GREENWOODS
+ HERBERT
SMITH
FREEHILLS

TAX BRIEF

7 November 2018

Vacillation in Small Business Territory

The taxation of small business entities has seen more than the usual degree of schizophrenia in the last few weeks.

Two weeks ago the Government (and the Opposition) couldn't have been more determined to give small businesses a tax cut. A Bill to accelerate the current schedule for reducing the corporate tax rate from 27.5% to 25% was introduced into the House of Representatives on 16 October and left the Senate on 18 October. (The rate will decline to 26% in 2020-21 and to 25% in 2021-22.) It may not be a record, but it must be close to the fastest passage of a tax Bill our Parliament has ever seen. After all, there are still Bills sitting in the Parliamentary wilderness dated 2016.

This speed and generosity can be contrasted with the Treasury Consultation Paper released on 22 October 2018, outlining proposed amendments to Div 7A. The Assistant Treasurer had asked the Board of Taxation to undertake a review of Div 7A in May 2012; its Report went to the Government in November 2014; and the Government released the Report to the public in June 2015, along with a non-committal press release basically thanking the Board for its work. The Government's reaction led many to assume the Board's Report was dead-on-arrival but in the May 2016 Budget, the Government announced it would be pursuing at least some of the measures. Now, more than 2 years later, Treasury's document has finally set out, "*the Government's proposed implementation of the amendments to improve the integrity and operation of Division 7A*." Elements of Treasury's Paper do sit more than a little incongruously alongside the Government's interest in reducing tax and the tax compliance burden for small businesses.

Some of the key proposals in Treasury's *Consultation Paper* are set out below.

Loans

The object of the rules in Division 7A is to set out the conditions under which private companies can distribute amounts to (or pay amounts for) shareholders and their associates without triggering tax in their hands. One of the main exemptions is for private company loans to shareholders made on certain terms. The Paper proposes major changes to terms upon which these loans will have to be made.

Maximum 10-year loan term

- Current law: private companies can lend amounts to shareholders without triggering Div 7A provided the maximum term of the loan does not exceed 7 years (if the loan is unsecured) or 25 years (if the loan is secured by a registered mortgage over real estate).
- Treasury's *Paper*: all loans would need have a maximum term of 10 years.
- Board's *Report*: this had been recommended by the Board.

Annual interest, at what rate

- Current law: the loan must carry interest at the "*benchmark interest rate*", a figure which is set each year by reference to the RBA Rate, "*Indicator Lending Rates – Bank variable housing loans interest rate*" published by the RBA just before the start of that year of income. The rate is publicised by the ATO in a TD issued in June, prior to the start of the year.
- Treasury's *Paper*: the rate would now be set using the RBA, "*Small business; Variable; Other; Overdraft - Indicator Lending rate*" published by the RBA just prior to the start of the income year. This is approximately 300 basis points higher than the existing rate.
- Board's *Report*: the Board had recommended using this new rate for the month of May, but had recommended that the "*statutory interest rate would be set at the start of the loan and fixed over the term of the loan*" on the basis that "*a fixed interest rate has the advantage of simplicity, particularly for taxpayers who have less complex arrangements*." Treasury was not convinced.

Deferral of interest

- Current law: the borrower must pay "*during the current year*" "*the minimum yearly repayment*" calculated under a formula which requires payment of an amount that exceeds just the interest – it requires repayment of both principal and interest each year.
- Board's *Report*: the Board had recommended that, while interest would accrue each year, it would not have to be paid each year. Instead, borrowers would have to pay accumulated unpaid interest by the end of year 3, 5, 8 and 10.
- Treasury's *Paper*: the borrower will still have to make a "*minimum yearly repayment*" consisting of both principal and interest.

Payments of principal

- Current law: the borrower repays the principal over the life of the loan as a component of the "*minimum yearly repayment*"
- Board's *Report*: under one option, the borrower must reduce the outstanding loan balance (both accumulated interest and a portion of the principal) during the term of the loan according to a schedule
  - 75% of the loan could remain outstanding by the end of year 3
  - 55% of the loan could remain outstanding by end of year 5
  - 25% of the loan could remain outstanding by the end of year 8
  - the original loan must be fully repaid by the end of year 10.

