

# ***TR 2010/3 - Income tax: Division 7A loans: trust entitlements***

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## Taxation Ruling

### Income tax: Division 7A loans: trust entitlements

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#### **ⓘ This publication provides you with the following level of protection:**

This publication (excluding appendixes) is a public ruling for the purposes of the *Taxation Administration Act 1953*.

A public ruling is an expression of the Commissioner's opinion about the way in which a relevant provision applies, or would apply, to entities generally or to a class of entities in relation to a particular scheme or a class of schemes.

If you rely on this ruling, the Commissioner must apply the law to you in the way set out in the ruling (unless the Commissioner is satisfied that the ruling is incorrect and disadvantages you, in which case the law may be applied to you in a way that is more favourable for you – provided the Commissioner is not prevented from doing so by a time limit imposed by the law). You will be protected from having to pay any underpaid tax, penalty or interest in respect of the matters covered by this ruling if it turns out that it does not correctly state how the relevant provision applies to you.

## What this Ruling is about

1. This Ruling expresses the Commissioner's opinion on the circumstances in which a private company with a present entitlement to an amount from an associated trust estate makes a loan to that trust within the meaning of subsection 109D(3) of Division 7A of Part III (Division 7A) of the *Income Tax Assessment Act 1936* (ITAA 1936),<sup>1</sup> in circumstances where funds representing that present entitlement remain intermingled with funds of the trust.

2. This Ruling sets out the Commissioner's views in the context of Division 7A. Nothing in this Ruling should be taken as applying to the provisions of other legislation administered by the Commissioner such as specific superannuation legislation or fringe benefits tax legislation.

3. In this Ruling (unless context otherwise dictates):

- **Division 7A loan** has the meaning given in paragraph 5 of this Ruling;
- **family group** means a group of related entities including or comprising a *private company* and a *trust*, that ultimately share the same directing mind and will, or in other words where the same entities or persons have the practical ability to, or capability to, control the family group;

<sup>1</sup> All legislative references in this Ruling are to the ITAA 1936 unless otherwise stated.

- **ordinary loan** means a 'loan' within the ordinary meaning of that term;
- **private company** means a private company, as defined in Division 7 of Part III, that is part of a *family group*;
- **sub-trust** means a separate trust arising in equity, in respect of which the *private company* is the sole beneficiary and upon which amounts that the *private company* is presently entitled to receive from another trust (called the main *trust*) are held;
- **subsisting UPE** means a UPE that has not been satisfied, including by being converted into (or replaced by) an ordinary loan;
- **trust** (other than a *sub-trust*) means a trust that is part of a *family group*, that has loans from a *private company* that may be relevant for the purposes of Division 7A (typically where the trust is an associate of a shareholder of the *private company*),<sup>2</sup>
- **trust purposes** are purposes of benefiting one or more beneficiaries or discretionary objects of a trust estate; but does not include use of funds representing a *private company* beneficiary's *UPE* for the purpose of solely benefiting that *private company*; and
- **unpaid present entitlement (UPE)** means a *private company's* unpaid present entitlement to an amount from a *trust* or *sub-trust*.

## Ruling

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### Section one: background

4. This Ruling considers the application of Division 7A to certain loans made by a private company to a trustee of a trust, in circumstances where:

- the trustee of the trust is an associate (within the meaning given in section 318) of one or more shareholders of the private company;
- the trust is part of the same family group as the private company;

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<sup>2</sup> Pursuant to sections 109ZD and 318, the trustee of a trust will be an associate of a shareholder of a company for relevant purposes if any of the private company's shareholders or their associates are capable of benefiting (including as discretionary objects) under that trust, either directly or through any interposed companies, partnerships or trusts.

- the private company has (or had) a present entitlement to an amount from the trust; and
- funds representing the present entitlement remain intermingled with other funds of the trust estate, or are otherwise able to be used for 'trust purposes', (including if they remain so intermingled or available to be used for trust purposes by being paid back to, reinvested in, or loaned back to the trust by a relevant sub-trust).

5. For the purposes of Division 7A, a loan (a 'Division 7A loan') includes:

- a loan within its ordinary meaning (an 'ordinary loan'), consisting of a payment and an obligation to repay;
- an advance of money ahead of a due date or with an expectation of repayment;
- the provision of credit or any other form of financial accommodation, in the context in which it appears being the supply or grant of some form of pecuniary assistance or favour, under a consensual agreement where a principal sum or its equivalent is ultimately payable;
- a payment of an amount for, on behalf of, on account of or at the request of an entity, where there is an obligation of repayment; and
- transactions that in substance effect such a Division 7A loan of money (as described in any of the above dot-points).

6. To be a loan that may be treated as a dividend under section 109D, the loan must be *made* by the relevant private company. A private company may make a Division 7A loan by bringing a Division 7A loan into existence; or causing, occasioning, effecting or giving rise to such a loan. Making a Division 7A loan need not necessarily involve positive action on the part of the private company but may be inferred from all the surrounding circumstances.

## **Section two: loans within the ordinary meaning**

7. A subsisting UPE is not of itself an ordinary loan.

8. However, in situations where a UPE is satisfied (for example, by being paid out) and loaned back to the trustee, the UPE is effectively replaced by an ordinary loan from the private company to the trustee of the trust.

9. A private company makes an ordinary loan to the trustee of a trust if it provides moneys to the trustee pursuant to an *agreement* under which the trustee borrows the money on behalf of the trust and the private company lends the moneys to the trustee of the trust. Such a loan from the private company can be effected by an agreed set-off in satisfaction of the trustee's obligation to pay the private company its trust entitlement, rather than as a cash transaction.

10. The agreement between the private company beneficiary and the trustee may be an implied agreement. For example, if the private company has *knowledge* that the trustee has treated its UPE as having been satisfied and a corresponding amount borrowed back (as evidenced, for example, by crediting a loan account in the name of the private company beneficiary) and the private company *acquiesces* to that treatment, it will be inferred that it has consented to that loan being made.

11. In the absence of sufficient evidence to the contrary, where the trust and private company beneficiary form part of the same family group, the Commissioner takes the view that the private company has knowledge of the trustee crediting a loan account in its name.

12. However, if the private company has acted inconsistently with treating the amount as having been loaned to the trust, it is not taken to have acquiesced to any treatment by the trustee of the amount as a relevant loan.

13. A trustee may also make a loan on behalf of the private company beneficiary by acting *pursuant to a term of the trust deed* which permits 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 a 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 (whether or not at interest). In these circumstances, the relevant trust funds are regarded as having been applied for the benefit of the private company (rather than an entitlement arising that is unpaid) and the private company beneficiary is taken to have made an ordinary loan to the trustee.

14. If an amount has been credited to a loan account in the name of the private company beneficiary *and* under the trust deed the trustee has the power to do so as a payment or application of trust funds for the benefit of that private company, in the absence of sufficient evidence to the contrary, the Commissioner takes the view that the trustee intended to, and in fact, created a loan in exercise of this power.

15. An ordinary loan does not arise in the manner described in paragraph 13 of this Ruling if instead of a debtor/creditor relationship being created (or other Division 7A loan arising), it is outside the power of the trustee to treat the funds otherwise than as a UPE and the amount to which the private company beneficiary is entitled remains a UPE rather than being converted into an ordinary loan.

### **Section three: Division 7A loans within the extended meaning**

16. Note that this section of the Ruling does not apply to taxpayers in respect of all or part of any UPE that arose before 16 December 2009 – see paragraph 28 of this Ruling.

17. Notwithstanding the extended definition of a 'loan' for the purpose of Division 7A, a subsisting UPE does not amount to a Division 7A loan specifically:

- within the ordinary meaning of a loan;
- under paragraph 109D(3)(a) of the extended definition as there is no advance of money involving a payment in advance of a due date or a payment in expectation of repayment; or
- under paragraph 109D(3)(c) of the extended definition as there is no payment coupled with an obligation to repay.

18. However, in some circumstances, a private company beneficiary provides *financial accommodation* to the trustee of a trust, or enters into a transaction with the trustee of a trust which *in substance effects* a Division 7A loan, such that the private company makes a Division 7A loan to the trustee of the trust in respect of its UPE.

#### ***Provision of financial accommodation or an in-substance loan***

19. A private company beneficiary provides financial accommodation to the trustee of a trust in respect of which it has a UPE if, under a consensual agreement:

- the private company supplies or grants some form of pecuniary aid or favour to the trust; and
- a principal sum or equivalent is ultimately payable to the private company.

20. As the amount of the UPE is a principal sum ultimately payable to the private company beneficiary, the private company provides financial accommodation to the trustee of a trust for the purposes of the extended meaning of a loan in subsection 109D(3) if it provides any pecuniary aid or favour to the trustee of that trust under a consensual agreement.

21. A consensual agreement for the provision of pecuniary aid or favour to the trustee of a trust arises if a private company beneficiary authorises (including by acquiescing with knowledge of) the trustee's continued use for trust purposes of the funds representing the private company's UPE by not calling for:

- the payment of that UPE; or

- the investment of the funds representing the UPE for the private company's sole benefit rather than their use for the benefit of the trust.

22. In these circumstances the private company provides pecuniary support to the trustee equal to the whole amount of the UPE that the private company beneficiary has allowed the trustee to use (including by knowledgeably acquiescing to this use) for trust purposes.

23. Accordingly, if a private company beneficiary has knowledge that funds representing its UPE are being used by the trustee for trust purposes (rather than being held and / or used for that private company's sole benefit), in not calling for payment of its UPE the private company provides the trustee with financial accommodation and, by extension, makes a Division 7A loan to the trustee.

24. The overall transaction between the private company beneficiary and the trustee includes:

- the use of the funds representing the private company's UPE by the trustee for trust purposes (until such time as the UPE is called for), and
- the private company's authorisation (or acquiescence with knowledge) of this use.

25. As such the overall transaction also effects, in substance, a loan of money from the private company to the trustee of the trust.

26. Where the trust and beneficiary form part of the same family group, in the absence of sufficient evidence to the contrary, the Commissioner takes the view that the private company has knowledge of the trustee's use of the funds representing the UPE for trust purposes.

## Date of effect

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27. Subject to the exception mentioned in paragraph 28 of this Ruling, this Ruling applies both before and after its date of issue. However, this Ruling does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 75 to 77 of Taxation Ruling TR 2006/10).

28. Section three of this Ruling (contained in paragraphs 16 to 26) provides the Commissioner's view of when a subsisting UPE may be a loan for the purpose of Division 7A. Section three of this Ruling does not apply to UPEs arising before 16 December 2009.

29. Section three of this Ruling has this date of effect due to public statements the Commissioner made prior to issuing this Ruling in draft form as TR 2009/D8 on 16 December 2009. Those statements evidenced a prior general administrative practice contrary to the view as set out in Section three. For example, many former versions of the fact sheet '*Division 7A – Answers to frequently asked questions*' published prior to February 2009 advised that the retention on trust of an unpaid present entitlement was not a loan for Division 7A purposes. Additional evidence of the existence of that prior practice includes statements made at the 5 December 2002 meeting of the *National Taxation Liaison Group*, where the Australian Taxation Office (ATO) considered trust distributions to private companies that remained outstanding for some years. The ATO advised that the former section 109UB of Division 7A may apply if the trustee on-lends funds to individual shareholders, but made no mention of whether the UPE could itself be a loan for Division 7A purposes.

