TAX - AcTION

UNPAID DISTRIBUTIONS OWED TO COMPANIES

We recently sent out a Tax-Action in relation to Division 7A and unpaid present entitlements ("UPE"). We have decided to update that publication in light of the recently finalised practice statement – PS LA 2010-4 on this topic. Whilst this update duplicates some of the content of the first publication, it now incorporates the latest practice statement and it provides an important summary of most of the relevant issues. We hope you find it useful.

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Our commentary re-addresses the following issues:-

- Is the ATO view that UPEs become loans correct?
- Test case versus declaratory relief – what is the right approach?
- Can pre-16th December 2009 UPEs be quarantined?
- Do we need to amend trust deeds?
- What choices do you have for post-15th December 2009 distributions?
- What are some of the flow on effects of this new ruling?
- Should we still use corporate beneficiaries?

Is the ATO view that UPEs become loans correct?

In TR 2010/3, the ATO tells us that UPEs owed to companies will effectively become loans in the year following the year the distributions were made. Unless corrective action is taken, the UPE will become a loan by the earliest of the due date or actual date of lodgement of the main trust's income tax return. For distributions made in the 30th June 2010 year, they will become loans on 30th June, 2011 as a transitional special rule. The ATO argument is that in effect the UPE becomes "*a transaction (whatever its terms or form) which in substance effects a loan of money*" and is deemed a loan under Section 109D(3)(d) of the 1936 Tax Act as a result.

Furthermore, the company, by not calling for payment of their UPE, has made "*a provision of credit or any other form of financial accommodation*" under Section 109D(3)(b).

The ATO makes the following comments in the final practice statement:-

> *45. Paragraph 23 of TR 2010/3 states the following:*
>
> *...if a private company beneficiary has knowledge that funds representing its UPE are being used by the trustee for trust purposes (rather than being held and / or used for that private company's sole benefit), in not calling for payment of its UPE the private company provides the trustee with financial accommodation and, by extension, makes a Division 7A loan to the trustee.*
>
> *46. Paragraph 25 of TR 2010/3 adds that this:*
>
> *...overall transaction also effects, in substance, a loan of money from the private company to the trustee of the trust.*
>
> *47. Paragraph 26 of TR 2010/3 states further:*

> *Where the trust and beneficiary form part of the same family group, in the absence of sufficient evidence to the contrary, the Commissioner takes the view that the private company has knowledge of the trustee's use of the funds representing the UPE for trust purposes.*

The practical outcome of not paying the UPE across to the company and leaving the UPE in the trust is that the trust will continue to have use of those trust funds. In effect, it could be argued that a financial accommodation which is in substance a loan has occurred. The ATO arguments are reasonably compelling! However, this is a matter which should be tested in the Courts and this has not yet occurred!

To balance this argument, it should be remembered that Division 7A has specific provisions which deal with UPEs which strongly imply that they are not loans and not captured under the main provisions of Division 7A.

Irrespective of the arguments, we believe that many trusts will have to comply with this ruling because their trusts are not complying with their trust deeds. Most deeds require that any UPE be held upon separate trust exclusively for the benefit of the beneficiary which is the company in this context. However, whilst a UPE account is set up in the trust ledger, the funds supporting this distribution are mixed with the general trust funds of the main trust and invested or applied for the benefit of all of the discretionary beneficiaries and not exclusively for the benefit of the company. If this is practically not a loan back from the bare trust or effectively the company, then what is it? We believe that the ATO would probably win the argument should the matter go to court. Remember, they will pick the case they want to fight!

If the UPE does become a loan, the important question is at what point in time does this occur where the UPE is still disclosed as a UPE? The ATO dogmatically concludes that this conversion occurs in the following year. We find this outcome offensive and if and when an UPE is converted into a loan will depend on the facts and circumstances of each case.

About the Editor

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The recent trust distribution withholding rules passed by Parliament in Tax Laws Amendment (Measures No. 2) Act 2010 indicates that Parliament has a different view. It recognises that UPEs still outstanding from prior years are not subject to the new TFN notification or withholding rules. These entitlements will be at least 12 months old and have clearly not been converted into loans in the eyes of Parliament as they are still referred to as UPEs. Therefore the ruling includes concepts that are not supported by these and other laws.

The problem facing taxpayers is that a failure to comply with a tax ruling should only occur where the taxpayer has a reasonably arguable position. In most cases, taxpayers will have little choice but to comply with the ruling or face penalties if they take on the ATO. In this context, the ruling goes too far and we believe is an abuse of power by the ATO.

Each taxpayer should make their own decision as to what to do about this ruling. However we believe most taxpayers will just accept and comply with the ruling to avoid a confrontation with the ATO. Unless you or your clients have deep pockets and want to fight the issue in the Courts, there seems little choice!

Test case versus declaratory relief – what is the right approach?

The ATO has recently announced that it will run a test case on this matter. However we do not believe this is the fastest or most effective way of resolving this issue. We would recommend that a taxpayer seeks declaratory relief on this issue. In that way, only the specific issue would be tested and the outcome will not be tainted by the facts in a particular case. There are two questions that need to be asked:-

- Given the existence of Sub-division EA, does Section 109D(3) have any application to UPEs?
- Is the Commissioner's view that a UPE converts into a loan during the year after the entitlement is granted correct?

A court can rule on these questions in advance of the transactions occurring under declaratory relief. If the answer to either or both of these questions is no, then TR 2010/3 no longer has substance and would have to be withdrawn or seriously modified. So would the practice statement!

Obtaining declaratory relief is not uncommon and we can sight at least two recent cases where this has occurred in the taxation arena. It is cheaper than running a test case as only specific issues are addressed. It will have a much wider application as only the issues are decided. Finally, the Commissioner will not be able to pick a case that the taxpayer cannot win on its specific facts and use this as the test case to get his precedent. It will mean that we get a decision that is not tainted by its specific facts and may therefore be unique to those facts.

We do not understand why the accounting bodies are not pursuing declaratory relief!

Can pre-16th December 2009 UPEs be quarantined?

Thankfully yes though not in all cases.

Where old UPEs have been converted into loans they are loans. Where they have been mixed with loan funds they are also effectively loans. Indicators of where a loan now exists include:-

- Interest is charged on the amount.
- The amount has been disclosed as a loan in the company tax return disclosures.
- The UPE account has been overdrawn.
- Credits have been made to the account other than trust distributions.
- UPE accounts of spouses or relatives have been combined together into one account.
- The trust deed automatically forces the UPE to be converted into a loan though thankfully this will be rare.
- The distribution minutes and journals were drafted in such a manner that the distribution immediately became a loan.

The only entries that should go to a UPE account are the crediting of distributions and the

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draw down of those distributions by payments made to or on behalf of the beneficiary.

The mere disclosure of the UPE as a loan in the trust or company's books or both is not evidence that the UPE is a loan but will make it difficult to prove it is not a loan. There will need to be clear evidence to the contrary.

