YOUR KNOWLEDGE

INSIDE

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Company money crackdown

The ATO is cracking down on business owners who take money or use company resources for themselves.

It's common for business owners to utilise company resources for their personal use. The business is often such a part of their life that the line distinguishing 'the business' from their life can be blurred.

While there are tax laws preventing individuals accessing profits or assets of the company in a tax-free manner, mistakes are being made and the Australian Taxation Office (ATO) has had enough.

The ATO has launched a new education campaign to raise awareness of these common problems and the serious tax consequences that can arise.

What the tax law requires

Division 7A is an area of the tax law aimed at situations where a private company provides benefits to shareholders or their associates in the form of a loan, payment or by forgiving a debt. It can also apply where a trust has allocated income to a private company but has not actually paid it, and the trust has provided a payment or benefit to the company's shareholder or their associate.

Division 7A was introduced to prevent shareholders accessing company profits or assets without paying the appropriate tax. If triggered, the recipient of the benefit is taken to have received a deemed unfranked

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dividend for tax purposes and taxed at their marginal tax rate. This unfavourable tax outcome can be prevented by:

- Paying back the amount before the company tax return is due (this is often done by way of a set-off arrangement involving franked dividends); or
- Putting in place a complying loan agreement between the borrower and the company with minimum annual repayments at the benchmark interest rate.

The problem areas

Division 7A is not a new area of the tax law; it has been in place since 1997. Despite this, common problems are occurring. These include:

- Incorrect accounting for the use of company assets by shareholders and their associates. Often, the amounts are not recognised;
- Loans made without complying loan agreements;
- Reborrowing from the private company to make repayments on Division 7A loans;
- The wrong interest rate applied to Division 7A loans (there is a set rate that must be used).

Like life, managing the tax consequences of benefits provided to shareholders and their associates can get messy quickly. Avoiding problems can often come down to a few simple steps:

- Don't pay private expenses from a company account;
- Keep proper records for your company that record and explain all transactions, including payments to and receipts from associated trusts and shareholders and their associates; and
- If the company lends money to shareholders or their associates, make sure it's on the basis of a written agreement with terms that ensure it's treated as a complying loan – so the full loan amount isn't treated as an unfranked dividend.

There are strict deadlines for managing Division 7A problems. For example, if the borrower is planning to repay the loan in full or put a complying loan agreement in place, this needs to be done before the earlier of the due date and actual lodgement date of the company's tax return for the year the loan was made. **-End-**

Accessing money in your SMSF

The ATO has made a call to professional accountants to help identify and manage illegal early access to superannuation by members of self-managed superannuation funds (SMSFs).

In general, access to your super is only possible if:

- You retire and turn 60; or
- You turn 65 (regardless of whether you're working).

Early access to superannuation is only possible in very limited circumstances such as terminal illness, permanent incapacity, and severe financial hardship and there are very strict protocols to follow before any amounts are paid out.

One of the benefits of an SMSF is the control that it provides to members. The flip side of full control is the temptation to dip into the super account and approve transfers without proper controls.

There are two common ways illegal early access occurs:

- When the trustees (or their business) are in financial distress and they use the superannuation account for a short-term loan; or
- A promoter offers access through a scheme – often getting people to establish the SMSF and roll over their superannuation into the SMSF.

Illegal access to the SMSF's account or assets is not difficult to identify and generally will be picked up by your auditor. Where illegal access has occurred, not only is it likely that your retirement savings have been lost or impaired, but you are likely to face additional tax, penalties and interest, and be disqualified as a trustee. In addition, your name will be published online.

One of the signs that there is a problem is when SMSF annual returns are not lodged on time or at all so ensure you are up to date with your SMSF compliance.

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Should you be the 'bank of Mum & Dad'?

The great wealth transfer from the baby boomer generation has begun and home ownership is the catalyst.

The average price of a home in NSW is $1,184,500, the highest in the country. Canberra is next at $948,500, followed by Victoria at $895,000, with the Northern Territory the lowest at $489,200[1]. With the target cash rate expected to remain steady at a 12 year high of 4.35% over 2024, the pressure is on parents and family to help the younger generation become homeowners.

