

The ATO, Unpaid Present Entitlements & Division 7A



Background

For many years you have been able to distribute income from your discretionary trust to a company, the company paid tax at 30% and you could leave the income there to distribute as fully franked dividends at a later time, possibly when your income was lower. Often, no cash was paid to the company when the income was distributed, giving rise to an Unpaid Present Entitlement (UPE). The ATO has now decided that the resulting UPE owed to the company should be treated as a loan (Under Division 7A of the tax act). The loan will need to be repaid within 7 years if not secured or 25 years if secured. Interest will also be payable on the loan. The ATO has provided some circumstances where the UPE need not be treated as a loan.

Facts

- The ATO has issued its opinion in the form of TR2010/3, this ruling outlines the new treatment of UPE's and the way that the ATO expects this to be administered.
- Importantly, there is no need to change the treatment of past unpaid present entitlements, they can be quarantined in the accounts of the Trust & Company.
- The ruling will take effect on UPE's that arose after 15 December 2009, this means that 2010 trust distributions may need to be treated differently than they have in the past.

Issues this causes

- If you are running a business, you may be using the cash that would otherwise have been distributed to the company as working capital. To distribute the funds would cause a working capital deficiency in the business.
- If the trust is an investment trust, you may also be using the cash to make further investments. You may not want to invest the money in the company as this would decrease the flexibility of income distributions in the future.

Don't Panic! There are solutions

- Discretionary trusts are still a sound structuring option, there are strategies that can be implemented in order to maintain a similar position in most cases.

- Each individual circumstance will be different, we will need to assess which option is best for you going forward.
- **For a Business** using the funds as working capital, a likely strategy is to exclude your UPE from being a loan by entering into a 'terms of investment' agreement with the company. The trust would pay a share of income (prior to all other distributions) to the company each year, however there is no repayment period in the agreement.
- **For Investors** you may choose to enter into a loan agreement between the company and the trust. Interest will be payable from the Trust to the Company, however assuming that the trust is investing the funds the interest will be deductible to the Trust.
- If any changes need to be made, we can address this when we prepare the 2010 accounts for the trust and company.

If you have any questions about how this affects you please contact us on 8272 5620 and we will be happy to discuss your particular circumstances further.