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[Insert Client Name]

[Insert Client Position]

[Insert Company Name]

[Insert Company Address]

[Suburb State Post Code]

Dear [Insert Client Name]

**Re: Division 7A and Unpaid Present Entitlements**

This letter outlines the approach the Australian Taxation Office (**ATO**) accepts in relation to the treatment of an unpaid present entitlement (**UPE**) owing by a trust to an associated private company beneficiary for the purpose of Division 7A of the *Income Tax Assessment Act 1936* (***ITAA 1936***). To recap, an UPE will arise where a related private company beneficiary has been made presently entitled to a share of trust income but that amount has not been paid by the trust.

**Executive Summary**

1. The ATO has taken the view in Taxation Ruling TR 2010/3 that an UPE owed by a trust to an associated private company constitutes a loan for the purposes of section 109D of the general provisions of Division 7A of the *ITAA 1936*.
2. The ATO currently provides certain administrative concessions which may be relied upon to ensure an UPE is not treated as a deemed dividend under Division 7A, which are set out in Practice Statement PSLA 2010/4. In particular, the Practice Statement provides that Division 7A will not apply to a subsisting UPE where one of three alternate methods are applied to ensure that the UPE is held on a separate sub-trust for the private company beneficiary. Note: This Practice Statement will continue to apply to trust entitlements arising before 1 July 2022 and is then proposed to be withdrawn when TD 2022/D1 is finalised (see next paragraph).
3. The Commissioner has issued a draft determination in relation to Division 7A (TD 2022/D1: when will an unpaid present entitlement or amount held on sub-trust become the provision of financial accommodation). The Commissioner has announced a prospective (from 1 July 2022) change to his previous approach (outlined in paragraph 3 above).
4. The ATO has also issued Practical Compliance Guideline PCG 2017/13, which allows certain subsisting UPEs held on a sub-trust which matured in the years ended 30 June 2017, 30 June 2018, 30 June 2019, 30 June 2020, 30 June 2021 or 30 June 2022 to be converted into to a complying loan agreement under section 109N of the *ITAA 1936* in respect of any outstanding loan principal.

**Background**

In practice, a trustee of a discretionary trust may often exercise its discretion to distribute income of the trust to an associated private company beneficiary, where the trustee and company are controlled by the same family group.

Where the amount of any such distribution of trust income is not paid, it is often referred to as an UPE owed by the trustee of the trust to the private company beneficiary.

Prior to the issue of TR 2010/3 it was generally thought that the existence of a UPE owing by a trust to a private company beneficiary would not, of itself, give rise to a deemed dividend under the definition of a loan as set out under Section 109D of the *ITAA 1936*.

However, pursuant to Taxation Ruling TR2010/3, section 109D will apply to treat the private company beneficiary as having paid an assessable dividend to the trust equal to the UPE at the end of the year in which the deemed loan is made, unless

* the loan is fully repaid before the lodgement date of the private company’s tax return for that year,
* an exception contained in Subdivision D of Division 7A applies, or
* the private company has an insufficient distributable surplus for section 109Y purposes.

Note: This Taxation Ruling will continue to apply to trust entitlements arising before 1 July 2022 and is then proposed to be withdrawn when TD 2022/D1 is finalised.

**Taxation Ruling TR 2010/3**

Taxation Ruling TR 2010/3 provides that an UPE owing to a private company by an associated trust may be regarded as a loan made directly by the private company to the trust under section 109D and that the associated trust will be taken to have derived a deemed dividend for the amount of the UPE, unless certain preventative action is taken.

Essentially, the ruling provides that an UPE may be treated as a loan for section 109D purposes under two scenarios.

1. *Scenario one – ordinary loans*

The first scenario is where there is an express or implied agreement between the trustee of the trust and the private company that the UPE be treated as an ordinary loan made by the company to the trust.

For example, the UPE may be paid out by the trustee to the private company beneficiary who then immediately lends back the funds representing that trust distribution to the trustee such that the UPE is effectively replaced by an ordinary loan from the private company to the trustee of the trust. This conversion of the UPE into an ordinary loan could be made through an exchange of cash or by way of set off in the accounts of the trust and the company.

