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Division 7A

- Trusts and distributions to companies
 - Draft Ruling TR 2009/D8 - ATO's view of when a "UPE" will be considered a 'loan' for Division 7A purposes
 - What should your clients do?
- Amendments to apply from 1 July 2009
 - Budget announcement.
 - Treasury consultation paper issued 5 June 2009.
 - Draft legislation issued 4 January 2010.

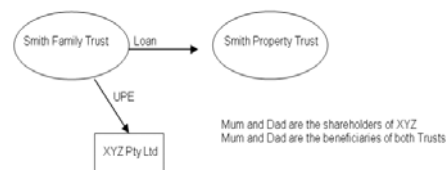
Division 7A – Trusts and distributions to companies

Subdivision EA: Trusts – Loans, Payments and Debts

Subdivision EA applies where:

- on or after 12 December 2002 a trustee:
 - makes a loan to a shareholder (or associate) of the company;
 - makes a payment to a shareholder (or associate) of the company which is to discharge a present entitlement attributable to an unrealised gain; or
 - forgives a debt to a shareholder (or associate) of the company; and
- either:
 - the trustee has an UPE to the company at the time the loan, payment or debt forgiveness occurred and the UPE is not repaid before the lodgement (or due date) of the trust's tax return; or
 - the company becomes presently entitled to an amount after the loan, payment or debt forgiveness occurred but before the lodgement (or due date) of the trust's tax return and is not repaid before that date.

Division 7A – Trusts and UPE (Subdivision EA)



Application of Subdivision EA

- For Subdivision EA to apply:
 - there must be an UPE to a private company; and
 - the UPE must remain unpaid at the time of the lodgement of the trust's tax return.
- A UPE gives a beneficiary an equitable right to demand payment from the trustee of that amount to which it has become presently entitled.
- Therefore, it is not a 'loan' in the ordinary sense.
- Issue: "Is a UPE a 'loan' within the meaning of section 109D(3)?"

History of the current Subdivision EA

- 4 December 1997 - *Taxation Laws Amendment (No. 7) Bill 1997* introduced
 - Applied to private companies making loans etc to shareholders or associates.
 - Defined "Loan" to include:
 - an advance of money;
 - a provision of credit or any other form of financial accommodation;
 - a payment of an amount for, 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.
 - Did not contain section 109UB (predecessor to Subdivision EA).

History of the current Subdivision EA

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- Arguments were raised that the proposed legislation did not apply to an arrangement where the trustee has a UPE a corporate beneficiary which remains unpaid.
- On the basis of these arguments, the Bill was amended to include section 109UB (which applied to trust distributions made after 27 March 1998).
- Section 109UB was later replaced with Subdivision EA (which applied from 12 December 2002).

History of the current Subdivision EA

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- Generally accepted by practitioners (and previously the ATO) that "UPE's" are dealt with in Subdivision EA not Section 109D (which applies where a company makes a loan)
- ATO Publication "Division 7A – answers to frequently asked questions" (dated 5 February 2009)
 - Question 94 Will a dividend be taken to arise simply because the trustee retains on trust an unpaid present entitled of a private company?
 - ATO: "Generally no. Immediately after the present entitlement is created in favour of the private company the trustee will owe an amount to the private company. **There will be an unpaid present entitlement, and accordingly, the general loan provisions of Division 7A do not apply...**"
- The ATO has revisited this view in draft Ruling TR 2009/D8.

Draft Ruling TR 2009/D8

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ATO addresses two main issues:

1. Is there a 'loan' instead of or in satisfaction of a UPE?
2. If there is a UPE:
 - is it a 'subsisting UPE'; therefore
 - has the company made a loan within the meaning of section 109D(3).

'Loan' instead of or in satisfaction of UPE

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- Section two of the draft Ruling outlines ways that the ATO considers that a UPE can be extinguished and converted back to being a loan from the company (as beneficiary) to the trust.
- These include:
 - By agreement.
 - Authorisation by the company including acquiescence with full knowledge.
 - Term of the Trust Deed.

By agreement

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- The company and trustee enter into an agreement whereby the:
 - company lends an amount to the trustee; and
 - the amount is set-off against the UPE to the company.