30. Whilst the prior public statements referred to in paragraph 29 of this Ruling considered whether a *subsisting UPE* could be a loan for Division 7A purposes, they did not encompass the situation discussed in Section two of this Ruling where a private company beneficiary makes an ordinary loan to the trustee of the trust. When the ordinary loan comes into existence there is no longer a subsisting UPE. It has never been doubted that ordinary loans made by private companies to their shareholders (or associates of their shareholders) will attract the operation of Division 7A. As such, the Ruling applies both before and after its date of issue if an ordinary loan is made as described in Section two of this Ruling.

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**Commissioner of Taxation**2 June 2010

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## Appendix 1 – Explanation

**❶** *This Appendix is provided as information to help you understand how the Commissioner's view has been reached. It does not form part of the binding public ruling.*

### Section one: background

31. One of the purposes of Division 7A is to ensure that private companies are not able to make distributions of profits to shareholders (or their associates) in the form of non-arm's length loans instead of in the form of dividends that would be assessable to the shareholder.<sup>3</sup> To achieve this purpose, subsection 109D(1) generally operates to treat such loans as assessable dividends of the relevant shareholders (or their associates) where:

- a private company makes a loan as defined in subsection 109D(3) to a shareholder (or their associate);<sup>4</sup>
- the loan is not fully repaid before the company's lodgement day for the year in which the loan is made;<sup>5</sup>
- the exceptions in Subdivision D of Division 7A do not apply; and
- the private company has sufficient distributable surplus such that section 109Y does not operate to reduce the amount of the dividend that would otherwise be deemed to have been paid.

32. This Ruling considers the first of these conditions. Specifically, it considers in what circumstances a private company is taken to 'make a loan' (within the meaning of subsection 109D(3)) to the trustee of a trust, where:

- the trustee of the trust is an associate (within the meaning given in section 318) of one or more shareholders of the private company;
- the trust is part of the same family group as the private company;
- the private company has (or had) a present entitlement to an amount from the trust; and

<sup>3</sup> See paragraphs 9.1 and 9.2 of the Explanatory Memorandum accompanying the Taxation Laws Amendment Bill (No. 3) 1998, and section 109N.

<sup>4</sup> Or to an entity which has been such a shareholder or associate at some time, and a reasonable person would conclude (having regard to all the circumstances) that that is why the loan is made: See subparagraph 109D(1)(d)(ii).

<sup>5</sup> See also subsection 109D(6).

- funds representing the present entitlement remain intermingled with other funds of the trust estate, or are otherwise able to be used for 'trust purposes', (including if they remain so intermingled or available to be used for trust purposes by being paid back to, reinvested in, or lent back to the trust by a relevant sub-trust). (See the definition of 'trust purposes' set out in paragraph 3 of this Ruling.)

### **Unpaid present entitlement**

33. A beneficiary can become presently entitled to an amount from a trust pursuant to a direct term of the relevant trust deed, or as a result of the trustee of the trust exercising a power under the trust deed to make the beneficiary so entitled (usually by resolution).<sup>6</sup> In situations where the funds to which the beneficiary is made presently entitled continue to be held on trust for that beneficiary until such time as the beneficiary calls for payment, the entitlement is commonly referred to as an 'unpaid present entitlement' (UPE).

34. When a beneficiary is presently entitled to an amount from a trust estate, it has an equitable right to that amount. That is, the beneficiary has rights in equity and not, without more, as a result of any debtor-creditor relationship.<sup>7</sup>

35. When a beneficiary is made presently entitled to an amount that is not paid, trust property representing the UPE may be held on a sub-trust (as corpus of that sub-trust). The trustee typically continues to legally hold property so held on sub-trust, but in its capacity as trustee of the sub-trust rather than of the main trust. (See the definition of 'sub-trust' set out in paragraph 3 of this Ruling.)

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<sup>6</sup> The amounts to which a beneficiary may become presently entitled is therefore subject to the terms of the trust. This is separate and distinct to any share of the net income of the trust estate included in the assessable income of the beneficiary under Division 6 of Part III of the ITAA 1936. See for example *Commissioner of Taxation v. Bamford*; *Bamford v. Commissioner of Taxation* [2010] HCA 10; 264 ALR 436; 2010 ATC 20-170.

<sup>7</sup> For example, see McCarthy J in *Commissioner of Inland Revenue v. Ward* 69 ATC 6050 at 6071; (1969) 1 ATR 287 at 313.

36. A sub-trust can arise whether or not there is a specific clause in the deed of the main trust so providing. For example, in *Case U157*<sup>8</sup> the trustee distributed income to a minor beneficiary, and despite there being no clause in the relevant trust deed that such amounts were to be held on separate trust, the Tribunal found:

As trustee, it was bound to hold that property on trust for its beneficiary. As that property was held specifically for the individual beneficiary..., it was not subject to the trusts of the [main trust]. It must, therefore, have been held on a separate trust for [that individual beneficiary].<sup>9</sup>

37. Any income derived from the investment of the corpus of the sub-trust (for example, by the sub-trust lending funds to the main trust)<sup>10</sup> is properly the income of the sub-trust and not the main trust.<sup>11</sup>

38. Irrespective of whether the beneficiary has a UPE to an amount from the main trust or is entitled to the corpus of a sub-trust, until that unpaid entitlement is satisfied (for example, by the entitlement being paid to the beneficiary or being set-off against amounts owing by the beneficiary), it remains outstanding. Such UPEs are referred to in this Ruling as 'subsisting UPEs'. (See also the definition of a 'subsisting UPE' set out in paragraph 3 of this Ruling.)

39. 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. The practice seeks to have the corporate rate of tax applied to the entitlement rather than the higher rate that applies when a trustee accumulates the income of the trust. Economically, the practice replicates a trustee accumulation and the policy of the law is thereby being compromised when the trustee uses the income, for effectively no cost, for trust purposes and not for the benefit of its real owner, the corporate beneficiary. In this sense, the trust has the benefit of the profits of the related private company. A question thus arises about the application of Division 7A. This Division was enacted in 1998 to ensure that private companies were not able to make tax free distributions of profits to shareholders (or their associates) in the form of payments, loans or forgiven debts.

<sup>8</sup> 87 ATC 912; *AAT Case VT 85/597* (1987) 18 ATR 3772. See also *Case V4 88 ATC 123* per KL Beddoe SM at 130 and *Case 24/96 96 ATC 296*; *AAT Case 10,796* (1996) 32 ATR 1168, at paragraph 12.

<sup>9</sup> 87 ATC 912 at 914; 18 ATR 3772 at 3774.

<sup>10</sup> See for example *Case U111 87 ATC 667*; *AAT Case 83* (1987) 18 ATR 3602 and *Case U157 87 ATC 912*; *AAT Case VT 85/597* (1987) 18 ATR 3772.

<sup>11</sup> See for example *Davies J* in *Case U111 87 ATC 667* at 670; *AAT Case 83* (1987) 18 ATR 3602 at 3605.

**Division 7A loans**

40. A 'loan'<sup>12</sup> is defined for the purposes of Division 7A in subsection 109D(3) as including:

- (a) an advance of money; and
- (b) a provision of credit or any other form of financial accommodation; and
- (c) a payment of an amount for, or on account of, on behalf of or at the request of, an entity, if there is an express or implied obligation to repay the amount; and
- (d) a transaction (whatever its terms or form) which in substance effects a loan of money.

41. In this Ruling, the term 'Division 7A loan' is used to refer to loans within the ordinary meaning of the word in addition to those arrangements or circumstances falling within the extended definition of a loan for Division 7A purposes set out in subsection 109D(3). (See also the definition of a 'Division 7A loan' set out in paragraph 5 of this Ruling).

42. For a Division 7A loan to be treated as a dividend under subsection 109D(1), that loan must be 'made' by the relevant private company.

43. 'Made' is the past tense of 'make'. The Macquarie dictionary<sup>13</sup> relevantly defines 'make' as follows:

**make** ... **1.** to bring into existence by shaping material, combining parts, etc.: *to make a dress*. **2.** to produce by any action or causative agency: *to make trouble*. **3.** to cause to be or become; render: *to make an old man young*... **6.** to bring into a certain form or condition: *to make bookcases out of orange boxes*. **7.** to cause, induce, or compel (to do something): *to make a horse go*. **8.** to give rise to; occasion. ... **12.** to do; effect: *to make a bargain*. **13.** to fix; establish; enact: *to make laws*.

44. The Australian Oxford Dictionary,<sup>14</sup> similarly defines 'make' in the relevant sense as follows:

**make** v. **1.** construct; create; form from parts or other substance... **2.** cause or compel (a person etc.) to do something... **3.** (a) cause to exist; create; bring about... (b) cause to become or seem... **4.** compose; prepare; draw up... **6.** (a) undertake or agree to... (b) execute or perform... **12.** establish or enact...

45. Accordingly, section 109D is looking to something on the part of a private company which brings into existence, causes, occasions, effects or gives rise to a loan, or to an arrangement or circumstance that is taken to be a Division 7A loan under subsection 109D(3).

<sup>12</sup> Herein referred to as a '**Division 7A loan**'.

<sup>13</sup> The Macquarie Dictionary, [Multimedia], version 5.0.0, 1/10/01.

<sup>14</sup> *The Australian Oxford Dictionary*, 2nd edition. Ed. Bruce Moore. Oxford University Press, 2004. Oxford Reference Online. Oxford University Press, 23/3/2010

**Section two: loans within the ordinary meaning**

46. What amounts to an ordinary loan was explained by Sackville and Lehane JJ in *Federal Commissioner of Taxation v. Radilo Enterprises Pty Ltd (Radilo)*<sup>15</sup> as follows:

A loan involves an obligation on the borrower to repay the sum borrowed. The matter is put this way by Dr Pannam:

A loan of money may be defined, in general terms, as a simple contract whereby one person ('the lender') pays or agrees to pay a sum of money in consideration of a promise by another person ('the borrower') to repay the money upon demand or at a fixed date. The promise of repayment may or may not be coupled with a promise to pay interest on the money so paid. The essence of the transaction is the promise of repayment. As Lowe J put it in a judgment delivered on behalf of himself and Gavan Duffy and Martin JJ: "Lend" in its ordinary meaning in our view imports an obligation on the borrower to repay'.<sup>16</sup> ... Repayment is the ingredient which links together the definitions of 'loan' to be found in the *Oxford English Dictionary*, the various legal dictionaries and the text books. In essence then a loan is a payment of money to or for someone on the condition that it will be repaid.<sup>17</sup>

47. The essential element of an ordinary loan is obligation to repay a borrowed amount. The fact that a debt exists is not, of itself, sufficient to characterise an arrangement as a loan. For example, in *Prime Wheat Association Ltd v. Chief Commissioner of Stamp Duties (Prime Wheat Association)*<sup>18</sup> Gleeson CJ acknowledged that a share sale agreement which provided for payment by instalments over a 20 year period was a debt and the provision of financial accommodation, but as there was only 'payment' and not 'repayment', there was no loan.<sup>19</sup> Similarly, the Full Federal Court found that the sale and lease-back arrangement in *Eastern Nitrogen Ltd v. Commissioner of Taxation*<sup>20</sup> was a financing arrangement for financial accommodation, but without the obligation to repay a sum advanced, it was not a loan.<sup>21</sup>

48. Once there is an arrangement for the repayment of an amount advanced, there is an ordinary loan irrespective of whether the rights in respect of that arrangement arise under contract or in equity.<sup>22</sup> Moreover, there is no requirement that an ordinary loan be in writing.

