PS LA 2010/4 (Withdrawn) - Division 7A: trust entitlements

This cover sheet is provided for information only. It does not form part of *PS LA 2010/4 (Withdrawn) - Division 7A: trust entitlements*

This Practice Statement is being reviewed as a result of a court/tribunal decision. Refer to Decision Impact Statement: Bendel and Commissioner of Taxation (Published 15 November 2023).

This Practice Statement is withdrawn on and with effect from 1 July 2022 as the position stated in this Practice Statement is no longer current.

Taxation Determination TD 2022/11 *Income tax: Division 7A: when will an unpaid present entitlement or amount held on sub-trust become the provision of 'financial accommodation'?* was published on 13 July 2022. This Determination contains the ATO view (and compliance approach) on this issue that applies to trust entitlements created on or after 1 July 2022.

An entity may continue to rely on this Practice Statement in respect of trust entitlements conferred on or before 30 June 2022. This includes circumstances where Option 1 and Option 2 have been put in place after 30 June 2022 for such entitlements.

That is, the Commissioner will not devote compliance resources to sub-trust arrangements conducted in accordance with this Practice Statement in respect of trust entitlements arising on or before 30 June 2022, even though those sub-trust arrangements may commence after 30 June 2022.

This document has changed over time. This version was published on *1 July 2022*

Australian Government
Australian Taxation Office

Practice Statement Law Administration

PS LA 2010/4

This Practice Statement is withdrawn on and with effect from 1 July 2022 as the position stated in this Practice Statement is no longer current.

Taxation Determination TD 2022/11 *Income tax: Division 7A: when will an unpaid present entitlement or amount held on sub-trust become the provision of 'financial accommodation'?* was published on 13 July 2022. This Determination contains the ATO view (and compliance approach) on this issue that applies to trust entitlements created on or after 1 July 2022.

An entity may continue to rely on this Practice Statement in respect of trust entitlements conferred on or before 30 June 2022. This includes circumstances where Option 1 and Option 2 have been put in place after 30 June 2022 for such entitlements.

This law administration practice statement is issued under the authority of the Commissioner and must be read in conjunction with Law Administration Practice Statement PS LA 1998/1. ATO personnel, including non ongoing staff and relevant contractors, must comply with this law administration practice statement, unless doing so creates unintended consequences or is considered incorrect. Where this occurs, ATO personnel must follow their business line's escalation process.

Taxpayers can rely on this law administration practice statement to provide them with protection from interest and penalties in the way explained below. If a statement turns out to be incorrect and taxpayers underpay their tax as a result, they will not have to pay a penalty. Nor will they have to pay interest on the underpayment provided they reasonably relied on this law administration practice statement in good faith. However, even if they don't have to pay a penalty or interest, taxpayers will have to pay the correct amount of tax provided the time limits under the law allow it.

SUBJECT: **Division 7A: trust entitlements**

PURPOSE: **To provide practical guidance on the administrative aspects of Taxation Ruling TR 2010/3**

TABLE OF CONTENTS **Paragraph**

STATEMENT **1**

Interpretation 3

PART A: INTRODUCTION **4**

Section two loans 6

Section three loans 10

Flowchart 16

PART B: SECTION TWO LOANS **17**

When is there a Section two loan? 17

Type 1: loan agreement either express or implied 18

Express loan agreement 20

Implied loan agreement 21
Type 2: where the trustee exercises a power under the trust deed 24
When has a Section two loan been made? 28
What are the taxation consequences where a Section two loan arises? 29
Self corrective options – Applicable until 31 December 2011 30
A private company or trust may be able to correct their accounts where a UPE has been misclassified as a loan 32
Application of the Commissioner's discretion under section 109RB where the taxpayer discovers a non-compliance with Division 7A 33
What does a taxpayer do if they do not meet the conditions for the self corrective option in relation to the exercise of the Commissioner's discretion in section 109RB? 38
PART C: SECTION THREE LOANS **40**
At what point will the ATO consider that a UPE becomes a Section three loan to which Division 7A applies? 46
Sub-trust 49
How do we determine if there is a sub-trust in place? 50
Is it necessary to have one sub-trust for each UPE? 54
When will the ATO consider that the funds in the sub-trust are held for the sole benefit of the private company beneficiary? 55
Option 1: invest the funds representing the UPE on an interest only 7-year loan 62
Option 2: invest the funds representing the UPE on an interest only 10-year loan 74
Option 3: invest the funds representing the UPE in a specific income producing asset or investment 86
Where there is a Section three loan, when has it been made? 95
What are the taxation consequences where a UPE becomes a Section three loan? 100
PART D: OTHER ISSUES **101**
Does Subdivision EA of Division 7A apply to UPEs if the UPE is treated as a Section three loan? 101
Can Subdivision EA of Division 7A apply if the UPE is placed on sub-trust for the sole benefit of the private company beneficiary? 106
Can Subdivision EA of Division 7A apply if the sub-trust does not pay the annual returns to the private company under a sub-trust arrangement? 108
Can a Section two loan arise if the trustee has put a complying loan agreement in place between the trust and an associate of the private company, on the mistaken belief that Subdivision EA of Division 7A applies to the arrangement? 109
Is it possible to quarantine UPEs created prior to 16 December 2009 so that Division 7A will never apply to those UPEs? 112

Can section 109R apply in circumstances where a UPE that is a Section three loan is paid out so that it can be re-loaned on Division 7A compliant terms? 115

Can a UPE between 2 trusts be financial accommodation and a loan for Division 7A purposes? 117

EXPLANATION **119**

Examples 119

Example 1 – Section two loan made pursuant to an implied loan agreement 120

Tax consequences 127

Example 2 – Section two loan evidenced by the trustee exercising the power conferred under a trust deed 133

Tax consequences 141

Example 3 – Commissioner exercises discretion in section 109RB in relation to Section two loan 147

Example 4 – Section three loan and the timing of conversion 158

Tax consequences 165

Example 5 – no Division 7A loan (pre-16 December 2009 UPE) 171

Tax consequences 178

Example 6 – Section three loan in a structure involving interposed trusts 180

Tax consequences – Red Discretionary Trust 195

Tax consequences – Blue Discretionary Trust 202

Example 7 – Accounting entries 207

Composite examples 214

Example 8 – Interaction between sections 109D and 109XI 215

Tax consequences – Pink Discretionary Trust 232

Tax consequences – Purple Discretionary Trust 233

Tax consequences – Con 239

Example 9 – Interaction between sections 109D and 109XI 245

Tax consequences – Pink Discretionary Trust 249

Tax consequences – Purple Discretionary Trust 250

Tax consequences – Con 251

STATEMENT

1. Taxation Ruling TR 2010/3 *Income tax: Division 7A loans: trust entitlements* provides advice on when a private company with a present entitlement to an amount from an associated trust estate will be taken to have made 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),[1] in

[1] All legislative references in this practice statement are to the ITAA 1936 unless indicated otherwise.

circumstances where funds representing that present entitlement remain intermingled with funds of the trust.

2. This practice statement provides guidance on the administration of Taxation Ruling TR 2010/3 and should be read in conjunction with that Ruling.

Interpretation

3. For the purposes of this practice statement, unless context otherwise dictates:

- ***benchmark interest rate*** has the meaning defined in subsection 109N(2)
- ***complying loan agreement*** means a written loan agreement which meets the minimum interest rate and maximum loan terms set out in section 109N
- ***Division 7A loan*** has the meaning given in paragraph 5 of TR 2010/3
- ***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
- ***financial accounts*** means finalised accounts for the income year whether audited or unaudited
- ***lodgment day*** for a private company or a trust is the earlier of:
  - (a) the due date for lodgment of the private company's or trust's tax return for the year of income (or, for a trust's tax return for the 2018–19 year of income, 5 June 2020 if that date is after the due date of the return), and
  - (b) the date of lodgment of the private company's or trust's tax return for the year of income
- ***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 an unpaid present entitlement (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*)
- ***trust purposes*** are purposes of benefiting one or more beneficiaries or discretionary objects of a trust estate; but do not include use of funds representing a *private company* beneficiary's *UPE* for the purpose of solely benefiting that *private company*
- ***UPE*** means a *private company*'s unpaid present entitlement to an amount from a *trust* or *sub-trust*

- ***Section two loan*** means an ordinary loan as described in paragraphs 7 to 15 of TR 2010/3
- ***Section three loan*** means a loan as described in paragraphs 16 to 26 of TR 2010/3.

PART A: INTRODUCTION

4. TR 2010/3 considers the application of Division 7A where a private company beneficiary has (or had) a present entitlement to an amount from an associated trust (that is part of the same family group as the private company).
5. TR 2010/3 considers two types of loans, which are referred to as Section two and Section three loans.

Section two loans

6. A Section two loan is a loan within the ordinary meaning of the term 'loan'. Such a loan can arise in situations where a UPE is satisfied (for example, by being paid out) and the funds are loaned back to the trustee. The UPE will effectively be replaced by an ordinary loan from the private company to the trustee of the trust.
7. Details of the arrangements that are considered to be Section two loans can be found in paragraphs 7 to 15 of TR 2010/3. Section two of TR 2010/3 applies to arrangements in existence before and after 16 December 2009.
8. The Australian Taxation Office (ATO) has always considered that Section two loans are loans for the purposes of Division 7A. An example of such a loan is where a distribution from a trust to a private company beneficiary is not recorded as being an outstanding entitlement and the accounts of both the company and the trust record a loan made by the private company to the trust. The ATO has always considered that, subject to evidence to the contrary, these accounting entries evidence a Division 7A loan.
9. Further detail about when a Section two loan arises and the Division 7A consequences can be found in Part B in paragraphs 17 to 39 of this practice statement.

Section three loans

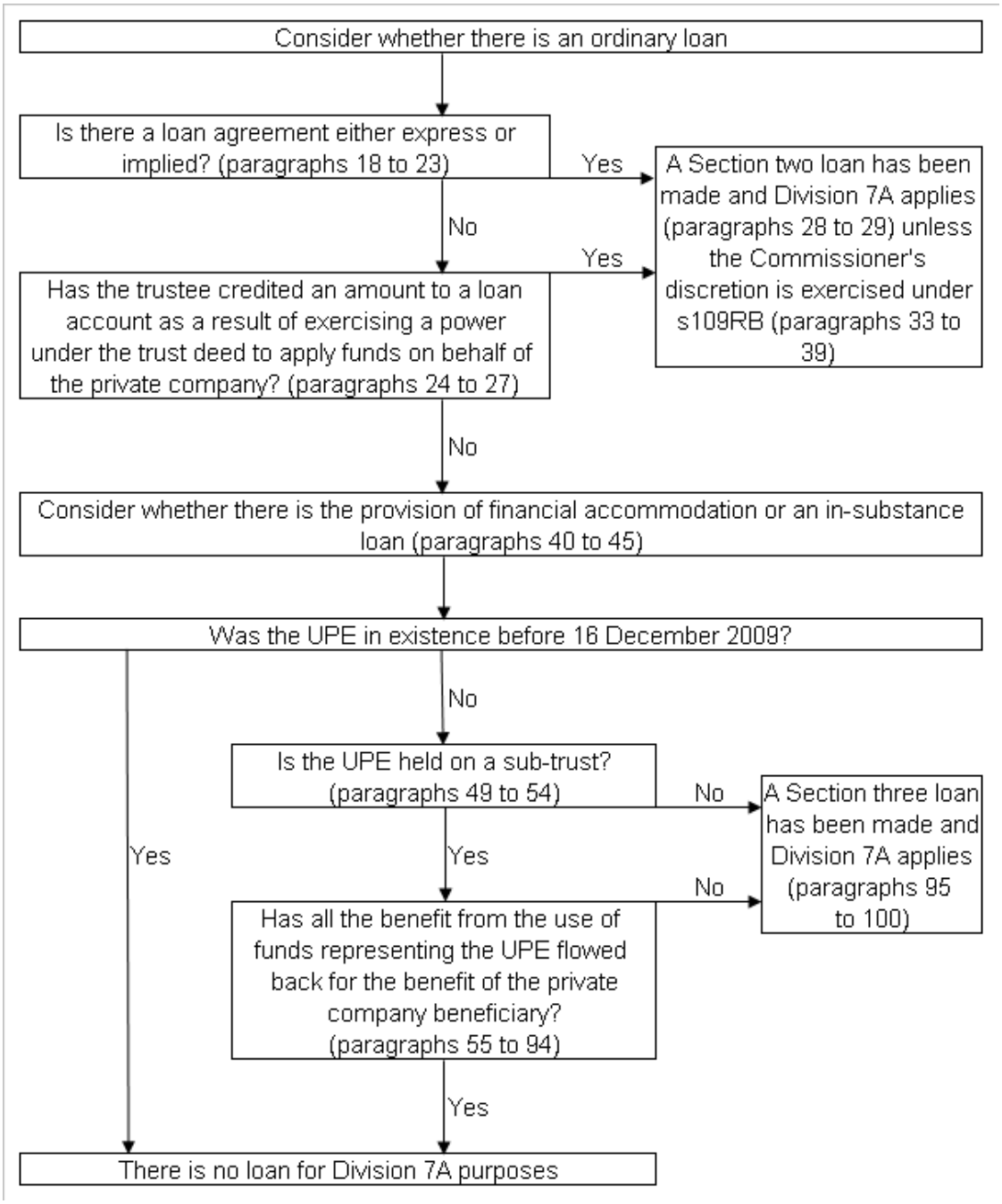
10. Section three loans deal with subsisting UPEs. A subsisting UPE means a UPE that has not been satisfied, including by being converted into (or replaced by) an ordinary loan.
11. A subsisting UPE is not a loan within the ordinary meaning of loan but may be a loan under the extended definition of a Division 7A loan if it is the provision of financial accommodation or an in-substance loan.
12. Details of circumstances under which a Section three loan can arise are in paragraphs 16 to 26 of TR 2010/3.
13. Section three of TR 2010/3 applies prospectively only. That is, the ATO will not apply Division 7A (other than Subdivision EA) to UPEs in existence before 16 December 2009.
14. A UPE will not be considered to be a Section three loan if funds representing the UPE are held on sub-trust for the sole benefit of the private company beneficiary. This practice statement sets out three options which satisfy the Commissioner that this has occurred. However, other arrangements may also result in the funds representing the UPE being used for the sole benefit of the

private company such that a Section three loan does not arise. This practice statement is *not* intended to suggest that the three options presented are the only circumstances in which a UPE will not be treated as a Section three loan.

