TR 96/D14 - Income tax: determining the co-operative status of a lending business

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Draft Taxation Ruling
Income tax: determining the co-operative status of a lending business

other Rulings on this topic

ITR 1493; ITR 720

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What this Ruling is about

Class of person/arrangement

1. This Ruling applies to companies which carry on business on a co-operative basis and whose business activities include the making of loans to its shareholders.

2. Division 9 of the *Income Tax Assessment Act 1936* (the Act) comprises sections 117 to 121 and deals with the taxation treatment of co-operatives and mutual companies.

3. Subsection 117(1) defines the term 'co-operative company' for the purposes of Division 9. This Ruling does not consider the provisions of paragraphs (a), (b) or (c) of subsection 117(1). Omitting those paragraphs, subsection 117(1) requires that:

- the rules of the company limit the number of shares that may be held by members;
- the rules prohibit the quotation of shares for sale or purchase at any stock exchange or in any other public manner whatever; and
- that the company 'is established for the purpose of carrying on any business having as its primary object or objects one or more of the following:

  (d) the **rendering of services** to its shareholders;

  (e) the obtaining of funds from its shareholders for the purpose of making loans to its shareholders to enable them to acquire land or buildings to be used **for the**

> **purpose of residence or of residence and business**.' [emphasis added]

4. This Ruling considers the basis on which a company whose business activities include the making of loans to its members will qualify as a co-operative company within the terms of paragraph 117(1)(e).

5. The Ruling also considers whether such a company that fails to qualify under 117(1)(e) might, nevertheless, qualify as a co-operative company within the terms of paragraph 117(1)(d).

Ruling

(a) Determining the co-operative status of a company for the purposes of subsection 117(1)

6. Subsection 117(1) defines 'co-operative company' to mean a company that is, amongst other things, 'established for the purpose of carrying on any business having as its primary object or objects' one or both of the objects specified in paragraphs (d) and (e).

7. In deciding whether a company is so established, two questions need to be asked:

- In what **business or businesses** is the company engaged?
- What is the **primary object or objects** of each business?

See *Brookton Co-operative Society Ltd v FC of T* (1981) 147CLR 441; 81 ATC 4346; (1981) 11 ATR 880 (*Brookton Co-operative*).

8. Whether a company satisfies the requirements of subsection 117(1) depends upon its activities during the year of income. A company that carries on business on a co-operative basis may engage in several distinct businesses. Each of these businesses may have one or more primary object or objects. If any of those businesses have a primary object which does not come within the scope of the objects listed in paragraphs (a) to (e) of subsection 117(1), the company will not qualify as a co-operative company.

9. To determine the primary object or objects of a business it is necessary to analyse the activities carried on by the company on a year by year basis. This analysis will show that the company's status may change from year to year.

10. In looking at a company that carries on a lending business, the company's activities are best reflected by the structure of its loan portfolio. Statistics reflecting both loans outstanding at year end and loans advanced during the year will be considered. We consider that

greater emphasis should be placed on loans made during the financial year.

(b) Meaning of the expression 'residence or of residence and business' within paragraph 117(1)(e)

11. For the purposes of paragraph 117(1)(e) the term 'residence or of residence and business' is restricted to land or buildings acquired by an individual **shareholder** to be used by **the shareholder** as his/her residence or as his/her residence and business.

(c) Application of paragraph 117(1)(d)

12. Generally, a company that carries on a business for the purpose of making loans to its shareholders will not be regarded as having been established for the purpose of rendering services to its shareholders. However, if the activities of a company indicate that a primary object of its business is the rendering of services to its shareholders, the making of loans may be merely incidental to the carrying on of the business and the company will not be precluded from satisfying the requirements of paragraph 117(1)(d). This type of lending is fundamentally different from that contemplated in paragraph (e) in that the lending is not a primary object of the company. Rather, it is an integral part of the activities of the company whose primary object is to render services to its members.

13. It is not envisaged that many companies which advance funds to shareholders will satisfy the criteria required by paragraph (d).

Date of effect

14. This Ruling applies to years commencing both before and after its date of issue. However, the Ruling does 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 Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20). The application of public Rulings where a taxpayer has a private ruling is considered at paragraph 19 of the Taxation Ruling TR 92/20 and also in Taxation Determination TD 93/34.

