TREASURER

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TAXATION OF DISTRIBUTIONS DISGUISED AS LOANS FROM PRIVATE COMPANIES

Financial Implications ($m)

1997-98	1998-99	1999-00	2000-01
2	50	30	30

Explanation

Currently, private companies are, in certain circumstances, able to make distributions of realised or unrealised profits that are effectively tax free by structuring them as loans to shareholders rather than as taxable distributions.

The Government has therefore decided to amend the *Income Tax Assessment Act 1936* (ITAA) to ensure that tax is payable on distributions from private companies which take the form of loans to shareholders which are not on commercial terms (as described below as ‘excluded loans’). Commercial loans with appropriate interest payments and repayments will not be affected by the provisions. In addition, the changes will not affect loans that are fully repaid within the same income year in which the loan was first paid or credited (subject to certain anti-avoidance provisions).

This measure is likely to impact on tax minimisation practices used by some high wealth individuals.

Section 108 of the ITAA will be strengthened so that advances, loans, or the crediting of amounts by private companies to shareholders (and their associates) will be deemed to be an assessable dividend (to the extent that there are realised or unrealised profits in the company) unless they come within a defined class of excluded loans.

Loans deemed to be assessable dividends will be unfrankable but will result in a debit to the company’s franking account as if they had been franked, in order to prevent dividend streaming opportunities.

The amended law will also apply to advances, loans, or credits made to unrelated third parties where there is an agreement that the third party will advance, loan, or credit a similar amount to a shareholder, or an associate of a shareholder, of the original lender.

The legislation will specifically cover the forgiveness, by private companies, of debts owed to them by shareholders and their associates. The forgiveness of a debt owed by a shareholder or an associate will be deemed to be a dividend paid to the debtor within the terms of section 108,

provided the loan was not itself previously taxed under that section. The forgiveness provisions will apply to both legally enforceable debt forgiveness and any activity which in economic terms amounts to a forgiveness of debt. The amount forgiven will be assessable to the debtor in the year in which the debt is forgiven regardless of the year in which the loan was initially provided. The dividend arising on the forgiveness of a debt by a private company will not be a frankable dividend but will result in a debit to the company's franking account as if it had been franked.

In order to qualify as an *excluded loan* the loan must satisfy certain conditions, including:

- a requirement that the effective rate of interest per annum payable under the loan is equal to or greater than a benchmark interest rate (this will be the same benchmark rate as applies for fringe benefits tax purposes); and
- the actual term of the loan is not greater than a specified maximum term for the loan; and
- the amount actually repaid in respect of the loan in a year of income is equal to or greater than either the specified minimum yearly repayment, or (in the year of income in which the loan is discharged) the amount of the loan plus any outstanding interest payable in respect of the loan.

The legislative rules defining an excluded loan will be supported by detailed regulations.

An excluded loan will also include any loan which is fully repaid in the same income year in which the loan amount was first paid or credited. Anti-avoidance provisions will be included to ensure this operates appropriately.

A repayment will not be treated as a repayment for the purposes of these provisions if the repayment has been funded by a loan from an associate of the taxpayer making the repayment. The definition of 'associate' will have broadly the same meaning as in subsection 26AAB of the ITAA.

A failure by any party to the loan to comply with any of these terms will result in the full amount of the loan being deemed to be a dividend in the year in which the term or terms are not complied with.

With the exception of the debt forgiveness measure, the measures will apply to loans entered into after the date of introduction of the legislation. A loan is entered into when an amount is actually paid or credited to the shareholder. A new loan will be deemed to have been entered into if the terms of an existing loan are altered (other than through an adjustment to the interest rate that is allowed for by the loan agreement), the period of the loan is extended or the loan is rolled over into another loan. The debt forgiveness measure will apply to any debt forgiven on or after the date of introduction of the legislation.

The above material is a full extract of the description of the measure as contained in *Budget Paper No 2: Budget Measures 1997-98.* This paper explains all outlays and revenue measures, and is available from Australian Government Bookshops or from the Treasury Internet site at http://www.treasury.gov.au/budget

CANBERRA
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