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Debt and equity tests: guide to 'at call' loans

Work out how debt and equity rules apply to 'at call' loans when you lend money 'at call' to a company.

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This guide is designed for tax professionals as well as controlling shareholders, directors and other connected entities of companies who lend money 'at call' to a company. It explains when and how debt/equity measures apply to 'at call' loans.

This guide is designed for tax professionals as well as controlling shareholders, directors and other connected entities of companies who lend money 'at call' to a company. It explains when the debt/equity measures contained in **Division 974** of the *Income Tax Assessment Act 1997* - 'the debt/equity rules' - apply to 'at call' loans made to a company by a connected entity.

A **connected entity** is either an associate of the entity, or another member of a wholly owned corporate group. For example, in the context of ‘at call loans’, a controlling shareholder would be a connected entity of the company.

This guide also explains the annual turnover test. This guide will only apply to trusts if the trust is taxed as a company. It is also not intended to apply to 'at call' loans between a resident company and a foreign entity or in situations where an 'at call' loan forms part of a more complex related scheme.

At call loans

For the purposes of this guide, an 'at call' loan (or related party 'at call' loan) is a loan to a company, by a **connected entity** (including a controlling shareholder or director), that does not have a fixed repayment term and is repayable on demand by the connected entity (that is, the lender). These loans are sometimes referred to as related party or credit shareholder loans.

'At call' loans may be classified as giving rise to either debt or equity interests in the company for tax purposes under the debt/equity rules. However, some companies satisfying a **turnover-carve-out** are excluded from the application of the debt/equity rules. An explanation of this carve-out is provided below.

Small business carve-out

If a company has a turnover of less than $20 million, there is a carve-out which means related party ‘at call’ loans will be treated as being debt interests rather than equity interests.

A company's annual turnover (worked out at the end of an income year) is to be determined in accordance with subsection 188-10(2) of the *Goods and Services Tax (GST) Act 1999*. This test is already used by small companies for GST purposes.

Private companies with related party 'at call' loans that do not qualify for debt treatment may change their loans so they are debt interests under the debt/equity rules. Taxpayers may elect to treat this change as if it occurred at the beginning of the previous income year. This election must be made before the earlier of the due date for the company's tax return or the date of actual lodgment for that year.

Because the turnover test applies on an annual basis, a company may qualify for deemed debt treatment under the debt/equity rules for one year but not the next. This means related party 'at call' loans to the company could change from being debt interests to being equity interests if their turnover exceeds $20 million.

At call loan as debt interest

An 'at call' loan will satisfy the debt test in two situations:

- If the 'at call' loan has a maximum term of 10 years or less, and there is an effectively non-contingent obligation to repay (at least) the amount that was borrowed, the 'at call' loan will be a debt interest, irrespective of whether it pays interest.
- If the loan is repayable 'at call' and has no fixed term, in order for it to be a debt interest there needs to be an effectively non-contingent obligation to pay an interest rate that is high enough to pass the debt test on a present value basis (an arm's length interest rate will achieve this).

Tax consequences of a debt interest

If an 'at call' loan satisfies the debt test and is classified as a debt interest, any payments in the nature of interest made by the company on the 'at call' loan may be deductible but cannot be franked.

Whether or not the interest payments would be deductible is determined by reference to the general deduction provisions of the income tax law (in particular, section 8-1 of the *Income Tax Assessment Act 1997*). This requires an assessment of, among other things, the use to which the borrowed funds are put.

A company may be indifferent as to whether an 'at call' loan is a debt interest or an equity interest. However, if the company is to pay interest on the loan and wants to be able to claim deductions for the interest paid (subject to section 8-1), the entity will need to ensure the terms of the 'at call' loan satisfy the debt test.

How to make an 'at call' loan a debt interest

If debt treatment is required, the company should review its 'at call' loan funding arrangements and amend the terms and conditions in such a way that the requirements of the debt test are satisfied.

To ensure debt treatment, the term of the loan should either be fixed at no more than 10 years, or, if the loan is for a term greater than 10 years or has no fixed term, an arm's length rate of interest will need to be paid. It is advisable that the loan be documented so that these terms can be demonstrated to be effectively non-contingent obligations of the company. One possible approach would be for the connected entity and the company to enter into a facility agreement making all money outstanding from time to time fall due and be repayable on a date not more than 10 years from the time the facility agreement is entered into.

Practically, the review of the 'at call' loan will not be important until a transaction occurs in respect of the loan, for example, when the company makes a payment of principal or interest. Prior to a transaction occurring, there will be no major taxation consequences of the 'at call' loan being classified as an equity interest (other than the requirement to keep a non-share capital account).

Amending 'at call' loans so they give rise to a debt interest

An 'at call' loan that is altered to either specify a term of 10 years or less, or requires that an arm's length rate of interest be paid, will be treated as a debt interest from the time the alteration occurred.

