

Tax and Superannuation Update – Autumn 2003 Edition

Free family business loan = Penalty

There is no such thing as a free loan.

They got rid of the free lunch in the 80's. They got rid of the free loan compliments of your company in the 90's. However, in the 00's not every business owner got the message. Many business owners incur the wrath of the ATO (and penalties) because they or their family:

1. borrow money from their company; or
2. got the company to pay for personal expenses, guarantee a debt or forgive a debt

Under Division 7A of the Tax Act money used for such purposes is an unfranked dividend and is taxable by the family member getting the money from the company. Think about how bad that is. The company suffers a debit to its franking account. This means that the company has already paid the 30% corporate tax rate that the shareholder is meant to get back - but doesn't. The 30% tax paid is lost forever. The family member getting the benefit has to pay full tax on that benefit. If they pay tax at 48.5% then the total tax paid is 78.5%.

There are 2 ways to get around Division 7A:

1. pay the 'money or benefit' back before the end of the financial year in which it was lent
 2. prepare a Division 7A loan agreement BEFORE any money comes out of the family company
- The Division 7A loan agreement must comply with all the rules – e.g. 7 year term & interest. The interest rate is referenced to the government approved benchmarked interest rate that changes from time to time (6.3% for 02/03). It is a revolving loan. This means that once prepared and stamped it continues to work from year to year.

Its not your Accountant's, Adviser's or Lawyer's job to forewarn you of

the above mess. If your company has already loaned you or your family money (or given some other benefit other than the usual dividends paid to shareholders) then you are already in breach. If you made that loan this financial year then immediately speak with your Accountant so that it can be paid back. If it was made last financial year or you don't pay it back then a Div 7A loan agreement won't help you. The Div 7A loan agreement has to be in place BEFORE the company makes the loan. It is illegal to back date a Division 7A loan agreement. Your professional adviser would be struck of if involved in such an activity.



Have you taken a loan from your company?

For the rest of us to be on the safe side get each family member their own Div 7A loan agreement. One for you, spouse, children and the Trustee of the Family Trust and anyone else that you may distribute to from your Family Trust (if any).

This helps overcome section 109U issues.

Qualified Tax Lawyers charge \$330 plus for each Div 7A loan agreement. However, you can build your own for \$33 each from www.lawcentral.com.au.

No "Right" to make a Will

Recently the Full Supreme Court stated that if you are under an "administration order" then you need to get your Administrator's permission before you sign your Will.

Otherwise your Will is not valid.

An "administrator" is a person appointed by the Guardianship and Administration Board ("Board") to make property and financial decisions on your behalf because you have a disability in performing this task.

This is an unfair case and takes away a person's right to make a binding Will. You can be subject to an administration order but still be of sound mind sufficient to make a Will.

As a matter of public policy, your right to make a Will is such an important personal right that a Court should not regard you as being deprived of this right unless there was a clear legislative intent to that effect. Under the Act there is no power given to any person to decide if you have the mental capacity to make a Will.

The Supreme Court allows the Board to decide if you have testamentary capacity or not. This is an absurd result in circumstances where the statute contains no criteria as to how testamentary capacity is evaluated.

The case was decided by the WA Supreme Court but the decision may well be adopted in other states.

Until the state government changes the Act all Estate Planning and Tax Lawyers making Wills need to ask the question "are you subject to an administration order".

Only fully qualified lawyers should undertake Estate Planning and the making of Wills.

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Don't kid yourself- You are going to die!

No one likes to think about dying. It is very easy to prevaricate about planning for your own death. However, your family and friends are the ones left to pay the price for your lack of foresight. Putting in place a "simple" Will with the intention of looking after your family is not sufficient. This is particularly true if you have your own business. A well thought out Business Succession Plan in conjunction with Estate Planning is essential to protect your family.

Our clients gave us permission to share this Business Succession Planning file:

FACTS

Peter, Mike and Linda built up their engineering business from scratch over 7 years. They are in a partnership structure.

Mike died.

WHAT MIGHT HAVE HAPPENED

This is what would have happened if their Adviser & Accountant hadn't done Business Succession Planning:

There was no written partnership agreement. There was therefore nothing stated that the business continues to trade after a partner's death. By operation of law, the partnership is dissolved.

Mike's interest in the business, which they estimated at \$350,000, is now owned by his Executor. The Executor holds the assets in trust for his beneficiaries named in his Will.

The Executor has many strict obligations in administering Mike's deceased estate. They collect in, sell and distribute the proceeds of the business interest to the beneficiaries, without consideration to the financial well-being of the remaining business partners.

As in most simple Wills, Mike's Executor does not have the power to carry on a business. The Executor, on behalf of the beneficiaries, receives full profit distributions from the partnership. However, the Executor is not allowed to contribute to the running of the business!

Peter & Linda's income is drying up fast. The business value has plummeted. Mike's wife and children receive nothing like the \$350,000 his share of the business was worth before he died.

Who gets Mike's interest? There are 2 likely possibilities:

- 1 Obviously Peter & Linda want to continue on the business without the intermeddling of Mike's family and share the profits which they should receive by reason of their continuing efforts. Unfortunately Mike's Executor answers to the beneficiaries and can not give the business to Peter & Linda because of some hand-shake; and -

- 2 Could Peter & Linda convince the Executor to sell them Mike's interest? But where to find the money? How is it valued? They are already in financial trouble.

