

# Tax Events

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## Trusts – Division 7A & UPES

Taxation Determination TD 2022/D1

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## 1. Introduction<sup>1</sup>

On the release of taxation ruling TR 2010/3, the Commissioner ruled that where a trustee:

- (a) distributed trust income to a company; and
- (b) the beneficiary company did not seek payment of that distribution (generally creating an unpaid present entitlement (**UPE**),

the company had provided “financial accommodation” to the trustee and pursuant to section 109D(3)b) ITAA 1936, and accordingly the company had made a loan to the trustee. Subject to the other section 109D conditions, the company had a Division 7A loan which prima facie would be a deemed dividend.

In conjunction with the release of TR 2010/3 and in part due to the Commissioner’s change of interpretation of section 109D as it applied to UPE’s, the Commissioner also released PS LA 2010/4.

PS LA 2010/4 provided taxpayers with a “concessional” Division 7A opportunity to treat the Division 7A UPE as a 10 year interest only “loan arrangement” rather than requiring the taxpayer to arrange for a section 109N ITAA 1936 complying loan arrangement (usually a principal and interest arrangement over a 7 year term). The cash flow benefit, albeit a deferred benefit, provided by PS LA 2010/4 lessened the onerous financial obligations where a company is used as a corporate beneficiary.

Subsequent to the introduction of TR 2010/3, Treasury had released a Division 7A consultation document which included, inter alia, a recommendation that a statutory amendment should be introduced to formalize the treatment of a UPE as the provision of financial accommodation for the purposes of section 109D ITAA 1936. To date there has been no Government acknowledgement of Treasury’s recommendation.

Accordingly and so it would seem, in the absence of the Government formalizing inter alia, the statutory Division 7A treatment of UPE’s, the Commissioner has decided to publish TD 2022/D1 which effectively introduces the Treasury recommendation by public ruling.

It is proposed that the TD when finalized in its present form will be applied to trust entitlements arising after 1 July 2022 and TR 2010/3 and PS LA 2010/4 will be withdrawn from that date. Relevantly, this should further maintain the Commissioner’s position with respect to UPEs that were in existence before 16 December 2009 will not change (as they fall outside the scope of TR 2010/3).

The practical result of this changed Division 7A UPE position will be the cash flow implications. With the withdrawal of PS LA 2010/4, the corporate beneficiary will now have to cash flow the repayment of the UPE (“deemed loan”) by a 7 year principal and interest payment program (section 109N) as compared to the current PS LA 2010/4 a 10 year “interest only” arrangement with the capital payment at the end of the term.

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## 2. Taxation Determination – TD 2022/D1

### 2.1 Overview

As was first provided by the ATO in TR 2010/3, the Commissioner now affirms that previous opinion in TD 2022/D1. The TD differentiates two circumstances:

- (a) There is an UPE; and

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<sup>1</sup> All statutory references are to Income Tax Assessment Act 1936 unless otherwise stipulated

(b) Where there is a sub-trust.

The point of difference and its relevance to the Division 7A application made by the draft TD is relevant to the timing when a loan is made for the purposes of section 109D. However, in the majority of discretionary trust circumstances there will be no practical differences.

## 2.2 Amounts Set Aside – This is the Standard Arrangement

In that regard I note that the Acis standard discretionary trust deed<sup>2</sup> provides that amounts set aside for the beneficiary is held by the trustee on a “sub-trust” arrangement.

### *3.9 Amounts Set Aside*

*Any amount Set Aside or held by the Trustee on behalf of a Beneficiary under this Deed, will no longer form part of the Trust Fund, but will be **held by the Trustee as a separate trust fund upon trust for the relevant Beneficiary absolutely**. The Trustee has the Right (but not the Obligation), pending payment to the Beneficiary, to invest or apply that amount for the benefit of the Beneficiary or deal with that fund, or any resulting Income, in any manner provided for in this Deed in relation to the Trust Fund.*

Notwithstanding this general trust deed provision for most lawyer’s precedent deed - it is relevant to note the differentiation the taxation determination provides.

## 2.3 Taxation Determination – Application to Different Circumstances

### **Circumstance 1 –Distribution is a UPE**

Having regard to the predominance of trust deeds that I have reviewed, the situation where a trust distribution is simply held as an UPE will be unusual. Notwithstanding this fact, the TD provides for the timing of the loan would generally be that provided by paragraph 10, second dot point.