On the positive side, the ATO has now provided very clear safe harbours in its final practice statement (PS LA 2010/4). Where UPEs have been disclosed as loans in either the trust or the corporate beneficiary or both, that taxpayer or taxpayers have until 31st December, 2011 to correct that disclosure without risk provided the following requirements are met:-

- The UPE has been incorrectly disclosed in either the trust's or company's financial statements.
- The UPE is still in substance a UPE and is not a loan (see earlier reasons why it may no longer be a UPE).
- The UPE has never been disclosed in the company tax return in the loans to shareholders and associates box (Label 8N).
- Interest has never been charged on the UPE.
- There are no transactions in the UPE account that should not belong there and would corrupt the UPE.
- The disclosures are fixed by 31st December, 2011.
- The trustee or public officer signs a declaration stating that all of these conditions have been met by 31st December, 2011.

This safe harbour can be self assessed and will not be challenged unless there is evidence to the contrary that all of these conditions have not been met. Any pre-16th December, 1999 UPEs meeting these requirements can therefore be quarantined. Any pre-16th December, 2009 UPEs that met all of these requirements and were correctly disclosed as a UPE in both the trust and the company's ledgers and financial statements also can also be quarantined as an automatic right.

Please note that you cannot rewrite history. If past distributions have been converted into loans they will be loans. However, there are two other safe harbours available to taxpayers where a UPE has been inadvertantly converted into a loan. At the same time, the ATO has also provided one safe harbour position where loans from companies to trusts have not been put on Division 7A terms due to an honest misunderstanding of the law and this is also included in this practice statement.

What about UPEs which have been corrupted into loans?

These unfortunately were always loans once loan transactions were mixed with the unpaid entitlements. Corruption will have occurred where any of the following have occurred (regardless of whether it is disclosed as a UPE or a loan):-

- Credits besides distributions have been made to the account in the trust.
- The UPE has been overdrawn.
- Interest has been charged on the account.
- The account has been disclosed as a loan to shareholders or associates in the company tax return.
- The trust deed deems a loan to come into existence.
- The distribution minutes and journals were badly drafted and result in a loan being brought into existence rather than a UPE.

The ATO is allowing two fix ups under PS LA 2010/4. Unfortunately they are narrow. They effectively allow the company and trust to bring the corrupted UPE (loan) up to date as if it had correctly complied with Division 7A from the very first point Division 7A would have applied to the loan. This involves making all of the minimum payments (interest and principal) that should have occurred in the year of the fix up which can occur in either the year ended 30th June, 2010 or 30th June, 2011. The fix ups should occur as soon as possible and need to be actually carried out by 31st December, 2011.

Guidance on how to do the fix ups to restate the loan as if it had been a complying Division 7A loan is set out at the attached web address:-

http://www.ato.gov.au/print.asp?doc=/content/00104288.htm

The various safe harbours are elaborated on below.

Safe harbour No. 1 for SBEs

This safe harbour for a discretion not to have deemed dividends **can be self assessed** provided all of the following conditions have been complied with:-

- The non-compliance with Division 7A is due to an honest mistake or inadvertent error. Ignorance of the law or missing one loan would seems to be grounds for this claim.
- The trust is carrying on a business or businesses and is an SBE (under $2 million business turnover). There is a flaw in the drafting of the practice statement in that it effectively states that the trust and the company both must be SBEs. It will be rare that the corporate beneficiary will conduct a business and will be an SBE. We trust and hope that this is a small drafting error which will be corrected in due course.
- The effective loan back to the trust has only funded the business operations of the trust.
- The taxpayer rectifies the loan as if it had been on Division 7A terms in the year of fix up (see web address above).
- The taxpayer has its 2010 and prior tax returns up to date.
- The taxpayer has, apart from these breaches, a good compliance record.
- The Trust does not hold any shares in the beneficiary company.

This safe harbour is quite narrow and is for the benefit of small businesses who have used their UPEs only to fund business operations. Taxpayers will need to meticulously ensure they meet all of the conditions to self assess this fix up. Where the UPEs arise out of investment trusts, this safe harbour cannot be used.

Safe harbour No. 2 – Other corrupted UPEs

This safe harbour for a discretion not to have dividends deemed **must be applied for** and should reasonably be granted by the ATO provided all of the following conditions have been complied with:-

- The non-compliance with Division 7A is due to an honest mistake or inadvertent error. Ignorance of the law or missing one loan would again seems to be grounds for this claim.
- The request for a discretion provides the ATO with the full facts and circumstances leading to the non-compliance. Where it has been missed due to a lack of reasonable care, it is less likely a discretion will be exercised.
- The effective loan back to the trust has only funded the business operations of the trust. Where the funds are applied for private purposes, a discretion is unlikely. Where the funds have been applied by the trust to acquire additional income earning investments, we would like to think that a discretion will still be possible but it cannot be guaranteed.
- The size of the taxpayer’s operations and unpaid entitlements and the sophistication of their advisors is also a relevant factor. Basically the Commissioner is saying that it will be more considerate to smaller taxpayers and clients of small / medium tax agents. The implication is that where there is a large taxpayer or a large accounting firm advising, the errors or mistakes should not have been missed and they are less likely to get a discretion.
- The taxpayer rectifies the loan as if it had been on Division 7A terms in the year of fix up (see web address above).
- The taxpayer has, apart from these breaches, a good compliance record.
- The speed in which the taxpayer acts to request the discretion once the errors have been identified. Our recommendation here is that these discretions should be acted on immediately and not left until 31st December, 2011. The sooner the better!
- The willingness of the taxpayer to take rectification action. This will include bringing the loans up to date as if they had been a complying loan in the first instance.

There are no guarantees in relation to this discretion as the Commissioner must approve it. The taxpayer must throw themselves at the mercy of the ATO. We personally recommend that these breaches are identified as soon as possible and the discretion is applied for in the next three months. We also recommend that corrective action is taken before the application is made as an act of good faith. We believe the ATO are less likely to deem dividends when the taxpayer has already rectified the loans. We cannot guarantee this as every discretion will be judged on its own merits.

Safe harbour No. 3 – Loans from companies to trusts

The ATO makes it clear that the two safe harbours listed above do not just apply to corrupted UPEs. Taxpayers who identify loans by companies to trusts can also use either of the safe harbours (as appropriate to their facts) to rectify those loans where those loans have not been correctly treated under Division 7A in the past. Whether you can self assess this discretion or need to apply to the Commissioner will depend on the facts of each case.

Is the ATO approach retrospective?

Some people are saying that the ATO approach in this area is retrospective. We disagree. Loans made by companies to trusts have been captured into Division 7A from virtually its inception. It has to be an unpaid entitlement to get the quarantined safe harbour. The ATO will only attack past unpaid entitlements where they have been compromised into loans, which is within the law. They are now allowing uncorrupted UPEs to be treated as such where the only mistake was the financial disclosure and they are allowing until 31st December, 2011 to fix these. They are providing a mechanism to fix up the UPEs that have been corrupted into loans. This is not a retrospective approach from the ATO!

