

Division 7A ITAA 1936 – Discretionary Trusts and Unpaid Distributions to a Corporate Beneficiary.

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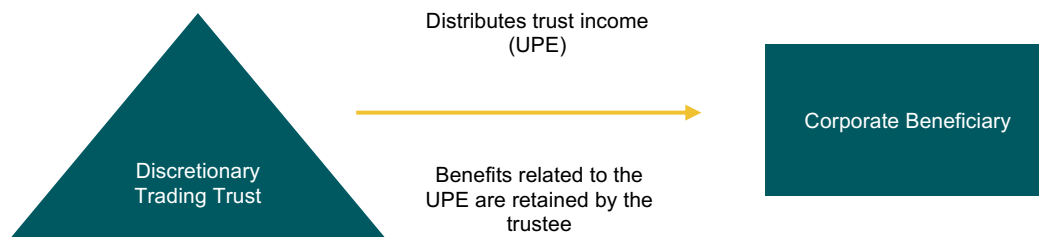
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Introduction

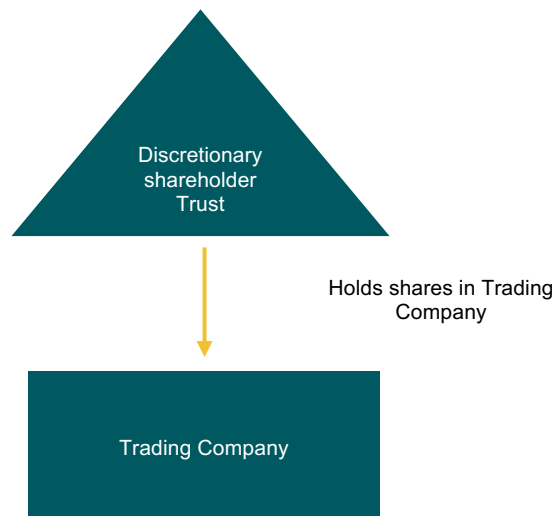
It has long been widely accepted by advisors that family based small business structuring arrangements variously utilise a structuring combination of a discretionary trust and a company, whether the company is positioned as the business entity or as a corporate beneficiary of a discretionary trust.

In addition to the immediate commercial and taxation benefits of the structuring combination in relation to the taxation of trust income at the base rate entity tax rate, the perceived advantage of the availability of the Division 115 general capital gains discount was/is a major influence with the implementation of this type of structuring combination arrangement.

Arrangement 1



Arrangement 2



More relevantly for today's discussion in relation to the application of Division 7A to unpaid trust distributions, this presentation will concentrate on the taxation implications of structure arrangement 1, whereby:

- A trading business is conducted by and/or the income earning assets are held by a discretionary trust;
- the trustee distributes a proportion of the trust's income to a corporate beneficiary (application of section 97 ITAA 1936);
- The trust distribution is 'set aside' and held by the trustee as a separate trust for the 'entitled beneficiary' pursuant to the trustee's prerogative rather than being paid to the beneficiary; and

- The trust income distributed to the corporate beneficiary is taxed at the prevailing corporate tax rate (more usually the base rate entity corporate tax rate).

Notably in more recent times, there has been significant 'pressure' applied by the Commissioner to the use of this tax structuring arrangement:

- (i) The extension of Division 7A to unpaid trust distributions 'owing' to a corporate beneficiary (including the nuanced application of Division 7A by subdivision EA) – TR 2010/3 (withdrawn) and more recently by TD 2022/11;
- (ii) The application of section 100A to unpaid trust distributions more generally¹ (noting the decisions in *Guardian AIT*² and *BBlood Enterprises* matter³);
- (iii) The application of Part IVA to arrangements which included a circular trust distribution to a company, the company re-distributing the income in the form of a fully franked dividend to the trust and the trust distributing the franked dividend to a tax advantaged entity (*Guardian AIT*);
- (iv) The more general application of Part IVA to trust arrangements for:
 - a. personal service arrangements (*Tupicoff*, *Gulland*, *Watson & Pincus*⁴) where the taxpayer has used a trust structure;
 - b. The Commissioner's PCG 2021/4 (Profit allocation rules for professionals); and
 - c. The Commissioner's successful argument in *Minerva*⁵ that a discretionary trust's distribution was based on achieving a tax benefit for the relevant taxpayer.
- (v) The Commissioner's clear tax interpretation demarcation between the term 'debt' and an 'unpaid distribution' (equitable obligation) – refer inter alia to TR 2015/4 (application of section 152-20), bad debt provision (section 25-35), section 109F (private company debt forgiveness) and the complementary application of section 109C, Division 245 ITAA 1997 (Commercial Debt Forgiveness issues); and
- (vi) The problematic use of Dividend Access Shares ("DAS") in a private company where the DAS are held by a discretionary trust (value shifting provisions - Division 745 ITAA 1997) in addition to the longer-term difficulty for shareholders who wish to satisfy the small business participation percentage criteria (section 152-70) for the purposes of accessing the Division 152 ITAA 1997 Small Business CGT Concessions.

