

TAX matters

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Division 7A Loan Agreements – Essential Elements Required to be in Writing

The evidential requirements for complying Division 7A loans are extremely important, with the Australian Taxation Office (“ATO”) more closely scrutinising such loans in recent times.

To avoid the adverse taxation consequences associated with a loan being treated as a dividend and assessed in the hands of the taxpayer, every loan must be in writing. As a general rule, this must occur before the lodgment day for the income year in which the loan is made.

The ATO has recently released Draft Tax Determination TD

2007/D19 outlining its views on the elements that must be evidenced in writing. These include:

- the names of the parties;
- the terms of the loan. This requires details relating to the amount of the loan, the date on which the loan amount is drawn, the requirement to repay the loan amount, the period of the loan, and the interest rate payable;
- that the parties named have agreed to the terms; and
- the date that the agreement was in writing. For example, the date the loan agreement was signed or executed.

The ATO has indicated in TD 2007/D19 that although the actual amount drawn down need not be specified in a written agreement that sets out the other terms of the loan, there must be some written evidence that the amount paid or credited to the shareholder (or their associate) on a particular date under the terms of the written loan agreement.

The requirement to evidence the elements in writing *may* be

satisfied where there is written confirmation of the existence of the loan and *all* of the essential elements. This may occur, for example, through an exchange of letters or other means of communication. However, as it is essential that the elements are expressed so as to evidence a loan agreement, we recommend that all loans between companies and shareholders (or their associates) be recorded in a formal written loan agreement.

For those of you that use revolving facility agreements, you will need to state the amount of the loan before the company’s lodgment day.

Contact Daniel Fry, Chris Smailes or Chris Bates.

Employment Termination Payments

As a result of the Simplified Superannuation reforms, from 1 July 2007 eligible termination payments (“ETPs”) ceased to exist and have been replaced by employment termination payments and superannuation lump sums.

The new employment termination payment rules cover payments in consequence of

termination where the payment is not made from a superannuation entity.

Under the old law ETPs could have been paid at any time following the termination of employment and employees could elect to have all or part of the payment made into superannuation.

However, under the new law employment termination payments must be made within 12 months of the termination of employment unless the Commissioner of Taxation considers that 12 months would be too short in the circumstances. By legislative instrument this time limit has been extended if the delay in payment was due to the commencement of legal action within 12 months of the termination of the person's employment, concerning either or both the person's entitlement to the payment and the amount of the person's entitlement.

Employment termination payments will no longer be able to be paid into superannuation (with the exception of certain transitional arrangements).

Concessional tax treatment will be available for employment termination payments received in an income year or relating to a single termination (i.e. where the payment is split over more than one income year) up to the employment termination payments cap. The cap is \$140,000 in the 2007/08 year. The concessional tax treatment of a life benefit termination payment will depend on

whether the person receiving the employment termination payment in consequence of their termination has reached the preservation age or not. In circumstances where the employment termination payment is a death benefit termination payment the concessional treatment will depend on whether the recipient of the payment is a dependant or non-dependant of the deceased.

Generally the pre-July 1983 and invalidity components of employment termination payments will be tax-free and the remainder of the payment will be subject to tax at marginal rates.

Contact Chris Smailes or Rachael Delamare.

The CGT Small Business Concessions – Be Alive to Death!

Subject to some exceptions, the usual CGT position is that the death of an individual does not give rise to a capital gain or capital loss. The deceased's legal personal representative ("LPR") and the beneficiaries of the deceased's estate are new CGT taxpayers who acquire the CGT assets of the deceased, as at the date of death, at the appropriate cost base and reduced cost base.

The CGT small business concessions as originally enacted had no special provisions that applied where an individual owned a CGT asset that would potentially qualify for the reliefs and the individual dies. The position was that the LPR (as a new taxpayer) or a beneficiary (also a new taxpayer) would have to satisfy all of basic and, if relevant, other

specific conditions for the CGT concessions to be available.

The *Tax Laws Amendment (2006 Measures No 7) Act 2007* has significantly altered the way in which the CGT small business concessions can operate subsequent to the death of an individual where the CGT event happens to a CGT asset of the deceased in the 2006/07 or a later income year.

Broadly, a disposal of a CGT asset (owned by a deceased at the date of the deceased's death) by the deceased's LPR or a beneficiary of the deceased's estate may qualify for the CGT small business concessions if the disposal occurs within two years of the deceased's death, without the LPR or the beneficiary having to satisfy all the basic and other conditions.

For the "death rule" to operate, the conditions set out at section 152-80 of the 1997 tax Act need to be satisfied. One of those is that the deceased individual would have been entitled to reduce or disregard a capital gain under the CGT small business concessions if a CGT event had happened in relation to the CGT asset immediately before the deceased's death. For the purposes of determining what the deceased's entitlement under the CGT small business concessions would have been, the following assumptions are made:

- (a) when applying the CGT 15-year small business exemption, the requirement that the CGT event happened in

connection with the deceased individual's retirement is ignored; and

- (b) when applying the CGT small business retirement exemption, the roll-over requirement for individuals under 55 years of age is ignored.

Where the conditions set out in section 152-80 are met, the LPR or the beneficiary (as the case may be) is entitled to reduce or disregard a capital gain under the CGT small business concessions in the same way as the deceased individual would have been entitled.

The following is an illustration of how the "death rule" might operate.

Twenty Four Seven Pty Ltd is a company which has carried on a supermarket business since its incorporation in 1988. All of the shares in the company are ordinary shares and have at all times been owned by Barry Hobbs, aged 60.

Barry dies on 31 October 2007 and in his Will he appoints his two sons, Michael and Stanley as his executors and trustees. Barry's shares in the company are gifted equally between Michael and Stanley.

Immediately before his death, Barry would have satisfied all of the basic conditions in section 152-10 in respect of the shares if they had been sold. Accordingly, if the shares were to be sold by Michael and Stanley as executors or as beneficiaries under a contract

entered into within two years of Barry's death (or a longer period allowed by the Commissioner), the "death rule" in section 152-80 would apply and Michael and Stanley would be entitled to disregard the entire capital gain made on the disposal of their shares (on the basis that Barry would have been entitled to do the same) by applying the 15 year exemption in section 152-105 if Barry had sold the shares immediately prior to his death. In looking at Barry's CGT position immediately prior to his death the requirement that the CGT event happened in connection with Barry's retirement is ignored.

Conversely (and curiously), if Barry had acquired his shares in 1981, the "death rule" would not have applied (as in this case Division 152 does not apply to pre CGT assets) and Michael and Stanley would have a market value cost base of Barry's shares when they dispose of them.

Please contact Chris Smailes or Alan Krawitz for further information.

Our office will be closed from 5.00pm on Friday 21 December 2007 and will re-open on Monday 7 January 2008.

Happy Xmas and prosperous 2008 to you and your loved ones from all of us at Norton & Smailes.