When will an 'at call' loan be an equity interest?

An 'at call' loan will generally be an equity interest if it does not satisfy the debt test in section 974-20 of the *Income Tax Assessment Act 1997*, and is not carved-out by the **turnover test**

A loan between a company and a **connected entity** which does not have a fixed term but is repayable on demand, and does not have a requirement to pay arms' length interest, will usually be an equity interest. Such a loan can meet the requirements of item 3 of the equity table in subsection 974-75(1) of the ITAA 1997 if the right to, or amount of, the return under the arrangement is at the discretion of the company that has been advanced the funds, or at the discretion of a connected entity of the company, such as a controlling shareholder of the company.

Accordingly, if the **turnover test** is failed, it will generally be the case that where a controlling shareholder lends money to a company, repayable on demand, with no fixed maximum term, and the loan is either interest free or has a low interest rate, the loan will be an equity interest for certain tax purposes.

Tax consequences of an equity interest

The tax consequences of an 'at call' loan being an equity interest are that any payment of interest on the loan will not be deductible but may be frankable. A
non-share capital account is also kept in this instance (refer to **Division 164** of the *Income Tax Assessment Act 1997*).

An 'at call' loan that gives rise to an equity interest may, in specific circumstances, attract the application of the dividend substitution provisions contained in **section 45B** of the *Income Tax Assessment Act 1936*.

Section 45B is designed to prevent the distribution of profits to shareholders as preferentially taxed capital rather than dividends.

The ATO considers that section 45B might apply if an 'at call' loan is repaid under a scheme which has, as one of its purposes, the enabling of a taxpayer to obtain a tax benefit. There are a number of relevant circumstances that need to be considered in working out whether section 45B might apply.

These circumstances, which are non-exhaustive, are set out in subsection **45B(8)** and include such things as the pattern of distributions of dividends, bonus shares and returns of capital or share premium; whether the taxpayer has capital losses that might have otherwise been carried forward and whether the taxpayer is a non-resident. Accordingly, the application or otherwise of section 45B of the ITAA 1936 to related party 'at call' loans will be determined by the facts and circumstances of the relevant taxpayer.

The non-share capital account

A non-share capital account is a notional account maintained by a company for tax purposes, which records contributions made to the company in respect of non-share equity interests (such as a related party at-call loan), and returns by the company of those contributions. The notional account allows a distribution on a non-share equity interest to be characterised as either a non-share dividend or a non-share capital return.

Sections 164-15 and 164-20 of the *Income Tax Assessment Act 1997* specify the credits and debits to be made to the non-share capital account.

The relationship between Division 7A of the ITAA 1936 and 'at call' loans

Division 7A of the *Income Tax Assessment Act 1936* deals with different situations from that to which Division 974 of the *Income Tax Assessment Act 1997* applies.

Division 7A treats certain amounts paid, lent or forgiven by private companies to certain associated persons (including individual shareholders) as assessable dividends. Division 7A of the ITAA 1936 thus deals with the situation where a company pays or lends to, or forgives an amount owing by, a shareholder, former shareholder, or an associate of a shareholder, of the company. That is, the company is paying (or lending to or forgiving) the shareholder etc.

In contrast, the debt/equity rules which apply to 'at call' loans deal with the situation where the shareholder, or connected entity, advances money to the company.

Example

Assume a shareholder has made an undocumented $50,000 'at call' loan with an uncertain term to a company on 1 July 1997, on the understanding that interest may be paid on the loan from time to time. The loan is still not formalised at 1 July 2005. The company has an annual turnover of $21 million.

The company does not meet the small business carve-out test in this instance. The annual turnover test is not satisfied as the company has a turnover greater than $20 million.

Accordingly, the 'at call' loan will give rise to an equity interest. The company will have a non-share capital account. It will also credit the non-share capital account to the value of the 'at call' loan to account for the equity interest.

The company repays $10,000 to the shareholder on 1 January 2006. For any repayments the company makes after 1 July 2005, it will debit its non-share capital account. Therefore, it will debit its non-share capital account for $10,000. The transactions above are illustrated in the following non-share capital account:

Non-share capital account

By keeping the loan 'at call' the company may, in certain circumstances, attract the application of section 45B of the ITAA 1936.

If the company wants to make the 'at call' loan a debt interest, it will have to formalise the loan, by making it for a fixed term of up to 10 years, or, if the loan is for a term greater than 10 years or has no fixed term, using an arm's length interest rate. It is advisable that the loan with these amended terms be appropriately documented.

What to read/do next

See also:

- Debt and equity tests: overview
- Debt and equity tests: guide to the debt and equity tests

Primary legislative reference

- Division 974 of the Income Tax Assessment Act 1997

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