

UNPAID PRESENT ENTITLEMENTS AND DIV 7A

As all practitioners will know, the ATO issued a draft ruling in December 2009 which set out the Commissioner's (new) approach to unpaid trust entitlements ("UPEs") in favour of corporate beneficiaries. The draft, understandably, has caused a great deal of concern within the accounting profession, but was issued in its final form in June 2010. Its effective date is 16 December 2009.

The ruling deals with circumstances where a trust makes a distribution of income to a corporate beneficiary, and does not physically pay the distribution, but retains the amount applied. The corporate beneficiary is assessed, and pays tax, on the distribution at the prevailing company tax rate (currently 30%). In a great many cases, the corporate beneficiary and the trust will be associated entities under Division 7A of the Income Tax Assessment Act 1936.

The Commissioner has now determined that, where it can be inferred that the corporate beneficiary consented to, or acquiesced in, the retention by the trust, and that it is aware that the retention amount is, or will be, used by the trust for general trust purposes, rather than held exclusively for the corporate beneficiary, the corporate beneficiary may be deemed to have provided financial accommodation to the trust. In most cases involving discretionary trusts (and many unit trusts) that inference is relatively easy to draw, since the trust and the corporate beneficiary will be associates under Div 7A. As such, the provision of financial accommodation may be converted into a loan for the purposes of Div 7A.

The result is that the "loan" to the trust will be deemed to be a dividend paid by the corporate beneficiary to the trust, unless an appropriate Div 7A loan agreement is in place. Where the "loan" becomes a dividend, the trust will be taxed on the amount of the dividend (ie the pre tax amount of the unpaid distribution) at the prevailing marginal rate (currently 46.5%) but without access to a franking credit for the tax paid by the corporate beneficiary.

Effectively, tax will be payable at 76.5% on the UPE.

The ruling identifies a number of scenarios which may arise, primarily:

1. The UPE is recorded as a loan in the trust's accounts, or treated as a loan by the trust deed. The ruling states that these UPEs will be treated as loans under Div 7A, and confirms that these have always been considered as loans for the purposes of Div 7A. The ruling applies retrospectively in relation to them.
2. The UPE is recorded as an unpaid entitlement in the trust's accounts, but the amount of the UPE retained is used for general trust purposes, and not held in a specific sub trust for the exclusive benefit of the corporate beneficiary. Therefore, any income earned on the UPE is dealt with by the trustee as income of the trust, and is distributed to beneficiaries generally. Where it can be inferred that the corporate beneficiary consented to this treatment, or acquiesced in it, the ruling will deem the "loan" to be a dividend in the absence of a proper Div 7A loan agreement. The draft of the ruling originally intended that this treatment of these UPEs would be retrospective. However, the final form of the ruling now provides that, since this treatment conflicts with prior express statements from the ATO, such UPEs are not Div 7A loans, and the ruling will only affect those UPEs arising after 16 December 2009.

3. The UPE is recorded as an unpaid entitlement in the trust's accounts, and the amount of the UPE retained is set aside in a specific sub trust for the exclusive benefit of the corporate beneficiary. All income earned on the UPE is applied exclusively for the corporate beneficiary. The ruling makes it clear that these UPEs are not loans for the purposes of Div 7A.

Where a trust has a UPE described in 2 above and which will be caught by the ruling and deemed to be a dividend, the trustee has a number of options:

- Pay the UPE to the corporate beneficiary;
- Establish a Div 7A loan agreement and ensure that the trust pays the required rate of interest and makes the minimum annual repayments required under Div 7A;
- Ensure that the UPE is dealt with appropriately. This means that the amount of the UPE must be held by the trustee on a sub trust and not be mixed with other trust funds or used for general trust purposes. It would be preferable for the amount of the UPE to be deposited into a separate bank account. All earnings on the amount set aside for the corporate beneficiary must be applied exclusively for its benefit.

Many trust deeds contain provisions which treat the amount of a UPE as a loan or have inadequate sub trust provisions which do not allow the trustee to determine that the UPE is held separately. The accounting treatment of the relevant UPE is determinative also, so it is critical that trustees examine their deeds and the trust accounting records to ensure that any UPE in favour of a corporate beneficiary will not be caught.

What to do?

Trustees of discretionary trusts should review their trust deeds to determine if:

- the trust deed contains a provision which treats UPEs as loans. These clauses should be removed; and
- the trust deed contains an adequate sub trust provision which requires the trustee to deal with the UPE for the exclusive benefit of the relevant beneficiary.

Trustees and their financial advisers must also review the accounting records of their trusts and determine if any UPEs are recorded as loans or unpaid trust entitlements.

Where the trustee determines that changes to the trust deed are necessary or desirable, ACIS can provide a deed of amendment.

Important Note

Great care needs to be taken when amending trust deeds to incorporate these changes, as the trustee must exercise caution to ensure that the trust is not resettled. Resettlement may result in capital gains tax or stamp duty liabilities.

While we do not provide an opinion on possible resettlement issues, if such an issue is identified, we will refer it to you for instructions.

If you have any queries or require trust deed amendments, please call toll-free on 1800-773-477.