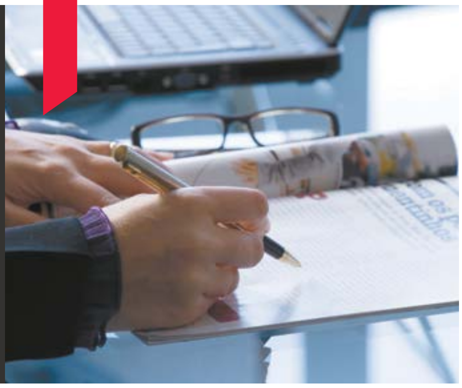
NOVEMBER 2018

TECHNICAL UPDATE



MAJOR PROPOSED CHANGES TO DIV 7A PRIVATE COMPANY LOAN AND PAYMENT RULES

TREASURY IS CONSULTING ON 'TARGETED AMENDMENTS' TO IMPROVE THE INTEGRITY AND OPERATION OF DIVISION 7A OF THE ITAA 1936. SUBMISSIONS ARE DUE ON 21 NOVEMBER 2018 AND BDO WILL BE LODGING A SUBMISSION. CONTACT BDO TO CONTRIBUTE TO OUR SUBMISSION.

CONSULTATION ON AMENDMENTS TO DIV 7A

On 22 October 2018 the Federal Treasury released for public consultation a paper on the 'targeted amendments' to improve the integrity and operation of Division 7A of the ITAA 1936.

The major proposed changes, most of which are to commence from 1 July 2019 include:

- Benchmark interest rate increased by more than 3% from housing rate to overdraft rate
- 10 year complying loan term replacing both 7 and 25-year loan terms
- Pre 1997 loans having to be repaid over 10 years with benchmark interest payable
- Trust unpaid present entitlements (UPE) to private companies to be deemed loans
- A self-correction mechanism to allow taxpayers to rectify breaches of Division 7A
- Assessment review period for Division 7A amendments increased to 14 years.

Division 7A is an integrity and anti-avoidance rule designed to prevent private company shareholders from avoiding paying tax at their marginal tax rates by funnelling private company profits to the shareholders or associates in the guise of payments, loans or debt forgiveness. However, Division 7A has proven to be a remarkably complex set of laws, which have caused confusion and placed onerous compliance requirements on both taxpayers and their advisors.

Accordingly, on 18 May 2012 the Government commissioned the Board of Taxation (BoT) to review the efficacy of the Division 7A regime. The BoT report was released by the Government on 4 June 2015.

The conclusions were the Division 7A rules were complex, inflexible, and imposed significant compliance costs on taxpayers, including many small businesses so the Board of Taxation recommended substantial changes to the structure of Division 7A. The Government has now finally responded to the BoT Report but has proposed to implement only some of the Board's recommendations. These proposals and BDO comments are outlined in more detail below.

The Board of Taxation took two years to examine Division 7A and make a holistic proposal for its replacement. Treasury has released a consultation paper that cherry-picks some of those ideas but is in no way represents a holistic reform of the tax law. While moves to amend Division 7A are welcome, they are still a band aid applied to an overly complex tax system.

BDO

1. SIMPLIFIED LOAN RULES

It is proposed that new and simpler loan rules will be implemented for complying Division 7A loans. The amendments propose an all-encompassing “single” loan model with a maximum 10-year term, a variable interest rate and payments of both principal and interest in each income year. The Consultation Paper states this is intended to better align with calculations for the repayment pf Principle and interest in commercial transactions.

Currently, Division 7A allows private company loans to shareholders or associates to have the maximum term of 7 years for an unsecured loan; or 25 years for a secured loan. There are also complex associated rules, including the prescribed requirements for a formal written loan agreement, rules to calculate the minimum amount payable annually, as well as when to pay loan related amounts.

Below is a summary of the proposed single 10-year loan model:

