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SPECIAL EDITION TAX UPDATE

October 2010

This update includes a commentary on the following topics:

- [PS LA 2010/4 Trust Unpaid Present Entitlements and Division 7A](#)

PS LA 2010/4 Trust Unpaid Present Entitlements and Division 7A

The Tax Office yesterday issued Practice Statement PS LA 2010/4. This Statement provides guidance on the Commissioner's opinion set out in TR 2010/3 in relation to when an unpaid present entitlement (UPE) from a trust to a company will constitute a loan under Division 7A. Division 7A regulates the making of loans by a private company to its shareholders or associates.

By way of background, TR 2010/3 discussed two types of loans for Division 7A purposes:

- » Section 2 loans: These are ordinary loans or where a UPE is recorded as a loan rather than a UPE. The ruling applies to section 2 loans arising both before and after its date of issue.
- » Section 3 loans: These are UPEs which remain in existence for a period of time and are seen to be financial accommodation and therefore a loan for Division 7A purposes. The ruling applies to section 3 loans arising after 16 December 2009 as the ruling reversed the Commissioner's view on this issue.

The initial draft of the Practice Statement was PS LA 3362 (refer June Special Edition Tax Notes). This final version provides practical ways for a taxpayer to apply TR 2010/3 and is quite different from its draft form.

Section 2 loans

In the draft Practice Statement, the ATO stated that where either the company or the trust recorded the distribution as a loan, the Tax Office would not consider this situation a Division 7A loan. In the final version this statement is no longer made. Instead, taxpayers can self-correct the financial accounts where a UPE has been incorrectly described as a loan, in order to avoid a Division 7A loan arising.

The ATO will allow taxpayers to correct the recording in the financial accounts on or before 31 December 2011, subject to a number of conditions. These include:

- » The 'loan' must have in fact been a UPE and all other evidence supports that fact;
- » The private company never disclosed the 'loan' as a loan to shareholders in its tax return;
- » The 'loan' account relates entirely to UPEs, i.e. no other transactions are recorded in the account, and no interest was paid on the 'loan';
- » On or before 31 December 2011 a declaration must be signed by the trustee and/or the company setting out compliance with the above conditions.

In addition the Practice Statement allows taxpayers to take advantage of the Commissioner's existing discretion regarding Division 7A loans which arise out of an honest mistake or inadvertent omission. Taxpayers can self-correct in these circumstances subject to strict conditions, without needing to apply in writing to the Commissioner. One of those conditions requires both the trust and the company to be a Small Business Entity (that is, carrying on a business with aggregated turnover of less than \$2mil). A mere corporate beneficiary with no other activity cannot meet this requireme

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Section 3 loans

To avoid a UPE becoming a Division 7A loan, the trust must either pay out the UPE or hold the amount of the UPE on sub-trust for the sole benefit of the corporate beneficiary by the lodgement date of the trust's tax return for the year in which the UPE arose. For UPEs arising between 19 December 2009 and 30 June 2010, the Practice Statement provides additional time to comply with Division 7A.

A sub-trust may be put in place by either investing the funds representing the UPE back into the main trust on commercial terms, or using one of the options outlined in the Practice Statement:

- » Option 1: invest the funds on a 7 year interest-only loan using the Division 7A benchmark interest rate
- » Option 2: invest the funds on a 10 year interest-only loan using the RBA small business variable overdraft rate
- » Option 3: invest the funds in a specific income producing asset.

The Practice Statement notes that where the sub-trust has invested in a specific income producing asset, the ATO requires the sub-trust to prepare its own separate accounts and tax return. Otherwise there is no requirement to prepare separate financial accounts and the main trust should set up an account in the equity section of its balance sheet labelled "sub-trust – XYZ Company Pty Ltd" (or similar).

In each case, the return on the investment must be paid to the corporate beneficiary by the lodgement date of the trust's income tax return each year. At the end of the investment period (or in the case of Option 3 when the investment is disposed of) the original UPE amount must be paid to the corporate beneficiary. Therefore, the sub-trust arrangement merely defers the time by which a trust must pay out a UPE to a corporate beneficiary.

The Practice Statement attempts to deal with loans or UPEs from a trust to an individual, as well as UPEs between a chain of trusts. However, many issues are yet to be resolved. Taxpayers will need to consider their own individual circumstances and consult with their adviser when applying the Practice Statement.