By Agreement (example)

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- Trustee has UPE to company of \$50,000
- Trustee lends shareholder of company \$100,000.
- Company agrees to lend trustee \$50,000 and set-off the \$50,000 against the UPE owing to the company before the lodgement of the trustee's tax return.

By Agreement (example)

- Subdivision EA will not apply because UPE is paid prior to the lodgement of the trustee's tax return.
- Trustee and company enter into a complying section 109N loan agreement for the \$50,000 before the lodgement of the company's tax return for the year in which the loan was made.

Authorisation of the company

- Applies where the trustee credits an entitlement to a 'loan account' in the name of the company beneficiary, with the **authorisation** of the company.
- Such authorisation may arise through **acquiescence with full knowledge** of what the trustee has done.

Where the trust and beneficiary form part of the same family group, the Commissioner will take the view that the private company has knowledge of what the trustee has done, subject to sufficient evidence to the contrary (paragraph 8)

Authorisation: Example

- The trustee resolves to distribute \$200,000 to the company.
- The trustee retains the funds and acquires additional assets.
- The trustee does not make any loans to any shareholders or associates.
- The trustee credits \$200,000 to an account named "Beneficiary Loan Account".

Authorisation: Example

- If the trustee and company are controlled by the same people, the company will be taken to have:
 - authorised the actions of the trustee; and
 - made a loan to the trustee.
- Therefore:
 - Subdivision EA will not apply because the UPE has been paid; and
 - section 109D may apply because the company has made a loan to the trust.

Term of the Trust Deed

- Where:
 - an amount has been credited to a loan account in the name of the company beneficiary; and
 - under the trust deed the trustee has the power to credit such amounts for the benefit of the beneficiary as a payment or application of trust funds

the Commissioner will form the view that the trustee has exercised this power to do so unless there is sufficient evidence to the contrary (Paragraph 9).

Term of the Trust Deed

- Based on the ATO's view:
 - Subdivision EA will not apply because the UPE has been paid; and
 - section 109D will apply because the company has made a loan to a shareholder (or associate).

What does this mean?

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- If the draft Ruling is finalised in its current form:
 - The ATO's view is that the company beneficiary has made a loan to the trust where:
 - there is agreement between the trustee and company; or
 - the trustee credits a loan account in the name of the company beneficiary (and the company and trust are control by the same people).
 - This means that section 109D will apply if there is not a section 109N loan agreement put in place between the company and the trustee prior to the lodgement of the company's tax return for the year in which the loan is made.
 - This view will apply to 'loans' made before or after the issue of the draft Ruling.

What should your clients do?

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- The financial statements should be reviewed to determine if they correctly reflect the transaction (UPE or Loan).
- If the financial statements record a 'loan' instead of a UPE, then if the client is audited, ask ATO to exercise its discretion that Division 7A does not apply to deem a dividend to have been paid to the trust.
- Going forward, ensure that a 'UPE' is recorded in the financial statements as:
 - an unpaid present entitlement; and
 - Trust Funds not as a liability.

Is a subsisting UPE a loan under section 109D(3)?

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- Section three of the draft ruling outlines the ATO view on whether a UPE is a loan as defined in section 109D(3).
- Section 109D(3) defines a 'loan' to include:
 - an advance of money;
 - a provision of credit or any other form of financial accommodation;
 - a payment of an amount for, 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;
 - a transaction (whatever its terms or form) which in substance effects a loan of money

Is a subsisting UPE a loan under section 109D(3)? ATO's View

28

- A company will have provided financial accommodation to a trust in which it has a UPE if that private company has, under a consensual agreement:
 - supplied or granted some form of pecuniary aid or favour to the trust; and
 - a principal sum or equivalent is ultimately payable.
- That is, where the company does not call for payment of the UPE the company has provided financial accommodation to the trust.
- Where the company allows the funds representing the UPE to be used for the benefit of the main trust, this is, providing financial accommodation or in substance is a loan of money to the main trust.

Is a subsisting UPE a loan under section 109D(3)?

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- The draft Ruling does not address the issue of 'at what point' does the ATO consider that a UPE to be 'subsisting'.
- There will not be a 'loan' where there is an investment of the funds representing the UPE for the company's absolute benefit (and no benefit accruing to the main trust for the use of those funds).

What does this mean?