Do we need to amend trust deeds?

Many lawyers will try to convince you that trust deed amendments are now necessary. In most cases, we disagree. Most deeds allow unpaid entitlements to exist where amounts distributed are not paid or applied to the benefit of the beneficiaries. However a few deeds may need amendment.

We have seen the occasional trust deed that effectively converts any unpaid entitlement that is not paid to a beneficiary into a loan under the terms of the deed. Thankfully these deeds are rare. However where you have such a deed, an amendment is probably essential. These deeds will automatically convert all pre-16th December, 2009 unpaid distributions into loans and will bring them into Division 7A. The ATO safe harbour will be of no use to you here.

A deed amendment will only protect the trust for distributions made after the amendment. It is therefore imperative to read your deeds to establish whether the deed requires amendment and to determine if the safe harbour is available to you.

We do recommend that you review all the trust deeds where a corporate beneficiary is being used. If you have one of these rare deeds, we suggest you consider amending it. Please ensure that where deeds are being amended, you obtain expert legal advice before proceeding. You would not want to trigger a resettlement for you or your client! The cure may be worse than the problem!

We also recommend that distribution minutes explicitly state that any distributions are to be set aside on separate trust for the beneficiary so there is clear evidence that there was always an intention to create a UPE.

What choices do you have for post-15th December 2009 distributions?

There are currently five choices available to you in relation to distributions made on or after 16th December, 2009. These are:-

1. Convert them into excluded loans under Division 7A
2. Pay them out to the company
3. Put them on separate trust
4. Take one of the three ATO options in the practice statement
5. Take on the Commissioner!

We stress from the outset that you need to ensure that your trust deed does not automatically convert a UPE into a loan and you need to correctly account for the UPE in the first instance. This means that the distribution must in first instance be credited into a UPE account specific to the particular beneficiary. We strongly recommend that each UPE ledger account is also sub-accounted so that each year’s distribution is specifically identified. It is imperative if you wish to quarantine pre-16th December, 2009 distributions that these are also isolated from later distributions. The ATO accepts that various distributions over several years to one beneficiary will be considered a single UPE. Separately sub-accounting each year's distribution in the one ledger account should not change this conclusion.

Please note that the UPEs should, according to the ATO (paragraph 59 of PS LA 2010/4), be disclosed in the equity section of the trust in its financial accounts and we recommend that this is done if this is not already the case.

Crediting distributions to loan accounts and mixing them with loan funds will make them immediately a loan and will automatically exclude you from accessing most of the options listed above. You should never combine or amalgamate UPE accounts of spouses into one account as this will also make it a loan.

Consistency is also important. Whilst TR 2010/3 attacks UPEs to companies, all UPEs to all beneficiaries must be consistently treated. There should be separate UPE accounts and loan accounts for each beneficiary in the general ledger of all trusts, even if the loan account is not used in some cases.

Each of the choices are briefly addressed below.

1. ***Convert them into excluded loans***

   For distributions made on the 30th June, 2010, the ATO has indicated they must be converted into loans by 30th June, 2011 or 12 months after the distribution. For subsequent distributions (30th June, 2011 year onwards) the loan must be brought into existence by the earliest of the due date or actual date of lodgement of the trust's tax return for the year the entitlement arose. This will need to be a 7 year or 25 year excluded loan. Interest will typically apply from 1st July, 2011 for 2010 UPEs and the first minimum repayment will be due in the 30th June, 2012 year. Interest will apply from 1st July following the date the trust tax return is lodged for later UPEs converted into loans.

   We suggest you defer the conversion into a loan until the last possible date to help ensure that interest deductions will be available to the trust assuming TR 2005/12 is complied with.

   Conversion can and should occur by transferring the balance out of the UPE account into a loan account by journal entry. This should be authorised by the company beneficiary. Processing this journal is a must in both books of account as the accounting must support what is happening.

2. ***Pay them out to the company***

   Whilst payment can occur anytime after the distribution is made, it can be deferred significantly where the unpaid distribution is converted into a loan during the year following the distribution under choice 1 earlier.

   However you do not need to make this loan an excluded loan. Where the loan comes into existence on 30th June, 2011 in relation to a 30th June, 2010 distribution, you now have until the due date or actual date (whichever is the earliest) of lodgement of the tax return of the trust for the year ending 30th June 2011 to pay the full distribution out to the company. This probably will be March to May, 2012 but may be earlier depending on when the return is actually lodged.

   Where the loan comes into existence on 15th May, 2012 in relation to a 30th June, 2011 distribution, you now have until the due date or actual date (whichever is the earliest) of lodgement of the tax return for the year ending 30th June 2012 to pay the full distribution out to the company. This probably will be March to May, 2013 but may be earlier depending on when the return is actually lodged.

   By paying the loan out before the return is lodged and not putting a Division 7A loan agreement in place, interest on this loan may be avoided depending on the specific facts of each case. However there may be a need to charge interest on these loans for other reasons besides Division 7A and this should be kept in mind.

3. ***Put them on separate trust***

   Whilst this is an option it is not recommended!

   For a distribution made on 30th June, 2010, the separate trust will need to be created by the earlier of the due date or actual date of lodgement of the tax return of the trust in which the entitlement arose. It will be a bare trust where trust assets will need to be held exclusively for the company. A separate tax file number and tax return will be required. The original trust will need to transfer funds or assets to this separate trust. There may be income tax, CGT, GST and stamp duty implications in relation to this transfer as the main trust will be deemed to have disposed of those assets to the separate trust. As the beneficiaries will be different, a change in beneficial ownership will have occurred. Arm's length income will need to be generated from those assets for the exclusive benefit of the company. Separate records will need to be maintained. The assets transferred or allocated will now belong exclusively to the company. Any tax implications on the holding and subsequent disposal of those assets will apply to the company only.

This choice is identical to Option 3 now available under the final practice statement (see below). The ATO has now indicated a separate TFN will be required for the separate trust and separate accounting and taxation records maintained.

This choice is too hard and we suggest that you would be better off taking one of the other choices or just transferring the funds or assets directly to the company.

4. ***Take one of the three ATO options in the practice statement***

There are now three options in the final practice statement. All involve the creation of a notional sub-trust for easy administration. They provide taxpayers with an easy solution and are not in accordance with the law or the ATO's view of the law (which may be different to the law). The three options are:-

- Notional 7 year interest only loan
- Notional 10 year interest only loan
- Allocation of specific assets to a separate trust

Taxpayers cannot chop and change from one option to another in respect of specific UPEs. However different options appear to be available for different UPEs including a UPE arising for one specific beneficiary in one year compared to a new UPE in the next year.

