

# Tax Law Update

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## Developments in Division 7A Loans, Bamford and Superannuation

by Peter Gell, Partner

### Taxation Ruling TR 2010/3 – Income Tax – Division 7a Loans – Trust Entitlements

Taxation Ruling TR 2010/3 was issued on 2 June 2010. The ruling sets out the opinion of the Commissioner on the circumstances in which a private company having a present entitlement to an amount from an associated trust estate makes a loan to that trust within the meaning of section 109D(3) of Division 7A of Part III of the *Income Tax Assessment Act 1936*. (the “Act”)

The ruling follows on from the ruling in draft form issued as TR 2009/D8 on 16 December 2009.

Ruling TR 2010/3 identifies 2 species of loans.

The first is a loan within the ordinary meaning of a loan. The ruling concedes that a subsisting unpaid present entitlement is not of itself an ordinary loan. Three broad circumstances are identified however where an unpaid present entitlement may be converted to a loan:

- (a) where an unpaid present entitlement is satisfied by being paid out by the trustee to the beneficiary and then lent back to the trustee;
- (b) an implied agreement which may arise where the private company has knowledge that the trustee

has treated the unpaid present entitlement as having been satisfied evidenced for example by crediting a loan account in the name of the private company beneficiary with acquiescence on the part of the private company to that treatment;

- (c) where the terms of the trust deed allow the trustee to make a loan on behalf of the private company. There can be clauses in a trust deed which permit the trustee to pay or apply money to or for the benefit of the beneficiary. Acting pursuant to such a power the trustee may apply trust funds for the benefit of the private company beneficiary by crediting a loan account in that private company's name and assuming a corresponding obligation to repay the sum so credited.

The ruling in its application to loans arising on this “ordinary” basis, applies to all existing loans – that is, the application of the ruling is not prospective. Where a loan occurs in these circumstances and where the unpaid present entitlement is mingled with trust funds generally there will be specific issue for trustees to consider as the trustee may find itself with a deemed dividend equal to the amount of the unpaid present entitlement.

Division 7A loans within the extended meaning – that is, loans that are not “ordinary loans” but which arise from the terms of section 109D (3) of the Act – are affected only if the unpaid present entitlements arose after 16 December 2009.

Section 109D(3)(c) defines a loan as including “a payment of an amount for or on account of or on behalf of or at the request of an entity if there is an express or implied obligation to repay the amount”.

The ruling analyses these principles by considering whether the supply or grant of some pecuniary aid or accommodation can amount to a loan.

The Commissioner's reasons for attacking unpaid present entitlements on this basis are expressed in paragraph 39 as follows:

*“A significant practice has developed of making a corporate beneficiary presently entitled to some or all of the income of a trust, usually a discretionary trust but not paying that entitlement ... economically the practice replicates a trustee accumulation and the policy of the law is thereby being compromised where the trustee uses the income for effectively no cost for trust purposes and not for the*

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*benefit of its real owner the corporate beneficiary.”*

If a private company beneficiary with knowledge that the trustee has credited an unpaid present entitlement as a loan from the private company and the private company acquiesces to that treatment the arrangement will be treated as a loan for Division 7A purposes. In considering the “knowledge” the private company may have of the trustee’s actions basically the Commissioner will apply a presumption of knowledge where both the trustee and the private company beneficiaries are entities within the same family group. This knowledge is taken to have occurred in the year following the treatment of the unpaid present entitlement. Precisely when in the income year following is not made clear.

### What is the effect of the ruling?

The ruling is particularly problematic for loans in the ordinary sense which may be created by the crediting of an unpaid present entitlement as a loan in the trust. There would be many circumstances where a crediting has already occurred. The ruling requires any such “loan” to be fully repaid before the company’s lodgment day for the income year in which the loan is made or the loan committed to a loan agreement complying with the minimum interest rate and maximum loan term as set out in section 109N of the *Income Tax Assessment Act 1936*. This opportunity may already have passed for many trusts. There may be many sleeper Division 7A issues which have already arisen and which are incapable of remedy.

The application of Divisions 7A to the financial accommodation scenario also means in reality that the only way a deemed dividend can be avoided is to provide for unpaid allocations owing to corporate beneficiaries to be held on separate

sub trust and not inter mingled with the rest of the trust fund assets.

### Decision Impact Statement: *Commissioner of Taxation v Philip Bamford & Ors*

The Commissioner of Taxation has issued a decision impact statement in relation to the Bamford case. It was issued on 2 June 2010.

The statement contains a concise summary of the facts and the issues relating to the meaning of the “income of the trust estate” and the meaning of “that share” under the terms of section 97(1) of the *Income Tax Assessment Act 1936*. The facts of the case and the conclusions reached by the High Court have been the subject of a previous tax case note issued by Hunt & Hunt.

