TD 2019/8 - Income tax: in the definition of 'financial intermediary business' what is meant by 'a business whose income is principally derived from the lending of money'?

Taxation Determination

Income tax: in the definition of 'financial intermediary business' what is meant by 'a business whose income is principally derived from the lending of money'?

Relying on this Determination

This publication (excluding appendixes) is a public ruling for the purposes of the *Taxation Administration Act 1953*.

If this ruling applies to you, and you correctly rely on it, we will apply the law to you in the way set out in the ruling. That is, you will not pay any more tax or penalties or interest in respect of the matters covered by this ruling.

Further, if we think that the ruling disadvantages you, we may apply the law in a way that is more favourable to you.

Ruling

1. The concept of 'a business whose income is principally derived from the lending of money'[1] is concerned with the character of the business that is being conducted. It contemplates a commercial or profit-making operation that involves scale, repetition and continuity of money-lending.[2]

2. It also requires a qualitative, rather than merely quantitative, analysis of how the business earns its income. Such analysis involves consideration of the extent to which the assets and activities of the company are concerned with lending money.

3. Whilst the actual proportion of income earned from money-lending is relevant, a mere mathematical comparison of types of income at a particular point in time is not in itself decisive.

Examples

Example 1 – single outlay of funds with no intention to enter into further lending activities

4. *Bank Co is an Australian body corporate, and is an authorised deposit-taking institution for the purposes of the Banking Act 1959. Bank Co incorporates a company in a*

[1] Being paragraph (b) of the definition of 'financial intermediary business' in subsection 317(1) of the *Income Tax Assessment Act 1936* (ITAA 1936). All further legislative references in this Determination are to the ITAA 1936 unless otherwise indicated.

[2] This Determination does not provide guidance on, and should not be relied upon in determining, whether an entity lends money in the ordinary course of its business of lending money for the purpose of another provision of the tax law. This may be relevant to, for example, whether an entity is entitled to a deduction for debts that are written off as bad under sections 8-1 or 25-35 of the *Income Tax Assessment Act 1997* (ITAA 1997) (in this respect, regard should be had to the guidance in Taxation Ruling TR 92/18 *Income tax: bad debts*) or whether a debt is a moneylending debt for the purposes of Division 245 of the ITAA 1997.

foreign jurisdiction for use as a special purpose vehicle (SPV). The SPV borrows money from a third party and uses the funds so acquired, along with the funds provided by Bank Co to capitalise the SPV, to lend a fixed term foreign currency loan to a third party. Apart from this loan, no other activity is conducted by the SPV in its first statutory accounting period other than:

- *entering into a cross currency swap agreement in order to hedge its foreign currency exposure, and*
- *distributing all returns on the loan to Bank Co in the form of dividends. The only income received by the SPV is the interest income from the fixed term foreign currency loan. There is no intention for the SPV to enter into further activities and the SPV will be wound up once the third party repays the loan in full.*

5. *It is considered that the SPV has not satisfied the paragraph (b) definition of financial intermediary business at any time during the statutory accounting period in question. A single outlay of funds to lend to a third party is not, by itself, sufficient to constitute the lending of money for the purpose of establishing the existence of financial intermediary business. As there is no intention to undertake further lending activities, there is insufficient continuity or repetition of activity for the SPV to be regarded as carrying on a business whose income is principally derived from the lending of money.*

Example 2 – single outlay of funds with demonstrated intention to enter into further lending activities

6. *Modifying the facts from Example 1, Bank Co is able to demonstrate that the SPV has an intention to enter into a number of further lending activities during the subsequent statutory accounting period. Evidence of this intention can be found in, among other things, the SPV's Memorandum of Association, its business plan and the Minutes of the Board of Directors. The SPV will not be wound up once the initial loan is repaid, and the terms of the loan facility that the SPV has in place enable it to draw down additional amounts to fund future lending activities.*

7. *It is considered that the SPV has satisfied the paragraph (b) definition of financial intermediary business at all times when it derived interest income during its first statutory accounting period. The SPV has a demonstrated intention to continue entering into a number of lending activities which will have a sufficient degree of scale, repetition and continuity to establish the existence of a financial intermediary business during its start-up phase. This will be the case, notwithstanding that there has been only a single lending activity during the relevant statutory accounting period*.[3]

