

Deemed dividend rules: new 10-year loan model

The government is acting to simplify the Division 7A rules that govern deemed dividends, proposing a new 10-year loan model for compliant loans. Significantly, companies with existing loans would be forced to transition to the new model, which also includes a considerably higher benchmark interest rate.

Division 7A is a long-standing tax integrity measure that treats certain payments by private companies to shareholders or their associates as unfranked “dividends” for tax purposes. Those deemed dividends are then assessable income of the recipient and taxed at the recipient’s marginal tax rate.

Current laws include an important exception to these rules: a payment is not treated as a dividend if it is converted into a loan that meets certain requirements, including a minimum statutory interest rate, certain minimum annual repayments and a maximum loan term of either 25 years for a loan secured by a registered mortgage over real estate, or seven years in any other case.

To simplify the rules for Division 7A-compliant loans and better align them to commercial practice, the government proposes to reform the laws from 1 July 2019 so that a compliant loan would instead be required to meet the following:

- a maximum loan term of 10 years – regardless of whether the loan is secured;
- a different benchmark interest rate that is considerably higher than the current benchmark; and
- annual repayments of both principal (in equal annual instalments over the term of the loan) and interest.

The government also proposes transitional rules to help companies with existing loans transition to the new 10-year model. These would operate as follows:

- All existing seven/25-year loans in place at 30 June 2019 would need to adopt the new, higher benchmark interest rate after that date.
- Existing seven-year loans would retain their existing loan term and mature as originally planned.
- Existing 25-year loans would need to convert to a 10-year term prior to the lodgment day of the company’s 2020-2021 tax return. However, it is not yet clear whether a 25-year loan with fewer than 10 years remaining as at 2021 would need to adopt a 10-year term.
- Pre-December 1997 loans would become subject to Division 7A and need to convert to a 10-year loan by the 2020-2021 lodgment day.

The proposals have attracted criticism that a 10-year loan model and higher interest rate would create cashflow problems for those who rely on their corporate structures to access funds.

All taxpayers with existing Division 7A loans (regardless of the loan term) will also need to consider the impact of the reforms on their cashflow, given the higher interest rate that could apply from 1 July this year.

Review your corporate structures now

While these proposals are not yet final, the government’s intention to cut the maximum term of compliant loans and introduce a higher benchmark interest rate is clear. Talk to us today to start identifying possible consequences for your structures and to discuss strategies for managing future cashflow or restructuring.