30

- If the draft Ruling is finalised in its current form the ATO's view is that the company beneficiary has made a loan to the trust where it does not call on the payment of the UPE.
- Unless the UPE is to the absolute benefit of the company, there will be a loan for the purpose of section 109D(3).
- Unless there is a section 109N loan agreement between the company and the trust before the lodgement of the company's tax return for the year in which the loan was made, section 109D will apply (deemed unfranked dividend subject to the company's distributable surplus).

What does this mean?

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- However, as the ATO has taken a contrary view in the past, they will only apply their view in relation to a 'subsisting UPE' to UPEs arising on or after the date of the issue of the draft Ruling (16 December 2009).
- This means that provided that the UPE's for the 2009 and prior are correctly reflected in the accounts, the ATO will not treat them as a 'loans' as defined in section 109D(3).
- From the 2010 year, Subdivision EA will have limited application.

What should your clients do?

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- If the draft Ruling is finalised in its current form or if it is not withdrawn before the lodgement of the 2010 trust income tax return:
 - convert the UPEs for the 2010 year and onwards to a loan by agreement between the company and trust; and
 - the company and trust should enter into a complying section 109N loan agreement before the lodgement of the company's tax return for the year in which the loan is made.

Division 7A

Changes to apply from 1 July 2009

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Division 7A Proposed Changes

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- Application of Division 7A changes to private companies to apply from 1 July 2009
- Application of Division 7A changes to trusts who have a UPE to a private company from 1 July 2009

Application of Division 7A Change – Private Companies

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Private Companies - Application

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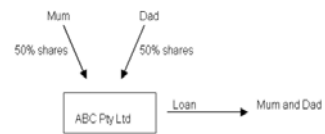
Division 7A applies where a **private company** on or after 4 December 1997 either:

- makes a loan to a shareholder (or associate);
- makes a payment for the benefit of a shareholder (or associate); or
- forgives a debt owed to the company by a shareholder (or associate)

Private Company Loans

- Division 7A applies if:
 - a private company makes a loan during the year to a shareholder or associate (who is not a company); and
 - the loan is not repaid at the end of the year.
- Division 7A only applies to private companies

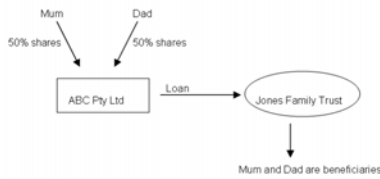
Example - Private Company Loans



Does Division 7A apply? **Yes**

- a private company
- has made a loan which remains unpaid at the end of the year
- to a shareholder

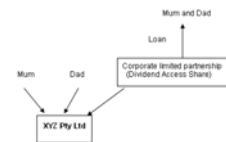
Example - Private Company Loans



Does Division 7A apply? **Yes**

- A private company
- has made a loan which remains unpaid at the end of the year
- to an associate of the shareholder

ATO – inappropriate arrangements



- XYZ Pty Ltd pays out accumulated profits to a Corporate Limited Partnership (CLP);
- CLP makes a loan to the shareholders (or associates) of XYZ Pty Ltd; and
- XYZ Pty Ltd may or may not have a distributable surplus at the end of the year.

Does Division 7A apply?

- CLP is treated as a company for tax purposes (section 94J 1936 Act); however
- CLP is not a private company (section 94N 1936 Act); therefore
- a private company has not made a loan to a shareholder or associate of XYZ.

Does Division 7A apply? **No**

ATO – inappropriate arrangements



- XYZ Trust has UPE to ABC Pty Ltd;
- XYZ Trust distributes income to CLP; and
- CLP makes a loan to the shareholders of ABC

Does Division 7A apply?

43

- CLP is treated as a company for tax purposes (section 94J 1936 Act); however
- CLP is not a private company (section 94N 1936 Act); therefore
- a private company has not made a loan to a shareholder or associate of XYZ.

Does Division 7A apply ? **No**

Proposed Amendment – 1 July 2009

44

A CLP will be considered a **private company** for the purpose of **Division 7A**

Issue with payments not being treated as a repayment?

45

- A repayment will not be counted if, when the payment was made it was reasonable to assume that the entity was going to re-borrow a similar or larger amount.
- However, under the rules prior to 1 July 2009, if an amount was 're-borrowed' first and the 're-borrowed' amount is used to make the payment, then, the payment would be counted as a 'repayment'.