Explanations

(a) Determining the co-operative status of a business

15. In deciding whether a company falls within subsection 117(1) two questions need to be asked:

- what business or businesses is the company carrying on; and
- what is the primary object or objects of each business?

This view was expressed in *Brookton Co-operative* by Gibbs CJ (at CLR 445; ATC 4348; ATR 882):

> 'The relevant words of s.117(1) require that two questions should be considered - first, whether the company is established for the purpose of carrying on any business, and, if so, whether such business had as its primary object or objects any one of those described in the lettered paragraphs of the sub-section.'

What business(es) does the company carry on?

16. As outlined above, the first question should be: what business or businesses is the company carrying on? Generally, there will be little difficulty in answering that question. As Mason J said in *Brookton Co-operative* (at CLR 451; ATC 4352; ATR 886):

> 'As a matter of common experience, companies are usually established for the purpose of carrying on a business. Consequently, to the question, "For what purpose is the X company established?", we expect to hear the response, "For the purpose of carrying on the business of ..." '

17. In the case of a lending co-operative, the main business would be that of obtaining funds from its shareholders and making loans to its shareholders to enable them to acquire land or buildings to be used for the purpose of residence or of residence and business.

Multiple businesses

18. Should a lending co-operative engage in several businesses, **all** must have as their primary object or objects one or more of those listed in paragraphs (a) to (e) of sub-section 117(1). This was established in *Brookton Co-operative* by Aickin J (at CLR 468; ATC 4362; ATR 897):

> 'If it embarks on or carries on two or more businesses, only one of which falls within the permitted list, then in my opinion it cannot be said to have been established, ie. brought into or kept

in operation for the purpose of carrying on the co-operative business but is so maintained for the purpose of carrying on both the permitted business and the other businesses.'

19. His Honour also said (at CLR 468-9; ATC 4363; ATR 898):

'The conclusion that if a company is maintained or kept in operation for the purpose of carrying on a co-operative business and also some other business it cannot qualify as a co-operative company under s.117 is in my opinion in accordance not only with the ordinary meaning of the words but also with the manifest purpose of the section.'

What are the primary objects?

20. The second question addressed in determining the co-operative status of a company is: what are the primary objects of the business that is being carried on? The question of which activities of a business represent its 'primary objects' is one of degree. The *Macquarie Dictionary* defines the word 'primary' as including:

'n. 1. first or highest in rank or importance; chief; principal;

2. first in order in any series, sequence, etc'

21. As stated earlier in this Ruling, a business may have several primary objects. It is necessary to determine which of the activities of a company can be identified as its core or fundamental activities. Thus, any part of a business that may be described as significant in relation to each of the other parts will be a primary object.

Multiple primary objects

22. Each business carried on by a company may have several primary objects. Indeed, it is implicit in the words of the section. This was acknowledged by remarks made in *Renmark Fruitgrowers Co-operated Ltd v. FC of T* (1969) 121 CLR 501; 69 ATC 4135; (1969) 1 ATR 385 (*Renmark Fruitgrowers*) by Menzies J (at CLR 506; ATC 4137; ATR 387):

'It is to be noticed, however, that the section makes it clear that a company's business may have a number of primary objects.'

and in *Brookton Co-operative* by Aickin J (at CLR 463-4; ATC 4360; ATR 895):

'Section 117 contemplates that there may be several primary objects of the business carried on by the company and moreover that there may be one or more secondary or subsidiary objects.'

Analysis of activities: determining the primary objects

23. In both *A & S Ruffy Pty Ltd v. FC of T* (1958) 98 CLR 637; [1958] ALR 432; (1958) 11 ATD 452 (*Ruffy*) and *Brookton Co-operative*, the High Court held that the primary objects of a business were to be judged primarily by its activities **during the year in question**. This approach was adopted in *Ruffy* and was followed by the High Court in *Brookton Co-operative* where Gibbs CJ said (at CLR 445; ATC 4348; ATR 882):

> 'The use of the present tense in the phrase "is established" makes it necessary to consider the purpose for which the company was carried on in the relevant income year, rather than at the time of its formation.'

