REINFORCING TAX SYSTEM INTEGRITY — TREATING NON-COMMERCIAL LOANS FROM MEMBERS TO CLOSELY-HELD ENTITIES AS EQUITY

The unified entity regime must treat loans from members to closely-held entities as equity where the loans are not sufficiently commercial, so as to safeguard the integrity of the regime.

Key features

The amount of a loan made on or after 22 February 1999 from a member of a closely-held entity, or an associate of such a member, to a closely-held entity will from the commencement of the unified entity regime be treated as part of the entity's contributed capital unless the loan is 'commercial'. Payments on loans that are not 'commercial' will be treated as entity distributions, and subject to the general limitations on returning contributed capital ahead of available profits. See the appendix to this attachment for further details.

Commencement

1 July 2001. From that date, loans made on or after 22 February 1999 will be affected.

Application from 22 February 1999 is appropriate as it was foreshadowed in the Treasurer's Press Release No.10 of 22 February and the accompanying letter from Mr Ralph to the Treasurer.

Current arrangements

No specific rules currently apply to non-commercial loans from members to closely-held entities, but provisions of Division 7A of the *Income Tax Assessment Act 1936* apply to non-commercial loans from private companies to shareholders and their associates.

Why change is needed

To ensure that the profits first rule to be introduced as part of the consistent treatment of entity distributions under the unified entity regime is effective, loans provided by members to closely-held entities need to be treated as equity, where the loans are not sufficiently commercial.

Treating Non-Commercial Loans from Members to Closely-Held Entities as Equity — Further Details

Loans to a closely-held entity by its members could be used at a later date as a means of returning to members as loan repayments what would otherwise be distributions. Where such loans are not sufficiently commercial, they could in effect return contributed capital ahead of retained profits. This would provide an unwarranted tax deferral advantage, and, if permitted, significant revenue deferral from taxing trusts like companies.

Therefore, the amount of a loan made on or after 22 February 1999 from a member of a closely-held entity, or an associate of such a member, to a closely-held entity will from the commencement of the unified entity regime be treated as part of the entity's contributed capital unless the loan is 'commercial'. Payments on such loans will be treated as entity distributions, and be subject to the general limitations on returning contributed capital ahead of profits.

As proposed in Section 12 of *A Tax System Redesigned*, a 'commercial loan' will have the same meaning for both a loan made to an entity by a member, and a loan made by an entity to a member. The criteria will essentially be the same as those for an 'excluded loan' currently in Division 7A of the *Income Tax Assessment Act 1936*:

- the loan must be made under a written agreement;
- the interest rate payable on the loan, for years of income after the year in which the loan is made, must equal or exceed the 'Indicator Lending Rates — Bank variable housing loan interest rate' last published by the Reserve Bank of Australia before the start of the year in which the loan is made; and
- the maximum term of the loan must not exceed 25 years, for a loan secured over real property, and for all other types of loans must not exceed 7 years.

Unlike loans from a closely-held entity to a member, there will be no minimum annual repayment requirement for loans made by members to a closely-held entity.

As the measure will not have effect until 1 July 2001 when the unified entity regime commences, and then applies to loans made after 22 February 1999, taxpayers will have time to rearrange their affairs so that their loans to their closely-held entities are unaffected by the measures.