

Tax Update

Final ATO Practice Statement on Unpaid Present Entitlements

On 14 October 2010 the ATO released Practice Statement Law Administration 2010/4 (the "PSLA"). The PSLA provides guidance on the administration of Taxation Ruling TR 2010/3, which sets out how and when an unpaid present entitlement ("UPE") from a trust to a company will be subject to Division 7A of the Income Tax Assessment Act 1936 ("Div 7A").

Broadly, the PSLA states that, if a UPE is made by a trust to a private company in the same family group in a particular income year and the amount is not held on a sub-trust which complies with the PSLA, then the UPE will become a loan to which Div 7A applies.

The PSLA does not apply to UPEs arising prior to 16 December 2009. If such UPEs are properly quarantined then, as set out in TR 2010/3, the ATO will not seek to apply Div 7A to them.

Complying Sub-Trust Arrangements

A UPE must be held on a sub-trust which is for the 'sole benefit' of the relevant private company. If the UPE is re-invested into the main trust, the ATO will accept it is nevertheless held for the 'sole benefit' of the company provided that one of the following arrangements is used:

- A documented, binding loan agreement under which the main trust is required to pay the sub-trust an annual return on the UPE equal to the Div 7A "Benchmark Interest Rate" (currently 7.4%) for 7 years. The principal amount of the UPE must be repaid at the end of the 7 years (or by 30 June 2018 if the arrangement is made before 30 June 2011). Interest for each year must be actually paid (as opposed to a mere book entry made) by the lodgement date for the trust.
- A documented, binding loan agreement on the same terms as above, except that the principal amount must be repaid after 10 years and the interest rate is a "Prescribed Interest Rate" based on a Reserve Bank small business overdraft indicator rate (currently 10.3%).



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- A direct investment by the sub-trust into a specific income producing asset of the main trust. There may be income tax (particularly CGT) consequences to the main trust, as it will be disposing of an asset. There is no minimum amount payable to the sub-trust, but its return on investment must be actually paid to the company by the sub-trust's lodgement date. There is no maximum period for which the investment can be held, but it must be repaid upon sale of the asset.

Once one arrangement is chosen, the trustee may not switch between arrangements (except that it may reinvest an amount from the sale of an asset held under option 3 into another asset under the same arrangement).

The interest payments made under options 1 or 2 are tax deductible to the main trust. Whilst not explicitly stated in the PSLA, it seems clear that the income derived by the sub-trust under option 3 is not the main trust's income and will not be assessable to it.

Accounting for the Sub-Trust

Where option 3 is used, it is expected by the ATO that all income and expenses attributable to the sub-trust's ownership of the asset will be shown in separately prepared accounts and that a separate return will be lodged for the sub-trust.

If options 1 or 2 above are used it is not necessary to separately prepare accounts or lodge tax returns for the sub-trusts. However, to demonstrate the existence of a sub-trust, at the minimum the amount representing the UPE must be set aside separately in the accounts of the main trust as being held on trust for the relevant company.

The main trust should set up a sub-trust account in the equity section of the main trust's accounts. The PSLA suggests that the account could be labelled: 'Sub-trust - XYZ company Pty Ltd'. Only one sub-trust is required per beneficiary (i.e. it is not necessary to create separate sub-trusts for each UPE to the same beneficiary).

Time to Comply

Generally, a UPE must be subject to a complying sub-trust by the time the trust's income tax return lodgement is due for the year in which the UPE was made. For UPEs arising between 16 December 2009 and 30 June 2010, the trustee has until 30 June 2011 to put the UPE on sub-trust.

How Does a Complying Sub-Trust Arise?

If the trust deed contains a clause that the trustee holds UPEs on sub-trust then the sub-trust may arise automatically. Otherwise, a sub-trust may be evidenced by a resolution of the trustee to set aside the UPE for the sole benefit of the relevant company.

According to the PSLA it is not necessary for the trust deed to specifically permit amounts to be held on sub-trust in order to create a complying sub-trust; it is sufficient if the deed permits amounts to be set aside for the exclusive benefit of a beneficiary and the amounts are otherwise dealt with in the manner required by the PSLA.

Other Aspects of the PSLA

The PSLA also set out two concessional arrangements the ATO has put in place:

- If a trust has been incorrectly showing a UPE to a company as a "loan" from the company in its books, and all available evidence shows that the amount is in truth a UPE and not a loan, the ATO will not treat the amount as an ordinary loan if the books are amended and the trustee signs and dates a declaration in the form set out in the PSLA by 31 December 2011 (this will not prevent the UPE from being subject to Div 7A if it is made after 16 December 2009 and is not otherwise compliant with the PSLA).
- Where an ordinary loan is made from a company to a trust and the loan has not been made Div 7A compliant, the trustee can self-assess the Commissioner's discretion to disregard the deemed dividend arising if various criteria are satisfied (broadly, the failure was an honest mistake, both trust and company are "small business entities", the loan was used only for business purposes, the trustee is not a shareholder of the company and both have a good history of compliance and are current in their tax obligations). To self-assess the discretion, corrective action must be put in place by 31 December 2011 (broadly, a complying loan must be put in place from the time of the loan and retrospectively complied with and a declaration stating that the necessary conditions are met must be made).

If you have any concerns or queries about implementing the PSLA or about dealing with trust distributions in general, please do not hesitate to contact our Tax and Financial Services Team.

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