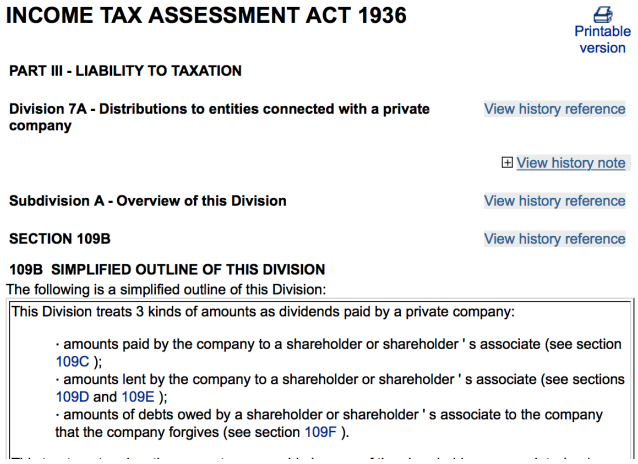
Recent and Upcoming Changes to Div 7A



INCOME TAX ASSESSMENT ACT 1936

Printable version

PART III - LIABILITY TO TAXATION

Division 7A - Distributions to entities connected with a private company — View history reference

View history note

Subdivision A - Overview of this Division — View history reference

SECTION 109B — View history reference

109B SIMPLIFIED OUTLINE OF THIS DIVISION

The following is a simplified outline of this Division:

This Division treats 3 kinds of amounts as dividends paid by a private company:

- amounts paid by the company to a shareholder or shareholder ' s associate (see section 109C);
- amounts lent by the company to a shareholder or shareholder ' s associate (see sections 109D and 109E);
- amounts of debts owed by a shareholder or shareholder ' s associate to the company that the company forgives (see section 109F).

October 2018

Ken Mansell
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Contents

The Treasury and the ATO do not want Division 7A to change…

That is a pretty big call, but I think history shows this is the case.

Let's go back to 2013. The Commissioner had, in late 2009, done a 180-degree change on whether an unpaid present entitlement to a corporate beneficiary was subject to Division 7A. And the new Assistant Treasurer from Western Sydney, when he was not on a patrol boat with the then Prime Minister Julia Gillard, stopping illegal arrivals, gave up trying to convince the Treasury and the ATO to clarify Division 7A and instead decided he would ask the Board of Tax to tell him if Division 7A could be made easier and clearer.

Home > David Bradbury

David Bradbury

Assistant Treasurer, Minister Assisting for Financial Services & Superannuation and Minister for Competition Policy & Consumer Affairs

5 March 2012 - 18 September 2013

NO.033

BOARD OF TAXATION TO CONDUCT A POST-IMPLEMENTATION REVIEW OF DIVISION 7A

The Gillard Government has tasked the Board of Taxation with undertaking a post-implementation review of Division 7A of Part III of the Income Tax Assessment Act 1936.

This post-implementation review provides an opportunity to examine the effectiveness of this important area of the tax law which has now been in operation for over a decade.

Change in Government and a new Assistant Treasurer hears the same complaints about Division 7A from tax practitioners, and the same stonewalling from the Treasury and the ATO and so the new Assistant Treasurer extends the scope and time frame of the Board of Tax review.

Arthur Sinodinos

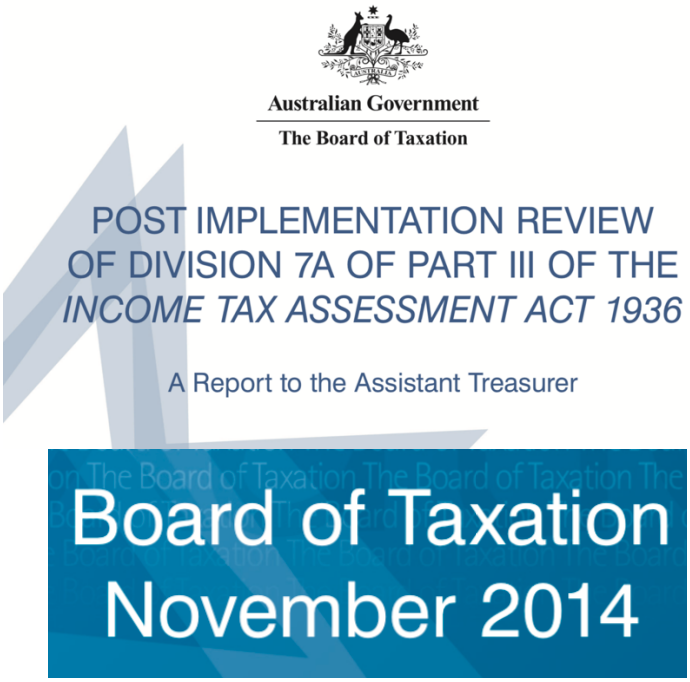
Assistant Treasurer
18 September 2013 - 19 December 2014

