

Major changes are coming to Private Company Loans

Since its inception, the private company loan rules contained in Division 7A have become increasingly complex with the Australian Taxation Office continuously implementing further changes to tighten up the provisions.

The Board of Taxation conducted a Post Implementation Review in 2012 and found the provisions had become complex, inflexible and imposed significant compliance costs on taxpayers.

The following amendments have been proposed to simplify Division 7A, make them more robust and easier to comply with. Whilst some changes are welcome, some will cause difficulties, increase costs and require further planning. The proposed amendments, if enacted, will apply from 1 July 2019.

Current Division 7A rules vs. Proposed Division 7A rules

	Current Rules	Proposed Rules
Loan Terms	<ol style="list-style-type: none"> 7 year loan (unsecured); or 25 year loan (secured) 	10 year loan only
Benchmark Interest Rate	Reserve Bank of Australia, Lending Rate - Housing loans; Banks; Variable; Standard; Owner-occupier Current rate is 5.30% (September 2018)	Reserve Bank of Australia, Lending Rate – Small Business; Variable; Other; Overdraft – Indicator Current rate is 8.30% (September 2018)
Loan Documentation	Formal written loan agreement	No requirement for formal written loan agreement. However, written or electronic evidence showing that the loan was entered into must exist
Minimum principal repayment	Calculation of the principal repayment amount is complex and is calculated annually	Equal repayments over the term of the loan
Calculation	Interest takes into consideration payments made throughout the year (if applicable)	Interest is calculated for the full income year, regardless of any repayments being made throughout the year (except Year 1)
Pre 4 December 1997 Loans	Generally exempt	From 2021 no longer exempt except where the loan has become statute barred

Example

The Director of Co X Pty Ltd withdrew \$100,000 on 1 July 2019 from the Company bank account for personal use. He does not have the funds to repay the loan. The Director decides to put in place a complying Division 7A Loan agreement for the \$100,000.

The loan paperwork was entered into on 30 June 2020. Below is an illustration of repayments in the first year – 30 June 2021 using the current rules and proposed rules.

	Current Rules		Proposed Rules	
Year 1	Interest	\$5,500	Interest	\$8,500
	Principal	\$12,096	Principal	\$10,000
Year 2	Interest	\$3,516	Interest	\$6,300
	Principal	\$13,253	Principal	\$10,000
Year 3	Interest	\$2,613	Interest	\$5,200
	Principal	\$13,921	Principal	\$10,000

*Interest rates shown are for illustrative purposes only

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Simplified Loan Rules

Existing 7 and 25 year Division 7A loans will be replaced with a new single 10 year loan.

Key proposed amendments

- Maximum term of 10 years regardless of security;
- The annual benchmark interest rate will be a rate published by the Reserve Bank of Australia prior to the start of each income year;
- No requirement for formal agreements;
- Minimum yearly repayment will still consist of both principal and interest components;
- Interest is calculated for the full income year regardless of when a repayment is made (except Year 1);
- The concept of distributable surplus ceases to be relevant.

Transitional Rules

- 7 year complying Divisions 7A loans in existence at 30 June 2019 must comply with the new rules to stay compliant.

The new benchmark interest rate will need to apply but it will retain the existing outstanding term.

- 25 year complying Division 7A loans will be exempt from the majority of changes until 30 June 2021.

The interest rate on these loans must equal or be greater than the benchmark interest rate per the new proposed rules from 1 July 2019.

Any amounts outstanding on the 25 year loans at 30 June 2021 will give rise to a deemed dividend unless a complying loan agreement is put in place.

- Pre-1997 loans will be taken to be financial accommodation as at 30 June 2021. Taxpayers will have until the lodgement day of the 2021 company tax return to either pay out the loan or put in place a complying loan agreement.

We strongly recommend that all private companies with loans to shareholders or related parties plan for these changes as they are likely to come into effect in the near future.

Hall Chadwick WA will be making a submission to Treasury on these changes. Please contact us should you wish to include any comments or feedback in this submission.

Please note that the comments made above are general in nature. If you are intending to apply the information to your personal circumstances, please contact our office where we will be able to assist with any questions you may have.

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Unpaid Present Entitlements

The amendment will clarify that unpaid present entitlements will come within the scope of Division 7A.

Key proposed amendments

- All UPEs that arose on or after 16 December 2009 will need to be put on complying loan terms by 30 June 2020;
- UPEs already on complying loan terms will need to adopt the new 10 year loan model.

Reviewing Breaches

A self correction mechanism will allow inadvertent breaches to be rectified voluntarily without penalties being imposed.

The taxpayer will need to meet eligibility criteria to qualify for self correction and avoid penalties.

Most importantly the taxpayer needs to demonstrate that it was an inadvertent breach and demonstrate steps have been taken as soon as practicable to rectify the breach.

Safe Harbours – Provision of Assets for Use

The amendment proposes to introduce a formula and accompanying rules to provide simplicity and certainty for the provision of assets for use by an entity.

The safe harbour will provide that:

- The value of the asset is its cost;
- A formal market valuation of the asset is required every five years;
- The charge is based on the actual number of days the asset is used (exceptions apply); and
- It applies to both appreciating and depreciating assets.