Each of these options are separately addressed below:-

- ***Notional 7 Year interest only loan***

  The first safe harbour option requires a notional return based on a notional Division 7A loan being in place where interest is actually paid based on the current Division 7A benchmark rate for that year. Furthermore the unpaid entitlement does not have to be paid to the company until 7 years have elapsed from the granting of the loan. However the amount will be treated as being held upon sub-trust during the period of the notional loan.

  For distributions made on 30th June, 2010, the notional loan must commence from 30th June, 2011. The notional loan must be repaid in full by 30th June, 2018 in this scenario. For distributions made on 30th June, 2011, the loan must commence from 15th May, 2012 (or earlier if the trust tax return is lodged earlier). The notional loan must be repaid in full seven years later by 14th May, 2019 in this scenario.

  The interest on the notional loan must be paid across to the company by the due date of lodgement of the main trust's tax return. It must be journalled into the trust's and company's books in the year it relates. The only exception to the rule is the interest for year seven which must be paid across when the notional loan is repaid on the seventh anniversary of the loan or by 30th June, 2018 for 30th June, 2010 distributions. The company will probably need to have a bank account to achieve this outcome though it is technically possible to do it by journal in the right circumstances. The interest is potentially deductible to the main trust and will be assessable to the company in the year it refers. A deduction will be available provided Section 8-1 is met and we presume that TR 2005/12 can be applied and relied upon in coming to this conclusion.

  Importantly, the interest is to be subtracted from the income of the main trust in determining its net income and taxable income under this option.

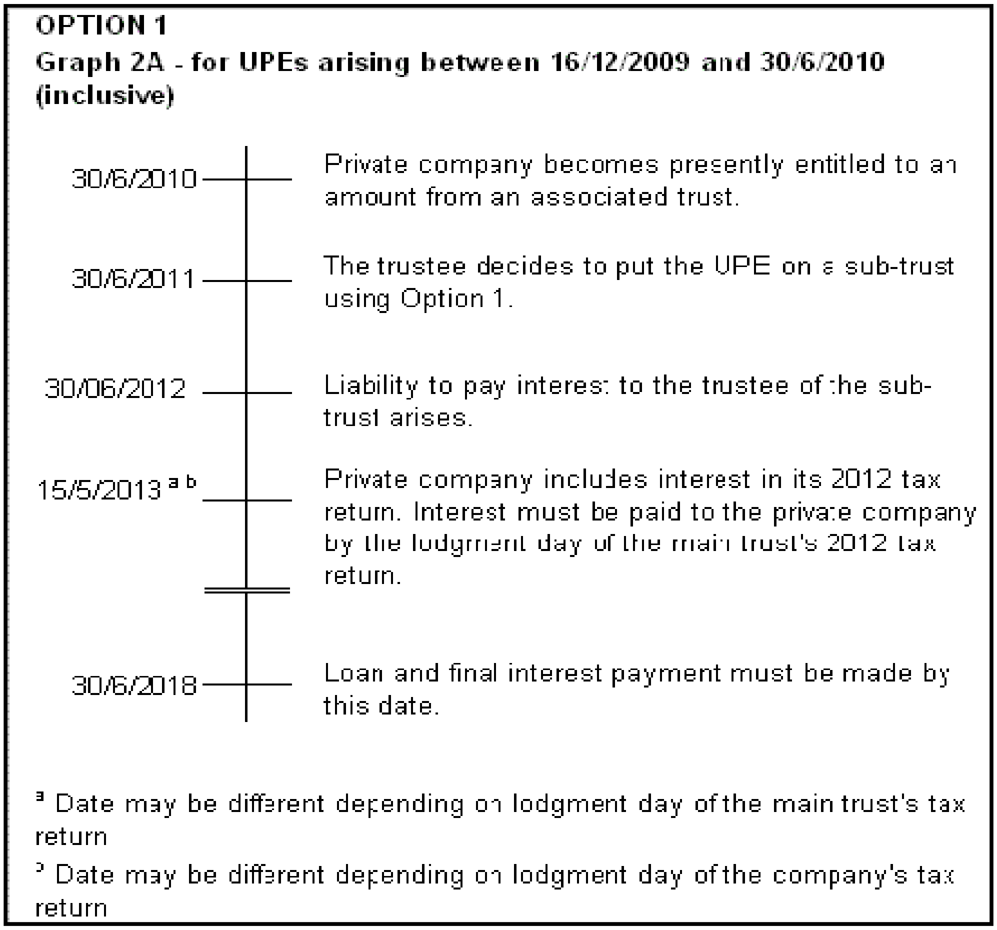
  This option requires a specific agreement to be put in place where the terms of the loan are stipulated and the main trust acknowledges obligations to pay the interest and principle in the time lines specified. We assume this agreement is effective for taxation purposes only though it must be followed.

  This option does not require a sub-trust or separate trust tax return to be completed. However the main trust must sufficiently disclose the income and capital of this sub-trust separately from the income and capital of the main trust. The practice statement provides no guidance on this disclosure requirement.

We do not know at this time if it will be possible for the company to re-lend the amount back to the trust on 30th June, 2018 as an excluded loan under Division 7A terms. The potential risk here is that this could be considered a trust reimbursement arrangement under Section 100A. That is a matter that can be considered at that time.

We personally recommend that if this option is pursued, the UPE amount should either remain in the UPE account or be journalled out of the UPE account and put to a new sub-trust account in the general ledger of the trust and the company (and not a loan account). We prefer a separate sub-trust account disclosed in the equity area of the trust's financial statements so the sub-trust is separately disclosed. Our reasoning for this at this time is that if the ATO loses their test case, this may enable the sub-trust amount to revert back to a UPE. You do not want to taint it into a loan in case the Commissioner loses the case as it will be tainted forever. In theory it is still a sub-trust according to the ATO. Example 7 in the explanation of the practice statement indicates it can remain in the UPE account.

We have extracted and attached a timeline from the practice statement which sets out how this notional sub-trust will operate for 30th June, 2010 distributions. Please note that the time-line will vary for later distributions.



OPTION 1

Graph 2A - for UPEs arising between 16/12/2009 and 30/6/2010 (inclusive)

30/6/2010
Private company becomes presently entitled to an amount from an associated trust.

30/6/2011
The trustee decides to put the UPE on a sub-trust using Option 1.

30/06/2012
Liability to pay interest to the trustee of the sub-trust arises.

15/5/2013 [a] [b]
Private company includes interest in its 2012 tax return. Interest must be paid to the private company by the lodgment day of the main trust's 2012 tax return.

30/6/2018
Loan and final interest payment must be made by this date.