Example 3 – revolving loan facilities between related parties

8. *Holding Co is a registered entity under the Financial Sector (Collection of Data) Act 2001, and is the holding company of a large corporate group that includes companies located in foreign jurisdictions. It is not an authorised deposit-taking institution for the purposes of the Banking Act 1959. Holding Co incorporates a company in a foreign jurisdiction (Finance Co) for the purposes of raising funds and providing loans exclusively*

[3] This conclusion is consistent with the finding in *Fairway Estates Pty Ltd v Commissioner of Taxation (Cth)* [1970] HCA 29; (1970) 123 CLR 153, pages 164–165 regarding the establishment of a business of lending money.

to other companies within the group. In its first statutory accounting period Finance Co raises funds from an external lender (with a guarantee from Holding Co) and then extends revolving loan facilities to five other companies within the group. Each loan facility is drawn upon repeatedly during that period.

9. *It is considered that Finance Co has satisfied the paragraph (b) definition of financial intermediary business at all times when it derived interest income during the statutory accounting period in question, regardless of the fact that the lending activity only involved companies within the same corporate group.*[4] *The issuance of revolving loan facilities in these circumstances is strongly indicative of the presence of repetition and continuity in the lending activities of Finance Co.*

Example 4 – incidental activities

10. *Invest Co is a registered entity under the Financial Sector (Collection of Data) Act 2001. It is not an authorised deposit-taking institution for the purposes of the Banking Act 1959. Invest Co incorporates a company in a foreign jurisdiction (Finance Co) for the purposes of engaging in finance and investing activity with unrelated entities in that jurisdiction. Most of the activity conducted by Finance Co from the time it was incorporated has involved the continuous issuance of loans, with the result that most of the assets on its balance sheet consist of loans, along with some property investments.*

11. *A number of the loans on issue are subsequently classified as bad debts, and accordingly are written off. As a result, in the statutory accounting period in question the income from Finance Co's property investments exceeded the income from its loan book.*

12. *It is considered that Finance Co has satisfied the paragraph (b) definition of financial intermediary business at all times when it derived interest income during the statutory accounting period in question, despite the fact that income from its property investments for that period exceeded its interest income. That is because the dominant or principal component of the income generating activity engaged in by Finance Co consisted of the lending of money, with its property investments representing only an incidental or subsidiary part of that activity. This is evidenced by the fact that most of the assets on the balance sheet of Finance Co are loans*.

Date of effect

13. This Determination applies to years of income commencing both before and after its date of issue. However, this 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 this Determination (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10 *Public Rulings*).

14. Any private rulings issued by the Commissioner, which are inconsistent with this Determination, can be relied on by the affected taxpayers for the period of effect of those rulings, in accordance with subsection 357-75(1) of Schedule 1 to the *Taxation Administration Act 1953*.

Commissioner of Taxation
22 May 2019

[4] Refer to *Commissioner of Taxation of the Commonwealth of Australia v Bivona Pty Ltd* [1990] FCA 93; (1990) 21 FCR 562, page 569.

Appendix 1 – Explanation

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.

15. In applying the active income test under the controlled foreign companies rules[5], Australian financial institution (AFI) subsidiaries are able to exclude their 'tainted interest income' from their 'passive income' if their sole or principal business is a financial intermediary business.[6] A financial intermediary business is defined in subsection 317(1) as, *inter alia*, a business whose income is principally derived from the lending of money at the time the tainted interest income is derived.

16. In our view this definition should be interpreted as a composite phrase that is seeking to define the character of the business[7], and it is not appropriate to focus on the words 'business' and 'income is principally derived from the lending of money' as separate and unrelated requirements.[8] In determining whether an AFI subsidiary's sole or principal business is a business whose income is principally derived from the lending of money, it is necessary to have regard to the following indicators.