<sup>15</sup> (1997) 72 FCR 300; 97 ATC 4151; (1997) 34 ATR 635.

<sup>16</sup> *Ferguson v. O'Neil* [1943] VLR 30 at 32.

<sup>17</sup> At ATC 4161; ATR 646; quoting CL Pannam, *The law of money lenders in Australia and New Zealand* (1964), at 6.

<sup>18</sup> (1997) 42 NSWLR 505; 97 ATC 5015; (1997) 37 ATR 479.

<sup>19</sup> At NSWLR 512; ATC 5019–5020; ATR 484.

<sup>20</sup> (2001) 108 FCR 27; [2001] FCA 366; 2001 ATC 4164; (2000) 46 ATR 474.

<sup>21</sup> See in particular Carr J at FCR 39; ATC 4173; ATR 485.

<sup>22</sup> See *De Vigier v. Inland Revenue Commissioners* [1964] 2 All ER 907 at 911; [1964] 1 WLR 1073 at 1080; per Lord Pearce at All ER 911; WLR 1080; per Lord Upjohn at All ER 915; WLR 1084.

49. A private company with a subsisting UPE has an equitable right to demand payment of the distributed amount. However, without more, there has been no payment requiring repayment, in the sense required for an ordinary loan. Accordingly, a UPE of itself is not a loan within the ordinary meaning of that term.

50. Notwithstanding that a UPE is not of itself an ordinary loan, it has long been acknowledged that a beneficiary's entitlement can be satisfied and replaced by a loan back to the trustee of the trust (see for example *Re East Finchley Pty Limited v. Commissioner of Taxation (East Finchley)*;<sup>23</sup> and paragraph 8.10 of the Explanatory Memorandum accompanying the introduction of the Tax Laws Amendment (2004 Measures No. 1) Bill 2004.

51. A private company beneficiary may make an ordinary loan to the trustee of a trust by:

- agreeing to make a loan to the trustee in satisfaction of a subsisting UPE; or
- having an amount applied by the trustee for the company's benefit in the form of a loan asset instead of having a UPE.

### **By agreement**

52. A private company beneficiary may make a loan to the trustee of a trust by providing moneys to the trustee pursuant to an agreement under which the trustee borrows the moneys on behalf of the trust and the private company lends the moneys to the trust.

53. A loan from the private company made under an agreement may be effected by an agreed set-off in satisfaction of the trustee's obligation to pay the private company its trust entitlement. The basic principle of set-off is explained by Mellish LJ in *Spargo's case*<sup>24</sup> as follows:

Nothing is clearer than that if parties account with each other, and sums are stated to be due on one side, and sums to an equal amount due on the other side on that account, and those accounts are settled by both parties, it is exactly the same thing as if the sums due on both sides had been paid. Indeed, it is a general rule of law that in every case where a transaction resolves itself into paying money by A to B and then handing it back again by B to A, if the parties meet together and agree to set one demand against the other, they need not go through the form and ceremony of handing money backwards and forwards...<sup>25</sup>

<sup>23</sup> [1989] FCA 481 at [55] to [56]; 89 ATC 5280 at 5291; (1989) 20 ATR 1623 at 1635.

<sup>24</sup> *In re Harmony and Montague Tin and Copper Mining Company (Spargo's Case)* (1873) 8 Ch. App. 407; [1861-73] All ER Rep 261.

<sup>25</sup> At Ch. App. 414; All ER Rep 265.

54. In *Manzi v. Smith*<sup>26</sup> the High Court said that payment by journal entry, such as in set-off cases, is only effective with the knowledge and agreement of the parties. Barwick CJ stated:

... the appellants were not shown to be in any wise privy to the said entries in the company's books, or for that matter had any knowledge of them. They had certainly not adopted them.

...

We were referred to cases in which a payment of money was held to have been made by means of entries in books of account. But in those cases the entries represented the agreement of the appropriate parties e.g. *Eyles v. Ellis*<sup>27</sup> ... *Spargo's Case*. These decisions, quite clearly, are not authority for the proposition for which they were advanced, namely, that a payment of money was made by the making by the company of a journal entry in the books of account without reference to, or without the agreement of, the persons said to be the recipients of the money.<sup>28</sup>

55. No UPE remains outstanding if the private company agrees to lend the amount to which it is entitled to the trust and effects this loan by way of set-off against that entitlement.

56. The agreement between the private company and the trustee may be express or implied. An implied agreement is inferred from the conduct of the parties<sup>29</sup> or from the surrounding circumstances.

57. If a trustee credits an entitlement to a loan account held in the name of the private company beneficiary, with the authorisation of the private company, the private company lends money to the trust within the ordinary sense. This was the situation in *Re East Finchley Pty Limited v. Commissioner of Taxation (East Finchley)*.<sup>30</sup>

58. In *East Finchley* the trustee advised beneficiaries that income had been appointed to them and that it had been credited to loan accounts in their names. The beneficiaries sent letters back acknowledging their entitlements and authorising their loan accounts to be so credited. Hill J found that by authorising this treatment, the beneficiaries had loaned money to the trust by way of set-off, explaining:

[T]he combination of the two letters ... constituted a sufficient demand for payment to bring about a situation that there was an obligation in equity by force of the trust deed to pay to the beneficiaries and an obligation by virtue of the loan agreement between the trustee and beneficiaries in law to pay by way of loan the moneys to the trustee by the beneficiaries so that the principle in *Spargo's case* brought about the result that there was in law a payment.<sup>31</sup>

<sup>26</sup> (1975) 132 CLR 671; [1975] HCA 35.

<sup>27</sup> [1827] EngR 409; (1827) 4 Bing. 112; 130 ER 710.

<sup>28</sup> CLR 673 and 674; HCA 35 at paragraphs 6 and 7.

<sup>29</sup> See, for example, *Empirnall Holdings Pty Ltd v. Machon Paull Partners Pty Ltd* (1988) 14 NSWLR 523 and *Clarke v. Dunraven* [1897] AC 59; [1895] P 248.

<sup>30</sup> [1989] FCA 481; 89 ATC 5280; (1989) 20 ATR 1623.

<sup>31</sup> At ATC 5291; ATR 1635.

59. In *Spellson v. George*<sup>32</sup> the Supreme Court of New South Wales had cause to consider what would amount to the consent of a beneficiary to the actions of a trustee in the context of a claim by the beneficiary that there had been a breach of trust. In his judgment, Handley JA, observed:

Consent may take various forms. These include active encouragement or inducement, participation with or without direct financial benefit, and express consent. Consent may also be inferred from silence and lack of activity with knowledge.<sup>33</sup>

60. If a private company beneficiary has *knowledge* that the trustee has treated an amount as a loan from that private company and acquiesces to that treatment, it will be inferred that it has consented to that loan being made. This consent or acceptance results in an ordinary loan being made to the trustee by the private company (see paragraphs 42 to 45 of this Ruling).

61. If the private company has knowledge that the trustee has treated its company's UPE as having been satisfied and lent back to the trust, but acts inconsistently with this treatment (rather than doing nothing or adopting the trustee's treatment), there is no inference that the private company has agreed to such a loan. In these circumstances the private company's actions are evidence that it has not agreed to the trustee's treatment of its UPE as having been satisfied and loaned back to the trustee.

### **Knowledge**

62. *Taylor v. Smith*<sup>34</sup> involved an agent acting upon a mistake of fact and exceeding its authority. The High Court considered the issue of ratification through acquiescence, the majority concluding that it must be done consciously and with full knowledge of the facts. Higgins J observed:

I cannot conceive of authority being given by a principal to an agent, either prospectively or retrospectively (by ratification), unless it be given consciously. I include, of course, conscious acquiescence in the sense explained in *De Bussche v. Alt* (1878) 8 Ch. D., at p. 314.

But it is also necessary for ratification that at the time thereof the alleged ratifier should have full knowledge of all the material circumstances under which the act was done...<sup>35</sup>

63. Accordingly, a company may authorise the actions of a trustee by its acquiescence, but only if it first has full knowledge of what the trustee has done.

<sup>32</sup> (1992) 26 NSWLR 666; [1992] NSWCA 254.

<sup>33</sup> At NSWLR 669-670; NSWCA 4.

<sup>34</sup> [1926] HCA 16; [1926] VLR 271; (1926) 38 CLR 48.

<sup>35</sup> At CLR 59. See also Knox CJ at CLR 54 and Rich J at CLR 60.

64. In considering the knowledge the private company may have of the trustee's actions, it is relevant that the arrangements being considered in this Ruling are those where both the trustee and the private company beneficiary are entities within the same family group that share the same directing mind and will.

65. The doctrine of a corporation's 'directing mind and will' was explained by Millet J in *El Ajou v. Dollar Land Holdings plc and another*<sup>36</sup> (referred to with approval on appeal)<sup>37</sup> as follows:

Since a company is an artificial person, the knowledge of those who manage and control it must be treated as the knowledge of the company.<sup>38</sup> ... Those who 'constitute the directing mind and will of the company' are the company for this purpose.<sup>39</sup> Their minds are its mind; their intention its intention; their knowledge its knowledge.

66. In circumstances where a number of entities share a common controller, the controller's knowledge of one of the group's affairs can generally be attributed to another member of the same group. In *Endresz v. Whitehouse*<sup>40</sup> Ormiston JA referred to 'the principle applicable to controlling directors'. He quoted from Ford's *Principles of Corporations Law* as follows:

A distinction has to be drawn between the case where the director is a controller of two companies and where the director is only one of several directors of two companies. In the former case each company will know what the other knows because they each have the same directing mind and will: attribution of the director's knowledge to each company does not depend on the existence of a duty but on the director being identified with each company as its directing mind and will.<sup>41</sup>

67. The directing mind and will of a private company need not be limited to its board or one or more directors.<sup>42</sup> Case law establishes that different persons may for different purposes satisfy the requirements of being an entity's directing mind and will.<sup>43</sup>

<sup>36</sup> [1993] 3 All ER 717 at 740; [1993] BCC 698 at 719.

<sup>37</sup> See Nourse LJ in *El Ajou v. Dollar Land Holdings plc* [1994] 2 All ER 685 at 696; [1993] EWCA Civ 4; [1994] BCC 143 at 151, although note that Millet J's decision was overturned on this appeal.

<sup>38</sup> See *J.C. Houghton & Co v. Nothard Lowe & Wills Ltd* [1928] AC 1, [1927] All ER Rep 97 and *Re Montagu's Settlement Trusts* [1992] 4 All ER 308 at 328, [1987] Ch 264 at 283.

