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Summary

Estate Planning Superannuation, Trusts, Tax & Asset Protection

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Parent to Child Loans

4 major reasons

- Purchase of a home for the child
- Payment of school fees for grandchildren
- Purchase of (or an injection of cashflow into) a child's business
- (By parents over 75) making of contributions into superannuation & the generation of income tax free income streams

Key considerations for loans can include enforceability, family law asset protection, estate planning & tax

Parent to Child Loans – Family Law Considerations

The Family Court has wide powers in determining the division of assets between the parties of most domestic relationships. The Court in particular has the power to disregard the formalities of ownership or a contractual agreement. The Court can order 3rd parties such as a parent or a professional advisor (eg a lawyer or accountant) to deal with assets in a particular way if the Court concludes that those assets are to be viewed as assets of the relationship.

There are 3 ways that the Family Court tends to treat money that a parent may have viewed as a loan (or may now want to have viewed as a loan), ie as a:

• Gift made by the parent and thus part of the divisible assets of the relationship;

• Loan made by the parent on favourable terms and a resource available to one of the children of the relationship (often loans made to fund the purchase of a non-income generating asset or a child's contributions into superannuation); and

• Loan made on commercial terms and thus to be viewed no differently than other finance. Typically these loans are made to help fund the purchase of an income generating investment asset or a business asset.

It is likely that the loan will have more chance of being accepted on its face by a Court if that loan and its terms are:

• In writing (securing a loan against real estate or other assets of one or both of the parties to the relationship might also be helpful);

Free of provisions not usually seen in genuine loans, eg no ability to unilaterally charge interest and no ability to terminate a loan simply because a domestic relationship has ended; and

• There has been written acknowledgement of those terms by the borrowing child and (if the child is in or about to commence a domestic relationship) the child's domestic partner.

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Secured Loans

- Security can be a 1st or 2nd mortgage over real estate or a personal property security
- Interest does not have to be charged
- Family Court more likely to view secured loan as genuine
- Lender is a priority creditor if borrower gets into financial difficulty
- Mortgages exempt from duty in most Australian states & territories, eg Victoria, but still dutiable in NSW

Secured v Unsecured Parent to Child Loans

Having a loan secured is the most frequent exercised option for a parent wanting to put a loan at least partly on a commercial footing in case the child has family law difficulties, given the lack of adverse taxation implications, particularly if non-deductible interest is charged on a loan used to buy a family home or other lifestyle assets.

A secured loan has the additional advantage that if the child gets into financial difficulties, either in the child's own right or by providing a guarantee or an indemnity to the child's own child or to the child's domestic partner or business, the parent is a priority creditor and ranks ahead of the child's unsecured creditors.

Real Estate Mortgages

Once a mortgage is registered, further dealings in relation to the land title, eg a transfer on sale, will need to have the consent of the registered mortgagee or mortgagees. Even if the owner of the land becomes bankrupt, the mortgagee has the status of a secured creditor and ranks ahead of all unsecured creditors in recovering the debt owned to the mortgagee (up to the value of the security).

Personal Property Securities

The availability of an asset to be used as security varies considerably. Superannuation is an example of an asset that, with limited exceptions for last minute contributions, pension income and limited recourse loans, is not available for creditors. Other assets are subject to specific legislation, eg life insurance and water rights. Many other personal assets, eg motor vehicles, plant and equipment, livestock and most forms of intellectual property, can be used as security by virtue of the (federal) *Personal Property Securities Act 2009*, which provides a registration régime for the assets that fall within s 10 of the Act and that are not expressly excluded by s 8.

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Unsecured Loans

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\# Rank behind secured loans for payment priority

Subject to **contract** law, unsecured loans are only enforceable if any of these occurred in past 6 years:

- Lender's right to demand repayment started (*if repayable at call, right commences immediately*)
- Acknowledged by the borrower
- Payment of interest occurred
- Part repayment of capital occurred

Written loan terms may be needed, eg where Div 7A rules apply to companies & trusts & arm's length terms may be needed (Other tax issues may impact on loans as well)

Unenforceable Loans

The danger of loans becoming unenforceable is that the borrower (or a person standing in the shoes of the borrower) may refuse to repay the loans. Among the parties likely to refuse to repay a loan are:

- The executor of a deceased (or the attorney of an incapacitated) shareholder;
- The shareholders of an insolvent company;
- A shareholder in dispute with co-shareholders in a company;
- A shareholder in receipt of a loan made pursuant to section 108 of the *Income Tax Assessment Act 1936* ("*ITAA 1936*") where the ATO is out of time to issue an amended assessment. Where a loan becomes unenforceable after the commencement of the debt forgiveness provisions in Division 245 of Schedule 2F of *ITAA 1936*, the adverse consequences that can flow from this Division may be a problem, eg a loss or reduction of cost base for CGT purposes.

Directors' Risk

If a sizeable unenforceable loan is shown as an asset in the books of account of a company (or other entity), it may lead to the situation where the company is incorrectly holding itself out to be solvent.

Income Tax Issues

Among a range of income tax issues that may need to be considered when loans are being made to related parties are the:

- Division 7A rules in *ITAA 1936* – impacting on "lending" companies with retained profits, as well as lending trusts with a "distributable surplus" in favour of a corporate beneficiary – see ATO *Taxation Ruling* TR 2010/3; and
- "Commercial" debt forgiveness rules and (for trust loans outside a family group) family trust election penalties in Schedules 2C and 2F of *ITAA 1936* respectively.

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Unpaid Trust Allocations

Subject to **trust** law, unpaid allocations of trust income or capital are held on absolute entitlement trust for beneficiary

- Beneficiary has a vested & indefeasible interest
- Asset for *Bankruptcy Act 1966* purposes
- No Statute of Limitations (*unlike loans*) – payment can be demanded even 80 years after allocation
- If held on separate trust, not subject to Div 7A loan rules
- Trustee can apply for benefit, eg university fees
- State/Territory prudent person rules apply

Recording of Unpaid Trust Allocations – Need for Separation from Loans

Traditionally many accountants (prior to the extension of Division 7A of *ITAA 1936* to trusts), when preparing the books of account for family, unit, testamentary and other trusts and for deceased estates, had not seen the need to distinguish between:

• unpaid trust allocations to beneficiaries and unitholders; and

• loans to the trustee or executor from beneficiaries and unitholders.

Historically, in the absence of either a dispute between family members or a financial crisis, the distinction between the two has not proved problematic and the accountant has not had cause to regret the merging of the two types of “liabilities”. Where, however, a dispute or financial crisis did occur and there was such a merger in the accounts of the trust or deceased estate, it then became quite a forensic exercise to trace the account balances and identify:

• The proportion of the moneys (if any) that are loan monies, recovery of which is no longer enforceable by the beneficiary or unitholder or legal personal representative or trustee in bankruptcy for the beneficiary or unitholder;

• The proportion of the moneys (if any) that are unpaid allocations held on trust and to what extent has the trustee been negligent in failing to properly invest these monies – assuming that the beneficiary has not consented to the administration of the unpaid allocations. (Many recently established trust Deeds purport to release the trustee of a family, unit or testamentary trust from the obligations of the prudent person rule, but whether that can be done unilaterally in respect of a beneficiary or unitholder having a vested and indefeasible interest is a moot point.)

The extension of Division 7A to trusts with distributable surpluses in favour of corporate beneficiaries has made the distinction particularly important for income tax purposes (Division 7A does not apply to unpaid allocations of trust income or capital, unless the beneficiary has agreed that the unpaid allocation be treated as a loan.)