In addition to the above taxation matters, trustees have been gently 'reminded' of their fiduciary obligations when determining trust distributions (*Owies*⁶) to ensure that the trustee has both sought relevant and real information and given genuine consideration of the needs of relevant beneficiaries of the trust.

A further factor that is highly relevant to present tax structuring arrangements for family based small business entities that carry on a business is the favourable 'base rate entity' tax rate of 25% (albeit the benefit is nullified if all of the income is to be distributed).

¹ TR 2022/4 & PCG 2022/2

² *Commissioner of Taxation v Guardian AIT* [2023] FCAFC 3

³ *BBlood Enterprises v FCT* [2022] FCA 1112 & on appeal in *B&F Investments Pty Ltd atf The Illuka Park Trust v Commissioner of Taxation* [2023] FCAFC 89

⁴ *Tupicoff v Commissioner of Taxation* [1984] FCA 382, *FCT v Gulland, Watson v. FCT and Pincus v. FCT* [1985] HCA 83

⁵ *Minerva Financial Group Pty Ltd v Commissioner of Taxation* [2022] FCA 1092

⁶ *Owies v JJE Nominees Pty Ltd* [2022] VSCA 142

Finally, with the concentrated focus on trusts, accountants have become more familiar with the subtle legal distinctions relating to unpaid trust distributions. Not the least of these knowledge developments are the more prevalent understanding of the importance of a trust deed (refer to Bamford) and what the trust deed actually states relevantly in relation to the treatment of unpaid distributions.

ASIC standard discretionary trust deed

In relation to the above, note how in particular the ASIC trust deed provides for the manner that a trustee can deal with the distribution to a beneficiary:

4.4 Trustee makes determinations

- (a) *The Trustee may determine, in relation to all, or any part of, the Income:*
- (i) *to pay, apply or Set Aside any amount for one or more of the Beneficiaries;*
 - (ii) *to accumulate any amount of Income.*

...

4.8 Beneficiaries Rights

Each of the Beneficiaries in whose favour the Trustee pays, applies or Sets Aside any Income (or is deemed to do so) have an immediate and indefeasible vested interest in that Income and is presently entitled to the relevant share of the Income.

4.9 Amounts Set Aside

Any amount Set Aside or held by the Trustee on behalf of a Beneficiary under this Deed, will no longer form part of the Trust Fund, but will be held by the Trustee as a separate trust fund upon trust for the relevant Beneficiary absolutely. The Trustee has the Right (but not the Obligation), pending payment to the Beneficiary, to invest or apply that amount for the benefit of the Beneficiary or deal with that fund, or any resulting Income, in any manner provided for in this Deed in relation to the Trust Fund.

The Division 7A implications of the above trust deed clauses will be discussed later in greater detail in relation to the application of the new taxation determination.

Application of Division 7A to unpaid trust distributions

1.1 introduction – Division 7A concepts

The primary focus of today's Division 7A presentation is particularly the practical implication of TD 2022/11 as it applies to a corporation's unpaid trust distributions. There are however further taxation issues associated with some other statutory integrity provisions which should be noted briefly.

Without wishing to overly emphasise the underlying policy objects of the present Division 7A provisions, the purpose of Division 7A is to provide a statutory mechanism to bring to account as assessable income (deemed dividend), transactions whereby a private company transfers or causes an economic benefit to be received by shareholder or a shareholder's associate, other than by reason of an explicit distribution of a dividend.

The mechanics of Division 7A is to deem as a dividend, the transactions involving any of the following 3 circumstances. Namely where the company:

- (i) Provides a 'loan' to the relevant entity (section 109D);
- (ii) Makes a payment to the relevant entity (section 109C and section 109CA); and
- (iii) Forgives a 'debt' owed by a relevant entity (section 109F).

Relevantly (i) and (ii) are more specific to an UPE.

Note that section 109F will not apply to the forgiveness of a UPE since the UPE is not debt.

Suffice it to also add, the Division also provides some caveats to the application of the above provisions, inter alia:

- Complying loan agreements (section 109M);
- Ordinary course of business transactions (section 109N); and
- Distributable surplus limits (section 109Y)

Further and noting that Division 7A is a specific integrity regime, there are other integrity provisions within Division 7A that are often overlooked but are of practical importance:

- Section 109E (minimum annual loan requirements);
- Section 109R (substituted loan payments);
- Section 109T (interposed entity transactions); and
- Subdivision EA which specifically deals with trustee arrangements (payments, loans, and debt forgiveness) with a company's shareholders (or associates) where the company has an unpaid present entitlement 'owed' by the trust.