Indicator 1 – level of activity

17. There are two aspects of the relevant statutory context that indicate that an AFI subsidiary is required to have something more than either nominal lending activity or an insignificant number of loans on issue at the time that tainted interest income is derived, in order for the AFI subsidiary to be considered to be engaged in a business whose income is principally derived from the lending of money.

18. Firstly, for the exemption to apply subsection 449(1) requires not only that a controlled foreign company (CFC) be an AFI subsidiary but also that the sole or principal business of the CFC be financial intermediary business.

19. Secondly, there is the juxtaposition of paragraph (b) of the definition of 'financial intermediary business' with paragraph (a) of the definition, which states simply 'banking business'. Paragraph (b) serves the same function as paragraph (a) in that it characterises the business the AFI subsidiary must be carrying on if the interest income it derives is to be excluded from passive income. The statutory context supports the view that the purpose of paragraph (b) is to encompass financial intermediary businesses that carry on, as banks do, the essential money-lending aspect of a banking business but which would otherwise be excluded from the description of banking business in paragraph (a) because (for example) they do not accept deposits.[9]

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[5] Part X.
[6] Section 449.
[7] To be regarded as having a 'business' at all, the company's activities must have a commercial character or profit-making purpose: *Inland Revenue Commissioners v Eccentric Club Ltd* [1924] 1 KB 390. For example, a company carrying on its activities for a private, philanthropic or religious purpose may not be regarded as having a business at all, notwithstanding that those activities have scale, repetition and continuity and include the lending of money.
[8] *Lloyd v Commissioner of Taxation (Cth)* [1955] HCA 71; (1955) 93 CLR 645 per Dixon CJ, page 660 and Fullagar J, page 667.
[9] This is consistent with the way financial intermediaries were described in Department of Treasury,1996, Financial System Inquiry (1996) Discussion Paper, Commonwealth of Australia, Canberra (at paragraph 2.16) as including non-bank deposit-taking institutions, life offices, general insurance companies, superannuation funds, other collective investment funds and several other types of entities.

20. The essential characteristics of the business of banking have been considered by the High Court in a number of cases. In *Commissioners of the State Savings Bank of Victoria v Permewan, Wright and Company Ltd*[10] the business of banking was defined by Isaacs J, in a passage that has been cited with approval on numerous occasions[11], in the following terms:

> The essential characteristics of the business of banking … may be described as the **collection of money by receiving deposits** upon loan, repayable when and as expressly or impliedly agreed upon, **and the utilization of the money so collected by lending it again** in such sums as are required.[12] (Emphasis added)

21. This passage emphasises that the core activities of a bank consist of accepting deposits and using deposited money towards issuing loans, as well as the repetition and continuity inherent in those activities when conducted in the course of a banking business. If, hypothetically, an entity were to receive only a small number of deposits and then on-lent those funds in the form of a small number of loans then it would be difficult to characterise such limited activity as amounting to a banking business. This is alluded to by Latham CJ in *Bank of New South Wales v Commonwealth*, where his Honour noted that:

> … the contention of the defendants that banking is essentially a business is well founded. A single transaction by an individual person who receives a deposit of money and promises to repay it is not a banking transaction. Banking is a business.
>
> …
>
> Banking began with the receipt of money subject to an obligation to make money available to or according to the directions of the depositor. An establishment which does not deal in money (using the term 'money' to include legal tender and all forms of generally acceptable credit) as a regular business and as its principal business would not be called a bank.
>
> …
>
> A bank, in order to carry on business successfully, must have a policy with respect to deposits, overdrafts &c. It must have managers and a system of management, a staff and offices.[13]

22. Further, Dixon J in *Bank of NSW v Commonwealth* noted that, '… 'banking' describes an activity which is carried on and in that sense continues'.[14]

23. A banking business to which paragraph (a) of the definition of financial intermediary business applies is therefore presumably required to exhibit a degree of scale, repetition and continuity in terms of its lending activity which extends beyond nominal lending activity or the issuance of an insignificant number of loans.

