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Ruling Compendium – TD 2011/15

This is a compendium of responses to the issues raised by external parties to Draft Taxation Determination TD 2010/D9 – Income tax: Division 7A – unpaid present entitlements – factors the Commissioner will take into account in determining the amount of any deemed entitlement arising under section 109XI of the *Income Tax Assessment Act 1936*.

This compendium of comments has been edited to maintain the anonymity of entities that commented on the draft ruling.

Summary of issues raised and responses

Issue No.	Issue raised	ATO Response/Action taken
1	<p>Payment of entitlement by set off</p> <p>The final Determination should make it clear that a present entitlement has been paid where the parties have agreed to a set off as between the relevant trust and the trust or company to which an unpaid present entitlement is due with the consideration for the set off being the entry into a Division 7A of the <i>Income Tax Assessment Act 1936</i> (ITAA 1936)¹ compliant loan agreement.</p>	<p>As Determinations are 'short form' rulings on a specific issue this cannot be confirmed in the finalised version of the draft Determination.</p> <p>Nonetheless, it is noted that <i>Taxation Ruling TR 2010/3 Income tax: Division 7A loans: trust entitlements</i> confirms that a present entitlement can be satisfied by way of set-off (see paragraphs 9 and 55 of that Ruling).</p>
2	<p>Automatic presumption for double trust structure</p> <p>In order for subsection 109XI(1) to apply, paragraph 109XI(1)(b) requires that a reasonable person would conclude (having regard to all the circumstances) that a company is or becomes entitled to an amount from the net income of an interposed trust solely or mainly as part of an arrangement involving an entitlement to an amount from the target trust.</p> <p>It is noted that the examples in the draft Determination provide no basis for the application of paragraph 109XI(1)(b) other than the existence of the double trust structure. For instance, at paragraph 8</p>	<p>When the condition in paragraph 109XI(1)(b) is satisfied is a separate issue not dealt with in the draft Determination or final Determination.</p> <p>The Commissioner only determines the amount of the deemed entitlement if the conditions in subsection 109XI(1) have been satisfied. That is, the conditions in subsection 109XI(1) are the gateway provisions which must be satisfied before a deemed entitlement is taken to arise. This was explained in the draft Determination, and will also be set out in paragraph 65 of the final Determination.</p> <p>However, the question considered by this Determination is not when will section 109XI apply, but rather when the conditions in subsection 109XI(1) are satisfied and the private company is taken to have an additional present</p>

¹ All legislative references are to the ITAA 1936 unless otherwise stated.

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	<p>of example 1 no reasons were given for the conclusion stated.</p> <p>Similarly, at paragraph 23 of example 3, no explanation of why ‘....it was discovered that the conditions of subsection 109XI(1) had been satisfied’ is given and readers are left to that it is so because of the double trust structure. The final version of the Determination would benefit from the inclusion of an explanation of the logic behind the formation of that conclusion.</p> <p>What may be described as cascading entitlements through a series of trusts may also arise as an automatic operation of the trust deeds. This may be expected to arise in the common situation where two unrelated families carry on business together through a unit trust, the units in which are held by the families’ own discretionary trusts. In this case, the net income of the unit trust will usually be distributed by default operation of the deed to the holders of units as at the end of the financial year. In such a situation, there has been no decision made nor overt action taken which results in an unpaid present entitlement of the family discretionary trusts to income of the unit trust.</p> <p>As a result, it is questioned whether it could reasonably be said that there was an arrangement (a term which implies some action being taken) under which a corporate beneficiary of one of the family discretionary trusts becomes entitled to an amount from the net income of that family discretionary trust solely or mainly as part of an arrangement involving an entitlement to an amount from the unit trust.</p>	<p>entitlement to trust income, what factors will the Commissioner taken into account in determining the amount of that deemed entitlement.</p> <p>The Examples will be adjusted in the final Determination to make it clear that the conditions in paragraph 109XI(1)(b) have been satisfied for reasons which may differ from the circumstances taken into account in determining the amount of the consequent deemed entitlement.</p>
3	<p>Paragraph 3(d) and paragraph 4 of TD 2010/D9</p> <p>Paragraph 3(d) proposes as a relevant factor:</p> <p>‘...whether any payment of a present entitlement is a genuine transaction and not designed to avoid the application of Subdivision EA...’.</p>	<p>The Commissioner disagrees with this construction of paragraphs 3(d) and 4.</p> <p>Paragraph 3 lists the relevant factors the Commissioner will take into account in determining the amount of the entitlement that is taken to arise pursuant to subsection 109XI(1).</p> <p>Paragraph 4 then states that, subject to the final factor at paragraph 3(d) being</p>