8 November 2013 Media Release

Board of Taxation Review extended

The Assistant Treasurer, Senator the Hon Arthur Sinodinos AO, today announced that the Board of Taxation (the Board) will extend its review of Division 7A of Part III of the *Income Tax Assessment Act 1936* to include the broader tax framework in which private business operates.

Unfortunately for the Government the Board of Tax is a well-run organisation and they provide the Government a report, with many substantial changes in late 2014.



But we don't see this report and all its recommendation until mid 2015, when another Assistant Treasurer, again hearing the complaints of Treasury and the ATO, finds a way to release the report, and defer it at the same time. He announces it while releasing a series of reports by the Board of Tax, and then says he has forwarded the reports to the Treasury to be considered in a broader review of the entire tax system. Let's review the review…

4 June 2015 Media Release

In the role of: Assistant Treasurer [23 December 2014 - 21 September 2015]

Release of Board of Taxation reports

Today the Government is releasing a number of Board of Taxation reports, as part of the national conversation on the future of the tax system.

These reports are an important input into the tax reform process. They will be carefully considered alongside the submissions we have received from all parts of the community in response to *Re:Think*, the tax discussion paper.

But the recommendations were now out in the public and people thought they were great. Ten-year loans, no need for writing, no payments due for the first two years, UPE can be excluded from Division 7A. Therefore, every year, some crazy people (AKA me) reminded

the Government in a pre-budget submission that we were waiting for them to act on this report by the Board of Tax…

Pre Budget Submission – Read the Board of Tax report on Div 7A

Posted on January 21, 2016

I don't generally get excited about pre budget submissions as I have not seen many ideas taken up in the Budgets (consult so you can say you consulted rather than looking for ideas) but I did write a very short submission this year.

Pre Budget Submission

Respond to the recommendations of the Board of Taxation report of November 2014 titled "POST IMPLEMENTATION REVIEW OF DIVISION 7A OF PART III OF THE INCOME TAX ASSESSMENT ACT 1936"

Summary: Given that the *Re:Think* tax review appears to have ended, as a part of the 2016/17 Budget, the Government should respond to the recommendations of the Board of Taxation in its post implementation review into Division 7A that was to be considered as a part of this review.

And in the 2016/17 Budget in May 2016, there was some joy. An announcement was made, a very unclear announcement, and nothing to start till over two years away, 1 July 2018.

Ten Year Enterprise Tax Plan — targeted amendments to Division 7A

Revenue ($m)

	2015-16	2016-17	2017-18	2018-19	2019-20
Australian Taxation Office	-	-	-	-	*

The Government will make targeted amendments to improve the operation and administration of Division 7A of the *Income Tax Assessment Act 1936* (an integrity rule for closely held groups).

These changes will provide clearer rules for taxpayers and assist in easing their compliance burden while maintaining the overall integrity and policy intent of Division 7A. It includes a self-correction mechanism for inadvertent breaches of Division 7A, appropriate safe-harbour rules to provide certainty, simplified Division 7A loan arrangements and a number of technical adjustments to improve the operation of Division 7A and provide increased certainty for taxpayers.

These changes draw on a number of recommendations from the Board of Taxation's Post-implementation Review into Division 7A and will apply from 1 July 2018.

This measure is estimated to have an unquantifiable cost to revenue over the forward estimates period.

This measure forms part of the Government's Ten Year Enterprise Tax Plan, which will encourage Australians to work, save and invest.

Budget 2016-17

And then we heard nothing. A classic go slow and what you don't like Treasury move. But we kept reminding them of the promise and in May 2018 they reconfirmed the promise to do something, but now whatever it is it will happen from 1 July 2019.

Tax Integrity — clarifying the operation of the Division 7A integrity rule

Revenue ($m)

	2017-18	2018-19	2019-20	2020-21	2021-22
Australian Taxation Office	-	-	*	*	*

The Government will ensure that unpaid present entitlements come within the scope of Division 7A of the *Income Tax Assessment Act 1936* from 1 July 2019. This will apply where a related private company is made entitled to a share of trust income as a beneficiary but has not been paid that amount, known as an unpaid present entitlement.

