Private company groups - Are you prepared for Division 7A changes proposed to apply from 1 July 2019?

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In brief

To support the 2018-19 Federal Budget proposal to amend the operation of the deemed dividend rules (contained in Division 7A of the *Income Tax Assessment Act 1936* (Cth)) which apply to many private company groups, Treasury released its Consultation Paper in October 2018.

With the proposed changes due to take effect in a little over six months, the opportunity to see the proposed changes outlined in this consultation paper was welcomed as it provided private businesses and tax practitioners with the first indication of what the new Division 7A rules may look like from 1 July 2019.

Although we support the broad aim to improve the integrity and operation of these provisions, we believe that more work needs to be done to provide increased certainty, reduce compliance costs and increase flexibility for private businesses that will need to deal with the rules. The changes, as currently proposed, may have significant cash flow and commercial impacts for affected taxpayers. PwC has lodged a submission in response to the Treasury Consultation Paper.

In detail

The Division 7A deemed dividend rules broadly apply to treat certain loans, payments (including the provision of assets for private use) and debt forgiveness by private companies to their shareholders (or associates) as taxable dividends, subject to certain exceptions. In addition, certain trust distributions to private companies where the amounts remain unpaid (referred to as 'unpaid present entitlements' (UPEs)) have also been subject to these rules in accordance with the Australian Taxation Office's (ATO) administrative guidance. One of the commonly relied upon exceptions to the deeming of a dividend is when a loan or payment is repaid or converted to a complying loan by the private company's lodgment day for the income year in which the payment occurs.

Importantly, pre-4 December 1997 loans and pre-16 December 2009 UPEs have been completely quarantined from the operation of these rules.

What is the current proposal?

The Government is now proposing to make a number of changes to Division 7A, to take effect from 1 July 2019, including:

- simplified Division 7A loan rules to make it easier for taxpayers to comply
- a self-correction mechanism to assist taxpayers to promptly rectify breaches of Division 7A

- safe harbour rules for the use of assets to provide certainty and simplify compliance for taxpayers, and

- technical amendments to improve its integrity and operation and provide increased certainty for taxpayers.

The proposed simplified loan rule is that there will be a maximum 10-year loan model to replace the existing seven year or 25 year (secured) options. Features of this 10-year loan model include:

- A requirement to make equal annual principal payments over the loan term with interest calculated on the annual opening loan balance at the 'small business variable - overdraft' benchmark rate. This rate is significantly higher than the interest rate that is required to be applied under the current rules (e.g. an 8.3 per cent rate for the year ended 30 June 2019, compared to the current Division 7A benchmark rate of 5.2 per cent).

- A formal written agreement will no longer be required but specific written / electronic evidence is still needed.

Furthermore, the 'distributable surplus' concept which broadly operates to limit the quantum of any deemed dividend that may arise in a given year to the private company's profits will be removed.

Whilst supportive of the introduction of a new, simplified loan regime, we consider this should not be at the expense of important commercial considerations. The proposed higher interest rate, with no adjustments for principal repayments when calculating annual interest charges and a lack of flexibility (over the timing of principal repayments and the ability to refinance) raises questions over the commerciality of the proposal. In addition, the removal of the distributable surplus concept has the potential to tax other capital flows (such as borrowings from third party lenders) and could, in some cases, result in double taxation.

Transitional measures are also canvassed in the Treasury Consultation Paper, which would operate to bring existing complying loan arrangements (including 25-year secured arrangements but with a reduced loan term) and the currently quarantined pre-4 December 1997 loans within the proposed 10-year loan model. We consider that the proposed Division 7A changes should not apply retrospectively to pre-4 December 1997 loans and that all seven and 25-year complying loan arrangements entered into prior to 1 July 2019 should be grandfathered. Any proposal to transition or unwind these arrangements will only further increase complexity and, in many cases, will add to the existing range of financial pressures that are already challenging many small businesses.

The Treasury Consultation Paper also confirms that UPEs will formally come within the scope of Division 7A from 1 July 2019, and will either be required to be repaid to the private company over time as a complying loan or will be subject to tax as a dividend. Although this might make for a more certain legislative approach to the treatment of UPEs, we consider that this change should not apply retrospectively. In particular, we recommend that pre 16-December 2009 UPEs (which are currently quarantined from the application of Division 7A under existing ATO guidance) should remain outside the operation of Division 7A and all existing arrangements entered into on or before 30 June 2019 be grandfathered and allowed to unwind based on existing guidelines.

The takeaway

Although the consultation process for the Division 7A reform is now well underway, it may still be some time before we see draft legislation on these measures, and therefore have certainty as to what the Division 7A provisions will look like from 1 July 2019.

However, given the proposed start date is rapidly approaching, affected taxpayers will need to start modelling the potential impacts on their business as soon as possible. For many, this will also include discussions with third party financiers to understand the likely cash flow and commercial impacts of the current proposals.

Please contact us if you would like to discuss the Treasury Consultation Paper, our submission, or your own circumstances in further detail.

Let's talk

For a deeper discussion of how these issues might affect your business, please contact:

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