<sup>39</sup> *Tesco Supermarkets Ltd v Nattrass* [1972] AC 153; [1971] 2 All ER 127; [1971] UKHL 1 per Viscount Dilhorne at AC 187; All ER 145; UKHL 16.

<sup>40</sup> (1997) 24 ACSR 208; [1998] 3 VR 461.

<sup>41</sup> See at ACSR 228-9; VR 482, quoting paragraph 16.220 of Ford's *Principles of Corporations Law*, looseleaf, vol 1, Butterworths, Service 5: 4/96. Note that Ormiston J referred to this principle applicable to controlling directors without having to decide whether it was appropriate to the matters considered in that judgment.

<sup>42</sup> See for example *The Lady Gwendole; Arthur Guinness Son and Co (Dublin) Ltd v. Owners of Motor Vessel Freshfield and Others* [1965] 2 All ER 283; [1965] 3 WLR 91; *Nationwide News Pty Ltd v. Naidu* (2007) 71 NSWLR 471; [2007] NSWCA 377; (2007) Aust Torts Reports 81-928.

<sup>43</sup> See *El Ajou v. Dollar Land Holdings Ltd* [1993] 3 All ER 717; [1993] BCLC 735; [1993] BCC 698. See also *Tesco Supermarkets Ltd v. Nattrass* [1972] AC 153; [1971] 2 All ER 127; [1971] UKHL 1 per Lord Reid at AC 171; All ER 132; UKHL 4.

68. If the same person or persons are the directing mind and will of both the relevant private company beneficiary and the trustee in respect of affairs relevant to the private company's UPE (such as the treatment of that UPE and / or dealings with that UPE), then subject to sufficient evidence to the contrary the Commissioner takes the view that both the company and trustee know what the other knows because they have this same directing mind and will.

***Evidence of an ordinary loan made by a private company by agreement***

69. Whether a UPE has been converted into an ordinary loan (that is, by being satisfied and replaced by a loan back to the trustee by agreement) is ultimately a question of fact. As mentioned at paragraph 56 of this Ruling, an ordinary loan may be expressly agreed or the agreement may be implied, so it will not necessarily be in writing.

70. In many instances, accounting entries evidence actual transactions (including loans), and provide evidence of what has in fact happened. However, if the accounts record the private company beneficiary as having made a loan to the trustee but the true substance of the arrangement is different, an ordinary loan is not taken to have been made by the private company.

71. For example, in Case 5/94<sup>44</sup> a UPE of a beneficiary from a trust under which such entitlements were to be set aside on separate trust, was instead recorded in the trust's books of account as a loan from the beneficiary. Specifically, the amounts allocated were:

distributed by way of journal entries in the Trust records and ... the accountant engaged to write up the accounting records of the Trust ... decided of his own volition to use the title of 'loan'. Furthermore, ... the question of how those allocations should be treated was not addressed by the parties and ... the choice exercised by the accountant was one of convenience.<sup>45</sup>

72. The Tribunal concluded:

The provision ... of the trust deed [that required amounts set aside for beneficiaries to be held on separate trust] is binding authority on the trustee of the trust and amounts set aside for any [beneficiary] become the subject of a separate and distinct trust. That position may vary where the parties meet and come to some other agreement ... Nor do we believe the making of a journal entry transferring the share of net income to an account titled 'Loan' changes the trust arrangement to one of loan. The selection of a loan account to receive the allocation credit was not only in contravention of the deed but also lacked the authorisation of the parties.<sup>46</sup>

<sup>44</sup> 94 ATC 130; AAT Case 9221 (1993) 27 ATR 1117.

<sup>45</sup> At ATC 135; ATR 1124.

<sup>46</sup> At ATC 136; ATR 1125.

73. The authorities thus suggest that if a UPE is *incorrectly* described in the accounts as a loan, this does not change its essential character from a trust entitlement. Of course, the situation is different if the amounts so credited evidence a real transaction. For example, in the Federal Court in *Di Lorenzo Ceramics Pty Ltd & Anor v. FC of T*<sup>47</sup> Lindgren J held that an entry by an accountant acting within the scope of his authority who had characterised a transaction as a loan, was evidence of the loan.

74. In the absence of sufficient evidence to the contrary, if both the private company beneficiary and the trustee have recorded an amount in the accounts as a loan made by the private company to the trustee, the Commissioner takes the view that the parties have agreed that the relevant transaction is such a loan and that a UPE no longer subsists.

75. Moreover, if a family group shares the same ultimate controllers or the same individuals have a directing mind in respect of cash flows and distributions within the family group, in the absence of sufficient evidence to the contrary the Commissioner takes the view that the private company beneficiary has knowledge of what the trustee has done in respect of amounts to which the private company is entitled. In these circumstances, if the trustee credits an entitlement to a loan account held in the name of the private company in satisfaction of that private company's UPE,<sup>48</sup> the private company is taken:

- to have knowledge of this; and
- to have agreed to such a loan being made.

76. If the private company beneficiary has consistently maintained in its accounts that it has an outstanding UPE and not a loan, this would be evidence suggesting that the private company has not agreed to the trustee treating the UPE as being satisfied and being replaced with a loan made by the private company to the trust.

### ***Pursuant to trust deed***

77. A trustee may make a loan *on behalf* of a private company beneficiary by acting pursuant to a term of the trust deed which permits the trustee to pay money to or for the benefit of a beneficiary. The application of trust funds for the benefit of a private company beneficiary by way of an ordinary loan to the trust and the corresponding assumption by the trustee of an obligation to repay that sum (whether or not at interest) to the private company, would be such a payment or application for the benefit of the private company. That is, if the trustee has applied trust funds by crediting a loan account in the name of the private company, the relevant trust funds are regarded as having been paid to or applied for the benefit of the private company, *rather than* an entitlement arising that is unpaid.

<sup>47</sup> (2007) 161 FCR 198; 2007 ATC 4662; (2007) 67 ATR 42.

<sup>48</sup> The accounting treatment being evidence of, but not necessarily determinative of, a loan made in satisfaction of the private company beneficiary's entitlement: See paragraphs 70 to 73 of this Ruling.

78. In these circumstances the trustee acting *on behalf* of the private company beneficiary applies funds to which the private company is entitled (in satisfaction of that entitlement) by lending them to the trust, resulting in the trust owing the private company funds under that loan. The private company has a loan asset and *not* a UPE in the trust, and is taken to have made the loan to the trust.

79. In order for the trustee to make an ordinary loan on behalf of the private company in these circumstances, it is not sufficient that the trust deed gives the trustee the power to do so. The trustee must actually make such a loan acting pursuant to that power.

***Evidence of an ordinary loan made by a private company via the trustee acting pursuant to the trust deed***

80. As explained in paragraphs 69 to 73 of this Ruling whether or not an ordinary loan has been made is a question of fact, and accounting records typically evidence (but are not necessarily determinative of) what has happened. If an amount has been credited to a loan account in the name of the private company beneficiary *and* under the trust deed the trustee has the power to so credit amounts for the benefit of the private company as a payment or application of trust funds, in the absence of sufficient evidence to the contrary the Commissioner takes the view that the trustee has exercised this power to apply funds to create a loan asset for the benefit of the private company. In these circumstances, the private company is taken to have made an ordinary loan to the trust.

81. A resolution by the trustee to *set aside* an entitlement for the benefit of the private company beneficiary is an example of evidence contrary to the trustee having exercised its power to *apply* funds to create a loan asset for the benefit of the private company.

82. A private company beneficiary is not taken to have made an ordinary loan to the trust if, instead of a debtor/creditor relationship between the private company and trustee being created pursuant to an exercise of the trustee's powers under the trust deed, it is outside the powers of the trustee to treat the funds otherwise than as a UPE.

**Summary**

83. Essentially, each of the scenarios discussed at paragraphs 52 to 81 of this Ruling where an ordinary loan arises involve either:

- the private company beneficiary agreeing to lend money to the trustee, whereby the private company's UPE is satisfied by being set-off against the loan funds that are to be advanced to the trustee; or
- the trustee creating a loan for the benefit of the private company beneficiary pursuant to the trust deed instead of creating a UPE.

84. In each of these scenarios, the private company is taken to make a Division 7A loan under section 109D (that is an ordinary loan), and has no outstanding UPE in the trust in respect of that amount. This loan is treated in full as an assessable dividend of the trust unless:

- the loan is fully repaid before the company's lodgement day for the income year in which the loan is made;<sup>49</sup> or
- an exception contained in Subdivision D of Division 7A applies (for example, if before the lodgement day for the income year in which the loan is made, the loan is committed to a written loan agreement which meets the minimum interest rate and maximum loan term set out in section 109N); or
- the private company has insufficient distributable surplus such that section 109Y operates to reduce the amount of the dividend that would otherwise be deemed to have been paid.

### **Section three: Division 7A loans within the extended meaning**

#### **Advance of money**

85. Paragraph 109D(3)(a) provides that an 'advance of money' is a loan for the purposes of Division 7A. This phrase suggests a payment of moneys ahead of a due date, or a payment in expectation of repayment or reimbursement. Where there is a UPE, a private company beneficiary has made no advance payment of an amount it owes and there has been no payment requiring repayment. There is merely an equitable right to demand payment of the distributable amount. Accordingly, a subsisting UPE is not a Division 7A loan within the meaning of paragraph 109D(3)(a).

#### **Provision of credit or any other form of financial accommodation**

86. Paragraph 109D(3)(b) includes within the meaning of a Division 7A loan 'a provision of credit or any other form of financial accommodation'.

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<sup>49</sup> See also subsection 109D(6).

87. The term 'credit' used in the phrase 'provision of credit' involves allowing time to pay a debt (including by granting a right to defer payment of a debt). A loan itself amounts to the provision of credit (see, for example, the decision of the High Court in *Herbert v. R*<sup>50</sup> where lending money, which necessarily involved allowing time for it to be repaid, was held to be the provision of credit). The provision of credit extends to allowing time to pay any debt, not just that arising under a loan agreement, as is evident from the judgments in *Herbert v. R*. Whether or not it also extends to allowing time to pay an equitable obligation is not clear from the cases.<sup>51</sup>

88. Nonetheless, paragraph 109D(3)(b) refers not only to the provision of credit but also to 'or other form of financial accommodation'.

89. The term 'financial accommodation' is not defined in the ITAA 1936. The word 'other' in the phrase 'or other form of financial accommodation' suggests that the provision of financial accommodation is not limited to situations where there is also the provision of credit.

90. The Australian Oxford Dictionary<sup>52</sup> does not define the term 'financial accommodation'. However it does define the words individually as:

**financial** ... **1** of finance...

**finance** ... **1** the management of (esp. public) money. **2.** monetary support for an enterprise

**accommodation** ... **3** a convenient arrangement; a settlement or compromise...

91. Similarly, the Macquarie Dictionary<sup>53</sup> does not define the phrase 'financial accommodation' but defines the words individually as:

**Financial** ... **1.** relating to monetary receipts and expenditures; relating to money matters; pecuniary...

**Accommodation** ... **1.** the act of accommodating ... **5.** anything which supplies a want; a convenience ... **7.** readiness to aid others; obligingness. **8.** a loan or pecuniary favour ...

