

TAX BULLETIN

AN UPDATE PUBLICATION
FOR OUR CLIENTS

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PRIVATE COMPANIES WITH UNPAID PRESENT ENTITLEMENTS - ATO'S PROPOSED ADMINISTRATIVE APPROACH NOW FINALISED

Summary

In June this year, the ATO issued its Ruling on the circumstances in which a private company with an unpaid present entitlement ("UPE") from an associated trust may be taken to have made a loan to that trust within the meaning of Division 7A. In conjunction with the Ruling, the ATO issued a draft Practice Statement to provide guidance on complying with the Ruling. The ATO has now issued the long awaited final version of its Practice Statement, PSLA 2010/4.

As alerted to clients in previous bulletins, a UPE may now be treated as a loan for Division 7A purposes where:

1. It is in fact an ordinary loan as evidenced by the trust deed or the accounting treatment; or
2. While no ordinary loan has been made there is an "extended meaning" loan by reason that circumstances indicate the private corporate beneficiary has acquiesced to the use by the trust of the UPE for the trust's own purposes.

With respect to ordinary loans, the Practice Statement outlines several ways in which corrective action can be taken to prevent a Division 7A problem from arising.

With respect to "extended meaning" loans, the Practice Statement confirms the ATO will not touch pre-16 December UPEs, while providing the following specific options for managing post-16 December UPEs:

1. Interest only 7 year loan (at the Division 7A benchmark interest rate);
2. Interest only 10 year loan (at the RBA small business variable interest rate);
3. Specific investment option.

These options, which vary considerably from the draft Practice Statement, involve arrangements that provide for an effective investment return to the company in respect of its entitlement. A table that summarises these options is set out on the following page.

Our overall view of the final Ruling and Practice Statement is that the ATO has used the proverbial 'sledgehammer to crack a nut' – its target is trusts that have used UPEs to acquire private 'lifestyle' assets for beneficiaries but trusts that are using UPEs for bona fide business and investment activities will also be adversely affected.



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	Option 1 - interest only 7-year loan	Option 2 - interest only 10-year loan	Option 3 - invest in a specific income producing asset or investment
Amount of the annual return	Main trust to pay interest calculated at the Benchmark interest rate to the sub trust.	Main trust to pay interest calculated at the Prescribed interest rate to the sub trust (RBA Small Business Variable Rate).	Sub trust is entitled to receive the share of net return (e.g. interest income or rental income) derived as a result of the specific asset or investment to the sub trust.
	Sub trust to pay annual return to the private company beneficiary by the lodgment day of the income tax return for the main trust except for the final payment of the annual return which must be paid to the private company when the investment or loan is due to be repaid.		
Nature of the annual return	Interest.	Interest.	Depends on the specific asset or investment.
Repayment of the funds representing the UPE (the principal)	The principal must be repaid at the end of the 7-year loan.	The principal must be repaid at the end of the 10-year loan.	The principal must be repaid by the lodgment day of the tax return of the private company beneficiary for the year in which the investment ends.
Deductibility of the annual return	Yes, the amount is deductible to the main trust provided that the trustee of the main trust satisfies section 8 1 of the ITAA 1997.	Yes, the amount is deductible to the main trust provided that the trustee of the main trust satisfies section 8 1 of the ITAA 1997.	No.
Assessability of the annual return	Yes, the amount is assessable to the private company beneficiary.	Yes, the amount is assessable to the private company beneficiary.	Depends on the specific asset or investment.
Sub-trust tax return	Not required.	Not required.	Required.

Background

For the purposes of Division 7A, a loan (a 'Division 7A loan') includes:

- a loan within its ordinary meaning, consisting of a payment and an obligation to repay;
- an advance of money ahead of a due date or with an expectation of repayment;
- the provision of credit or any other form of financial accommodation (i.e. the supply or grant of some form of pecuniary assistance or favour under a consensual agreement where a principal sum or its equivalent is ultimately payable);
- a payment of an amount for, on behalf of, on account of or at the request of an entity, where there is an obligation of repayment; and
- transactions that in substance affect such a Division 7A loan of money (as described in any of the above dot-points).

UPE becomes an ordinary loan

A private company beneficiary's UPE is not itself an ordinary loan to the trust. However, according to the ATO, it may (unintentionally) be extinguished and converted into a Division 7A loan via either an implied loan agreement or the automatic exercise of power under a trust deed.