It is the failure of the corporate beneficiary to call for immediate payment of their entitlement when they become aware of their trust entitlement that constitutes the provision of financial accommodation.

*6. Where a private company beneficiary is made presently entitled to trust income and that entitlement is not satisfied, there is a UPE.*

*7. A private company beneficiary with a UPE, by arrangement, understanding or acquiescence, consents to the trustee retaining that amount to continue using it for trust purposes if the company:*

- *has knowledge of an amount that it can demand immediate payment of from the trustee, and*
- *does not demand payment.*

*8. This constitutes the provision of financial accommodation to the trustee under paragraph 109D(3)(b). As a result, the private company beneficiary makes a loan to the trustee under the extended definition of a 'loan' in subsection 109D(3).*

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<sup>2</sup> From my experience, the respective precedent trust deeds prepared by other lawyers, similarly provide that amounts “set aside” by the trustee, are held by the trustee on a separate trust for the absolute benefit of the nominated beneficiary and that amount does not form part of the main trust – that is, a sub-trust is created.

9. *The private company beneficiary makes a loan when the financial accommodation is provided.*[9]

*This will occur at the point in time when the private company beneficiary has knowledge of an amount that **it can demand immediate payment** of from the trustee **and does not demand payment** of the amount.*

10. *If the **private company beneficiary and the trustee have the same directing mind and will**, the private company beneficiary **is taken to have knowledge** of the amount that it can demand immediate payment of from the trustee **when the trustee does**.*

11. *The time when the amount of a beneficiary's entitlement is known will depend on how that entitlement is expressed. If a trustee resolves to make a private company beneficiary presently entitled to:*

- *a **fixed amount** from the trust income, the private company beneficiary **has a right to demand** immediate payment of that amount from the trustee, or*
- *a **percentage of trust income**, or some other part of trust income identified in a calculable manner, the private company beneficiary cannot demand immediate payment from the trustee; it will **only be** able to demand immediate payment of an amount from the trustee **when the trust income** (or the relevant part they are entitled to) **is calculated**, typically after the end of the relevant income year.*

#### **Circumstance 2 – Where the Distribution is put on a Sub-Trust Arrangement**

As with circumstance 1, where there is a sub-trust arrangement – the provision of financial accommodation will occur (para 8o) when the corporate beneficiary "...By not exercising its right to call for payment of the sub-trust fund, the private company beneficiary consents or acquiesces to the provision of financial accommodation to the entity that is using the sub-trust fund (or part of the sub-trust fund)."

That is, whereas if the trust distribution is put on sub-trust arrangement, there is no Division 7A issue, unless where a UPE is placed on a sub-trust arrangement, there will be no provision of financial accommodation unless and until the associated funds are used by the private company beneficiary's shareholder or associate, which would invariably be the trust itself.

The TD more particularly provides:

12. *Where a private company beneficiary is made presently entitled to trust income and the trustee sets aside an amount from the main trust and holds it on sub-trust for the exclusive benefit of the private company beneficiary, **the present entitlement to income is paid and there is no UPE**. The amount set aside by the trustee ceases to be an asset of the main trust and forms the corpus of the sub-trust (the sub-trust fund). **The trustee's obligation in respect of the entitlement to distributed income comes to an end and a new obligation arises for the sub-trustee under a separate trust.***

13. *The private company beneficiary has a new right to call for payment of the sub-trust fund and can call the sub-trust to an end. **A choice by the private company not to exercise that right does not constitute financial accommodation in favour of the trustee in its capacity as trustee of the sub-trust**, because the sub-trust fund is held for private company beneficiary's sole benefit.*

14. ***However**, the private company beneficiary by arrangement, understanding or acquiescence, consents to the sub-trustee allowing those funds to be used by the private company beneficiary's shareholder or their associate if:*

- all or part of the sub-trust fund is used by that entity, and
- the private company beneficiary has knowledge of this use.

15. ***This constitutes the provision by the private company beneficiary of financial accommodation to the entity using the sub-trust fund under paragraph 109D(3)(b).*** This will be the case whether or not the use of the sub-trust fund is on commercial terms whereby a return is paid to the sub-trust fund. As a result, the private company beneficiary makes a loan to the entity using the sub-trust fund under the extended definition of a 'loan' in subsection 109D(3).

