TR 1999/14 - Income tax: determining the co-operative status of a company which makes loans to shareholders

Taxation Ruling
Income tax: determining the co-operative status of a company which makes loans to shareholders

Contents Para

What this Ruling is about 1
Ruling 6
Date of effect 14
Explanations 15
Examples 44
Detailed contents list 48

Preamble

*The number, subject heading, **Class of person/arrangement**, **Date of effect** and **Ruling** parts 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. Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a public ruling and how it is binding on the Commissioner.*

What this Ruling is about

Class of person/arrangement

1. This Ruling applies to certain companies, the business activities of which include the making of loans to 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-operative 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 (1). Omitting those paragraphs, subsection (1) requires that:

- the rules of the company limit the number of shares that may be held by shareholders;
- the rules prohibit the quotation of shares for sale or purchase at any stock exchange or in any other public manner whatever; and
- 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]

Subsection (1) also refers to companies which have no share capital. In cases where this is applicable, this Ruling should be read by

replacing the word 'shareholder' or 'shareholders' with the word 'member' or 'members'.

4. This Ruling considers the basis on which a company, the business activities of which include the making of loans to shareholders, qualifies as a 'co-operative company' within the terms of paragraph 117(1)(e).

5. This Ruling also considers whether such a company, which has failed to qualify under paragraph 117(1)(e), might nevertheless qualify as a 'co-operative company' within the terms of paragraph (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, among 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:

- What **business or businesses** is the company carrying on?
- What is/are the **primary object/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 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 (1), the company does 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. The company's status may change from year to year.

10. In looking at a company which makes loans, 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 should be considered. We consider that, as a

general rule, greater emphasis should be placed on loans made during the relevant income 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 **shareholders** to be used by **them** as their own residence or as their own residence and business.

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

12. Generally, a company that carries on a business of making loans to shareholders is not regarded as having been established for the purpose of rendering services to shareholders. However, if the activities of a company indicate that a primary object of its business is the rendering of services to shareholders, the making of loans may be merely incidental to the carrying on of the business, and the company is not 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 business of the company. Rather, it is included in the activities of the company whose primary object is to render services to shareholders.

13. We do not envisage that many companies which make loans to shareholders satisfy the criteria required by paragraph 117(1)(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 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 business of a company and the primary object of that 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?
- What is/are the **primary object/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 is 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. If a company which makes loans is to qualify as a 'co-operative company', the main business would be that of obtaining funds from shareholders and making loans to 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 company which makes loans 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 subsection 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 is/are the primary object/objects of each 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:

> '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 business 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 is 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 section 117. 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 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 later 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 which makes loans, 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** should both be considered. As it is necessary to determine the **current** primary object or objects of the company, we consider that, as a general rule, greater emphasis should be placed on statistics relating to loans advanced **during the year**. This emphasis is warranted because of the 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 may 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 subsection 117(1), then the company is not a 'co-operative company' 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 business may have secondary objects in conjunction with its primary objects. Secondary objects are those activities that do not impact on the overriding character of the business. They should be no more than occasional or incidental. Should any of the secondary objects of a business not conform with the objects set out in paragraphs (a) to (e) of subsection 117(1), that does not preclude the company from satisfying the requirements of the subsection. 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 generally the statistics relating to loans advanced during the year should prevail in determining the co-operative status of the company under Division 9.

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

28. Historically, many companies were established specifically to make loans to shareholders for owner-occupied housing. In particular, co-operative housing societies were established with the expressed intention of ensuring that members were able to acquire a home of their own in which they and their families would reside. Relevant income tax legislation must be read and understood against this social and economic background.

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. The use of the word 'home' by the Honourable E G Theodore is significant. *The Macquarie Dictionary* defines the word 'home' as including:

'1. a house, or other shelter that is the fixed residence of a person, a family, or a household.

2. a place of one's domestic affections…'

31. In our view, it is implicit in the Second Reading Speech that the legislature intended to restrict the benefits of Division 9 to those companies which make loans to shareholders to enable them to acquire land or buildings to be used as their own residence or as their own residence and business.