24. It would be highly anomalous if a business that accepts deposits and lends money but nonetheless does not satisfy the paragraph (a) requirement of being a 'banking business' because of the paucity of its deposit-taking and lending activity is then considered to satisfy paragraph (b) because it has still engaged in what can be regarded

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[10] *Commissioners of the State Savings Bank of Victoria v Permewan, Wright and Company Ltd* [1914] HCA 83.

[11] See *Melbourne v Commonwealth* [1947] HCA 26; (1947) 74 CLR 31 per Latham CJ, page 63, per Rich J, pages 64–65, per Starke J, page 69; *Bank of NSW v Commonwealth* [1948] HCA 7; (1948) 76 CLR 1, per Latham CJ, page 194; *Australian Independent Distributors Ltd v Winter* [1964] HCA 78; (1964) 112 CLR 443, pages 454–455. These authorities all emphasise that a banking business must involve the taking of deposits and the lending of money.

[12] [1914] HCA 83; (1914) 19 CLR 457, pages 470–471.

[13] [1948] HCA 7; (1948) 76 CLR 1, pages 193–194.

[14] [1948] HCA 7; (1948) 76 CLR 1, page 333.

as a nominal degree of lending activity, though not enough to characterise it as a banking business.

25. This analysis is consistent with the way the courts have viewed what is meant by being in 'the business of lending money' outside a banking context. In considering whether a person could be regarded as being in the business of the lending of money, Bowen CJ in *Commissioner of Taxation (Cth) v Marshall & Brougham Pty Ltd* noted in relation to the term 'moneylending':

> … it has been said that a person must hold himself out as willing to lend money generally to all and sundry (subject to creditworthiness) (see *Litchfield v Dreyfus* [1906] 1 KB 584). It is not decisive whether the lender is a registered money-lender or not, although this will be a factor to take into account.[15]

26. In *The Commissioner of Taxation of the Commonwealth of Australia v Hunter Douglas Ltd*, Lockhart J said in relation to finance companies:

> … Moneys borrowed by a finance company are turned over by making loans to its customers. Moneys borrowed by a trading company for the purpose of financing the purchase of trading stock are borrowed with a view to disposal of the stock at a profit. They are, in each case, part of the company's circulating capital.[16]

27. These cases all demonstrate that, even where a company is not carrying on a banking business, to have a business of lending money a company must hold itself out as a lender of money and money must be part of the circulating capital of that business. This is consistent with the business having scale, repetition and continuity and not merely making loans (or investing in other debt-like securities) as an investment. This supports the view that to have a business whose income is principally derived from the lending of money at a particular time, the lending activities of the business need to be part of an operation that has a sufficient degree of scale, repetition and continuity. This view is also consistent with the statutory context of Part X of the ITAA 1936 (which treats certain income of an AFI subsidiary as not being 'passive income' for the purposes of the active income test where the AFI subsidiary's sole or principal business is a financial intermediary business[17]) and Subdivision 768-G of the ITAA 1997 (which treats certain assets of an AFI subsidiary as 'active assets' where, likewise, the AFI subsidiary's sole or principal business is a financial intermediary business).

Indicator 2 – assets and activities are principally related to the derivation of interest income

28. In our view it is necessary to determine the dominant or principal component of the business being carried on by an AFI subsidiary, based on its assets and activities, not merely whether most of its income for a particular statutory accounting period consists of interest income. This follows from a consideration of whether the word 'principally' in the paragraph (b) definition imposes either a quantitative or qualitative requirement.[18]

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[15] (1987) 17 FCR 541, page 549.
[16] [1983] FCA 242; (1983) 50 ALR 97, page 116.
[17] The Explanatory Memorandum to the Taxation Laws Amendment (Foreign Income) Bill 1990 states (under the heading 'Section 326: AFI subsidiary') that '[t]he modifications of the active income test by Subdivision F are intended to apply only to non-resident **financial institutions** that are themselves controlled, directly or indirectly, by a small number of Australian financial institutions' (emphasis added).
[18] As noted by the High Court in *Commissioner of Taxation v FH Faulding & Co Ltd* [1950] HCA 42; (1950) 83 CLR 594, pages 596–597, 601–602, to determine whether the word 'principally' is being used in a quantitative or qualitative sense it is necessary to have regard to the relevant statutory context.