Over the last 15 years, home ownership has fallen from 70% to 67% of the population. Over time, declining home ownership will increase the wealth gap in Australia as for many, home ownership is a significant factor in wealth accumulation. According to the Actuaries Institute, wealth inequality is significantly higher now than in the 1980s, with the wealthiest 20% of households currently having six times the disposable income of the lowest 20%[2].

The Domain's First Home Buyer Report 2024 estimates the time for a couple aged between 25 and 34 to save a 20% deposit for an entry level home to be 6 years and 8 months in Sydney, and 5 years and 5 months in Melbourne (the Australian average is 4 years and 9 months). In that time, they are begrudgingly paying rent (or staying with Mum and Dad).

So, should you help your children buy a home? If they can, many parents would prefer to assist their children when they need it most, rather than benefiting from an inheritance later in life. However, it's essential that any support does not risk your financial security, and that means looking at what support you can afford to provide.

The downside of cash gifts

A cash gift towards a deposit or mortgage is a simple and effective method of helping a family member. However, there are a few downsides:

- Where the gift forms all or a significant portion of the deposit, lenders may want to ensure that the loan is serviceable and may require verification of the source of the funds to ensure the amount is not a loan and does not require repayment (i.e., a gift letter).
- In the event of a divorce or separation, the gift may not overtly benefit your child, and instead form part of the property pool to be divided.

For income tax purposes, gifts from a family member out of natural love and affection are not normally taxed.

The 'bank of Mum & Dad'

If you provide a loan to your child to purchase a home, it's essential that the terms of the loan are documented, preferably by a lawyer.

There are many ways to structure the loan depending on what you're trying to achieve. For example, the loan might mimic a bank loan with interest and regular payments, require repayment when the property is sold or ownership changes, and/or managed by your estate in the event of your death (treated as an asset of the estate, offset against the child's share of the estate, or forgiven).

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There is a lot to think about before lending large amounts of money; what should happen in a divorce, if your child remortgages the property, if you die, if your child dies, if the relationship becomes acrimonious, etc. As always, hope for the best but plan for the worst.

Providing security to lenders

A family guarantee can be used to support a loan in part or in full. For example, with some lenders you can use your security to contribute towards your child's deposit to avoid lender's mortgage insurance (which ranges between 1% to 5% of the loan).

When you act as a guarantor for a loan, you provide equity (cash or often your family home) as security. In the event your child defaults, you are responsible for the amount guaranteed. If you have secured your child's loan against your home and you do not have the cashflow or capacity to repay the loan, your home will be sold.

If you are contemplating acting as guarantor for your child, you need to look at the impact on your finances and planning first. Your retirement should not be sacrificed to your child's aspirations. And, where you have more than one child, look at equalising the impact of the assistance you provide in your estate.

Co-ownership

There are two potential structures for buying property with your children:

- **Joint tenants** - the property is split evenly and in the event of your death, the property passes to the other owner(s) regardless of your will.
- **Tenant-in-common** – the more popular option as it allows for proportions other than 50:50 (i.e., 70:30). If you die, your share is distributed according to your will.

Regardless of ownership structure, if the property is mortgaged and the other party defaults on the loan, the loan might become your responsibility. It is vital to consider this before loan arrangements are entered into.

It's also essential to have a written agreement in place that defines how the co-ownership will work. For example, what happens if your circumstances change and you need to cash out? What if your children want to sell and you don't? Will the property be valued at market value by an independent valuer if one party wants to buy the other one out? It's not uncommon for children to assume that they will only need to pay the original purchase price to buy your share with no recognition of tax, stamp duty or interest. And, what happens in the event of death or dispute?

If you are not living in the home as your primary residence, then it is likely that capital gains tax (CGT) will apply to any increase in the market value of the property on disposal of your share (not the price you choose to sell it for). And, you will not benefit from the main residence exemption. In these situations, it is essential to keep records of all costs incurred in relation to the property to maximise the CGT cost base of the property and reduce any capital gain on disposal.

Utilising a family trust

A more complex option is to purchase a property in a family trust where you or a related company acts as trustee. This strategy is often used for asset protection purposes. Typically, at some point in the future, you would pass control of the trust to your child and it might be possible to do this without triggering material CGT or stamp duty liabilities, although this would need to be checked. On the eventual sale of the property, CGT will apply to any increase in value of the property and the main residence exemption cannot be used to reduce the tax liability, even if the child was living in the home.