15. Further detail about when a Section three loan arises and the Division 7A consequences can be found in Part C in paragraphs 40 to 100 of this practice statement.

Flowchart

16. The flowchart below summarises the relevant issues when determining whether a Section two loan or a Section three loan has arisen in any particular case. It also provides a link to the appropriate paragraphs within Parts B and C of this practice statement which further elaborate on the particular issues.



PART B: SECTION TWO LOANS

When is there a Section two loan?

17. Section two of TR 2010/3 deals with situations where there are ordinary loans, including where the UPE has been replaced by a loan. As set out in TR 2010/3 the following two types of arrangements are considered to be Section two loans.

Type 1: loan agreement either express or implied

18. Paragraph 9 of TR 2010/3 states the following:

> 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.

19. Paragraph 10 of TR 2010/3 states further:

> 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.

Express loan agreement

20. The ATO will treat an arrangement as being an express loan agreement where the agreement is evidenced by:

- a written agreement
- a trust resolution, or
- another document.

Implied loan agreement

21. Subject to evidence to the contrary, the ATO considers that an implied loan agreement will arise where the amount is recorded in the financial accounts of the private company as an asset in the form of a loan and in the financial accounts of the trust as a liability in the form of a loan.

22. Where a UPE has been forgiven the ATO may consider that a Section two loan has arisen, despite the fact that the amount had been recorded as a UPE in the accounts.

23. Where a UPE has been misclassified as a loan in either, or both, the financial accounts of the private company and the trust, these accounts may be amended to correct this error if the conditions set out in paragraph 32 of this practice statement are met.

Type 2: where the trustee exercises a power under the trust deed

24. Paragraph 14 of TR 2010/3 states the following:

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.

25. Subject to evidence to the contrary, the ATO considers that such a loan will arise where:

- the trustee has exercised the power under the trust deed to pay or apply money to or for the benefit of the beneficiary and the exercise of the power to apply the trust funds for the benefit of the corporate beneficiary is evidenced in a trust resolution or other written document, and
- the financial accounts of the trust have recorded the amount as a loan.

26. The ATO will not consider that a type 2 loan is in existence where the financial accounts of the private company and the trust record the amount as a UPE.

27. Where a UPE has been misclassified as a loan in the financial accounts of either, or both, the private company and the trust, these accounts may be amended to correct this error if the conditions set out in paragraph 32 of this practice statement are met.

When has the Section two loan been made?

28. Subject to evidence to the contrary, the ATO will consider a Section two loan to have been made at the following times:

- where there is a loan agreement: on the date the amount was loaned to the trust under the terms of the loan agreement
- where there is no loan agreement: the date the amount is recorded as being debited to the loan account according to the loan account ledger of the private company, or
- in situations where neither of the above dot points in this paragraph apply: the date the amount is recorded as being credited to a loan account in the name of the private company according to the loan account ledger of the trust.

What are the taxation consequences where a Section two loan arises?

29. The Section two loan will be subject to Division 7A. Generally, section 109D will apply to treat the private company as having paid an assessable dividend to the trust (equal to the Section two loan) at the end of the income year in which the loan is made, unless:

- an exception contained in Subdivision D of Division 7A applies (for example, if before the lodgment day for the income year in which the loan is made, the loan is put under a complying loan agreement) – whereby no amount of the Section two loan will be assessable under section 109D
- the loan is fully repaid before the private company's lodgment day for the income year in which the loan is made, or
- the private company has insufficient distributable surplus such that section 109Y will operate to reduce the amount of the dividend that would otherwise be deemed to have been paid – whereby

section 109D will apply to the extent of the amount of the distributable surplus.

Self corrective options – Applicable until 31 December 2011

30. During the consultation process for this practice statement, the ATO received feedback that some small businesses may have been incorrectly classifying UPEs as loans in their accounts or alternatively were not aware that Division 7A can potentially apply to ordinary loans (as opposed to UPEs) between a private company and an associated trust.

31. In recognition of the genuine concerns of small business and their willingness to comply, the ATO has introduced two self corrective administrative options for taxpayers. Provided certain conditions are met, these options allow taxpayers to:

- self correct accounts where a UPE has been misclassified as a loan
- operate on the basis that the Commissioner would exercise his discretion under section 109RB to disregard a deemed dividend.

A private company or trust may be able to correct their accounts where a UPE has been misclassified as a loan

32. Whether an amount is a UPE or an actual (Section two) loan is a question of fact. However, the ATO will accept that an amount is not a loan but a UPE where all the following conditions have been met:

(a) the financial accounts of the trust and / or the private company have incorrectly classified the amount, which is in fact a UPE, as a loan from the private company to the trust

(b) with the exception of the financial accounts and their underlying working papers, including the journal entries, accounting ledgers and / or trial balance, all available evidence supports the view that the amount is in fact a UPE

(c) the private company has never included that amount in calculating the amount of loan reported at Label 8N of the private company's income tax return (label marked 'loans to shareholders and their associates')

(d) the trust has not paid or credited any interest on or in respect of that amount

(e) the loan account in which the amount is included is entirely comprised of amounts correlating to UPEs and repayments of such UPEs between the trust and the private company (that is, its balance is not affected by any unrelated transactions)

(f) on or before **31 December 2011**, the financial accounts of all relevant entities are amended or restated to properly classify the amount as a UPE

(g) on or before **31 December 2011**, the trustee of or public officer of the trust, or public officer of the company, (as is relevant) signs and dates a declaration setting out all of the above conditions listed in this paragraph in the context of the amount and declaring them to be true and correct.

Where this is the case, irrespective of the turnover of the entity, the ATO will not treat the amount as a Section two loan for Division 7A purposes.

Application of the Commissioner's discretion under section 109RB where the taxpayer discovers a non-compliance with Division 7A

33. Where a taxpayer discovers a non-compliance with Division 7A in respect of one or more Section two loan(s), the taxpayer may seek the Commissioner's discretion under section 109RB. Under section 109RB, the Commissioner may in certain circumstances disregard a deemed dividend that arises under Division 7A. Usually the taxpayer is required to apply to the Commissioner in writing to exercise this discretion.

34. In situations where Division 7A operates to treat the private company as having paid a dividend to the trustee of a trust in respect of a Section two loan made by the private company to that trustee, a taxpayer will not be required to make a written request for the Commissioner to exercise his discretion to disregard this dividend where all the following conditions have been satisfied:

    (a) the failure to comply with one or more of the provisions of Division 7A in respect of that Section two loan was the result of an honest mistake or inadvertent omission by the trustee, the private company or other relevant party

    (b) the trust or private company are small business entities, as defined in section 328-110 of the *Income Tax Assessment Act 1997* (ITAA 1997), in the income year in which the Section two loan is made. In summary, a small business entity is an entity which carries on a business and together with affiliates and other connected entities has a turnover of less than $2 million

    (c) the loan funds were used by the trustee of the trust only for the purpose of carrying on the business (or businesses) of the trust

    (d) 'corrective action' as defined in paragraph 35 of this practice statement has been taken by the taxpayer on or before **31 December 2011**

    (e) the private company and the trust have lodged all required income tax returns up to and including the 2009-10 income year if necessary

    (f) notwithstanding the current non compliance with Division 7A, the family group, including the private company, the trust and their controlling mind(s),,have a history of good tax compliance over the last four years

    (g) the trustee of the trust is not a shareholder of the private company.

35. For the purpose of this practice statement, 'corrective action' taken by the taxpayer means the following:

    (a) the trustee or public officer of the trust and the public officer of the private company have both signed and dated a declaration stating that an honest mistake or inadvertent omission has been made which resulted in the operation of Division 7A mentioned in paragraph 34 of this practice statement

    (b) the Section two loan mentioned in paragraph 34 of this practice statement is put on complying loan terms under a written agreement that complies with all the requirements of section 109N that now exist and all requirements that existed at any time during the period that began with the year in which the Section two loan was made (a complying loan agreement), and

    (c) the taxpayer has made a payment, or payments, equal to the total of minimum yearly repayments that would have been payable had the complying loan agreement existed from the start of the period that began with the year in which the Section two loan was made. That payment has two components, a capital and interest component. The

interest component should be compounded to reflect non payment of earlier years. Guidance on how to calculate the compounding interest can be drawn from a fact sheet on our website at http://www.ato.gov.au/print.asp?doc=/content/00104288.htm

36. If the conditions set out in paragraphs 34 and 35 of this practice statement are satisfied, it would be reasonable for an ATO officer to conclude that the Commissioner's discretion in section 109RB should be exercised in the taxpayer's favour.

37. Paragraphs 34 to 36 of this practice statement are not limited in their application to loans which have their genesis in UPEs but are applicable to all Section two loans (that is, ordinary loans) between private companies and associated trusts, provided the conditions are met.

What does a taxpayer do if they do not meet the conditions for the self corrective option in relation to the exercise of the Commissioner's discretion in section 109RB?

38. If the self corrective option is not applicable, the private company will need to apply directly to the Commissioner in writing to ask that he exercise his discretion to disregard each deemed dividend that has occurred.

39. The ATO has prepared a separate practice statement to provide further guidance on the application of the Commissioner's discretion in section 109RB. Tax officers are advised to refer to draft Law Administration Practice Statement PS LA 2843 for further guidance.

PART C: SECTION THREE LOANS

40. Section three of TR 2010/3 applies to UPEs arising from 16 December 2009 (paragraph 28 of TR 2010/3).

41. Section three of TR 2010/3 need only be considered if the UPE has not been satisfied (for example, by being paid out and replaced by a Section two loan).

42. A UPE may itself be a Division 7A loan if the UPE is considered to amount to the provision of financial accommodation or an in-substance loan (paragraphs 19 to 26 of TR 2010/3).

43. Paragraph 23 of TR 2010/3 states the following:

> …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.

44. Paragraph 25 of TR 2010/3 adds that this:

> …overall transaction also effects, in substance, a loan of money from the private company to the trustee of the trust.

45. Paragraph 26 of TR 2010/3 states further:

> 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.

At what point will the ATO consider that a UPE becomes a Section three loan to which Division 7A applies?

46. A UPE owing from a trust to a private company in the same family group will become a loan to which Division 7A applies to the extent that:

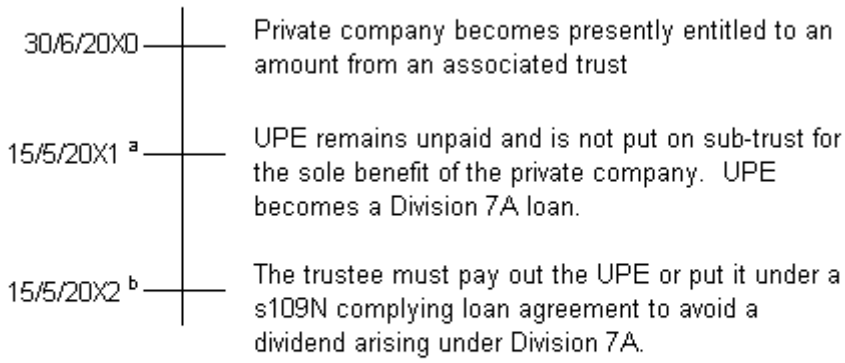
    (a) it has not been paid out to the private company beneficiary, and

    (b) the trustee fails to hold the funds representing the UPE on sub-trust for the sole benefit of the private company beneficiary by the main trust's lodgment day for the income year in which the present entitlement arises and all times thereafter.

47. For UPEs arising between 16 December 2009 and 30 June 2010, the trustee has until 30 June 2011 to put the funds representing the UPE on sub-trust for the sole benefit of the private company beneficiary (refer to paragraph 96 of this practice statement).

48. Graph 1 below illustrates the key dates where the trustee fails to put the UPE on sub-trust for the sole benefit of the private company beneficiary.

Graph 1



[a] Date may be different depending on lodgment day of the main trust's tax return and for UPEs arising from 16/12/2009 to 30/6/2010, the relevant date is 30/6/2011 rather than the lodgment day

[b] Date may be different depending on lodgment day of the company's tax return

Sub-trust

49. A UPE will not be considered to be a loan to which Division 7A applies if the funds representing the UPE are held on sub-trust for the sole benefit of the private company beneficiary.

