CPA Australia Ltd
ABN 64 008 392 452

Level 20, 28 Freshwater Place
Southbank VIC 3006 Australia

GPO Box 2820 Melbourne
VIC 3001 Australia

P 1300 737 373
Outside Aust +613 9606 9677

cpaaustralia.com.au

Anthony Pulvirenti
Private Wealth
Australian Taxation Office

Email: Anthony.Pulvirenti@ato.gov.au

3 February 2025

Dear Mr Pulvirenti,

Taxation Determination 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?

CPA Australia is Australia's leading professional accounting body and one of the largest in the world. We represent the diverse interests of more than 173,000 members in over 100 countries and regions. We make this submission in response to The ATO's **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?** (TD) released on 11 December 2024 on behalf of our members.

We make the following summary comments and key points for your consideration:

- The TD needs to clarify its position and provide guidance and examples for legitimate guarantee arrangements.
- The TD needs to provide a link to TD 2011/16 in the binding section and saying that those factors can be used if the arrangement is commercial; and
- The TD need to state it does not apply to a genuine conduit financing arrangement that is used for thin capitalisation (Division 820) purposes.

Please refer to the Appendix for our detailed discussion. If you have any queries, contact me at jenny.wong@cpaaustralia.com.au or Bill Leung, Tax Technical Advisor at bill.leung@cpaaustralia.com.au.

Yours sincerely,

Jenny Wong
Tax Policy Lead

Appendix

Detailed discussion

Introduction

Subdivision E of Division 7A of the Income Tax Assessment Act 1936 (ITAA 36) contains the section relating to the provision of guarantees by private companies, sections 109U. Section 109U is intended to prevent Division 7A from being circumvented by structuring a loan through a company with no (or little) distributable surplus, the repayment of which is guaranteed or secured by a private company with distributable profits. If a number of conditions are satisfied, then Division 7A operates as if the company with distributable profits makes a payment to a shareholder (or their associate). The amount of the deemed payment is determined by the Commissioner of Taxation. That amount is then reduced by the amount of the interposed company's distributable surplus adjusted for other amounts taken to have been paid as dividends by the interposed company. In determining the amount of the deemed payment, the Commissioner can take into account a wide range of factors.

The current draft of TD 2024/D3 does not reference or give emphasis to section 109(b) in paragraph 10. In determining if Section 109U is triggered it is also important to have regard to section 109U(1)(b):

(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

If there is no attempt to circumvent Division 7A and no aggravating factors, then the amount to the deemed payment could be nil.

General comments

Overall, we are concerned with the approach taken by the ATO under TD 2024/D3 does not certainty for legitimate guarantee arrangements. In most private groups, entities, including corporates, would generally be required to provide security that will fall within the definition of s109U. As an example, a "FinCo" entity established will fall foul of the TD. We submit that the view provided by the ATO in the TD could be better targeted to the arrangements of concern instead of taking a blanket approach with no guidance and examples for legitimate arrangement to assist taxpayers self-assess their position. The view also prevents the "conduit financing" expanded test under the new thin capitalisation rules under Division 820 of the ITAA 97 for all middle market taxpayers, as they will fail s109U under the ATO's interpretation, where the FinCo is a company and the borrower is a trust.

To address our concerns, the ATO could:

- provide a link to **TD 2011/16** in the binding section and saying that those factors can be used if the arrangement is commercial; and
- provide that TD does not apply to a genuine conduit financing arrangement that is used for thin capitalisation (Division 820) purposes.

Detailed comments

There will be many private groups that use a FinCo that undertakes commercial borrowings from banks and on lends to group entities such as trusts where the banks require security or guarantees from the other companies in the group. Even if the FinCo lends on Division 7A terms, there is no clear comfort from TD 2024/D3 that section 109U will not apply and result in a deemed dividend. This gives rise to significant uncertainty for taxpayers trying to self-assess their position.

In contrast, where the FinCo has a distributable surplus, this issue does not arise, as the requirement in section 109U(1)(d) will not be satisfied. You would simply be able to rely on section 109N as a basic exception to section 109D. But where the FinCo is a pass-through entity with minimal retained earnings, then 109U can apply with no clear safe harbour. It is somewhat unfair that if you have a FinCo with retained earnings then you can get certainty about any Division 7A risk by making loans on Division 7A terms, but a FinCo that has no distributable surplus cannot be assured of no deemed dividend for its borrowers, even if it lends out on complying terms.

The problem with section 109U is that it deems section 109V to apply (being a notional payment), rather than section 109W to apply (being a notional loan).

When a taxpayer has standard back-to-back loans (e.g., A Co lends to B Co which on-lends to C Trust), the application of section 109T gives rise to a notional loan under section 109W. Where the last leg is a complying loan, section 109X works to make the section 109N exception apply to the section 109W notional loan.

Due to section 109U deeming section 109V (rather than section 109W) to apply, taxpayers cannot rely on section 109X as there is no section 109X exception for the purposes of section 109V. Instead, taxpayers have to rely on the Commissioner's determination of the amount of the notional section 109V payment.

In TD 2024/D3, the ATO refers to a compliance approach in very general terms:

> *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*

The TD should instead include binding comments and examples such as those that were included in TD 2011/16 to give certainty to taxpayers. Similar to TD 2011/16, where the final stage is a complying Division 7A loan for which annual repayments are being made where the borrower has capacity to repay and is not forgiven, the ATO should include binding comments that the Commissioner will determine the amount of any notional payment under 109V as nil.

This would be consistent with comments made in the **Taxpayer Alert 2024/2** which says that it applies where one of the "typical features" of the arrangement is that:

- Lending Co. pays or loans some or all of the amount borrowed to the shareholders of Trading Co. (or the shareholders' associates). If Lending Co. does make a loan, the loan does not comply with the requirements of section 109N.

This seems to recognise that a section 109N loan to a target entity is not an arrangement of concern for the ATO. If this is the position of the ATO we think it still should be included as a safe harbour in the binding part of the TD at a minimum.

Furthermore, the ATO should go further to address situations such as those where taxpayers are seeking to comply with the conduit financing rules in the new thin capitalisation rules in Division 820. These require the conduit financer (i.e., the FinCo) to lend out to associates on essentially the same terms as they borrowed from third parties (refer to section 820-427C(1)(d). If a FinCo borrows from a bank, they must on-lend the amounts on the same terms. As banks would generally not lend on Division 7A terms, the FinCo would need to loan out to its related parties on non-complying terms. In such situations, section 109V should also be applied in a way that the amount of any notional payment is nil unless there are any artificial or contrived features (e.g., such as where the intention of the parties, or the practical inability or lack of willingness to ever repay the loan, is such that the FinCo will default and the bank will call on the guarantee).