


TD 2007/D17 - Income tax: if a private company provides trade credit to a shareholder (or their associate) on the usual terms it gives to parties at arm's length, will a failure by the shareholder (or their associate) to repay the amount within the agreed payment term prevent section 109M of the Income Tax Assessment Act 1936 from applying?

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This document has been finalised by TD 2008/1.



Draft Taxation Determination

Income tax: if a private company provides trade credit to a shareholder (or their associate) on the usual terms it gives to parties at arm's length, will a failure by the shareholder (or their associate) to repay the amount within the agreed payment term prevent section 109M of the *Income Tax Assessment Act 1936* from applying?

❶ This publication provides you with the following level of protection:

This publication is a draft for public comment. It represents the Commissioner's preliminary view about the way in which a relevant taxation provision applies, or would apply to entities generally or to a class of entities in relation to a particular scheme or a class of schemes. You can rely on this publication (excluding appendixes) to provide you with protection from interest and penalties in the way explained below. If a statement turns out to be incorrect and you underpay your tax as a result, you will not have to pay a penalty. Nor will you have to pay interest on the underpayment provided you reasonably relied on the publication in good faith. However, even if you don't have to pay a penalty or interest, you will have to pay the correct amount of tax provided the time limits under the law allow it.

Ruling

1. No. A failure of a shareholder (or their associate) to repay the trade debt within the agreed payment term will not prevent section 109M of the *Income Tax Assessment Act 1936* (ITAA 1936)¹ applying, provided the private company deals with the failure to repay in the same manner in which it deals with defaults on similar loans made to parties at arm's length. If the amount is fully repaid before the company's lodgment day² (or by the end of the income year for the 2003-04³ and earlier income years), section 109M does not need to be considered.

¹ All subsequent legislative references in this draft Determination are to the ITAA 1936 unless otherwise indicated.

² As defined in subsection 109D(6). The lodgment day for a private company's year of income is the earlier of:
(a) the due date for lodgment of the private company's return of income for the year of income; and
(b) the date of lodgment of the private company's return of income for the year of income.

³ Law Administration Practice Statement PS LA 2005/3 (GA) includes an administrative concession for the 2003-04 income year which allows taxpayers in specified circumstances up until the company's lodgment day to repay a loan.

Date of effect

2. 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 Ruling (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

Example 1

3. *During the 2006-07 income year a private company in the ordinary course of business sells goods on a credit basis to both shareholders and arm's length parties. The terms and conditions set out in the written credit agreements are the same, with the payment term being 60 days.*

4. *The private company's lodgment day was 28 December 2007 and at that time a shareholder, Gavin, owed the company \$2,500 for goods purchased on 31 March 2007. The company followed its normal debt collection policies and procedures in respect of the shareholder's failure to repay the trade debt on time.*

5. *Section 109M can apply because the credit is provided to Gavin in the ordinary course of the company's business and on the usual terms on which the company makes similar loans to parties at arm's length.*

Example 2

6. *The same facts as in Example 2 except the private company did not follow its usual debt collection policies and procedures. Furthermore, it had a history of allowing Gavin extra time to pay his trade debts, without following the policies and procedures it applies in respect of trade debtors at arm's length.*

7. *Section 109M does not apply because the credit is not provided to Gavin on the usual terms on which the company makes similar loans to parties at arm's length.*

Example 3

8. *A private company produces widgets which are sold on a credit basis to the trustees of the ABC Discretionary Trust and DEF Discretionary Trust. The widgets are materials used in the production of goods for sale to the general public. The shareholders of the private company are beneficiaries of both trusts and as a result the trustees of the trusts are associates of the shareholders.*

9. *The widgets are sold on similar terms and price to those sold by similar manufacturers to arm's length customers. At 30 June 2007 both trustees owed the private company for widgets purchased during the 2006-07 income year. By the company's lodgment day for 2006-07 tax return, the trustee of the ABC Discretionary Trust had fully repaid the trade debt outstanding at 30 June 2007, but the trustee of the DEF Discretionary Trust still owed an amount in respect of 2006-07 purchases.*

10. *Section 109M does not need to be considered in relation to the ABC Discretionary Trust trade debt because it was fully repaid before lodgment day.*

11. *Although the loan to the trustee of the DEF Discretionary Trust is made in the ordinary course of the company's business, section 109M does not apply because the company does not make similar loans to parties at arm's length, that is, entities that are neither shareholders nor associates of such shareholders of the company.*

Commissioner of Taxation
17 October 2007

Appendix 1 – Explanation

❶ *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

12. The provision of trade credit is a loan for Division 7A purposes because it falls within the definition of 'loan' in subsection 109D(3). A 'loan' includes:

- an advance of money;
- a provision of credit or any other form of financial accommodation;
- a payment of an amount for, on account of, on behalf of or at the request of, an entity, if there is an express or implied obligation to repay the amount; and
- a transaction (whatever its terms or form) which in substance effects a loan of money.

12. If the private company enters into commercial transactions, dealings and exchanges with entities (including a shareholder, or an associate of a shareholder of the private company), on a credit basis then there is a loan for the purposes of Division 7A.