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Loan agreement

- A private company may make a loan to a trust by providing moneys to the trustee pursuant to an express or implied loan agreement. Such a loan from the private company may be affected by an agreed set-off in satisfaction of the trustee's obligation to pay the private company its trust entitlement. This will result in an ordinary loan being made to the trustee.
- The ATO considers that an express loan agreement will arise where it is evidenced by a written agreement, trust resolution or another document.
- The ATO considers that an implied loan agreement will arise if the amount is recorded in the financial accounts of both the private company and the trust as a loan. This will be taken as evidence that the private company has knowledge that the trustee has adopted this treatment and has consented to that loan being made.
- The ATO will not, however, (without additional evidence) consider a loan agreement to be in existence if either one or both of the parties record the amount as a UPE.

Exercise of power under the trust deed

- A trustee may make 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 beneficiary. The application of trust funds for the benefit of the private company by crediting a loan account will result in the company being taken to make a loan to the trust.
- The ATO will not, without additional evidence, consider that a loan is in existence if the financial accounts of the trust record the amount as a UPE.

Corrective action for UPEs that become ordinary loans

Incorrect Financial Accounts

Where a UPE has been misclassified as a loan the ATO will allow a private company or trust until 31 December 2011 to correct their financial accounts - conditions apply however, and they must all be satisfied:

- a) the financial accounts of the trust and/or the private company have incorrectly classified the UPE as a loan from the private company to the trust;
- b) with the exception of the financial accounts - refer below - all available evidence supports the view that the amount is in fact a UPE;
- c) the private company has never included the amount of the UPE in calculating the amount of a loan reported at Label 8N of the private company's income tax return (i.e. the label marked 'loans to shareholders and their associates');
- d) the trust has not paid or credited any interest on or in respect of the UPE;
- e) the 'loan account' in which the UPE is included is entirely comprised of amounts relating to UPEs, and repayments of such UPEs, between the trust and the private company (that is, its balance is not affected by any non-UPE transactions);
- f) on or before 31 December 2011 the financial accounts of all relevant entities are amended to properly classify the amount as a UPE; and
- g) on or before 31 December 2011 the trustee/public officer of the trust, or public officer of the company, signs and dates a declaration setting out that all of the above conditions have been met.

As 'financial accounts' are restrictively defined in the PSLA as the "finalised accounts for the income year whether audited or unaudited" (emphasis added), condition (b) above may be problematic.



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For example, if the journal entries and/or trial balance underlying the finalised accounts (i.e. on which those accounts are based) are regarded as separate from those accounts, then there will be evidence that does not support the view that the amount is a UPE - we will be seeking clarification from the ATO on this point and submitting that the ATO needs to adopt a pragmatic interpretation of the phrase 'financial accounts'.

Self-assessing the exercise of an ATO discretion

If the requirements to correct the financial accounts are not able to be met, or for some other reason a Division 7A deemed dividend has arisen because the UPE has become an ordinary loan, the trust may be able to self-assess on the basis of undertaking its own corrective action. This requires all of the following conditions to be met:

- a) the breach of Division 7A was the result of an honest mistake or inadvertent omission;
- b) the trust and the private company are "small business entities" i.e. they must carry on a business and have a turnover (together with certain related parties) of less than \$2m;
- c) the loan was used for business purposes by the trust;
- d) corrective action, including entering into a complying loan agreement, is taken and the trust makes "catch up" interest and principal payments to the private company;
- e) the private company and the trust have lodged all required income tax returns and have a good history of tax compliance; and
- f) the trustee of the trust is not a shareholder of the private company.

As this option to self assess corrective action is limited to small business entities it will exclude many taxpayers.

Division 7A loans within the extended meaning

According to the ATO a private company beneficiary will be said to have provided financial accommodation to a trust in which it has a UPE if that private company has, under a consensual arrangement:

- supplied or granted some form of pecuniary aid or favour to the trust; and
- a principal sum or equivalent is ultimately payable to the trust.

Enabling the funds representing a UPE to be used for trust purposes is the provision of pecuniary support to the trustee of the trust. If this happens with the knowledge and acquiescence of the private company a benefit is provided to the trust.

Funds will be considered to be used for trust purposes if:

- the trustee of the main trust does nothing other than record in its books of account the private company's entitlement; or
- the UPE is held in a 'sub-trust', but the trustee of the sub-trust allows the funds to remain intermingled in the main trust on terms that do not entitle the private company to the sole benefit of any income generated by the use of those funds.

