TD 2008/D2 - Income tax: Division 7A of Part III of the Income Tax Assessment Act 1936 - what is the meaning of 'because' in the context of the expression 'because the entity has been such a shareholder or associate at some time' in relation to payments, loans and debt forgiveness with former shareholders of a private company?

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This document has been finalised by TD 2008/14.

Draft Taxation Determination

Income tax: Division 7A of Part III of the *Income Tax Assessment Act 1936* – what is the meaning of 'because' in the context of the expression 'because the entity has been such a shareholder or associate at some time' in relation to payments, loans and debt forgiveness with former shareholders of a private company?

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Ruling

1. In this context 'because' means by reason that. The reason must be a real and substantial reason for the payment, loan or forgiveness concerned,[1] even if it is not the only reason or not the main reason for the transaction.

2. The test for determining whether the event falls within the relevant provisions of Division 7A is a reasonable person's conclusion which is an objective test requiring a weighing up of all the circumstances to determine whether the reason is real and substantial.

[1] See paragraph 109C(1)(b) (payments), subparagraphs 109D(1)(d)(ii) and 109D(1A)(d)(ii) (loans) and paragraph 109F(1)(b) (debt forgiveness) of the *Income Tax Assessment Act 1936*. All legislative references in this draft Determination are to the *Income Tax Assessment Act 1936* unless otherwise stated.

Date of effect

3. When the final Determination is issued, it is proposed to apply both before and after its date of issue. However, the final 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 the final Determination (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

Example 1

4. *Jenny was a significant shareholder and an employee of a private company but then ceased to be a shareholder, director or employee of the company. She was also then no longer an associate of any of the current shareholders. The remuneration paid to Jenny during her employment was less than that paid to arm's length employees undertaking similar work.*

5. *While Jenny was a shareholder the company made a loan to Jenny. Similar loans were not made to persons who were employees only. (Assume that, because of its features, the loan itself did not attract the operation of section 109D or 109E.)*

6. *The loan was not fully repaid when Jenny sold her shares in the company and ceased employment.*

7. *When Jenny announced her intention to retire, it was proposed that the amount owed by Jenny to the company be forgiven. Jenny realised that Division 7A would apply if the debt were forgiven while she was still a shareholder, regardless of the reason for the forgiveness.*[2] *Jenny arranged with the new owner for the loan to be forgiven after she sold her shares, and this duly occurred.*

8. *A reasonable person would conclude, having regard to all the circumstances and particularly to the arrangement made between Jenny and the new owner in the course of negotiating the sale of Jenny's shares, that a real and substantial reason for the forgiveness of the debt was that Jenny had been a shareholder of the company. This is so even though a reasonable person might also conclude that another reason for the forgiveness was that Jenny had previously been an employee of the company, in that the forgiveness was perhaps in partial recognition of services previously rendered by Jenny as an employee.*

9. *Therefore, the condition in paragraph 109F(1)(b) is satisfied and a dividend is taken to have been paid.*

Example 2

10. *Company A is a private company which owns a major business in a small rural community. The business was established and operated by a local family with the shareholders being the husband, wife and their two children – Richard and Sarah. All were involved in running the business, either as directors or employees.*

11. *To encourage local sport, Company A had a history of making payments to promising local junior sportspersons competing in State competitions to help defray travel and accommodation costs. No sponsorship was involved.*

[2] See paragraph 109F(1)(a).

12. *During the 2005-06 income year all of the shares in Company A were sold to persons who were not associates of the local family members. Family members ceased being directors.*

13. *In the 2007-08 income year three promising junior athletes from the community are selected to represent the region in a series of State-wide events. Company A makes a payment to a parent of each of the three juniors to help cover the junior athletes' travel and accommodation costs. Each parent receives the same amount: $1,000.*

14. *One of the parents receiving the payment is Richard, a former shareholder in the company. Given the circumstances, a reasonable person would not conclude that the payment is made to Richard because he was a shareholder at some time. The reason for the payment is Richard's child's promise as an athlete. There is nothing to indicate that Richard's former status as a shareholder is a real and substantial reason for the payment.*

15. *Therefore, the condition in paragraph 109C(1)(b) is not satisfied and Division 7A does not apply to the payment.*

Example 3

16. *The facts are the same as those in Example 2 except that:*

- *Richard's child is not a promising athlete and is below the standard usually applied in making the payments; and*
- *the travel and accommodation costs Company A is told will be incurred by Richard for his son relate to a family travel itinerary with destinations not all of which relate to the son's sporting endeavours.*

17. *Having regard to these circumstances a reasonable person would conclude that a real and substantial reason for the payment to Richard is that he was a shareholder at some time.*

18. *Therefore, the condition in paragraph 109C(1)(b) is satisfied and a dividend is taken to have been paid to Richard.*

Commissioner of Taxation
27 February 2008

Appendix 1 – Explanation

This Appendix 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.

