



Taxation Determination

Income tax: if a private company makes a loan to a shareholder or their associate in an income year and the loan has not been fully repaid, what elements of the loan agreement need to be in writing for the purposes of paragraph 109N(1)(a) of Division 7A of Part III of the *Income Tax Assessment Act 1936*?

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Ruling

1. The entire agreement between the parties must be in writing including:
 - the names of the parties;
 - the loan terms (that is the amount of the loan and the date the loan amount is drawn, the requirement to repay the loan amount, the period of the loan and the interest rate payable);
 - that the parties named have agreed to the terms; and
 - when the written agreement was made, for example the date it was signed or executed,

for the purposes of paragraph 109N(1)(a) of the *Income Tax Assessment Act 1936*.¹ An agreement that is partly oral and partly in writing is not an agreement in writing for the purposes of this paragraph.

¹ All legislative references in this Determination are to the *Income Tax Assessment Act 1936* unless otherwise stated.

2. However, while these essential elements may be contained in a formal written loan agreement between the private company and the shareholder or associate, the requirement for the agreement to be in writing would also be sufficiently satisfied if there is written confirmation of the existence of the agreement and the essential elements. For example, an exchange of letters, emails, fax, or other means of communication would be sufficient if they are dated and provide written evidence of the terms of the agreement and the parties' acceptance of those terms.
3. If a formal written loan agreement between the parties does not contain all the essential elements, the requirement of paragraph 109N(1)(a) may still be satisfied provided there is supporting written evidence of the remaining elements of the agreement between the parties.
4. The essential elements of the agreement need to be in writing before the company's lodgment day for the income year in which the loan was made (or at the time of making the loan for the 2003-04² and earlier income years). If the loan is fully repaid before the company's lodgment day (or by the end of the income year for the 2003-04 and earlier income years), section 109N does not need to be considered in relation to that loan.

Previous Rulings

5. This Determination replaces Taxation Determination TD 2004/86 which was withdrawn on and from the issue date of the draft version of this Determination. To the extent that our views in TD 2004/86 still apply, they have been incorporated in this Determination.

Example 1

6. *On 10 August 2006 Joe Star, a shareholder in a private company took out a loan of \$22,000 from the company. The term of the loan was to be for three years at a commercial interest rate.*
7. *Before the company's lodgment day for the 2006-07 income year, Joe and the company executed a formal written loan agreement that set out the agreed terms of the loan. The written agreement specified their names, the amount of the loan, the date the loan funds were paid to Joe, the dates for repayment by Joe of amounts of the loan principal, and that the applicable interest rate was set at the benchmark interest rate referred to in subsection 109N(2) for each of the income years after the loan was made. The agreement was signed and dated by Joe and the appropriate delegate of the company.*
8. *The formal written loan agreement would satisfy paragraph 109N(1)(a) because it specifies all of the essential elements and was in writing before the company's lodgment day for the income year in which the loan was made.*

² However, PS LA 2005/3 (GA) sets out an administrative concession under which taxpayers, in specified circumstances, may have until the private company's lodgment day for the 2003-04 income year to meet the repayment or written loan documentation requirements for loans made in that income year.

Example 2

A written agreement after the end of the income year covering several loans made during the year

9. *Greg is a shareholder in a private company, CC Pty Limited. The company paid several amounts to Greg by way of loan during the income year ending 30 June 2007. The company's bank statements showed the amounts and dates of each loan and these amounts were recorded by the company as entries in Greg's Drawings account. The company also recorded loan repayments made by Greg and a dividend paid to Greg in the same account. As there was a possibility that some of the loans would not be fully repaid before the company's lodgment day for its 2006-07 income tax return, Greg and the company decided to put the loan agreement in writing.*

10. *A written agreement was signed and dated by the parties before the company's lodgment day for the 2006-07 income year. It specified that:*

- (a) the term of each loan recorded in Greg's Drawings account with CC Pty Limited for the year ended 30 June 2007 is seven years from and including the date the loan amount was paid or credited to Greg or such shorter time period as the parties may agree; and*
- (b) interest is payable at the benchmark interest rate worked out under subsection 109N(2) for the 2007-08 and later income years.*

11. *For each loan, the formal written agreement together with the Drawings account contain the essential elements of the loan agreement for the purposes of paragraph 109N(1)(a).*

Example 3

A written agreement at the beginning of the income year that facilitates several loans during the year

