

TAX-ACTION

Issue 1 – March 2004

TAX-ACTION – A NEW PUBLICATION FROM GUSTAX

In order to assist practitioners and taxpayers to be kept informed and up to date with income tax changes, Gustax Consulting Pty Ltd will send out information bulletins to clients and friends of our practice on an adhoc basis. These publications, like the following on the replacement provisions to section 109UB, will be sent irregularly as issues of importance arise. We trust you will find the attached useful. Please let us know if you do not wish to receive these publications in the future.

THE REPLACEMENT TO THE SECTION 109UB PROVISIONS – DIVISION 7A

As promised by the Government, these provisions are intended to be back dated to 12th December 2002 and are designed to close down certain abuses and difficulties that arose under the old Section 109UB of the 1936 Tax Act. As well, there are some additional changes that are effective from 19th February 2004. It is worth reminding readers of the application of the old section before discussing the implications of these changes.

The good news is that distributions made to companies do not need to be converted into arm's length loans and can be left as "indefeasible entitlements" provided the detailed circumstances listed below do not occur. As well, these unpaid entitlements will not be taxed as special income in the company if they are not paid within a set period of time across to the company.

Having stated that, the circumstances where a deemed loan and a deemed dividend can arise in relation to indefeasible entitlements held by a company have been increased significantly. Although the new provisions will allow these deemed loans to be repaid or put on arm's length terms, taxpayers and advisors will need to be more vigilant in ensuring these additional circumstances do not arise.

THE OLD SECTION 109UB

An indefeasible entitlement exists when a trust makes a distribution to a beneficiary but does not pay that distribution across to the beneficiary. As the beneficiary can make a legal claim to that entitlement which is indefeasible at law, the entitlement is called an indefeasible entitlement. It is not a loan as no consideration has been provided by the beneficiary in return for this entitlement. Therefore it does not get directly covered under the Division 7A rules relating to loans made to shareholders and associates.

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In relation to distributions made to companies which remained as unpaid indefeasible entitlement accounts, special rules were introduced in the form of section 109UB to deal with these accounts. These rules, which are explained below, came into effect from 4.00 PM on 27 March 1998 though they could technically apply to indefeasible entitlement accounts brought into existence prior to that date.

A deemed dividend generally would arise where the following conditions were all met under these provisions:-

- A trust has made a distribution of net income to a private company beneficiary (creating an indefeasible entitlement account).
- That indefeasible entitlement account remained unpaid
- After the company first became presently entitled, the trustee made a loan to the shareholder or an associate of a shareholder of the corporate beneficiary.

Where all of the above were met, the private company was deemed to have made a loan to the shareholders or associates and a dividend could then be deemed at the end of the year in which the loan was deemed. The value of the dividend deemed would be limited to:-

- The unpaid distributions made to the company less any previous deemed dividends based on the same section
- The distributable surplus of the company where this was less than the unpaid distributions.

Where the deemed loan arising under these rules was to another company, the loan did not result in a deemed dividend as the intercompany loan exemption of section 109K still applied.

Finally it is worth noting that the old Section 109UB only applied to loans made by the trust where there was an unpaid indefeasible entitlement with a company. The new provisions will extend the

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section so that it can apply to payments to shareholders and associates of shareholders as well as the forgiveness of debts owed by shareholders and associates of shareholders of the company.

THE PROBLEMS THE NEW PROVISIONS ATTEMPT TO FIX

Problem 1

The first problem with the old Section 109UB was that there was no exemption for loans in the ordinary course of business or arm's length loans. In addition, as the loans were deemed to exist, they were incapable of repayment and a deemed dividend could not generally be avoided. The new provisions, which came into effect from 12th December 2002 and only apply to loans arising after that date, now allow those deemed loans to become "arm's length" loans or to be repaid without the deeming of a dividend. The loans will be required to be repaid prior to the earliest of:-

- The due date of lodgement of the Trustee's tax return for the year the loan was made.
- The actual date of lodgement of the Trustee's tax return for the year the loan was made.

For interpretation purposes, it is believed that this date will be the earlier of the date the party receiving the loan lodges or is required to lodge their tax return or the earlier of the date the company lodges or is required to lodge their tax return.

