

Unpaid Present Entitlements – Final Practice Statement

The Tax Office has released its final Practice Statement (PS LA 2010/4), which details its response to the UPE Ruling (TR 2010/3) from a practical perspective.

In the draft Practice Statement, the Tax Office outlined:

- ▶ the evidence which it thought indicated a UPE had been converted to a loan
- ▶ the evidence which it thought indicated a UPE continued to be a UPE
- ▶ the requirement for subsisting UPEs to be held on sub trust as a means of avoiding the application of Division 7A
- ▶ the options for the main trust paying a return to the private company through the sub trust by way of interest or a share of the trust's income.

Whilst touching on these issues in the final release, the Tax Office has changed its view in a number of aspects.

Corrective Action Errors in accounts

The first concession applies where amounts have been recorded, in error, in the accounts of the company and the trust.

Where the trust and company treated these amounts as loans in the accounts, the Tax Office argues this is evidence of the UPE being converted into a loan.

However, the Tax Office is allowing small taxpayers (less than \$2M turnover), in limited circumstances, to correct their accounts before 31 December 2011 where the amounts have been incorrectly recorded as a loan as a result of an honest mistake.

Non compliance with Division 7A

The second concession applies where an amount has been converted into a loan, and the trust has previously failed to treat the amount as a Division 7A loan.

In limited circumstances, the Tax Office will allow the trust and company to self correct their non compliance where this was the result of an honest mistake. This is similar to the Division 7A amnesty in 2009 where taxpayers could self correct their non compliance.

To take advantage of this option, the loan must be made Division 7A compliant and the trust must make retrospective repayments equal to those which would have been paid had the loan been compliant.

Where the trust and company do not satisfy the conditions to self correct an honest mistake, they may apply to the Tax Office to disregard the non compliance.

Returns to the Sub-Trust

It is in this area the Tax Office has significantly changed its approach from the draft. They suggest three options for the return to the company to be calculated and paid:

- ▶ Option 1 - interest only 7-year loan
- ▶ Option 2 - interest only 10-year loan
- ▶ Option 3 - invest the funds in a specific income producing asset or investment.

In addition, they suggest trusts may choose their own method of calculating a return to the company. If trusts pursue this option (and there are no guidelines on what would be acceptable), they must ensure:

- ▶ the sub-trust invests the funds representing the UPE in the main trust on commercial terms pursuant to a power as trustee to do so, and
- ▶ all the benefits from the investment flow back to the sub-trust and the company beneficiary, and
- ▶ all the benefits (for example, annual return on investment) are actually paid to the company beneficiary by the lodgment day of the tax return of the main-trust for the year in which the return arises.

Option 1 – 7-Year Loan:

- ▶ 7-year interest only loan from the sub-trust to the main trust
- ▶ document agreement including, details of the 7-year interest only loan, amount of the UPE and the start and end dates of the 7-year loan
- ▶ obligation to repay the principal to the sub-trust no later than the end of the 7-year loan period
- ▶ obligation to pay the interest to the sub-trust

$$\text{Funds invested by the sub-trust} \times \text{Benchmark interest rate} \times \frac{\text{Days investment held in the year}}{\text{Total number of days in the year}}$$

Benchmark interest rate is as defined by subsection 109N(2).

Funds invested by the sub-trust means the funds representing the UPE that are held on sub-trust and invested back into the main trust as at 30 June in the relevant year.

Days investment held in the year means the number of days during the relevant financial year in which the funds represented by the UPE are invested in the main trust by the trustee of the sub-trust not including the day the investment commences if the investment commences on 30 June of the relevant year.

Option 2 – 10-Year Loan:

- ▶ document agreement including, details of the 10-year interest only loan and amount of the UPE
- ▶ an obligation to repay the principal to the sub-trust at the end of the 10-year loan period
- ▶ an obligation to pay the interest to the sub-trust

$$\text{Funds invested by the sub-trust} \times \text{Prescribed interest rate} \times \frac{\text{Days investment held in the year}}{\text{Total number of days in the year}}$$