  Provided the borrower met these milestones, no particular payment of principal would need to be made in any year.
  The Board had also examined a more ambitious interest-only model but Treasury's Paper shows no interest in it, discounting it as, "*not consistent with the policy intent behind Division 7A* …"

- Treasury's *Paper*: the minimum yearly repayment requires the borrower to repay a fixed and equal portion of the principal sum each year. Compared to the cash flows required under the current rules, this will result in higher minimum repayments in earlier income years because of the requirement to make equal annual principal repayments.

Transition

The process for handling the transition of loans on foot when the new rules commence is not straightforward –

- to remain compliant, 7-year loans on foot at the start of the new rules would have to bear the new benchmark interest rate each year (the *Paper* assumes this will not require the renegotiation of loan documents), be repaid in equal annual instalments, and they will only remain on foot for the balance of their existing term (i.e., they cannot be extended to the balance of a 10-year term);

- 25-year loans on foot at the start of the new rules would be allowed to continue under the existing rules until 30 June 2021. Thereafter, a new loan which complies with the new model would have to be put in place assuming the existing borrowing needs to be refinanced; and
- loans entered into prior to the start of Div 7A in 1997 (and which remained unaffected by Div 7A since then) will be brought within the scope of the new rules from July 2021.

The Board had recommended a much simpler process:

- complying 25-year loans would simply be grandfathered for the rest of their life; and
- complying 7-year loans would have their term extended to 10-years but be required to apply the new interest and principal repayments rules for the remainder of the term.

The role of distributable surplus

Under current law, the amount that can be a dividend is capped at the "*distributable surplus*" of the company. The logic is clear: there should not be a dividend if the company doesn't have any profits. Treasury's *Paper* takes the position that this, "*is considered contrary to the efficient operation of the Division 7A integrity rule*."

While the discussion of this proposal happens in the context of loan arrangements, it seems the Government is proposing to remove the concept of "*distributable surplus*" entirely so that, "*dividends can be deemed for the entire value of the benefit that was extracted from the private company*" and throughout Div 7A. This would mean, for example, that if a company was established with an amount of capital and the same amount was immediately lent back to the shareholder, the entire amount would be subject to tax. The proposal also seems to rule out the possibility of a company returning capital to shareholders short of going into liquidation.

The Board, however, had been very clear that, "*the rules regarding the calculation of distributable surplus* [should remain] *as part of any rewrite of the Division 7A rules*." In fact, the Board had considered that the Government should provide relief from Division 7A in some situations where the distributable surplus consisted only of unrealised profits.

Companies who are entitled to trust income

The ATO has taken the view that where a trust makes a company presently entitled to a share of the income of the trust but does not pay the amount to the company, then the company has made a loan of that amount to the trustee. If the trustee happens to be an associate of the shareholder, a deemed dividend would arise. This is not self-evident and has yet to be tested before a Court but the Paper proposes to codify this analysis of unpaid present entitlements (**UPEs**).

The Paper says, "*UPEs will be treated consistently with other payments made by private companies to taxpayers, by either requiring the UPE to be repaid to the private company over time as a complying loan or subject to tax as a dividend*." This is consistent with the Board's recommendation. Existing provisions in Div 7A which deal with other manifestations of UPEs will presumably be overhauled as part of this process.

Tax statute of limitations

Treasury's *Paper* is proposing the period of review for Division 7A transactions be extended to 14 years after the end of the income year in which the deemed dividend is alleged to have arisen. This would apply from 1 July 2019.

This was not a matter which the Board examined and so there is no recommendation about it. Just why the ATO needs 14 years to address Div 7A matters but only 4 years for most other errors is not explained. Presumably, the 14 years is the 10-year period of the loan plus the 4 year standard amendment period; the logic seems to be the ATO must be allowed to recast the entire loan arrangement for a problem that arose at its inception, even though the issue was not spotted until its conclusion.