Explanation

19. Division 7A may apply to a payment or loan made to an entity, or a debt forgiven in favour of an entity, by a private company, if either:

- the payment, loan or forgiveness occurs when the entity is a shareholder in the private company or an associate of such a shareholder; or
- a reasonable person would conclude (having regard to all the circumstances) that the payment, loan or forgiveness occurs because the entity has been a shareholder of the company or an associate of such a shareholder at some time.

20. In these circumstances, a dividend is taken to have been paid to the entity. For convenience the following discussion focuses on paragraph 109C(1)(b) which deals with payments but the reasoning applies equally to subparagraphs 109D(1)(d)(ii) and 109D(1A)(d)(ii) and paragraph 109F(1)(b), which are the equivalent provisions dealing with loans and debt forgiveness.

21. Paragraph 109C(1)(a) applies if a taxpayer is a shareholder, or an associate of a shareholder, when a payment is made. No causal relationship between the payment and the entity's status as a shareholder or associate is required.

22. Paragraph 109C(1)(b) does require a causal relationship. The word 'because' is not defined in the *Income Tax Assessment Act 1936*. It is defined in *The Australian Oxford Dictionary*, 1999, Oxford University Press, Melbourne as 'for the reason that; since'. This directs attention to the question of whether the fact that the entity was in the past a shareholder or associate is *a reason* for the payment being made.

23. However, the Commissioner considers that to be a cause of the payment, a reason must be real and substantial and not merely remote or insignificant. Whether a reason is real and substantial is a question of fact and degree determined on balance, according to the facts and circumstances.

24. In some cases it may be reasonable to conclude that there is more than one reason for the payment being made. The Commissioner considers that, as a matter of ordinary language, an event may occur *because of* a particular circumstance even if it also occurs because of one or more other circumstances.

25. Semantically there may be some room to argue that 'because' instead directs attention only to identifying the sole or dominant cause of the relevant event. However, the Commissioner considers that is not the most natural reading of the provision and that in any case the context of the provision supports the broader view of the matter.

26. Paragraph 109C(1)(b) prevents the operation of the primary rule in paragraph 109C(1)(a) from being avoided simply by ending the relevant shareholding or association before making a payment. Given the breadth of paragraph 109C(1)(a), which as mentioned above requires no causal relationship between the making of the payment and the entity's status, the Commissioner considers it appropriate to take a broad view of the rule in paragraph 109C(1)(b) that is intended to support its operation. In particular, it would tend to make paragraph 109C(1)(b) ineffective if the existence of some other reason for a payment were enough to prevent the paragraph from applying. In other words, because paragraph 109C(1)(b) is there to stop people contriving ways to avoid paragraph 109C(1)(a), paragraph 109C(1)(b) in turn should be interpreted in a way that makes it relatively difficult to avoid, including by means of further contrivances.

27. In conclusion therefore, the existence of multiple reasons for a transaction does not prevent a reasonable person from concluding that the payment, loan or debt forgiveness occurred because the entity has been a shareholder or associate at some time. For the purposes of paragraph 109C(1)(b), subparagraphs 109D(1)(d)(ii) and 109D(1A)(d)(ii) and paragraph 109F(1)(b) it is sufficient that a reasonable person would conclude (having regard to all the circumstances) that a real and substantial reason for a transaction occurring is that the entity was a shareholder, or an associate of a shareholder, at some time.

Appendix 3 – Your comments

28. We invite you to comment on this draft Determination. Please forward your comments to the contact officer by the due date. (Note: the Tax Office prepares a compendium of comments for the consideration of the relevant Rulings Panel or relevant Tax officers. The Tax Office may use a version (names and identifying information removed) of the compendium in providing responses to persons providing comments. Please advise if you do not want your comments included in the latter version of the compendium.)

Due date:	**28 March 2008**
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References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 2006/10

Subject references:

- deemed dividends
- disguised dividends
- dividends

Legislative references:

- ITAA 1936 Pt III Div 7A
- ITAA 1936 Pt III Div 7A Subdiv B
- ITAA 1936 109C(1)(a)
- ITAA 1936 109C(1)(b)
- ITAA 1936 109D
- ITAA 1936 109D(1)(d)(ii)
- ITAA 1936 109D(1A)(d)(ii)
- ITAA 1936 109E
- ITAA 1936 109F(1)(a)
- ITAA 1936 109F(1)(b)

Other references:

- The Australian Oxford Dictionary, 1999, Oxford University Press, Melbourne

ATO references

NO: 2007/7256
ISSN: 1038-8982
ATOlaw topic: Income Tax ~~ Tax integrity measures ~~ private company distributions