareholder (because the bank is interposed between company shareholder).

(2) The amount of the payment (as worked out under section 109V) is to be reduced by any Amount treated as a dividend as a result of the operation of section 109U in relation to the payment or loan made by the interposed entity to the target entity.

(3) A private company is not taken under this Division to pay a dividend because of the Operation of subsection (1) in relation to a guarantee if the Commissioner is satisfied that:

(a) the target entity would suffer undue hardship if the private company were taken to pay a dividend to the entity because of the liability

(b) when the target entity entered into the loan, the entity had the capacity to pay the loan.

(2) This section does not limit the operation of section 109T.

### 109UB Certain trust amounts treated as loans

(1) If:

- (a) a private company is, or has been, presently entitled to an amount from the net income of a trust estate: and
- (b) the trustee has not paid the amount to the private company: and
- (c) the trustee has made a loan to a shareholder of the private company, or an associate of such a shareholder after the time that the private company first became presently entitled to that amount:

the private company is taken to have made a loan to the shareholder or associate, at the time that the trustee made the loan.

(2) The amount of the loan is the lesser of the amount of the loan made by the trustee and the amount worked out -using the formula:

Unpaid present entitlement - Previous notional loans where-

*Unpaid present entitlement means* the total amount to which the Private company is. or

has been, presently entitled that the trusts has not paid.

*previous notional loans* means the sum of amounts previously treated as a loan under this section as a result of its operation in relation to the unpaid present entitlement.

*Some provisions preventing loan giving rise to dividend do not apply to notional loan*

- (3) Sections 109M and 109N do not apply to a loan that is taken to have been made under this Section (so it must generally be taken into account for the purposes of working out whether the private company is taken wider section 109D to have paid a dividend).

**(36) Schedule 9, item 2, page 116, (Line 24) omit the formula, substitute:**

*Net assets* - Non - commercial - Paid - up share \_ Repayments of  
Loans value non-commercial loans

- (37) Schedule 9, item 2, page 116 (line 26) to page 117 (Line 3), omit the definition of *book value*, substitute:

*net assets* means the amount (if any), at the end of the Company's Year of income., by which the company's assets (according to the company's accounting records) exceed the  
SUM OF,

- (a) the present legal Obligations of the company to persons other than the company; and
- (b) the following provisions (according to the company's accounting records)
  - (i) provisions for depreciation;
  - (ii) provisions for annual leave and long service leave;
  - Gii) provisions for amortisation of intellectual property and trademarks;
  - (iv) other provisions prescribed under regulations made for the purposes of this subparagraph.

If the Commissioner considers that the company's accounting records significantly undervalue its assets or overvalue its provisions, the Commissioner may substitute a value that the Commissioner considers is appropriate.

- (38) Schedule 9, item 2, page 117 (line 5), before "109D", insert "108".
- (39) Schedule 9, item 2, page 117 (line 6), at the end of the definition of *non-commercial loan*, add 'as are shown as assets in the company's accounting records at the end of the year of income'.
- (40) Schedule 9, item 2, page 117 (after line 11), at the cad of subsection (2). add:

*repayments of non-commercial loans* means the total of:

- (a) any repayments to the company of loans that have been taken by section 108, 109D or 109E to be dividends; and
- (b) amounts set off against loans that have been taken by section 108, 109D or 109E to be dividends, other than such amounts that are set off as a result of-

- (i) a dividend (being a later dividend for the purposes of action 109ZC or a subsequent dividend for the purposes of subsection 108(2)) being paid by the company to the extent that the dividend has not been franked under section 160AQF; or
  - (ii) a loan, or a part of a loan, being forgiven.
- (41) Schedule 9, item 2, page 118 (Line 20), omit "payment or"-
  - (42) Schedule 9, item 2, page 118 (line 21), omit "payment or".
  - (43) Schedule 9, item 2, page 118 (line 27) omit "payment or".
  - (44) Schedule 9, item 2, page 119 (after line 7), at the end of section 109ZB, add,
    - (3) However, this Division does not apply to a payment made to a shareholder, or an associate of a shareholder, in their capacity as an employee (as defined in the *Fringe Benefits Tax Assessment Act 1986*) or an association of such an employee.
  - (45) Schedule 9, item 2, page 120 (after line 14), after the definition of forgive, insert:
 

*guarantee*, in relation to a loan, includes providing security for the loan.
  - (46) Schedule 9, item S, page 121 (line 4), omit "116OAQCN", substitute, "160AQCNC".
  - (47) Schedule 9, item 5, page 121 (be 6). omit "16OAQCP", substitute, "16QAQCNC".
  - (48) Schedule 9, item 7, page 122 (after line 21), at the end of the item, add:
    - (3) However, sections 109U, 109UA and 109UB of the *Income Tax Assessment Act 1936* only apply to payments or loans made after 4.00 p.m., by legal time in the Australian Capital Territory, on 27 March 1998.
  - (49) Schedule 9, page 122 (after line 28), after item 9, insert:
 

9A Transitional--written loan agreements

Division 7A of Part 1U of the *Income Tax Assessment Act 1936* applied in relation to the 1997-98 year of income as if paragraph 109N(1)(a) of the Act were repealed and the following paragraph were substituted:

    - (a) the loan is covered by a written agreement that was made before 1 July 1998; and