

Tax Update

Division 7A of Part III of the *Income Tax Assessment Act 1936* (Cth)

In recent years, there has been rigorous debate and uncertainty amongst taxation practitioners regarding the application of Division 7A of Part III of the Income Tax Assessment Act 1936 (Cth) to unpaid present entitlements of corporate beneficiaries. The long awaited Draft Taxation Ruling TR 2009/D8 attempts to quell such uncertainty and outlines the Commissioner of Taxation's position in this regard. The draft ruling is ultimately at odds with previously accepted practice and controversially treats almost all unpaid present entitlements as Division 7A loans. The consequences for discretionary trusts with corporate beneficiaries are significant to say the least, and should not be viewed lightly.

There is no doubt that the prevailing object of Division 7A of Part III of the *Income Tax Assessment Act 1936* (Cth) ("Division 7A") is to thwart tax avoidance. Traditionally, Division 7A has sought to prevent the practice of distributing the profits of a private company to shareholders (or their associates) in the form of tax-free non-arm's length loans. In such circumstances, Division 7A generally operates to treat the loan as a dividend assessable in the hands of the relevant shareholder (or associate).

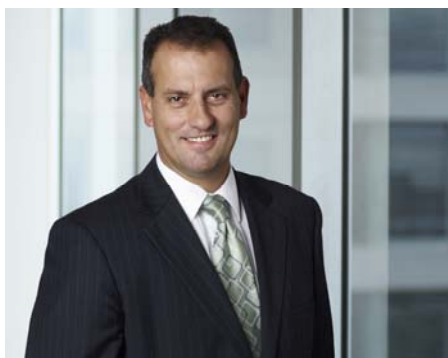
Unpaid present entitlements

It is common practice, and certainly advantageous, for discretionary trusts to have corporate beneficiaries. The most obvious advantage of such a structure is that income allocated to presently entitled corporate beneficiaries is subject to the fixed corporate tax rate of 30%.

An unpaid present entitlement ("UPE") exists where a trustee of a discretionary trust resolves to distribute income of the trust to a beneficiary that is presently entitled, but the income remains unpaid. Where the beneficiary is a company, this allows the trust to access the corporate tax rate and to use the retained income for the activities of the trust.



Anja Schneider Lawyer
Taxation & Financial Services
T +61 3 9321 7912
aschneider@rigbycooke.com.au



Arthur Athanasiou Partner
Taxation & Financial Services
T +61 3 9321 7878
aga@rigbycooke.com.au

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Our Team

- Arthur Athanasiou – Partner
- Ross Higgins – Partner
- Graham Candy – Senior Consultant
- Ben Elbaum – Lawyer
- Anja Schneider - Lawyer

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The Australian Taxation Office's ("ATO") position, until recently, has been that a UPE will generally not constitute a "loan" for Division 7A purposes unless the company and associated trust actively convert the UPE to a loan. As will be seen, however, Draft Taxation Ruling TR 2009/D8 ("Draft Ruling") essentially ignores this position (which has applied since 1999).

Draft Taxation Ruling TR 2009/D8

The Draft Ruling describes in detail the circumstances in which the Commissioner of Taxation will hold that a corporate beneficiary with a UPE has provided a Division 7A loan to a trust in the same family group. A corporate beneficiary and a trust will generally be in the same family group where they are controlled (either directly or indirectly) by the same entity or person.

The Draft Ruling discusses two forms of Division 7A loans in relation to UPEs:

1. a loan instead of or in satisfaction of a UPE; and
2. subsisting UPEs and Division 7A loans.

Significantly, it appears that the only circumstances in which a UPE will not constitute a Division 7A loan is where the relevant funds are held in a sub-trust and set aside for the absolute benefit of the corporate beneficiary (rather than for broader trust purposes) under the specific terms of the trust deed, and the corporate beneficiary is solely entitled to any income generated from the investment of such funds.

Where a Division 7A loan exists in accordance with the Draft Ruling, the trust will be deemed to have received a dividend equal to the amount of the UPE owing (unless the loan has been paid by the lodgement date or is put on a commercial footing in accordance with Division 7A).