Division 7A is an integrity rule that requires benefits provided by private companies to related taxpayers to be taxed as dividends unless they are structured as Division 7A complying loans or another exception applies. This measure will ensure the unpaid present entitlement is either required to be repaid to the private company over time as a complying loan or subject to tax as a dividend.

Budget 2018-19

Budget Measures
Budget Paper No.2

The Government will also defer the start date of the *Ten Year Enterprise Tax Plan – targeted amendments to Division 7A* measure that was announced in the 2016-17 Budget from 1 July 2018 to 1 July 2019. This will enable all Division 7A amendments to be progressed as part of a consolidated package.

This measure is estimated to have an unquantifiable impact on revenue over the forward estimates period.

But in October 2018, the first crack in the Treasury/ATO wall of not changing Division 7A occurred in over 8 years. The Treasury released a Consultation paper indicating the changes that are proposed to be made on 1 July 2019.

Australian Government
The Treasury

TSY/AU

Targeted amendments to the Division 7A integrity rules

Consultation Paper

October 2018

Some of the more radical changes recommended by the Board of Tax have been ignored by the Treasury, but it does look like there will be some substantial changes to Division 7A that will apply from 1 July 2019.

The next section of this paper discusses these changes.

1 July 2019 and the new Division 7A

The Treasury discussion paper proposes 5 major changes to Division 7A, and a series of smaller technical changes. Of these five changes, one is totally the opposite to what the Board of Tax recommended and one ignores some of the best recommendation the Board made.

Change 1 – Simplified Loans

The biggest change is that the current 7 year and 25-year loan models will be replaced by a single loan model which has the following features:

- A 10-year loan begins at the end of the income year in which the advance is made. This is three years longer for most loans and removes the confusion of whether a loan is appropriately secured over real property with the 25-year loans.

- The taxpayer is still given until the lodgement day of the private company's income tax return to repay the loan or put it on complying loan terms. No change here is a good outcome.

- The annual benchmark interest rate will be the Small business; Variable; Other; Overdraft Indicator Lending rate most recently published by the Reserve Bank of Australia prior to the start of each income year. For the year starting 1 July 2018 this rate is 8.3%. This is a massive increase from the 5.2% of the current benchmark interest rate that currently applies. Does this mean we will always draw down on the mortgage at ~4% to pay of the company loan rather than pay interest at 8.3%?

- There will be no requirement for a formal written loan agreement, however written or electronic evidence showing that the loan was entered into must exist by the lodgement day of the private company's income tax return. I do worry what the Commissioner will say is "evidence" of such a loan and whether this will make the corrective action change below useless.

- The minimum yearly repayment amount consists of both principal and interest, BUT the principal component is a series of equal annual payments over the term of the loan. The interest component is the interest calculated on the opening balance of the loan each year using the benchmark interest rate.

- The minimum yearly repayment amount reduces the balance of the loan each income year. Where the minimum yearly repayment has not been made in full any shortfall will give rise to a deemed dividend for the year.

- Interest is calculated for the full income year, regardless of when the repayment is made during the year (except Year 1). If the loan is paid out early, that is before Year 10, interest will not be charged for the remaining years of the loan.

- Repayments of the loan made after the end of the income year but before the lodgement day for the first income year are counted as a reduction of the amount owing even if they are made prior to the loan agreement being finalised. Interest for Year 1 is calculated for the full income year on the balance of the loan outstanding at lodgement day.

Here is the Government's example of how this will work…

Example: Calculation of the deemed dividend

Bert is the sole director and shareholder of Sesame Pty Ltd.

On 1 August 2019, Bert withdraws $100,000 from Sesame Pty Ltd to pay for the renovation of his house. Bert does not have the funds to pay back Sesame Pty Ltd by the lodgment day of Sesame Pty Ltd's income tax return, 15 May 2021. To avoid the $100,000 being treated as if it were a dividend paid from Sesame Pty Ltd, Bert decides to put in place a complying Division 7A loan agreement.