[a] Date may be different depending on lodgment day of the main trust's tax return

[b] Date may be different depending on lodgment day of the company's tax return

- ***Notional 10 year interest only loan***

This safe harbour option is virtually identical to the first option except the notional loan runs for 10 years rather than 7 and the notional interest is at a higher rate. The rate applicable is as follows:-

> *Prescribed interest rate for a particular income year is the Reserve Bank of Australia's indicator lending rate for small business variable (other) overdraft for the month of May immediately before the start of that income year. These rates can be found at Table F5 at the*

> *Reserve Bank of Australia website (http://www.rba.gov.au/statistics/tables/index.html). The rate for the year ending 30 June 2011 is 10.3%.*

For distributions made on 30th June, 2010, the notional loan must commence from 30th June, 2011. The notional loan must be repaid in full by 30th June, 2021 in this scenario. For distributions made on 30th June, 2011, the notional loan must commence from 15th May, 2012 or when the trust return is lodged if earlier. The notional loan must be repaid in full by 14th May, 2022 in this scenario.

Please note that the dates in the practice statement narrative and the tables are inconsistent depending on the year the distribution arises. UPEs for the 2010 year can be converted into notional loans by 30th June, 2011 and must be repaid by 30th June, 2021. UPEs for the 2011 year must be converted into notional loans by 15th May, 2012 and must be repaid in full by 14th May, 2022.

The interest on the notional must be paid across to the company by the due date of lodgement of the main trust's tax return. It must be journalled into the trust's and company's books in the year it relates. The only exception to the rule is the interest for year ten which must be paid across when the notional loan is repaid on the tenth anniversary of the loan or by 30th June, 2021 for 30th June, 2010 distributions. The company will probably need to have a bank account though it is technically possible to charge the interest by journal in the right circumstances. The interest is potentially deductible to the main trust and will be assessable to the company in the year it refers. A deduction will be available provided Section 8-1 is met and we presume that TR 2005/12 can be relied upon in coming to this conclusion.

Importantly, the interest is to be deducted from the income of the main trust in determining its net income and taxable income under this option.

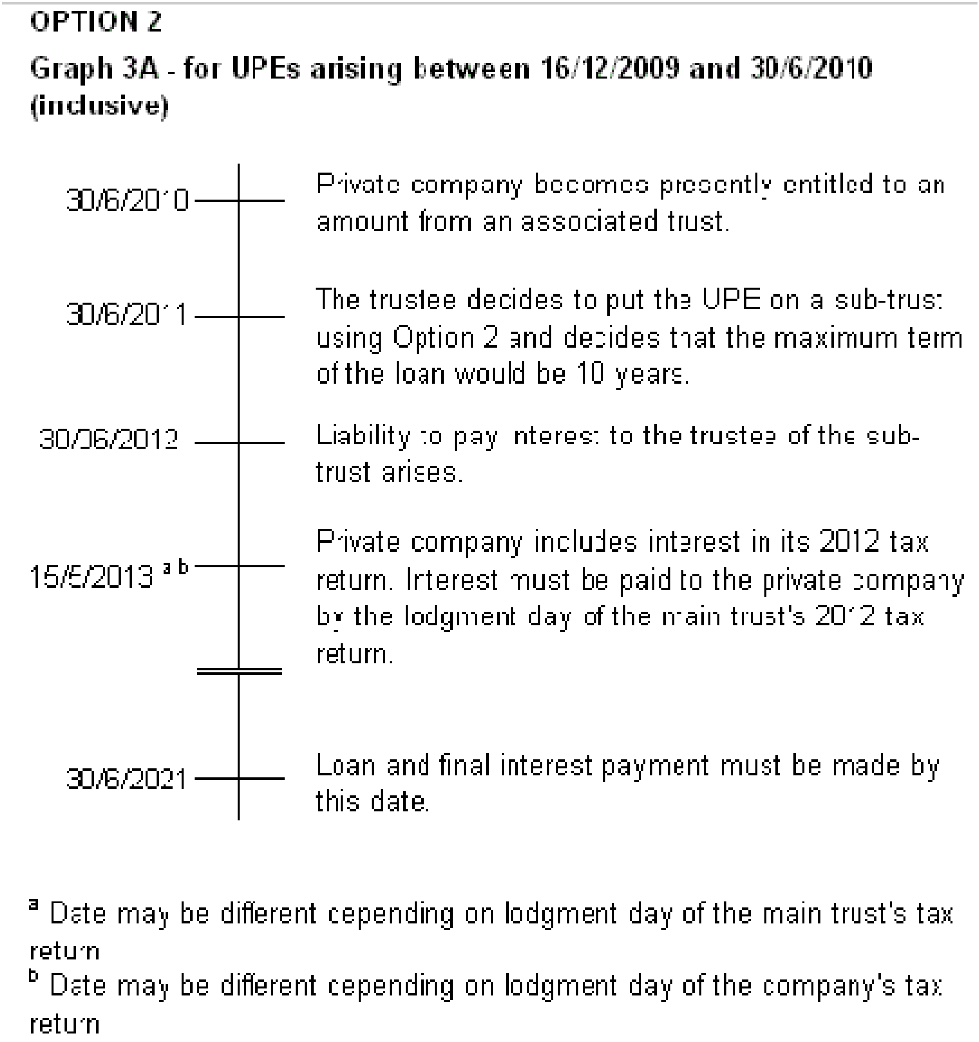
This option requires a specific agreement to be put in place where the terms of the loan are stipulated and the main trust acknowledges obligations to pay the interest and principle in the time lines specified. Again this agreement must be honoured but it is in place for taxation purposes only as the amount is still considered a UPE.

This option does not require a sub-trust or separate trust tax return to be completed. However the main trust must sufficiently disclose the income and capital of this sub-trust separately from the income and capital of the main trust. How this is to be done has not been made clear in the practice statement.

We do not know at this time if it will be possible for the company to re-lend the amount back to the trust on 30th June, 2021 as an excluded loan under Division 7A terms. The potential risk here is that this could be considered a trust reimbursement arrangement under Section 100A. Again we note that this issue can be addressed at that time.

We personally recommend that if this option is pursued, the UPE amount should either remain in the UPE account or be journalled out of the UPE account and put to another sub-trust account in the general ledger of the trust and the company (and not a loan account). We prefer a separate sub-trust account disclosed in the equity area of the trust's financial statements so the sub-trust is separately disclosed. Our reasoning for this at this time is that if the ATO loses their test case, this may enable the sub-trust amount to revert back to a UPE. You do not want to taint it into a loan in case the Commissioner loses the case as it will be tainted forever. Example 7 in the explanation of the practice statement indicates it can remain in the UPE account.

We have extracted and attached a timeline from the practice statement which sets out how this notional sub-trust will operate.



OPTION 2

Graph 3A - for UPEs arising between 16/12/2009 and 30/6/2010 (inclusive)

30/6/2010 Private company becomes presently entitled to an amount from an associated trust.

30/6/2011 The trustee decides to put the UPE on a sub-trust using Option 2 and decides that the maximum term of the loan would be 10 years.