No planning killed the business.

Now the lawyers are going to clean it up - 4 cars back from the hearse.

Thankfully this didn't happen. We worked with the adviser and accountant to put in place a Business Succession Plan.

WHAT DID HAPPEN

Mike, Peter & Linda are fortunate to have a caring & professional Adviser & Accountant. We worked on the team to put in place:

1. a written Partnership Deed
2. proper Estate Planning including a 3 Generation Testamentary Trust, Superannuation Testamentary Trust and Bankruptcy Trust
3. a fully funded Business Succession Plan

Upon Mike's death there was sufficient money for Peter & Linda to buy out the Executor's interest. This was an enforceable contract binding the Executor. The Accountant had valued the business each year and this was updated at the back of the plan each year. Mike's family got full value for the business. Mike's estate also had Capital Gains Tax insurance.



Alas poor Yorrick. He never planned for this day.

Legal Brief

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Your daughter-in-law gets nothing.

I recently debated at the Tax Institute's "Trusts v Companies". I argued for Trusts. Trusts won, but I don't think people realise how many Trusts are available.

There are the common "3 Generation Testamentary Trust" and "Superannuation Testamentary Trust" that are found in your Estate Planning Will. There are "CGT Complying Family Trusts" (which replaced all Family Trusts since August 2002). There are "Unit Trusts". However, I was surprised to hear that few people knew of the Capital Protected Trust. A Capital Protected Trust protects your capital in the Trust. Your grandchild or others get your capital - not your children or their divorced spouses. The Capital Protected Trust protects the capital and assets of the trust from the children's spouses and Defactos.

Who are the 3 types of beneficiaries?

1. Primary Beneficiary (income only) - YOU;
2. Secondary Beneficiaries (entitled to income only and have limited rights) - YOUR CHILDREN;
3. Capital Beneficiaries (get the capital and may receive income) - GRAND & GREAT GRAND CHILDREN.

YOU - The Primary Beneficiaries are like normal discretionary beneficiaries - except they have no entitlement to the trust capital. Such Beneficiaries can of course include the Trustee and Appointor.

YOUR CHILDREN - Secondary Beneficiaries are your children and other parties related to the Primary Beneficiary. The Trustee may distribute income to them - but they have absolutely no entitlement to the capital. No loans, never a Trustee or Appointor. They aren't shareholders or office holders if the Trustee is a company.

GRAND & GREAT - Your grand & great grandchildren are the Capital Beneficiaries. They get the capital - before the vesting day or whenever the Trustee wants to. Capital Beneficiaries may also receive income just like Secondary Beneficiaries. The assets are not protected from the spouses of the Capital Beneficiaries.

The Appointor ("God") is you and your spouse. Upon your & your spouse's death it is a family friend or your Accountant or Adviser - never a Beneficiary.

Capital Protected Trusts are powerful. They have the ability to override the Family Court and last 80 years. Therefore instructions for Capital Protected Trusts are only taken after discussion with the Adviser, Accountant and client.

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the most tax effective amount into your Super. Many small business owners have their own Self Managed Super Funds. Sadly, from 1 July 2003 Super contributions to SMSFs have to be done quarterly (not annually).

If business is doing well you may want to put in more Super.

If you aren't doing so well then you may want to contribute less. Sadly such flexibility isn't an option. If in the first quarter you committed Super based on a successful year and that wasn't forthcoming, then there still is an obligation to pay the Superannuation Guarantee.

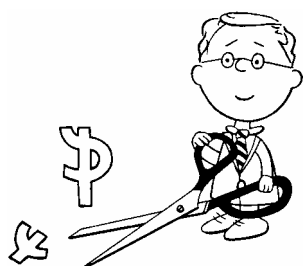
The Superannuation Guarantee has a maximum salary level (currently \$116,880 per year - \$29,220 per quarter). At the maximum salary level, the quarterly superannuation guarantee obligation is \$2,630 and the annual amount about \$10,520.

Anyone working for a company or a trust (including you the owner) is an "employee" and your "employer" must pay the Super. Only sole traders and partners don't have to pay Super for themselves. They can of course still contribute to their Super if they want to. A sole trader and partner can have their own SMSF and yet are not required to pay the superannuation guarantee. SUGGESTIONS

1. Review and amend your Self Managed Super Fund. If it is over 4 years old it is usually out of date.
2. Amend all Employment

Contracts (for family members to) so that "all bonuses are paid into Super, unless otherwise directed by the employee".

3. Make a first quarter contribution as a payment in advance that is likely to cover the year. This is because it is not a strict rule that you have to pay every quarter.



Prevent the family lawyer from cutting into your trust assets.

11th hour contributions to Super - gone!

Traditionally the small business owner was able to write a cheque for his Super fund late-June based on how well the business did that year. At the end of the financial year you speak to your Adviser and Accountant. They work out how much you earn and stick in

Brett Davies Lawyers is a private law firm. It only deals with clients through your Advisers.