24. In looking at a company carrying on a lending business, the company's activities are best reflected by the structure of its loan portfolio. Statistics reflecting **loans outstanding at year end and loans advanced during the year** will both be considered. As it is necessary to determine the **current** primary object or objects of the company, we consider that greater emphasis should be placed on statistics relating to loans advanced **during the year**. This emphasis is warranted because of the substantial historical bias within statistics relating to loans outstanding at year end; that is, they reflect the lending activity of many prior years as well as current year lending practices. Although the memorandum of association or other constituent documents of the company will also be considered, they should not be given the same weight as current or recent lending activities because they reflect more the reason for establishment rather than the current practices of the business.

25. Lending activity may be divided into various loan categories of differing objects such as 'owner-occupied', 'residential investment', 'personal' and 'commercial'. Subject to their relative importance, these categories may **each** represent a primary object. If any of these categories is deemed to be a primary object of the business, and it is not within the ambit of the subsection, then the company is not a co-operative for the purpose of Division 9. As Aickin J stated in *Brookton Co-operative* (at CLR 467; ATC 4362; ATR 897):

> 'If a company is kept in operation in a particular year for the purpose of carrying on a business having as its primary object one of the permitted activities and also for the purpose of carrying on some other activity or for a purpose of carrying on some other business, then it will not qualify as a co-operative company unless that other business has as its primary object one of the permitted activities.'

Distinguishing primary from secondary objects

26. It is recognised that a company may have secondary objects in conjunction with its primary objects. Secondary objects are those activities which do not impact on the overriding character of the business. They should be no more than occasional or incidental and should not impact upon the overriding character of the business. Should any of the secondary objects of a business not conform with the objects set out in paragraphs (a) to (e) of section 117(1), that will not preclude the company from satisfying the requirements of subsection 117(1). Illustrations of our view of a company's primary and secondary objects are shown in the **Examples** at the end of this Ruling.

Conflicting loan statistics

27. In the event that statistics relating to loans advanced during the year conflict with statistics relating to loans outstanding as at year end, that is they show differing primary objects, we consider that the former statistics should prevail in determining the co-operative status of a business under Division 9.

(b) Meaning of the expression 'residence' within paragraph 117(1)(e)

28. The traditional business of lending co-operatives has been to advance funds to shareholder for owner-occupied housing.

29. Subsection 117(1) of the Act is derived from section 20(1A) of the *Commonwealth Income Tax Assessment Act 1932*. The then Treasurer, the Honourable E G Theodore, in the Second Reading Speech set out the ambit of the section when he said:

> 'Some co-operative building societies at present obtain funds from their members to make loans to other members for the purpose of buying or erecting homes, or homes and business premises combined. Such organisations have hitherto been taxed on their full profits on such transactions. It is proposed to allow the deduction of interest or dividends paid on shares to members of such societies if 90 per cent of the total loans are made to members.'

30. In our view, it is clearly implicit in that statement that the legislature intended to restrict the benefits of Division 9 to those companies which make loans to its shareholders to enable them to acquire land or buildings to be used as the residence or combined

residence and business of the individual shareholders who borrow funds.

31. On the other hand, if a primary object of a company that carries on a business of lending in a particular year of income is to provide finance to its shareholders to acquire land or buildings for the purpose of selling or leasing the property acquired to other persons, the company cannot be treated as a co-operative for that income year. This will be the case even if the property is to be used by the purchaser or lessee as a residence or combined residence and business.

32. The view has been advanced that paragraph 117(1)(e) is satisfied if a company makes loans to shareholders for the purpose of acquiring land or buildings, irrespective of whether the borrowers themselves use or occupy the land or buildings acquired by such loans as their own residence or as their combined residence and business premises. It has been suggested that had the legislature intended to restrict the provision to owner-occupied premises they would have inserted the words 'the shareholder's' before the phrase 'residence or residence and business' within paragraph (e). We do not accept this interpretation.

(c) Application of paragraph 117(1)(d)

33. We consider that it may be possible, in exceptional circumstances, for a company whose business includes the making of loans to its shareholders to establish that its primary object is the rendering of services rather than the making of loans.