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	<p>Paragraph 4 then reads so far as is relevant -</p> <p>‘As a consequence of taking account of the matters referred to above and where the Commissioner is satisfied that the transactions are genuine and not designed to avoid the application of Subdivision EA..., the Commissioner will determine...’. (Emphasis added)</p> <p>It appears that the part of Paragraph 4 emphasised above is a repeat of Paragraph 3(d). At first blush, one would not have thought that that was necessary.</p> <p>Alternatively, is that part of Paragraph 4 emphasised above intended to take into account different matters than those covered by Paragraph 3(d).</p>	<p>satisfied, the amount so determined by the Commissioner will be the lesser of certain amounts. The Commissioner needs to consider all relevant factors.</p>
	<p>It is difficult to understand the meaning of paragraph 3(d) of the draft Determination, and the reasoning underpinning it, particularly given Example 4.</p> <p>Paragraph 3(d) states:</p> <p>(d) whether any payment of a present entitlement is a genuine transaction and not designed to avoid the application of Subdivision EA otherwise than as envisaged within the scheme of Division 7A (such as genuinely and in substance paying an entitlement by the relevant lodgment date or putting a relevant loan under a loan agreement as described in section 109N).</p> <p>Paragraph 4 then goes on to say:</p> <p>As a consequence of taking account of the matters referred to above and where the Commissioner is satisfied that the transactions are genuine and not designed to avoid the application of Subdivision EA otherwise than as envisaged within the scheme of Division 7A ... (Emphasis added)</p> <p>Paragraph 3(d) in its entirety and the following words in paragraph 4</p>	<p>In determining the amount of the entitlement that is taken to arise under subsection 109XI(1) the Commissioner will take account of all relevant matters. As section 109XI is designed to ensure that Division 7A can apply to arrangements which have in substance been funded by company profits (including amounts in respect of which the company is entitled), it is appropriate that the Commissioner have regard to the substance of the relevant transactions and whether the transactions are genuine. At paragraph 56 of the draft Determination the point is made that the Commissioner is not limited to the matters specifically referred to in subsection 109XI(6). Other facts and circumstances can be taken into account.</p> <p>Example 4 will be omitted from the final Determination for the reasons set out below.</p>