An express loan agreement will arise where the existence of such an ordinary loan is evidenced in a written loan agreement, trust resolution or other document.

Furthermore, an ordinary loan agreement can be implied if the amount of the UPE is recorded as a ‘loan’ in the financial accounts of both the private company and the trust. That is, an ordinary loan will be inferred where the trustee creates a credit loan liability account for the amount of the UPE in the trust’s accounts and the private company discloses the UPE amount is a debit loan asset in its accounts. The ATO has adopted the view that where the trust and the private company are part of the same family group with the same ultimate controllers that the private company will have knowledge that the trustee has credited a loan in its name and acquiesced to this treatment unless there is evidence to the contrary.

Finally, an ordinary loan will also potentially arise where the trustee has exercised a power to pay or apply trust funds on behalf of the private company beneficiary under a power in the trust deed, and the financial accounts of the trust have recorded that amount paid or applied as a credit loan account in the private company’s name and the trustee has assumed a corresponding obligation to repay the loan amount. In these circumstances, the relevant trust funds are regarded as having been paid or applied for the benefit of the private company beneficiary who is taken to have made an ordinary loan to the trustee. However, such a loan will not arise where it is outside the power of the trust deed for the trustee to treat the funds otherwise than as an UPE. It is also necessary that the exercise of the power in the trust deed be set out in a trust resolution or some other written document.

Subject to evidence to the contrary, an ordinary loan will be taken to have been made from the date the amount was loaned under a written agreement, the date the amount of the UPE is booked as a loan in the general ledger of the private company where there is an implied agreement, or otherwise when the UPE is first booked as a loan in the financial accounts of both the company and the trust. In all of these circumstances the trust will therefore be deemed to have received a dividend at the end of the year in which such an ordinary loan is made for section 109D purposes.

1. *Second scenario – subsisting UPEs*

The second scenario is where there is no ordinary loan but the private company has acquiesced to the use of the funds represented by the UPE which have become intermingled with the other funds of the trust. Such amounts are referred to as ‘subsisting UPEs’.

In these circumstances, the UPE will be regarded by the ATO as being the ‘provision of financial accommodation’ or an ‘in-substance loan’ by the private company to the trust under the extended definition of ‘loan’ in section 109D.

Taxation Ruling TR 2010/3 provides that a private company will be regarded as providing a financial accommodation to the trustee of a trust for the purposes of section 109D if it provides any pecuniary aid or favour to a trustee of the trust under a consensual agreement under which a principal sum is ultimately payable by the trust to the private company. Such a consensual agreement will arise if a private company beneficiary authorises (including by acquiescence) the trustee’s continued use of funds representing the UPE by not calling for its payment or the for the funds representing the UPE to be invested for the sole benefit of the private company. Such knowledge will be inferred where the private company and the trust are part of the same family group unless there is evidence to the contrary.

Alternatively, the overall transaction between the private company and the trust could be characterised as an in-substance loan of money from the private company to the trust for section 109D purposes as the private company has acquiesced to the use of the funds representing the UPE by the trustee for trust purposes.

As the above views were considered a significant departure from the ATO’s prior interpretation of Division 7A, Taxation Ruling TR 2010/3 is not retrospectively applied to a subsisting UPE made prior to 16 December 2009 (being the issue date of the draft version of the ruling). Moreover, there are special transitional provisions applicable to UPEs arising between 16 December 2009 and 30 June 2010. However, Taxation Ruling TR2010/3 does apply to ‘ordinary loans’ made before 16 December 2009.

**Practice Statement PSLA 2010/4**

Practice Statement PSLA 2010/4 sets out separate administrative concessions for ordinary loans and subsisting UPEs, which are respectively discussed below.

1. *Ordinary loans*

Where an ordinary loan has been inadvertently triggered, a non-compliant taxpayer may request the Commissioner of Taxation to exercise the discretion under section 109RB, which may result in either the deemed dividend being disregarded for Division 7A purposes or it being franked subject to certain corrective action being undertaken.

The discretion may be given where it can be demonstrated that the Division 7A deemed dividend has arisen because of an “honest mistake or inadvertent omission” of the private company, the recipient or any other entity whose conduct contributed to the result.

