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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, a 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.

In September 2023, the Tribunal’s decision in *Bendel and Commissioner of Taxation* [2023] AAT 3074 challenged the ATO’s view on the treatment of UPE. It was held that a UPE was not a loan under s109D(3) for Division 7A purposes. The ATO subsequently lodged an appeal and released an Interim Decision Impact Statement (Interim DIS) affirming that the ATO will continue to administer the law in accordance with TD2022/11 until the appeal process is finalised.

The comments below are based on the approach accepted by the Commissioner at the time of writing.

**Executive Summary**

1. The ATO has issued Taxation Determination TD 2022/11 which effectively expands arrangements that will be regarded as a loan for Division 7A purposes. It states that a UPE owed by a trust to an associated private company or amount held on sub-trust that not used for the exclusive benefit of the private company beneficiary will constitute a loan for the purposes of section 109D of the general provisions of Division 7A of the *ITAA 1936*.
2. The ATO’s views in TD 2022/11 amends their views in Taxation Ruling TR 2010/3 of when an UPE would constitute a loan for Div 7A purposes. When TR 2010/3 was originally issued, the ATO previously provided certain administrative concessions which may have been relied upon to ensure an UPE was not deemed to be a loan under Division 7A, which are set out in Practice Statement PSLA 2010/4. In particular, the Practice Statement provided that Division 7A would 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. With the issue of TD 2022/11, this earlier Taxation Ruling and Practice Statement has been withdrawn but will continue to apply to trust entitlements arising before 1 July 2022.
3. The ATO has also issued Practical Compliance Guideline PCG 2017/13, which allows certain pre-1 July 2022 UPEs held on a sub-trust on terms that comply with PS LA 2010/4 (Option 1) to be converted into to a complying 7 year Division 7A loan, thus providing a further extension to repayment requirements.

**Background**

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 a 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, with the issue of Taxation Ruling TR 2010/3, the ATO changed its approach and advised that section 109D would 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 was 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 applied,
* the private company had an insufficient distributable surplus for section 109Y purposes.

That said, the accompanying Practice Statement (Practice Statement Law Administration PS LA 2010/4, discussed later) that was issued at the same time as this ruling, provided certain administrative concessions that enabled certain sub-trust arrangements to be put in place in relation to the UPE that would ensure that a deemed dividend would not arise.

TR 2010/3 and the accompanying Practice Statement have now been withdrawn but will continue to apply to historical arrangements and trust entitlements arising before 1 July 2022.

Tax Determination TD 2022/11 is the ATO’s revised view on how Division 7A will apply to trust entitlements. This Taxation Determination will apply to trust entitlements arising on or after 1 July 2022. The major changes in TD 2022/11 stem from a wider view as to what constitutes ‘financial accommodation’ and in turn what constitutes a loan under subsection 109D(3)(b) of the *ITAA 1936*.

**UPEs arising on or after 1 July 2022 - Taxation Determination TD 2022/11**

Taxation Determination TD 2022/11 describes two circumstances under which a private company provides financial accommodation where it has been made presently entitled to a trust distribution.

1. *Circumstance one – where there is an unpaid present entitlement*

The first circumstance is when there is a UPE owed by the trustee to the private company beneficiary and the company:

* has knowledge of an amount that it can demand immediate payment of from the trustee and
* does not demand this payment.

The private company is taken to consent to the trustee retaining the UPE for continued use for trust purposes. This consent, whether by agreement, understanding or acquiescence, represents the provision of financial accommodation under subsection 109D(3)(b). As a result, the UPE will be treated as a loan made by the private company beneficiary to the trustee.

A UPE will be taken to become a loan at the point in time in which the private company beneficiary has knowledge of an amount that it can demand immediate payment of from the trustee and does not demand payment.

If the private company beneficiary and the trustee have ‘the same directing mind and will’ (which would often be the case for privately held or closely held groups), the private company beneficiary will be taken to have the knowledge of the UPE at the same time as the trustee.

Therefore, the timing of the loan – being a time no earlier than the time at which income of the trust estate determined – will typically arise after the end of the income year. As such, the deemed loan will typically be regarded as arising in the income year following the year in which the distribution is made. This will be the case whether the entitlement is expressed as:

* a fixed amount of the trust income,
* a percentage of trust income, or some other part of trust income identified in a calculable manner, or
* a combination of fixed and calculable amounts.

A deemed dividend would not arise, if, before the lodgement date of the private company’s tax return for the year in which the financial accommodation arises:

* the present entitlement is fully repaid, or
* both parties enter into a complying loan agreement in respect of the financial accommodation as set out in section 109N of the *ITAA 1936*.

A complying loan agreement is entered into by making the financial accommodation subject to the complying loan terms specified in section 109N of the ITAA 1936. In general, this will require that the private company beneficiary enters into a loan agreement with the trustee to discharge the UPE and loan back the corresponding amount of funds on complying loan terms. The terms of the loan agreement must be in writing, the interest rate must be equal to or higher than the benchmark interest rate for the income year (as published by the Reserve Bank of Australia prior to the start of the income year) and must not exceed a loan term of 7 years (unless secured over real property, in which case a longer 25 year term is permissible, subject to satisfying certain conditions).

