



ATO Releases Draft Ruling on Division 7A Loans and Trust Entitlements

The Australian Taxation Office's (ATO's) recently proposed changes to the treatment of trusts, may significantly effect taxpayers' investment and business structures from a cashflow, tax and asset protection perspective.

Draft Taxation Ruling (TR 2009/D8) was released by the ATO on 16 December 2009. This ruling outlines the ATO's position on the operation of Division 7A to trusts that have private company beneficiaries with unpaid present entitlements.

What is Division 7A?

Division 7A of Part III of the Income Tax Assessment Act 1936 (ITAA 1936) was introduced on 4 December 1997 in order to address actions taken by shareholders of private companies in extracting a company's profits as a tax free loan, instead of as a taxable dividend.

In general, Division 7A provides that a loan made by a private company to a shareholder or associate of that company is treated as an unfranked dividend to the recipient, unless the loan is placed under an approved written loan agreement.

What is an Unpaid Present Entitlement?

Many discretionary trusts apply distribution strategies that include the use of private company beneficiaries. These strategies involve a trust making distributions to a company beneficiary and those distributions to the company remaining unpaid.

These strategies have been quite popular in the past as they allow a trust to access the corporate tax rate on profits generated, whilst retaining the use of these profits to fund ongoing activities of the trust.

The distributions to the company beneficiary that remain unpaid by the trust, are generally referred to as unpaid present entitlements (UPE's).

Until recently it has been accepted by the ATO and tax practitioners alike, that a UPE does not represent a loan from the company to the trust for Division 7A purposes, provided that the UPE is not classified as such.

However, the release of TR 2009/D8 outlining the ATO's views on the treatment of UPE's to companies, now indicates otherwise.

The release of TR 2009/D8 by the ATO providing their preliminary views on this matter, indicate that there are circumstances where a UPE may be regarded as a loan for the purposes of Division 7A.

What is a Loan for Division 7A Purposes?

Section 109D(3) provides that a loan includes:

- (a) an advance of money; and
- (b) a provision of credit or any other form of financial accommodation; and
- (c) a payment of an amount for, on account of, on behalf of or at the request of, an entity, if there is an express or implied obligation to repay the amount; and
- (d) a transaction (whatever its terms or form) which in substance effects a loan of money.

According to TR 2009/D8 a private company may provide financial accommodation to the trust by reason of the company not demanding payment of the UPE and allowing the trust to invest the underlying funds for the trust's purposes.

In this situation, the UPE may be a loan for Division 7A purposes, unless the company calls for payment of the UPE, or requests the investment of the funds representing the UPE for the company's absolute benefit.

This requirement for a UPE to be invested for the company's absolute benefit is a new development that takes effect from the date of issue of the ruling, being 16 December 2009 and accordingly, will be relevant for trust distributions made in the 2009/2010 year.

Other circumstances of when a UPE will be treated as a loan according to TR 2009/D8 include:

- there is in effect an agreement for the company to lend money to the trust;
- the trustee credits amounts to a loan account held in the name of the company beneficiary;
- the trustee, acting pursuant to a term of the trust deed, pays or applies money to or for the benefit of the beneficiary; or
- the trustee credits a loan account in the name of the company beneficiary and under the trust deed the trustee has the power to credit such amounts for the benefit of the company beneficiary as a payment or application of funds.

Where to from here?

Whilst the ATO may regard UPE's as loans for Division 7A purposes, the ATO's opinion has not been finalized and is contrary to other professional opinions.

However, as it currently stands, the release of TR 2009/D8 will impact the treatment of UPE's to company beneficiaries arising in respect of the 2009/2010 and later years.

Accordingly, consideration will need to be given to the distribution strategies employed by discretionary trusts in the 2009/2010 and later years, in light of the ATO's approach.

Over the coming months, as the ATO position is clarified, we will be discussing with clients the impact of the ATO Draft Ruling.

In the meantime, if your structure includes the use of trusts and company beneficiaries, please feel free to contact your Davidsons team member to discuss the likely impact of TR 2009/D8 and to develop a strategy going forward.

Geelong
5221 6399

Melbourne
9699 9422

Torquay
5261 2029