30/06/2012 Liability to pay interest to the trustee of the sub-trust arises.

15/5/2013 [a] [b] Private company includes interest in its 2012 tax return. Interest must be paid to the private company by the lodgment day of the main trust's 2012 tax return.

30/6/2021 Loan and final interest payment must be made by this date.

[a] Date may be different depending on lodgment day of the main trust's tax return

[b] Date may be different depending on lodgment day of the company's tax return

- ***Allocation specific assets to a separate trust***

  The third option requires a separate trust to be established and for specific assets to be transferred from the main trust to this sub-trust to satisfy the unpaid entitlement.

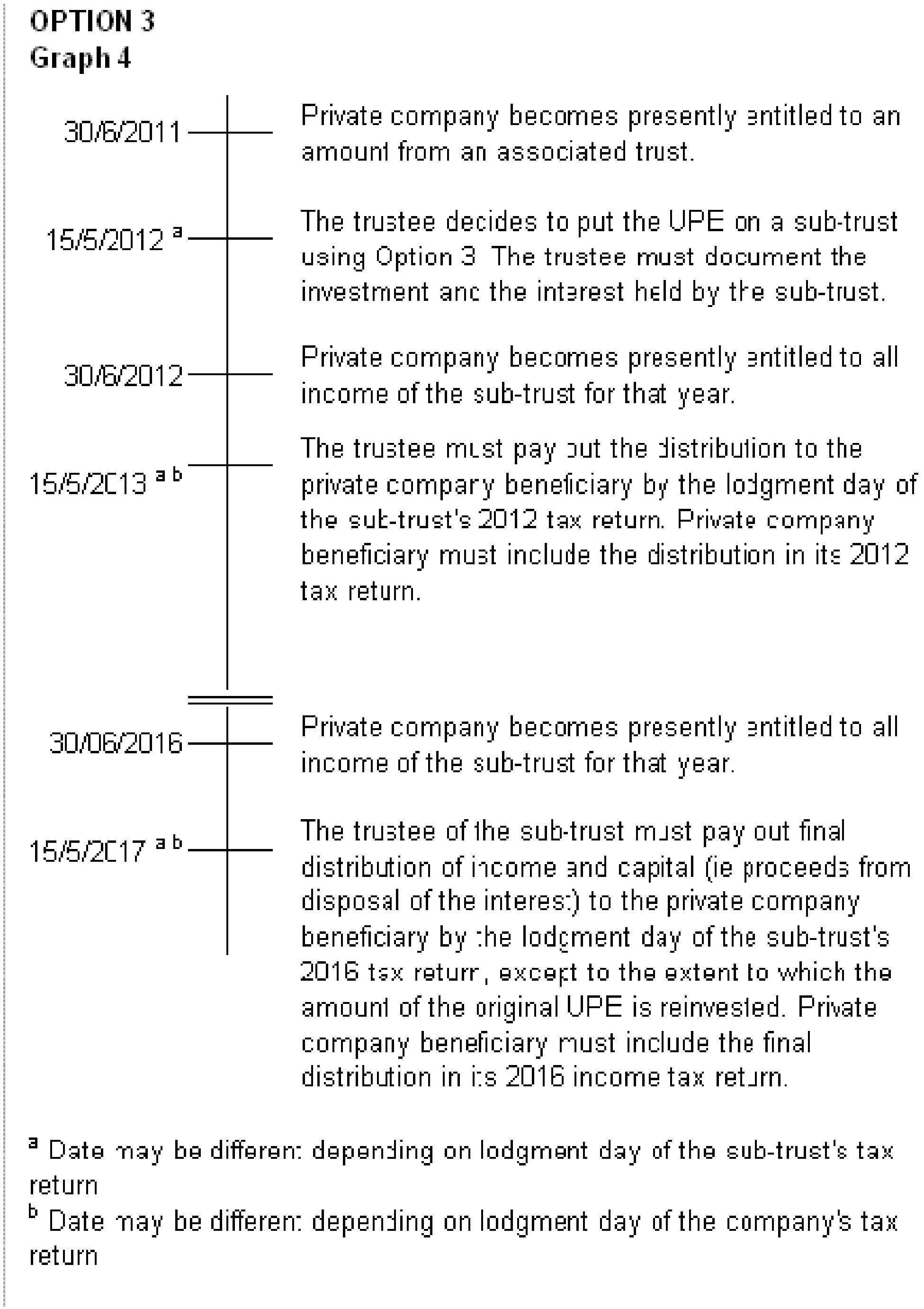
  For a distribution made on 30th June, 2011, the separate trust will need to be created on 15th May, 2012 being the last date the UPE can be paid out without triggering Division 7A. This is the date the main trust must lodge its 2011 tax return. Where the lodgement date is earlier, the sub-trust will need to come into existence earlier. There is no discussion on converting UPEs from 30th June, 2010 into separate or sub-trusts in the practice statement but we assume it can be done.

  The sub-trust will be a bare trust where trust assets will need to be held exclusively for the company. A separate tax file number and tax return will be required. Separate financial statements and general ledgers will be required. The original trust will need to transfer funds or assets to this separate trust. There may be income tax, CGT, GST and stamp duty implications in relation to this transfer as the main trust will be deemed to have disposed of those assets to the separate trust. Arm's length income will need to be generated from those assets for the exclusive benefit of the company and the assets transferred must be income generating assets. Separate records will need to be maintained. The assets transferred or allocated will now belong exclusively to the company. Any tax implications on the subsequent use or disposal of those assets will apply to the company only.

  The ATO has now indicated a separate TFN will be required for the separate trust and separate accounting and taxation records must be maintained.

This choice is too hard and we suggest that you would be better off taking one of the other choices or just transferring the funds or assets directly to the company.

A flowchart of the relevant dates for a distribution made on 30th June, 2011 is set out below.



OPTION 3
Graph 4

30/6/2011 — Private company becomes presently entitled to an amount from an associated trust.

15/5/2012 [a] — The trustee decides to put the UPE on a sub-trust using Option 3 The trustee must document the investment and the interest held by the sub-trust.

30/6/2012 — Private company becomes presently entitled to all income of the sub-trust for that year.

15/5/2013 [a b] — The trustee must pay out the distribution to the private company beneficiary by the lodgment day of the sub-trust's 2012 tax return. Private company beneficiary must include the distribution in its 2012 tax return.

30/06/2016 — Private company becomes presently entitled to all income of the sub-trust for that year.

15/5/2017 [a b] — The trustee of the sub-trust must pay out final distribution of income and capital (ie proceeds from disposal of the interest) to the private company beneficiary by the lodgment day of the sub-trust's 2016 tax return, except to the extent to which the amount of the original UPE is reinvested. Private company beneficiary must include the final distribution in its 2016 income tax return.

