

Tax Update

2010

ATO's Final Ruling on Division 7A and Trust Entitlements

In Issue No. 1 February 2010 we discussed the ATO's draft tax ruling TR 2009/D8 on Division 7A and the potential deeming of unfranked dividends in relation to unpaid present entitlements of corporate beneficiaries.

The ATO has now issued its final tax ruling TR 2010/3, together with a draft practice statement PS LA 3362.

The final ruling remains controversial. It has not changed in substance from the draft despite a submission by six professional bodies that much of the legal reasoning in the ruling is questionable. The ruling represents a complete reversal of interpretation by the ATO since 1997 and is arguably inconsistent with existing parts of Division 7A.

The ATO states an unpaid present entitlement ("UPE") may result in a Division 7A loan in broadly three circumstances, of which circumstance 3 is particularly problematic:

1. The private company beneficiary agrees (expressly or impliedly) to lend money to the trustee and the private company's UPE is satisfied by being set-off against the funds that are to be advanced to the trustee.
2. The trustee makes a loan on behalf of the private company beneficiary by acting pursuant to a term of the trust deed, which permits the trustee to pay or apply money to or for the benefit of the trustee, rather than creating a UPE.
3. The private company beneficiary provides "financial accommodation" (or an in-substance loan) to the trustee of the trust, under a consensual arrangement, by not calling for the payment of the UPE or the investment of the UPE amount for the private company's sole benefit after a certain amount of time.



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The Ruling states a UPE will not result in a Division 7A loan where the trustee holds an amount representing the UPE on a sub-trust for the sole benefit of the private company beneficiary; we note this is not usually the case under most trust deeds and ordinarily the trustee uses the funds for the benefit of the beneficiaries generally.

Regarding circumstance 3, the Ruling indicates that where the private company and trust ultimately share the same controlling entity or entities, the Commissioner will effectively deem consent or authorisation by the private company (by having knowledge and not doing anything) of the trustee's continued use of the funds that give rise to a 'loan', unless there is sufficient evidence to the contrary.

Contrary evidence could be where the UPE is held on sub-trust. This may allow payment of interest or a share of net income to a corporate beneficiary without having to comply with prescribed minimum principal and interest payments under a Division 7A loan. This may be a key solution to managing exposures.

The Ruling applies retrospectively to UPEs that have converted into loans under circumstances 1 and 2. Where UPEs have not converted into loans, but fall under circumstance 3, the Ruling applies only to UPEs created on and after 16 December 2009. UPEs prior to this date should be quarantined.

The draft PS LA raises the following practical issues:

- The ATO will initially look at the terms of the trust deed, the trustee resolutions and how the UPE is accounted for in the trust's and private company's accounts;

- Whether a UPE has converted into an ordinary loan and the timing of the conversion – typically this may arise where the UPE has been allocated to a loan account in the books of the trust and the company;
- When a subsisting UPE say arising on 30 June 2010 amounts to 'financial accommodation' – the draft indicates the loan is taken to arise at the end of the income year after the income year to which the UPE relates, that is on 30 June 2011. Therefore Division 7A would apply if the loan was not repaid before lodgement of the company's 2011 tax return.
- What, in the ATO's view, evidences a UPE held under a sub-trust which is held for the sole benefit of the private company beneficiary – the draft provides some guidelines on the investment of the UPE amount; and
- Whether interest paid by the trust to the private company beneficiary is deductible under a Division 7A loan agreement which was put in place to replace the UPE – the draft indicates it is generally deductible.

The Ruling raises challenges for all trusts with corporate beneficiaries. It could lead many businesses to restructure as companies. Accounting treatment will continue to be critical in recording UPEs and quarantining pre 16 December 2009 UPEs. The terms of trust deeds should be reviewed in relation to UPEs and the ability to hold the UPE on sub-trust. Division 7A compliance management is now more important than ever.

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