As the trust and beneficiary form part of the same family group, the ATO will form the view that the private company has knowledge of the trustee's use of the funds for trust purposes, subject to sufficient evidence to the contrary.



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UPEs that are not Division 7A loans

If funds representing the UPE are used only for the private company's sole benefit the private company does not provide financial accommodation. This will be the case if the funds remain with the main trust but are held on terms entitling a sub-trust to (i) all the benefits from the use of the funds and (ii) repayment of the principal.

The ATO will consider the following to evidence the existence of a sub-trust:

- the UPE is set aside separately in the accounts of the main trust as being held on trust for the private company;
- separate accounts are prepared for the sub-trust; or
- a separate bank account is opened in the name of the trustee for the private company beneficiary in respect of the funds within the sub-trust.

Where the funds in the sub-trust are invested back into the main trust, the taxpayer must show that all the benefits from the use of the funds flow back to the sub-trust.

The Practice Statement provides that, if the funds are invested in the main trust using one of the following investment options, the ATO will consider that the funds in the sub-trust are held for the sole benefit of the private company beneficiary.

Option 1: Funds invested on an interest only 7 year loan at the Division 7A benchmark interest rate

The funds invested must be repaid within 7 years to the private company. The benchmark interest rate is currently 7.4%.

This option can be distinguished from the conversion of the UPE to a conventional Division 7A loan between the private company and the main trust in that principal need not be repaid throughout the investment period but rather can be deferred to the end of the 7 year investment period.

Option 2: Funds invested on an interest only 10 year loan at the prescribed interest rate

The funds invested must be repaid within 10 years to the private company. The prescribed interest rate is the RBA Small Business Variable Rate which is currently 10.3%.

Option 3: Funds invested in a specific income producing asset or investment

The funds invested must be paid to the private company or reinvested for the benefit of that company if the asset or investment is disposed of. A separate tax return must be lodged by the sub-trust.

Under Option 1 and 2 the Practice Statement indicates that the interest payable by the trust would be expected to be deductible as long as the requirements for deductibility have been satisfied.

Under each option, if the calculated return is not paid out to the private company, the ATO will treat the investment as a loan that is subject to Division 7A.

Timing – UPEs arising between 16 December 2009 and 30 June 2010

According to the ATO, the parties will have until 30 June 2011 to decide to place the UPE on a sub-trust using one of the three options.

If an investment is made, the first liability to pay interest or to distribute income to the private company will arise on 30 June 2012. However, the actual payment of the interest by the main trust, or income distribution by the sub-trust, will not be required until lodgement day of the relevant trust's 2012 tax return – for example, 15 May 2013.



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If an investment is not made, the parties will have until lodgement date of the company's 2011 income tax return to either repay the loan or enter into a complying Division 7A loan agreement

Timing – UPEs arising after 30 June 2010

In subsequent income years, the parties will have until lodgement date of the tax return to place the UPE on a sub-trust.

If an investment is made, the first payment of interest or income distribution will be required to be made by lodgement date for the tax return for the following income year.

What action should you now be taking?

With respect to any trust that distributes to a corporate beneficiary:

- Review the trust deed to determine if it grants the trustee the power to pay a distribution to the beneficiary, apply the distribution on the beneficiary's behalf or set the distribution aside in a sub-trust;
- Take steps to ensure that any amounts set aside in a sub-trust are either (i) invested in a specific asset or (ii) put on 7/10 year loan terms that comply with the requirements of the final Practice Statement;
- Ensure that the financial accounts of both the trust and the corporate beneficiary correctly record distributions as UPEs in accordance with the conditions prescribed by the ATO;
- If the company and/or trust cannot meet the conditions prescribed by the ATO for correcting their financial accounts, endeavour to put in place complying Division 7A loan agreements and make 'catch up' capital and interest payments as quickly as possible; and
- Consider the long-term business or investment strategy for the trust.

What action will we be taking?

We were heavily involved in consultation prior to the issue of the final Practice Statement and will now be:

- seeking clarification from the ATO on a number of aspects of the final Practice Statement; and
- lobbying the Government and Treasury for a legislative solution to the 'mess' that Division 7A has become as a result of the ATO approach to UPEs.

FURTHER INFORMATION

For further details on the issues raised in this Tax Bulletin, please contact your regular Pitcher Partners tax contact in any member firm.

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