Breaches of Div 7A

Where a taxpayer has inadvertently triggered Div 7A, current law allows the Commissioner to exercise a discretion to disregard a deemed dividend or allow it to be franked. The Board had proposed changing the system to allow "*a legislated, self-correction mechanism*" that taxpayers would access with "*a single, clear, objective test for governing eligibility for self-correction and a mechanism to allow the Commissioner to apply an appropriate penalty, even where self-correction is validly made*."

The process which the *Paper* envisions involves the taxpayer taking remedial action at the latest within 6 months of an error being discovered by the ATO: the parties must convert the benefit into a complying loan agreement, on the terms that would have applied if a loan agreement been had been set up properly *ab initio*; the parties must make catch-up payments of principal and (compounded) interest; the company will return the compound interest as assessable income in the year in which the catch-up payment is made.

But this process will only be allowed if there are objective factors (which are not set out in the *Paper*) which demonstrate the breach of Div 7A was "*an inadvertent breach*." Another portion of the *Paper* suggests that appropriate circumstances, "*would be set out by the ATO in its public advice and guidance products*" so the ATO might become the arbiter of what factors demonstrate an inadvertent breach (presumably similar to those outlined in PS LA 2011/29). And the taxpayer must also engage in some detective work for the ATO and "[take] *reasonable steps to identify and address any other breaches of Division 7A*."

This process is clearly tightly defined but, ultimately, its success will depend on the ATO. Only experience will show whether this system will work for anything but the most innocuous non-compliance.

Use of company assets

The existing rules can deem a dividend to arise where a company makes an asset available to a shareholder or associate to use. The Board had recommended trying to get some order into these rules such as excluding them in a case where the company's only distributable surplus was unrealised profit.

Treasury's *Paper* has taken the position that the problem which needs to be solved is not to confine the scope of the rule, but rather to get a better way of calculating the amount of the dividend. The *Paper* offers a safe harbour for determining the size of the dividend which will apply where the user has the exclusive use of an asset (excluding motor vehicles) –

Asset's value x Deemed interest rate x number of days used

The "*value*" of an asset for these purposes is determined at the end of the income year, and is a moveable amount:

- for the first 5 years, the value of the asset is its cost (including any improvements);
- after 5 years, the value will be the greater of the cost or market value. Assets will have to be revalued every five years.

The deemed interest rate here is an unspecified benchmark rate plus 5%. If the benchmark rate is the proposed new Div 7A benchmark rate then the deemed interest rate will be in the order of 13.5% (which is the figure used in an example in the Consultation Paper). While this may produce a simpler calculation, it could be expected to exceed a market value charge in most circumstances.

Another problem with this recommendation will follow if the requirement that a company has "*distributable surplus*"' before it can be deemed to be paying a dividend is dispensed with for all aspects of Div 7A: an individual who acquires an asset, places it in a company and begins to use the asset would have a tax liability, even though the company has no profits.

For further information, please contact

Sydney

Andrew White
andrew.white@greenwoods.com.au
phone +61 2 9225 5984

Cameron Blackwood
cameron.blackwood@greenwoods.com.au
phone +61 2 9225 5950

Melbourne

Narelle McBride
narelle.mcbride@greenwoods.com.au
phone +61 3 9288 1715

Perth

Nick Heggart
nick.heggart@greenwoods.com.au
phone +61 8 9211 7593

Greenwoods & Herbert Smith Freehills Pty Limited (ABN 60 003 146 852)

www.greenwoods.com.au

Sydney ANZ Tower, 161 Castlereagh Street, Sydney NSW 2000 Australia
Ph +61 2 9225 5955, Fax +61 2 9221 6516

Melbourne 101 Collins Street, Melbourne VIC 3000, Australia
Ph +61 3 9288 1881 Fax +61 3 9288 1828

Perth QV.1 Building, 250 St Georges Terrace, Perth WA 6000, Australia
Ph +61 8 9211 7770 Fax +61 8 9211 7755