How do we determine if there is a sub-trust in place?

50. A sub-trust may be evidenced by a resolution by the trustee to set aside the funds representing the UPE for the sole benefit of the private company beneficiary.

51. However, it is common for trust deeds to expressly provide that UPEs are to be held on a sub-trust and that the trustee has wide powers to invest the amount held in the sub-trust. The setting up of the sub-trust may therefore happen without any requirement for the trustee to resolve to do so.

52. Subject to paragraph 54 of this practice statement, the ATO will consider the following to evidence the existence of a sub-trust:

- where the amount representing the UPE is set aside separately in the accounts of the main trust as being held on trust for the private company beneficiary
- where separate accounts are prepared for the sub-trust, or
- where a separate bank account is opened in the name of the trustee as trustee for the private company beneficiary in respect of the funds within the sub-trust.

53. Where a sub-trust has invested in a specific income producing asset or investment, as described in paragraphs 86 to 94 of this practice statement, the ATO requires the sub-trust to prepare its own separate accounts.

Is it necessary to have one sub-trust for each UPE?

54. It is expected that there would only be one sub-trust if the beneficiary is the same.

When will the ATO consider that the funds in the sub-trust are held for the sole benefit of the private company beneficiary?

55. The ATO will consider that the funds in the sub-trust are held for the sole benefit of the private company beneficiary where:

- the trustee of the sub-trust invests the funds representing the UPE in the main trust on commercial terms pursuant to a power as trustee to do so, and
- all the benefits from the investment flow back to the sub-trust and the private company beneficiary, and
- all the benefits (for example, annual return on investment) are actually paid to the private company beneficiary by the lodgment day of the tax return of the main-trust for the year in which the return arises.

56. For the avoidance of doubt, the annual return on investment can either be paid in cash or set off against an account owing from the private company to the main trust, but it cannot be paid by crediting it to a liability account owing to the private company from the main trust or sub-trust. The payment of the principal funds invested in the main trust (that is, the funds representing the UPE) and annual return to the private company must be such that if those payments had instead been repayments of a Division 7A loan made by a private company, they would not be disregarded by section 109R.

57. A taxpayer may determine the appropriate terms of the investment, based on the criteria set out in paragraphs 55 and 56 of this practice statement or alternatively a taxpayer may adopt one of three investment options described in paragraph 58 of this practice statement. There is no requirement for the taxpayer to adopt any of the options.

58. The ATO will consider that the funds in the sub-trust are held for the sole benefit of the private company beneficiary if the funds are invested in the main trust using one of the following investment options:

> *Option 1* – invest the funds representing the UPE on an interest only 7-year loan (see paragraphs 62 to 73 of this practice statement)

Option 2 – invest the funds representing the UPE on an interest only 10-year loan (see paragraphs 74 to 85 of this practice statement)

Option 3 – invest the funds representing the UPE in a specific income producing asset or investment (see paragraphs 86 to 94 of this practice statement)

59. The trustee must not swap between the options once the initial choice is made in respect of the investment of the funds representing each UPE until that investment is paid out to the private company. However, in respect of Option 3, the taxpayer may choose to invest in another asset or investment if the first asset or investment is disposed of. For example, the trustee may choose to use Option 3 in respect of the UPE for the 2010 income year and use the amount to acquire a CGT asset. If the trustee subsequently disposes of the CGT asset in the 2012 income year, the trustee must pay out to the sub-trust any net gain derived from the sale. The trustee, in the capacity of the trustee of the sub-trust, has the choice to either pay out or use the original funds representing the UPE to invest in another Option 3 asset. The trustee cannot apply those funds towards one of the other options.

60. For the avoidance of doubt, paragraph 59 of this practice statement does not preclude the trustee from choosing Option 3 in respect of the UPE in one particular year, and another option in respect of a new UPE arising in the following year.

61. The table below provides an overview of the three available investment options. These options are explained in detail in the paragraphs which ensue.

<table>
<tr><th></th><th>Option 1 – interest only 7-year loan</th><th>Option 2 – interest only 10-year loan</th><th>Option 3 – invest in a specific income producing asset or investment</th></tr>
<tr><td rowspan="2">Amount of the annual return</td><td>Main trust to pay interest calculated at the Benchmark interest rate to the sub-trust.</td><td>Main trust to pay interest calculated at the Prescribed interest rate to the sub-trust.</td><td>Sub-trust is entitled to receive the share of net return (e.g. interest income or rental income) derived as a result of the specific asset or investment to the sub-trust.</td></tr>
<tr><td colspan="3">Sub-trust to pay annual return to the private company beneficiary by the lodgment day of the income tax return for the main trust except for the final payment of the annual return which must be paid to the private company when the investment or loan is due to be repaid.</td></tr>
<tr><td>Nature of the annual return</td><td>Interest.</td><td>Interest.</td><td>Depends on the specific asset or investment.</td></tr>
<tr><td>Repayment of the funds representing the UPE (the principal)</td><td>The principal must be repaid at the end of the 7-year loan.</td><td>The principal must be repaid at the end of the 10-year loan.</td><td>The principal must be repaid by the lodgment day of the tax return of the private company beneficiary for the year in which the investment ends.</td></tr>
</table>

	Option 1 – interest only 7-year loan	Option 2 – interest only 10-year loan	Option 3 – invest in a specific income producing asset or investment
Deductibility of the annual return	Yes, the amount is deductible to the main trust provided that the trustee of the main trust satisfies section 8-1 of the ITAA 1997.	Yes, the amount is deductible to the main trust provided that the trustee of the main trust satisfies section 8-1 of the ITAA 1997.	No.
Assessability of the annual return	Yes, the amount is assessable to the private company beneficiary.	Yes, the amount is assessable to the private company beneficiary.	Depends on the specific asset or investment.
Sub-trust tax return	Not required.	Not required.	Required.

Option 1: invest the funds representing the UPE on an interest only 7-year loan

62. The trustee may, in its capacity as the trustee of the main trust and the sub-trust, decide to put the funds representing the UPE on a 7-year interest only loan from the sub-trust to the main trust.

63. Under Option 1, the trustee must pay an annual return on the funds equal to the Benchmark interest rate and calculated as follows:

$$\text{Funds invested by the sub-trust} \times \text{Benchmark interest rate} \times \frac{\text{Days investment held in the year}}{\text{Total number of days in the year}}$$

Benchmark interest rate is as defined by subsection 109N(2).

Funds invested by the sub-trust means the funds representing the UPE that are held on sub-trust and invested back into the main trust as at the last day of the relevant income year.

Days investment held in the year means the number of days during the relevant financial year in which the funds represented by the UPE are invested in the main trust by the trustee of the sub-trust not including the day the investment commences if the investment commences on the last day of the relevant income year.

64. A taxpayer adopting Option 1 must document the terms of the investment agreement. The agreement must be legally binding, but the document evidencing that agreement may be prepared as part of the tax return working papers.

65. The terms of the investment must:

(a) include an obligation, and not a discretion, on the part of the trustee to pay the interest to the trustee of the sub-trust

(b) contain details of the 7-year interest only loan, including the amount of UPE on loan, the start and end dates of the 7-year loan, and

(c) include an obligation to repay the principal amount back to the sub-trust no later than at the end of the 7-year loan period. For the avoidance of doubt, where the trust has a 30 June year end, the date of investment is 30 June 2011 in which case the investment must be repaid by 30 June 2018.

66. The sub-trust's annual entitlement to interest may be recorded as a journal entry at the end of the income year, increasing the sub-trust's entitlement, as long as the interest is actually paid out to the sub-trust and on paid to the private company beneficiary by the lodgment day for the main-trust for that year, except for the final payment of interest which must be paid out to the sub-trust and on paid to the private company when the loan principal is due to be repaid.

67. The interest paid by the main trust to the sub-trust is assessable to the private company beneficiary and must be included in the income tax return of the private company beneficiary.

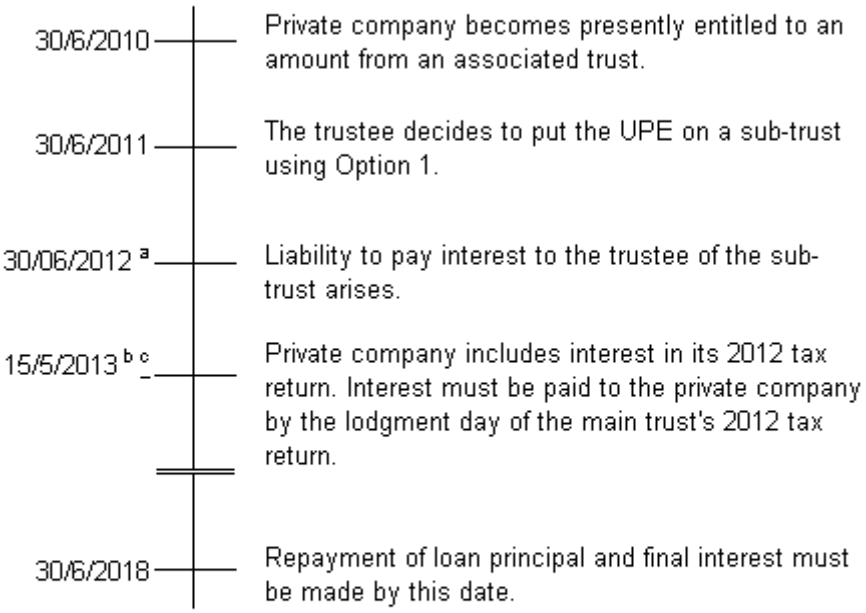
68. The interest paid is an expense deductible to the main trust as long as the main trust satisfies the general deduction provisions in section 8-1 of the ITAA 1997.

69. In addition, under this option, the funds invested by the sub-trust must be repaid within 7 years from the date of investment. If for example, the loan is made on 15 May 2012, it would be expected that the loan be repaid to the sub-trust and then on paid to the private company by 14 May 2019. The repayment to the sub-trust and payment out to the private company must be such that if those payments had instead been repayments of a Division 7A loan made by a private company, they would not be disregarded by section 109R.

70. If, on 30 June 2011, the trustee decides to place the UPE arising between 16 December 2009 and 30 June 2010 on a sub-trust using Option 1, the key dates of which the trustee must take note of are illustrated in Graph 2A below.

OPTION 1

Graph 2A - for UPEs arising between 16/12/2009 and 30/6/2010 (inclusive)

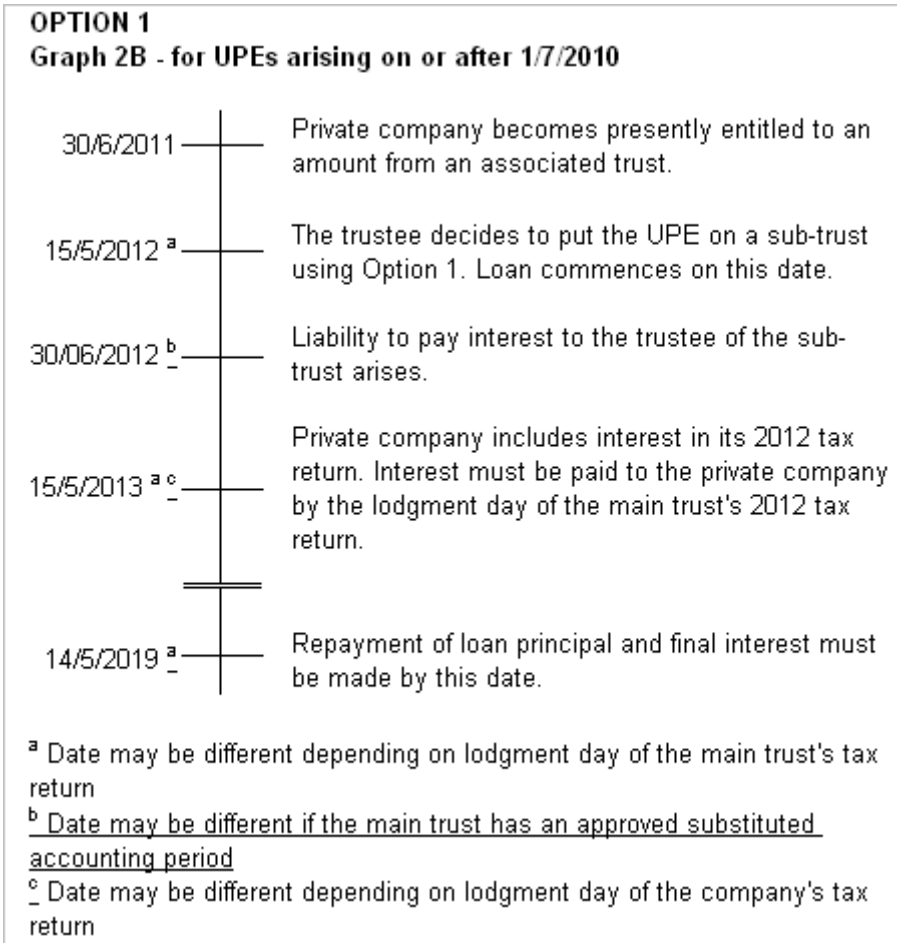


[a] Date may be different if the main trust has an approved substituted accounting period

[b] Date may be different depending on lodgment day of the main trust's tax return

[c] Date may be different depending on lodgment day of the company's tax return

71. If, on 15 May 2012 (or the applicable lodgment date for the main trust), the trustee decided to place the UPE for the 2011 income year on sub-trust using Option 1, the key dates which the trustee must take note of are illustrated in Graph 2B below.