It is intended that today's discussion will specifically deal with Division 7A and UPE.

One final preliminary observation that is particularly relevant to any discussion of Division 7A and trusts concerns the definition of the term 'associate'. Division 7A applies where the operative provisions -section 109C, section 109CA, section 109D and section 109F, are provided to a shareholder of a private company and/or the shareholder's associate. In that regard the term 'associate' is relevant.

Subsection 318(3) ITAA 1936 defines as an 'associate' of a trust, an entity, which:

Section 318(3) [Associates of a trustee]

For the purposes of this Part, the following are associates of a trustee (in this subsection called the primary entity):

- (a) any entity that benefits under the trust;
- (b) if a natural person benefits under the trust — any entity that, if the natural person were the primary entity, would be an associate of that natural person because of subsection (1) or because of this subsection;
- (c) if a company is an associate of the primary entity because of paragraph (a) or (b) of this subsection — any entity that, if the company were the primary entity, would be an associate of the company because of subsection (2) or because of this subsection.

Notably, paragraph 318(3)(a) deems an entity to be an associate of a trustee if an entity **'benefits under the trust'**. This term is amplified by subsection 318(6)(a) in the following manner:

Section 318(6) [Interpretation]

- (a) a reference to an entity benefiting under a trust is a reference to the entity benefiting, or being capable (whether by the exercise of a power of appointment or otherwise) of benefiting, under the trust, either directly or through any interposed companies, partnerships or trusts; and

The inclusion of an entity 'being capable of benefiting' generally means an associate of a trust will be all encompassing having regard to the broad definition of the term beneficiary contained in trust deeds.

1.1 Division 7A – Section 109C 'payments'

The term **'payment'** is defined by subsection 109C(3) in the following manner:

Section 109C(3) In this Division, 'payment' to an entity means:

- (a) a payment to the extent that it is to the entity, on behalf of the entity or for the benefit of the entity; and
- (b) **a credit of an amount to the extent that it is:**
 - (i) to the entity; or
 - (ii) on behalf of the entity; or
 - (iii) **for the benefit of the entity;** and
- (c) a transfer of property to the entity.

Note: See also section 109CA (Payment includes provision of asset).

Whereas, based on the above definition, it might seem that section 109C has limited application to UPE's, however a practical example of the application of this section to a UPE is illustrated by taxation determination **TD 2015/20**. This tax determination states that **a release** by a private company **of its unpaid present entitlement** owed by a trust is a 'payment' within the meaning of Division 7A.

The taxation determination states that if a private company releases all, or part, of its unpaid present entitlement (UPE), it does so by crediting an amount against the UPE amount owing (a debit) within the meaning of paragraph 109C(3)(b). Such a crediting is taken to be a 'payment' for the purposes of subparagraph 109C(3)(b)(iii) to the extent that the release represents a financial benefit to an entity – that is the trust. Invariably the trust will either be a shareholder of the company and/or an associate of the company's shareholder.

That is the benefit is that the UPE is no longer payable to the company.

The application of the taxation determination is illustrated by the following example:

Example 1 (extract from TD 2015/20)

ABC Pty Ltd is the trustee of ABC Trust (a discretionary trust).

XYZ Pty Ltd is within the class of potential objects. On 30 June 2012, ABC Pty Ltd resolved to make XYZ Pty Ltd presently entitled to \$100 of the income of the trust estate.

The amount to which XYZ Pty Ltd was presently entitled was not paid and, in accordance with the terms of the ABC Trust deed, was set aside separately in the accounts of the ABC Trust on terms such that the subsisting UPE was not a Division 7A loan within the meaning of Taxation Ruling TR 2010/3 and was not a debt for the purposes of section 109F.

On 30 June 2014, XYZ Pty Ltd entered into a deed of release, a condition of which was that the funds representing the UPE remain part of the ABC Trust estate.

Upon being made presently entitled, XYZ Pty Ltd accounted for the UPE by recording a debit entry against a 'trust entitlement' ledger.

For the purposes of accounting for the release, XYZ Pty Ltd made a credit entry in that ledger to offset the debit (reflecting the UPE ceasing to be an asset of the company). The amount so credited for the benefit of ABC Pty Ltd (in its capacity as trustee of the ABC Trust), is a payment within the meaning of subparagraph 109C(3)(b)(iii).

If ABC Pty Ltd is, in its capacity as trustee for the ABC Trust, a shareholder of the private company (or an associate of such a shareholder), the release will be a payment to which section 109C applies.

