



NEW DEBT / EQUITY RULES

The ATO deadline for documenting at-call loans (30 June 2005) has now passed. Any entity affected by the new rules should be taking steps to comply with the new rules. If these loans are not properly documented, they are at risk of being characterised as equity interests. This means that instead of repayments being made in reduction of an outstanding loan balance, amounts returned to the lender may be characterised as dividends and therefore taxable in the lender's hands.

A small business carve-out was announced by the Assistant Treasurer in May 2004. The announced carve-out was originally formulated so that where a company to which the related party loan is made satisfies a combined maximum net assets value test and an interest deductibility cap at the end of an income year, the loan will be excluded from the debt/equity tax rules in that year.

The Assistant Treasurer announced changes to the carve-out on 15 July 2005. The carve-out will now operate to exempt companies with annual turnover of less than \$20 million and effectively excludes all small business from the operation of the debt/equity rules.

Unfortunately, the small business carve-out has not yet been legislated and therefore some uncertainty still exists as to exactly how it will operate.

THE NEW ACIS DIV 974 LOAN AGREEMENT

The new ACIS Div 974 Loan Agreement has been designed and drafted for maximum flexibility. It may be used as a fixed sum or a facility agreement and for a single or for multiple lenders. This is achieved by adopting a standard set of terms for each loan to the relevant entity which is then incorporated into each individual loan when it is made. Loans can be made as further advances under an existing loan agreement (retaining the original term of the loan) or as a new loan by completing a new loan agreement. In all cases further advances or new loans must be documented by minute under a completed loan agreement.

COMPANY CREDIT LOAN ACCOUNTS EXPLAINED

On the 1 July 2001 new debt / equity rules were introduced which affect various Company transactions whereby a financial benefit is provided to a Company either by or for the benefit of a Related Entity. These provisions are distinct from Division 7A arrangements which apply to loans between shareholders and a Company or beneficiaries and a trust. The new rules are specified in Division 974 of the Income Tax Assessment Act of 1997.

The purpose of the new rules are to identify whether the financial benefit received by a Company (a "Scheme") constitutes a debt owed by the Company to the other entity or whether the Scheme is an acquisition of an interest in the Company. The difference is significant because if the financial benefit is a debt owed by the Company then the repayment of the debt is not income in the hands of the lender and any interest paid by the Company is tax deductible to the Company. If the advance of monies is not a loan then the

"lender" is an investor who is deemed to have an equity interest in the Company and the repayment of monies to the investor will be deemed a dividend, which can be franked by the Company but which is income when received by the investor.

The rules provide tests to determine whether the Scheme creates a debt and the rules also provide for a test to ascertain whether the Scheme constitutes an equity interest in the Company.

The Debt Test

The Scheme satisfies the debt test if all the following conditions are met:

1. the Scheme is a financing arrangement for the entity or the entity is a Company and the Scheme gives rise to an interest as a member or shareholder of the Company by the entity providing the financial benefit;
2. the first entity receives a financial benefit greater than nil under the Scheme;
3. the first entity who has received the financial benefit has "an effectively non contingent obligation under the Scheme" to provide a financial benefit to the second entity who provided the financial benefit referred to in paragraph 2 above;
4. the financial benefit provided by the first Company under 3 above is at least equal to the financial benefit received by the first Company under paragraph 2 above.

"Financial Benefit" means anything of economic value and includes property and services.

For the purposes of determining whether the first entity receives a financial benefit greater than nil under the Scheme we must determine if the term of the Scheme is 10 years or less. If the term is greater than 10 years, then for the financial benefit to be greater than nil, the Company must be required to pay amounts annually or at maturity that in total (measured in present value terms) are more than the issue price. It is necessary to apply a present value calculation using as a discount rate, 75% of the normal borrowing rate for a loan of similar duration. (So if the term is greater than 10 years, the Scheme can't be an interest free.)

The Equity Test

The Scheme creates an equity interest in the first Company if the following test is satisfied. The Scheme satisfies the equity test if any of the following occur:

1. the Scheme gives rise to an interest in the Company to the entity as a stock holder of the Company;
2. the Scheme is a financing arrangement that gives rise to an interest carrying a right to a return from the Company and the right of return is contingent on the economic performance of the Company;
3. the Scheme is a financing arrangement that gives rise to an interest carrying a right to a return from the Company and the right or return is at the discretion of the Company;
4. the Scheme is a financing arrangement that gives right to an interest issued by the Company that either:
 - (i) gives it's holder a right to be issued with an equity interest in the Company; or
 - (ii) is or may be convertible into such an interest.

The return referred to in paragraphs 2, 3 and 4 above may take the form of a chose in action or a proprietary right.

If the Scheme passes the debt test i.e. it is a debt, then it will not be an equity interest. If the Scheme passes both tests and qualifies as both a debt and an equity interest then it will be a debt interest.

Transition Provisions

Transitional provisions apply as follows:

1. If a Scheme was entered into before 1 July 2001 and the Scheme was intended to create a debt but does not pass the debt test, then as from 1 July 2005 the Scheme will be treated as creating an equity interest.
2. If the Scheme was entered into on or after 21 February 2001 and it was intended that the Scheme would be a debt but it does not pass the debt test then it shall be treated as a debt until 1 January 2003, from which time it will be treated as an equity interest provided it is a loan to a Company by a connected entity, the loan has no fixed term and is repayable on demand.

What to do now?

1. Look at all Company debts and liabilities especially with related parties and investors.
2. If created before 1 July 2001 then you need to decide if that Scheme needs to be restructured to ensure compliance with Debt Test, before 30 June 2005.
3. If created after 21 February 2001 and is an at-call loan then the Scheme will need to be restructured by 31 December 2002.
4. If The Scheme is entered into after 21 February 2001 and is not an at-call loan, the rules apply as from 1 July 2001 and the Scheme will need to be restructured immediately if the Debt Test is not met.

The effect of these provisions is wide and the terms of the provisions are complex.

The rules potentially relate to inter-company loans between group companies, service agreements, Intellectual Property Licenses between connected entities and raising capital from investors.

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