

UNPAID PRESENT ENTITLEMENTS / TRUST DISTRIBUTIONS TO CORPORATE BENEFICIARIES

We have followed closely the Australian Taxation Office's new view on the loan account/unpaid present entitlements between trusts and corporate beneficiaries. This new view is contained in Tax Ruling TR 2010/3.

In TR 2010/3 the Australian Taxation Office has firmly brought the relationship between Trusts and corporate beneficiaries of those Trusts within the ambit of Division 7A. It has done so by firmly stating that loans between the Trust and a Company are caught by Division 7A and furthermore that unpaid distributions by a Trust to a Company will generally be treated as loans.

It is common practice for Trusts to distribute profits to companies. If the profit is retained in the Trust it will be taxed at 46.5%. If the profit is distributed to individuals then the marginal tax rate at a certain point will exceed 31.5%. For adults this will occur when their taxable income exceeds \$80,000. However, companies are only taxed at 30% so it makes sense for a trust to distribute to a company to cap the tax rate at 30%.

However, by distributing to beneficiaries this does not mean that the Trust needs to pay the profit to the Company immediately. The Trust can retain the profit and reinvest it for example in its business or use it to purchase new assets. The distribution will remain unpaid and is known as an 'Unpaid Present Entitlement.'

The new ruling changes the treatment of these 'Unpaid Present Entitlements' by deeming them in most circumstances to be loans. The only exception from being treated as a loan is if the 'Unpaid Present Entitlement' is maintained separately from the other assets of the Trust. In practice this has not usually occurred.

As the 'Unpaid Present Entitlement' is now deemed to be a loan this means that it is caught by Division 7A. Division 7A requires that a Loan Agreement be entered into between the Trust and the Company if there is a loan in existence. Under the Loan Agreement the loan is required to be repaid to the Company with interest over a period of time. If the loan is unsecured the period is seven (7) years. If the loan is secured against real property this period can be extended to twenty-five (25) years.

If the assets of the Trust are not in a liquid form i.e. cash then the only way that the loan can in practice be repaid is by the Company paying a dividend to its shareholders. (The dividend would then be offset via Journal entry against the Unpaid Present Entitlement between the Trust and the Company). Generally, this dividend would be fully franked. However, if the marginal tax rate of the shareholder is higher than 30% then the individual shareholder will pay additional top-up tax.

The implications are that not only is there potential additional tax payable by shareholders, but there will be a significant increase in compliance costs to set in place and administer loan agreement(s) between the Company and the Trust and to ensure these agreements are complied with. Failure to comply with the agreement might result in a significant further additional tax burden.

The original intent of Division 7A was as an integrity provision. It was aimed at ensuring that loans that were in-substance distributions of profit from companies to individuals were caught, thereby necessitating that either the loans be repaid, loan agreements be entered into requiring repayment over a period of time (with interest) or that dividends be paid covering the loan balance.

The existence of the loans and unpaid present entitlements between Trusts and companies is not a disguised distribution of profits to individuals. In the majority of cases the funds have been retained within the Trust structure to invest in working capital including cash, stock and debtors as well as purchase buildings and plant & equipment to continue the business.

There are a few instances of Trusts investing these unpaid present entitlements in private assets such as holiday homes and yachts. However, these are more the exception than the rule. The vast majority of operators of trusts should not be penalised because of the behaviour of a few.

The effect of the ATO's ruling and Practice Statement will be to potentially cause significant hardship by requiring that the companies owed the Unpaid Present Entitlement make distributions to allow the Division 7A loans to be serviced. These distributions will be subject to tax at individual marginal tax rates generally in excess of 30%. If the businesses had been structured as companies rather than as trusts this would not have occurred.

We also take exception to the retrospectivity involved. The 'loan' accounts have arisen over a long period of time. What is the ATO's attitude to this? Will the ATO go back and require significant amendments to prior year tax returns with accompanying penalties and interest? Will there be a similar exception as made by the ATO during the year ended 30 June 2008 in PSLA 2007/20? Under this statement taxpayers were permitted to make a one-off adjustment to ensure that loan accounts for companies were brought into line with the Division 7A provisions. We think that such a one-off adjustment would be unfairly onerous to taxpayers, but at least it would ensure that taxpayers were compliant and not potentially in 'no-mans land'.

We are following the ATO's actions in the matter carefully and have made representations to our Accounting Bodies including speaking at length to the parties in the Accounting bodies that are dealing with the Australian Taxation Office on this issue. We will endeavour to ensure that the matter is resolved in our client's favour. We will apply whatever efforts we can to ensure that our client's are treated fairly.

Should you have any queries or comments please do not hesitate to contact Andrew Hengel. Your comments and thoughts would be much appreciated.