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## Cornwall Stodart Tax Digest: Company Beneficiaries, Present Entitlements and Division 7A of the Income Tax Assessment Act 1997 – Private Groups' Funding Arrangements under Attack

### Introduction

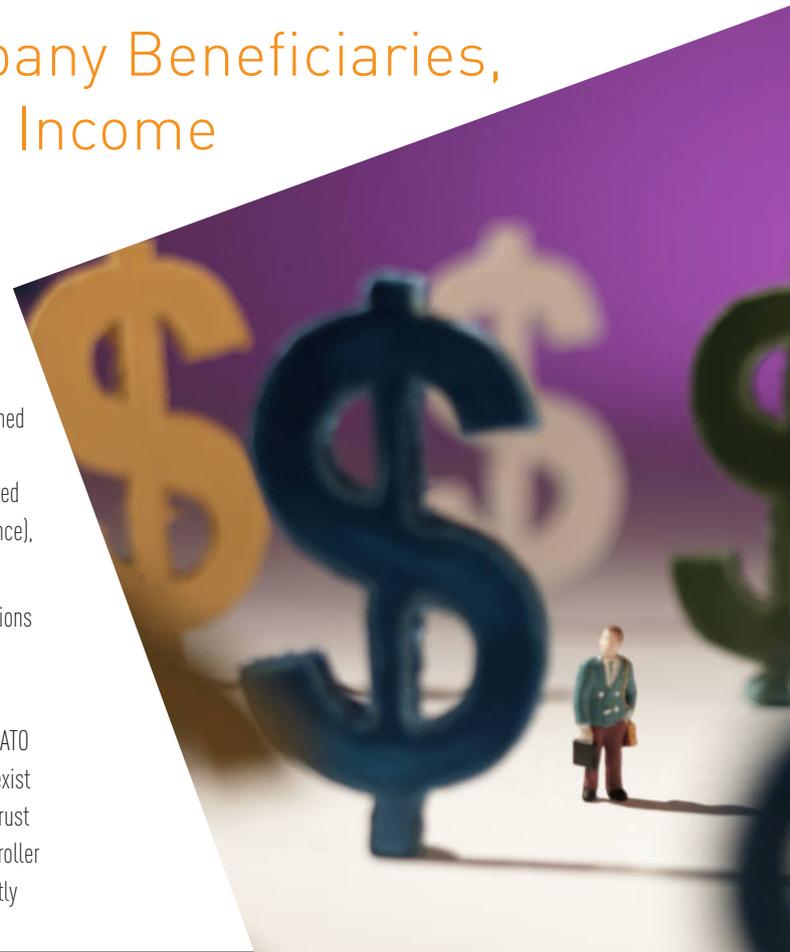
The ATO's Draft Tax Ruling TR 2009/D8 (**Draft Ruling**) deals with the intended tax treatment of distributions to **private** company beneficiaries by trustees of trusts within 'closely held groups' ('private company' is defined for these purposes in s103A of the Income Tax Assessment Act 1936 (**Act**)). It will remain open for comment by the business community and their professional advisors until 12 February 2010. The ATO is now seeking, in certain circumstances, to render unpaid distributions to income tax (Unpaid Present Entitlements (UPEs)) as a dividend received by the trust (which made the distribution) from the company beneficiary, pursuant to Division 7A-s109D(1) of the Act. These forms of dividends are not accompanied by franking credits.

Traditionally, UPEs have been viewed as only creating equitable rights in the beneficiary and not (without some other circumstance or factor) a debtor-creditor relationship. The ATO now contends a UPE will constitute

a loan – both in the conventional sense of the word and pursuant to the extended definition contained in s109D(3) of Act – to the trust that was the source of the distribution. Unless the exceptions contained in the Division operate, or if the transaction (considered as a whole) only gives rise to equitable rights to payment of the amount distributed (circumstances which will be rare having regard to the ATO's new stance), UPEs will need to be repaid to avoid additional tax.

Significant adverse financial consequences for private groups' operations may flow from the Draft Ruling, should it be accepted.

The application of the proposed provisions and the meaning given to 'closely held group' contained in the Draft Ruling will also assist the ATO in expanding the operation of Division 7A. A 'closely held group' will exist where entities including or comprising the private company and the trust (the source of the income distribution) share the same ultimate controller or controllers, being an entity or person who either directly or indirectly



has the practical ability or capability to control the family group. 'Control' is not defined.

A UPE, without some other factor or circumstance, merely gives rise to equitable rights. Where a trustee unilaterally applies a company beneficiary's UPE to become intermingled with the trust's assets, the ATO has traditionally viewed this as a fact or knowledge not possessed by the beneficiary. Accordingly, this has not been a situation where the UPE has been 'paid or applied' for that beneficiary's benefit and, therefore, a loan has not been made. With the introduction of the concept of controller of a closely held group, knowledge of the trustee's actions will be viewed as falling within the knowledge of the company beneficiary. This knowledge, in the circumstances described above and in other related instances, becomes critical to the question of whether a 'loan' exists. Further, it will be the not doing of something, where the company beneficiary has knowledge of the trustee's actions, which may also give rise to the relevant Division 7A loan.

## Ordinary Meaning of Loan

The Draft Ruling outlines the ATO's view of when a loan, as ordinarily understood, is created. Fundamentally, a loan arises where there is a requirement to repay an amount which has been paid. Once there is an arrangement for the repayment of an amount advanced, there will be a loan within the ordinary common law meaning, irrespective of whether the rights surrounding that arrangement arise under contract *or in equity*.