16. The private company beneficiary makes a loan when the financial accommodation is provided; that is, the point in time when the private company beneficiary has knowledge of the use of an amount of the sub-trust fund and does not call for payment of that part of the sub-trust fund by the private company beneficiary's shareholder or their associate. The amount of the loan in those circumstances is the amount of the sub-trust fund that the private company knows (or is taken to know) is used by its shareholder or their associate.

17. If the private company beneficiary and the trustee have the same directing mind and will, the private company beneficiary is taken to have knowledge of the use of the sub-trust fund (or part of the sub-trust fund) when the trustee does.

I note that paragraph 52 highlights the subtle distinction where an amount is set aside on a sub-trust arrangement;

52. A private company's choice not to exercise its right to end the sub-trust does not constitute financial accommodation in favour of the trustee of the sub-trust (in that capacity), because the sub-trust fund is held for the private company beneficiary's sole benefit. However, if the funds are retained for use by the trustee in its capacity as trustee of the main trust or otherwise used by another shareholder or associate of a shareholder of the private company, as explained in this Determination, this may amount to the provision of financial accommodation by the private company beneficiary.

### **Distinction with the two Circumstances**

The distinction between circumstance 1 and circumstance 2 is simply that there is a different trust to whom the "financial accommodation" has been provided- circumstance 1 the accommodation is made to the main trust whereas in circumstance 2, the financial accommodation is made to the sub-trust.

Refer to examples 1 & 3 as being typical family trust situations, particularly example 3 would be the most common circumstance.

### ***Example 3 - circumstance two: use of sub-trust fund by the trustee of AB Family Trust - no commercial rate of return***

Additional fact to those provided in example 2 – amount set aside and held on a sub-trust arrangement by the same trustee as for the main trust.

37. Assume the same additional facts as in Example 2 of this Determination and that Trustee Ltd uses the \$10,000 set aside on sub-trust fund for the purposes of AB Family Trust.

#### Application of Division 7A

38. When Trustee Ltd sets aside \$10,000 on sub-trust, the money is no longer part of the main trust fund. It is the corpus of the sub-trust. There is no outstanding UPE as Trustee Ltd,

in its capacity as trustee for AB Family Trust, has no further obligations in relation to the distributed income.

39. As X Co and Trustee Ltd are controlled by Ashley and Bo, X Co is taken to have knowledge that the sub-trust fund is being used by Trustee Ltd for the purposes of AB Family Trust. Trustee Ltd as trustee for AB Family Trust receives a benefit, being the use of the sub-trust funds. This is the provision of financial accommodation to Trustee Ltd as trustee for AB Family Trust.

40. X Co can call for payment of its entitlement held on sub-trust if it does not agree to those funds being used for the purposes of AB Family Trust. On the facts, there is no evidence to suggest that X Co does anything other than acquiesce to Trustee Ltd using those funds for the purposes of AB Family Trust. Accordingly, X Co allows (and is taken to agree to) the use of funds to which it is entitled for the purposes of AB Family Trust.

41. In this example, X Co has provided financial accommodation to Trustee Ltd as trustee for AB Family Trust. X Co is taken to have made a loan to Trustee Ltd under the extended definition of a 'loan' in subsection 109D(3) when the sub-trust fund was so used.

In the vast majority of circumstances, there will be no practical circumstances – the timing of the loan will be when the trustee, albeit of the main trust or the sub-trust, has knowledge of the distribution.

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### 3. Practical Illustration – Taxation Determination Example 6

Whereas this example relates to the trust distribution being held by the main trust as an UPE, the Division 7A requirements are similar for the different treatment of the trust distributions.

#### **Example 6 - present entitlement to a percentage share where trust income is subsequently determined**

111. Ashley and Bo are spouses and they have organised their family business affairs via a discretionary trust, AB Family Trust. Ashley and Bo control Trustee Pty Ltd, the trustee of their discretionary trust.

112. X Pty Ltd, a private company that is a beneficiary of AB Family Trust, is controlled by Ashley and Bo.

113. **On 30 June 2023**, Trustee Pty Ltd resolves that 100% of AB Family Trust's income for the 2022-23 income year be distributed to X Pty Ltd.

114. At 30 June 2023, **X Pty Ltd does not know the amount of trust income**, if any, that it can demand immediate payment of from Trustee Pty Ltd.

