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Tax Alert
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Division 7A - More hidden trust traps!

This Alert discusses some changes to Division 7A which may have been overlooked following the recent ATO publications dealing with trusts and unpaid entitlements. However these changes which also deal with trusts and interposed entities need to be properly understood, so that any exposure to Division 7A is promptly identified and dealt with.

Tax practitioners will, by now, be familiar with the Commissioner's interpretation of Division 7A in relation to trusts with unpaid present entitlements (**UPE's**) in favour of a private company beneficiary within a family group. The Commissioner's views were recently finalised in Taxation Ruling TR 2010/3 and Practice Statement Law Administration PS LA 2010/4.

Briefly, the upshot of the Commissioner's position is that a UPE that arises *after* 16 December 2009 will be a loan by the beneficiary to the trust within the meaning of Division 7A, unless that amount is held on a sub-trust. If there is a UPE and Division 7A applies, the Practice Statement gives guidance on the ways in which the UPE can be dealt with by the trust, thus avoiding the operation of Division 7A.

UPE's arising *before* 16 December 2009 can be quarantined, and the ATO will not treat them as being loans, but will still be subject to the existing rules in Subdivision EA.

However, it is the unheralded insertion of Subdivision EB into Division 7A which should now be the focus of tax practitioners dealing with their clients having trust entities, particularly as the provisions operated with effect from 1 July 2009.

So what are the new provisions?

The new anti-avoidance rules "look-through" entities and can deem loans or payments made to a target under an arrangement to avoid Division 7A, as if they were made without the interposed entities being involved.

The rules were introduced because arrangements were detected by the Commissioner that either avoided the operation of Division 7A altogether, or otherwise led to a limited exposure to Division 7A, which was contrary to the intended effect of Subdivision EA.

The Explanatory Memorandum introducing the changes explained the effect of the changes as follows:

> *"1.40 Under these amendments, where a corporate beneficiary has a present entitlement to an amount from the net income of a trust estate and the whole of that amount has not been paid, and an entity is interposed between that trust and a target entity (the shareholder of the private company or their associate), the trust is treated as having directly paid or loaned an amount to the target entity for the purposes of Division 7A. Subdivision EA then operates as if the trustee makes a payment or loan to the target entity"*

Importantly, the provisions of Subdivision EB can operate where the relevant UPE came into existence *before* 1 July 2009.

Section 109XE summarises the effect of the new provisions in Subdivision EB:

> ***Payments and loans***
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> *This Subdivision allows an amount to be included in an entity's (the target entity's) assessable income under Subdivision EA if an entity interposed between a trustee and the target entity makes a payment or loan to the target entity under an arrangement involving the trustee.*
>
> *This result is achieved by treating the trustee as making a payment or loan of an amount*

determined by the Commissioner to the target entity.

The arrangement must involve the trustee and one or more interposed entities in making payments or loans for the purpose of the target entity receiving a payment or loan from an interposed entity.

If the target entity repays a fraction of the loan made by the interposed entity, the target entity is treated as repaying the same fraction of the loan taken to have been made by the trustee.

Some provisions that prevent payments or loans from giving rise to assessable income do not apply to payments or loans this Subdivision treats a trustee as making.

Present entitlements

*This Subdivision similarly allows an amount to be included in an entity's assessable income under Subdivision EA if a private company is or becomes presently entitled to an amount from the net income of a trust estate interposed between the private company and another trust estate (the **target trust**) under an arrangement involving the target trust.*

A summary of the operative provisions of Subdivision EB is below:

Section 109XF deems certain loans or payments made by a trust with a UPE (**head trust**) between interposed entities to a target entity, to be a payment from the head trust to the target.

A typical arrangement that would attract the operation of section 109XF, would be where the head trust with a UPE lends an amount to a second trust which makes a payment to a target who is an associate. In such a case, the head trust would be deemed to have made a payment to the target directly, ignoring the existence of the interposed second trust.

Section 109XG operates identically to section 109XF, however it only deals with loans in certain circumstances.

Section 109XH says that the amount the trustee is taken under section 109XF or 109XG to have paid or lent the target entity is the amount (if any) determined by the Commissioner.

Section 109XI deals with the arrangement involving the interposing of one or more trusts between a private company beneficiary and the trust that makes the payment or loan to the shareholder (or their associate) which circumvents the operation of Subdivision EA.

A typical arrangement to which section 109XI will now apply to, involves a head trust that distributes, but does not pay, net income to a second trust, which in-turn distributes, but does not pay, that net income (or a portion of it) to a private company beneficiary, and the head trust entering into a transaction with an associate, which would otherwise give rise to the operation of Division 7A.

In such a case, the private company will now be taken to have a UPE from the head trust so that Division 7A can apply to the relevant transactions, and the amount of the UPE is to be determined by the Commissioner.

The operation of section 109XI, and the amount which the Commissioner determines, is the subject of a draft taxation determination, TD 2010/D9, which was issued on 15 December 2010.

Another draft taxation determination, TD 2010/D10, which was issued on the same date, deals with a similar issue, but relates to section 109T.

Tax practitioners should take this opportunity to look at their client groups with impending lodgement deadlines, to review any transactions involving trusts with UPE's, to assess whether the provisions of subdivision EB apply, and if so, seek guidance on how to deal with such issues.

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