92. Combining these two definitions indicates that the phrase 'financial accommodation' could be, at its widest, a reference to any monetary supply or monetary arrangement or, more narrowly, a reference to a supply or grant of some form of pecuniary aid or favour.

<sup>50</sup> (1941) 64 CLR 461; [1941] HCA 12; [1941] ALR 100; per McTiernan J at CLR 467; ALR 104.

<sup>51</sup> Whilst a UPE is not a common-law debt (see, for example, *Euroasian Holdings Pty Ltd v. Ron Diamond* (1996) 64 FCR 147; (1996) 14 ACLC 502; per Heerey J at FCR 150; ACLC 504), debts may also extend to equitable debts (see, for example, the comments of Lindley LJ in *Webb v. Stenton* (1883) 11 QBD 518 at 527).

<sup>52</sup> The Australian Oxford Dictionary, 1999, Oxford University Press, Melbourne.

<sup>53</sup> The Macquarie Dictionary, [Multimedia], version 5.0.0, 1/10/01.

93. Whilst the extended definition of 'loan' in subsection 109D(3) has not been judicially considered, former section 46D contained a definition of 'loan' which also included the 'provision of credit or any other form of financial accommodation'. This definition was considered by the Full Federal Court in *Radilo*. The case concerned the issue of non-redeemable preference shares which paid a fixed annual dividend of a percentage of the issue price, and which converted to ordinary shares after a fixed time. The question at issue was whether the preference dividends were equivalent to 'interest on a loan' as defined in that section, consequently disentitling the respondent to imputation credits on the dividends. Sackville and Lehane JJ stated:

The provision of credit implies a consensual transaction, such as the delivery of goods on terms permitting deferred payment or the granting of overdraft facilities by a bank... Similarly, in its statutory context, the expression 'or any other form of financial accommodation' refers to a consensual arrangement between the person providing the accommodation and the recipient. Under a consensual arrangement for the provision of credit or financial accommodation a principal sum, or its substantial equivalent (by way of indemnity against a liability on maturing bills, for example, in the case of accommodation provided in the form of a bill acceptance facility), will ultimately be payable.<sup>54</sup>

94. The Court concluded that there was no such principal sum ultimately payable in this case as the company did not redeem the preference shares, rather they were converted to ordinary shares which the holder could sell if they wished. Importantly, the company would retain the capital rather than having to repay it. It was decided therefore, that the issue of the preference shares did not fit within the extended definition of 'loan' in section 46D.

95. Given that, broadly speaking, the scheme of Division 7A targets benefits provided by a private company to shareholders and associates, a reference to financial accommodation that looks to the provision of 'assistance' or 'favour' to the shareholder or associate is more appropriate than one that looks at financial arrangements at large.

96. In the Commissioner's view, the statutory context in which the phrase appears limits what amounts to financial accommodation under this definition to:

- the supply or grant of some form of pecuniary aid or favour (as suggested by the ordinary meaning of this term – see paragraphs 90 to 92 of this Ruling);
- under a consensual arrangement (similarly to *Radilo*);<sup>55</sup> and
- where a principal sum or equivalent is ultimately payable (similarly to *Radilo*).<sup>56</sup>

<sup>54</sup> At FCR 312; ATC 4160–4161; ATR 645.

<sup>55</sup> Per Sackville and Lehane JJ at FCR 312; ATC 4160-4161; ATR 645.

97. As the amount of the UPE is payable on demand to a private company beneficiary, a principal sum is ultimately payable. The private company therefore provides financial accommodation to the trustee of a trust in the context of section 109D if it provides or grants, under a consensual agreement with the trustee, any pecuniary aid or favour to that trust.

98. *Eldersmede Pty Ltd & Ors v. Commissioner of Taxation*<sup>57</sup> (*Eldersmede*) concerned a group of unit trusts ultimately beneficially owned by a family group, with one individual in effective control of all relevant entities. A series of entitlements arose, but were not paid over to the relevant beneficiaries. At no relevant time did the beneficiary call upon the trustee to pay or take any steps to recover the amount of the distribution, nor did it call upon the trustee (*Eldersmede*) to invest the amount of the distribution on a commercial basis for its (the beneficiary's) benefit. The Administrative Appeals Tribunal (AAT) held that in doing so, the beneficiary provided a benefit to the trustee of the trust.<sup>58</sup> In reaching this decision the AAT noted that:

- once declared, the UPE was held for the beneficiary under a trust for that beneficiary alone,<sup>59</sup> and
- in the absence of any contrary provisions in the Deed of Trust, *Eldersmede* was obliged to inform the beneficiary of the amount of the distribution transferred to it and invest the amount of the distribution prudently.<sup>60</sup>

99. On appeal, the Full Federal Court (in *Corporate Initiatives Pty Ltd & Ors v. FC of T (Corporate Initiatives)*<sup>61</sup>) upheld the AAT's decision, finding:

...the resolutions for distribution did not confer on [the beneficiary] any proprietary right in any assets of [the trust]. *Eldersmede* was free to deal with those assets for trust purposes including, although not limited to, funding the distribution to [the beneficiary]. Therefore it cannot be said that *Eldersmede* anyway could not make use of money it was holding for someone else and thus was in no better position by reason of [the beneficiary's] failure to make demand.

In her written submissions counsel for the applicants readily accepted that for [the beneficiary] to 'formally provid(e) a loan to *Eldersmede* of the unpaid distribution' could be seen to be a benefit as the funds could be used by *Eldersmede* under the terms of the loan. ... However, it is **difficult to see the practical difference between a formally recorded loan and what happened here. In effect, *Eldersmede* was the recipient of a loan** repayable on demand and, as stated above, could use the amount of the loan for trust purposes.

<sup>56</sup> Per Sackville and Lehane JJ at FCR 312; ATC 4161; ATR 645.

<sup>57</sup> [2004] AATA 710; 2004 ATC 2129; (2004) 56 ATR 1179.

<sup>58</sup> At ATC 2160-2161; ATR 1213.

<sup>59</sup> At ATC 2161; ATR 1214.

<sup>60</sup> At ATC 2161; ATR 1214.

<sup>61</sup> [2005] 142 FCR 279; 59 ATR 351; 2005 ATC 4392.

...

...we think that in not calling on Eldersmede to pay the amount of the distribution [the beneficiary] 'provided' a benefit to [the trust].

...In the present case **the inaction of [the beneficiary] was the only means by which Eldersmede gained the benefit we have identified.**<sup>62</sup> [Emphasis added]

100. The Full Federal Court also noted that:

The Tribunal referred to the obligation of Eldersmede as trustee of [the trust] to inform [the beneficiary] that it was entitled to a transfer of the amount of the distribution: *Whakatance Paper Mills Ltd v. Public Trustee* (1939) SR(NSW) 426 at 440 and other authorities cited by the Tribunal at ATC 2160-2161. However, in the circumstances of the present case where the **same individuals, [the controlling individual] and his accounting and legal advisors, were on both sides of the transaction** this aspect does not seem relevant. Those circumstances are highly relevant, in our view, to the conclusion by the Tribunal that there was a 'scheme', the effect of which was the provision of a benefit by [the beneficiary] to Eldersmede, the benefit being the continued use of funds by Eldersmede as a result of [the beneficiary] not calling for the payment of the funds distributed to it.<sup>63</sup> [Emphasis added]

101. In *Eldersmede and Corporate Initiatives* a beneficiary was taken to have provided a benefit to the trustee of a related trust<sup>64</sup> directly as a result of that beneficiary's inaction. The beneficiary provided that benefit to the trustee by failing to either:

- call for payment of its UPE; or
- call for the trustee to invest the amount of that UPE at a commercial return for its (the beneficiary's) benefit.

102. The findings of the AAT and comments by the Full Federal Court indicate that there would be a similar provision of a benefit by an unrelated beneficiary not calling for payment of funds distributed to it if it has knowledge of the UPE and authorises, or with this knowledge acquiesces to, the trust's continued use of those funds for trust purposes.

<sup>62</sup> At FCR 285; ATC 4397; ATR 356-357.

<sup>63</sup> At FCR 283; ATC 4395; ATR 354-355.

<sup>64</sup> In this case, notwithstanding that the UPE may have been held on sub-trust (see *Eldersmede* at AATA [71]; ATC 2159; ATR 1211), both the AAT and the Full Federal Court found that the benefit was provided to Eldersmede in its capacity as trustee of the *main trust*, the Eldersmede Distribution Trust, which enjoyed use of the funds representing the UPE for trust purposes: See *Eldersmede* at AATA [78]; ATC 2160-2161; ATR 1213 and *Corporate Initiatives* at FCR 285; FCAFC [23]; ATC 4397; ATR 284; ALR 344.

103. Funds representing a subsisting UPE are used for trust purposes if they remain intermingled with the trust funds of the trust (or of the main trust, if there is also a sub-trust) and are used other than for the sole benefit of a private company beneficiary. This occurs *if* for example:

- (i) the trustee of the main trust does nothing other than record in its books of account the private company's entitlement; or
- (ii) a sub-trust is recognised, but:
  - the trustee of the sub-trust allows funds representing the UPE to remain intermingled in the main trust either informally; or by making a loan to the trustee of the main trust (who may be the same trustee entity, but acting in a different capacity); or investing in the main trust; and
  - the use of these funds by the main trust is on terms that do *not* entitle the private company to the sole benefit of any income generated by use of those funds (in addition to the return or repayment of those funds).

104. Accordingly, if funds representing a subsisting UPE are used for trust purposes in such a way with the knowledge and acquiescence of the private company, in allowing this to continue the private company provides a benefit to the trustee of the trust. Even if there is a sub-trust, in allowing the funds representing the UPE to be used for the trust purposes of the main trust (such as is set out in subparagraph 103(ii) of this Ruling), the private company provides a benefit to the trustee of the main trust.

105. Where the UPE is an entitlement to an amount of money, enabling those funds to be used for trust purposes is the provision of pecuniary support to the trustee of the trust. In the circumstances described, the UPE would not be used for the sole benefit of the private company beneficiary, but rather would be able to be used in aid or favour of the trust, for trust purposes. This is a form of financial accommodation provided by the private company in the amount of the funds the beneficiary has allowed the trustee to use for trust purposes.

106. Where a private company beneficiary provides financial accommodation to the trustee of the trust it makes a Division 7A loan of this amount to the trustee.<sup>65</sup>

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<sup>65</sup> See also paragraphs 42 to 45 of this Ruling.

*Evidence of a Division 7A loan made by a private company providing financial accommodation to the trustee*

107. If any beneficiary has a UPE that is being held on sub-trust, the trustee of which is entitled to invest its funds, that beneficiary should expect the trust to do so prudently and to be solely entitled to any income generated by that investment.

108. The private company beneficiaries considered by this Ruling share a commonality of control with the trust in which they have a subsisting UPE. *Corporate Initiatives* illustrates that if both the trustee and the company have the same controlling mind, knowledge of the use to which the funds that the beneficiary is solely entitled are being put may be imputed by virtue of the relationship.