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	<p>should be removed.</p> <p>‘... and where the Commissioner is satisfied that the transactions are genuine and not designed to avoid the application of Subdivision EA otherwise than as envisaged within the scheme of Division 7A....’</p> <p>Short of any further valid illustration or clarification being provided paragraph 3(d) should be deleted from the finalised Determination.</p>	
	<p>If the ATO has concerns about taxpayers ‘artificially contriving’ transactions to reduce the amount of unpaid distributions then it should use Part IVA – putting aside the fact that they may not have the resources to do so in any event, a taxpayer in the middle market should not have to ‘second guess’ (for example) whether a legally binding assignment, loan and/or set off arrangement that has been entered into will or will not be regarded by the ATO as a ‘genuine transaction’.</p>	<p>The Commissioner disagrees. As stated in paragraph 37 of the draft Determination Division 7A is an anti-avoidance or integrity provision directed to ensuring that disguised or informal distributions of company profits to shareholders or their associates should be included in the assessable income of the shareholders or associates.</p> <p>In applying Subdivision EA in circumstances where there are entitlements to trust income through interposed entities the Commissioner is required to determine the amount that the private company is taken to be or to become entitled to from the net income of the target trust.</p> <p>The Commissioner will take into account all matters that he considers relevant.</p>
4	<p>Example 1</p> <p>4.1 In paragraph 9, the loan made to the shareholder (that is Richard) of the private company beneficiary (that is Diamond Pty Ltd) is stated to be used for private purposes. It is noted that it is irrelevant that the loan is used for private or income producing purposes for a section 109XA(2) loan to arise, and that accordingly the conclusion reached in paragraph 15 would remain the same regardless of the how the shareholder applied the loan funds.</p> <p>It is therefore suggested that the reference to the private use of the loan funds be excised from the example, and that the commentary emphasise that a section 109XA(2) loan may arise irrespective of how the loan funds are applied by the shareholder of the private</p>	<p>The Commissioner agrees that unless the funds were borrowed to acquire certain employee share scheme interests (see section 109NB) it is not relevant for section 109XA purposes how the funds are used.</p> <p>A footnote will be inserted at the end of paragraph 10 of the final Determination to cover this point.</p>

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	company beneficiary. This is an important distinction as there may be a common misconception amongst many taxpayers that a potential Subdivision EA liability will not arise where the funds are used for an income producing purpose by the shareholder of the private company beneficiary.	
	4.2 On the website version of the draft Determination we note that Diagram 2 has been inadvertently replicated twice and that the scenario set out in Example 1 is not currently diagrammatically set out in the draft Determination.	The website version of the draft Determination has been corrected.
5	<p>Example 4</p> <p>Example 4 in TD 2010/D9 should be withdrawn as it fails to consider the application of subsection 109XI(3). The facts in Example 4 are an example of the operation of subsection 109XI(3).</p> <p>The facts provide that the Brown Investment Trust (BIT) agrees to extend the terms on the sale of the property. If the sale (and thus the extended terms) are not (i) in the ordinary course of its business; and (ii) on the usual terms that it employs in this business (that is under section 109M), then BIT will have made a loan to the Brown Business Trust (BBT) under section 109D. Accordingly, subsection 109XA(2) should apply to the facts and thus section 109XB applies to deem there to be a dividend to BBT in the first instance before applying 109XI (as BIT has an unpaid present entitlement to a corporate beneficiary for 109XA purposes).</p>	<p>The Commissioner agrees that the example did not consider the application of subsection 109XI(3).</p> <p>Example 4 will be withdrawn from the final Determination.</p>
6	<p>Additional examples – composite entitlements</p> <p>In practice, the existence of what might be referred to as ‘composite’ unpaid present entitlements is commonplace.</p> <p>The examples in the draft Determination assume that there will always be a direct correlation between the two entitlements. For instance, in reaching the conclusion that subsection 109XI(1) applies</p>	<p>The Commissioner agrees that the usefulness of the final Determination would be improved by the addition of examples involving composite entitlements and interposed trusts with other sources of income and expenses.</p> <p>Additional examples will be included in the final Determination.</p>

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	<p>in example 1, it is assumed that the \$7,000 distribution from Green Discretionary Trust can be traced directly to the distribution from the target trust (that is, White Discretionary Trust) of \$10,000.</p> <p>This is possible only if the interposed trust has no other income to distribute, or the entitlement of the corporate beneficiary related only to amount to which the interposed trust was entitled from the target trust.</p> <p>In a majority of cases the interposed trust will have income from other sources in addition to the trust distribution from the target trust.</p> <p>It is acknowledged that in practice there may be some complexities involved in determining the quantum of components that comprise a composite unpaid present entitlement. This will involve questions as to how to apportion expenses and losses between different income sources and other practical matters. It is also acknowledged that it would not be possible to deal with all possible permutations and combinations that might arise in this regard in the Draft Determination. However, it is considered very important that the Commissioner's views on composite unpaid present entitlements be made public, as this circumstance will be common in practice. Examples illustrating reasonably simple facts will give taxpayers considerable comfort in relation to this scenario as a matter of principle.</p>	
	<p>The ways in which such composite entitlements can arise is best illustrated by the following example:</p> <p>The Jones Discretionary Trust (JDT) holds all the units in two unit trusts, the Jones Unit Trust (JUT) and the Jones Investment Unit Trust (JIUT). As at 30 June 2010, the following entitlements that have arisen from trust distributions remain unpaid:</p> <ul style="list-style-type: none"> • an unpaid present entitlement owing from JUT to JDT of \$10,000; 	<p>Additional examples including composite entitlement examples will be included in the final Determination. Included will be examples based on the example provided.</p>