12. *On 1 July 2007 a private company LMN Pty Limited (LMN) and one of its shareholders, Z, executed and dated a formal written facility agreement to cover all loans to be made by LMN to Z during the 2007-08 income year that are not repaid before LMN's lodgment day for that income year. The written agreement specified that:*

- (a) it applies to each amount paid by LMN to Z during the income year ended 30 June 2008 other than remuneration for services rendered by Z, payments of dividends and debts owed by LMN to Z, and amounts to the extent they have been repaid before LMN's lodgment day for that income year;*
- (b) Z is required to make annual repayments, and the balance owing by Z at LMN's lodgment day for the 2007-08 income year is to be fully repaid by 30 June 2014;*
- (c) interest is payable at the benchmark interest rate worked out under subsection 109N(2) for each of the income years after the loan amounts were advanced; and*
- (d) the amounts paid to Z are recorded in the private company's accounts as loans to the shareholder.*

13. *Although the formal written agreement does not specify the amounts lent, it clearly identifies the amounts covered by the terms of the agreement, and the company's accounts record the amounts subject to the agreement. It also includes the names of the parties, the date it was executed, the interest rate and the period of the loans. Therefore, for each loan, all the essential elements of the loan agreement are in writing for the purposes of paragraph 109N(1)(a).*

Example 4

A loan made pursuant to a clause in a private company's constitution

14. *The constitution of private company EFG Pty Limited (EFG) contains a clause setting out the terms and conditions under which loans may be made to its shareholders.*

15. *The clause provides for the maximum term of the loan to be seven years and that the rate of interest payable each year after the year of income in which the loan is made will be the Division 7A benchmark interest rate required by subsection 109N(2).*

16. *On 1 July 2007, EFG and one of its shareholders, Bob, agree in writing that all loans by EFG to Bob in the 2007-08 income year will be governed by the clause in the constitution of EFG and the loan transactions will be recorded in the shareholder loan account of Bob in the general ledger of EFG.*

17. *Bob borrows amounts from EFG each month during the 2007-08 income year and the amounts and dates are recorded in Bob's loan account before EFG's lodgment day for that income year.*

18. *Membership of the company in itself does not mean that Bob will be bound by the loan clause in the constitution. The contract between a borrower and lender is a separate agreement constituted once the loan is advanced to Bob and it is agreed that it is on the terms in the clause in the constitution.*

19. *In this case, EFG and Bob have agreed in writing that the loans are on the terms in the loan clause in the company's constitution and all other essential elements of the agreement are in writing. Therefore the requirement of paragraph 109N(1)(a) is met.*

Date of effect

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

Appendix 1 – Explanation

❶ *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.*

Legislative context

21. Division 7A is an integrity provision aimed 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. In particular, where an amount of a loan from a private company to a shareholder (or their associate) is not repaid before the company's lodgment day for the income year in which the loan was made, that amount is, unless the loan comes within specified exclusions, treated as an assessable dividend to the extent that there are realised or unrealised profits in the company.³

22. If a loan meets the criteria of section 109N, a deemed dividend will not arise in the year of income in which the loan is made. Subsection 109N(1) requires that:

- (i) the agreement that the loan is made under is in writing before the company's lodgment day⁴ for the year of income;
- (ii) 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;⁵ and
- (iii) the term of the loan does not exceed the maximum term for that kind of loan – 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.⁶

23. Under the law applying for the 2003-04 and earlier income years, a written loan agreement is required to be in place at the time the loan is made, if the loan is not fully repaid by the end of the private company's income year.⁷

Loan Agreement

24. The general meaning of 'agreement' was discussed in *Re Symon, Public Trustee v. Symon* [1944] SASR 102, where Mayo J said at 110:

'Agreement'...signifies primarily a contract, that is, a legally binding arrangement between two or more persons, by which rights are acquired by one or more to acts or forbearances on the part of the other or others.

³ Section 109D.

⁴ In Division 7A, the lodgment day is the earlier of the due date for lodgment and the date of lodgment of the private company's income tax return for the year of income in which the loan is made (subsection 109D(6)).

⁵ The benchmark interest rate is the Indicator Lending Rates – Bank variable housing loan interest rate, last published by the Reserve Bank of Australia before the start of the year of income, unless the regulations provide for working out the rate (subsection 109N(2)).