Alternatively, the loan will need to be put in writing as an "arm's length" loan by the earlier of these dates. The trust will effectively stand in the shoes of the company for effective compliance of these requirements. Therefore the arm's length loan will be with the trustee of the trust and the loan repayment will be to the trustee of the trust.

About the Editor

Tony Evans is a Chartered Accountant who has extensive tax consulting experience over 20 years working in the profession including specialist tax consulting and business services experience. A director of GuSTAX Consulting Pty Ltd, he was previously a partner with a boutique tax division in one of the mid-tier accounting firms in Melbourne. Tony's diverse tax specialisation's include: -

- Income tax consulting
- GST
- Employment taxes
- Corporate Taxes
- CGT
- PAYG
- Expatriate Taxation

He is also recognised as an excellent communicator and trainer and has conducted numerous technical sessions for the ICAA and members of the profession.

Tony is also a member of the ICAA's indirect taxes committee and the ICAA National tax CPE committee. Tony is also a member and regular attendee at three different tax discussion groups and presents to many other groups. ♦

Despite the fact that there is additional time to either repay the loan or put it on arm's length terms, the repayment is deemed to occur at the end of the year of income in which the loan was made or the conversion into an arm's length loan is deemed to occur immediately before the loan was made. As well, tax agents and advisors cannot lodge the tax return late and buy additional time as a result to fix the deemed loan.

These provisions will not apply where the shareholder or associate is a company as these loans remain unaffected.

Editor's comment - this relief is most welcome as it now avoids deemed dividends where inadvertent loans came into existence. It also provides a planning opportunity in that loans made by trusts do not need to be repaid by year end but by the due date of the tax return lodgement (or actual date of lodgement if earlier). Where loans are not repaid but are put on arm's length terms, the interest and minimum repayments still need to be made in the year following the making of the loan. However, at least advisors and taxpayers can now fix the problem provided they identify it prior to the due date of the income tax return.

Problem 2

The old provisions previously only applied to loans and did not apply to debts forgiven. Where the shareholder and/or associate of the shareholder owed the trust money and this loan is forgiven, the new provisions can deem a loan between company and the shareholder and/or associate to the lower of the following amounts:-

- The forgiven amount.
- The distributable surplus in the company.
- The indefeasible entitlement account between the trust and the company.

As the loan has been made by the trust and not the company, this event was not always caught under the previous Section 109UB or other provisions included in Division 7A.

Typically this strategy would have been used by taxpayers and advisors where the loan was in existence prior to the creation of the indefeasible entitlement with the company and therefore there was no deemed loan and subsequent deemed dividend under the old Section 109UB.

Care is required here, as the deemed forgiveness of a loan from the trust to a shareholder or associate of a shareholder will trigger these new provisions. Therefore taxpayers and advisors will now need to check all loans made by trusts to ensure that the statute of limitations does not expire thus leading to a potential problem. This change in the law is effective from 12th December 2002. Again, it should be noted that these provisions will not apply where the shareholder or associate is a company.

Problem 3

One common abuse under the old Section 109UB was to create the loan in the trust to the shareholders and/or associates prior to the indefeasible entitlement with the company coming into existence. As section 109UB only applied if a loan came into existence after an indefeasible entitlement with a company came into existence, this reversing the order of the transactions defeated the application of the old section. The law is now being amended to shut down this loophole by ensuring that a deemed loan will still arise where the trust makes loans to shareholders and associates prior to conferring the present entitlement on the company. These loans will still be capable of repayment or being put on arm's length terms as discussed above. This change to the law will be effective from 19th February 2004, being the date the legislation was introduced into parliament. The provisions will only apply where the loan was created within set time limits prior to the conferring of the indefeasible entitlement.

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Problem 4

As part of the announcement made on 12th December 2002, Section 109UB was to be removed and new law introduced to take account of the avoidance of deemed dividends under Division 7A by the creation of credit indefeasible entitlement accounts via the use of certain tax-free distributions from a trust. This amendment will only apply where there is also an unpaid indefeasible entitlement account between the company and the trust.

However it should be noted that the ATO may still consider arrangements prior to this time to fall with in the confines of the anti-avoidance provisions in any event.