34. In *Employers' Mutual Indemnity Association Ltd v. Federal Commissioner of Taxation* (1943) 68 CLR 165; [1943] ALR 417; (1943) 7 ATD 307 the High Court considered whether the issue by the company of policies of insurance to its members would constitute the 'rendering of services' for the purposes of section 117 of the Act. The majority of the High Court held that a broad or general interpretation should be rejected in favour of a narrower meaning. Latham CJ expressed the view (at CLR 174; ALR 420; ATD 309):

> 'In my opinion the words "rendering of services to" persons mean doing work of some kind for those persons. **When it is the primary object of a company to do work for other persons, then it may be said that the primary object of the company is the rendering of services to such persons**. But the issuing of an insurance policy to a person cannot be described as doing work for that person. It is making a contract with him ... but the making of a contract with him does not amount to doing work for him.' [emphasis added]

35. In *The Social Credit Savings and Loans Society Ltd v. FC of T* (1971) 125 CLR 560; 71 ATC 4232; (1971) 2 ATR 612, Gibbs J

adopted a similar construction of section 117 of the Act when he stated (at CLR 568; ATC 4237; ATR 618):

> 'It would seem to me inconsistent with [the majority judgments in *Employers' Mutual Indemnity Association*] to refer to the making of a contract to lend money, or the payment of the money lent, as the rendering of services to the borrower within s. 117 (d), although to lend a man money might be regarded as rendering him a service in a broad and general sense of the word. Moreover, a comparison of the words of par. (d) with those of par. (e) strongly suggests that the making of a loan cannot be regarded as the rendering of services within the former paragraph. If the making of loans by a company to its shareholders can properly be described as the rendering of services by the company to its shareholders within par. (d), it would seem that the provisions of par. (e) were mere surplusage.'

36. However, in *Revesby Credit Union Co-operative Ltd v. FC of T* (1965) 112 CLR 564; [1965] ALR 752 (*Revesby Credit Union*) McTiernan J held that the taxpayer company in that case, which provided loans to its shareholders, was a co-operative company within the meaning of subsection 117(1) on the basis that it was established for the purpose of carrying on a business having as its primary object the rendering of services to its shareholders. The stated objects of the taxpayer company in *Revesby Credit Union* were very similar to those of the company in the *Social Credit Savings* case. His Honour appears to have placed considerable weight on the fact that, in addition to making loans, it provided its members with (at CLR 573-4; ALR 756):

> 'advice and assistance ... of a diverse and general nature, going far beyond the sort of advisory services which might be regarded as incidental to the conduct of a money-lending business, and not related at all to the supervision or collection of repayments or the assessment or enforcement of securities.'

37. His Honour pointed out that the lending of money to its members was only one of the activities of the society and said (at CLR 577: ALR 758-9):

> 'The various activities are not isolated and unrelated to each other but taken as a whole form an integrated scheme for the assistance of members in overcoming their financial problems and in particular to achieve this end by providing a ready source of cheap credit together with incidental advice and assistance as each case may require.'

38. His Honour continued (at CLR 577; ALR 759):

> 'These activities must be considered as a whole and not separately and accordingly the question is not whether the

> lending of money by itself or the giving of advice and assistance by itself is the rendering of services but whether the whole of the appellant society's activities taken together constitute "the rendering of services".'

39. His Honour concluded that the activities of the taxpayer constituted the rendering of services. He said (at CLR 578-9; ALR 760):

> 'They are more than the making of an agreement and involve positive acts, as the payment of money to the members, the giving of advice and the provision of facilities for consultation and the doing of the specific acts of assistance mentioned in the evidence. They are clearly the doing of work for the benefit of another and clearly go beyond the performance of the terms of an ordinary commercial agreement.'

40. McTiernan J in *Revesby Credit Union* appears to have placed considerable emphasis also on his conclusion that the society was not conducting itself like a commercial lending institution. He said (at CLR 577; ALR 759):

> 'The facts that in making a loan, the appellant society puts little emphasis on valuing and obtaining adequate security and that it gives loans to persons who commercially would be regarded as bad risks rather than to those who could afford to repay the loan indicates that it is not conducting itself like a money-lending institution and that its object is not mere money-lending.'

41. He also said (CLR at 579; ALR at 760):

> 'Furthermore, the facts that the appellant society is so much a co-operative organization rather than a commercial money-lender, that its effective rates of interest are lower than current market rates, and that it gives loans without regard to security and in many cases where commercial institutions would not venture to risk their money, in my view deprives the transactions of the appellant society of that commercial element which characterizes the activities of ordinary commercial and financial institutions.'

42. His views on this aspect of the case should be read in the light of the comments of Gibbs J in the subsequent *Social Credit Savings Society* case discussed below.

