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MAY 2008 Newsletter

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Deadline looms for shareholder loan accounts

If you have a shareholders loan account now is the time to check that all is ok with it. Division 7A of the Tax Act can trigger tax on shareholder loans where you have borrowed money from your company or where the company has paid expenses on your behalf. While this legislation was introduced in 1997, many small businesses have been in breach of Division 7A.

Last year, the Australian Tax Office (ATO) issued a practice statement (PSLA 2007/10) that provided an amnesty period up to 30 June 2008 to correct any Division 7A breaches. Time is running out.

If you have borrowed money from your company or trust, had expenses paid on your behalf, or simply drawn cash in excess of your wages or dividends then you could have a Division 7A breach. This would have resulted in a debit loan account in your financial statements. If your loan does not comply with the current guidelines, then the loan might be deemed an unfranked dividend with the loan amount assessable in the hands of the shareholders.

Debit loan accounts can be easily overlooked and also created unintentionally.

The amnesty allows taxpayers to put in place corrective action that will avoid the tax liability that otherwise would have occurred and also the resultant penalties.

There are certain conditions that need to be met to qualify for this relief. The first requires that it is clear that the failure to comply was the result of an honest mistake or inadvertent omission. A further condition is that where corrective action requires you to establish a complying loan agreement, and in most cases it will, then you need to have met the minimum payments that would have been required if the loan had been put in place in the year when the debt was incurred. This is a cash flow or financing issue.

As the amnesty is about to end, it is crucial to ensure that you review and manage any loan account issues now. After 30 June this year, it will be too late to take corrective action. Any loan account that does not meet the guidelines will be deemed an unfranked dividend and taxed in the hands of the shareholder.

Do you have debit loans to shareholders (or associates) or think that you could be affected? Talk to your adviser today about safeguarding your position and ensuring you don't get caught by this tax. It may take some time to put in place the corrective action required so don't leave it till the last minute.

Fringe benefits tax warning

A recently decided tax case, Slade Bloodstock Pty Ltd and Commissioner of Taxation, sounds a warning to all small businesses. In this case the ATO took issue with a company where they paid expenses on behalf of the shareholders and those payments were charged back against a shareholders loan. The company had a debt to the shareholders for moneys they had previously advanced to it. As the company paid expenses on behalf of the shareholders, it was charged against the loan reducing the indebtedness. Sounds ok so far and there would be a lot of small businesses who would have done exactly the same thing. So, where was the problem?

The ATO attempted to treat the payments by the company as an expense fringe benefit and charged the company with fringe benefits tax. When tested in the Federal Court, the ATO lost - thankfully. However, what did come out of the case was the need for companies to have agreements in place confirming that any payments being made on behalf of the shareholders represented a reduction in the loan account and it was appropriate for such payments to be applied as a reduction of the loan. This documentation was the evidence relied on in court that the payment was not an expense fringe benefit payment.

Many shareholders think that where the company owes them money there is no problem with loan accounts and no problem with the company paying expenses on their behalf and applying it as a reduction of the loan account. This case indicates that in principle, there is no problem with this but you need to have documentation in place that confirms the intention of both the company and the shareholders. This documentation should include an agreement between the company and shareholders on the treatment of such payments. It is also recommended that the company record a minute each year confirming the nature of any payment that it makes on behalf of the shareholders. These payments should be recorded in the company accounts, in the first instance, as a reduction in the shareholder loan account. Do not charge it to an expense account and then later adjust it to the loan account.

Like many other areas, the devil is in the detail.

Market tightens its grip on small business

Have you noticed that your customers are paying you a little slower than usual? A recent Dun & Bradstreet survey shows business to business payment days have hit their highest level since 2001. The average payment period across all industries has reached 55.8 days.

Of great concern for many small business operators will be the slowdown in payments by big business. The report shows a blow out in the length of time it took to get paid with businesses with 500+ employees taking 62.7 days to make payments, more than double the standard payment terms and an increase of 5.6 days from the December quarter.

Despite maintaining payment periods which are more than three weeks past normal terms, small businesses were the quickest to pay. The 1-5, 6-19 and 20-49 categories took just under 55 days to settle accounts in the March quarter.

The report also shows that public companies continue to be slower payers than their private counterparts with the gap between the two increasing further. The public sector added 6.5 days to the time it takes to settle accounts while the private sector jumped 3.2 days. Taking almost five weeks longer than the standard term, public companies averaged 64.5 days to pay bills in the March quarter; private companies took 55.6 days.

During the economic good times, many businesses let their debtor management slip. Now that the financial pressure is on, some have been caught out.

On top of a cash flow cycle slow down, the major banks have tightened their lending criteria and are moving to enforce these criteria. Existing bank customers that are operating outside of their loan covenants may face follow up from the bank.

A loan covenant is a binding performance requirement under which the debtor has to comply. Typically these cover issues such as required leverage, interest coverage, operating ratios. It's worth going back to your contracts and reviewing what covenants are in place to ensure your business is compliant.

Highly leveraged companies are particularly susceptible. If a large portion of your business gross profit is directed towards the financing of loan capital this indicates that you are in a higher risk position. Don't lose control over your position. It may be a good time for a business health check.

For those who are likely to need to borrow money, don't expect any special favours. The banks may not be chasing you for your business as they once were. Be particularly wary if you are on a growth path and funding that growth with debt. The banks are going to want to see strong financials to continue lending to you.

If you are a high growth company or are likely to need cash in the next 12 months, talk to us today. Presenting a strong financial position will play a pivotal role in your future. This is an area to keep a close eye on.

Quote of the month

Experience is one thing you can't get for nothing

Oscar Wilde

The material and contents provided in this publication are informative in nature only. It is not intended to be advice and you should not act specifically on the basis of this information alone. If expert assistance is required, professional advice should be obtained.