Accordingly, if it was contemplated that the solution to the UPE/Division 7A issue is that the company 'forgives' its entitlement to the UPE, section 109C will apply to deem the forgiveness as a Division 7A payment.

Just for completeness, Division 245 ITAA 1997 (Commercial Debt Forgiveness regime) would not apply to the trust as a UPE is not debt.

1.1 Division 7A – Section 109D 'loans' – TR 2010/3

1.1.1 Overview TR 2010/3

The more topical issue for this presentation concerns the Commissioner of Taxation's recent issue of taxation determination of TD 2022/11, the practical implications of the withdrawal of both TR 2010/3 and PS LA 2010/4 as from 1st July 2022 and the differences between the various taxation rulings

To the extent that taxation determination TD 2022/11 introduces yet another 'line in the sand' for the treatment of unpaid trust distributions to a company, a brief overview of the historical developments of the application of section 109D in relation to unpaid trust distributions is relevant.

2.3.2 TR 2010/3 – nature, application and implication

The Commissioner first published the "unlegislated/non-court related" the Division 7A changes to the taxation treatment of unpaid trust distributions to a corporate beneficiary in taxation ruling TR 2010/3, where the trust distributions were either retained by the trustee (section 109D) or alternatively on-lent to shareholders or associates of the shareholder by the trustee (subdivision EA)

In that taxation ruling, the Commissioner ruled that the Division 7A 's definition of the term 'loan' provided by section 109D(3), included inter alia arrangements whereby a private company provided a shareholder or associate thereof with 'financial accommodation':

1. This Ruling expresses the Commissioner's opinion on the circumstances in which a private company with a present entitlement to an amount from an associated trust estate makes a loan to that trust within the meaning of subsection 109D(3) of Division 7A of Part III (Division 7A) of the Income Tax Assessment Act 1936 in circumstances where funds representing that present entitlement remain intermingled with funds of the trust.

Subsection 109D(3) then and now provides that the term 'loan includes:

- (a) *an advance of money; and*
- (b) *a provision of credit or any other form of financial accommodation; and*
- (c) *a payment of an amount for, or on account of, on behalf of or at the request of, an entity, if there is an express or implied obligation to repay the amount; and*
- (d) *a transaction (whatever its terms or form) which in substance effects a loan of money*

From a practical perspective, it was paragraph 109D(3)(b) that represented the critical change in application to unpaid distributions. As noted in the ruling, the Commissioner stated that:

19. A private company beneficiary provides financial accommodation to the trustee of a trust in respect of which it has a UPE if, under a consensual agreement:

- *the private company supplies or grants some form of pecuniary aid or favour to the trust;*
- *and*
- *a principal sum or equivalent is ultimately payable to the private company.*

Suffice it to state, in most family-based trust arrangement, the entities that control the company are invariably the entities that control the trustee. Accordingly, the 'consensual agreement' element would usually be typically satisfied.

The legal rationale for the Commissioner's section 109D application was a result of the Commissioner's technical conclusion:

- (a) the equitable obligations/entitlements that arise when a beneficiary is made presently entitled to trust income.

34. When a beneficiary is presently entitled to an amount from a trust estate, it has an equitable right to that amount. That is, the beneficiary has rights in equity and not, without more, as a result of any debtor-creditor relationship. (Commissioner of Inland Revenue v. Ward (1969) 1 ATR 287 at 313.)

and

- (b) the company providing financial accommodation to the trustee:

104. Accordingly, if funds representing a subsisting UPE are used for trust purposes in such a way with the knowledge and acquiescence of the private company, in allowing this to continue the private company provides a benefit to the trustee of the trust. Even if there is a sub-trust, in allowing the funds representing the UPE to be used for the trust purposes of the main trust (such as is set out in subparagraph 103(ii) of this Ruling), the private company provides a benefit to the trustee of the main trust.

Having regard to typical tax structuring arrangements, a discretionary trust will conduct the business and/or holds income earning assets and the trustee appropriates the trust income distributions to a company.

The principal reasonings for this structure interaction using the company as a trust beneficiary, includes:

- (a) The statutory need to distribute the income of the trust on an annual basis to ensure that section 99A did not apply to the trust income and taxed at the top marginal rate of tax;
- (b) To have the income of the trust taxed at the corporate tax rate (if a business trust – base rate entity);
- (c) To retain the use of the assets within the trust structure to fund working capital requirements of the trust and/or further investment acquisitions; and
- (d) Access Division 115 to reduce any capital gains.

2.3.3 Practical Consequences of TR 2010/3

Relevantly, TR 2010/3 grandfathered UPE's that arose before 16 December 2009 with the consequence these UPE's would not cause any Division 7A issues unless there was some change made to those pre-existing December 2009 unpaid amounts, albeit subdivision EA could still apply.