Be wary of state tax issues. For example, in some states, owning property through a trust will mean that the tax-free land threshold will not apply, increasing any land tax liability. Also, if the trust has any foreign beneficiaries, this could result in higher rates of stamp duty.

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Reduced or rent free property

Buying a house and allowing your child to live in the house rent-free or at a reduced rent enables you to put a roof over their heads but adds no value to your child's ability to secure a loan or utilise the equity of the property to build their own wealth.

If you intend to treat the property your child is living in as an investment property and claim a full deduction for expenses relating to the property, then rent needs to be paid at market rates. If rent is below market rates, the ATO may deny or reduce deductions for losses and outgoings depending on the discount provided. Any rental income received is assessable to you. In addition, CGT will be payable on any gain when the property is sold, or ownership is transferred.

If the intention is to provide this property to your child in your estate, ensure your will is properly documented to support this intent.

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Quote of the month

"If you could kick the person in the pants responsible for most of your trouble, you wouldn't sit for a month."

Former US President, Theodore Roosevelt

Do your kids really want to take over your business?

Generational succession - handing your business across to your kids or family - sounds simple enough but, many families end up in a dispute right at the point when the parents, business, and children are most vulnerable. It's important that generational succession is managed as closely and diligently as if you were selling your business to a stranger to avoid misunderstandings and disputes.

If you are looking to hand your business to your children or relatives, there are a few key issues to think about:

Capability and willingness of the next generation – do your kids really want the business?

There needs to be a realistic assessment of whether or not the business can continue successfully after the transition. In some cases, the exiting generation will pursue generational succession either as a means of keeping the business in the family, perpetuating their legacy, or to provide a stable business future for the next generation. All of these are reasonable objectives, however, they only work where there is capability and willingness.

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The alternative scenario can also exist where generational succession is pursued by the younger generation. In some cases, it's seen as their birth right. In these cases, the willingness will exist but this does not automatically translate to capability.

Capital transfer – how much money needs to be taken out of the business during the transition?

What level of capital do the current business owners, generally the parents exiting the business, need to extract from business at the time of the transition? The higher the level of capital needed, the greater the pressure that will be placed on the business and the equity stakeholders.

In most cases, the incoming generation will not have sufficient capital to buy out the exiting generation. This will require the vendors to maintain a continuing investment in the business or for the business to take on an increased level of debt.

In many cases, the exiting generation will want to maintain a level of equity investment. This might be a means of retaining an interest in the business or alternatively staging their transition. In either case, it is important to map the capital transition both from a business and shareholder perspective. This needs to be documented and signed off firstly from the business's perspective and then by both generational groups. No generational transition should be undertaken without a clear and agreed capital program.

Income needs – ensuring remuneration is on commercial terms

In many SMEs, the owners arrange their remuneration from the business to meet their needs rather than being reasonable compensation for the roles undertaken. This can result in the business either paying too much or too little.

Under a generational succession, there should be an increased level of formality around compensation to directors and shareholders.

Compensation should be matched to roles and where performance incentives exist these should be clearly structured.

Operating and management control

Once the capability and capital assessments have been completed, it is important to look at the transition of control. This can be a very sensitive area. It's essential to establish and agree in advance how operating and management control will be maintained and transitioned.

The plan for operating and management control should be documented and signed off by all parties with either timelines for time driven succession or milestones for event-focussed transitions.

Transition timeframes and expectations

Generational succession is often a process rather than an event and achieved over an extended period of time. The critical issue is to identify and ensure that all parties have a common understanding and acceptance of the time period over which the transition will take place. This should be included in the documented succession plan.

The need for greater formality and management structure

Generational succession often requires a greater level of formality in the management and decision making process. This formality should achieve a separation of function between management, the Board, and shareholders.

Often in an SME business, these roles merge and there are no clear dividing lines or boundaries. Roles, responsibilities, and clear key performance indicators (KPIs) for management should be agreed and documented.

Need assistance? We can work with you to successfully transition your business.