72. Under Option 1, the ATO does not require the sub-trust to create separate sub-trust financial accounts or lodge a separate sub-trust tax return provided that:

- the capital and income of the sub-trust to which the private company beneficiary has an indefeasible entitlement is sufficiently clear from the financial accounts of the main trust, and
- the net income of the sub-trust as defined in section 95 (broadly akin to the taxable income of the sub-trust) is included in the income tax return for the private company beneficiary for that particular year.

73. The ATO may issue a notice pursuant to sections 162 or 163 requiring the trustee of the sub-trust to lodge a tax return if, for example, the private company beneficiary fails to include income from the sub-trust in the relevant private company tax return.

Option 2: invest the funds representing the UPE on an interest only 10-year loan

74. The trustee may, in its capacity as the trustee of the main trust and the sub-trust, decide to put the funds representing the UPE on a 10-year interest only loan between the sub-trust and the main trust.

75. Under Option 2, the trustee must pay an annual return on the funds equal to the Prescribed interest rate and calculated as follows:

$$\text{Funds invested by the sub-trust} \times \text{Prescribed interest rate} \times \frac{\text{Days investment held in the year}}{\text{Total number of days in the year}}$$

Prescribed interest rate for a particular income year is the Reserve Bank of Australia's indicator lending rate for small business variable (other) overdraft for the month of May immediately before the start of that income year. These rates can be found at Table F5 at the Reserve Bank of Australia website (http://www.rba.gov.au/statistics/tables/index.html). The rate for the year ending 30 June 2011 is 10.3%.

Funds invested by the sub-trust means the funds representing the private company's UPE that are held on sub-trust and invested back into the main trust as at the last day of the relevant income year.

Days investment held in the year means the number of days during the relevant financial year in which the funds represented by the UPE are invested in the main trust by the trustee of the sub-trust not including the day the investment commences if the investment commences on the last day of the relevant income year.

76. A taxpayer adopting Option 2 must document the terms of the investment agreement. The agreement must be legally binding, but the document evidencing that agreement may be prepared as part of the tax return working papers.

77. The terms of the investment must:

(a) include an obligation, and not a discretion, on the part of the trustee to pay the interest to the trustee of the sub-trust

(b) contain details of the 10-year interest only loan, including the amount of UPE on loan, and

(c) include an obligation to repay the principal amount back to the sub-trust at the end of the 10-year loan period unless the date of investment is 30 June 2011 in which case the investment must be repaid by 30 June 2021.

78. The sub-trust's annual entitlement to interest may be recorded as a journal entry at the end of the income year, increasing the sub-trust's entitlement, as long as the interest is actually paid out to the sub-trust and then on paid to the private company beneficiary by the lodgment day for the main-trust for that year, except for the final payment of interest which must be paid out to the sub-trust and then on paid to the private company when the loan principal is due to be repaid.

79. The interest paid by the main trust to the sub-trust is assessable to the private company beneficiary and must be included in the income tax return of the private company beneficiary.

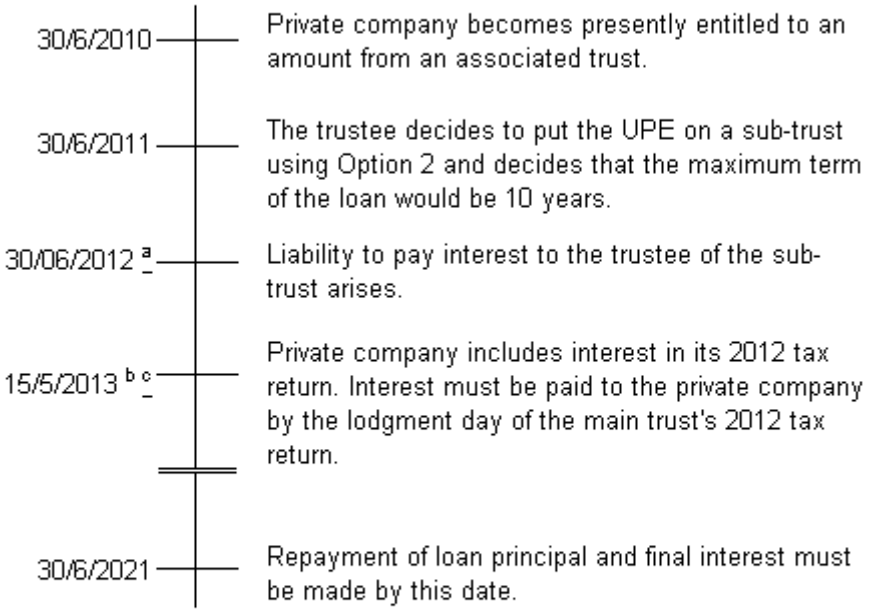
80. The interest paid is an expense deductible to the main trust provided the general deduction provisions in section 8-1 of the ITAA 1997 are satisfied.

81. When the loan is repaid to the sub-trust by the end of the 10-year period, it must then be immediately on paid to the private company. The repayment to the sub-trust and pay out to the private company must be such that if those payments had instead been repayments of a Division 7A loan made by a private company, they would not be disregarded by section 109R.

82. If, on 30 June 2011, the trustee decides to place the UPE arising between 16 December 2009 and 30 June 2010 on a sub-trust using Option 2, the key dates which the trustee must take note of are illustrated in Graph 3A below.

OPTION 2

Graph 3A - for UPEs arising between 16/12/2009 and 30/6/2010 (inclusive)

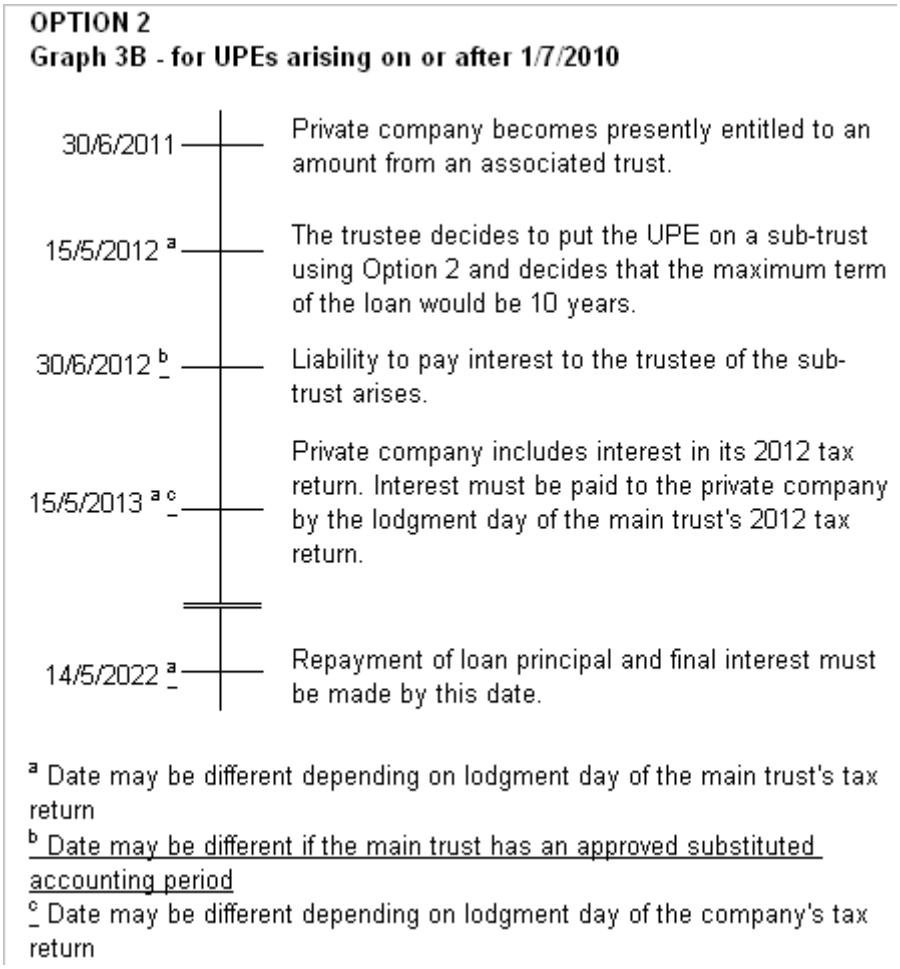


[a] Date may be different if the main trust has an approved substituted accounting period

[b] Date may be different depending on lodgment day of the main trust's tax return

[c] Date may be different depending on lodgment day of the company's tax return

83. If, on 15 May 2012 (or the applicable lodgment date for the main trust), the trustee decides to place the UPE for the 2011 income year on a sub-trust using Option 2, the key dates which the trustee must take note are illustrated in Graph 3B below.



84. Under Option 2, the ATO would not require the sub-trust to create separate sub-trust financial accounts or lodge a separate sub-trust tax return provided that:

- the capital and income of the sub-trust to which the private company beneficiary has an indefeasible entitlement is sufficiently clear from the financial accounts of the main trust, and
- the net income of the sub-trust as defined in section 95 (broadly akin to the taxable income of the sub-trust) is included in the income tax return for the private company beneficiary for that particular year.

85. The ATO may issue a notice pursuant to sections 162 or 163 requiring the trustee of the sub-trust to lodge a tax return if the private company beneficiary fails to include income from the sub-trust in the relevant private company tax return.

Option 3: invest the funds representing the UPE in a specific income producing asset or investment

86. The trustee may, in its capacity as the trustee of the main trust and the sub-trust, decide to invest the funds representing the UPE in a specific investment, such as an interest bearing account or the acquisition of an interest in an income producing asset.

87. However, the ATO would not consider that the funds are held for the sole benefit of the private company beneficiary where the investment benefits entities other than the private company beneficiary. For example, Division 7A will potentially apply if the funds are used to invest in the following:

- acquisition of depreciating assets unless the depreciable asset is leased at arm's length rates
- acquisition of private assets, or
- low interest loans to associated parties.

88. An income producing asset is one which is held with the intention of generating assessable income, such as rent or capital gains, provided that the income or gains generated from the asset is an arm's length commercial amount.

89. Under Option 3, as the sub-trust will acquire an interest in a specific investment or income producing asset, the normal tax laws, such as capital gains tax upon the disposal (including the disposal by the main trust to the sub-trust where the sub-trust acquires an existing asset held by the main trust), may be applicable.

90. The investment must be reflected in the accounts of the sub-trust. The sub-trust will need to prepare its own accounts showing the investment and prepare its own tax return.

91. The investment must be documented in the tax return working papers of the main trust and the sub-trust and where the funds are used to acquire part of an asset, must clearly identify the percentage of the specific asset acquired using funds from the sub-trust.

92. Because the sub-trust will have an interest in an asset or investment, it is expected that:

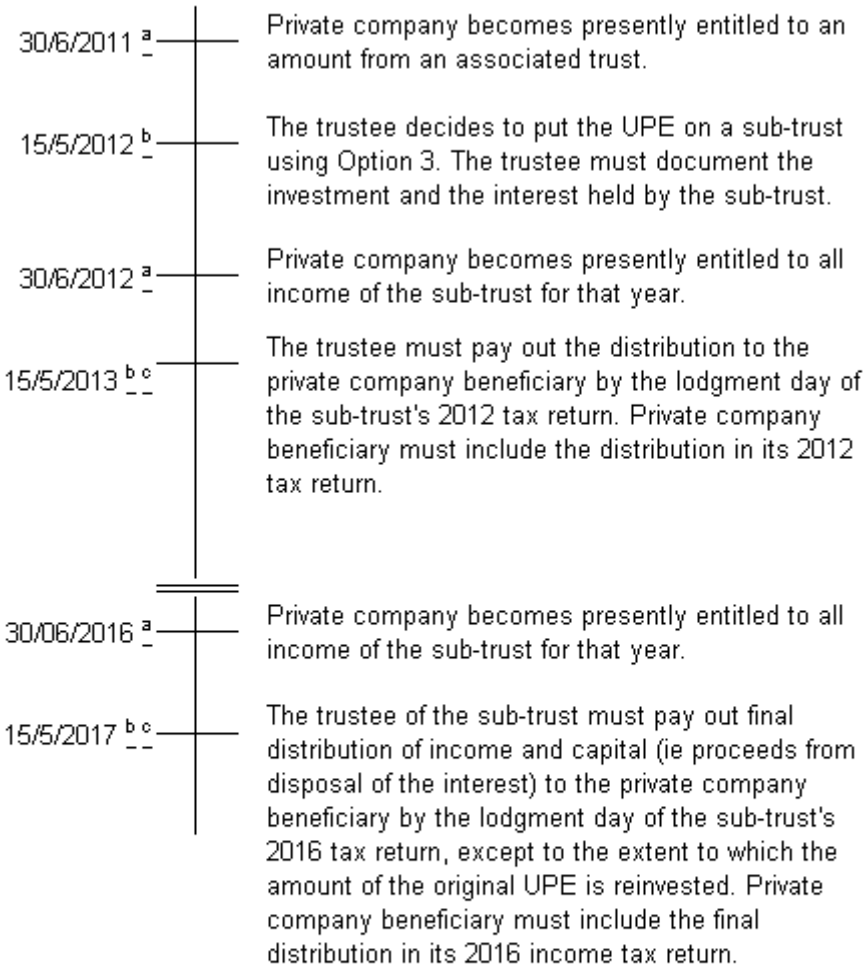
(a) the sub-trust will show all income and expenses attributable to its ownership of the interest in the asset or investment in its accounts and tax return.