The Tax Office view of the decision adopts the propositions which emerge from the High Court’s decision. That is:

- the income of a trust estate for trust law purposes and its income for tax purposes are 2 different subject matters;
- in section 97(1) the phrase “income of the trust estate” takes its meaning from the general law of trusts and not from taxation law;
- under the general law of trusts the concept of “income” is governed by rules designed to ensure that trustees fairly apportion receipts and outgoings of a period between those entitled to income and those with an interest in capital;
- the rules of apportionment adopted by the general law of trusts take the form of presumptions about whether particular receipts or outgoings constitute income or capital. The presumptions can be displaced by the trust deed itself;
- broadly when the calculation

is done in determining the share of the trust income to which a beneficiary is presently entitled under section 97 that percentage is then applied to the net tax income to work out the amount which is included in the assessable income of the beneficiary under section 97(1)(a) of the *Income Tax Assessment Act*.

Interestingly, the ruling contains a comment which is suggestive of a difficulty now in streaming income:

*“Subject to the possible operation of provisions outside Division 6, the amount included in a beneficiary’s assessable income under section 97 consists of an undissected or unallocated proportionate share of the entirety of the tax net income.”*

What the Commissioner means by this paragraph has not been made expressly clear and the Commissioner has indicated that a number of issues remain uncertain from the decision. These issues include particularly the following:

- the effect for trust law purposes of provisions in trust deeds which equate the trust’s distributable income with its tax net income where the tax net income includes notional amounts such as franking credits or deemed capital gains or where the time at which the income is recognised for tax purposes differs from the time at which it is recognised for trust accounting purposes;
- how a trust’s distributable income is to be determined where the trust instrument employs different notions of income for different purposes;
- how the statutory flow-through provisions relating to discount capital gains and trusts and

franking credits and trusts interact with Division 6.

These issues and others are to be the subject of consultation and further discussion. There may be further practice statements issued in the future.

In the meantime of particular interest is the repeal of practice statement PS LA 2005/1 which dealt with the taxation of capital gains of a trust. Broadly speaking that practice statement allowed the tax liability to follow the trust dollars in circumstances where there may have been differing entitlements to the income and the capital of the trust and the trust derived a capital gain which is income for tax purposes but not for trust law purposes. It will be interesting to see what will be the replacement practice statement dealing with that specific issue.

### Proposed changes to superannuation – Superannuation Industry (Supervision) Amendment Bill 2010

This Bill has been introduced to the Lower House and has been

the subject of debate at this time. The Bill inserts a new section 67A. This section includes the definition of “acquirable asset”. Under the legislation the term “asset” must now be read in the singular so that it is not interpreted as permitting borrowing arrangements over multiple non identical assets. The definition does however permit borrowing arrangements over a collection of assets that are identical and have identical market value such as a collection of ordinary shares in a company or a collection of units in a unit trust that have the same fixed rights attached to them or a collection of economically equal and identical commodities.

The explanatory memorandum to the Bill deals with real property in paragraphs 1.14 and 1.15. In the case of purchase of real property a single title for land and the accompanying house on it is considered a “single acquirable asset”. Additional items such as furnishings will not be allowed to be purchased through the same limited recourse borrowing arrangements. Leasehold

arrangements are permitted as explained in paragraph 1.15.

Associated expenses in acquiring the underlying asset can be included as part of the borrowing. Section 67A(1)(a)(i) allows expenses that are considered to be extrinsically linked to the purchase of the acquirable asset to be included in the borrowing. Examples are given of conveyancing fees, stamp duty, brokerage or loan establish costs.

The Bill also clarifies the provision of guarantees by third parties in support of the limited recourse borrowing arrangements. The Bill does not prevent a lender exercising rights under a guarantee given by the third party however the rights of the lender and the guarantor against the custodian trustee must be enforceable only to the extent of rights relating to the acquirable asset.

More information will become available as the bill progresses through both houses of parliament.

## Contacts

Peter Gell, Sydney (City)	+61 2 9391 3125	<a href="mailto:pgell@hunthunt.com.au">pgell@hunthunt.com.au</a>
Ian Miller, Sydney (North Ryde)	+61 2 9804 5704	<a href="mailto:imiller@hunthunt.com.au">imiller@hunthunt.com.au</a>
Bill Hazlett, Melbourne	+61 3 8602 9259	<a href="mailto:bhazlett@hunthunt.com.au">bhazlett@hunthunt.com.au</a>
Paul de Silva, Brisbane	+61 7 3292 9720	<a href="mailto:pdesilva@macrossans.com.au">pdesilva@macrossans.com.au</a>
Chris Sharp, Adelaide	+61 8 8414 3385	<a href="mailto:csharp@hunthunt.com.au">csharp@hunthunt.com.au</a>
Peter Murray, Perth	+61 8 9488 1300	<a href="mailto:peter.murray@marksandsands.com.au">peter.murray@marksandsands.com.au</a>
Antony Logan, Hobart	+61 3 6231 0131	<a href="mailto:alogan@hunnthas.com.au">alogan@hunnthas.com.au</a>
Kirsty Smith, Darwin	+61 8 8924 2600	<a href="mailto:ksmith@huntnt.com.au">ksmith@huntnt.com.au</a>
Pauline Tregenza, Newcastle	+61 2 4925 5587	<a href="mailto:ptregenza@hunthunt.com.au">ptregenza@hunthunt.com.au</a>

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