The repayments that Bert would be required to make according to the new loan model would be as follows:

Year	Interest Rate*	Opening Balance $	Interest Amount $	Principal Amount $	Minimum Repayment $	Closing Balance $
2020-21	8.50%	100,000	8,500	10,000	18,500	90,000
2021-22	7.00%	90,000	6,300	10,000	16,300	80,000
2022-23	6.50%	80,000	5,200	10,000	15,200	70,000
2023-24	8.00%	70,000	5,600	10,000	15,600	60,000
2024-25	9.00%	60,000	5,400	10,000	15,400	50,000
2025-26	8.25%	50,000	4,125	10,000	14,125	40,000
2026-27	7.90%	40,000	3,160	10,000	13,160	30,000
2027-28	8.00%	30,000	2,400	10,000	12,400	20,000
2028-29	9.20%	20,000	1,840	10,000	11,840	10,000
2029-30	7.50%	10,000	750	10,000	10,750	0

*Interest rates shown are for illustrative purposes only

The interest paid by Bert each year will be taxed as income to Sesame Pty Ltd at its corporate tax rate.

Note that if the repayment actually made in the income year is less than the required minimum yearly repayment, a deemed dividend will arise for the amount of the shortfall between the minimum yearly repayment and the actual repayment made for that income year.

For example, the minimum yearly repayment in the above loan model example for the 2022-23 income year would be $15,200. If the actual repayment made in the 2022-23 income year was $12,200, the deemed dividend would be $3,000. Bert will include this $3,000 as income for the year and pay tax at his marginal tax rate.

Existing 7- or 25-year loans on 1 July 2019 will be transitioned to the new 10-year loan model.

A loan maturing 30 June 2021 will continue to mature on this date. This means that under the transitional rules, its remaining term will be 2 years. The outstanding loan balance would be repayable over 2 years, and interest would be charged using the new benchmark interest rate under the proposed model. Current loan agreements with written reference to the benchmark interest rate should not be required to be renegotiated under this option.

All complying 25-year loans in existence as at 30 June 2019 will be exempt from the majority of changes until 30 June 2021. However, the interest rate payable for these loans during this period must equal or exceed the new benchmark interest rate.

On 30 June 2021, the outstanding value of the loan will give rise to a deemed dividend unless a complying loan agreement is put in place prior to the lodgement day of the 2020-21 company tax return. The first repayment will be due in the 2021-22 income year.

There is one change that was recommended by the Board of Tax that the Treasury should have considered, but they have completely ignored. The recommendation was:

- The prescribed maximum loan balances during the term of the loan (including any accumulated interest) would be as follows:
  - 75 per cent of the original loan by the end of year three;
  - 55 per cent of the original loan by the end of year five;
  - 25 per cent of the original loan by the end of year eight; and
  - 0 per cent of the original loan (that is, fully repaid) by the end of year 10.
- Subject to meeting the maximum loan balances, there would be no specified annual principal repayments.
- Interest would be able to be accrued annually but would have to be paid by the end of years three, five, eight, and 10.

This would mean if you accidently missed the first year, there would be no problem as it just has to be fixed by year 3. But it looks like this was to cleaver and original to ever be put in Division 7A.

Change 2 – Self-correct without telling the Commissioner

Under the proposed changes, qualifying taxpayers will also be permitted to self-assess their eligibility for relief from the consequences of Division 7A. To qualify for self-correction, the taxpayer will need to meet eligibility criteria in relation to the benefit that gave rise to the breach. The eligibility criteria will require that:

- The breach of Division 7A was an inadvertent breach;
- Appropriate steps have been taken as soon as practicable; and
- The taxpayer has taken, or is taking, reasonable steps to identify and address any other breaches of Division 7A.

Under this approach, in order to self-correct an eligible taxpayer must:

- Convert the benefit into a complying loan agreement, on the same terms that would have applied had the loan agreement been entered into when it should have been; and

- Make catch-up payments of the principal and interest that would have been payable as prior minimum yearly repayments had the taxpayer complied with Division 7A when it should have. The interest component of the catch-up payment will be compounded to reflect prior year non-repayments. This compounded interest should be declared as assessable income in the private company's income tax return for the income year in which the catch-up payment is made.

So now when you get the new client with heaps of Div7A issues you can clearly tell them how to fix it up. I just hope the Commissioner agrees that totally missing the fact that there was a loan account is an inadvertent breach, so we can fix them up when they come past our desks.

It should also be noted that those who decide not to fix a Division 7A problem they find but rather decide to duck and cover and hope the amendment periods go by, have some bad news in this paper. The paper proposes that the period of review for Division 7A transactions be extended to cover 14 years after the end of the income year in which the loan, payment or debt forgiveness gave rise or would have given rise to a deemed dividend. That is effectively ten years for the loan to be repaid and the four-year amendment period after that. This will apply from 1 July 2019.