(b) the sub-trust will make annual distributions to the private company, as it is the only beneficiary and it is a requirement that these distributions be paid out to the private company by lodgment day for the sub-trust's tax return for the relevant year.

93. If and when the sub-trust disposes of its interest in an asset, it is expected that the proceeds attributable to the disposal of that interest would be paid via the sub-trust to the private company by the lodgment day for the sub-trust's tax return for the relevant year.

94. For example, if, on 15 May 2012, the trustee decides to place the UPE for the 2011 income year on a sub-trust using Option 3 and disposes of the interest on 30 May 2016, the key dates of which the trustee must take note are illustrated in Graph 4 below.

OPTION 3
Graph 4



[a] Date may be different if the main trust has an approved substituted accounting period
[b] Date may be different depending on lodgment day of the sub-trust's tax return
[c] Date may be different depending on lodgment day of the company's tax return

Where there is a Section three loan, when has it been made?

95. Paragraph 112 of TR 2010/3 states the following:

> … 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 … until some time during the income year following that in which the UPE is taken to have arisen for tax purposes…

96. Due to the operation of other provisions of Division 7A (for example, Subdivision EA discussed in Part D at paragraphs 101 to 111 of this practice statement), it is generally considered appropriate that a Section three loan be taken to have been made at the trust's lodgment date for the year in which the UPE arose. However, if a UPE arising between 16 December 2009 and 30 June 2010 was treated as a Section three loan made at the trust's 2010 lodgment date, a taxpayer who wished to avoid such a UPE being taken to be a Section three loan may not be given sufficient time to put appropriate arrangements in place.

97. Accordingly, a Section three loan will be taken to have been made as at the later of:

- the lodgment day for the main trust for the income year in which the present entitlement arises, and
- 30 June 2011,

as long as the UPE is still a subsisting UPE at that time (that is, if the UPE has not been satisfied by that time) and is not being held on sub-trust for the sole benefit of the private company beneficiary.

98. For example, if a distribution made on the last day of the 2011 income year is not paid to the private company or held on sub-trust for the sole benefit of the private company by the lodgment day for the main trust's return for the 2011 year, which in this case assume is 15 May 2012, then a Section three Division 7A loan is considered to be made as at 15 May 2012. Practically speaking, this means that in this example the private company has until the lodgment day for the private company's 2012 income tax return to have its UPE paid or made subject to a complying loan agreement to avoid it being treated as an assessable dividend.

99. To avoid a Section three loan arising the parties have until the day on which the Section three loan would have otherwise arisen (that is, the lodgment day for the main trust's tax return for the 2011 income year, which in this example is 15 May 2012) to either pay out the private company's UPE or ensure that the funds representing that UPE are held on sub-trust and used only for the private company's sole benefit (and not for any benefit of the main trust or any other entity).

What are the taxation consequences where a UPE becomes a Section three loan?

100. The Section three loan will be subject to Division 7A. Generally, section 109D will apply to treat the private company as having paid an assessable dividend to the trust (equal to the UPE) at the end of the income year in which the Section three loan is made, unless:

- the loan is fully repaid before the private company's lodgment day for the income year in which the loan is made. That is the lodgment day for the income year ***after*** the year in which the UPE arose, or
- an exception contained in Subdivision D of Division 7A applies (for example, if before the lodgment day for the income year in which the loan is made, the loan becomes subject to a complying loan agreement), or
- the private company has insufficient distributable surplus such that section 109Y will operate to reduce the amount of the dividend that would otherwise be deemed to have been paid.

PART D: OTHER ISSUES

Does Subdivision EA of Division 7A apply to UPEs if the UPE is treated as a Section three loan?

101. No. Subdivision EA of Division 7A operates where a private company beneficiary has a UPE and the trustee of the trust makes a relevant payment or loan to, or forgives a debt owing by, an associate of the private company beneficiary. Broadly speaking, the amount that Subdivision EA can treat as a dividend over time is limited to the amount of the private company's UPEs.[2]

102. Paragraph 182 of TR 2010/3 states the following:

> …given the legislative context of Division 7A … 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.

103. That is, for Subdivision EA purposes, a UPE that is treated as a Section three loan will be treated as having been satisfied by the trust's lodgment day for the year in which the UPE arose. The Commissioner will adopt this treatment even for those Section three loans which are taken to have been made on 30 June 2011.

104. For the avoidance of doubt, the ATO may, in appropriate cases, apply Subdivision EA in respect of UPEs in existence before 16 December 2009.

105. Note that where a Section two loan arises, there is no UPE as it has been satisfied and replaced with an ordinary loan. In such circumstances, Subdivision EA would have no application, as there is no relevant UPE in existence.

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

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

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

Can Subdivision EA of Division 7A apply if the sub-trust does not pay the annual returns to the private company under a sub-trust arrangement?

108. Yes, Subdivision EA may apply if the annual returns derived from the investment of the funds representing the UPE back into the main trust are not paid to the sub-trust and then on paid to the private company beneficiary by the lodgment day for the main-trust's tax return for the relevant year. This is because any unpaid returns will be trust income to which the private company is entitled but has not been paid (UPEs). Certain payments, loans and the forgiveness of debts from the sub-trust may then attract Subdivision EA.

[2] Pursuant to subsection 109XA(4) and section 109XB.

Can a Section two loan arise if the trustee has put a complying loan agreement in place between the trust and an associate of the private company, on the mistaken belief that Subdivision EA of Division 7A applies to the arrangement?

109. Yes. If the trustee of the trust made the private company entitled to income, but that entitlement was satisfied and replaced by a loan made by the private company to the trustee, that loan will be a Section two loan. This fact is not altered by the trustee or its advisor mistakenly thinking that the private company's UPE instead remained outstanding and putting complying loan agreements in place in respect of any loans made by the trustee to other shareholders of the private company or their associates (on the mistaken belief that Subdivision EA of Division 7A applied to those loans).

110. In such an instance, Division 7A would apply to the Section two loan from the private company to the trust, and there would be no unpaid entitlement in respect of which Subdivision EA might operate.

111. Taxpayers affected by this may request in writing that the Commissioner exercise his discretion under section 109RB to disregard the deemed dividend associated with the Section two loan that arises due to a complying loan agreement not being made in respect of such a loan. Subject to evidence to the contrary, the ATO would consider this to be an honest mistake.

Is it possible to quarantine UPEs created prior to 16 December 2009 so that Division 7A will never apply to those UPEs?

112. Division 7A will not apply to treat UPEs created prior to 16 December 2009 as loans, even if partly repaid, unless the UPEs have converted to Section two loans. Note however that Subdivision EA can apply where a private company has a UPE created prior to 16 December 2009 and the trustee of the trust makes a payment or loan to, or forgives a debt owing by, an associate of the private company beneficiary.

113. Where the financial accounts of the trust indicate that a UPE arose prior to 16 December 2009 and that amount is recorded as a UPE and not a loan, subject to evidence to the contrary, the ATO will assume:

    (a) the UPE arose prior to 16 December 2009

    (b) the UPE is not a Section two loan, and

    (c) TR 2010/3 has no application in respect of that UPE.

114. A taxpayer is not required to inform the Commissioner or otherwise take any corrective action in relation to a subsisting UPE that arose before 16 December 2009 to obtain the protection provided under paragraphs 27 to 29 of TR 2010/3.

Can section 109R apply in circumstances where a UPE that is a Section three loan is paid out so that it can be re-loaned on Division 7A compliant terms?

115. Section 109R can apply in some circumstances to not treat a payment as a repayment of a loan for Division 7A purposes.

116. Where a UPE is considered to be a loan for Division 7A purposes, the ATO will treat the payment of the UPE as being a repayment for Division 7A purposes if the UPE is paid out by the time of the lodgment of the return and replaced with a loan under a complying loan agreement. That is, the ATO will not seek to apply section 109R in these circumstances.

Can a UPE between 2 trusts be financial accommodation and a loan for Division 7A purposes?

117. Yes, where Trust One has made a distribution to Trust Two and both Trusts are in the same family group and the UPE is not paid out or put on sub-trust for the sole benefit of Trust Two by the lodgment day for Trust One's tax return for the year in which the present entitlement arose, the UPE will, for the same reasons as given in TR 2010/3 and the administrative practices set out in this practice statement, become a loan for Division 7A purposes on that lodgment day.

118. However, just because the UPE is a loan for Division 7A purposes, does not mean that Division 7A applies. Only loans from private companies or from trusts involved in interposed entity arrangements of the kind considered in Subdivisions E, EA and EB may be relevant for Division 7A purposes. For example, such a UPE that is treated as a Division 7A loan may be relevant for Division 7A purposes if a private company has a UPE to an amount from the net income of Trust Two and Trust One is a shareholder or associate of a shareholder of the private company (under Subdivision EA), as is the case in Examples 6, 8 and 9 of this practice statement.

EXPLANATION

Examples

119. All Trust Deeds in the examples at paragraphs 120 to 255 of this practice statement contain the following clauses:

> **Clause 1: definitions**
>
> 'Net Income' means in relation to the Trust Fund 'net income' as that term is defined in relation to trust estates by Section 95 of the *Income Tax Assessment Act 1936* (as amended).
>
> 'Trust Fund' means:
>
> (i) the Settlement Sum;
>
> (ii) ….
>
> (iii) any Net Income accumulated by the Trustee pursuant to the power so to do hereinafter contained.
>
> **Clause 5: discretions as to income of the trust fund**
>
> The Trustee may at any time prior to the expiration of any year determine with respect to all or any parts of the Net Income of such a year to pay apply or set aside the same or any part thereof for all or one or more of the Beneficiaries living or in existence at the time of the determination.
>
> **Clause 6: amount set aside for the Beneficiaries**
>
> Any amount set aside for any Beneficiary or held for a Beneficiary pursuant to Clause 5 shall not form part of the Trust Fund but shall upon such setting aside or upon the thirtieth day of June be held by the Trustee as a separate Trust Fund upon trust for such Beneficiary absolutely with power to the Trustee pending payment over to such Beneficiary to invest or apply for the benefit of such Beneficiary or deal with such fund or any resulting income there from or any part thereof in the manner provided for in this Deed in relation to the Trust Fund.

Example 1 – Section two loan made pursuant to an implied loan agreement

120. Johann is the trustee of Grey Discretionary Trust. Silver Pty Ltd is a beneficiary of Grey Discretionary Trust. Silver Pty Ltd and Johann, in his capacity as trustee of the Grey Discretionary Trust, are part of the same family group.

121. The net accounting income for Grey Discretionary Trust for the 2010 income year is $10,000. The net income of the Grey Discretionary Trust as defined in section 95 for the 2010 income year is also $10,000.

122. On 30 June 2010, Johann exercises his discretion pursuant to Clause 5 of the Trust Deed and distributes the $10,000 net income to Silver Pty Ltd for the year ended 30 June 2010.

123. An ATO officer requested and obtained the Financial Statements for the Grey Discretionary Trust, including the trust distribution statement and accounting ledger in relation to the distribution.

124. The ATO officer noted a trust resolution evidencing Johann's exercise of his discretion to distribute the $10,000 net income to Silver Pty Ltd for the year ended 30 June 2010. However, the ATO officer did not see any trust resolution evidencing that Johann exercised the power conferred to him in Clause 5 of the Trust Deed to apply the $10,000 for the benefit of Silver Pty Ltd.

125. The distribution is recorded in the accounting ledger of the Grey Discretionary Trust as being a distribution on 30 June 2010 and the entries are:

Dr Trust Distribution	$10,000
Cr Loan – Silver Pty Ltd (liability)	$10,000

126. In the accounting ledger of Silver Pty Ltd the transaction is recorded as:

Dr Loan – Grey Discretionary Trust (asset)	$10,000
Cr Trust Distribution (income)	$10,000

Tax consequences

127. Whilst the Grey Trust Deed contains a power for the trustee to pay or apply money to or for the benefit of the private company beneficiary, there is no evidence that the trustee has exercised the power.

128. Similarly, whilst the Trustee has the power to set aside the funds representing the UPE in the sub-trust upon distribution, there is also no evidence that this has happened. There is also no evidence that Johann has exercised any of the self corrective options outlined in paragraphs 32 and 34 of this practice statement.

129. The ATO will infer based on the evidence (the accounting ledger of the Grey Discretionary Trust) that once the distribution was made it was immediately set off against a loan back to Grey Discretionary Trust. The ATO will further infer based on the relationships of the parties and the evidence (accounting ledger of Silver Pty Ltd) that the loan was made with the consent of Silver Pty Ltd.

130. In this situation the UPE is treated as having been immediately satisfied (by being taken to have been paid out to Silver Pty Ltd) and an actual loan made back to Grey Discretionary Trust, which will be taken to have been made on 30 June 2010.

131. Section 109D may apply if the $10,000 is not fully repaid before the lodgment day for Silver Pty Ltd for the 2010 income year.