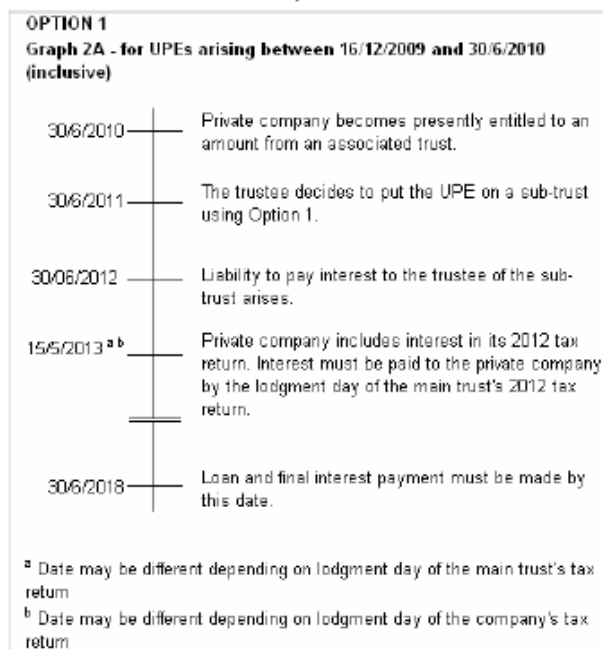
Prescribed interest rate for a particular income year is the Reserve Bank of Australia's indicator lending rate for small business variable (other) overdraft for the month of May immediately before the start of that income year. These rates can be found at Table F5 at the Reserve Bank of Australia website (<http://www.rba.gov.au/statistics/tables/index.html>). The rate for the year ending 30 June 2011 is 10.3%.

Funds invested by the sub-trust means the funds representing the private company's UPE that are held on sub-trust and invested back into the main trust as at 30 June in the relevant year.

Days investment held in the year means the number of days during the relevant financial year in which the funds represented by the UPE are invested in the main trust by the trustee of the sub-trust not including the day the investment commences if the investment commences on 30 June of the relevant year.

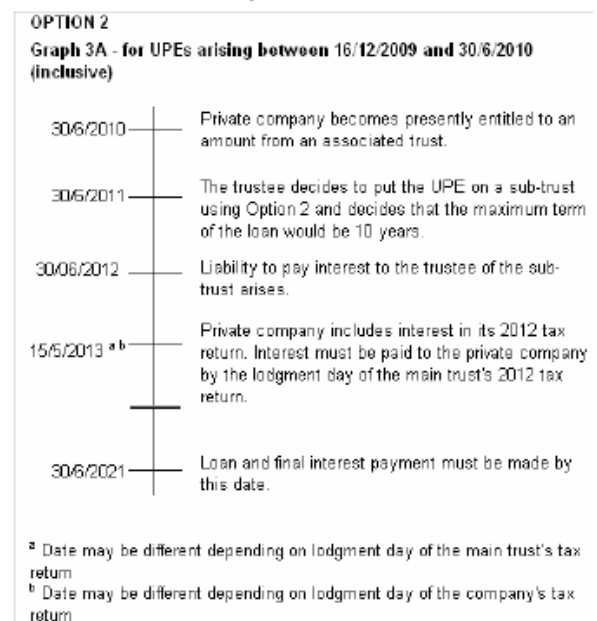
The Tax Office provides this illustration of Option 1.

If, on 30 June 2011, the trustee decides to place the UPE for the 2010 income year on a sub-trust using Option 1, the key dates of which the trustee must take note of are illustrated in Graph 2A below.



The Tax Office provides this illustration of Option 2.

If, on 30 June 2011, the trustee decides to place the UPE for the 2010 income year on a sub-trust using Option 2, the key dates which the trustee must take note of are illustrated in Graph 3A below.