43. Nevertheless, it is clear from His Honour's judgment that he did not consider that, on the facts presented to him, the making of loans to members was a primary object of the business being carried on.

44. By way of contrast, in the *Social Credit Savings Society* case, Gibbs J held that the Society did not qualify as a co-operative

company because it did not have as one of its primary objects the obtaining of funds from its shareholders for the purpose of making loans to its shareholders to enable them to acquire land or buildings to be used for the purpose of residence or of residence and business. He also rejected the argument that a primary object of business of the Society was the rendering of services to its shareholders. His Honour said (at CLR 569; ATC 4237; ATR 618):

> 'In the present case it was a primary object of the business of the Society to make loans to its members. It was not, however, a primary object of the business of the Society to render services to members otherwise than by making loans to them.'

45. His Honour distinguished the *Revesby Credit Union* case, despite the fact that the stated objects of the respective taxpayers were very similar. He said (at CLR 570; ATC 4237-8; ATR 619):

> 'It may be true to say in the present case also that the Society is rather a co-operative organization than a commercial money-lender and that its transactions lack the commercial element which characterizes the activities of ordinary commercial and financial institutions and that the terms on which loans are made are such as to confer a benefit on the borrower by comparison with current market standards. These circumstances in themselves would not, in my opinion, justify the conclusion that the making of loans by the Society can be described as the rendering of services to its members within par. (d). The other matters on which McTiernan J. relied - the giving of guidance and advice and the doing of specific acts of assistance for the benefit of the members, which formed an integral part of the activities of the appellant Society in that case - are not, so far as the evidence discloses, present in this case, except either as merely incidental to the making of the loans or as isolated instances.'

46. In our view, if a company does make loans to its shareholders for purposes other than those described in paragraph (e), it will only satisfy paragraph (d) if it is shown upon an examination of its entire activities that the making of loans is not a primary object of the business being carried on, but is merely incidental to the rendering of services to shareholders.

47. We do not consider that many companies which make loans to shareholders will qualify as a co-operative company under paragraph (d).

Examples

48.

AXL LENDING SOCIETY

LOANS FOR THE 1993 FINANCIAL YEAR

LOAN CATEGORY	LOANS ADVANCED DURING THE YEAR (%) EXAMPLE 1	LOANS ADVANCED DURING THE YEAR (%) EXAMPLE 2
Owner-occupied	39	95
Residential Investment	28	2
Personal	4	1
Commercial	29	2

Example 1

49. In this example, Owner-occupied, Residential Investment and Commercial loans would all be regarded as primary objects in the current year. Personal loans would be regarded as a secondary object. On these statistics the society would have three primary objects, two of which are not within the ambit of paragraph 117(1)(e). AXL would not, therefore, be a co-operative within Division 9 and would not be eligible for deductions allowable under paragraph 120(1)(b). The same result would follow if only one of the primary objects was outside the scope of paragraph 117(1)(e), i.e., if the society did not engage in Residential Investment lending.

Example 2

50. In this example, only Owner-occupied loans would be regarded as a primary object in the current year. Due to their relative size, all other types of loan would be regarded as secondary objects. As there are no primary objects outside the scope of paragraph 117(1)(e), the society would be a co-operative within Division 9 and would be entitled to deductions allowable under paragraph 120(1)(b).

Your comments

51. If you wish to comment on this Draft Ruling, please send your comments by: 26 July 1996

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case references
- Brookton Co-operative Society Limited v. FC of T (1981) 147 CLR 441; 81 ATC 4346; (1981) 11 ATR 880
- Employers' Mutual Indemnity Association Limited v. FC of T (1943) 68 CLR 165; [1943] ALR 417; (1943) 7 ATD 307
- Renmark Fruitgrowers Co-operated Limited v. FC of T (1969) 121 CLR 501; 69 ATC 4135; (1969) 1 ATR 385
- Revesby Credit Union Co-operative Limited v. FC of T (1965) 112 CLR 564; [1965] ALR 752
- A & S Ruffy Proprietary Limited v. FC of T (1958) 98 CLR 637; [1958] ALR 432; (1958) 11 ATD 452
- The Social Credit Savings and Loans Society Limited v. FC of T (1971) 125 CLR 560; 71 ATC 4232; (1971) 2 ATR 612