TD 2007/D19 - Income tax: if a private company makes a loan to a shareholder or 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?

This document has been finalised by TD 2008/8.

Draft Taxation Determination

Income tax: if a private company makes a loan to a shareholder or 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*?

Ruling

1. The elements of a loan agreement that need to be in writing for the purposes of paragraph 109N(1)(a) of the *Income Tax Assessment Act 1936* (ITAA 1936)[1] are:

- 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
- the date the agreement was in writing, for example the date it was signed or executed.

[1] All legislative references in this draft Determination are to the ITAA 1936 unless otherwise stated.

2. These essential elements may be contained in a formal written loan agreement between the private company and the shareholder or associate. Alternatively, the requirement for the loan agreement to be in writing would 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 loan agreement and the parties' acceptance of those terms. It is essential that together they evidence a loan agreement.

3. The essential elements of the loan 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 2003-04[2] 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.

Previous Rulings

4. Taxation Determination TD 2004/86 is withdrawn on and from the issue date of this draft Determination. To the extent that our views in TD 2004/86 still apply, they have been incorporated in this draft Determination.

Example 1

5. *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.*

6. *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.*

7. *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

8. *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 payable 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.*

9. *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:*

- *the term of each loan recorded in Greg's Drawings account with CC Pty Limited for the year ended 30 June 2007 is 7 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*
- *interest is payable at the benchmark interest rate worked out under subsection 109N(2) for the 2007-08 and later income years.*

10. *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

11. *Under a written agreement dated 1 July 2006 between a private company LMN Pty Limited (LMN) and one of its shareholders, Z, it was specified that:*

- *loan amounts drawn by Z from the private company's bank account in the year ending 30 June 2007 are to be recorded in Z's loan account with LMN for that year;*
- *amounts so recorded in the loan account are to be repaid by Z within 5 years of the end of that income year, that is by 30 June 2012;*
- *interest is payable at the benchmark interest rate worked out under subsection 109N(2); and*
- *prior to the company's lodgment day for the 2007 income tax return, Z is to give the company written confirmation of the amounts the company lent to him during the income year under the terms of this agreement.*

12. *After the end of the year of income, but before LMN's lodgment day, Z reviews the entries in the loan account and sends an email to the company confirming that the debit entries in his loan account represent the amounts loaned under the terms of the loan agreement.*

13. *The written agreement between the parties facilitates the advancement and the recording of the loan amounts. It includes the names of the parties, the interest rate and the period of the loans, but does not specify the amounts lent. These amounts and the dates are recorded in the loan account in accordance with the written agreement, and Z gives written confirmation before the company's lodgment day for that year. Therefore, 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 on which loans may be made to its shareholders. The clause only governs loans where EFG and the relevant shareholder agree the clause will apply.*

15. *The clause specifies that where a loan is made pursuant to its terms, it will have a maximum term of 7 years and interest will be payable each year at the Division 7A benchmark interest rate required by subsection 109N(2).*

16. *On 1 July 2007, EFG makes a loan of $10,000 to Bob, and both EFG and Bob agree in writing on that day that the loan will be governed by the clause in the constitution of EFG. The loan is made by EFG drawing a company cheque payable to Bob. The date, the payee and the amount of the loan are recorded on the cheque butt and the transaction is also recorded in shareholder loan account of Bob in the general ledger of EFG.*

17. *In this case, all the essential elements of the loan agreement are in writing and therefore the requirements of paragraph 109N(1)(a) are met.*

Date of effect

18. When the final Determination is issued, it is proposed to apply both before and after its date of issue. However, the Determination will 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).

Commissioner of Taxation
14 November 2007

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.

Legislative context

19. 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]

20. 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 day[4] 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]

21. 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]

Explanation

Loan Agreement

22. 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.

23. 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.

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

- an advance of money;
- a provision of credit or any other form of financial accommodation;
- 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
- a transaction that in substance effects a loan of money.

25. Although this is a broad definition, the essence of such transactions is a repayment obligation.

26. 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.

27. Having regard to the purpose of Division 7A and context of section 109N, the loan 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.

28. 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

29. 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'.

30. In *McNamara Business & Property Law v. Kasmeridis & Anor* [2005] SASC 269, the Full Court after referring to the equivalent definition[8] 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.

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

- a written loan agreement containing 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.

32. A loan agreement may be in writing even though the actual amount drawn down is not specified in the 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 written agreement. This ensures that there is written evidence that the agreed loan terms apply to the amount paid to the shareholder or associate.

33. 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).

[8] Writing 'includes any visible form in which words may be reproduced or represented'.

Appendix 2 – Your comments

34. 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:	**14 December 2007**
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References

Previous draft:

Not previously issued as a draft

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 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)
- Acts Interpretation Act 1901 25
- Acts Interpretation Act 1915 (SA)

Case references:

- 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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