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	<ul style="list-style-type: none"> • an unpaid present entitlement owing from JIUT to JDT of \$8,000; and • an unpaid entitlement owing from JDT to the company beneficiary of the Jones family group, Jones Pty Ltd of \$18,000. This unpaid present entitlement represents the downstream result of the distributions derived by JDT from JUT and JIUT that have been distributed by JDT to Jones Pty Ltd and which remain unpaid. <p>An interest free loan of \$5,000 is made on 31 March 2010 by the trustee of JUT to Tom, who is a shareholder of Jones Pty Ltd.</p> <p>If, by the determination time (being the earlier of the time at which the 2010 income tax return of JUT is due for lodgement and the date of actual lodgement), JUT has paid \$10,000 to JDT to fully discharge the entitlement owing to JDT as at 30 June 2010, it is understood that the Commissioner would determine that the amount of the deemed unpaid present entitlement owing from JUT to Jones Pty Ltd under section 109XI would be nil. This is clear from the existing commentary and the existing examples in the draft Determination.</p> <p>Alternatively, in the event that JDT makes a payment of \$10,000 to Jones Pty Ltd to discharge \$10,000 of the composite unpaid present entitlement owing from JDT to Jones Pty Ltd by the determination time (as opposed to the payment from JUT referred to in the preceding paragraph), it is submitted that the Commissioner should reach the same conclusion. That is, it is submitted that the taxpayer should be permitted to nominate which component of the composite unpaid present entitlement owing from JDT to Jones Pty Ltd has been discharged in order to ensure that section 109XI is not triggered. The composite unpaid distribution owing from JDT to Jones Pty Ltd consists of two elements being the \$10,000 that has been sourced from JUT and the \$8,000 that has been sourced from Justin this scenario the taxpayer is nominating in effect that the</p>	

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	<p>\$10,000 paid to Jones Pty Ltd is being applied to discharge the unpaid present entitlement that has been sourced from JUT.</p> <p>Of course, the quantum of any unpaid present entitlement that is owed from JDT to Jones Pty Ltd would also be affected by any other income or expenses that JDT has in its own right that are unrelated to the distributions that it has received from JUT and JIUT. If, for example, JDT has funded its investments into JUT and JIUT with interest bearing debt, it would have incurred interest expense in its own right that would have reduced the amount of distributable income available.</p> <p>To modify the above example, assume that JDT has incurred interest expense of, say, \$3,000 over the relevant period, which means that the unpaid present entitlement owing to Jones Pty Ltd from JDT is reduced by a corresponding amount (from \$18,000 to \$15,000). The question then arises as to the extent that the interest expense is to be allocated against the two elements of the composite distribution. If, for example, the facts are that two thirds of the interest expense incurred by JDT relates to the distributions derived from JUT, with the balance relating to the JIUT distributions, this should mean that the two elements of the composite unpaid present entitlement of \$15,000 are respectively \$8,000 for the JUT component and \$7,000 for the JIUT component. Accordingly, given these modified facts, should a payment of \$8,000 be made by JDT to Jones Pty Ltd before the relevant determination time, this should mean that the deemed unpaid present entitlement owing from JUT to Jones Pty Ltd should be nil.</p>	
7	<p>Minority of unpaid present entitlement sourced in distribution from other trust</p> <p>The nexus between the two entitlements (that is, the private company's entitlement from the interposed trust and that interposed trust's entitlement to an amount from the target trust) would become</p>	<p>The Commissioner only determines the amount of the deemed entitlement if the conditions in subsection 109XI(1) have been satisfied. Therefore, both the draft Determination and the final Determination proceed on the that those conditions (including paragraph 109XI(1)(b)) have been satisfied.</p> <p>When the condition in paragraph 109XI(1)(b) is satisfied is a separate issue</p>