Change 3 – Distributable surplus

The third major change is to the concept of distributable surplus – actually it is the total removal of the concept of distributable surplus.

This is very strange given the Board of Tax report made the following recommendation…

Recommendation 5

The Board recommends retaining the rules regarding the calculation of distributable surplus, including the requirement for periodic testing, as part of any rewrite of the Division 7A rules.

This appears extremely strange given the consultation paper states that:

"These amendments incorporate the Government's response on the findings and recommendations of the Board of Taxation in their final report on the 'Post Implementation Review of Division 7A of Part III of the Income Tax Assessment Act 1936'."

Therefore, the Government's response to not changing the distributable surplus concept already in the law is to remove it.

The treasury states that this will align the treatment of dividends with section 254T of the Corporations Act 2001 which allows dividends to be paid out of both profits and capital.

But let's be honest, if a certain amount is 'distributed' to the shareholder, then tax should be paid on the entire amount, and it should not be arbitrarily limited. Also, the calculation of what is a distributable surplus can be a bit of a nightmare. While I hate the fact that the Treasury does not acknowledge what they have done in the paper they have released, I can't say I am too disappointed with the outcome.

Change 4 – UPE argument over

After eight years of arguing with the Commissioner on whether UPE's fall within Division 7A, the argument is over as the paper state the law should be changed to specifically say that a UPE will be treated just like a loan.

This is bitterly disappointing as, while the Board of Tax report did recommend that UPE's be treated the same as loans under Division 7A for simplicity reasons…

> **Recommendation 8**
>
> The Board recommends introducing legislative amendments to align the treatment of UPEs with the treatment of loans for Division 7A purposes in conjunction with either Recommendations 6 and 9 (Amortisation Model option) or Recommendation 10 (Interest Only Model option).

… the Board of Tax report also recommended a novel way of solving the UPE / Division 7A impasse that the current Treasury proposals simply ignore. This idea of the Board of tax was…

Recommendation 9

If the Amortisation Model is adopted, the Board recommends:

- introducing a legislative amendment that allows trusts to make a once-and-for-all election for loans from companies (including UPEs owing to companies) to be excluded from the operation of Division 7A (the business income election);
- making the election by completing a label in the trust's tax return by the due date for lodging the return for the year of income in which it is made (or such further time as the Commissioner allows);
- enabling the election to be made in any income year, subject to the requirement that Division 7A obligations must remain in place for income years prior to the income year in which the election is made;
- ensuring that a trust that makes such an election (an excluded trust) forgoes the CGT discount on capital gains arising from assets other than goodwill and 'intangible assets inherently connected with the business carried on by the trustee';
- applying a business income election to all loans the trust owes to a private company, whenever created, and to all CGT assets (other than goodwill or relevant intangible assets) whenever acquired;
- not excusing entities that make a business income election from Division 7A obligations for the period prior to the income year for which the election is made; and
- amending interposed entity rules to preserve the integrity of the provisions, without imposing undue compliance costs on trusts that wish to benefit from the proposed limited business income exception.

This would have meant, at the tick of a box, we could have gone back to the pre-December 2009 situation for UPEs to corporate beneficiaries, and the Commissioner could be happy that, while the trust is effectively getting access to the company tax rate on these amounts, just like a company the trust can no longer get access to the CGT discount in Division 115.

Now, under the proposed changes in the recently released Treasury paper, where a UPE remains unpaid at the lodgement day of the private company's income tax return, the UPE will be a deemed dividend from the company to the trust or the UPE can be put on 'complying loan terms' under which principal and interest payments are required to be made.

All UPEs arising on, or after 16 December 2009 and on, or before, 30 June 2019, that have not already been put on complying loan terms or deemed to be a dividend, will need to be put on complying terms by 30 June 2020. The first repayment for such loans would be due in the 2019-20 income year. Any amounts outstanding that have not been put on complying loan terms by the end of the 2019-20 income year will result in a deemed dividend for the outstanding amount of the UPE.

All UPEs that arise on, or after, 1 July 2019 will need to be either paid to the private company or put on complying loan terms under the new 10-year loan model prior to the private company's lodgement day, otherwise they will be a deemed a dividend.

Effectively, from 1 July 2019 there will be no argument… a UPE is the same as a loan.

Change 5 – Private use of company assets

Section 109CA applies Division 7A to the provision of an asset for private use. The deemed dividend is the amount that would have been paid for the provision of the asset by parties dealing at arm's length less any amounts actually paid.