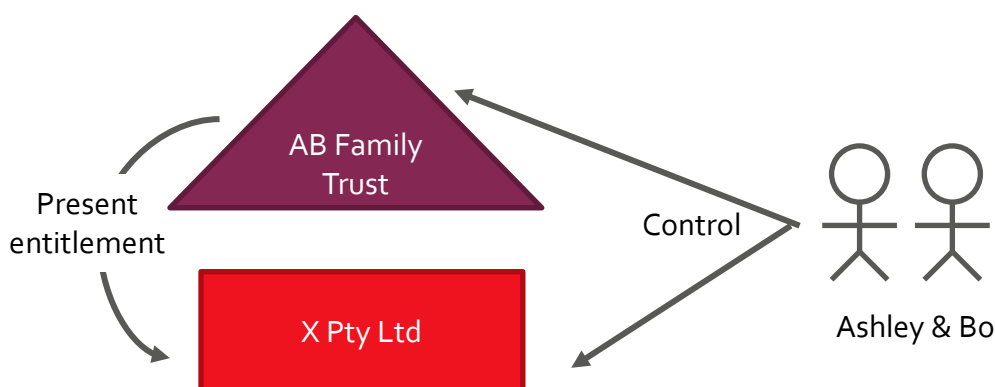
115. On **1 August 2023**, Trustee Pty Ltd **determines the net income of AB Family Trust as \$50,000**. X Pty Ltd **has a right to demand immediate payment of \$50,000 from Trustee Pty Ltd on 1 August 2023**.

116. The distribution and UPE are recorded in the accounting ledger of AB Family Trust as being a distribution for the year ended 30 June 2023 and the entries are:

DR Loan - Trust distribution	\$50,000
CR UPE - X Pty Ltd (liability)	\$50,000

117. In the accounting ledger of X Pty Ltd, the transaction is recorded as:

DR UPE - AB Family Trust (asset)	\$50,000
CR Trust distribution (income)	\$50,000



### Tax consequences

118. X Pty Ltd is **taken to have knowledge of the amount** it can demand immediate payment of from Trustee Pty Ltd on **1 August 2023**. If X Pty Ltd does not demand immediate payment of the \$50,000, then it provides financial accommodation to Trustee Pty Ltd as trustee for AB Family Trust in the 2023-24 income year.

119. X Pty Ltd's lodgment day for the 2023-24 income year is **15 May 2025**.

120. To avoid a deemed dividend under Division 7A, X Pty Ltd and Trustee Pty Ltd as trustee for AB Family Trust **agree to discharge the UPE**; on **15 May 2025 they enter into a new loan that meets the requirements of a complying loan agreement and set-off their respective obligations**. That is, Trustee Pty Ltd's obligation to pay the UPE to X Pty Ltd and X Pty Ltd's obligation to fund the complying loan are set off against each other.

121. The discharge of the UPE and the new complying loan agreement are recorded in the accounting ledger of AB Family Trust on 15 May 2025 as follows:

DR UPE - X Pty Ltd	\$50,000
CR Loan - X Pty Ltd (liability)	\$50,000

122. In the accounting ledger of X Pty Ltd, the transaction is recorded as follows:

DR Loan - AB Family Trust (asset)	\$50,000
CR UPE - AB Family Trust	\$50,000



123. **The first minimum yearly repayment under the complying loan agreement will be due by 30 June 2025.** That is, the transaction replacing the UPE with a formal loan is not treated as a new loan made in the 2024-25 income year. To avoid Division 7A consequences, subsequent minimum yearly repayments are required to be made until the loan is fully repaid by 30 June 2031.

#### Timeline – present entitlement to a percentage share

30/6/2023	Private company beneficiary becomes presently entitled to 100% of trust income.
1/8/2023*	The income of the trust is determined. The private company beneficiary provides financial accommodation to the trustee.
15/5/2025**	The trustee discharges its obligation in respect of the UPE. The private company beneficiary and the trustee enter into a new loan that meets the requirements of a complying loan agreement by this date.
3/6/2025	The first minimum yearly repayment under the complying loan agreement is due by this date

\*Date may be different depending on when the income of the trust is determined for the 2022-23 income year.

\*\*Date may be different depending on the lodgement day of the private company beneficiary's tax return.