⁶ Subsection 109N(3). However, if a loan is refinanced by a new loan, the maximum term of the new loan is reduced if subsection 109N(3A) or 109N(3C) applies.

⁷ However, PS LA 2005/3 (GA) sets out an administrative concession under which taxpayers, in specified circumstances, may have until the private company's lodgment day for the 2003-04 income year to meet the repayment or written loan documentation requirements for loans made in that income year.

25. In *Commissioner of Taxation v. Radilo Enterprises Pty Ltd* 97 ATC 4151 at 4161; (1997) 34 ATR 635 at 646 the joint judgment of Lehane and Sackville JJ refers to Dr Pannam's description of a loan of money:

A loan of money may be defined, in general terms, as a simple contract whereby one person ('the lender') pays or agrees to pay a sum of money in consideration of a promise by another person ('the borrower') to repay the money upon demand or at a fixed date. The promise of repayment may or may not be coupled with a promise to pay interest on the money so paid. The essence of the transaction is the promise of repayment. As Lowe J put it in a judgment delivered on behalf of himself and Gavan Duffy and Martin JJ: "Lend' in its ordinary meaning in our view imports an obligation on the borrower to repay.' (*Ferguson v. O'Neill* [1943] VLR 30 at 32.) Without that promise, for example, the old *indebitatus* count of money lent would not lay [sic]. Repayment is the ingredient which links together the definitions of 'loan' to be found in the Oxford English Dictionary, the various legal dictionaries and the text books. In essence then a loan is a payment of money to or for someone on the condition that it will be repaid.

CL Pannam, *The Law of Money Lenders in Australia and New Zealand* (1964) at 6. See also *Brick and Pipe Industries Ltd v. Occidental Life Nominees Pty Ltd* (1990) 9 ACLC 324, at 357-358; [1992] 2 VR 279, at 321-323, per Ormiston J.

26. A loan for the purposes of Division 7A is defined in subsection 109D(3) as including:

- (a) an advance of money;
- (b) a provision of credit or any other form of financial accommodation;
- (c) an amount paid for, on account of, on behalf of, or at the request of, a shareholder or associate, if there is an express or implied obligation to repay the amount; and
- (d) a transaction that in substance effects a loan of money.

27. Although this is a broad definition, the essence of such transactions is an obligation to repay an amount of money.

28. In the context of section 109N, there must be a binding agreement for the repayment of the amount of the loan by the shareholder or associate. The amount of the loan and a binding obligation to repay it are essential elements of a loan agreement. Whether or not there is a binding obligation to repay a loan depends on the facts.

29. Where a private company's constitution includes a clause that sets out the terms and conditions under which a loan may be made to a member, membership in itself does not mean a member will be bound by this clause. Where the loan agreement between the member and the company is implied partly from the company's constitution and partly from the conduct of the parties, it is not a deemed contract under section 140 of the *Corporations Act 2001* created as a consequence of a person becoming a member. Rather as in *Bailey v. New South Wales Medical Defence Union Ltd*⁸, the contract between the member and the company is a separate agreement within the meaning in paragraph 24 of this Determination between a borrower and a lender. Such a contract will only be fully constituted after the shareholder receives a loan from the company based on the terms set out in the loan clause.

⁸ (1995) 184 CLR 399.

30. Having regard to the purpose of Division 7A and context of section 109N, the agreement is required to be in writing to ensure that written evidence exists before the private company's lodgment day (or at the time of making the loan for the 2003-04 and earlier income years) verifying that the borrower has a binding obligation to repay the loan and that the parties are bound to loan terms that satisfy the minimum interest rate and maximum term requirements in section 109N.

31. Therefore, for the purposes of section 109N, the amount of the loan, the binding obligation to repay the loan, the interest payable and the period of the loan are essential elements of the agreement that are required to be in writing. These essential elements need to be in writing before the private company's lodgment day for the income year in which the loan is made (or at the time of making the loan for the 2003-04 and earlier income years). It is not sufficient if only some of these essential elements are in writing.

In writing

32. Section 25 of the *Acts Interpretation Act 1901* defines writing as 'In any Act, unless the contrary intention appears:...**writing** includes any mode of representing or reproducing words, figures, drawings or symbols in a visible form'.