109. For this reason (and the reasons given in paragraphs 62 to 68 of this Ruling) subject to sufficient evidence to the contrary, the Commissioner takes the view that as the trust and private company are part of the same family group, the private company has knowledge as to whether the funds to which it is presently entitled are being used for trust purposes (as opposed to being used for its sole benefit).

110. Accordingly, if funds representing the private company's UPE are being used for trust purposes such as illustrated in paragraph 103 of this Ruling, subject to sufficient evidence to the contrary, the Commissioner takes the view that the private company has made a Division 7A loan to the trustee of the trust for the amount of those funds being used, as a result of having provided financial accommodation to the trust.

*Timing*

111. In the circumstances where the private company is taken to know the use to which the funds representing its UPE are being put, the private company beneficiary is taken to have made a Division 7A loan to the trustee of the trust when those funds are first used other than for the private company's sole benefit. The Commissioner accepts that a distribution may be taken to have been made at the end of an income year in certain instances provided it is in fact made within two months into the *following* income year.<sup>66</sup>

112. Accordingly, a Division 7A loan may not in fact arise in respect of a UPE until some time into the income year following that in which that UPE is taken to have arisen for tax purposes. Because of this, subject to sufficient evidence to the contrary the Commissioner accepts that a private company does not make a Division 7A loan as a result of providing the trustee with financial accommodation in the circumstances discussed in paragraphs 109 and 110 of this Ruling, until some time during the income year following that in which the UPE is taken to have arisen for tax purposes. (As Division 7A operates on an income year basis, pinpointing the precise time during that year is not necessary.)

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<sup>66</sup> See Taxation Ruling IT 329.

*Evidence of a private company not providing financial accommodation to the trustee*

113. If funds representing the UPE are instead used only for the private company's sole benefit, the private company does not provide financial accommodation in respect of that UPE. For example, if there is a sub-trust but the funds representing the UPE remain intermingled in the main trust as a consequence of an investment back by the sub-trust, the private company does not provide any financial accommodation to the main trust if this investment by the sub-trust is *on terms entitling* the sub-trust to:

- all the benefits from use of those funds; and
- a repayment of the principal of the investment.

114. The private company provides no financial accommodation in these circumstances because the main trust receives no pecuniary aid or favour from the private company. These circumstances may be evidenced by the terms of the agreement between the sub-trust and the main trust.

115. In these circumstances, as the investment by the sub-trust into the main trust is the payment or advance of a sum with the entitlement and expectation of repayment (in addition to an entitlement to a return equal to all of the benefits from use), this investment is itself a Division 7A loan within the meaning of the extended definition in subsection 109D(3). However, without more, as the Division 7A loan is from the sub-trustee to the trust and not from the company itself, this Division 7A loan is not a deemed dividend for the purposes of the Division. If, however, the private company has an unpaid present entitlement to the *income* of this sub-trust, that Division 7A loan to the main trust (the investment into the main trust) may give rise to a deemed dividend under Subdivision EA. As mentioned at paragraph 35 of this Ruling, the UPE originally set aside on the sub-trust forms the corpus of the sub-trust. Accordingly, when the sub-trust *does* derive income (such as that which may be derived from its investment into the main trust), it needs to pay this income to the private company beneficiary to prevent any unpaid entitlement arising in respect of that income. If the private company has a UPE from the sub-trust, Subdivision EA may operate in respect of a Division 7A loan from the sub-trustee to the trust.

**Transactions effecting in-substance loans**

116. Paragraph 109D(3)(d) of the extended definition of a loan covers arrangements that in substance effect a loan of money (that is, consisting of a payment requiring repayment).

117. In the *Prime Wheat Association* case the High Court considered whether a share sale agreement which provided for payment by instalments over a 20 year period was a 'loan security' for stamp duty purposes. The relevant legislation defined a loan to include any 'transaction (whatever its terms or form) which in substance effects a loan of money'. Gleeson CJ explained that this paragraph of the definition of loan:

...does not have a meaning which renders everything else in the definition superfluous. The definition had its origin in money lending legislation. There is ample authority to establish that the paragraph does not entitle a court to disregard the legal nature and effect of the instrument in question, or to treat all forms of financial accommodation as loans. ... A sale on terms giving the purchaser time to pay is not a disguised loan. The essence of a loan is an obligation of repayment. Here what was involved on the part of the purchasers was payment, not repayment...<sup>67</sup>

118. Similarly, on its face a UPE may only require the trust to make a payment rather than a repayment. However, the relevant transaction may go beyond the trustee declaring and not paying the entitlement. If the private company beneficiary is made aware of its entitlement, and chooses not to call for the amount to which it is entitled or have it used for its sole benefit, the overall transaction includes:

- the private company's decision to allow the UPE to remain outstanding for the benefit of the trust; and
- the trustee's use of those funds for trust purposes.

119. A 'transaction' is not defined for the purposes of paragraph 109D(3)(d). However, use of the word 'transaction' followed by the words 'whatever its terms or form', suggests a wide application.

120. In *Grimwade v. Federal Commissioner of Taxation*<sup>68</sup> the meaning of 'transaction' was discussed by the High Court. Latham CJ and Webb J, delivering the majority judgment, held that a transaction must be bilateral (that is, to be a transaction at least two parties must be involved).<sup>69</sup> A private company beneficiary allowing the trust to retain use of the funds to which it has a UPE together with that trust using those funds for trust purposes would satisfy this meaning of a 'transaction', with both the trust and the private company involved in the dealing.

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<sup>67</sup> At ATC 5020.

<sup>68</sup> [1949] HCA 9; (1949) 78 CLR 199.

<sup>69</sup> At paragraph 14; CLR 220.

121. *Gorton and others v. Federal Commissioner of Taxation*<sup>70</sup> also stands for the proposition that a transaction must involve dealings between more than one person, the transactions there involving the 'agreement and co-operation' between the relevant parties rather than unilateral acts. Agreement and co-operation can arise out of the positive acts of one party with the knowledge and acquiescence of the other party.<sup>71</sup>

122. In considering the benefit conferred on a trust by a beneficiary not calling for payment of its UPE, the Full Federal Court in *Corporate Initiatives* observed that:

...it is difficult to see the practical difference between a formally recorded loan and what happened here [namely, a UPE that was not called for]. In effect [the trustee] was the recipient of a loan repayable on demand and ... could use the amount of the loan for trust purposes.<sup>72</sup>

123. Whilst a UPE may not involve a payment and a repayment, in effect a UPE that a private company beneficiary has *allowed* to remain outstanding for use by the trustee for trust purposes is in substance the same as a UPE that is paid to the beneficiary and loaned back to the trustee of the trust to use for broader trust purposes. In these circumstances, there has not merely been the declaration by the trustee of an entitlement of the private company. Rather, the transaction between the private company and the trustee includes the trustee's use of the funds representing the UPE for trust purposes, and the private company allowing this use (including by acquiescence with knowledge) by not demanding payment of its UPE or investment of the funds representing the UPE solely for its benefit (without benefit accruing to the trust). This transaction effects, in substance, a loan of money from the private company to the trustee<sup>73</sup> (as well as being the provision of financial accommodation – see paragraphs 103 to 105 of this Ruling).

<sup>70</sup> (1964) 113 CLR 604; [1969] ALR 560; (1965) 39 ALJR 343; (1965) 14 ATD 119; (1965) 1 ATR 65; [1965] HCA 1

<sup>71</sup> See further the discussion of acquiescence with knowledge at paragraphs 56 to 68 of this Ruling.

<sup>72</sup> At FCR 285; ATC 4397; ATR 356.

<sup>73</sup> It has been said that 'in-substance' provisions such as that in paragraph 109D(3)(d) may do no more than recognise the general power of the judiciary to go behind the form of an agreement when it is clear that the agreement does not reflect the actual agreement between the parties: See for example Pannam, CL (1965) *The law of money lenders in Australia and New Zealand*, The Law Book Company Limited, Australia, pp. 29-30; and Hill, G (1979) *Stamp and death duties (New South Wales and Australian Capital Territory)*, 2<sup>nd</sup> edn, The Law Book Company Limited, Australia, p.174. See also *Metropolitan Discounts & Investment Co Ltd v. Bowra Radio & Electrical Co Ltd (in Liq)* (1944) 18 ALJ 88 at 90 and 92 and *Benison v. Custom Credit Corporation Ltd*. [1962] WAR 44 at 47 discussed therein. Accordingly, this transaction may also fall within the ordinary meaning of a loan.

124. However, if the use of the funds representing the UPE are not capable of benefiting the trust and are used only for the sole benefit of the private company beneficiary (such as in the circumstances described in paragraph 113 of this Ruling), the transaction is not in substance a loan, the provision of credit or the provision of another form of financial accommodation. In these circumstances, the private company does not make a Division 7A loan to the trustee within the meaning of paragraph 109D(3)(d).

#### ***Evidence of in-substance loan made by a private company***

125. For the reasons given in paragraphs 107 to 109 of this Ruling, if funds representing the private company's UPE are being used for trust purposes such as illustrated in paragraph 103 of this Ruling, subject to sufficient evidence to the contrary, the Commissioner takes the view that the private company has *allowed* this use (by acquiescing to this use with knowledge of it). In these circumstance the Commissioner takes the view that the private company has made a Division 7A loan to the trustee within the meaning of paragraph 109D(3)(d).

#### **Other considerations**

126. If the UPE of a private company beneficiary is held on sub-trust and the funds are used for the private company's sole benefit (and not for any benefit of the main trust) the private company is not taken to make a Division 7A loan, unless the trustee of the sub-trust makes a Division 7A loan as **agent** for the private company.

127. A principal and agent relationship may arise when the private company is an absolutely entitled beneficiary of the sub-trust that consents to the trustee acting as its agent and directs the trustee consistent with the direction given to an agent by a principal.

## Appendix 2 – Examples

**❶** *This Appendix provides Examples. It does not form part of the binding public ruling.*

128. The operation of Division 7A in the following examples is heavily dependant on the facts of each situation. These examples provide the Commissioner's observations on considerations that are both within and beyond the scope of the binding public ruling. For this reason it is not appropriate to make the examples part of the binding public ruling.

### Section one: background

129. Assume the following fact scenario for all examples:

- Ashley and Bo are individuals who are spouses;
- Ashley and Bo have organised their family business affairs via a family discretionary trust, the AB Family Trust. Ashley and Bo are the controlling minds of Trustee Ltd, the trustee of their family trust;
- Ashley and Bo, together with other family members and related entities are objects of the AB Family Trust;
- X Co is one such related entity and is a private company that, like Trustee Ltd, is controlled by Ashley and Bo;
- During an income year commencing after 16 December 2009 (the income year), Trustee Ltd resolves that \$10,000 of AB Family Trust's income for that year be distributed to X Co. No cash payment is made to X Co. The manner in which distributions can be made is described in the trust deed of the AB Family Trust; and
- AB Family Trust's trust law income and net income as defined in subsection 95(1) are the same for that income year.

### Section two: loans within the ordinary meaning

#### ***Example 1 – loan made by agreement***

##### *Additional facts*

130. X Co enters into an agreement with Trustee Ltd in its capacity as trustee of the AB Family Trust, under which X Co agrees to lend Trustee Ltd \$10,000. No payments are made, but Trustee Ltd credits a loan account in the name of X Co with \$10,000 in satisfaction of X Co's trust entitlement to \$10,000.