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	<p>remote in circumstances where the interposed trust has income from other sources (and consequently it would be difficult to say reasonably that the solely or mainly test was satisfied) as illustrated in the following scenario.</p> <ol style="list-style-type: none"> 1. DT1 (a special purpose trust) is entitled to an amount of \$10,000 from the net income of the Business Unit Trust 2. The net income of DT1 is \$10,000 3. DT2 (an investment trust) is entitled to an amount of \$10,000 from the net income of DT1. 4. The trustee of DT 1 makes a loan of \$5,000 to Mrs Smith, shareholder of Smith Pty Ltd. 5. The net income of DT2 is \$30,000 comprising dividend income of \$20,000 and the distribution from DT1 of \$10,000. 6. The trustee of DT2 resolves to distribute (but does not pay) all of the dividend income and \$2,000 of the other income (that is, the distribution of income received from DT1) to Smith Pty Ltd, with the balance of \$8,000 to Mr Smith. <p>Given that a significant majority of the \$22,000 that Smith Pty Ltd is entitled to is funded from dividend income, for the purposes of subsection 109XI(1)(b) it is questioned whether a reasonable person would be able to conclude that the company is or becomes entitled to the \$22,000 UPE solely or mainly as part of an arrangement involving an entitlement from the target trust.</p> <p>In the event that subsection 109XI(1)(b) were held to be satisfied, for the purpose of subsection 109XI(4) would the Commissioner determine that Smith Pty Ltd is taken to be entitled to \$2,000 of the net income of the target trust or a different amount?.</p>	<p>that is not addressed in either the draft Determination or final Determination. Additional examples including multiple income sources and expenses will be included in the final Determination.</p>
8	Distribution to company not directly traceable to particular income sources	Additional examples will be included in the final Determination.

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	<p>Drawing on the example above, the trustee of DT2 again resolves to distribute its net income to Smith Pty Ltd and Mr Smith. However, the trustee resolves to distribute DT2's net income between the two beneficiaries without distinguishing between classes of income in so doing.</p> <p>Since Smith Pty Ltd's \$22,000 UPE could be seen to be partly funded from the trust distribution from DT1 and partly from DT2's own dividend income, the final version of the Determination would benefit from an explanation of whether and, if so, how the Commissioner would form the conclusion necessary under paragraph 109XI(1)(b).</p> <p>Assuming that the required conclusion would be reached, the final version of the Determination would also greatly benefit from an explanation of how the Commissioner would determine under subsection 109XI(4) the amount that Smith Pty Ltd would be taken to be entitled to from the net income of the target trust in these circumstances.</p>	
9	<p>Allocation of expenses against items of income</p> <p>The final version of the Determination would benefit greatly from an explanation of how the Commissioner would determine under subsection 109XI(4) the amount that a company would be taken to be entitled to from the net income of a trust in circumstances where there are other sources of income and expenses.</p> <p>Drawing on the above example, DT2 receives \$30,000 of income from various sources, including:</p> <ol style="list-style-type: none"> 1. a distribution of \$10,000 from DT1 2. dividend income of \$15,000 3. rental income of \$5,000. <p>DT2 has \$6,000 of deductible expenses which reduce this</p>	<p>In this example, the amount that the Commissioner will determine is the amount of the deemed entitlement will depend on all of the facts of the case. The draft Determination provides that the deemed entitlement will not be more than \$10,000. Because each beneficiary received a share of the undissected trust income, it would be reasonable to suppose each beneficiary was rateably entitled to income in respect of the DT1 distribution. However, the actual amount of the deemed entitlement will likely depend on what category of income the expenses are attributable against. Some may need to be apportioned.</p> <p>As stated above, additional examples will be included in the final Determination.</p>