132. If Silver Pty Ltd has a sufficient distributable surplus as explained in section 109Y, Silver Pty Ltd must put in place a complying loan agreement with Grey Discretionary Trust (in accordance with the terms set out in section 109N) before the lodgment day for Silver Pty Ltd for the 2010 income year to avoid a deemed dividend under Division 7A.

Example 2 – Section two loan evidenced by the trustee exercising the power conferred under a trust deed

133. Peter is the trustee of Black Discretionary Trust. Copper Pty Ltd is a beneficiary of Black Discretionary Trust. Peter, in his capacity as trustee of the Black Discretionary Trust, and Copper Pty Ltd are part of the same family group.

134. The net accounting income for Black Discretionary Trust for the 2010 year of income is $10,000. The net income, as defined in section 95, of the Black Discretionary Trust for the 2010 income year is also $10,000.

135. On 30 June 2010, Peter exercises his discretion pursuant to Clause 5 of the Trust Deed and distributes the $10,000 net income to Copper Pty Ltd for the 2010 income year.

136. An ATO officer requested and obtained the Financial Statements for Black Discretionary Trust, including the trust resolution, distribution statement and accounting ledger in relation to the distribution.

137. The ATO officer sights the trust resolution signed by Peter which provides that Peter:

(a) exercised the power conferred on him in Clause 5 of the Trust Deed to distribute the $10,000 net income to Copper Pty Ltd for the 2010 income year, and

(b) exercised the power conferred on him in Clause 5 of the Trust Deed to apply the $10,000 distributed to Copper Pty Ltd per subparagraph (a) above for the benefit of Copper Pty Ltd.

138. The distribution is recorded in the accounting ledger of the Black Discretionary Trust as being a distribution on 30 June 2010 and the entries are:

Dr Trust Distribution	$10,000
Cr Loan – Copper Pty Ltd (liability)	$10,000

139. There is no evidence of any minutes of a meeting of the Directors of Copper Pty Ltd in relation to the loan of the $10,000 to Black Discretionary Trust.

140. The $10,000 is recorded in the financial accounts of Copper Pty Ltd as both income from, and a current asset owing from, Black Discretionary Trust.

Tax consequences

141. Clause 5 of the Trust Deed contains a power for the trustee to pay or apply money to or for the benefit of the private company beneficiary, and there is evidence that the trustee has exercised the power.

142. The evidence (Trust Deed) notes that Peter has the power to pay, apply or set aside income of the Black Discretionary Trust. Upon exercising his discretion to distribute $10,000 to Copper Pty Ltd, the evidence (trust resolution) shows that Peter exercised his power to apply trust funds for the benefit of a beneficiary. The evidence (accounting ledger) also shows that Peter credited a loan account in the name of Copper Pty Ltd.

143. There is no evidence to suggest that Peter instead exercised his discretion to set this sum aside for the benefit of Copper Pty Ltd as a UPE.

144. In this situation an ordinary loan will be taken to have been made on 30 June 2010.

145. Section 109D may apply if the $10,000 is not fully repaid before the lodgment day for Copper Pty Ltd for the 2010 income year.

146. If Copper Pty Ltd has a sufficient distributable surplus as explained in section 109Y, Copper Pty Ltd must put in place a complying loan agreement with Black Discretionary Trust (in accordance with the terms set out in section 109N) before the lodgment day for Copper Pty Ltd for the 2010 income year to avoid a deemed dividend under Division 7A.

Example 3 – Commissioner exercises discretion in section 109RB in relation to Section two loan

147. Future Pty Ltd has a loan account with Pineapple Discretionary Trust. Both entities (Future Pty Ltd and the trustee of the Pineapple Discretionary Trust) are part of the same family group and are associates for tax purposes.

148. As at 30 June 2008 the loan account had a debit balance in the books of Future Pty Ltd, comprised of entries made during the 2008 income year.

149. Future Pty Ltd and Pineapple Discretionary Trust carry on related but separate businesses. There are business transactions between the two entities which are posted to the loan account during the 2008 income year.

150. Pineapple Discretionary Trust distributes income to Future Pty Ltd during the 2008 income year. Pineapple Discretionary Trust retains the cash which is used in its business. An entry is made to the loan account for the amount of Future Pty Ltd's entitlement to income of the trust.

151. No qualifying section 109N written loan agreement was put in place because the company's tax agent mistakenly believed that only loans to individuals would be subject to Division 7A. No loan repayments have been made.

152. In September 2010, the company's tax agent, became aware that the loans made by Future Pty Ltd to the Pineapple Discretionary Trust during the 2008 income year (including in respect of the trust entitlement) were subject to section 109D and resulted in the Future Pty Ltd being taken to pay a dividend to Pineapple Discretionary Trust at 30 June 2008.

153. 'Corrective action' was taken during the 2010-11 income year which involved:

- the entities entering into a loan agreement on 1 October 2010 that complies with the requirements of section 109N, and
- the trustee of Pineapple Discretionary Trust making a payment on 1 October 2010, of an amount equal to the total minimum yearly repayments that would have been payable by then had the complying loan agreement been put in place by the due date of lodgment of Future Pty Ltd's 2008 tax return and had the interest payable been compounded.

154. Both entities have a good compliance history and have lodged all relevant returns.

155. The trustee of Pineapple Discretionary Trust applies to the Commissioner to exercise his discretion to disregard the dividend arising under Division 7A.

156. In such a situation, subject to other contributing factors, it would not be unreasonable for a taxation officer to conclude that the Commissioner's discretion should be exercised in the taxpayer's favour. In this context it is noted that a significant number of tax agents have made similar mistakes as there has been a degree of confusion as to the correct application of Division 7A to transactions between private companies and entities such as trusts.

157. The self corrective options were not available because:

- the loan account contained entries not only in relation to the UPE, but also other transactions between the trust and private company
- the entities were not small business entities, as that term is defined in section 328-110 of the ITAA 1997.

Example 4 – Section three loan and the timing of conversion

158. Jane is the trustee of Brown Discretionary Trust. Sulpher Pty Ltd is a beneficiary of Brown Discretionary Trust. Jane, in her capacity as trustee of the Brown Discretionary Trust, and Sulpher Pty Ltd are part of the same family group.

159. The net accounting income for Brown Discretionary Trust for the 2011 year of income is $10,000. The net income, as defined in section 95, of the Brown Discretionary Trust for the 2011 income year is also $10,000.

160. On 30 June 2011, Jane exercises her discretion pursuant to Clause 5 of the Trust Deed and distributes the $10,000 net income to Sulpher Pty Ltd for the year ended 30 June 2011. The ATO has sighted the trust resolution and distribution statement to ascertain this.

161. The distribution is recorded in the accounting ledger of the Brown Discretionary Trust as being a distribution on 30 June 2011 and the entries are:

Dr Trust Distribution	$10,000
Cr UPE – Sulpher Pty Ltd (liability)	$10,000

162. In the accounting ledger of Sulpher Pty Ltd the transaction is recorded as:

Dr Loan – Brown Discretionary Trust (asset)	$10,000
Cr Trust Distribution (income)	$10,000

163. This entitlement remains unpaid and intermingled in the funds of Brown Discretionary Trust as at 30 June 2012.

164. Both Sulpher Pty Ltd and Brown Discretionary Trust lodged their 2011 tax returns on their due date for lodgment, that is, 15 May 2012.

Tax consequences

165. The ATO will not consider this to be a Section two loan because the amount has been recorded in the accounts of Brown Discretionary Trust as a UPE, rather than a loan. This is despite it having been recorded as a loan in the accounts of Sulpher Pty Ltd.

166. The UPE of $10,000 comes into existence on 30 June 2011.

167. There is no evidence that Jane set aside the $10,000 on a sub-trust. Even if there were a sub-trust, there is no evidence that it invested $10,000 in the Brown Discretionary Trust on terms entitling it to the sole benefit of the return on investment of the $10,000 and a return of the principal.

168. Therefore the UPE is treated as a Section three loan as it amounts to financial accommodation or an in-substance loan and the loan is taken to have been made on 15 May 2012.

169. Section 109D applies if the $10,000 is not fully repaid before the lodgment day for Sulpher Pty Ltd for the 2012 income year.

170. If Sulpher Pty Ltd has a sufficient distributable surplus as explained in section 109Y, Sulpher Pty Ltd must put in place a complying loan agreement with Brown Discretionary Trust (in accordance with the terms set out in section 109N) before the lodgment day for Sulpher Pty Ltd for the 2012 income year to avoid a deemed dividend under Division 7A.

Example 5 – no Division 7A loan (pre-16 December 2009 UPE)

171. Bianca is the trustee of the Orange Discretionary Trust. Gold Pty Ltd is a beneficiary of the Orange Discretionary Trust. Bianca, in her capacity as trustee of the Orange Discretionary Trust, and Gold Pty Ltd are part of the same family group.

172. The net accounting income for Orange Discretionary Trust for the 2009 year of income is $10,000. The net income, as defined in section 95, of the Orange Discretionary Trust for the 2009 income year is also $10,000.

173. On 30 June 2009, Bianca exercised her discretion and distributes the $10,000 net income to Gold Pty Ltd for the year ended 30 June 2009.

174. An ATO officer requested and obtained the Financial Statements for Orange Discretionary Trust, including the trust resolution, distribution statement and accounting ledger in relation to the distribution.

175. A trust resolution, signed by Bianca, provides that Bianca distributes $10,000 to Gold Pty Ltd in accordance with the powers conferred to her in Clause 5 of the Trust Deed.

176. The distribution is recorded in the accounting ledger of the Orange Discretionary Trust as being a distribution on 30 June 2009 and the entries are:

Dr Trust Distribution	$10,000
Cr UPE – Gold Pty Ltd (liability)	$10,000

177. In the accounting ledger of Gold Pty Ltd the transaction is recorded as:

Dr UPE – Orange Discretionary Trust (asset)	$10,000
Cr Trust Distribution (income)	$10,000

Tax consequences

178. The ATO will not consider this to be a Section two loan because of the following:

- there is no evidence of an express loan agreement, that is, there is no written agreement, trust resolution or other written document to support the existence of a loan between Bianca as trustee of the Orange Discretionary Trust and Gold Pty Ltd.
- there is no evidence of an implied loan agreement. That is, the financial accounts of Gold Pty Ltd and the Orange Discretionary Trust both record the amount as a UPE, and
- whilst the Trust Deed provides Bianca with the power to pay or apply money to or for the benefit of Gold Pty Ltd, there is no evidence that Bianca exercised the power to apply the $10,000 for the benefit of Gold Pty Ltd. The available trust resolution merely shows the distribution of the $10,000 to Gold Pty Ltd, and the amount is recorded as a UPE in the financial accounts of the Orange Discretionary Trust.

179. As the UPE came into existence prior to 16 December 2009, the ATO will not consider this to be a Section three loan. Accordingly, the ATO will accept, based on the facts outlined in paragraphs 171 to 177 of this practice statement, that there is no section 109D loan for Division 7A purposes.

Example 6 – Section three loan in a structure involving interposed trusts

180. Ruby is the trustee of Red Discretionary Trust and Blue Discretionary Trust.

181. Sapphire Pty Ltd is a beneficiary of Red Discretionary Trust.

182. Red Discretionary Trust is a beneficiary of Blue Discretionary Trust.

183. Ruby (in her capacity as trustee of both the Blue Discretionary Trust and Red Discretionary Trust) and Sapphire Pty Ltd are part of the same family group.

184. The net accounting income for Blue Discretionary Trust for the 2011 year of income is $10,000. The net income, as defined in section 95, of the Blue Discretionary Trust for the 2011 income year is also $10,000.

185. On 30 June 2011, Ruby, as the trustee of Blue Discretionary Trust, exercises her discretion and distributes the $10,000 net income to Red Discretionary Trust for the 2011 income year. The ATO has sighted the trust resolution and distribution statement to ascertain this.

186. The distribution is recorded in the accounting ledger of the Blue Discretionary Trust as being a distribution on 30 June 2011 and the entries are:

Dr Trust Distribution	$10,000
Cr UPE – Red Discretionary Trust (liability)	$10,000

187. In the accounting ledger of Red Discretionary Trust the transaction is recorded as:

Dr UPE – Blue Discretionary Trust (asset)	$10,000
Cr Trust Distribution (income)	$10,000

188. The net accounting income for Red Discretionary Trust for the 2011 income year is $15,000, including the $10,000 distribution from Blue Discretionary Trust. The net income, as defined in section 95, of the Red Discretionary Trust for the 2011 income year is also $15,000.

189. On 30 June 2011, Ruby, as the trustee of Red Discretionary Trust, exercises her discretion and distributes the $15,000 net income to Sapphire Pty Ltd for the 2011 income year. The ATO has sighted the trust resolution and distribution statement to ascertain this.