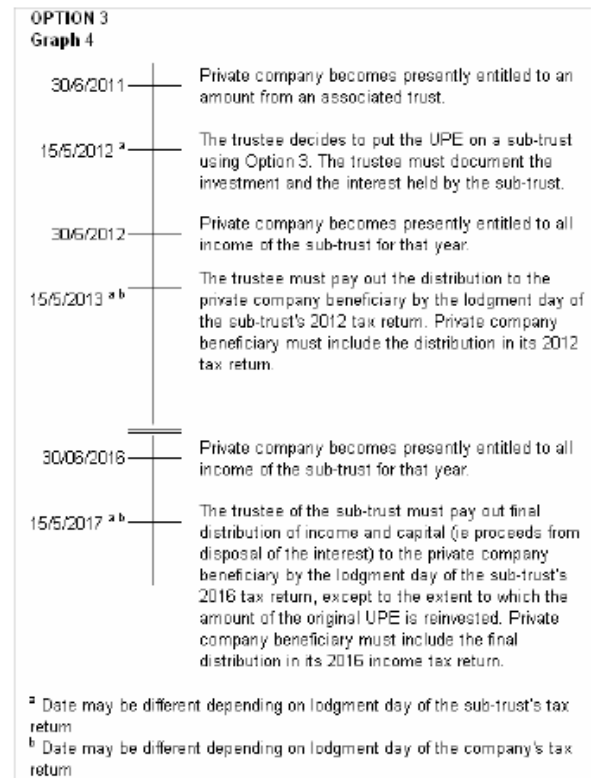


Option 3 – Investment:

- ▶ the sub-trust may invest in a specific investment, interest bearing account or income producing asset
- ▶ the Tax Office does not consider funds are held for the sole benefit of the company where the investment benefits other entities, such as:
 - depreciating assets (unless leased at arm's length rates)
 - private assets, or
 - low interest loans to associated parties
- ▶ an income producing asset is one held with the intention of producing assessable income (e.g. rent or capital gains) provided the income or gain is an arm's length commercial amount
- ▶ as the sub-trust will acquire an investment or income producing asset, the normal tax laws, such as CGT upon disposal, may be applicable
- ▶ sub-trust must prepare accounts and tax return – the investment must be shown in the accounts
- ▶ sub-trust must disclose income and expenses attributable to the asset or investment in its accounts and tax return
- ▶ the sub-trust will make distributions each year to the company as sole beneficiary and these distributions must be paid to the company by lodgment day for the sub-trust's tax return
- ▶ when the sub-trust disposes of an asset, the disposal proceeds must be paid by the sub-trust to the company by the lodgment day for the sub-trust's tax return.

The Tax Office provides this illustration of Option 3.

For example, if, on 15 May 2012, the trustee decides to place the UPE for the 2011 income year on a sub-trust using Option 3 and disposes of the interest on 30 May 2016, the key dates of which the trustee must take note are illustrated in Graph 4 below.



PKF Commentary

The major changes in calculating the return to the sub-trust are the requirement for the sub-trust to actually pay the amounts to the company, and the removal of the equity option (which was attractive to many trusts).

The Tax Office has indicated the equity option was deleted because it provided tax planning opportunities. To that end, they have indicated the equity option will not be acceptable where the trustee decides to identify their own way of calculating returns to the company.

In practical terms, the options produce similar results. Amounts paid to the company should generally be deductible to the main trust. There will be a leakage if the trust is in losses or the interest is not deductible.

It appears the 10-year loan may be the better option. It may be impractical for sub-trusts to make specific investments, thus leaving the two interest options as the practical choices. Also, as the 10-year loan allows the main trust three additional years to find the money to repay the principal, this may be the preferred choice.

It is also important to ensure returns are actually paid to the sub-trust and the company. Consideration may be given to ways in which these funds can subsequently be made available to the main-trust.



Chartered Accountants
& Business Advisers

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

Lance Cunningham | Director of Taxation, PKF Australia Limited
(02) 9240 9736 | lance.cunningham@pkf.com.au
Level 10, 1 Margaret Street | Sydney | New South Wales 2000 | Australia

PKF Australia Limited is a national network of legally independent member firms that trade as PKF. Member Firms of PKF Australia Limited have offices in ACT, NSW, QLD, SA, TAS, VIC and WA. Member Firms of PKF Australia Limited, are also Member Firms of the PKF International Limited network of legally independent firms. Neither PKF Australia Limited nor its member firms accept responsibility or liability for the actions or inactions on the part of any member firm or firms of PKF Australia Limited or of PKF International Limited.

Disclaimer: The material contained in this publication is in the nature of general comment and information only and neither purports, nor is intended, to be advice on any particular matter. Readers should not act or rely upon any matter or information contained in or implied by this publication without taking appropriate professional advice. All financial figures are quoted in Australian Dollars unless otherwise indicated.