A loan instead of or in satisfaction of a UPE

The Draft Ruling notes that an agreement between the corporate beneficiary and the trustee, allowing the corporate beneficiary to make a loan to the trust in satisfaction of its UPE, is a clear example of a Division 7A loan. There is little doubt that this is the correct interpretation of the law.

The corporate beneficiary will also be taken to have lent funds to the trust where the trustee credits the UPE to a loan account in the name of the corporate beneficiary and this is done with the corporate beneficiary's authorisation. Importantly, the Commissioner considers that such authorisation can occur through acquiescence with full knowledge, and knowledge is presumed to exist where the corporate beneficiary and trustee are controlled by the same persons, as is the case where the entities are part of the same family group (although the presumption can be rebutted).

More controversially, the Commissioner has also effectively stated that a Division 7A loan can be created unilaterally by the action of the trustee. That is, a trustee may make a loan on behalf of the corporate beneficiary by acting pursuant to a term of the trust deed which allows the trustee to pay money to or for the benefit of the beneficiary. Where the trustee credits an amount to a loan account in the name of the corporate beneficiary (and assumes an obligation to repay the sum to the corporate beneficiary), and the trustee has the power under the trust deed to credit amounts for the benefit of the corporate beneficiary as a payment or application of trust funds, the Commissioner will consider that such a power has been exercised unless there is evidence to the contrary. However, such a loan will not arise if the trustee does not have the power under the trust deed to treat the funds other than as a UPE.

Subsisting UPEs and Division 7A loans

Perhaps the most contentious part of the Draft Ruling is the issue of subsisting UPEs and Division 7A loans. As the definition of "loan" includes "financial accommodation", a Division 7A loan will exist if the corporate beneficiary has, under a consensual agreement with the trustee (including by acquiescence with knowledge), provided or granted any pecuniary aid or favour to the trustee. The Draft Ruling provides that this will occur where funds representing a subsisting UPE are not called for by the corporate beneficiary or used for the absolute benefit of the corporate beneficiary, and remain intermingled with the funds of the trust for use by the trust for trust purposes.

The definition of "loan" also includes arrangements which in substance effect a loan. The Commissioner states that a UPE which a corporate beneficiary has allowed to remain outstanding and the funds of which can be used by the trustee for trust purposes (as opposed to being used, invested or lent for the absolute benefit of the corporate beneficiary with no benefit accruing to the main trust) will also be an in-substance loan (as well as constituting "financial accommodation").

The lessons to be learned

There are several important lessons to be learned from the Draft Ruling. First, if the financial statements of the trust describe a UPE as a "loan", the Commissioner will generally treat it as such unless there is clear evidence to the contrary. Accordingly, it is essential that the financial statements of the trust do not incorrectly describe UPEs as "loans." However, an amount described in financial statements as a "UPE" will not necessarily be treated by the Commissioner as such and this may occur, for example, where the funds are not held on sub-trust for the corporate beneficiary.

As has always been the case, it is imperative that the relevant trust deed be read and understood properly, and the way in which the trust is treated for taxation and accounting purposes must be consistent with the terms of the trust deed. It may be that the trust deed should be varied to ensure that the trustee does not have the power to treat relevant funds other than as a UPE.

Ultimately, it seems that in order to avoid a UPE being deemed to be a dividend under Division 7A, the UPE should either be:

1. paid to the corporate beneficiary;
2. held on sub-trust for the corporate beneficiary (provided this is authorised by the trust deed) and only invested for the sole benefit of the corporate beneficiary; or
3. dealt with under a written loan agreement in accordance with Division 7A.

The public has until 12 February 2010 to comment on the Draft Ruling, and given the ATO's controversial departure from its previous position, it is expected that it will receive a considerable response. It is not known when the ATO will finalise its ruling.

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Level 13, 469 La Trobe Street
Melbourne Vic 3000
T 61 3 9321 7888
F 61 3 9321 7900
www.rigbycooke.com.au