## Extended Definition of Loan under Division 7A of the Act

In addition to a loan as ordinarily understood, s109D(3) of the Act extends the meaning of loan to include:

- an advance of money;
- a provision of credit or any other form of financial accommodation;
- 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
- a transaction (whatever its terms or form) which in substance effects a loan of money.

The ATO considers that a transaction which in substance effects a loan within its ordinary meaning – an advance of money, the provision of credit, the provision of financial accommodation or a payment on behalf or at the request of an entity (**where there is an express or implied obligation to repay the amount**) – will be taken to be a loan for Division 7A purposes.

## Distributions to Company Beneficiaries and Loans

First, a loan must be 'made'. The ATO suggests that a loan is made where a company beneficiary by some action (or inaction) brings into existence, causes, occasions, effects or gives rise to a loan *or to an arrangement or circumstance* that is deemed to be a Division 7A loan under subsection 109D(3). This interpretation gives 'made' an extremely wide meaning.

The ATO considers that Division 7A loans will occur in the following instances, with varying consequences for the UPE:

### 1. Actual Loans - UPE is Extinguished

- (a) The company beneficiary **agrees** to lend the amount to which it is entitled to the trust by way of set-off. Thus a loan will arise in the case of an agreed set-off in satisfaction of the trustee's obligation to pay the company beneficiary its trust entitlement. Where parties meet together and agree to set one demand against the other, they need not go through the form and ceremony of handing money backwards and forwards. Thus a journal entry in the books of account of the trust with the agreement of the parties will amount to a set-off. The credit to the loan account of the company beneficiary will constitute payment of the entitlement. Thus instead of having a UPE, the beneficiary company will now have a loan owed to it by the trustee of the trust.
- (b) A loan will arise if a trustee credits an entitlement to a loan account held in the name of the company beneficiary (with its authorisation). The credit to the loan account will

constitute payment of the entitlement. Thus, instead of having a UPE, the company beneficiary will have a loan owed to it by the trustee. Critically, the company beneficiary may authorise the actions of the trustee by its acquiescence, provided it has full knowledge of what the trustee has done. In circumstances where a number of entities share a common controller, the controller's knowledge of one of the group's affairs will be generally attributed to another member of the same group. Alternatively, knowledge will be deemed to exist where the same individuals have the directing mind in respect of cash flows and distributions within the family group (but sufficient evidence to the contrary may refute this contention).

(c) Pursuant to the terms of the trust deed, a trustee may make a loan on behalf of the company beneficiary by acting pursuant to a term of the trust deed that permits the trustee to pay money to or for the benefit of the beneficiary. The application of trust funds for the benefit of the company beneficiary by way of a loan investment in the trust – and the corresponding assumption by the trustee of an obligation to repay the sum to the company beneficiary – would be such a payment or application for the benefit of the company beneficiary. The UPE is extinguished and replaced with a loan asset (sufficient evidence to the contrary may refute this contention).

## 2. UPE Subsists and Division 7A Loan

As ordinarily understood, UPEs do not give rise to payment requiring repayment in the sense necessary for a loan to exist. Thus the ATO has confined the instances in which a loan for Division 7A purposes can arise where a UPE subsists. A UPE is only a right to enforce recovery of the amount in equity and is not a debt enforceable at common law; thus there is also no deferred payment – a further condition for a loan. However, the ATO regards a UPE as a provision of credit, being an arrangement for the deferred payment of the amount that is ascertainable and unavoidably due, whether currently or in the future and not contingent on any event or action. The ATO will look at the substance and effect of the transaction relating to a UPE regardless of its form. The ATO will regard a Division 7A loan as coming into existence in the following two instances (although a UPE is still considered to exist):

- (a) *Financial Accommodation* – this form of loan will occur where a consensual agreement between the company beneficiary and the trustee can be said to exist which grants or supplies some form of pecuniary aid or favour to the trust and the principal sum or equivalent (the UPE) is ultimately payable. Where a UPE remains intermingled with the trust's fund and is not applied for the absolute benefit of the corporate beneficiary, a financial accommodation will be said to arise. The consensual agreement to the UPE's treatment by the trustee occurs because the beneficiary does nothing to obtain repayment of the UPE (which is otherwise at call) or seek its investment for a commercial return. The benefit provided is the use of the funds representing the UPE for trust purposes, which is the provision of pecuniary support to the trust. A loan has been 'made' in the relevant sense because the acceptance of the acts of the trustee will amount to authorisation (or acquiescence with knowledge), and knowledge of the trustee's action will be held to exist where the entities are part of a closely held group.
- (b) *Transactions effecting in-substance loans* – these are arrangements which in substance effect relationships that are properly described as loans at common law (ie, requiring a payment and repayment). For a 'transaction' to exist there must be a transaction 'with some other person'. Where a trustee makes a company beneficiary presently entitled to an amount from the trust and that company beneficiary allows the trust to retain use of the funds, it is regarded as a transaction. While a UPE may not involve a payment and repayment, in effect a UPE that a beneficiary has allowed



to remain outstanding for use by the trustee for trust purposes is practically the same as a UPE that is paid to the beneficiary and lent back to the trust to use for broader trust purposes. In these circumstances, it is claimed that the mere declaration of the company beneficiary's entitlements does not embody the real nature of the overall transaction effected by the parties. Again, the loan must be 'made' and the acceptance of the acts of the trustee will amount to authorisation (or acquiescence with knowledge), and knowledge of the trustee's act will be held to exist where the entities are part of a closely held group. As can be observed, this situation will cover any other situation not covered by the extended definition of 'loan' contained in Division 7A.

At present there is some uncertainty as to the extent of the Draft Ruling's retrospective effect. We will keep clients advised on any further developments as they occur.

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