ATO ATTACK ON TRUSTS & UNPAID PRESENT ENTITLEMENTS CONTINUES

In December 2009, the ATO released a draft ruling (TR 2009/D8) outlining how Division 7A should apply to private companies with an unpaid present entitlement from a trust.

Given the extensive consultations between the professional bodies and the ATO on this issue last year, the professional bodies were surprised by the content of the draft ruling released by the ATO in December. The professional bodies are currently preparing submissions in relation to the draft ruling.

The draft ruling outlines when the ATO considers that an unpaid present entitlement should be treated as a loan. A consequence of treating an unpaid present entitlement as a loan under Division 7A is that, unless the loan satisfies certain requirements, the loan will be treated as a deemed dividend for tax purposes.

Division 7A – background

Division 7A is designed to ensure that private companies are not able to distribute profits to shareholders by way of non-arm's length payments or loans rather than as taxable dividends.

Where Division 7A applies, such payments and loans are treated as dividends in the hands of the shareholders.

Draft ruling

The draft ruling is concerned about when a private company will be taken to have made a "loan" to a shareholder for the purposes of Division 7A.

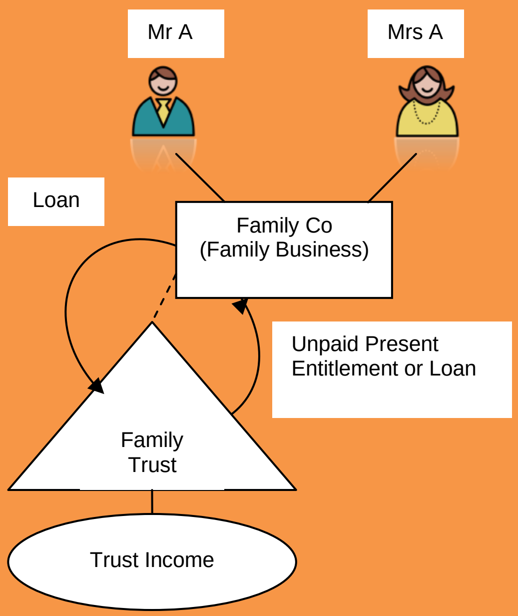
More specifically, the draft ruling is concerned about the situation where:

- a private company has a present entitlement to an amount from a related trust (ie it can call for immediate payment of the amount by the trust);
- the amount remains in the trust rather then being distributed to the private company (ie there is an unpaid present entitlement); and
- the amount is used by the trust for its own purposes or intermingled with other trust funds (as opposed to being held by the trust on a sub-trust for the company).

The draft ruling provides that there will be a Division 7A loan where:

- a private company beneficiary lends (by agreement, authorisation or ratification) money in satisfaction of an unpaid present entitlement;
- the trustee creates a loan for the benefit of the private company beneficiary pursuant to the trust deed instead of creating an unpaid present entitlement;
- there is a subsisting unpaid present entitlement and the private company has in substance effected a loan or provided financial accommodation in respect of that unpaid present entitlement; or
- an unpaid present entitlement has been allowed to remain outstanding for use by the trust generally (as opposed to being used or invested or lent for the absolute benefit of the corporate beneficiary).

To illustrate
The draft ruling seeks to treat unpaid present entitlements such as the one below as loans (and therefore dividends).



*Mr A and Mrs A are also potential beneficiaries of family trust

Based on some of the examples in the draft ruling, it is important to note that an unpaid present entitlement can be converted into a loan as a result of acquiescence.

In this regard, the draft ruling states that there may be a loan (by way of financial accommodation) where a private company authorises (including by acquiescence with knowledge) the continued use by the trust of funds representing the company's unpaid present entitlement by not calling for:

- the payment of that unpaid present entitlement; or
- the investment of the funds representing the unpaid present entitlement for the company's absolute benefit (as opposed to the funds being intermingled with the trust's other funds).

WARNING
Companies entitled to distributions from a trust that have remained unpaid for any length of time should carefully consider the application of the draft ruling.

If you would like further information or require assistance in relation to the above please do not hesitate in contacting our office on 02 9555 1309.