- A maximum term of 10 years which will commence at the end of the income year in which the advance is made. BDO Comment: there will be no option to extend the term for secured loans
- The annual benchmark interest rate will be the Small business; Variable; Other; Overdraft Indicator Lending rate most recently published by the Reserve Bank of Australia prior to the start of each income year. BDO Comment: this rate is currently 8.65%, which is a substantial increase on the current Division 7A benchmark rate of 5.2%, which is based on the bank variable housing rate
- There will be no requirement for a formal written loan agreement. However, written or electronic evidence showing the loan was entered into must exist by the lodgment day of the private company’s income tax return. This evidence may be included in an exchange of letters, emails, fax, accounting records, etc. and must show:
  - the parties to the loan;
  - the agreement that the loan be made, including details of the date and evidence of its execution and binding nature on the parties to the agreement
  - the loan terms (loan amount, date the loan was drawn, the requirement to repay the loan amount, the term of the loan and the interest rate payable). BDO Comment: This change is welcomed, however, it is just a clarification of the ATO’s administrative approach in in TD 2008/8
- The minimum yearly repayment amount consists of both principal and interest. The principal component will be a series of equal annual payments over the term of the loan. The interest component will be calculated on the opening balance of the loan each year using the benchmark interest rate. BDO Comment: While the mechanism is different to the current rules it has a similar result except for in the year of the final payment. However, under the current Division 7A rules there are no adverse consequences if the interest amount is not paid in the year of final repayment. It appears the proposed new rule would require the payment of interest in the last year
- The minimum yearly repayment amount will reduce the loan balance each income year. Where the minimum yearly repayment is not made in full any shortfall will be a deemed dividend for the year. BDO Comment: This is similar to the existing rules
- Interest is calculated for the full income year, regardless of when the repayment is made during the year (except Year 1). If the loan is paid out early, i.e. before Year 10, interest will not be charged for the remaining years of the loan. BDO Comment: This has a similar result as under the current rules, however, this does not meet the stated aim of the proposed changes to better align Division 7A loans with commercial transactions. Under a commercial transaction the interest would only be payable for the period while the loan is unpaid
- Repayments of the loan made after the end of the income year but before the lodgment day for the first income year are counted as a reduction of the amount owing even if made prior to the loan agreement being finalised. Interest for Year 1 is calculated for the full income year on the balance of the loan outstanding at lodgment day. BDO Comment: Clarification is needed in relation to whether the repayment made before lodgement day would be taken into account as part of the minimum yearly repayment for that repayment is made, which is the current ATO treatment as per ATO ID 2010/82.

Transitional rules

Transitional rules will be introduced to allow taxpayers that have existing Division 7A loans to transition to the new 10 year loan model as follows:

- Complying 7 year loans in existence as at 30 June 2019 - These loans must comply with the proposed loan model and new benchmark interest rate but will retain their existing outstanding term. Current loan agreements with written reference to the benchmark interest rate should not be required to be renegotiated
- Complying 25 year loans in existence as at 30 June 2019 – These loans will be exempt from the majority of changes until 30 June 2021. However, the interest rate payable during this period must equal or exceed the new benchmark interest rate. On 30 June 2021 the outstanding value of the loan will give rise to a deemed dividend unless a loan agreement complying with the new rules is put in place prior to the lodgement day of the 2020-21 company tax return, with the first repayment due in the 2021-22 income year. BDO Comment: Many borrowers that have taken out 25 year loans will find it difficult to rearrange their affairs to instead repay the loan over 10 years. With the current restrictions on Bank lending many may find it difficult to refinance with an arm’s length lender. In addition, the consultation paper does not provide sufficient details on this. It is assumed the requirement to have a complying loan agreement means that the 25-year loan has to convert to a 10-year loan, but it is not clear when this 10 year term has to start. It is expected that the 10-year term would start from 1 July 2021 but does this include existing 25 year loans that have less than 10 years to run as at 1 July 2021?

- Pre-1997 loans – Under the current rules, loans made before 4 December 1997 are generally exempt from the operation of Division 7A, however, the consultation paper proposes to make pre 1997 loan subject to Division 7A from 1 July 2021, this will be achieved by deeming the balance of the pre 1997 loan as at 30 June 2021 to be "financial accommodation" provided by the company and therefore deemed to be a loan provided by the company on 30 June 2021. The taxpayer will have until the lodgment day of the 2020-21 company tax return to either pay out the loan amount or put in place a complying loan agreement, otherwise it will be treated as a dividend in the 2020-21 income year, with the first repayment due in the 2021-22 income year. BDO Comment: This proposal would be a major turnaround of Government policy with more than 20 years of the treatment of pre 1997 loans being reversed.

Application to non-resident private companies

The consultation paper specifically mentions the practical difficulties and uncertainty in applying Division 7A to loans, payments and debts forgiven by non-resident private companies. While Treasury does not suggest any specific amendments to overcome these issues, it invites stakeholder feedback on the extent of any uncertainty and how best to remove any such uncertainty. BDO Comment: The current rules specifically include non-resident companies in the Division 7A rules but there is still uncertainty on how the rules operate, particularly in relation to how the source of income rules and double tax agreements apply for non-resident shareholders or associates.

