



TD 2004/86 - Income tax: if a shareholder borrows from a private company under a clause in the company's constitution setting out the terms on which such loans are to be made, is there a 'written agreement' for the purposes of paragraph 109N(1)(a) of Division 7A of the Income Tax Assessment Act 1936 ?

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 This document has changed over time. This is a consolidated version of the ruling which was published on *22 December 2004*



Taxation Determination

Income tax: if a shareholder borrows from a private company under a clause in the company's constitution setting out the terms on which such loans are to be made, is there a 'written agreement' for the purposes of paragraph 109N(1)(a) of Division 7A of the *Income Tax Assessment Act 1936*?

Preamble

*The number, subject heading, date of effect and paragraph 1 of this document are a 'public ruling' for the purposes of Part IVAAA of the **Taxation Administration Act 1953** and are legally binding on the Commissioner.*

1. Yes. If a shareholder borrows from a private company under a clause in the company's constitution setting out the terms on which such loans are to be made, there is a 'written agreement' for the purposes of paragraph 109N(1)(a) of Division 7A of the *Income Tax Assessment Act 1936* (ITAA 1936).

Background

2. A private company is taken to pay a dividend to an entity under subsection 109D(1) of the ITAA 1936, subject to section 109Y of the ITAA 1936, if:

- the private company makes a loan to the entity during the current year; and
- the loan is not fully repaid by the end of the current year; and
- the loan is not excluded by subdivision D of Division 7A of Part III of the ITAA 1936; and
- the entity is a shareholder in the private company, or an associate of the shareholder when the loan is made; or a reasonable person would conclude that the loan is made because the entity has been such a shareholder or associate at some time.

3. Subdivision D of Division 7A of the ITAA 1936 sets out rules for determining when payments and loans are not treated as dividends. Section 109N provides criteria for one of 6 categories of loans in subdivision D that are not treated as dividends.

4. For the exclusion in subsection 109N(1) of the ITAA 1936 to apply, the rate of interest on the loan must be equal to or exceed the benchmark interest rate for the year and the term of the loan must not exceed the maximum term for that kind of loan. In addition, in keeping with those requirements being verifiable, subsection 109N(1) requires that the form of the loan be a 'written agreement'.

5. The class of arrangements to which this Determination applies is where a private company includes in its constitution¹ a loan clause. The clause provides the terms on which a loan is made by the company to a member, unless varied in whole or in part by agreement between the company and the member. The clause in the constitution provides for:

- the rate of interest payable on the loan for years of income after the year in which the loan is made to equal the benchmark interest rate determined by subsection 109N(2) of the ITAA 1936; and
- the maximum term of the loan to be made in accordance with subsection 109N(3) of the ITAA 1936.

Explanation

6. 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 acts or forbearances on the part of the other or others.

7. The long held view per *Hickman v Kent or Romney Marsh Sheepbreeders Association* [1915] 1 Ch 881 is that general articles dealing with the rights of members 'as such' are a statutory agreement between them and the company as well as between the members themselves. This view is now to be found in statutory form in subsection 140(1) of the *Corporations Act 2001*.

8. Subsection 140(1) of the *Corporations Act 2001* provides that a company's constitution (if any) and any replaceable rules that apply to the company have effect as a contract between:

- the company and each member;² and
- the company and each director and company secretary; and
- a member and each other member;

under which each person agrees to observe and perform the constitution and rules so far as they apply to that person.

9. Predecessors to section 140 of the *Corporations Act 2001* have been held to mean that the contractual effect of the memorandum and articles is only in so far as they confer rights or obligations on the member in his capacity as a member: *Eley v Positive Government Security Life Assurance Co.* (1876) 1 Ex D 88. Subsection 140(1) provides for a similar limitation in that the company, members, directors and company secretary

¹Under section 1408 (Item 19) of Part 10.1 of the *Corporations Act 2001* the memorandum and articles of association of a company incorporated prior to 1 July 1998 are taken to be the company's constitution (see section 1415 of the *Corporations Act 2001*).