The Treasury paper proposes to include a way to calculate the arm's length price of the use (note that the taxpayer will continue to be able to use their own calculation of the arm's length value). However, this method cannot be used for motor vehicles.

The proposed formula for valuing the use of an asset is:

$$A\ x\ IR \times days\ used\ days\ in\ year$$

Where:

A = Value of asset at 30 June for the income year in which the asset was used (a formal valuation should be obtained every 5 years).
IR = benchmark interest rate plus 5 per cent uplift interest.
Days used = days shareholder (or their associate) used or had the exclusive right to use the asset.
Days in year = days in income year (i.e. 365 or 366).

Example:

Sesame Pty Ltd owns a yacht valued at $1,200,000. Bert invites his friends Ernie and Oscar to spend the day on the yacht one Sunday every month. Bert has no right to use the yacht at any other time during the income year. The benchmark interest rate for the income year is 8.5 per cent. Therefore, the interest rate used in the formula is 13.5 per cent.

The charge is calculated as follows:

$$\$1{,}200{,}000 \times \left(\frac{13.5\%}{365}\right) = \$443.84\ per\ day$$

The yacht was used for 12 days over the income year. Therefore, the deemed dividend calculated according to the safe harbour formula is $5,326.

Summary of the five big changes

There are lots of other proposed changes that will not be as relevant as these five changes and we can consider these later in this paper. But from these main changes…

From 1 July 2019:

- If you find a Division 7A problem, you just fix it by paying what you missed, but with some compounding interest;

- You don't need written loan agreements, but it should be clear in the accounts this was treated as a loan;
- You don't need to do distributable surplus calculations;
- UPEs to corporate beneficiaries are just treated like loans from the company to the trust;
- You pay the same principal off each year, 1/10th of the initial loan;
- The interest is just the Small business; Variable; Other; Overdraft Indicator Lending rate most recently published by the Reserve Bank of Australia prior to the start of each income year, which just happens to be substantially higher than the current benchmark interest rate;
- I pay off the loan over 10 years in every case; and
- If there is private use of a company asset that is not minor, there is an easy formula to work out what should be paid before lodging the return to avoid Division 7A.

Not as good a change as we hoped for, but possibly a good start? And given the Treasury and the ATO blocking this for so long, probably as good as we can get.

The other technical changes

- There is confusion as to the application of Division 7A to non-resident private companies in certain circumstances– for example whether it applies only where the shareholder of the private company (or their associate) is an Australian resident, how 'source' considerations apply to the deemed dividend and how the provisions potentially interact with the transfer pricing rules and double tax treaties. This will be clarified somehow???
- It is unclear when the private use of an asset arises if it is just a right to use, rather than actual use. This will be the first day of the year.
- A forgiven debt will only be exempt to the extent that the original debt was made assessable income as a loan under Division 7A.
- Section 109M, which provides an exemption for certain loans will be amended to limit the exception to loans in the ordinary course of a business of lending money to third parties, rather than in the ordinary course of any business.
- Section 109T will be amended to apply in any case where a loan, payment or other benefit is provided to a taxpayer, if a reasonable person would conclude that this benefit would not have been provided but for a loan, payment or other benefit being provided or being expected to be provided by the private company to another entity

(whether or not this is the same entity that provided the benefit to the taxpayer).

- These amendments will also clarify and provide integrity in relation to the interaction between Division 7A and the FBT provisions.

Other recent changes and issues with Division 7A…

Division 7A and Ordinary Commercial Transactions

Taxation Determination TD 2018/13 Income tax: Division 7A: can section 109T of the Income Tax Assessment Act 1936 apply to a payment or loan made by a private company to another entity (the 'first interposed entity') where that payment or loan is an ordinary commercial transaction?

In this Determination the Commissioner states that Division 7A, and specifically the interposed entity rules in section 109T, can apply to a payment or loan made by a private company to another entity where that payment or loan is an ordinary commercial transaction.

This section states that if a reasonable person would conclude that the payment or loan to the first interposed entity is made solely or mainly as part of an arrangement involving a payment or loan to a shareholder or shareholder's associate, Division 7A operates as if the private company made a payment or loan to the target entity.

This can be the case even if the first payment or loan is an ordinary commercial transaction.