Distributable surplus

The proposed amendments include the removal of the concept of 'distributable surplus', which is one of the essential numeric components to calculate a deemed Division 7A dividend. Broadly, the distributable surplus is the realised and unrealised profits in the company. If there is no distributable surplus at the end of the company's year of income there would be no deemed dividend, or the deemed dividend amount would be limited by the amount of distributable surplus.

The result of removing the concept of distributable surplus means a deemed dividend can arise where there are no realised or unrealised profits in the company i.e. where the only source of the funds is from share capital or borrowed funds. The consultation paper justifies this on the basis that the corporations law no longer requires dividends to be paid out of profits as per section 254T of the Corporations Act 2001 (Cth). BDO comment: While the corporations law no longer requires dividends to be paid out of profits, the income tax definitions of 'dividend' and 'frankable distribution' generally do not include distributions out of share capital. It would be more appropriate to look at what is permitted under the tax law rather than the corporations law.

2. UNPAID PRESENT ENTITLEMENTS

The Government announced amendments to clarify how unpaid present entitlements (UPEs) that trusts owe to private companies are dealt with under Division 7A. Broadly, UPEs arise where a trust makes a private company entitled to a share of its income or capital gains for a year but does not actually pay that amount to the private company. The Commissioner has taken the view UPEs are subject to Division 7A being a 'financial accommodation' under the extended meaning of a 'loan', unless the funds representing the UPE are held under sub-trust for the sole benefit of the private company.

The practical application of the Commissioner's view is that the sub-trust arrangement must result in the UPE funds being either lent back to the trust for 7 or 10 years on interest only terms, or invests the amount in a specific income-producing trust asset. Accordingly, trusts were not required to repay the UPE amount until the end of the interest-only loan or when the specific income producing asset is disposed of.

Broadly, the amendments propose to deem the UPE to be a loan whether or not it is subsequently put under a sub-trust i.e. treat UPEs consistently with loans made by private companies to shareholders/associates. For UPEs that comes into existence after 30 June 2019, to avoid being deemed to be a dividend, the UPE would have to be paid to the private company or put it under a complying loan by the lodgement day of the company's tax return for the year the UPE came into existence.

All UPEs arising between 16 December 2009 and 30 June 2019, that are not already on complying loan terms or deemed to be a dividend, will need to be put on complying terms by 30 June 2020. BDO Comment: It appears that the pre 30 June 2019 UPE sub trusts that are put under a complying loan agreement will have a further 10 years to fully pay out the UPE (with annual repayments and interest).

3. REVIEWING BREACHES OF DIVISION 7A

Self-Correction Mechanism

The consultation paper proposes the introduction of a self-correction mechanism to allow taxpayers to rectify inadvertent breaches of Division 7A. This will provide the opportunity for shareholders and associates voluntarily correct their arrangements without penalty.

Currently, Division 7A contains a rectification measure. However, this requires the Commissioner to exercise a discretion to disregard a deemed dividend or allow it to be franked, provided the dividend arose as a result of an honest mistake or inadvertent omission. Taxpayers currently must apply to the Commissioner to exercise this legislative discretion.

The current Commissioner's discretion to disregard a deemed dividend will be replaced with the self-correcting mechanism, but the Commissioner's discretion will remain where taxpayers seeks the Commissioner's discretion to have the dividend franked.

To qualify for self-correction, the taxpayer will need to meet eligibility criteria in relation to the benefit that gave rise to the breach. The eligibility criteria will require that:

- on the basis of objective factors, the Division 7A breach was inadvertent
- appropriate steps were taken as soon as practicable (and no later than six months after identifying the error unless the Commissioner allows more time) to ensure affected parties are placed in the position they would have been in had they complied with their obligations (this includes the entering into a complying loan agreement and making catch up payments of principle and interest to the company)
- the taxpayer has taken, or is taking, reasonable steps to identify and address any other Division 7A breaches. BDO Comment: This is a welcome change that will either cut compliance costs for taxpayers or legitimate the approach of some taxpayers of informally self assessing the Commissioner discretion on the basis that the Commissioner is likely to exercise his discretion if he were asked.

