

July 2010

Costly company guarantee

This article appeared in this month's edition of the Law Society Journal (NSW).

Elyse and Oscar operate a successful nursery business through their family trust. They have come to see you as they have decided to expand the business and open a second shop.

The business has been in Oscar's family for many years and operates from a premises owned by a family company Oscar inherited from his parents when he took over running the business. Up until the proposed expansion the business had no debt.

You recommend to Elyse and Oscar that it is often a good idea, if possible, to keep business and personal assets separate, and that, instead of providing their house as security for the loan required to fund the expansion, they could use the business premises.

They like the idea and, after speaking to their bank call you to tell you that their bank has approved the finance, but that they need to see you to have the guarantee explained and to sign all the loan documents.

You review the documents and explain that, although the family trust is borrowing the money, the guarantee has a clause saying the company is primarily liable for the debt along with the family trust. You tell them this is a fairly standard guarantee clause and nothing to worry about.

The sting

The family trust must include the amount of the loan as an unfranked (and unfrankable) dividend under Division 7A of Part III of the *ITAA1936* in its next tax return.

Section 109UA Certain Liabilities Under Guarantees Treated As Payments states:

"Section 109T (about payments by companies to their shareholders and associates) 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 to 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.

In the above example the company is treated as making a payment to the family trust because it guaranteed a loan advanced by the bank to the family trust and the liability of the company was not contingent on any default by the family trust borrower.

Section 109UT does not require a payment to be made and deems that a payment has been made if the company has an immediate liability under the guarantee, as is the case here.

Division 7A is also a self activating provision (unlike the former s.108 which required the Commissioner to exercise his discretion) so the family trust has a positive legal obligation to include the deemed dividend in its taxable income, otherwise penalties and interest will apply.

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Section 109UA(3) *ITAA 1936* gives the Commissioner a discretion to not treat the loan amount as a dividend if he is satisfied that:

1. the borrower would suffer hardship because of the dividend; *and*
2. when the borrower entered into the loan with their bank they had the capacity to pay the loan.

Very often it is the case that the borrower, being the trading entity, cannot repay the loan when it is first taken out. This is the very reason why the extra guarantee security is required.

It is always prudent to make sure all guarantees given by companies are contingent (that is, require a default by the borrower before creating a liability for the company) rather than rely on the exercise of the Commissioners discretion.

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