[a] Date may be different depending on lodgment day of the sub-trust's tax return

[b] Date may be different depending on lodgment day of the company's tax return

5. *Take on the Commissioner!*

Unfortunately and obviously this is a choice but it will be unpalatable to most taxpayers who will not want to be involved in costly litigation with the ATO where the outcome is uncertain (unless you are the test case).

It basically involves treating all distributions as unpaid entitlements into the future, leaving them as they are and waiting for the ATO audit and the deemed dividends.

Position looking forward

You cannot just ignore this ruling and practice statement. If you ignore the ruling without a reasonably arguable position, you will be in breach of the Tax Agent Services Regime. You may put your tax agency in jeopardy! Unless you have a reasonably arguable position, you or your client will face penalties unless they win in Court.

Taxpayers and advisors must commit to a course of action in relation to distributions to corporate beneficiaries. The choice will depend on a range of factors and will need to be tailored to each situation.

What are some of the flow on effects of this new ruling?

Unfortunately there are numerous flow on effects from this ruling which must be considered. We have brought some of them to your attention below:-

- ***How does Sub-division EA interact with the practice statement***

  Where UPEs are owed to a company by a trust and the trust makes loans to shareholders of the company or their associates, Division 7A will generally apply to those loans made by the trust. 7 or 25 Year Division 7A loans may need to be put in place where the company has a distributable surplus. Forgiveness of existing loans made by the trust to those parties are similarly affected. The payment of unpaid distributions owed to the shareholders or associates can also trigger the application of Division 7A in this situation.

  Similarly, where a taxpayer utilises either of the three options under the practice statement, the notional loans or separate trust will still be considered an amount held upon separate trust and will also trigger the application of Sub-division EA where the main trust makes loans, forgives loans or makes certain payments to shareholders or their associates.

  The practice statement also makes it clear that where the terms of the three options in the practice statement are not met, Sub-division EA can also apply at the time the breach occurs.

  Where a UPE is converted into a 7 year or 25 year Division 7A loan (the PS LA 2010/4 three options are not utilised), then Sub-division EA will no longer apply unless it was triggered before the UPEs were converted into loans. However the back to back loan provisions in Sections 109T, 109V and 109W can now be triggered where the trust makes loans, forgives loans or makes certain payments to the shareholders or their associates. Therefore Division 7A can apply to those transactions irrespective of whether the UPE is a loan, or is still treated as a UPE.

- ***Can we just ignore our quarantined pre-16th December, 2009 distributions?***

  The answer is clearly no. Whilst the ATO will ignore them now, they may eventually be considered a trust reimbursement arrangement under Section 100A of the 1936 Tax Act. They will need to be paid to the company eventually. How long you have will depend on the facts and circumstances of each case.

  We recommend that you age your quarantined distributions so you know how long they have remained unpaid. This will assist in identifying the Section 100A risk. Clearly any reductions of unpaid entitlements should probably occur against the post-15th December distributions first and then on a first in first out basis on the pre-16th December distributions.

  Please also note that where the trust makes loans, forgives loans or makes certain payments to the shareholders and their associates whilst the quarantined UPEs are in place, Sub-division EA can still apply to deem dividends unless complying Division 7A loans are put in place.

- ***Will the trust be able to claim interest deductions where an unpaid entitlement is converted into a loan?***

  Where the trust funds have remained in the trust and have been applied to income producing purposes in the trust, the answer is yes provided TR 2005/12 is complied with. It is imperative that the UPE has been in existence for at least 6 months before it is converted into a loan or paid out to access this ruling. You should also keep records to show how the income of the trust each year has been reinvested into income producing assets in the trust so tracing can be proven.

  However where the unpaid trust funds came from another trust as an unpaid distribution or went out to other entities, back to back loans may have to be brought into existence so the trust has interest income to offset the interest paid to the company. Otherwise deductions for the interest on these converted loans will be in jeopardy!

- ***Can a UPE be paid out and re-lent back as a Division 7A loan***

  The answer is quite clearly yes provided it was a UPE. Where it was already a loan because it had been corrupted, arrangements to repay and re-borrow are generally ineffective. However, paragraph 121 of the practice statement provides an interesting and we suspect unintended safe harbour.

  > *121. Where a UPE is considered to be a loan for Division 7A purposes, the ATO will treat the payment of the UPE as being a repayment for Division 7A purposes if the UPE is paid out by the time of the lodgment of the return and replaced with a loan under a complying loan agreement. That is, the ATO will not seek to apply section 109R in these circumstances.*

  This would seem to suggest that all past corrupted UPEs can be paid out and re-lent on Division 7A terms and effectively be re-set. However, we suggest you would still need to do a rectification of the loan first and bring it up to date as if it had been compliant before it is repaid and re-borrowed.

- ***Will back to back loan agreements need to be put in place?***

  Many tax agents or client groups will have arrangements where a unit trust makes distributions to a discretionary trust unit-holder who in turn makes distributions to a company. These distributions will often remain unpaid and will be UPEs. The ATO has effectively clarified several issues here:-

  - The UPE owed by the unit trust to the discretionary trust can become a loan under Division 7A as it can also be considered a financial accommodation (unless it is a pre-16th December, 1999 UPE which we assume can be quarantined as well though this is not confirmed in the practice statement).
  - The UPE owed by the discretionary trust to the company will need to be dealt with (unless it is pre-16th December, 1999 and is quarantined). It will need to be put on 7 or 25 year Division 7A loan terms or placed into one of the three options in the practice statement.
  - The fact that the UPE owed to the company is now on special terms will not trigger a Sub-division EA problem for the UPE owed by the unit trust to the discretionary trust. Effectively the ATO will ignore it. Whilst this seems generous, it is not as generous as it seems!

  Loan agreements may need to be put in place between the unit trust and the discretionary trust under the back to back provisions in Sections 109T, 109V and 109W to stop deemed dividends arising where the UPE owed to the company is converted into a Division 7A loan. After all, both UPEs could be deemed to be loans by the ATO and there is a clear link between the two. This risk is not addressed in the practice statement.

  Alternatively loan agreements may be required to ensure interest deductions in the discretionary trust so back to back loans will be needed in any event. This will be the case where the UPE owed to the company is converted into a loan or is treated as a separate trust under option 1 (7 year interest–free notional loan) or option 2 (10 year interest–free notional loan) under the practice statement. Otherwise the discretionary trust will have interest expense but no interest income. The interest expense will not relate to the income earned from the unit-holding as it relates to loans arising out of subsequent unpaid distribution income.

  Unfortunately there is no guidance from the ATO here on the terms of the loan between the unit trust and the discretionary trust. It, in theory, should mimic the terms of the loan or notional loan between the discretionary trust and the company.