Issue with payments not being treated as a repayment?

46

Example

- If shareholder:
 - had borrowed \$500,000 from the company during the 2009;
 - repaid the \$500,000 to the company on 30 June 2009; and then
 - re-borrowed \$500,000 back from the company on 3 July 2009

Repayment on 30 June 2009 would not be counted as having been made – loan balance at 30 June 2009 - \$500,000 **X**

Example

- If shareholder borrowed \$100,000 from the company on 1 July 2007.
- On 1 May 2009 (before the 2008 company tax return is lodged), the shareholder borrows a further \$100,000 from the company which it uses to repay the \$100,000 on 13 May 2009 (before 2008 company tax return is lodged).

Repayment on 13 May 2009 will be counted as having been made because funds were 'borrowed' because being repaid **✓**

Amount borrowed on 1 May 2009 is a new loan.

Proposed Amendment – 1 July 2009

47

Division 7A rules to be amended to ensure that a 're-borrowing' taken out before a loan is repaid will also be captured (section 109R).

Private Company Payments

48

- Division 7A applies if:
 - a private company pays an amount during the year to or for the benefit of a shareholder or associate (who is not a company); or
 - a reasonable person would conclude that the payment is made because the entity has been such a shareholder or associate at some time.
- A payment includes:
 - a payment made to, on behalf of, or for the benefit of an entity; and
 - the transfer of property.

Use of company assets

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- Up to 30 June 2009, Division 7A did not extend to the use of company assets for shareholders or their associates
- Example: ABC Pty Ltd owns a boat and a house which the shareholders use free of charge.
- There is no:
 - payment by the company to or for the benefit of the shareholders; or
 - transfer of property.

Does Division 7A apply ? **No**

Use of company assets - 1 July 2009

50

- 'Payments' to include the grant of a lease, licence or other right to use an asset (that is, benefits provided by way of a licence or right to use real property and chattels)
 - minor and infrequent benefits will be excluded (<\$300)
 - excludes benefits which would otherwise be deductible as a 'once only' deduction
 - a right to use a dwelling is excluded if:
 - the shareholder or associate carries on a business;
 - the shareholder or associate is granted to right to use the dwelling for the primary purpose of carrying on the business; and
 - the area of the dwelling is less than 10% of the area of the land.

Use of company assets

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- Value will be market value less any consideration given by the shareholder or associates
- Appears to apply to grants made on or after 1 July 2009

Distributable Surplus

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The adverse consequences of Division 7A is that the private company is taken to pay the shareholder (or associate) an **unfranked dividend at the end of the income year** in which the loan or payment is made or debt is forgiven.

Distributable surplus equals **net assets** less non-commercial loans less paid-up share value less repayments of non-commercial loans

Distributable Surplus

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Net assets means the amount (if any) **at the end of the company's year of income**, by which the company's assets exceed the sum of:

- the present obligations of the company;
- provisions for depreciation;
- provisions for annual leave and long service leave; and
- provisions for amortisation of intellectual property and trademarks.

No distributable surplus - no adverse Div 7A consequences

Distributable Surplus

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Example: In the 2009 year ABC Pty Ltd transfers all of its assets (equal to \$2 million in value) to an associate of the shareholder for no consideration. At the end of the 2009 year, ABC Pty Ltd does not have a positive net asset position.

Division 7A does not apply because ABC Pty Ltd does not have a distributable surplus. ✓

The associate is not a shareholder therefore the \$2 million is not a dividend under section 44(1). ✓

Distributable Surplus – 1 July 2009

55

- net assets; less
- non-commercial loans; less
- paid-up share value; less
- repayments of non-commercial loans; plus
- Division 7A payments and Debts Forgiven ☹️

Private Company - Forgiven Debts

56

- Division 7A applies if:
 - a private company forgives a debt during the year owed by a shareholder or associate (who is not a company); or
 - a reasonable person would conclude that the debt is forgiven because the entity has been such a shareholder or associate at some time.
- A debt is forgiven:
 - if the amount would be forgiven under the debt forgiveness provisions; or
 - a reasonable person would conclude that the private company will not insist on the amount being repaid.
- Be careful with statute barred debts – PS LA 2006/2
- No changes proposed