190. The distribution is recorded in the accounting ledger of the Red Discretionary Trust as being a distribution on 30 June 2011 and the entries are:

Dr Trust Distribution	$15,000
Cr UPE – Sapphire Pty Ltd (liability)	$15,000

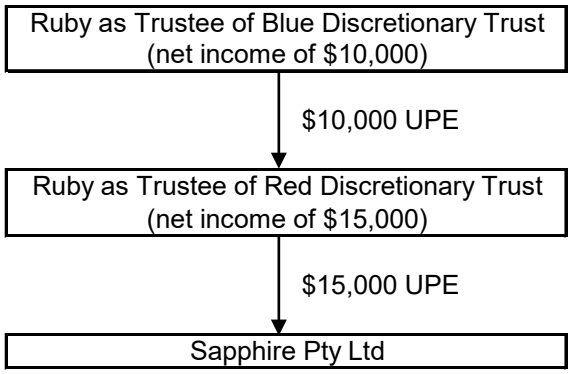
191. In the accounting ledger of Sapphire Pty Ltd the transaction is recorded as:

Dr UPE – Red Discretionary Trust (asset)	$15,000
Cr Trust Distribution (income)	$15,000

192. Both of these entitlements remain unpaid and intermingled in the funds of Blue Discretionary Trust and Red Discretionary Trust (in the amount of $10,000 and $5,000 respectively) as at 30 June 2012.

193. The tax returns for Red Discretionary Trust and Blue Discretionary Trust are lodged on 15 May 2012, which is the due date for lodgment of their returns for the 2011 income year.

194. The following is a diagram showing this example.



Tax consequences – Red Discretionary Trust

195. The ATO will not consider Sapphire Pty Ltd's $15,000 UPE income from the Red Discretionary Trust to be a Section two loan because the amount has been recorded in the accounts of Red Discretionary Trust and Sapphire Pty Ltd as a UPE, rather than a loan.

196. The UPE of $15,000 comes into existence on 30 June 2011.

197. In order to determine whether there is a Section three loan, the ATO officer considers whether Ruby has set aside the $15,000 on a sub-trust for the sole benefit of Sapphire Pty Ltd.

198. There is no evidence that Ruby set aside the $15,000 on a sub-trust. Even if there were a sub-trust, there is no evidence that the $15,000 has been invested in the Red Discretionary trust for the sole benefit of Sapphire Pty Ltd.

199. Therefore the UPE is treated as a Section three loan as Sapphire Pty Ltd is providing financial accommodation of $15,000 to Red Discretionary Trust by not calling for payment of this amount or for $15,000 to be set aside and used for its sole benefit. This loan is taken to have been made on 15 May 2012.

200. Section 109D applies if the $15,000 is not fully repaid before the lodgment day for Sapphire Pty Ltd for the 2012 income year.

201. If Sapphire Pty Ltd has a sufficient distributable surplus as explained in section 109Y, Sapphire Pty Ltd must put in place a complying loan agreement with Red Discretionary Trust (in accordance with the terms set out in section 109N) before the lodgment day for Sapphire Pty Ltd for the 2012 income year to avoid a deemed dividend under Division 7A.

Tax consequences – Blue Discretionary Trust

202. The UPE of $10,000 to Red Discretionary Trust is also a loan under the extended definition of loan in Division 7A as Red Discretionary Trust is providing financial accommodation of $10,000 to Blue Discretionary Trust by not calling for payment of this amount or for $10,000 to be set aside and used for its sole benefit. Such a loan would be taken to have been made on 15 May 2012.

203. This loan could potentially be treated as an assessable dividend due to the operation of Subdivision EA of Division 7A. In this situation, Subdivision EA operates where:

- a private company beneficiary (Sapphire Pty Ltd) is owed a UPE from a trust (Red Discretionary Trust), and
- the trustee of the trust (Ruby as Trustee for the Red Discretionary Trust) makes a loan to an associate of the private company beneficiary (Sapphire Pty Ltd).

204. Blue Discretionary Trust is an associate of Sapphire Pty Ltd under section 318 (which defines associate). Therefore Subdivision EA potentially applies to treat the UPE owing from Blue Discretionary Trust to Red Discretionary Trust as an assessable dividend to Blue Discretionary Trust of $10,000.

205. However, the ATO would not treat the UPE owing from Blue Discretionary Trust to Red Discretionary Trust as an assessable dividend, as Division 7A has been applied to the UPE owing from Red Discretionary Trust to Sapphire Pty Ltd. In effect, the provisions have operated to treat Sapphire Pty Ltd's UPE as having been satisfied and lent back to Red Discretionary Trust on 15 May 2012.

206. Paragraph 182 of TR 2010/3 states the following:

> …given the legislative context of Division 7A … 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.

Example 7 – Accounting entries

207. Jade is the trustee of Aqua Discretionary Trust. Water Pty Ltd is a beneficiary of Aqua Discretionary Trust. Aqua Discretionary Trust and Water Pty Ltd are part of the same family group.

208. Both the net accounting income and section 95 net (tax) income of Aqua Discretionary Trust for each of the 2010 to 2018 years are as follows:

Income year	Net income
2010	$10,000
2011	$11,000
2012	$12,000
2013	$13,000
2014	$14,000
2015	$15,000
2016	$16,000
2017	$17,000
2018	$18,000

209. In each of the 2010 to 2018 years, Jade exercises the discretion and distributes the net income to Water Pty Ltd. The net income is not paid to Water Pty Ltd.

210. The lodgment day for the income tax return for the Aqua Discretionary Trust and Water Pty Ltd for the relevant years is 15 May for the calendar year after the end of the income year.

211. On the 30 June 2011, Jade decides to put the UPE to which Water Pty Ltd became presently entitled on 30 June 2010 on a sub-trust using Option 1.

212. On the lodgment day of each of the income years from 2011 to 2018, Jade decides to put the UPE to which Water Pty Ltd became presently entitled for that income year on a sub-trust using Option 1.

213. Based on the facts in paragraphs 207 to 212 of this practice statement, and assuming that the Benchmark interest rate remains at 7.4% throughout the 2010 to 2018 income years, the ATO would expect to see the following transactions recorded in the accounting ledger of Aqua Discretionary Trust:

Sub-trust - Water Pty Ltd

30/06/2010	Opening balance		$0
30/06/2010	Cr UPE	$10,000	$10,000
30/06/2011	Cr UPE	$11,000	$21,000
30/06/2012	Cr Interest ($10,000 @ 7.40% for full year and $11,000 @ 7.40% between 15/5/12 and 30/6/12 - 47 days, leap year)	$845	$21,845
30/06/2012	Cr UPE	$12,000	$33,845
15/05/2013	Dr Income distribution to Water Pty Ltd	-$845	$33,000
30/06/2013	Cr Interest ($21,000 @ 7.40% for full year and $12,000 @ 7.40% between 15/5/13 and 30/6/13 - 47 days)	$1,668	$34,668
30/06/2013	Cr UPE	$13,000	$47,668
15/05/2014	Dr Income distribution to Water Pty Ltd	-$1,668	$46,000
30/06/2014	Cr Interest ($33,000 @ 7.40% for full year and $13,000 @ 7.40% between 15/5/14 and 30/6/14 - 47 days)	$2,566	$48,566
30/06/2014	Cr UPE	$14,000	$62,566
15/05/2015	Dr Income distribution to Water Pty Ltd	-$2,566	$60,000
30/06/2015	Cr Interest ($46,000 @ 7.40% for full year and $14,000 @ 7.40% between 15/5/15 and 30/6/15 - 47 days)	$3,537	$63,537
30/06/2015	Cr UPE	$15,000	$78,537
15/05/2016	Dr Income distribution to Water Pty Ltd	-$3,537	$75,000
30/06/2016	Cr Interest ($60,000 @ 7.40% and $15,000 @ 7.40% between 15/5/16 and 30/6/16 - 47 days, leap year)	$4,583	$79,583
30/06/2016	Cr UPE	$16,000	$95,583
15/05/2017	Dr Income distribution to Water Pty Ltd	-$4,583	$91,000
30/06/2017	Cr Interest ($75,000 @ 7.40% and $16,000 @ 7.40% between 15/5/17 and 30/6/17 - 47 days)	$5,702	$96,702
30/06/2017	Cr UPE	$17,000	$113,702
15/05/2018	Dr Income distribution to Water Pty Ltd	-$5,702	$108,000
30/06/2018	Cr Interest ($91,000 @ 7.40% and $17,000 @ 7.40% between 15/5/18 and 30/6/18 - 47 days)	$6,896	$114,896
30/06/2018	Dr Income distribution to Water Pty Ltd (UPE 2010 distribution)	-$10,000	$104,896
30/06/2018	Dr Income distribution to Water Pty Ltd (interest 2010 distribution)	-$740	$104,156
30/06/2018	Cr UPE	$18,000	$122,156

Composite examples

214. This practice statement explains various scenarios where UPEs will not give rise to Section three loans. However, in situations where a trust is part of a larger group of entities, the trustee may prefer to satisfy the UPE (including by paying it out and replacing it with a Section two loan made under a Division 7A complying loan agreement – that is, a loan agreement complying with section 109N of the ITAA 1936) rather than creating a sub-trust for the sole benefit of the beneficiary. There may be other Division 7A consequences if a UPE remains outstanding and is not treated as a loan. The following examples illustrate.

Example 8 – Interaction between sections 109D and 109XI

215. Ben is the trustee of Pink Discretionary Trust and Purple Discretionary Trust, and the controlling mind of Zinc Pty Ltd.

216. Pink Discretionary Trust is a beneficiary of Purple Discretionary Trust.

217. Zinc Pty Ltd is a beneficiary of Pink Discretionary Trust.

218. Con is a shareholder of Zinc Pty Ltd, and a beneficiary of both of the Pink Discretionary Trust and Purple Discretionary Trust.

219. Ben (in his capacity as trustee of both the Purple Discretionary Trust and Pink Discretionary Trust) and Zinc Pty Ltd are part of the same family group.

220. On 15 January 2011, Con approaches Ben for an interest free loan of $10,000. Ben, as trustee of the Purple Discretionary Trust, decides to make an interest free loan of $10,000 to Con.

221. The net accounting income for Purple Discretionary Trust for the 2011 year of income is $10,000. The net income, as defined in section 95, of the Purple Discretionary Trust for the 2011 income year is also $10,000.

222. On 30 June 2011, Ben, as the trustee of Purple Discretionary Trust, exercises his discretion and distributes the $10,000 net income to Pink Discretionary Trust for the 2011 income year. The ATO has sighted the trust resolution and distribution statement to ascertain this.

223. The distribution is recorded in the accounting ledger of the Purple Discretionary Trust as being a distribution on 30 June 2011 and the entries are:

Dr Trust Distribution	$10,000
Cr UPE – Pink Discretionary Trust (liability)	$10,000

224. In the accounting ledger of Pink Discretionary Trust the transaction is recorded as:

Dr UPE – Purple Discretionary Trust (asset)	$10,000
Cr Trust Distribution (income)	$10,000

225. The net accounting income for Pink Discretionary Trust for the 2011 income year is $15,000, including the $10,000 distribution from Purple Discretionary Trust. The net income, as defined in section 95, of the Pink Discretionary Trust for the 2011 income year is also $15,000.

226. On 30 June 2011, Ben, as the trustee of Pink Discretionary Trust, exercises his discretion and distributes the $15,000 net income to Zinc Pty Ltd for the 2011 income year. The ATO has sighted the trust resolution and distribution statement to ascertain this.

227. The distribution is recorded in the accounting ledger of the Pink Discretionary Trust as being a distribution on 30 June 2011 and the entries are:

Dr Trust Distribution	$15,000
Cr UPE – Zinc Pty Ltd (liability)	$15,000

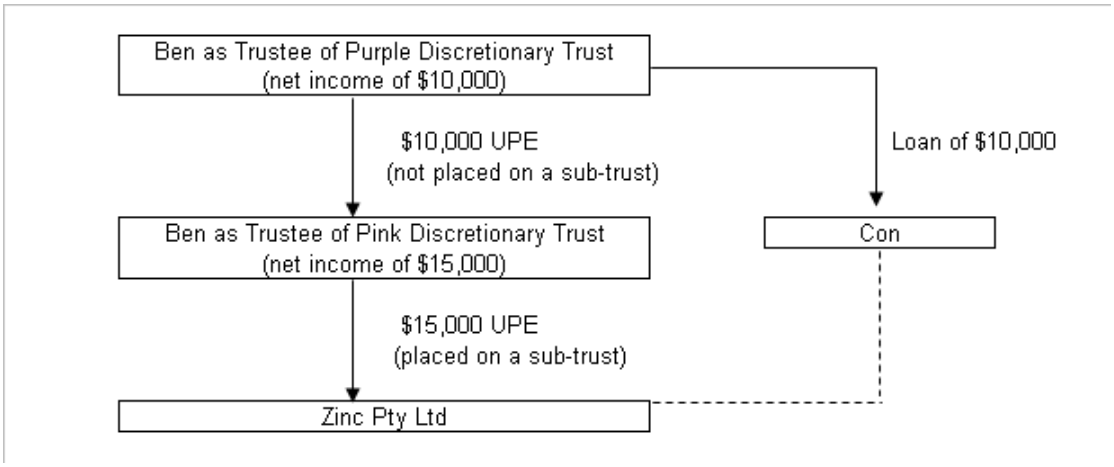
228. In the accounting ledger of Zinc Pty Ltd the transaction is recorded as:

Dr UPE – Pink Discretionary Trust (asset)	$15,000
Cr Trust Distribution (income)	$15,000

229. On 1 May 2012, Ben, as trustee of Pink Discretionary Trust, places the UPE of $15,000 on a sub-trust for the sole benefit of Zinc Pty Ltd in accordance with PS LA 2010/4. No similar action is taken in respect of Pink Discretionary Trust's UPE to $10,000 from Purple Discretionary Trust, and funds representing that UPE are not used for the sole benefit of Pink Discretionary Trust.