Reference should be made to Taxation Ruling TR 2010/8 for guidance as to when that discretion may be exercised under section 109RB. In addition, Practice Statement PSLA 2011/29 provides further guidance on the matters that the Commissioner of Taxation will have regard to when considering requests to exercise the discretion under section 109RB(3).

Where the Commissioner does not exercise the discretion under section 109RB, a deemed dividend will only not arise if the amount of the loan is paid before the lodgement day of the company’s return for the year in which the loan was made, or the loan is placed on a complying section 109N loan agreement or the company has an insufficient distributable surplus for section 109Y purposes.

1. *Subsisting UPEs*

Practice Statement PSLA 2010/4 also provides administrative concessions in respect of subsisting UPEs which are deemed to be loans under the extended definition of loan, being the provision of financial accommodation or the making of an in-substance loan.

As is the case with ordinary loans, any potential Division 7A liability can be legitimately avoided if the UPE is paid out or is converted into a complying section 109N loan.

*Sub-trust arrangements*

In addition, the Practice Statement also provides that the deemed dividend provisions of Division 7A will not apply where the funds are held on a sub-trust for the sole benefit of the private company beneficiary, and there is an effective agreement to provide an ‘annual return’ on the company’s investment as well as a repayment of the principal funds representing the UPE within a prescribed time frame.

The ATO will regard a sub-trust as having arisen where the UPE is set aside separately in the financial accounts of the main trust as being held on trust for the private company, separate accounts are prepared for the sub-trust or a separate bank account is opened by the trustee on behalf of the private company in relation to the UPE.

Where the funds representing the UPE are invested to acquire a specific asset, the ATO will accept that the company receives an ‘annual return’ on the asset if any assessable income generated by the asset (e.g. rent or a capital gain on the asset’s disposal) flows back solely to the company under the sub-trust. Where this option is selected the sub-trust will need to prepare its own accounts and prepare a separate income tax return for lodgement with the ATO.

Alternatively, where the funds representing the UPE are not invested in a specific asset, Practice Statement PSLA 2010/4sets out the following two options which can be used to calculate the annual return on the funds held on the sub-trust:

* Option 1 – the funds representing the UPE must be repaid within seven years to the private company from the date of investment together with annual interest payments paid on such funds calculated using the benchmark interest rate that applies to complying loans subject to section 109N or
* Option 2 – the funds representing the UPE must be repaid within 10 years to the private company from the date of investment together with annual interest payments paid on such funds calculated using the Reserve Bank of Australia small business variable overdraft rate.

The Practice Statement confirms that interest payable under these options will be deductible to the trust (subject to meeting ordinary deductibility conditions) and assessable to the private company. Whilst the making of an Option 1 or Option 2 loan can be documented in the tax working papers of the trust, it would be prudent to have a separate investment agreement drafted to reflect these loan arrangements.

The application of all these options differs depending on whether the subsisting UPE arose in the year ended 30 June 2010 or in an income year thereafter.

*2010 UPEs*

For UPEs arising between 16 December 2009 and 30 June 2010 affected trusts and private companies had until 30 June 2011 to either invest the subsisting UPE in an appropriate asset or enter into a loan arrangement covered under Options 1 and 2.

If a separate investment is made in these circumstances, the liability to distribute income to the private company arose on 30 June 2012 with the principal UPE repaid when the investment is sold.

Where Options 1 and 2 are applied, interest will have to be paid under Options 1 and 2 annually over the remaining loan term. Where Option 1 applies the principal of the loan had to have been paid by 30 June 2018 whereas it must be paid by 30 June 2021 if Option 2 applies.

*2011 UPEs and thereafter*

For UPEs arising on or after 1 July 2010 the private company will become presently entitled to the subsisting UPE at the end of the relevant year of income in which the UPE arose. According to the Practice Statement, the relevant UPE must then be put on a sub-trust by the lodgement date of the distributing trusts’ income tax return for the year of income (commonly 15 May in the subsequent year) or the subsisting UPE will be deemed to be a loan for Division 7A purposes at that time.

Where the subsisting UPE is invested to acquire a specific asset in these circumstances all of the income of the sub-trust must be annually paid, and the principal representing the UPE must be paid by the lodgement date of the sub-trust tax return in the year in which the specific investment ends.