## 4. Other Matters

### 4.1 Timing

As will be noted from the above discussion, where the trustee appropriates the trust income using the "percentage" share method, the provision of financial accommodation is linked to the date when the trustee/beneficiary become aware of the amount of the entitlement.

As would be usual, this will not usually occur until the finalisation of the financial accounts for the trust.

Care will need to be exercised to ensure the corporate beneficiary understands the Division 7A timing requirements in relation to:

- (a) When is the section 109D loan is made;
- (b) What steps need to be implemented by the relevant date (lodgment of the company's tax return), either to:
  - (i) Repay the loan; or
  - (ii) Prepare a section 109N complying loan agreement, and
- (c) Ensure the minimum loan requirements (section 109E) are satisfied.

#### 4.2 Interaction with Subdivision EA (Section 109XA)

Subdivision EA (section 109XA) applies where a trustee makes, inter alia, a loan to a shareholder or associate of a private company, at a time when the trust has an unpaid present entitlement.

*Section 109XA(2) Section 109XB applies if:*

- (a) *a trustee makes a loan (including a loan through an interposed entity as described in section 109XG) to a shareholder or an associate of a shareholder of a private company (except a shareholder or associate that is a company) (the actual transaction); and*
- (b) *either:*
  - (i) *the company is presently entitled to an amount from the net income of the trust estate at the time the actual transaction takes place, and the **whole of that amount has not been paid to the company** before the earlier of the due date for lodgment and the date of lodgment of the trustee's return of income for the trust for the year of income of the trust in which the actual transaction takes place; or*
  - (ii) *the company becomes presently entitled to an amount from the net income of the trust estate after the actual transaction takes place, but before the earlier of the due date for lodgment and the date of lodgment of the trustee's return of income for the trust for the year of income of the trust in which the actual transaction takes place, and the whole of the amount has not been paid to the company before the earlier of those dates.*

In relation to the application of the above section, the Commissioner had determined that even in those circumstances that the trustee/company had decided to apply PS LA 2010/4, the sub-trust arrangement did not negate the application of section 109XA(2) because the ATO still considered the main trust had not paid the trust distribution to the corporate beneficiary.

Refer to PS LA 2010/4:

#### ***Can Subdivision EA of Division 7A apply if the UPE is placed on sub-trust for the sole benefit of the private company beneficiary?***

*106. Yes, Subdivision EA of Division 7A can still apply, because the private company's equitable right to call for the payment of the UPE still exists notwithstanding that the UPE has been placed on sub-trust and invested back into the main trust.*

*107. For example, if funds representing a UPE are placed on sub-trust and the trustee of the sub-trust invests that amount back into the main trust using Option 1 and then the trustee of the main trust makes a loan or payment to an individual shareholder of the private company, Subdivision EA can apply. If Subdivision EA applies then the amount paid or lent to the individual private company shareholder could be treated as an assessable dividend paid to that individual.*

Noting of course that PS LA 2010/4 will be withdrawn as from 1<sup>st</sup> July 2022 coinciding with the introduction of TD 2022/D1.

Notwithstanding all of the above, TD 2022/D1 surprisingly states with regard to subdivision EA, that:

145. Taking that background into consideration, the Commissioner considers that the express terms of subsection 109D(3) are not required to be interpreted in a constrained way to accommodate a specific integrity rule within Division 7A (that is, Subdivision EA).

146. Consistent with the legislative context of Division 7A, an amount that has been treated as a loan and dealt with under section 109D (for example, a UPE that constitutes financial accommodation and is made subject to a complying loan agreement, as described in paragraphs 93 to 95 of this Determination) should be regarded as a loan for all purposes of Division 7A, including Subdivision EA. Accordingly, the Commissioner will not treat a UPE in those circumstances as a present entitlement that remains unpaid for Subdivision EA purposes. This is consistent with the position taken in TR 2010/3.

147. Subdivision EA also still has scope to operate in circumstances where the UPE of a private company does not result in financial accommodation (for example, because the private company does not have knowledge of the amount that it can demand immediate payment of from the trustee at the relevant time).

148. As described in paragraph 12 of this Determination, where a private company beneficiary is made presently entitled to trust income and the trustee sets aside an amount from the main trust and holds it on sub-trust for the exclusive benefit of the private company beneficiary, the present entitlement to income is paid and there is no UPE. In those circumstances, the conditions for Subdivision EA to operate are not satisfied.

**Brian Richards**

**April 2022**

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