32. 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 shareholders to acquire land or buildings for the purpose of selling or leasing the property acquired in its entirety to other persons, the company cannot be treated as a 'co-operative company' for that income year. This is the case even if the property is to be used by the purchaser or lessee as a residence or combined residence and business.

33. 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 own residence and business. It has been suggested that, had the legislature intended to restrict the provision to owner-occupied premises, it 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.

34. We consider that the words 'the shareholder's', if so included, would be redundant. *The Macquarie Dictionary* defines the word 'residence' as including:

'1. the place, especially the house, in which one resides…'

Accordingly, it is necessary to relate the premises to a person, and the only persons referred to in paragraph 117(1)(e) are the shareholders.

(c) Distinguishing between the application of paragraphs 117(1)(d) and (e)

35. We consider that it may be possible, in exceptional circumstances, for a company, the business of which includes the

making of loans to shareholders, to establish that its primary object is the rendering of services rather than the making of loans.

36. 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 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]

37. 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 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 shareholders. His Honour placed considerable weight on the fact that, in addition to making loans, it provided 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.'

38. 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.'

39. It is clear from His Honour's judgment that he did not consider the making of loans to members was a primary object of the business being carried on.

40. In the more recent case of *The Social Credit Savings and Loans Society Ltd v. FC of T* (1971) 125 CLR 560; 71 ATC 4232; (1971) 2 ATR 612 (*Social Credit Savings*), 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 shareholders for the purpose of making loans to shareholders to enable them to acquire land or buildings to be used for the purpose of residence or of residence and business. Further (by way of contrast with the *Revesby Credit Union* case) he also rejected the argument that a primary object of business of the Society was the rendering of services to 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.'

41. In *Social Credit Savings*, Gibbs J went on to distinguish the decision of McTiernan J in the *Revesby Credit Union* case. 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.'

42. In our view, if a company does make loans to shareholders for purposes other than those described in paragraph 117(1)(e), it only satisfies 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.

43. For these reasons we do not envisage that many companies which make loans to shareholders qualify as a 'co-operative company' under paragraph 117(1)(d).

Examples

44. In both of the following Examples it is assumed that the requirements set out in subsection 117(1), as to the rules of the company, and in section 118, as to the amount of business with shareholders, are satisfied.

AXL COMPANY
LOANS IN THE 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

45. 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, AXL 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 company' within Division 9 and would not be eligible for deductions allowable under section 120. The same result would follow even if only one of the primary objects was outside the scope of paragraph 117(1)(e).

Example 2

46. 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), AXL would be a 'co-operative company' within Division 9 and would be entitled to deductions allowable under section 120.

47. While the above examples have focused entirely on a statistical analysis of loans made during the relevant year of income, the totality of circumstances in any particular case will be considered.

Detailed contents list

48. Below is a detailed contents list for this Ruling.

	Paragraph
What this Ruling is about	**1**
Class of person/arrangement	1
Ruling	**6**
Determining the co-operative status of a company for the purposes of subsection 117(1)	6
Meaning of the expression 'residence or of the residence and business' within paragraph 117(1)(e)	11
Application of paragraph 117(1)(d)	12
Date of effect	**14**
Explanations	**15**
Determining the business of a company and the primary object of that business	15
What business(es) does the company carry on?	*16*
Multiple businesses	*18*
What are the primary objects?	*20*
Multiple primary objects	*22*
Analysis of activities: determining the primary objects	*23*
Distinguishing primary from secondary objects	*26*
Conflicting loan statistics	*27*
Meaning of the expression 'residence' within paragraph 117(1)(e)	28
Distinguishing between the application of paragraphs 117(1)(d) and (e)	35
Examples	**44**
Example 1	45
Example 2	46

Commissioner of Taxation
15 September 1999

Previous draft:

Previously released as TR 96/D14

Related Rulings/Determinations:

Subject references:

- building society
- co-operative
- dividends
- lending

Legislative references:

- ITAA36 Pt III Div 9
- ITAA36 117(1)
- ITAA36 117(1)(d)
- ITAA36 117(1)(e)
- ITAA36 118
- ITAA36 120

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

ATO references:
NO 95/8035-2
BO
FOI Index detail: I 1020819
ISSN: 1039 - 0731