Where Options 1 and 2 are applied for a UPE arising in the 2011 or a later tax year, the sub-trust must be in place by the lodgement date of the main trust’s tax return for that year, with interest accruing from the time at which the sub-trust investment commences. Thereafter interest will have to be paid under Options 1 and 2 annually over the remaining loan term, essentially by lodgement date for the main trust. Where Option 1 applies the principal of the loan must be paid within seven years from the date of investment whereas it must be paid within 10 years of investment if Option 2 applies.

**Practical Compliance Guideline PCG 2017/13**

Practical Compliance Guideline PCG 2017/13 recognises that the amount of the UPE placed by a trust and the private company beneficiary on a sub-trust between 16 December 2009 and 30 June 2014 on a seven year interest only loan under Option 1 would result in the loan principal becoming payable at the end of the loan term in the years ended 30 June 2017, 30 June 2018, 30 June 2019, 30 June 2020, 30 June 2021 or 30 June 2022 (depending on the date on which the funds representing the UPE were placed in the sub-trust).

The Guideline recognises that trustees who adopted Option 1 under Practice Statement PSLA 2010/4 in these circumstances will be obligated to repay the loan principal at the end of the seven year loan term in accordance with the terms of any investment agreement entered into between the trustee of the sub-trust and the private company beneficiary.

As a concessional measure, if the trustee fails to repay this loan in full at the end of the seven year loan term, any unpaid loan principal arising on the maturity of an investment subject to Option 1 will be allowed to be put on a seven year complying loan basis under section 109N before the company’s lodgement day for the year in which the unpaid loan principal becomes payable in order to ensure that a deemed dividend does not arise in respect of the outstanding loan principal. This will effectively provide a further period in which the amount of any outstanding loan principal can be repaid albeit with periodic payments of both principal and interest.

However, if such a seven year unsecured section 109N complying loan is not put in place between the sub-trust and the private company beneficiary before the private company’s lodgement day for the year in which the unpaid principal becomes due for payment a deemed dividend will arise at the end of the year in which the loan matures.

The Guideline also confirms that the Commissioner will not seek to apply the prohibition on repayments under section 109R in relation to the outstanding loan principal which meets the above requirements under the Guideline.

**Announced changes**

Practice Statement Law Administration PS LA 2010/4 and Taxation Ruling TR 2010/3 are proposed to be withdrawn with effect from 1 July 2022. As such, the 2022 income year will be the final year that taxpayers can take advantage of complying sub-trust arrangements under PSLA 2010/4. However, the ATO has stated that compliance resources will not be allocated to arrangements involving pre-1 July 2022 trust entitlements and sub-trust arrangements that correspond to the guidance in Practice Statement Law Administration PS LA 2010/4 and Taxation Ruling TR 2010/3. For the avoidance of doubt, this would include a sub-trust arrangement commenced on or after 1 July 2022 in respect of a trust entitlement arising before that date.

The major changes in TD 2022/D1 include:

* A UPE with a corporate beneficiary becomes a loan when the corporate beneficiary has knowledge of the amount and does not demand payment. Under the previous rulings, this occurred upon lodgement of the trust’s income tax return. However, under the new ruling the time that a person is deemed to have knowledge of the UPE amount is:
  + for present entitlements to a fixed amount of income – when the UPE is created.
  + for present entitlements to a percentage of trust income – when the trust accounts are finalised.

For fixed UPEs, there will be a change with respect to timing. The first minimum yearly repayment is due in the year following the creation of the UPE. This is a year earlier than under the existing view. For percentage UPEs, the timing remains the same as under the previous guidance.

* Where UPEs are held on a sub-trust arrangement, the use of the funds held on sub-trust by the main trust will be a loan for Division 7A purposes. Therefore, instead of sub-trusts being able to lend money to the main trust on interest only terms, the loan between the sub-trust and the main trust will need to be placed on complying Division 7A loan terms.

Subdivision EA also still has scope to operate in circumstances where the UPE of a private company does not result in financial accommodation.

We appreciate that the above matters are technically complex. Please contact me on [insert telephone number of partner] should you wish to discuss any of the issues detailed above.

Yours faithfully

**[Insert name of Partner]**