Review Period

To improve integrity and ensure compliance with the new loan model, as well as the ability to self-correct, the consultation paper proposes to extend the review period for Division 7A transactions to 14 years after the end of the income year in which the loan, payment or debt forgiveness gave rise or would have given rise to a deemed dividend. This will apply from 1 July 2019. BDO Comment: The proposed 14-year review period appears to be an overreaction to a few taxpayers attempting the avoid their Division 7A responsibilities by waiting until after the relevant 2 or 4-year assessment review period before identifying breaches of the Division 7A requirements. The 14-year review period is not necessary as the ATO already has the ability to extend the review period where the taxpayer has been involved in tax evasion, which would include situations where taxpayers are aware of the Division 7A breach but do not take any action before the review period has past.

4. SAFE HARBOURS – PROVISION OF ASSETS FOR USE

Safe harbour mechanism

The proposed amendments seek to introduce a new safe harbour mechanism which would apply to the rules for the 'provision of assets for use'. Under the current rules a Division 7A deemed dividend may arise where a private company provides an asset for the use by a shareholder or their associate. In such circumstances the provision of the use of an asset is treated as a 'payment' for Division 7A purposes. The deemed dividend amount is the amount the parties would have paid for to use of that asset if they had been dealing at arm's length less any amounts actually paid.

In practice, determining this arm's length amount can be difficult in some cases and cause increased compliance costs for taxpayers. Accordingly, safe harbour rules were recommended by the Board of Taxation to facilitate compliance, reduce uncertainties and lower administrative costs for taxpayers.

It is proposed that a detailed numeric formula based on the value and usage period of the asset with 5 per cent interest uplift will be legislated to ascertain the safe harbour value of the use of the asset. However, the taxpayer will continue to be able to use their own calculation of the arm's length value instead of the legislative formula.

The safe harbour will apply for the exclusive use of all assets excluding motor vehicles. This is because the market value for rental of a motor vehicle is readily ascertainable by other means.

The release of the consultation paper so close to the proposed 1 July 2019 start date might cause some further uncertainty. It is unlikely that we will see draft legislation before the end of this year, leaving five months for the Government to release draft legislation, consult further, introduce a Bill into Parliament, secure the numbers in the Senate and enact the legislation before 1 July 2019. Compounded with a looming Federal Election and Federal Budget before then as well, BDO query if the proposed start date of 1 July 2019 is realistic.

5. MINOR TECHNICAL AMENDMENTS

The consultation paper also contains a number of proposed technical amendments to improve the integrity and operation of Division 7A. The more interesting of these include the following:

- In relation to a debt forgiveness by a private company, currently it is not a deemed dividend where the debt was previously deemed to be a dividend under Division 7A. However, this applies whether or not the deemed dividend was actually taken into account in the taxpayer's assessment for the relevant year. Amendments are proposed so that a debt forgiveness will be a Division 7A deemed dividend where the earlier deemed dividend in relation to the loan was not actually taken into account in the debtor's income tax assessment
- Amendments are proposed to ensure the Division 7A exemption for companies that make loans 'in the ordinary course of business', i.e. the business of money lending, will only apply to loans made in the ordinary course of a business of lending money to third parties, rather than in the ordinary course of any business. BDO Comment: We see this particular concession should be expanded instead of restricted as proposed. There is a good argument that all loans made on commercial terms by the private companies, particularly to trusts for use in working capital, should be excluded from the operation of Division 7A. If the company is receiving a commercial interest rate and the repayment terms are in line with arm's length terms, the company and the borrower are in similar financial and tax situation as if the company and the borrower had instead been dealing with arm's length parties. i.e. there is no loss to the Government revenue. This is in line one of recommendations of the BoT which was to exclude UPEs of trading trusts from the operation of Division 7A so that it could reinvest profits in their business.

BDO COMMENT

The Division 7A rules are particularly complex and easy to unintentionally breach with resulting harsh pecuniary penalties. Therefore, the measures allowing for self-correction for inadvertent breaches and safe harbour rules will provide a relief from the possible harshness of Division 7A. These proposed amendments are aimed at improving the operation and administration of Division 7A and better aligning them with commercial transactions. However, the Government has not gone as far as the BoT recommended in this regard. In particular, with the removal of the 25 year secured loan option the alignment with commercial transaction has not been met. In addition, some of the proposed amendments may lead to an increased Division 7A liability, namely the removal of concept of distributable surplus so that distributions of both income and capital may give rise to a deemed dividend. Submissions are due on 21 November 2018 and BDO will be lodging a submission. Contact your local BDO Tax adviser if you have any comments on the above and to contribute to our submission.

FOR MORE INFORMATION:
TO CONTACT US TODAY, CLICK HERE. ALTERNATIVELY, PLEASE CALL US ON 1300 138 991

BNE 0963/1118