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	<p>assessable income to net income of \$24,000.</p> <p>The trustee resolves to distribute \$20,000 of the trust's net income to Smith Pty Ltd and the balance to Mr Smith without distinguishing between categories of income.</p> <p>From the above, the following determinations, amongst others, are possible:</p> <ul style="list-style-type: none"> • 50% of Smith Pty Ltd's UPE (\$10,000/\$20,000) relates to DT2's UPE with DT1, so the amount determined by the Commissioner under subsection 109XI(4) could be 50% of DT2's UPE in DT1: \$5,000; • \$10,000 of Smith Pty Ltd's UPE relates to DT2's UPE with DT1, so the amount determined by the Commissioner under subsection 109XI(4) could be \$10,000; • One third of Smith Pty Ltd's UPE (\$10,000/\$30,000 gross income) relates to DT2's UPE with DT1, so the amount determined by the Commissioner under subsection 109XI(4) could be \$3,333 (one third of DT2's UPE in DT1); • 41.67% of Smith Pty Ltd's UPE (\$10,000/\$24,000 net income) relates to DT2's UPE with DT1, so the amount determined by the Commissioner under subsection 109XI(4) could be \$4,167 (41.67% of DT2's UPE in DT1); • \$4,000 of Smith Pty Ltd's UPE (\$10,000-\$6,000) relates to DT2's UPE with DT1, so the amount determined by the Commissioner under subsection 109XI(4) could be \$4,000; • One sixth of Smith Pty Ltd's UPE ([\$10,000-\$6,000]/\$24,000 net income) relates to DT2's UPE with DT1, so the amount determined by the Commissioner under subsection 109XI(4) could be \$1,667 (one sixth of \$10,000); and • None of Smith Pty Ltd's UPE relates to DT2's UPE with DT1 	

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	<p>(being entirely funded by DT2's other sources of income), so the amount determined by the Commissioner under subsection 109XI(4) could be \$nil.</p> <p>Not all of the above determinations are suggested to be ones that a reasonable person would make, but it is noted that further variations are possible once the diluting effect of Mr Smith's UPE in DT2 is taken into account. Since Mr Smith's personal UPE funds part of DT2's assets, it would also be reasonable to reduce the amounts above by one sixth (4,000/24,000ths, representing Mr Smith's UPE balance as a proportion of the total UPEs in DT2).</p>	
10	<p>Application of subsection 109XB(1)</p> <p>Where section 109XI applies section 109XB includes an amount (the Division 7A amount) in the shareholder's or an associate's assessable income as if it were a dividend paid by the private company, subject to the limit imposed by section 109Y.</p> <p>In the above scenarios, the maximum Division 7A amount that would be included in the assessable income of Mrs Smith pursuant to subsection 109XB(1) is \$5,000. However, it can be readily seen that the loan to Mrs Smith is partly funded by the private company's UPE and partly by the non-corporate beneficiary's UPE.</p> <p>Given that the policy intent of Division 7A is to tax disguised distributions of company profits to shareholders or their associates, we question the fairness and equity of applying subsection 109XB(1) in the manner proposed.</p> <p>We consider that not only would it be more reasonable for the Division 7A amount to be determined in proportion to its funding, but that that would also be a more fair and equitable treatment.</p>	<p>If there is a deemed present entitlement and the Commissioner has determined the amount of that entitlement then sections 109XA and 109XB are applied to the facts of the case with the amount of the actual transaction determined by subsection 109XA(4). Essentially, the legislative framework is to attribute the source of relevant loans first to funds representing a company's unpaid entitlements, to the extent that this is possible, and then to other sources of funding within the trust.</p>