*Treatment under this Ruling*

131. X Co makes an ordinary loan to Trustee Ltd in its capacity as trustee of the AB Family Trust for the purposes of section 109D pursuant to the loan agreement between these two parties. This loan is made when the funds are taken to have been advanced under the loan agreement. As X Co's present entitlement to \$10,000 from the AB Family Trust is satisfied by way of set-off against its obligation to advance \$10,000 to Trustee Ltd under the loan agreement by entry in the accounts, X Co is taken to have made this loan at the time Trustee Ltd credits X Co's loan account.

132. Assuming X Co has no other entitlements in respect of the AB Family Trust, X Co only has a debt owing from Trustee Ltd and no UPE to any amount from the AB Family Trust.

***Example 2 – loan made pursuant to a term of the trust deed****Additional facts*

133. In respect of amounts resolved to be distributed to a beneficiary, the trust deed of the AB Family Trust gives Trustee Ltd the power to:

- pay such amounts to the beneficiary;
- apply such amounts for the benefit of the beneficiary;  
or
- hold such amounts on sub-trust for the sole benefit of that beneficiary, under the same terms as the AB Family Trust.

134. There is nothing in the trust deed of the AB Family Trust or at law that prohibits Trustee Ltd from crediting loan accounts for the benefit of its beneficiaries generally, or for X Co specifically. Likewise, there is nothing in the trust deed of the AB Family Trust or at law that prohibits Trustee Ltd from borrowing money in its capacity as trustee of the AB Family Trust from its beneficiaries generally, or from X Co specifically.

135. Upon resolving to distribute \$10,000 to X Co, Trustee Ltd applies \$10,000 on behalf of X Co by depositing the funds in a loan account with itself (that is, in its accounts crediting a loan account in the name of X Co). The resolution is silent as to whether the amount to be distributed to X Co is to be held on sub-trust or applied for the benefit of X Co.

*Treatment under this Ruling*

136. The accounting records of Trustee Ltd evidence (but are not determinative of) its transactions. The facts show that:

- an amount has been credited to a loan account in the name of X Co;
- under the trust deed of the AB Family Trust Trustee Ltd has the power to so credit amounts for the benefit of X Co as an application of trust funds for the benefit of X Co; and
- in this example, there is no evidence to suggest that Trustee Ltd did not intend to, was not entitled to or otherwise did not actually create, such a loan.

137. Based on these facts, the Commissioner takes the view that Trustee Ltd has exercised its power to apply funds for the benefit of X Co by crediting a loan account in the name of X Co, creating a debt owed to X Co. In these circumstances, X Co is taken to have made an ordinary loan under section 109D to Trustee Ltd (as trustee for the AB Family Trust) when Trustee Ltd credited an amount to the loan account in its name.

138. In these circumstances, X Co's entitlement to the \$10,000 distribution has been satisfied by that sum being applied for its benefit, and it has no subsisting UPE in respect of this distribution.

***Example 3 – loan agreed to and adopted by X Co****Additional facts*

139. Assume the same facts as in Example 2 except that Trustee Ltd either:

- has no power to apply amounts resolved to be distributed to a beneficiary for the benefit of the beneficiary, but only to pay the amounts to the beneficiary or hold them on sub-trust for the benefit of that beneficiary; *or*
- did not exercise its power to apply amounts resolved to be distributed to a beneficiary for the benefit of the beneficiary (and there was evidence indicating this).

140. Upon resolving to distribute \$10,000 to X Co, Trustee Ltd credits this amount to a loan account in the name of X Co, and treats the funds as having been lent back to itself by X Co. That is, Trustee Ltd continues to use the funds for the benefit of the AB Family Trust, rather than solely for X Co.

141. X Co adopts Trustee Ltd's treatment of the amount, also recognising in its accounts that it has a loan to Trustee Ltd.

*Treatment under this Ruling*

142. There being no evidence to the contrary, X Co's treatment of the amount to which it is entitled as a loan demonstrates its knowledge of the actions of Trustee Ltd. Moreover, X Co's knowledge of the actions of Trustee Ltd may be further presumed as they each have the same directing mind and will (Ashley and Bo).<sup>74</sup>

143. In adopting the actions of Trustee Ltd, X Co is taken to have agreed to and authorised Trustee Ltd's treatment of the amount resolved to be distributed to X Co as a loan. X Co's entitlement is therefore treated as having been discharged, and set-off against an equal amount it lent to Trustee Ltd.

144. Having implicitly agreed to Trustee Ltd's treatment of its entitlement as having been discharged and loaned back, X Co is taken to have made an ordinary loan under section 109D to Trustee Ltd (as trustee for the AB Family Trust) when the amount was credited to the loan account in its name.

145. In these circumstances, X Co's entitlement to the \$10,000 distribution has been satisfied by that sum being set off against the loan funds X Co is taken to have advanced to Trustee Ltd, and it has no subsisting UPE in respect of this distribution.

***Example 4 – purported loan not agreed to by X Co****Additional facts*

146. Assume the same facts as in Example 3 except that X Co does not account for its entitlement as a loan, but instead consistently records the sum in its accounts from time to time as an unpaid trust entitlement.

*Treatment under this Ruling*

147. As Ashley and Bo are the directing mind of both Trustee Ltd and X Co, X Co is taken to have known that its trust entitlement was treated by Trustee Ltd as having been discharged and set off against a loan back to the AB Family Trust, there being no evidence to the contrary.<sup>75</sup> Nonetheless, X Co's accounting treatment indicates that X Co did not accept that its entitlement had been satisfied by being set-off against any loan by it back to Trustee Ltd. There is evidence that X Co did not authorise Trustee Ltd's treatment of the UPE in this example.

148. Accordingly, X Co is not taken to have made an ordinary loan to Trustee Ltd as a result of Trustee Ltd's actions which were not exercised in accordance with its powers under the trust deed nor approved by X Co.

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<sup>74</sup> See paragraphs 62 to 68 of this Ruling.

<sup>75</sup> See paragraphs 62 to 68 of this Ruling.

149. Despite not making an ordinary loan, as X Co's entitlement to the \$10,000 distribution from the AB Family Trust arose on or after 16 December 2009, consideration should be given to whether it has made a Division 7A loan within the extended meaning, as explained in Section three of this Ruling. If Trustee Ltd has kept the funds represented by the UPE intermingled with the other funds of the AB Family Trust, without a sub-trust arising, the treatment under Section three of this Ruling is as set out in Example 5 at paragraph 150 of this Ruling.

### **Section three: Division 7A loans within the extended meaning**

#### ***Example 5 – UPE not set aside for X Co's sole benefit***

##### *Additional facts*

150. Upon resolving to distribute \$10,000 to X Co, Trustee Ltd records the entitlement of X Co in its accounts, but keeps the funds represented by that UPE intermingled with the other assets of the AB Family Trust. No sub-trust arises.

##### *Treatment under this Ruling*

151. For the reasons as given in paragraph 62 to 68 of this Ruling, as X Co and Trustee Ltd share the same directing mind and will, X Co is taken to know that the funds representing its trust entitlement are being used by Trustee Ltd for the purposes of the AB Family Trust.

152. Knowing that the funds to which it is entitled are being used for the benefit of the AB Family Trust, if X Co does not agree with this use it can take steps to call for payment of its entitlement or call for the amount of that entitlement to be set-aside and used for its sole benefit rather than for the trust purposes of the AB Family Trust. However, there is no evidence to suggest that X Co does anything other than consciously acquiesce to Trustee Ltd using the funds to which X Co is entitled for the benefit of the AB Family Trust. In doing so, X Co allows (and is taken to agree to) funds to which it is entitled to be used for the benefit of the AB Family Trust with no return required to be paid to X Co.

153. In agreeing to allow Trustee Ltd to use the funds for the trust's purposes, X Co has provided pecuniary support to the AB Family Trust. This is the provision of financial accommodation in a relevant sense. Further, in agreeing that the funds to which it is entitled can be used by Trustee Ltd for the trust purposes of the AB Family Trust rather than for its sole benefit, and by deferring the crystallising of a debt by not calling for payment of its UPE, X Co has in substance provided a loan to Trustee Ltd (as trustee for the AB Family Trust).

154. Either way, X Co is taken to have made a loan under section 109D to Trustee Ltd (as trustee for the AB Family Trust) when the Trustee Ltd was allowed to use the relevant funds for the trust purposes of the AB Family Trust.

***Example 6 – amount of UPE set aside on sub-trust and not invested back into the main trust***

*Additional facts*

155. In respect of amounts resolved to be distributed to a beneficiary, the trust deed of the AB Family Trust gives Trustee Ltd the power to:

- pay such amounts to the beneficiary;
- apply such amounts for the benefit of the beneficiary;  
or
- hold such amounts on sub-trust for the sole benefit of that beneficiary, under the same terms as the AB Family Trust (which includes the power to invest and make loans, including interest free loans and the term that the trustee does not act as agent for any or all of the beneficiaries of the AB Family Trust).

156. Upon resolving to distribute \$10,000 to X Co, Trustee Ltd sets \$10,000 aside on sub-trust by creating a sub-account in its bank account with a third-party deposit taking institution for the amount of \$10,000, and holding the ownership of this sub-account on sub-trust for the sole benefit of X Co. That is, Trustee Ltd remains the legal owner of the sub-account, but now in its capacity as trustee of the sub-trust of the money set aside for the sole benefit of X Co.

157. The \$10,000 sub-account with the deposit-taking institution is corpus of the sub-trust and X Co, as sole beneficiary of this (fixed) sub-trust, is entitled to all of the income derived in respect of that account.

158. As sole beneficiary of the (fixed) sub-trust, X Co is entitled to all of the income earned by Trustee Ltd in its capacity as trustee of the sub-trust. Upon becoming entitled to this income, as X Co is the *sole* beneficiary of the sub-trust, neither in law nor equity does any further sub-trust arise in respect of that income.

*Treatment under this Ruling*

159. In this example, no part of the funds representing X Co's UPE are used by Trustee Ltd for the trust purposes of the AB Family Trust. X Co has not made any ordinary loan to, or provided financial accommodation or an in-substance loan to the AB Family Trust or to the sub-trust. Accordingly, in this example X Co is not taken to have made a Division 7A loan under section 109D.

***Example 7 – sub-trust makes a loan back to the AB Family Trust other than for X Co's benefit****Additional facts*

160. In respect of amounts resolved to be distributed to a beneficiary, the trust deed of the AB Family Trust gives Trustee Ltd the power to:

- pay such amounts to the beneficiary;
- apply such amounts for the benefit of the beneficiary; or
- hold such amounts on sub-trust for the sole benefit of that beneficiary, under the same terms as the AB Family Trust (which includes the power to invest and make loans, including interest free loans and the term that the trustee does not act as agent for any or all of the beneficiaries of the AB Family Trust).