- ***What happens when a UPE is forgiven?***

  Paragraph 22 of the final practice statement makes the following comment:-

  > *22. Where a UPE has been forgiven the ATO may consider that a Section two loan has arisen, despite the fact that the amount had been recorded as a UPE in the accounts.*

  This seems to suggest that the ATO will seek to deem dividends in relation to UPEs that are forgiven irrespective of whether they are pre-16th December 2009 or not. The basis for this conclusion is not clear and it will depend on who the UPE is with. It would seem that only the forgiveness of UPEs owed to companies could trigger this risk. Irrespective, taxpayers and advisors should think very carefully before any UPEs are extinguished by forgiveness. We do not necessarily agree with the ATO view but we also prefer to see UPEs paid out rather than have them forgiven. What the beneficiary then does with the proceeds is their prerogative.

- ***Where trusts have assets which are made available for the use of shareholders or their associates of the corporate beneficiary, could a deemed dividend arise?***

  Provided there are no loans to a company and just UPEs owed to a company, the use of assets held by the trust for less than market value rent is not currently captured into Division 7A even after the recent law amendments. It would seem that adopting any of the three options in the practice statement will mean that you are still deemed to have a UPE and this risk is still mitigated.

  Once a UPE owed to a company is converted into a loan or is deemed to be a loan by the Commissioner, a problem can then arise under Sections 109T, 109V and 109W. Where a reasonable person can link the converted or deemed loan from the company to the trust to the use of the asset held by the trust, a deemed dividend could potentially arise unless a market value rent is received for the use of that asset. Some of the exceptions available to company assets are not available to trust assets and cannot mitigate this risk.

  The ATO have indicated that they will be looking closely at any situation where the asset in the trust has been funded by unpaid distributions (past and present) owed to companies. It seems their intention is to deem dividends in all cases including where the asset is funded out of quarantined pre-16th December, 2009 unpaid entitlements. We cannot see how they will be successful in doing this in relation to quarantined UPEs or UPEs under the practice statement as the law appears to be deficient. Taxpayers prudently should still prove conclusively that these trust assets have been funded from other resources and not out of unpaid entitlements to avoid any arguments.

- ***Use of ATO safe harbours in the draft practice statement?***

  We caution taxpayers to fully understand the circumstances where the three options in the practice statement will be available so reliance is only placed on these options where they can be used.

  We do note the restrictions suggested by the ATO that the funds representing the UPEs had to have remained in the main trust (as set out in the draft practice statement) before the safe harbours could be used appear to have been lifted in the final version. We believe this is because either Sub-division EA or the back to back provisions (sections 109T, 109V and 109W) will capture virtually any instance where the funds have leaked out of the main trust to individuals or other entities.

- ***Can we do interim distributions prior to 16th December, 2009?***

  The answer to this is simple. Distributions cannot be back dated. If the distribution did not actually happen before 16th December, 2009, it is now too late.

  Even where interim distributions did actually occur, they are likely to be a problem unless your trust deed caters for interim distributions and its terms are complied with. If the income did not exist at the time of the alleged interim distribution, you will also have a problem. The ATO view is that distributions are generally made on the last day of the year irrespective of the date of the distribution minute so expect an argument from them as well.

  Finally, you would expect any interim distributions to be very closely scrutinised in an audit situation. We suggest that you proceed with great care as a result.

Should we still use corporate beneficiaries?

Corporate beneficiaries will still provide some tax deferral even if the ATO position in TR 2010/3 is embraced. The question is whether their use is cost effective or beneficial. This will depend on the facts and circumstances of each case.

Taxpayers and advisors should never lose sight of the fact that when you make a distribution to a company, the distribution belongs exclusively to the company. They are a separate taxpayer and they are entitled to their distributions. If other taxpayers wish to access the funds that truly belong to the company, they should access them in a legitimate way. This will include getting dividends and arm’s length loans. Unfortunately many of our clients have a single pocket mentality and it is this mentality that gets them into trouble under Division 7A.

As there is a differential tax rate for companies, it should not surprise anyone that the ATO will look closely at any arrangement which provides another taxpayer access to the company’s funds without the additional top up tax being paid or a commercial interest being paid. You can criticise the ATO approach but in the end they are only trying to protect the revenue.

We suggest taxpayers also consider the following:-

- Can they make the ATO ruling or practice statement work cost effectively and acceptably for them. If so, prudently they should continue to use corporate beneficiaries within the ruling / practice statement.
- Conversely where the client is spending the profits as fast as they are earning them and has consistent tax rates applicable to their income, the time value for money saved in using the corporate beneficiary may be outweighed by the accounting and administration costs of operating the company.
- Advisors should consider whether individual incomes be topped up to $180,000 rather than $80,000 per annum. The tax rate differential is currently only 8.5% (38.5% personal rate compared to 30% company rate) and it means the funds end up in the hands of individuals and solves many of these problems.
- Trustees may consider accumulating income and paying tax at the rate of 46.5%. Whilst this is not a tax efficient solution, the income now belongs to the trust and not to any individual or company. As well as avoiding Division 7A issues, the individuals may now meet means tests to qualify for other entitlements and may be eligible for deductions and rebates not otherwise available.
- Where the controllers of the trust receive wages, you may consider reducing the wages paid and topping their income up with dividends from corporate beneficiaries. This will ensure distributions to companies are regularly passed out and will enable easier compliance with minimium loan repayment requirements on converted loans. However there are numerous other factors to consider here like work related deductions, payroll tax avoidance, income protection insurance policies etc. and all implications (tax and other) should be considered. Ideally, you would not use quarantined pre-16th December 2009 distributions this way.
- Corporate beneficiaries may be an option as an investment vehicle. Whilst the 50% General CGT Discount is forfeited, there are advantages. Where public company shares are acquired, there is no additional tax to pay on dividends received by companies where the dividends are fully franked. Where the company funds are not needed and the investments can be held long term, the CGT implications are less relevant. More importantly, the company can pay dividends to shareholders after they turn 60 and are receiving their non-assessable non-exempt pension from their superfund. This may enable recovery of franking credits at this time and will mean that there will be minimal additional tax on this dividend income.

Conclusions

Whether you agree or not with the ruling and practice statement, every corporate beneficiary arrangement will need to be reviewed and some action taken. Affected clients will pay more fees for their tax returns because of this shift in interpretation by the ATO. The extent of remedial action required and therefore any fee increases will depend on the circumstances of each client.

We recommend you contact your clients and put them on notice. Ultimately they will complain about any fee increase and the blame for this should be put on the ATO. Everyone is in the same boat here.

Taxpayers and advisors should also remember that amendments were made to Division 7A which have significantly tightened up these rules. These changes occurred effective from 1st July, 2009. From the same date, the use of assets held by a company for less than market value rent can be deemed to be payments under Division 7A and could lead to deemed dividends. The rules are now very complex and can be inadvertently breached. Great care and diligence is now required!

Please also note that Division 7A is now a focus audit area of the ATO. Taxpayers cannot just ignore the ruling and hope it goes away. The rules of the ball game have changed and you ignore them at your own peril!

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