

Taxation

During the past few months there have been considerable developments in the area of private company loans and payments to shareholders, or their associates (Division 7A of the *Income Tax Assessment Act 1936*).

The Commissioner's views of unpaid present entitlements (UPE)

On 2 June 2010, the Commissioner released his views in a *Taxation Ruling* and *Draft Practice Statement* about the circumstances in which a UPE of a private company beneficiary of an associated trust estate may be a 'loan' back to the trust estate.

For the purposes of Division 7A, a loan broadly consists of a payment and an obligation to repay (an ordinary loan), advance of money with an expectation of repayment, provision of credit or any other form of financial accommodation, and a payment of an amount on behalf of the trust estate to another where there is an obligation of repayment.

Where the UPE is treated as a Division 7A loan, the Commissioner will treat this as a deemed unfrankable dividend unless the loan is repaid in full before the tax return is required to be lodged, or the loan is covered by a complying Division 7A loan agreement. A complying Division 7A loan is a loan that is over a seven-year period, or a 25-year period where it is secured by a mortgage over real property, and the minimum benchmark interest rate is charged (currently 5.75%).

To fall within the Ruling:

- the private company beneficiary must have or had a present entitlement;
- the funds representing the UPE remain intermingled with other funds of the trust estate, or otherwise used for trust purposes; and
- those funds must have been loaned back to the trust estate. Importantly, the Commissioner may infer that a loan has been made, without there needing to be a positive action on the part of the private company beneficiary.

Under the Ruling, the Commissioner sets out the different types of loans that are termed Section 2 loans and Section 3 loans. The Commissioner's views on Section 2 loans apply to UPEs both before and after 2 June 2010, and his views on Section 3 loans apply to UPEs made on or after 16 December 2009.

Ordinary loans—Section 2 loans

A Section 2 ordinary loan is:

- where a UPE is satisfied (or paid out) and the private company beneficiary loans the amount back to the trustee of the trust estate;
- where the UPE is not paid out but there is an 'agreement' under which the trustee of the trust estate borrows an amount from the private company beneficiary. This can be an agreed set off in satisfaction of the trustee's obligation to pay the trust entitlement to the private company beneficiary. Importantly, the agreement can be implied such as where there is a crediting of a loan account in the name of the private company and the private company acquiesces to that. In the context of a family group, the Commissioner takes a view that private company beneficiary will have knowledge of the credited amount; and
- where the trust instrument allows the trustee to make a loan on behalf of the private company beneficiary, and there is a crediting of a loan account in the name of the private company beneficiary and a corresponding obligation to repay (whether or not at interest).

Extended meaning of loans—Section 3 loans

A Section 3 extended loan arises where 'financial accommodation' is provided. For example, a Division 7A loan will arise if the private company beneficiary provides pecuniary aid or favour to the trustee under a 'consensual agreement', and the principal sum loaned is ultimately payable.

Consensual agreement can arise where the private company beneficiary allows (including by acquiescing with knowledge of) the trustee's continued use of the funds by not calling for the payment of the UPE, or where the investment of the UPE funds is for the sole benefit of the corporate beneficiary. In the context of a family group, the Commissioner holds a view that the private company beneficiary knows what the trustee is doing with the UPE funds, unless there is evidence to the contrary.

Sub-trust arrangements

Where there is a UPE and the funds are held and/or used for the private company beneficiary's sole benefit there will not be Division 7A loan providing:

- there is a power under the trust deed that allows amounts to be held on sub-trust for the private company beneficiary;
- there is a sub-account in the main trust's bank account; and
- the trustee of the main trust (which is the legal owner of the sub-account) acts in the capacity as the trustee of the sub-trust for the benefit of the private company beneficiary.



Care also needs to be exercised where the sub-trust then invests those funds for the sole benefit of the private company beneficiary.

Where there is a specific investment made, the returns on that investment would need to flow back to the sub-trust (for the sole benefit of the private company beneficiary), however, where the investment is not specified, the Commissioner requires that the rate of return to the sub-trust be at the benchmark rate, or the trust net income multiplied by the funds invested divided by the value of the gross commercial assets of the main trust.

What do I need to do?

- Examine the trust deed closely to see whether there is a power to hold amounts on a sub-trust. Where this power exists ensure that the sub-trust operates and invests in a manner that the Commissioner will accept, to ensure there is not a Division 7A loan, including an appropriate rate of return.
- Where such a power does not exist, or the sub-trust is not operated in an acceptable manner, and therefore there is a Division 7A loan, then the loan should be paid out before the lodgement of the 2010 tax return for the trust estate, or the loan should be Division 7A compliant.

Other things to watch for:

- The definition of a loan is very broad and includes the provision of 'financial accommodation'. Not calling in the UPE, and allowing the trustee to use the funds, can be 'financial accommodation'.
- A lack of documentation, or accounting entries, does not mean that there is not a loan, as it may be implied.
- Take care with accounting entries to ensure that there is a recognition of a UPE.
- In family groups the corporate beneficiary may be deemed to know what the trustee of the trust is doing with its UPE.

Division 7A to now capture the 'use' of private company assets

Recently passed legislation, with effect from 1 July 2009, requires that where a private company provides assets for use by its shareholders, or associates, for less than their market value, a deemed unfrankable dividend will arise. However, exceptions apply where the use of the private company asset is minor, the use is otherwise deductible to the shareholder, or associate, or the asset is a dwelling that meets certain conditions.

For example, if a private company owns a holiday home and it allows its shareholder to use that holiday home for two months of the income year at no cost, the amount of the deemed dividend would be the arm's length rent that would be payable if the home was rented in the market place. That amount would need to be included in the assessable income of the shareholder.

What do I need to do?

Before the end of the income year, you should start reviewing those arrangements where there are shareholders, or associates, using the assets of the private company at no charge or at a charge less than market value. Failure to do so may result in an deemed unfrankable dividend that is assessable in the hands of the shareholder or associate.

You should be aware that the concept of an associate is very broad under the tax law.

Contacts

If you would like further details about the information contained in this bulletin, please contact:

Paul Sokolowski, Partner
Telephone 61 3 9229 9753
psokolowski@abl.com.au

Seaton Theobald, Senior Associate
Telephone 61 3 9229 9956
stheobald@abl.com.au

Further information

For copies of recent publications, or for further information about the firm, please visit the Arnold Bloch Leibler web site at www.abl.com.au.

This publication is intended to provide a general outline and is not intended to be a complete or definitive statement of the law on the subject matter covered. Further professional advice should be sought before any action is taken in relation to the matters described in this publication.

Privacy

If you no longer wish to receive this, or future, marketing publications, please contact us by email, facsimile or mail at the following addresses:

E-mail: privacy@abl.com.au
Facsimile: (03) 9229 9900
Post: Privacy Officer
Arnold Bloch Leibler
Level 21, 333 Collins Street
Melbourne VIC 3000