Under such loan-back arrangements, the first minimum yearly repayment will be due by the end of the private company beneficiary’s income year following the income year in which the financial accommodation was provided.

For example, a private company beneficiary becomes presently entitled to trust income on 30 June 2023. The income of the trust is determined and the private company beneficiary provides financial accommodation to the trustee following the income year (say, August 2023, during the 2023-24 income year). Prior to the due date of the private company beneficiary’s income tax return for the 2023-24 income year (e.g. 15 May 2025), the private company beneficiary and the trustee enter into a complying loan agreement in respect of the new loan following satisfaction of the UPE. Under the terms of this Division 7A complying loan, this loan will commence to bear interest during the 2024-25 year and will have its first minimum yearly repayment due by 30 June 2025.

1. *Circumstance two – where present entitlements are satisfied by sub-trust*

The second circumstance is where the present entitlement is set aside from the main trust and held on sub-trust but the funds are ***not*** held wholly for the exclusive benefit of the private company beneficiary.

Where a trustee sets aside an amount of the present entitlement from the main trust and holds it on sub-trust, the amount will cease to be an asset of the main trust and will form the corpus of the sub-trust. The trustee’s obligation to pay the entitlement is discharged and the private company beneficiary has a new right to call for payment from the sub-trustee. The private company beneficiary not making demand for this payment will not constitute financial accommodation where the funds are held for the company’s sole benefit. That is, where this sub-trust is maintained as a separate pool of funds held and invested directly for the benefit of the private company beneficiary, there should be no financial accommodation element.

However, financial accommodation will arise where, by agreement, understanding or acquiescence, the private company beneficiary consents to the funds in the sub-trust being used by:

* the trustee in its capacity as trustee of the main trust for the benefit of the main trust, or
* otherwise for the benefit of the private company beneficiary’s shareholder or their associate.

The part of the sub-trust fund applied for this purpose will be taken to become a loan at the point in time in which the private company beneficiary has knowledge of the use of an amount of the sub-trust by or for the benefit of its shareholder or their associate and does not demand payment of that part of the sub-trust fund. If the private company beneficiary and the sub-trustee have ‘the same directing mind and will’, the amount of the sub-trust will be taken to have knowledge of the use of the sub-trust fund at the same time as the sub-trustee.

**UPEs arising before 1 July 2022 – TR 2010/3 and PS LA 2010/4**

Trust entitlements that arose on or after 16 December 2009 and before 1 July 2022 may still rely upon Taxation Ruling TR 2010/3 and Practice Statement PSLA 2010/4 to determine whether there is a loan for the purpose of Division 7A.

A brief outline of the key elements of these pronouncements is set out below.

***Taxation Ruling TR 2010/3***

Taxation Ruling TR 2010/3 provides that a 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 provided that an UPE may be treated as a loan for section 109D purposes under two scenarios.

*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. In TR 2010/3, the ATO 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 would 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 would 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 would 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 would 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.

*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 would 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 provided 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 provided any pecuniary aid or favour to a trustee of the trust under a consensual agreement under which a principal sum was ultimately payable by the trust to the private company. Such a consensual agreement would arise if a private company beneficiary authorised (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 would 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 was not retrospectively applied to a subsisting UPE made prior to 16 December 2009 (being the issue date of the draft version of TR 2010/3). However, when introduced, Taxation Ruling TR 2010/3 did apply to ‘ordinary loans’ made before 16 December 2009.

***Practice Statement PSLA 2010/4***

Practice Statement PSLA 2010/4 set out separate administrative concessions for ordinary loans and subsisting UPEs, which are respectively discussed below. Again, these concessions only apply to UPEs that arose prior to 1 July 2022.

*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.

*Subsisting UPEs*

Practice Statement PSLA 2010/4 also provided administrative concessions in respect of subsisting UPEs which would otherwise be 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 relevant UPE is paid out or is converted into a complying section 109N loan within the appropriate time frame.

Sub-trust arrangements

The Practice Statement provided 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.

Under PS LA 2010/4, 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 (again, reiterating that these options are only available for UPEs that arose prior to 1 July 2022):

* 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 confirmed 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 investment 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 arrangements.

*Timing issues for PS LA options*

For UPEs arising on or after 1 July 2010, under the PS LA, the relevant UPE is required to be put on a complying sub-trust by the lodgement date of the distributing trust’s income tax return for the year of income (often 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 provides a concession for taxpayers that have adopted Option 1 under PS LA 2010/4 in relation to UPEs arising in the years ended 30 June 2010 through to 30 June 2022.

The Guideline recognises that trustees who adopted Option 1 under Practice Statement PSLA 2010/4 in these circumstances will be obligated to repay the investment principal at the end of the seven year 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, the ATO have stated in PCG 2017/13 that, rather than repaying the investment principal under Option 1, it will be permissible for the trustee of the relevant sub-trust and the private company beneficiary to convert this payment obligation into a seven year complying loan under section 109N. For this to be effective, it will need to be entered into 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 seven year period in which the amount of any outstanding loan principal can be repaid albeit with periodic payments of both principal and interest. Again, it must be borne in mind that these concessions are only available to UPEs that arose prior to 1 July 2022.

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.

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]**