

Private Client Bulletin June 2010

Trust entitlements and Division 7A—what you must know before 30 June 2010

For a long time, discretionary trusts have been a preferred investment vehicle for small businesses and private investments for family groups for a variety of reasons, but undoubtedly one of those reasons is the flexibility they offer in terms of distributions of the taxable income of the trust.

In a typical family trust operating a small business, the taxable income of the trust will be distributed between the parents in order to fund living expenses (and would be taxed at individual marginal rates) with a distribution of any surplus taxable income being declared in favour of the corporate beneficiary. The surplus income would then be taxed at the company tax rate.

Typically, the trust would cash flow 30 per cent of the distribution to the corporate beneficiary sufficient to fund the tax liability on the distribution declared, with the balance of the distribution being retained by the trust as an 'unpaid present entitlement' (UPE) in favour of the company. The benefit to the trust is it could reinvest those funds in the business to generate future profits. This strategy must be revisited in light of a recent Australian Taxation Office (ATO) tax ruling (TR 2010/13) and accompanying draft practice statement (PS LA 3362).

The tax ruling and draft practice statement detail the Commissioner's view on the circumstances in which what might have once been considered a UPE is in fact a 'loan' by the company to the associated trust for the purposes of Division 7A of the *Income Tax Assessment Act 1936*.

What is the problem with having a Division 7A loan?

A 'loan' from a private company to an associated trust (a trust that is part of the same family group) is subject to the provisions of Division 7A (Div 7A Loan). Interest, at the benchmark rate, must be paid on Div 7A Loans by the trust and the capital must be repaid within seven years, unless the loan is secured by first mortgage over real property, in which case it can be repaid over 25 years. If these minimum requirements in respect of a Div 7A Loan are not met, then the amount of the Div 7A Loan will be treated as an unfranked dividend paid by the company to the associated trust.

Practically speaking, the creation of a Division 7A Loan means the trust must repay the loan over time, either from future profits generated by the trust or via external borrowings. For a small business operated through a discretionary trust, the inability to effectively reinvest profits represents a potentially massive change in the way they fund their business.

The problem arises because of the ATO's interpretation of the difference between a UPE and a loan.

When is an existing unpaid entitlement a 'loan'?

The problem for trustees arises because the ATO has adopted a very wide interpretation of what constitutes a loan. So wide in fact, that what trustees and corporate beneficiaries (and their advisors) have for some time considered to be a UPE may in fact be, as far as the ATO is concerned, a loan. This situation can arise because of one or more of the following:

1. The terms of the trust deed. Many older deeds specifically say that any distribution declared in favour of a beneficiary that is not paid will **automatically** create a loan from the beneficiary in favour of the trustee. This causes an immediate problem.
2. The way in which both resolutions by the trustee are made and how the UPE is recorded in the accounts of the trust and company. In the ATO's view, careful attention needs to be paid to both the declaration of distributions and the recording of them in the accounts for any unpaid distribution to be considered a UPE and not a loan.

What about future distributions?

Problems may occur even if the trust deed is appropriately worded, resolutions are made correctly and UPEs are recorded in the accounts. The ATO's view of what constitutes a loan is so wide that a loan will be created if—

1. a UPE is created in favour of a corporate beneficiary, and

2. the beneficiary does not call on the trustee to pay the UPE in full, but instead allows the funds to be reinvested and intermingled with other assets of the trust.

This makes it almost impossible for a small business run through a trust to avoid creating a Div 7A loan because it will be almost impossible for any funds reinvested to not be intermingled with other trust assets.

Similarly, in an investment trust, the funds representing a UPE created in favour of a corporate beneficiary could remain within the trust but could only be invested by the trustee for the sole benefit of the corporate beneficiary (that is, by creation of a new sub-trust) with all income and capital gains of that particular investment flowing to the corporate beneficiary.

Our recommendations

These announcements by the ATO represent a major shift in the administration of trusts and corporate beneficiaries moving forward. The requirement to manage separate sub-trusts for any UPEs may force some clients to move away from a trust structure altogether. Those clients with trusts should do the following immediately:

1. Review their trust deeds to ensure they are not automatically creating a loan, as opposed to a UPE, whenever a distribution remains unpaid. For many old trust deeds, an amendment to the deed is required. If you are concerned about this, then you should contact us immediately.
2. Review their accounts to ensure UPEs are recorded correctly in the books of the trust and the corporate beneficiary.
3. Speak to their advisor about managing future distributions and the UPEs that might be created.



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