29. A practical consideration in determining the correct approach is that an assessment as to whether the sole or principal business of an AFI subsidiary is 'financial intermediary business' must be made at the time that an amount of tainted interest income is derived.[19] The interest income of a CFC which is majority owned by an Australian financial institution is generally derived on an accruals basis. That being the case, a quantitative test would then effectively require a calculation of the various components of the income of a CFC to be conducted on a daily basis, which is an outcome that was not presumably intended.

30. Additional support for this proposition is found in *Commercial Banking Co of Sydney Ltd v Commissioner of Taxation*[20], in which the High Court was required to consider whether, for the purposes of the subsection 6(1) definition of 'income derived from personal exertion', the principal business of the taxpayer consisted of the 'lending of money'. Dixon J noted that:

> … The word 'principal' is introduced in order to exclude incidental and subsidiary activities in a business, but if the **chief part of the business** from which the profit is obtained consists of the lending of money that is enough.[21] (Emphasis added)

31. In other words, the word 'principally' has been included in the paragraph (b) definition to focus on the assets and activities of the CFC, rather than the character of income derived at a particular point in time.

[19] Subsection 449(1).
[20] [1950] HCA 15.
[21] [1950] HCA 15; (1950) 81 CLR 263, page 304.

References

Previous draft:

TD 2019/D3

Related Rulings/Determinations:

TR 92/18; TR 2006/10

Legislative references:

- ITAA 1936
- ITAA 1936 6(1)
- ITAA 1936 317(1)
- ITAA 1936 449(1)
- ITAA 1936 Pt X
- ITAA 1997
- ITAA 1997 8-1
- ITAA 1997 25-35
- ITAA 1997 Div 245
- ITAA 1997 Subdiv 768-G
- TAA 1953
- TAA 1953 Sch 1 357–75(1)
- Banking Act 1959
- Financial Sector (Collection of Data) Act 2001

Cases relied on:

- Australian Independent Distributors Ltd v Winter [1964] HCA 78; (1964) 112 CLR 443
- Bank of New South Wales v Commonwealth [1948] HCA 7; [1948] 2 ALR 89; (1948) 76 CLR 1; (1948) 22 ALJ 191
- Commercial Banking Co of Sydney Ltd v Federal Commissioner of Taxation [1950] HCA 15; [1950] ALR 453; (1950) 81 CLR 263; (1950) 9 ATD 112; (1950) 24 ALJ 132
- Commissioner of Taxation v FH Faulding & Co Ltd [1950] HCA 42; [1950] ALR 862; (1950) 83 CLR 594; (1950) 9 ATD 201
- Commissioner of Taxation v Marshall & Brougham Pty Ltd (1987) 17 FCR 541; 87 ATC 4522; (1987) 18 ATR 859
- Commissioners of Taxation of the Commonwealth of Australia v Bivona Pty Limited [1990] FCA 93; (1990) 21 FCR 562; 90 ATC 4168; (1990) 21 ATR 151; (1990) 92 ALR 593
- Commissioners of the State Savings Bank of Victoria v Permewan, Wright and Company [1914] HCA 83; (1914) 19 CLR 457
- Fairway Estates Pty Ltd v Commissioner of Taxation (Cth) [1970] HCA 29; (1970) 123 CLR 153; 70 ATC 4061; (1970) 1 ATR 726; (1970) ALJR 306
- Inland Revenue Commissioners v Eccentric Club Ltd [1924] 1 KB 390
- Lloyd v. Commissioner of Taxation (Cth) [1955] HCA 71; (1955) 93 CLR 645
- Melbourne v Commonwealth [1947] HCA 26; [1947] ALR 377; (1947) 74 CLR 31; (1947) 21 ALJ 188
- The Commissioner of Taxation of the Commonwealth of Australia v Hunter Douglas Ltd (1983) 50 ALR 97

Other references:

- Department of Treasury,1996,Financial System Inquiry (1996) Discussion Paper, Commonwealth of Australia, Canberra
- Explanatory Memorandum to the Taxation Laws Amendment (Foreign Income) Bill 1990

ATO references

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