Notwithstanding the TR 2010/3 change to the application of Division 7A to unpaid trust distributions payable to a corporate beneficiary, the practical implications of the taxation ruling was ameliorated by the issue of PS LA 2010/4 and Section 3 Sub-trust options.

More specifically, PS LA 2010/4 provided for a 'sub-trust' arrangement to be facilitated which negated the section 109D implications:

49. A UPE will not be considered to be a loan to which Division 7A applies if the funds representing the UPE are held on sub-trust for the sole benefit of the private company beneficiary.

...

51. However, it is common for trust deeds to expressly provide that UPEs are to be held on a sub-trust and that the trustee has wide powers to invest the amount held in the sub-trust. The setting up of the sub-trust may therefore happen without any requirement for the trustee to resolve to do so.

52. Subject to paragraph 54 of this practice statement, the ATO will consider the following to evidence the existence of a sub-trust:

- *where the amount representing the UPE is set aside separately in the accounts of the main trust as being held on trust for the private company beneficiary*
- *where separate accounts are prepared for the sub-trust, or*
- *where a separate bank account is opened in the name of the trustee as trustee for the private company beneficiary in respect of the funds within the sub-trust.*

...

55. The ATO will consider that the funds in the sub-trust are held for the sole benefit of the private company beneficiary where:

- *the trustee of the sub-trust invests the funds representing the UPE in the main trust on commercial terms pursuant to a power as trustee to do so, and*
- *all the benefits from the investment flow back to the sub-trust and the private company beneficiary, and*
- *all the benefits (for example, annual return on investment) are actually paid to the private company beneficiary by the lodgment day of the tax return of the main-trust for the year in which the return arises.*

...

58. The ATO will consider that the funds in the sub-trust are held for the sole benefit of the private company beneficiary if the funds are invested in the main trust using one of the following investment options:

Option 1 - invest the funds representing the UPE on an interest only 7-year loan (see paragraphs 62 to 73 of this practice statement)

Option 2 - invest the funds representing the UPE on an interest only 10-year loan (see paragraphs 74 to 85 of this practice statement)

Option 3 - invest the funds representing the UPE in a specific income producing asset or investment (see paragraphs 86 to 94 of this practice statement)

Notably, of the options provided, only option 3 specifically required the sub-trust to be applied to a specific asset/investment. More usually, the sub-trust amount was mixed with the general trust assets.

Consequently, Options 1 or 2 – interest only loans were implemented to protect the unpaid trust distributions from the more commercially disadvantage of a companying Division 7A loan arrangement (section 109M – 7 years P & I requirement).

Accordingly, the sub-trust arrangement, other than the additional administration duties, provided a 'half-way' remedy to the implications of TR 2010/3.

1.1 Taxation determination TD 2022/11

2.4.1 Overview

TD 2022/11 introduces some critically important Division 7A practical changes which vary the practical application of TR 2010/3 and PS LA 2010/4. In brief, the TD 2022/11 changes are:

- (i) TD 2022/11 applies to trust distributions made as from 1st July 2022;
- (ii) TR 2010/3 and PS LA 2010/4 cease to have application to trust distributions made after 1st July 2022;
- (iii) Confirm the timing issues for the application of Division 7A to unpaid trust distributions;
- (iv) Clarification when and what 'sub-trust' arrangement negates the application of a section 109D deemed dividend; and
- (v) Explains when subdivision EA applies to trust loans to a company shareholder or shareholder's associates.

2.4.2 Application of TD 2022/11 – Timing issues

TD 2022/11 will only apply to trust distributions to a private company that are made after 1st July 2022 that are:

- (i) Unpaid at the relevant date;
- (ii) Not otherwise dealt with by a section 109M complying loan agreement;
- (iii) Dealt with by a 'compliant' sub-trust arrangement; or
- (iv) The corporate beneficiary does not have a distributable surplus (refer to section 109Y)

To the extent that transactions are pre 1st July 2022 distributions and arrangements made in accordance with TR 2010/3 and PS LA 2010/4 they will not be impacted by the requirements of TD 2022/11:

47. TR 2010/3 and Law Administration Practice Statement PS LA 2010/4 Division 7A: trust entitlements have been withdrawn with effect from 1 July 2022 for trust entitlements arising on or after that time. Taxpayers can continue to rely on both TR 2010/3 and PS LA 2010/4 in relation to trust entitlements that arose on or before 30 June 2022.

