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Trusts under attack by Tax Office

Division 7A – Unpaid Present Entitlement of Corporate Beneficiaries

Many closely held trusts are in danger of being assessed under the Division 7A deemed dividend rules following the Tax Office's release of a draft ruling.

Just before Christmas 2009 the Tax Office released draft ruling TR 2009/D8, which sets out the Tax Office's view on when a trust can be deemed to have received a dividend from an associated private company in situations where the private company has an unpaid present entitlement (UPE) to an amount from the trust.

The draft ruling indicates that the Commissioner will treat virtually all corporate beneficiaries' UPEs as loans from the company to the trust, and therefore will be subject to the Division 7A deemed dividend rules, unless they are covered by the necessary and prescribed written loan agreement.

The draft ruling indicates that, with few exceptions, this will be applied retrospectively to previous years.

When the Tax Office changes its view on the law it generally does not apply that view retrospectively. In the draft ruling the Tax Office argues that in relation to its view as stated in the draft ruling, it has only changed its position where the trustee has created a sub-trust over the UPE, which would only apply to a very limited number of UPE situations.

PKF disagrees with the Tax Office on this point as the Tax Office has on many cases, since Division 7A was introduced in 1997, indicated that a UPE will not be treated as a loan for Division 7A purposes unless it was actively converted into a loan by the actions of the parties. In particular, the Tax Office has not previously referred to whether or not a sub-trust has been created.

PKF will be preparing a submission to the Tax Office contesting the Tax Office's approach in this draft ruling.

Example

An example where the Tax Office says it has not changed its view that there is a deemed dividend can be summarised as follows:

- ▶ A and B are individuals who are spouses and have control of a private company, X Co Pty Ltd (X Co).
- ▶ A and B, together and related entities (including X Co), are also objects of a discretionary trust, the AB Family Trust, which is also under A and B's control.
- ▶ During an income year the trustee resolves that \$10,000 of AB Family Trust's income for that year be distributed to X Co. No cash payment is made to X Co (i.e. it is a UPE) and the trust uses the funds for the general purposes of the trust.
- ▶ In respect of amounts resolved to be distributed to a beneficiary, the trust deed of the AB Family Trust gives the trustee the power to:
 1. pay such amounts to the beneficiary;
 2. apply such amounts for the benefit of the beneficiary; or
 3. hold such amounts on sub-trust for the sole benefit of that beneficiary, under the same terms as the AB Family Trust.

If the trustee does not resolve to create a sub-trust in respect of the UPE in its distribution resolution, the Tax Office says the company will be taken to have made a Division 7A loan to the trust. The Tax Office indicates that this is so whether or not the trust and company have described the UPE as a "loan" in their accounts, i.e. the amount can be a Division 7A loan even if it is described in the accounts as a UPE.

The Tax Office says that it has always been its view that in these circumstances the UPE has been converted to a loan. It will therefore apply its view retrospectively in these and similar circumstances.

However, if the above example is changed so the trustee did resolve to create a sub-trust over the UPE amount (but still used the funds for the general purposes of the trust), the Tax Office says the UPE will not be a loan under ordinary concepts but it will be “financial accommodation” and therefore a “loan” under the extended definition of “loan” for Division 7A. Accordingly it can still be a deemed dividend.

- ▶ Create a sub-trust (where the trust deed allows) and ensure the UPE is invested for the sole benefit of the corporate beneficiary; or
- ▶ Cover the UPE with a Division 7A complying written loan agreement under which the trust agrees to make the minimum loan repayments and interest payments in accordance with Division 7A.

However, in these sub-trust circumstances the Tax Office concedes that it has changed its view and will only apply its view in these and similar circumstances to UPEs created after 16 December 2009 (the date it released the draft ruling).

However where the trust is using the UPE funds in its own business or investment activities, a proper reconstruction of the group’s affairs should, in many cases, result in no further tax payable by the group.

Action to be Taken

The main thrust of the draft ruling is that where there is an unpaid UPE to a corporate beneficiary, it is more likely than not that Division 7A will apply. If the Tax Office persists with this view in its final ruling it would appear that the only ways to avoid a deemed dividend under Division 7A would, in most cases, be to either:

If a UPE was created in a previous year and the time for putting a complying agreement in place has expired, you may need to request the Tax Office for an extension of time to prepare the written loan agreement under section 109RB.

Although the Tax Office has not yet finalised its position it would be prudent to discuss these issues with your PKF tax advisor to consider your options.

- ▶ Pay the UPE out to the beneficiary;

Should you require assistance or additional information, please contact your PKF Tax Adviser

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