13. Section 109M is one of the provisions in Subdivision D of Division 7A which describes the loans that are not treated as dividends under section 109D. Section 109M provides:

A private company is not taken under section 109D to pay a dividend because of a loan made:

- (a) in the ordinary course of the private company's business; and
- (b) on the usual terms on which the private company makes similar loans to parties at arm's length.

14. Subdivision D only needs to be considered if the loan is not fully repaid before lodgment day for loans made in the 2004-05 or a later year of income and by the end of the year of income for loans made in the 2003-04⁴ and earlier years of income.⁵ Therefore, if the trade debt is fully repaid before the relevant day for the income year then section 109M will have no application.

15. Paragraph 109M(a) requires the loan to have been made in the ordinary course of carrying on the private company's business. Whether it does depends on the circumstances of the case.

16. Paragraph 109M(b) requires consideration of whether there are, or have been, similar loans made to parties at arm's length. If loans are only made to parties not at arm's length (even though such loans may be made on arm's length terms), paragraph 109M(b) is not satisfied.

⁴ Law Administration Practice Statement PS LA 2005/3 (GA) includes an administrative concession for the 2003-04 income year which allows taxpayers in specified circumstances up until the company's lodgment day to repay a loan.

⁵ Subsection 109D(1).

17. In paragraph 109M(b) the phrase ‘at arm’s length’ is used. There is no reference to ‘dealing at arm’s length’ in the paragraph. The meaning of ‘at arm’s length’ is explained in the following paragraphs from Taxation Ruling TR 2006/7:

189. The phrase ‘at arm’s length’ has been considered in many courts and used in various legislative contexts. As explained by Davies J in *Re Hains (deceased); Barnsdall v. Federal Commissioner of Taxation*⁶ (*Barnsdall*) the term ‘at arm’s length’ was developed in the law with respect to transactions between persons, one of whom, such as a trustee or a solicitor, is in a position of special influence with respect to the other, a beneficiary or client. His Honour referred to the classic statement of principles found in the speech of Lord O’Hagan in *Macpherson v. Watt*.⁷

190. Davies J pointed out, however, that such cases are of little assistance in the interpretation of statutes which are concerned with taxation.⁸

191. His Honour then went on to set out the interpretation of the phrase ‘not at arm’s length’ that was provided in *Australian Trade Commission v. WA Meat Exports Pty Ltd*.⁹ This is the leading case on the meaning of the phrase ‘not at arm’s length’ in the definition of ‘prescribed associate’ in subsection 4(8) of the *Export Market Development Grants Act 1974*. The Federal Court decided in that case that the ordinary meaning of the phrase applies. After quoting legal dictionaries in order to ascertain the ordinary meaning of ‘arm’s length’,¹⁰ the Federal Court reached the conclusion that the ordinary meaning of the phrase ‘not at arm’s length’ is the circumstance where one party ‘has the ability to exert personal influence or control over the other’.¹¹

18. Whether parties are at arm’s length requires consideration of any connection between the parties and of all the relevant circumstances. In the context of Division 7A private companies, their shareholders and associates of such shareholders, have sufficient connection to not be at arm’s length.

19. For section 109M purposes it is not relevant whether a trade debt is paid outside of payment terms such as 30, 60 or 90 day terms so long as it can be accepted that the credit was provided in the ordinary course of the private company’s business and is similar to the usual arrangements made by the company with parties at arm’s length.

20. If the private company does not deal with a failure to repay on time by a shareholder (or their associate) in the same manner in which it deals with defaults of similar loans made to parties at arm’s length, then this casts doubt on whether the trade credit was provided on the usual terms on which the private company makes similar loans to parties at arm’s length.

⁶ (1988) 81 ALR 173 at 176.

⁷ [1877] 3 App Cas 254 at 266; (1988) 81 ALR 173 at 176.

⁸ (1988) 81 ALR 173 at 176. See also *Re CHK Engineering Pty Ltd and Australian Trade Commission* (1997) 45 ALD 797 at 797.

⁹ (1987) 75 ALR 287; (1988) 81 ALR 173 at 176.

¹⁰ (1987) 75 ALR 287 at 291.

¹¹ (1987) 75 ALR 287 at 291.

Appendix 2 – Your comments

21. We invite you to comment on this draft Taxation 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:	16 November 2007
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References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 2006/7; TR 2006/10

Subject references:

- deemed dividends
- disguised dividends
- dividends

Legislative references:

- ITAA 1936 Pt III Div 7A
- ITAA 1936 109D
- ITAA 1936 109D(1)
- ITAA 1936 109D(3)
- ITAA 1936 109D(6)
- ITAA 1936 Pt III Div 7A Subdiv D
- ITAA 1936 109M
- ITAA 1936 109M(a)

- ITAA 1936 109M(b)
- Export Market Development Grants Act 1974 4(8)

Case references:

- Australian Trade Commission v. WA Meat Exports Pty Ltd (1987) 75 ALR 287
- Macpherson v. Watt [1877] 3 App Cas 254
- Re CHK Engineering Pty Ltd and Australian Trade Commission (1997) 45 ALD 797
- Re Hains (deceased); Barnsdall v. Federal Commissioner of Taxation (1988) 81 ALR 173; 88 ATC 4565; 19 ATR 1352

Other references:

- PS LA 2005/3 (GA)

ATO references

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