48. For the avoidance of doubt:

- The Commissioner will take a compliance approach of not devoting compliance resources to sub-trust arrangements conducted in accordance with PS LA 2010/4 in respect of trust entitlements arising before 1 July 2022 (see paragraphs 97 and 98 of this Determination), even though those sub-trust arrangements may commence after 30 June 2022.*
- This Determination does not apply to unpaid present entitlements arising before 16 December 2009.*

The TD confirms the Commissioner's previous ruling in relation to what constitutes the provision of financial accommodation for the purposes of subsection 109D(3) referring to the authority of *Corporate Initiatives Pty Ltd v Commissioner of Taxation* [2005] FCAFC 62.:

72. The Full Federal Court also concluded that, by not calling for payment of funds distributed to it, the private company beneficiary with knowledge of the UPE provided a benefit to the trustee who could continue to use the trust funds for trust purposes, and stated that (emphasis added):

We therefore think the Tribunal was correct in proceeding on the basis that, on demand being made by SBS as trustee for CUT, Eldersmede would have to do something to arrange funds for the payment, whether by selling, or borrowing against, available assets, which would then no longer be available for other trust purposes. Not having to do this was a benefit. Eldersmede was thus in a better or more favourable position than it would have been had it been required to fund the distributions.

73. After concluding that failing to call for payment of a UPE constitutes a benefit to the trustee, the Full Federal Court expressed difficulty in differentiating between the practical effect of a formally recorded loan and a beneficiary failing to call for payment of a UPE.

A critical issue with regard to section 109D concerns the timing of a 'loan'. Subsection 109D(1) applies to a loan made during the relevant year. In relation to a trust distribution, the trustee will resolve to distribute the trust income as at 30th June whereby the beneficiary has a present entitlement as at that time.

However, unless the beneficiary has been appropriated a specific dollar amount, it is usual for the appropriation to be based on a specific percentage of the trust income. In either instance TD 2022/11 provides that the 'loan' is made in the year when knowledge of the amount of the beneficiary's entitlement.

78. For financial accommodation to be provided, there must be a consensual arrangement between the parties. A consensual arrangement can only arise where a private company beneficiary:

- has a UPE and has knowledge of an amount of trust income that it can demand immediate payment of from the trustee;*
- has had its present entitlement satisfied by way of a sub-trust and has knowledge of the use of a sub-trust fund.*

This requires two elements to be satisfied:

- (i) The requisite knowledge of the entitlement; and
- (ii) Knowledge of the actual amount.

With regard to the first element, it will be most unusual that this element will not be satisfied. Note as the TD 2022/11 provides:

83. If the same person or persons are the directing mind and will of both the relevant private company beneficiary and the trustee in respect of affairs relevant to the private company beneficiary's UPE (such as the treatment of that UPE and/or dealings with that UPE), then subject to sufficient evidence to the contrary the Commissioner takes the view that both the private company beneficiary and the trustee know what the other knows because they have this same directing mind and will.

With regard to the second element, knowledge of the actual amount will invariably be when the financial statements for the trust are completed, albeit a fixed amount or a percentage based amount.

88. Where there is a UPE, financial accommodation is provided at the point in time when the private company beneficiary has knowledge of an amount of trust income that it can demand immediate payment of from the trustee and does not exercise its right.

89. The time when the amount of a beneficiary's entitlement is known will typically arise after the end of the income year, in the following income year. This will be the case whether the entitlement is expressed as:

- a fixed amount from 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.

90. Generally, the distributable income of a trust estate for an income year is only capable of being determined with sufficient certainty to quantify the amount of the entitlement when accounts are finalised. This will usually be after the income year has ended.

Accordingly, the section 109D timing issues will be as follows:



The above diagram illustrates the section 109D timing issues, supported by paragraph 12 tax determination: 2022/11

*12. The time when the amount of a beneficiary's entitlement is known will typically arise after the end of the income year, that is, in the **following income year**, in which the entitlement arises. This will be the case whether the entitlement is expressed as:*

- a fixed amount from 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.

2.4.3 ASIC trust deed – TD 2022/11 treatment of amount set aside on sub-trust

As was referred to earlier in this presentation the standard ASIC discretionary trust deed provided the trustee with the options to ‘set aside’ the trust distribution:

4.9 Amounts Set Aside

Any amount Set Aside or held by the Trustee on behalf of a Beneficiary under this Deed, will no longer form part of the Trust Fund, but will be held by the Trustee as a separate trust fund upon trust for the relevant Beneficiary absolutely. The Trustee has the Right (but not the Obligation), pending payment to the Beneficiary, to invest or apply that amount for the benefit of the Beneficiary or deal with that fund, or any resulting Income, in any manner provided for in this Deed in relation to the Trust Fund.

That is the ASIC trust deed and the actions of the trustee in accordance with clause 4.9 is sufficient to evidence the existence of the creation of a sub-trust.