33. In *McNamara Business & Property Law v. Kasmeridis & Anor* [2005] SASC 269, the Full Court after referring to the equivalent definition⁹ in the *Acts Interpretation Act 1915* (SA) said at paragraphs 60 and 61:

...In the context of forming agreements, this definition encompasses the situation where a document is physically signed by parties to acknowledge their acceptance of its terms, but also extends beyond this method of entering into a contract.

The statutory requirement that an agreement be made in writing is sufficiently satisfied if there is written confirmation of the existence of an agreement.

34. Similarly, for the purposes of section 109N, the requirement for a loan agreement to be in writing will be satisfied if there is:

- a formal written loan agreement containing all the terms of the loan and it is signed and dated by the parties, or
- there is written confirmation of the existence of the loan agreement and its essential terms, for example, an exchange of letters, emails, fax, or other means of communication if they are dated and provide written evidence of the terms of the agreement and the parties' acceptance of those terms.

It would not be sufficient if an exchange of documentation, such as letters, only amounts to negotiations or if the agreement is partly oral and partly in writing.

⁹ Writing 'includes any visible form in which words may be reproduced or represented'.

35. All the essential elements of a loan agreement may be in writing even though the actual amount drawn down is not specified in the formal written agreement that sets out the loan terms. However, there must be some written evidence before the private company's lodgment day (or at the time of making the loan for the 2003-04 and earlier income years) that a payment or crediting of an amount to the shareholder or associate on a particular date was made under the terms of the formal written agreement. An example of this is where a formal written loan agreement states that its terms apply to all amounts lent to the shareholder during the income year and those amounts are recorded in the private company's accounts as loans to the shareholder. Another example is where a formal written loan agreement sufficiently identifies the transactions it applies to, for instance to every payment made by the company to the shareholder's personal credit card account. This ensures that there is not merely an oral agreement, without supporting written material, that the terms in the formal written agreement apply to the amount paid to the shareholder or associate.

36. The written evidence must be dated in order to verify whether the loan agreement was in writing before the private company's lodgment day (or at the time of making the loan for the 2003-04 and earlier income years).

37. To satisfy paragraph 109N(1)(a) it is not essential for a written loan agreement to specify yearly repayment amounts or how these are calculated. However, a deemed dividend may arise under section 109E in income year(s) after the loan is made if a minimum yearly repayment or repayments that satisfy section 109E are not made in respect of the amalgamated loan that incorporates the loan.¹⁰

¹⁰ The loan being a constituent loan in terms of subsection 109E(3).

References

Previous draft:

TD 2007/D19

Related Rulings/Determinations:

TR 2006/10

Previous Rulings/Determinations:

TD 2004/86

Subject references:

- Division 7A
- loan agreements
- shareholder loans
- written agreements

Legislative references:

- ITAA 1936 Pt III Div 7A
- ITAA 1936 109D
- ITAA 1936 109D(3)
- ITAA 1936 109D(6)
- ITAA 1936 109E
- ITAA 1936 109E(3)
- ITAA 1936 109N
- ITAA 1936 109N(1)
- ITAA 1936 109N(1)(a)
- ITAA 1936 109N(2)
- ITAA 1936 109N(3)
- ITAA 1936 109N(3A)
- ITAA 1936 109N(3C)
- TAA 1953

- Acts Interpretation Act 1901 25
- Acts Interpretation Act 1915 (SA)
- Corporations Act 2001 140

Case references:

- Bailey v. New South Wales Medical Defence Union Ltd (1995) 184 CLR 399; 132 ALR 1; 69 ALJR 890; 13 ACLC 1,698
- Brick and Pipe Industries Ltd v. Occidental Life Nominees Pty Ltd (1990) 9 ACLC 324; (1990) 3 ACSR 649; [1992] 2 VR 279
- Commissioner of Taxation v. Radilo Enterprises Pty Ltd (1997) 22 ACSR 727; (1997) 142 ALR 305; (1997) 97 ATC 4151; (1997) 34 ATR 635; (1997) 72 FCR 300
- Ferguson v. O'Neill [1943] ALR 51; [1943] VLR 30
- McNamara Business and Property Law v. Kasmeridis & Anor (2005) 92 SASR 382; [2006] ALMD 596; [2005] SASC 269
- Re Symon, Public Trustee v. Symon [1944] SASR 102

Other references:

- Indicator Lending Rates – Bank variable housing loan interest rate, Reserve Bank of Australia
- PS LA 2005/3 (GA)

ATO references

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