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## Important changes to Division 7A

In the lead up to Christmas, the Australian Taxation Office released Draft Taxation Ruling TR 2009/D8 dealing with the application of **Division 7A to unpaid present entitlements** ("UPEs"), the consequences of which could be very significant for you or your clients.

The default position will be that future UPEs (from 16 December 2009) and many existing UPEs from a trust to a private company will constitute loans for Division 7A purposes. As they will be considered to be a loan from a private company to an associated trust, standard Division 7A loan terms will need to be applied.

The position asserted by the ATO in the draft ruling represents a significant departure from the previously accepted practice and will have a material impact on the way that discretionary trusts utilise corporate beneficiaries.

At a general level, the ATO are asserting that many amounts treated as UPEs are in fact loans. This means that the core provisions of Division 7A (s109D) apply to the "loan" from the corporate beneficiary to the trust. Where a genuine UPE exists, rather than a loan, Subdivision EA (s109XB) would have residual application.

There are a number of elements to the ATO's approach. The key factors that should be taken into account when preparing 2009 accounts and tax returns, or considering 2010 distributions, are shown below.

### Accounting

Where the corporate beneficiary and the discretionary trust are part of the same family group, in that they are controlled directly or indirectly by the same people, the ATO will treat the accounting records as evidence of the nature of the transactions between the parties. If the UPE is described as a "loan" in the accounting records of the corporate beneficiary or the trust, the ATO will treat it as a loan. This will trigger Division 7A implications for the discretionary trust.

It is, therefore, particularly important that the financial statements you prepare correctly describe balances as either loans or UPEs and that the client's accounting records do the same.

An amount described as a UPE in the accounting records can still be treated as a loan for Division 7A purposes. This may arise in circumstances where the funds are not maintained in a separate trust, or the terms of the trust deed consider the amount to be a loan (discussed below).

### Trust Deeds

Some trust deeds include a clause that treats an unpaid distribution to a beneficiary as a loan. Where such a clause is present in the trust deed, the ATO will treat the UPE as a loan and Division 7A will apply to the trust.

Other trust deeds create a sub-trust or a separate trust over the unpaid distribution. Where such a clause is present, there is scope for Division 7A not to apply to the unpaid distribution. However, where the funds attributable to the sub-trust or separate trust are not appropriately separated from the main trust, the ATO will treat the UPE as a loan. As such, it may be challenging to show that the funds are appropriately separated from the main trust where they continue to be inter-mingled with the funds of the main trust.

It is now more important than ever to read and understand the trust deed and ensure that the accounting and tax treatment applied by the trust is consistent with the trust deed.

### Existing UPEs

It is proposed that when the ruling is finalised, it will apply both retrospectively and in the future. There appears, however, to be some scope for UPEs existing at 16 December 2009 to be excluded from the application of the draft ruling, although the scope of that exclusion is not clear. We expect it will be similar to the s108/Division 7A treatment, so that changes in the UPE will "refresh" the balance and bring it within the scope of the draft ruling.

## Next Steps

Submissions are currently being prepared in response to the draft ruling and it is likely to be the subject of some rigorous discussions with the ATO.

Your default position should be that future UPEs will constitute loans for Division 7A. If you believe that you can substantiate an amount as a genuine UPE, then the accounting records, trust deed and concept of separation from the main trust need to be adequately considered.

We are also working on determining how the benefits of the existing use of corporate beneficiaries can be maintained post implementation of these changes. This may require clients to restructure their affairs to varying degrees.

As the ATO are likely to take a more active compliance approach in respect of UPEs and Division 7A, we would recommend that you review any likely exposures for your clients with material Division 7A loans or UPEs.

We will keep you updated with any developments on this issue

## Contact Us

If you have any questions about the issues contained in this newsletter, please contact your **William Buck** advisor.

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