230. The tax returns for Pink Discretionary Trust and Purple Discretionary Trust are lodged on 15 May 2012, which is the due date for lodgment of their returns for the 2011 income year.

231. The following is a diagram showing this example.



Tax consequences – Pink Discretionary Trust

232. The evidence shows that Ben, as trustee of Pink Discretionary Trust, placed the UPE of $15,000 on a sub-trust for the sole benefit of Zinc Pty Ltd before the lodgment day for Pink Discretionary Trust. Accordingly, the ATO would not consider the UPE to be a loan under the extended definition of loan in Division 7A, so Pink Discretionary Trust will not be treated as having received a dividend in respect of this UPE.

Tax consequences – Purple Discretionary Trust

233. The evidence shows that funds representing Pink Discretionary Trust's UPE of $10,000 have been used by Ben, as trustee of Purple Discretionary Trust, for the purposes of the Purple Discretionary Trust, and not for the sole benefit of Pink Discretionary Trust. Ben, as trustee of Pink Discretionary Trust is aware that the funds representing Pink Discretionary Trust's UPE are being used in this manner, and still does not call for payment of its UPE. The ATO would consider that Ben, as trustee of Pink Discretionary Trust, was providing financial accommodation to Purple Discretionary Trust, and thus made a loan to Purple Discretionary Trust within the extended definition of loan in Division 7A.

234. Nonetheless, Pink Discretionary Trust is not a private company. Accordingly, Division 7A will only apply to treat the loan Pink Discretionary Trust is taken to have made to Ben as trustee of Purple Discretionary Trust as a dividend if relevant interposed entity rules in Division 7A apply. In particular, Subdivision EA of the ITAA 1936 will (broadly) apply to treat that loan as dividend if a private company has an entitlement to income of Pink Discretionary Trust that remains outstanding by Pink Discretionary Trust's lodgment day.

235. Zinc Pty Ltd's UPE to $15,000 from Pink Discretionary Trust was put on sub-trust held for its sole benefit, and still remains outstanding at Pink Discretionary Trust's lodgment date.

236. As such, the $10,000 amount Pink Discretionary Trust is taken to have loaned to Ben as Trustee of Purple Discretionary Trust will be taken to be a dividend paid to that trust.

237. If instead of placing Zinc Pty Ltd's $15,000 UPE on sub-trust, Ben as trustee of Pink Discretionary Trust had paid that sum to Zinc Pty Ltd and re-borrowed it under a Division 7A complying loan agreement (that is, an agreement which complies with section 109N of the ITAA 1936), Pink Discretionary Trust would not have a private company beneficiary with an outstanding entitlement to its income, and Pink Discretionary Trust's $10,000 UPE to an amount from Purple Discretionary Trust (taken to be a section three loan) would not be treated as a dividend paid to that trust.

238. Then, if a reasonable person would conclude that the Division 7A complying loan was made by Zinc Pty Ltd to Ben as the trustee of Pink Discretionary Trust solely or mainly as part of an arrangement involving the $10,000 loan to Con,[3] section 109T would deem Zinc Pty Ltd to have made a loan to Con.[4] However, as Zinc Pty Ltd's loan to Ben as trustee of Pink Discretionary Trust was itself a Division 7A complying loan, without more, the Commissioner would, consistent with the reasoning set out in TD 2011/16, treat that deemed loan as being $nil.

Tax consequences - Con

239. The evidence shows that Purple Discretionary Trust made a loan of $10,000 to an associate of Zinc Pty Ltd, being Con.

240. The evidence also shows that Pink Discretionary Trust is presently entitled to an amount of $10,000 from the income of Purple Discretionary Trust at 30 June 2011, that is, after the date the loan was made and before the lodgement date of the trust return. Similarly, Zinc Pty Ltd is presently entitled to an amount of $15,000 from the income of Pink Discretionary Trust at 30 June 2011.

241. If a reasonable person would conclude that Zinc Pty Ltd became entitled to the net income of Pink Discretionary Trust solely or mainly as part of an arrangement involving an entitlement to an amount from Purple Discretionary Trust, under subsection 109XI(1) of the ITAA 1936, Zinc Pty Ltd will be taken to be entitled to an amount from the net income of Purple Discretionary Trust. The Commissioner is required under subsection 109XI(4) to determine the amount (if any) that Zinc Pty Ltd is taken to be entitled to from the net income of Purple Discretionary Trust.

242. As Pink Discretionary Trust's $10,000 trust entitlement from Purple Discretionary Trust has been treated as being a loan that is subject to Division 7A at Purple Discretionary Trust's lodgment date for its 2011 income year, it will not be treated as a present entitlement that remains unpaid for Subdivision EA purposes at that date (see paragraphs 106 to 110 of this practice statement).

[3] Or the $10,000 Section three loan from Ben as trustee of Pink Discretionary Trust to Ben as trustee of Purple Discretionary Trust

[4] Or the loan to Ben as trustee of Purple Discretionary Trust, where relevant.

243. The evidence shows that the transactions are genuine and not designed to avoid the application of Subdivision EA otherwise than as envisaged within the scheme of Division 7A. Therefore, consistent with the reasoning set out in TD 2011/15 the amount to which Zinc Pty Ltd will be taken to be entitled to from the net income of Purple Discretionary Trust will be taken by the Commissioner to be nil.

244. As the amount to which Zinc Pty Ltd is taken to be presently entitled to would be $nil, the interest free loan of $10,000 would not be assessable to Con as a dividend under Subdivision EA of the ITAA 1936.

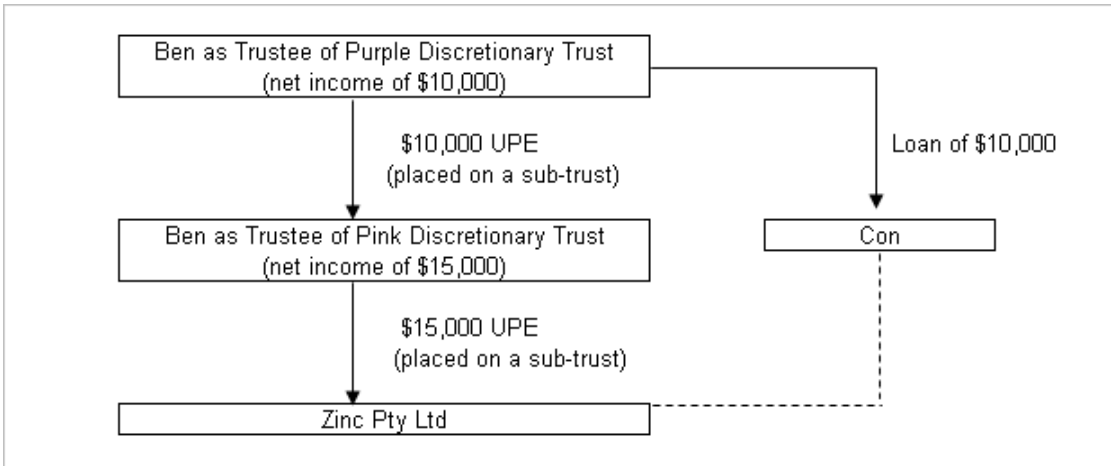
Example 9 – Interaction between sections 109D and 109XI

245. Assuming the same facts as paragraphs 215 to 228 in Example 8.

246. On 1 May 2012, Ben, as trustee of Pink Discretionary Trust, places the UPE of $15,000 on a sub-trust for the sole benefit of Zinc Pty Ltd in accordance with PS LA 2010/4. Similarly, Ben, as trustee of Purple Discretionary Trust, places the UPE of $10,000 on a sub-trust for the sole benefit of Pink Discretionary Trust in accordance with PS LA 2010/4.

247. The tax returns for Pink Discretionary Trust and Purple Discretionary Trust are lodged on 15 May 2012, which is the due date for lodgment of their returns for the 2011 income year.

248. The following is a diagram showing this example.



Tax consequences – Pink Discretionary Trust

249. The evidence shows that Ben, as trustee of Pink Discretionary Trust, placed the UPE of $15,000 on a sub-trust for the sole benefit of Zinc Pty Ltd before the lodgment day for Pink Discretionary Trust. Accordingly, the ATO would not consider the UPE to be a loan under the extended definition of loan in Division 7A, so Pink Discretionary Trust will not be treated as having received a dividend in respect of this UPE.

Tax consequences – Purple Discretionary Trust

250. The evidence shows that Ben, as trustee of Purple Discretionary Trust, placed the UPE of $10,000 on a sub-trust for the sole benefit of Pink Discretionary Trust before the lodgment day for Purple Discretionary Trust. Accordingly, the ATO would not consider the UPE to be a loan under the extended definition of loan in Division 7A.

Tax consequences - Con

251. The evidence shows that Purple Discretionary Trust made a loan of $10,000 to an associate of Zinc Pty Ltd, being Con.

252. The evidence also shows that Pink Discretionary Trust is presently entitled to an amount of $10,000 from the income of Purple Discretionary Trust at 30 June 2011, that is, after the date the loan was made and before the lodgment day of the trust return. Similarly, Zinc Pty Ltd is presently entitled to an amount of $15,000 from the income of Pink Discretionary Trust at 30 June 2011.

253. If a reasonable person would conclude that Zinc Pty Ltd became entitled to the net income of Pink Discretionary Trust solely or mainly as part of an arrangement involving an entitlement to an amount from Purple Discretionary Trust, under subsection 109XI(1), Zinc Pty Ltd will be taken to be entitled to an amount from the net income of Purple Discretionary Trust. The Commissioner will be required under subsection 109XI(4) to determine the amount (if any) that Zinc Pty Ltd is taken to be entitled to from the net income of Purple Discretionary Trust.

254. The evidence shows that the transactions are genuine and not designed to avoid the application of Subdivision EA otherwise than as envisaged within the scheme of Division 7A. Therefore, consistent with the reasoning set out in TD 2011/15 the amount to which Zinc Pty Ltd will be taken to be entitled to from the net income of Purple Discretionary Trust will be taken by the Commissioner to be $10,000.

255. As the amount to which Zinc Pty Ltd is taken to be presently entitled to is $10,000, the interest free loan of $10,000 would be assessable to Con as a dividend under Subdivision EA.

Amendment history

Date of amendment	Part	Comment
13 May 2020	Paragraph 3	Definition of 'lodgment day' updated to reflect concessions for the lodgment of trust income tax returns for the 2018–19 year of income as part of the Commissioner's COVID-19 response.
13 May 2014	Contact details	Updated.
1 July 2011	Paragraphs 232, 233, 234, 236, 238, 240 and 252	Updated to clarify the entities involved in the arrangement.
15 June 2011	Paragraphs 32 and 34	Updated to provide additional guidance on what the ATO will consider acceptable as part of the self corrective options which taxpayers may take on or before 31 December 2011.
	Paragraphs 39, 40 and 41	Updated following publication of PS LA 2843 (draft) which covers the issue is greater detail.
	Paragraph 56	Updated to provide greater clarity.
	Paragraphs 57 to 59	Removed to be republished in a different product.
	Paragraphs 63, 65, 66, 70, 71, 75, 78, 82, 83, 94 and 98	Updated to ensure that the commentary applies to taxpayers with an approved substituted accounting period.
	Paragraph 89	Updated to provide greater clarity.
	Paragraphs 119, 124, 137 and 141	Updated trust clauses.
	Paragraph 128	Updated to provide greater clarity.
	Paragraph 152	Corrected an error in the relevant year.
	Paragraphs 214 to 255	Updated following publications of ATO view (TD 2011/15 and TD 2011/16) on 15 June 2011.
	Paragraphs 9, 15, 16, 39 to 255	Updated paragraph numbering and cross-referencing.
10 May 2011	Contact details	Updated.

Subject references	Division 7A: trust entitlements
Legislative references	ITAA 1936 ITAA 1936 95 ITAA 1936 Pt III Div 7 ITAA 1936 Pt III Div 7A ITAA 1936 109D ITAA 1936 109D(3) ITAA 1936 Pt III Div 7A Subdiv D ITAA 1936 109N ITAA 1936 109N(2) ITAA 1936 109R ITAA 1936 109RB ITAA 1936 109T ITAA 1936 Pt III Div 7A Subdiv E ITAA 1936 Pt III Div 7A Subdiv EA ITAA 1936 109XA(4) ITAA 1936 109XB ITAA 1936 109XI ITAA 1936 109XI(1) ITAA 1936 109XI(4) ITAA 1936 Pt III Div 7A Subdiv EB ITAA 1936 109Y ITAA 1936 162 ITAA 1936 163 ITAA 1936 318 ITAA 1997 8-1 ITAA 1997 328-110
Related public rulings	TR 2010/3 TD 2010/18 TD 2011/15 TD 2011/16
Related practice statements	PS LA 1998/1 PS LA 2843 (draft)
File references	1-2LDF9DV 1-22SOQQX
Date issued	14 October 2010
Date of effect	14 October 2010
Business line	Private Groups & High Wealth Individuals
ISSN	2651-9526

© AUSTRALIAN TAXATION OFFICE FOR THE COMMONWEALTH OF AUSTRALIA

You are free to copy, adapt, modify, transmit and distribute this material as you wish (but not in any way that suggests the ATO or the Commonwealth endorses you or any of your services or products).