²A shareholder, as defined in subsection 6(1) of the ITAA 1936, includes a member.

agree to observe and perform in accordance with the constitution and rules in so far as they apply to them in that capacity.

10. The constitution provides a set of rules for the administration of the company. However, it does not exclusively regulate the relationships between the members and the members with the company. It does not preclude a member from contracting individually with the company upon terms which may or may not be defined by reference to the constitution.

11. In *Bailey v New South Wales Medical Defence Union Ltd* (1995) 184 CLR 399 it was found that the member's contractual right to indemnity could not be described as 'flowing from the general regulations of the Union as applicable alike to all shareholders'. McHugh and Gummow JJ said at 426:

In our view, the steps taken by Dr Bailey in acquiring and maintaining his position as a financial member of the Union brought about and continued a single contract which conferred upon him entitlements to the benefits of indemnity and assistance specified in Art 57 and qualified by other articles.

Further at 439 they said:

The present case did not involve a 'statutory contract' constituted solely by the articles and unsupplemented by any external facts. The particular rights to indemnity upon which the Estate sues the Union could not, consistently with *Hickman*, be described as flowing from the general regulations of the Union as applicable alike to all shareholders. The attaining of the right to indemnity had been dependent upon Dr Bailey making the necessary application for membership and the payments from time to time were fixed by the regulations as necessary for him to remain a financial member with the appropriate level of protection. Further and again consistently with *Hickman* and the cases which have followed it, the entitlement in Art 57 was not conferred upon members 'as such'.

12. In *Bailey* the High Court found that a contract of insurance did exist between the company and Dr Bailey, the terms of which were to be found 'largely but not wholly in the articles of the company',³ and that such a contract, 'may, as this case illustrates, pick up in a particular fashion provisions of the articles'.⁴

13. Where a loan clause is included in a private company's constitution setting out the terms and conditions under which a loan will be made to a member, membership in itself does not mean a member will be bound by this clause. The loan agreement between the member and the company 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* the contract between the member and the company is a separate agreement within the meaning in paragraph 6 between a borrower and lender.

14. 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.

15. Despite there not being a deemed contract under section 140 of the *Corporations Act 2001*, where a loan is made to a member and it is agreed that the terms of the loan are as specified in the relevant loan clause in the constitution, this will be sufficient to satisfy the requirement of a written agreement for the purpose of paragraph 109N(1)(a) of Division 7A of the ITAA 1936.

³ per Brennan CJ, Deane and Dawson JJ at p414.

⁴ per McHugh and Gummow JJ at p439.

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Date of effect

16. This Determination applies to years commencing both before and after its date of issue. However, it 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 the Determination (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Commissioner of Taxation

22 December 2004

Previous draft:

Previously issued as TD 2004/D65

Related Rulings/Determinations:

TR 92/20

Subject references:

- Dividends
- Loan Agreements
- Shareholder Loans

Legislative references:

- TAA 1953 Pt IVA
- ITAA 1936 6(1)
- ITAA 1936 Div 7A s109D
- ITAA 1936 Div 7A s109D(1)
- ITAA 1936 Div 7A s109N
- ITAA 1936 Div 7A s109N(1)
- ITAA 1936 Div 7A s109N(1)(a)
- ITAA 1936 Div 7A s109N(2)

- ITAA 1936 Div 7A s109N(3)
- ITAA 1936 Div 7A s109Y
- ITAA 1936 Div 7A Subdiv D
- Corporations Act 2001 s140
- Corporations Act 2001 s140(1)
- Corporations Act 2001 s1408
- Corporations Act 2001 s1408 Item 19
- Corporations Act 2001 s1415

Case references:

- Hickman v Kent or Romney Marsh Sheepbreeders Association [1915] 1 Ch 881; [1914-15] All ER Rep 900; (1915) 113LT 159
- Re Symon, Public Trustee v Symon [1944] SASR 102
- Eley v Positive Government Security Life Assurance Co. (1876) 1 Ex D 88; 34LT 190
- Bailey v New South Wales Medical Defence Union Ltd (1995) 184 CLR 399; 132 ALR 1; 69 ALJR 890; 13 ACLC 1,698

ATO references

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