Whereas with TR 2010/3, the above process to ‘set aside’ the trust distributions on the sub-trust arrangement in compliance with PS LA 2010/4 negated the section 109D issues.

However, TD 2022/11 adopts a more stricter application of the sub-trust rule.

The revised TD 2022/11 application of sub-trust arrangements is illustrated by Example 2:

Example 2 - circumstance two: sub-trust

Additional facts

32. *In respect of amounts resolved to be distributed to a beneficiary, the trust deed of AB Family Trust gives Trustee Ltd the power to:*

- *pay such amounts to the beneficiary, or*
- *set aside and hold such amounts on sub-trust for the exclusive benefit of that beneficiary.*

33. *On 1 August 2023, after determining the net income of AB Family Trust, Trustee Ltd sets aside \$10,000 on sub-trust by:*

- *creating a sub-account in its bank account with a third-party deposit-taking institution*
- *transferring the amount of \$10,000 into the sub-account, and*
- *holding the ownership of this sub-account on sub-trust for the absolute benefit of X Co.*

34. *That is, Trustee Ltd is the legal owner of the sub-account, but in its capacity as trustee for the sub-trust. **The sub-account funds are neither intermingled with the funds of the AB Family Trust** nor used to benefit the AB Family Trust (for example, the funds are not used as security for, nor to offset, loans of the AB Family Trust).*

35. *The \$10,000 sub-account with the deposit-taking institution is corpus of the sub-trust and X Co, as the only beneficiary of this sub-trust, is entitled to all of the income derived in respect of that account. X Co has a new right to call for payment of the sub-trust and can call the sub-trust to an end.*

36. *When the sub-trust is settled, Trustee Ltd satisfies its obligation in respect of the distributed income and there is no outstanding UPE.*

Application of Division 7A

37. *Upon settlement of the sub-trust, X Co has a new right to call for payment of the sub-trust and can call the sub-trust to an end.*

38. *In this example, no part of X Co's entitlement is used by Trustee Ltd for the purposes of AB Family Trust, or by or for the benefit of any other shareholder or their associate. Therefore, X Co has not provided financial accommodation to a shareholder or their associate, or made a loan to Trustee Ltd, in its capacity as trustee for AB Family Trust or the sub-trust, under the extended definition of a 'loan' in subsection 109D(3).*

The critical factor (and exceptional circumstances) provided by the above example, is that the sub-trust amount is not intermingled with the funds of the trust.

Accordingly, and notwithstanding the fact that the ASIC deed provides that the unpaid distribution is set aside as a separate trust (sub-trust), as it will be more generally the instance, the fact that the sub-trust amount is 'mingled' with the other resources of the trust will result in the application of section 109D.

Consequently and based on the application of TD 2022/11, a simple sub-trust arrangement where the relevant amount is otherwise dealt with by the due date:

- (i) Paying the amount;
- (ii) Placing the sub-trust amount on a complying loan agreement; or
- (iii) Allocating funds to the sub-trust amount for the sole and absolute benefit of the corporate beneficiary.

The sub-trust amount will be a deemed dividend pursuant to section 109D.

Advisors will need to carefully consider the cash flow implications of the sub-trust changes resulting from TD 2022/11, albeit by the need to actually pay the trust distributions to the company or satisfy the unpaid trust distributions by the complying section 109M requirements – 7 year principal and interest payments.

A more fundamental strategy might also include a complete restructuring of the trust's business by transferring the business to a company (with the trust holding the shares – using a subdivision 122-A rollover for example)

2.4.4 UPE - set aside on a sub-trust arrangement

In addition to the above treatment of a sub-trust arrangement, the TD makes other significant rulings in relation to an UPE, namely:

13. *Where a private company beneficiary is made presently entitled to trust income, the trustee may be authorised to set aside an amount from the main trust and hold it on sub-trust for the exclusive benefit of the private company beneficiary. In this case, the amount set aside by the trustee ceases to be an asset of the main trust and forms the corpus of the sub-trust (the sub-trust fund). Where the trustee's obligation to pay the entitlement to trust income is discharged by the setting aside of the amount on sub-trust for the beneficiary, the trustee's obligation in respect of the entitlement to distributed income comes to an end and a new obligation arises for the sub-trustee under a separate trust.*

14. *The private company beneficiary has a new right to call for payment of the sub-trust fund and can call the sub-trust to an end. A choice by the private company not to exercise that right*

does not constitute financial accommodation in favour of the trustee in its capacity as trustee of the sub-trust, because the sub-trust fund is held for private company beneficiary's sole benefit.

That is, when the UPE is set aside as a sub-trust amount, as per the ASIC trust deed, the implications are:

- (i) The UPE obligation ceases to exist as it is discharged by the sub-trust arrangement;
- (ii) If the private company does not call for the payment of the trust amount, there is no provision of financial accommodation to the trust.