EXAMPLE

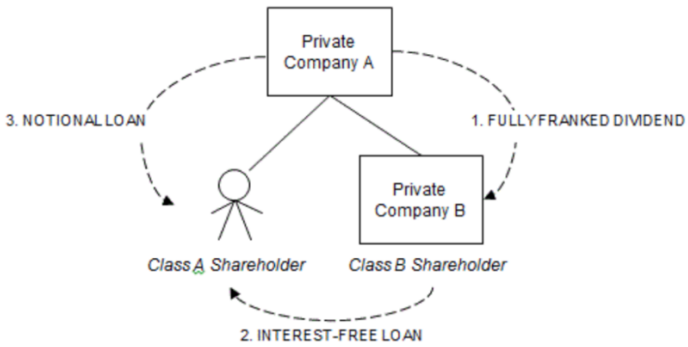
Private Company A has a significant distributable surplus including accumulated profits of $100,000.

Private Company A has two classes of shares with the Class A shares being held by Mr A and the Class B shares being held by Private Company B.

Private Company B has no distributable surplus.

Private Company A pays a fully franked dividend of $100,000 to Private Company B. On the same day, Private Company B uses that dividend to make an interest-free loan of $100,000 to Mr A.

Mr A does not repay the loan made by Company B by Private Company A's lodgment day for the year of income and it is not put on section 109N complying terms.



EXAMPLE

Private Company D has a significant distributable surplus including accumulated profits of $100,000.

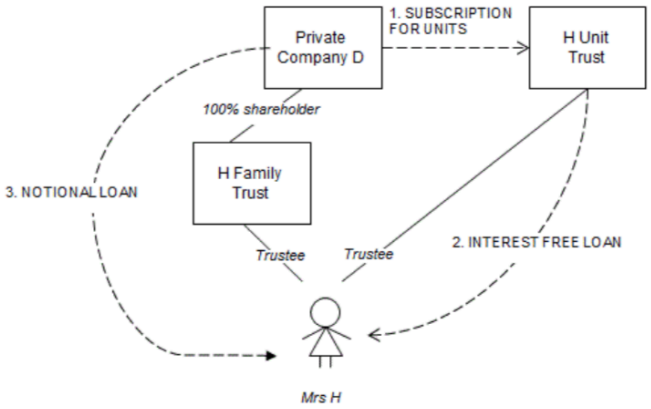
The H Family Trust is the sole shareholder of Private Company D.

Mrs H is the sole director of Private Company D and is also the trustee of the H Family Trust.

Mrs H is also a beneficiary of the H Family Trust and is the trustee of the H Unit Trust.

Private Company D subscribes for two units in the H Unit Trust and pays $50,000 for each unit. The H Unit Trust uses those funds to make an interest-free loan of $100,000 to Mrs H.

Mrs H does not repay the loan made by the H Unit Trust by Private Company D's lodgment day for the year of income and it is not put on section 109N complying terms.



14 year to pay off a UPE without having to worry about Division 7A

Practical Compliance Guideline PCG 2017/13 Division 7A - unpaid present entitlements under sub-trust arrangements maturing in the 2017, 2018 or 2019 income years

This Guideline applies to a private company beneficiary of a trust and sub-trust where the trustee:

- Has, in accordance with Law Administration Practice Statement PS LA 2010/4 Division 7A: trust entitlements, validly adopted investment Option 1 on, or before, 30 June 2012 to place funds representing an unpaid present entitlement (UPE) under a sub-trust arrangement on a 7-year interest only loan with the main trust, and