Application of Division 7A – Trusts (Subdivision EA)

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Trusts – Loans, Payments and Debts

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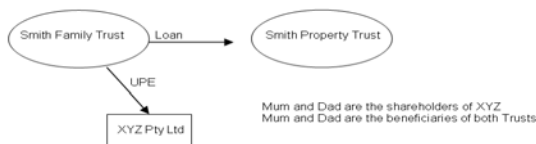
Subdivision EA applies where:

- on or after 12 December 2002 a trustee:
 - makes a loan to a shareholder (or associate) of the company;
 - makes a payment to a shareholder (or associate) of the company which is to discharge a present entitlement attributable to an unrealised gain; or
 - forgives a debt to a shareholder (or associate) of the company; and
- either:
 - the trustee has an UPE to the company at the time the loan, payment for debt forgiveness occurred and the UPE is not repaid before the lodgement (or due date) of the trust's tax return; or
 - the company becomes presently entitled to an amount after the loan, payment for debt forgiveness occur but before the lodgement (or due date) of the trust's tax return and is not repaid before that date.

However Subdivision EA does not apply where the shareholder or associate to whom the loan, payment or debt is forgiven is a company (does not need to be a private company)

Example – Trust Loan

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Does Subdivision EA apply? **Yes**

- Trust has UPE to a private coy
- and has made a loan
- to an associate of the shareholder of the private company

Example – Trust Loan

60



Does Subdivision EA apply? **No**

- Smith Family Trust has made a loan to an associate of the shareholder of the private company; however
- Smith Family Trust does not have an UPE to a private coy

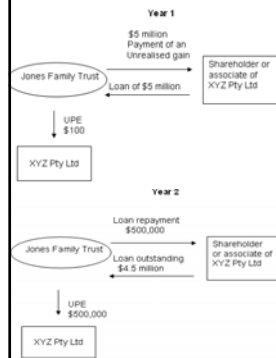
Example – Trust Loan



Does Subdivision EA apply? **No**

- Smith Family Trust has made a loan to ABC who is an associate of the shareholder of XYZ; however
- Subdivision EA does not apply where a loan is made to a company.
- Also, ABC does not have a distributable surplus therefore no Division 7A issues.

Example – Trust payments



Year 1

- Subdivision EA applies and the shareholder or associate includes \$100 in their assessable income as a deemed dividend.

Year 2

- Division 7A does not apply because the Jones Family Trust has not made a loan to an associate in Year 2.
- The \$500,000 payment is not a dividend because it is discharging an obligation of the Jones Family Trust to pay money to the shareholder (section 109J).

Proposed Amendment – 1 July 2009

Draft legislation:

- applies a 'reasonable' person test:
 - introduction of second trust - a reasonable person would conclude the company becomes entitled to an amount solely or mainly as part of an arrangement involving an entitlement to an amount from the 'target' trust;
 - loan to interposed loss company – a reasonable person would conclude that the trustee made the loan solely or mainly as part of an arrangement involving the loan to the target entity
 - distribution of unrealised gains – a reasonable person would conclude that at the time the original transaction took place, the shareholder intended to make the loans back to the trustee
- in relation to the first and second arrangements – the amount of the entitlement and loan will be determined by the Commissioner

Recap of proposed Changes from 1 July 2009

Summary of proposed Changes from 1 July 2009

- 'Payments' to include benefits provided by way of a licence or right to use real property and chattels
 - minor and infrequent benefits will be excluded (<\$300)
 - excludes benefits which would otherwise be deductible
- Corporate Limited Partnerships to be treated as a 'private companies' for the purpose of Division 7A
- Subdivision EA
 - loans to companies which do not have a distributable surplus;
 - introducing a second trust

Summary of proposed Changes from 1 July 2009

- Extending when a 'repayment' may be disregarded
 - Current – if a payment is made and a reasonable person would consider that it will be re-borrowed
 - Proposed – also includes where an amount is borrowed from the company first, then an amount is repaid
- Definition of distributable surplus
 - Distributable surplus is calculated at the end of the year
 - Therefore if there are no assets at 30 June, there will be no distributable surplus
 - Proposed - distributable surplus to include Division 7A 'payments' and 'amounts forgiven'



Thank You

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