The implications flowing from the above are as follows:

- (i) The fact that there is no UPE existing as a consequence of the sub-trust arrangement, negates the application of subdivision EA.

Subdivision EA only applies where a trustee, inter alia:

- (a) makes a loan to an entity who is a shareholder of a private company; and
- (b) the trustee has an UPE owing to the private company.

That is in the absence of an UPE, subdivision EA does not apply. This is confirmed by paragraph 148 TD 2022/11:

148. As described in paragraph 13 of this Determination, where a private company beneficiary is made presently entitled to trust income and the trustee satisfies that UPE by setting aside an amount from the main trust and holding it on sub-trust for the exclusive benefit of the private company beneficiary, the present entitlement to income is paid and there is no UPE. In those circumstances, the conditions for Subdivision EA to operate are not satisfied.

Further, if the unpaid distribution to the company has been made subject to section 109D and/or subjected to a section 109M loan agreement, subdivision EA will not apply:

146. Consistent with the legislative context of Division 7A, an amount that has been treated as a loan and dealt with under section 109D (for example, a UPE that constitutes financial accommodation and is made subject to a complying loan agreement, as described in paragraphs 102 to 104 of this Determination) should be regarded as a loan for all purposes of Division 7A, including Subdivision EA. Accordingly, the Commissioner will not treat a UPE in those circumstances as a present entitlement that remains unpaid for Subdivision EA purposes. This is consistent with the position taken in TR 2010/3.

- (ii) to the extent that the sub-trust amount is held for the absolute benefit of the corporate beneficiary, if the '**controlling minds**' of the company allow by express or implied acquiescence the application of the sub trust

The concept of 'controlling minds' is explained by paragraph 83 in the following manner:

83. If the same person or persons are the directing mind and will of both the relevant private company beneficiary and the trustee in respect of affairs relevant to the private company beneficiary's UPE (such as the treatment of that UPE and/or dealings with that UPE), then subject to sufficient evidence to the contrary the Commissioner takes the view that both the private company beneficiary and the trustee know what the other knows because they have this same directing mind and will.

Finally, the sub-trust is regarded as a 'transparent trust' (refer to PS LA 2000/2) and as such there is no requirement for separate taxation returns to be prepared for the sub-trust.

2.4.5 Sub-trust amount deemed to be a section 109D loan in certain instances

The contradiction that would appear to arise with the prima facie ruling that a setting aside a trust distribution as a sub-trust amount, section 109D will apply where the company 'allows' its sub-trust amount to be applied for the use of an entity who is a shareholder or an associate of the shareholder.

This outcome will have section 109D implications if:

- (i) The company 'allows' its sub-trust amount to be generally used by the trustee for the trust's benefit; and/or
- (ii) The company allows its sub-trust amount to be applied by the trustee to make a loan to a shareholder or associate of the company.

Incidentally this has the same taxation impact as if subdivision EA applied.

Whereas if the sub-trust amount are mingled with the other trust resources, with knowledge of the company, the company is deemed to have made a section 109D loan to the trustee, whether there is interest payable or otherwise.

Note: In either instance, it is the company that is making the financial accommodation and as such the company should facilitate the complying loan agreement to negate any section 109D application

The above is illustrated by example 3 of TD 2022/11:

Example 3 - circumstance two: use of sub-trust fund by the trustee of AB Family Trust - no commercial rate of return

Additional fact

39. Assume the same additional facts as in Example 2 of this Determination and that Trustee Ltd uses the \$10,000 set aside on sub-trust fund for the purposes of AB Family Trust.

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40. As X Co and Trustee Ltd are controlled by Ashley and Bo, X Co is taken to have knowledge that the sub-trust fund is being used by Trustee Ltd for the purposes of AB Family Trust. Trustee Ltd as trustee for AB Family Trust receives a benefit, being the use of the sub-trust funds. This is the provision of financial accommodation by X Co to Trustee Ltd as trustee for AB Family Trust.

41. X Co can call for payment of its entitlement held on sub-trust if it does not agree to those funds being used for the purposes of AB Family Trust. On the facts, there is no evidence to suggest that X Co does anything other than acquiesce to Trustee Ltd using those funds for the purposes of AB Family Trust. Accordingly, X Co allows (and is taken to agree to) the use of funds to which it is entitled for the purposes of AB Family Trust.

42. In this example, X Co has provided financial accommodation to Trustee Ltd as trustee for AB Family Trust. X Co is taken to have made a loan to Trustee Ltd under the extended definition of a 'loan' in subsection 109D(3) when the sub-trust fund was so used.