



ATO CLARIFIES SUB-TRUSTS AND UNPAID ENTITLEMENTS

Following the release of TR 2010/3 and TR 2010/4, attention has been focussed on the terms of trust deeds and, in particular, terms which become relevant in the context of unpaid trust entitlements to corporate beneficiaries. We now have some clarity from the ATO (in TR 2010/4) in relation to the acceptable method of dealing with unpaid present entitlements (UPEs) in cases where the trust records the trust distribution as an “unpaid entitlement” and relies on a sub-trust clause in the trust deed to avoid Div 7A. However, it is important to understand how, in practice, the activities of the trustee interact with the terms of the trust deed.

Sub-trust clauses appear in virtually every modern discretionary trust deed. Such clauses ensure the “present entitlement” of the relevant beneficiary to unpaid amounts (and, therefore, the correct taxing point). The sub-trust mechanism exists only because of the practical reality that not all beneficiary entitlements are actually paid by the trustee. Sometimes, the amount “distributed” is retained by the trustee but the relevant beneficiary is the entity responsible for payment of the tax on that “distribution”.

The creation of a sub-trust imposes obligations on the trustee in relation to the amount distributed, and requires the trustee to account to the relevant beneficiary for that amount and any income earned on it, when demanded. However, most beneficiaries do not demand payment of the distribution amount. In addition, the beneficiary and the trustee are usually closely related parties. This point is precisely what the ATO (in TR 2010/3) uses to create “loans” out of unpaid entitlements to corporate beneficiaries.

Regardless that the trust deed says that an unpaid entitlement is held in sub-trust, legally the sub-trust may have ceased to exist and a loan has arisen by implied agreement i.e. the action (or inaction) of the trustee or the beneficiary terminates the sub-trust. The sub-trust is then replaced by a “loan”. The same result occurs whether or not the beneficiary is a company. However, the ATO has no interest in “loans” by non-corporate beneficiaries and so the result has no practical consequence. That does not alter the effect of the action (or inaction) of the trustee and/or the beneficiary on the sub-trust and, in most cases, the sub-trust ends, at a point after the distribution resolution is made and the sub-trust clause ceases to apply.

It should also be noted that, as between a trustee and a beneficiary, it is always open for them to agree upon a different treatment of the beneficiary’s entitlement at any time. Therefore, if agreed by them, the unpaid amount may be recorded as a loan, unpaid entitlement or any other way. Regardless of whether the sub-trust arrangement ends by express agreement, rather than by implication, the result is the same.

Taxation Rulings TR 2010/3 and TR 2010/4

According to TR 2010/3 a loan is created in a number of situations where a UPE is recorded in favour of a corporate beneficiary.

Section 2 loans

The ATO takes the view that a UPE (in favour of a corporate beneficiary) becomes a loan where the beneficiary can be said to have agreed to treat the UPE as a loan. The section 2 type of loan arises regardless of the presence of a sub-trust clause. In these cases, the failure of the corporate beneficiary to demand payment amounts to an implied agreement by

“acquiescence”. The implied agreement terminates any sub-trust and the sub-trust clause ceases to apply.

Section 3 loans

The ATO takes the view that a UPE (in favour of a corporate beneficiary) becomes “financial accommodation”, and falls within the extended definition of “loan” in Div. 7A, where the UPE is held on sub-trust, but the trustee fails to account solely to the relevant beneficiary for all of the benefits of the investment of the entitlement. The section 3 type of loan arises while recognising that the sub-trust continues to exist. In these cases, the failure of the trustee to account exclusively to the relevant beneficiary results in financial accommodation being extended to the trustee, which is deemed a loan under Div. 7A. Clause 8.5 continues to apply but is varied to the extent that the trustee is released from the obligation to account to the beneficiary. The taxation consequence of that release is that a “loan” is created.

The ACIS Trust Deed

The sub-trust clause in the current ACIS trust deed was drafted in response to TR 2010/3, which expressly acknowledges that a UPE will not be a “loan” if the amount of a beneficiary’s entitlement is held in a sub-trust. However, in order to succeed in such a claim, the UPE must be held exclusively for the relevant beneficiary, including all of the benefits of the investment of that amount. This is precisely what our trust deed says.

However, the terms of the trust deed cannot be viewed in isolation from the practical reality of the trust’s operations. The trust’s activities, patterns of distribution, accounting practice, assets and the actions of the various parties (among other things) must be considered when determining the characterisation of any unpaid entitlement. The trust deed sets up a default position and is drafted in such a way as to satisfy TR 2010/3. That’s not to say that the sub-trust cannot be terminated or varied by agreement (which is precisely what the ATO is saying when it creates Section 2 or 3 loans out of unpaid entitlements). What transpires between the parties is as important, in that regard, as the contents of the trust deed.

TR 2010/4 now provides some practical guidance on the ATO’s position as set out in TR 2010/3 and permits the trustee and the beneficiary to enter into an “Investment Agreement”. This mechanism recognises the practical difficulty of maintaining the sub-trust by accounting for returns, exclusively, to the relevant beneficiary where separate accounts are not kept by the trustee. The use of an Investment Agreement allows the trustee and the beneficiary to retain the characterisation of the beneficiary’s interest as a UPE (held in sub-trust) rather than a loan, without the need to physically separate the amount of the UPE.

ACIS can supply an Investment Agreement which complies with TR 2010/4. To order, just locate the UPE Investment Agreement Order Form on our website (www.acis.net.au), complete the details and return.

If you have any queries, please call toll-free on 1800-773-477.