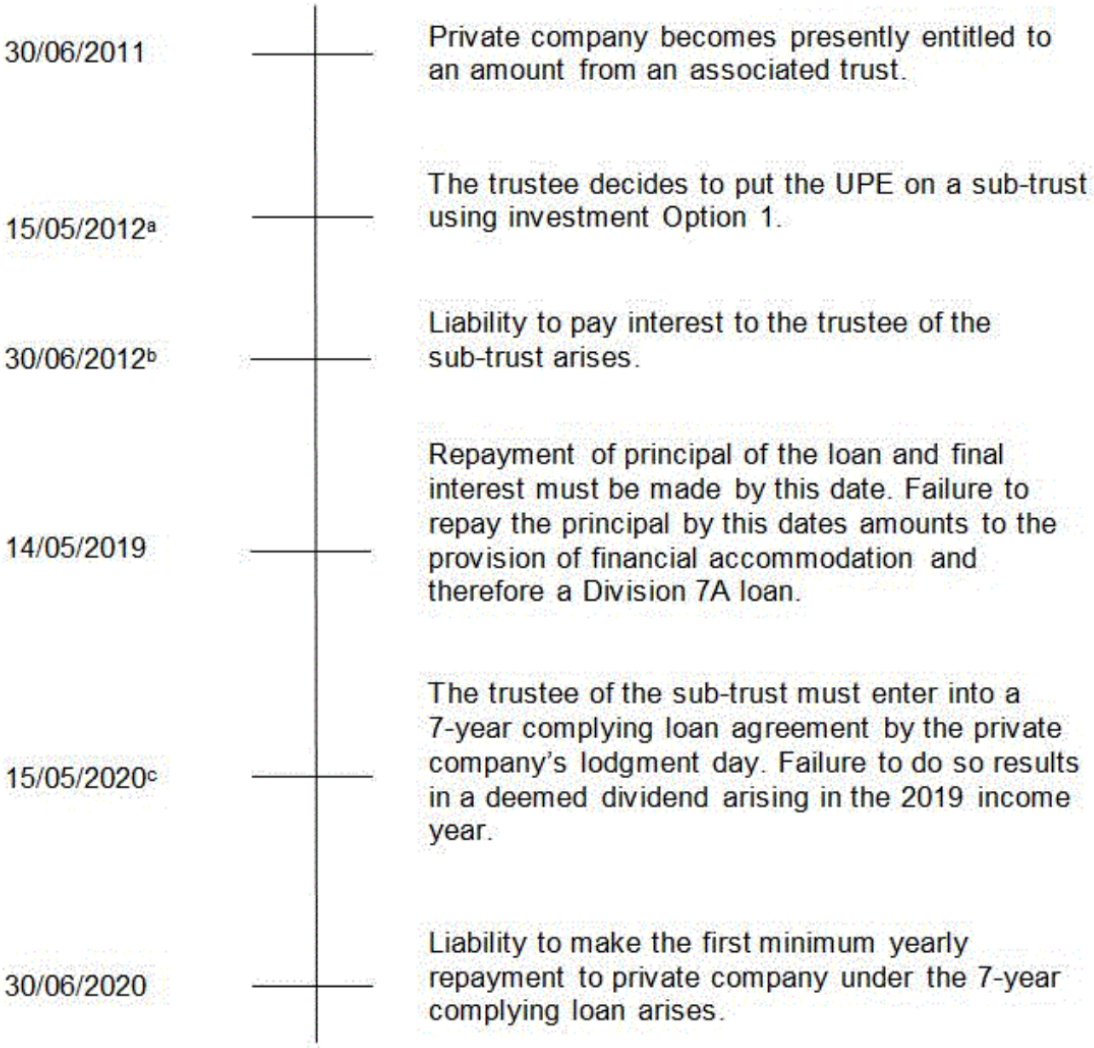
- Does not repay the principal of the loan when it matures in the 2017, 2018 or 2019 income year.

Where this is the case the Commissioner states the following:

14. If all, or part, of the principal of the loan is not repaid on or before the date of maturity, the Commissioner will accept that a 7-year loan on complying terms in accordance with section 109N may be put in place between the sub-trust and the private company beneficiary prior to the private company's lodgment day. This will provide a further period for the amount to be repaid with periodic payments of both principal and interest.

This means you can potentially pay off a UPE over 14 years. For example:

Investment Option 1 not repaid on maturity (30 June 2019)



Unpaid present entitlement unitisation arrangements

Unit trust arrangements and unpaid present entitlements

We currently have concerns about a number of arrangements involving one or both of unpaid present entitlements and unit trusts. These arrangements may have implications under Division 7A of the *Income Tax Assessment Act 1936* (ITAA 1936).

The Commissioner has stated he is concerned about an arrangement where a private group seeks to extinguish unpaid present entitlements or avoid obligations under Division 7A by implementing an arrangement where a private company subscribes for units in a unit trust. The unit trust may then provide payments or loans to other entities within the private group.

These arrangements may give rise to various income tax consequences, such as the application of:

- Division 7A ITAA 1936
- Section 100A of the ITAA 1936
- Part IVA of the ITAA 1936.
- Unpaid present entitlements

The Commissioner states the following attracts his attention:

- Private companies include assessable trust distributions, but do not receive payment of the distribution from the trust before the earlier of either the due date for lodgement, or the date of lodgement of the trust's tax return for the year in which the loan was made.
- A complying loan agreement has not been put in place.
- Failure to put the funds on a sub-trust for the sole benefit of the private company beneficiary.
- Failure to repay loans or sub-trust investments at the conclusion of the term specified in the original agreement.
- Arrangements purporting to extinguish the UPE of the private company beneficiary.
- Non-lodgement of returns and activity statements.