

TAX BULLETIN

AN UPDATE PUBLICATION
FOR OUR CLIENTS

4 June 2010

PRIVATE COMPANY WITH AN UNPAID PRESENT ENTITLEMENT (“UPE”)

Summary

Some six months after it released a draft version, the ATO has issued its final 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 has issued a draft Practice Statement which provides guidance on complying with the Ruling.

According to the Ruling an unpaid distribution may be treated as a loan for Division 7A purposes where the circumstances indicate that one of the following has occurred:

1. an express or implied loan agreement has been entered into between the parties; or
2. the trustee has exercised its power to apply trust funds on behalf of the private company by crediting the private company’s loan account; or
3. whilst neither party has accounted for the obligation and asset as a loan, the private company has acquiesced to the use by the trust of the funds representing the UPE for its own purposes.

The circumstances referred to above include such things as the wording of the trust deed and the accounting treatment adopted by both the trustee and the company.

As the ATO’s views in the Ruling are different from those that it has publicly stated in the past it will not apply to UPEs arising before 16 December 2009 - being the date of issue of the original draft Ruling. This ‘prospective’ treatment however will only apply to UPEs that are covered by point 3.

In respect to post-16 December 2009 UPEs that are prima facie covered by point 3, the draft Practice Statement sets out methodologies under which the trust will not be considered to have used the funds for its own purposes and therefore avoid treatment as a loan for Division 7A purposes. Broadly, these methodologies involve arrangements that provide for an effective investment return to the company in respect of its entitlement.

In respect to UPEs covered by points 1 and 2 these will always be treated by the ATO as loans for Division 7A purposes irrespective of whether they arise before or after 16 December 2009.

Where a UPE is treated as a Division 7A loan, the ATO will regard that loan as first arising in the subsequent income year. This means that in the case of a 2010 income year distribution, the parties would have until the lodgement date of the company’s 2011 income tax return to either repay the loan or enter into a complying Division 7A loan agreement.



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 effect such a Division 7A loan of money (as described in any of the above dot-points).

Loan instead of or in satisfaction of UPE

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

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.

Timing of loan

Where there is a loan agreement the loan will arise on the date it was made under the agreement. If there is no agreement, the loan will arise at the date the amount is recorded as such either in the loan account ledger of the private company or of the trust.



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 that is ultimately payable.

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.

Timing of loan

The private company beneficiary will be taken to have made a Division 7A loan to the trustee of a trust when those funds are first used other than for the private company's sole benefit.

Subject to evidence to the contrary, the ATO will accept that the private company does not make a Division 7A loan until the income year following that in which the UPE is taken to have arisen for tax purposes.

For a distribution made in relation to the 2010 income year, this would be 30 June 2011. The parties would then 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.

The draft Practice Statement also indicates that as long as the funds have been used in the gaining or producing of assessable income, interest on loans that arise under the above circumstances would be expected to be deductible.

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 the 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

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- 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.

If the funds are invested in a specific investment the ATO will consider the condition to be met if the entire net return derived from that part of the investment directly attributable to the sub-trust investment of the UPE flows back to the sub-trust. It would be expected that the sub-trust would also benefit from any gains that are derived when the asset is sold.

Where no specific investment is made, the ATO will consider that the benefits from the use of the funds flow back to the sub-trust where the terms of the investment of the fund into the main trust are documented in the form of a written agreement on the following terms:

- the trustee is obliged to adopt an approved method of calculating the return on the investment to the sub-trust; and
- the sub-trust must pay that return out to the solely entitled private company beneficiary.

The draft Practice Statement provides two methodologies to calculate an appropriate rate of return, based on the days the investment was held in the year.

Option 1: Funds invested x Division 7A benchmark interest rate

The funds invested must be repaid within 7 years to the private company.

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: Trust net income x (Funds invested by the sub-trust ÷ Value of the gross "commercial assets" of the main trust)

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

Timing

According to the ATO, the parties will have until the day the loan would have otherwise have arisen (i.e., 30 June 2011 for a 2010 income year distribution) to ensure that the funds representing the private company's UPE are held on sub-trust and used only for the private company's sole benefit.

Date of effect

With one exception, the final Ruling will apply both before and after its date of issue. The Ruling will not apply to UPEs that arose before 16 December 2009 and that have not have already been extinguished and converted into a loan back to the trust. The ATO has confirmed that it will accept the quarantining in the accounts of UPEs created prior to 16 December 2009.

Although the Practice Statement is only in draft form, the ATO states that it may be relied upon to determine the tax treatment of trust distributions made in respect of the 2010 financial year.



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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.
- Ensure that both the accounting records of the trust and the corporate beneficiary appropriately record distributions as UPEs.
- Consider the long-term business or investment strategy for the trust. The implications of the Ruling in light of your particular circumstances should be discussed with your adviser in order to develop the appropriate response.

What action will we be taking?

We have already been heavily involved in consultation prior to the issue of the final Ruling and draft Practice Statement. We will be making a submission to the ATO on a number of aspects of the draft Practice Statement.

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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