161. Upon resolving to distribute \$10,000 to X Co, Trustee Ltd sets aside that amount on sub-trust. Trustee Ltd, as trustee of the sub-trust has all the powers of investment and dealing with trust property of the sub-trust as are set out in the trust deed for the AB Family Trust. Further, under the terms of the trust, Trustee Ltd, in its capacity as trustee of the sub-trust, does not act as agent for X Co, notwithstanding that X Co is the sole beneficiary of the sub-trust.

162. In its capacity as trustee of the sub-trust, Trustee Ltd lends or invests the sum of the UPE set-aside on sub-trust, back to itself in its capacity of trustee of the AB Family Trust, interest-free. Accordingly, despite the \$10,000 being set aside on sub-trust, actions of the trustee of the sub-trust have enabled the \$10,000 to remain in the AB Family Trust, able to be used by Trustee Ltd for the trust purposes of the AB Family Trust.

*Treatment under this Ruling*

163. For the reasons as given in paragraph 62 to 68 of this Ruling, as X Co and Trustee Ltd share the same directing mind and will, X Co is taken to know that the funds representing its trust entitlement are being used by Trustee Ltd for the purposes of the AB Family Trust. (Even if X Co and the AB Family Trust were not part of the same family group, deriving no income from the *sub-trust* (to which X Co is solely entitled) should indicate to X Co that the funds to which it is entitled are being used otherwise than for its sole benefit.)

164. As in Example 5, if X Co does not agree with the funds to which it is entitled being used for the purposes of the AB Family Trust it can take steps to call for payment of its entitlement or call for the amount of that entitlement to be used for its sole benefit instead. However, there is no evidence to suggest that X Co does anything other than consciously acquiesce to Trustee Ltd using those funds for the benefit of the AB Family Trust. Accordingly, X Co allows (and is taken to agree to) funds to which it is entitled being used for the benefit of the AB Family Trust.

165. In these circumstances X Co has provided pecuniary support to the AB Family Trust. This is the provision of financial accommodation in a relevant sense. Further, in agreeing that the funds to which it is entitled can be used by Trustee Ltd for the trust purposes of the AB Family Trust rather than for its sole benefit, and by deferring the crystallising of a debt by not calling for payment of its UPE, X Co has in substance provided a loan to Trustee Ltd (as trustee for the AB Family Trust).

166. In either instance, X Co is taken to have made a loan under section 109D to Trustee Ltd (as trustee for the AB Family Trust) when the main trust was allowed to use the relevant funds for trust purposes.

***Example 8 – sub-trust invests in the AB Family Trust for full flow-through return for the benefit of X Co***

*Additional facts*

167. Assume the facts are as for Example 7, except that in its capacity as trustee of the sub-trust Trustee Ltd ensures that the investment back to the AB Family Trust is on terms entitling the sub-trust to all the benefits that flow from use of those funds by the AB Family Trust (in addition to a return of the amount invested). As the sole beneficiary of the sub-trust, X Co is entitled to any income derived by the sub-trust from this investment.

168. An investment in a trust on terms requiring all the benefits from use of the funds invested to flow back to the investor could be structured in a number of ways. However, in this example Trustee Ltd in its capacity as trustee of the sub-trust invests the full amount of the UPE it was set aside into the AB Family Trust, on terms *requiring* the sub-trust be paid:

- a reasonable percentage of the overall income each year generated by the AB Family Trust (calculated in this example by reference to the proportion of the amount invested by the sub-trust compared to the AB Family Trust's other sources of capital/funding); plus
- on withdrawal of the investment, an amount equal to the principal sum originally invested.

*Treatment under this Ruling*

169. As sole beneficiary of the sub-trust, X Co is solely entitled to any return received by Trustee Ltd in its capacity as trustee of the sub-trust from its investment in the AB Family Trust. For the reasons explained in paragraph 158 of this Ruling, any income derived by the Trustee Ltd in its capacity as trustee of the sub-trust is already set aside and held for the sole benefit of X Co and no further sub-trusts arise.

170. Whilst the AB Family trust has retained use of the funds to which X Co is entitled, ultimately only X Co can benefit from this use. In these circumstances, X Co has not made any ordinary loan to, or provided financial accommodation or an in-substance loan to, the AB Family Trust or to the sub-trust. Rather, X Co has a UPE that is being invested under terms where the full amount of that UPE plus any benefit from its use is held for its sole benefit. Accordingly, X Co is not taken to have made a Division 7A loan under section 109D.

*Further considerations*

171. Note that in this example the provisions of Subdivision EA need also be considered in respect of the *sub-trust*. If the income generated by the sub-trust from its investment in the AB Family Trust is not paid out to X Co, X Co (as the sole beneficiary of the sub-trust) has a new UPE to income of the *sub-trust* (being the *return* on the sub-trust's investment in the main AB Family Trust). As the investment from the sub-trust to the main AB Family Trust would itself amount to a Division 7A loan (depending on its terms, as an ordinary loan or within the extended meaning of a loan as described in paragraph 5 of this Ruling) this Division 7A loan may attract the operation of Subdivision EA to the extent to which X Co has an outstanding UPE to income of the sub-trust.<sup>76</sup>

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<sup>76</sup> See subsections 109XA(2), 109XA(4) and section 109XB.

## Appendix 3 – Alternative view

**❶** *This Appendix sets out an alternative view and explains why it is not supported by the Commissioner. It does not form part of the binding public ruling.*

172. During consultation on this Ruling it has been said that the existence of Subdivision EA makes it clear that in situations involving trusts which have a private company beneficiary with a UPE to income from that trust, Division 7A is only intended to apply when the trust separately pays or lends amounts to, or forgives debts of, a shareholder or associate of the private company.

173. In support of this view its proponents cite extrinsic materials to the predecessor of Subdivision EA (the former section 109UB) including:

- drafting instructions for section 109UB, which stated:

The definition of *loan* in subsection 109D(3) includes ‘a transaction (whatever its terms or form) which in substance effects a loan of money’. There is some doubt whether this phrase covers the situation where income of a trust estate to which a private company beneficiary had become presently entitled is not actually paid over by the trustee but instead is lent by the trustee to a shareholder of the private company beneficiary. There is persuasive opinion that such an amount is held by the trustee under a separate trust for the benefit of the corporate beneficiary. Accordingly, it is arguable that Division 7A would not apply to the amount held in the subtrust [sic] if it is lent by the trustee to a shareholder of the corporate beneficiary. This is because the amount held in the subtrust [sic] has not actually been lent by the private company to the trust.
- the Explanatory Memorandum to the Taxation Laws Amendment Bill (No. 3) 1998 introducing section 109UB, which stated:

**New section 109UB** will apply if a private company, as a beneficiary of a trust estate, is or has been presently entitled to some or all of the net trust income which has not actually been paid. In such a situation the amount to which the company is presently entitled is held on a secondary trust for the benefit of the company. The provision applies to any subsequent loan by the trustee to a shareholder (or associate) of the company.

174. The Board of Taxation’s November 2002 report on *The Taxation of Discretionary Trusts* is also cited. This report proceeded on the basis that Division 7A would practically only apply to trusts if the former section 109UB applied. The report acknowledged that trusts in the circumstances under consideration would be effectively accumulating income and made no mention of a sub-trust. It recommended improvements be made, either by enhancements to section 109UB (which were ultimately legislated as Subdivision EA) or by effectively deeming the amount of the UPE to have been accumulated in the trust (or subject to a top-up tax by the company) if it were not paid out within a reasonable time.

175. Support for the alternative view is also said to come from the fact that Division 7A contains no specific anti-overlap rule dealing with UPEs treated as loans under section 109D and the potential for Subdivision EA to apply to relevant dealings by the respective trustee.

### **Commissioner's view**

176. Division 7A is intended to ensure that private companies are not able to make tax free distributions of profits to shareholders or their associates. It applies, *inter alia*, to payments and loans of amounts by companies to shareholders or their associates. Subdivision E anticipates arrangements designed to overcome the primary provisions by interposing an entity between the private company and its shareholders or associates. It may operate when the company makes a loan or payment to the interposed entity which then on pays the amount to the shareholder or associate. It was thought that a special rule would be necessary to support Subdivision E when a private company entered into a similar arrangement but the interposed entity was a trust and the private company didn't actually make a payment or loan to the interposed trust but merely had a UPE to the income of the trust that was in effect paid over to the shareholder or associate. Subdivision EA now deals with the situation where a private company beneficiary has a UPE and the trustee makes a relevant payment to, or a loan to, or forgives a debt owed to it, by a shareholder or an associate of a shareholder of the private company. That is to say, it operates when there is a dealing between the trustee and a third party at the time the private company has a UPE or before it subsequently becomes so entitled.

177. It is true that it was thought that the UPE was not a loan of money by the private company to the trust because the amount was held by the trustee under a separate trust for the benefit of the corporate beneficiary. The Commissioner accepts that there is no loan if the amount is held by the trustee under a separate trust for the sole benefit of the corporate beneficiary. This Ruling deals with circumstances that are different to that. That is, it deals with the situation where the UPE is **not** held under a separate trust **for the sole benefit of the corporate beneficiary**. It deals with circumstances where the amount is used for trust purposes and where there is no third party dealings by the trustee of the kind dealt with in Subdivision E and Subdivision EA.

178. The Commissioner is of the view that the extrinsic materials referred to in paragraph 173 of this Ruling make it clear that at the time the predecessor to Subdivision EA was introduced, the prevailing view was that UPEs were held on sub-trust for the benefit of the private company beneficiary (and presumably not for any other entity). In the circumstances where the prevailing view was that a UPE was set aside on a separate trust for the benefit of the private beneficiary, it is understandable that there was doubt as to whether such a UPE could amount to a Division 7A loan.

179. In the situation where a UPE is set aside on a separate (sub) trust and held for the sole benefit of the private company beneficiary, the Commissioner agrees that the UPE would not be a loan for Division 7A purposes as the private company has not provided any financial accommodation or made an in-substance loan.<sup>77</sup> Examples of where a UPE is held on sub-trust for the sole benefit of the private company beneficiary include those arrangements described in Example 6 and Example 8 of this Ruling.

180. Whilst the Board of Taxation seemed to acknowledge UPEs may be retained in the trust, it did not specifically address or reconsider the question of whether a UPE could in these circumstances be a loan under section 109D. The Board seems to have accepted as correct the assumption that UPEs were held on a separate trust for the benefit of the private company beneficiary and did not entertain the notion that such amounts may not be so held. Indeed, prior to 16 December 2009 the Commissioner had a general administrative practice that the retention on trust of an unpaid present entitlement was not a loan for Division 7A purposes and this practice was based on the same assumption.

181. The failure to provide a specific anti-overlap rule to deal with private company UPEs that are treated as loans under section 109D is understandable given the prevailing view when Division 7A was introduced that UPEs were held on a separate trust for the benefit of the private company beneficiary.

182. Nonetheless, given the legislative context of Division 7A, an amount that has been treated as a loan and dealt with under section 109D should be regarded as a loan for all purposes of Division 7A, including Subdivision EA. Accordingly, the Commissioner will not treat a UPE that is subject to this Ruling and is considered to constitute a Division 7A loan as a present entitlement that remains unpaid for Subdivision EA purposes.

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<sup>77</sup> As explained in Section three of this Ruling.

## **Appendix 4 – Detailed contents list**

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