Basically credit indefeasible entitlement accounts may be created in a trust by the making of tax-free distributions from asset revaluation reserves and similar untaxed sources. These entitlements then allow the beneficiary to draw out of the trust the profits distributed to the company but not paid to the company. However, we were led to believe that entitlements created from certain tax-free distributions will be ignored including:-

- Distributions of corpus
- Capital profits reserves (realised)
- CGT Concessional amounts.
- Amounts previously taxed in the trust

The type of tax-free distributions intended to be caught by these announcements included:-

- Asset revaluation reserves
- Excess accounting distributions over the tax distributions
- Any other amounts not subject to tax in the trust and nor specifically excluded above.

The actual legislation, which is effective from 12th December 2002, indicates that it will apply to unrealised gains that are included in unpaid present entitlement accounts. Unrealised gains are not defined but the legislation states that unrealised gains will be ignored for the purpose of applying

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these amendments where they are taxable in the year before payment, the year of payment or the year after payment. We would assume that distributions of corpus, capital profits reserves (realised), CGT concessional amounts and amounts that have already been taxed in the trust would still be considered realised and will not trigger these provisions.

Some examples of unrealised gains that will be ignored are included in the explanatory memorandum and include:-

- Accrued income treated as distributable income by the trust but not actually received by the trust until the following year.
- Gains arising on decrease in values of trading stock in the trust which are not actually realised until the trading stock is disposed of in the following year.

However, where timing differences between accounting and taxable income arise and these timing differences do not reverse in the following year and they are effectively distributed as unrealised income, a deemed loan may come into existence. These differences may arise from:-

- Prepaid income (more than 12 months in advance)
- Income from long term contracts

Clearly, the current draft of the law may be flawed in respect of these and similar items. There will be numerous other items that could fall into this risk area.

It should be noted that the conversion on an indefeasible entitlement between the trust and the beneficiaries (who are also shareholders and associates) into loans will be considered a payment of this entitlement account and will trigger this provision provided there is also an unpaid indefeasible entitlement account between the trust and the company. However this conversion of the indefeasible entitlement into a loan must occur on or after 12th December 2002 to be captured under these new provisions.

Although these provisions apply from 12th December 2002, they can be triggered in relation to pre-existing present entitlement accounts between the trust and the beneficiaries who are also shareholders and/or associates of the company. Therefore there is an element of retrospectivity to these provisions.

The deemed loan can only arise in relation to unrealised gains that are included in these indefeasible entitlement accounts. As well, where the indefeasible entitlement accounts comprise both unrealised amounts and realised amounts, the payment of parts of these entitlements can be applied against the realised amounts first thus avoiding the deemed loan. However, this means that taxpayers and advisors will now need to analyse all indefeasible entitlement accounts in a trust (other than the indefeasible entitlement account with the company) that were in existence on 12th December 2002 or come into existence subsequently to determine that portion that relates to unrealised amounts. You will then need to ensure that these amounts are never paid out by the trust whilst there is an unpaid indefeasible entitlement account with the company and a distributable surplus in the company.

There are bound to be other implications from the new provisions and these will come to light as we all explore the new legislation in more detail. We have only addressed the more obvious deficiencies in the old law as well as the common abuses of the old law. The new provisions are hard to understand and may have other applications not yet determined.

The effective date of these proposals.

Whilst the new provisions are either effective from 12th December 2002 or 19th February 2004, there is a high probability that these provisions have a pseudo-retrospective impact as mentioned earlier. This impact needs to be recognised by advisors and taxpayers.

Planning around these changes

Position prior to changes

As the start date for these changes is the 12th December 2002 at the earliest, advisors and taxpayers should remember that inadvertent loans to shareholders and associates of shareholders made by trusts prior to this date where there is an indefeasible entitlement outstanding to a company cannot be repaid or put on “arm’s length” loan terms. Technically these deemed loans will still become deemed dividends on 30th June 2003 if there is a distributable surplus in the company.

There are two main ways of solving this problem. The first is for the company to declare (but not pay) dividends to these shareholders prior to the creation of the loan in the trust. This outstanding dividend entitlement from the company can then be transferred so that the trust will honour these payments to these parties on behalf of the company. This will mean that the payments made to the shareholders will now only diminish credit loans in existence rather than create inadvertent debit loans. This will not fix situations where the inadvertent debit loan from the trust is to an associate of a shareholder rather than a shareholder.

The second solution is to pay dividends out of the company so that there is no longer a distributable surplus in the company at 30th June 2003. This means that no dividend can be deemed. This may be an expensive solution to the problem where there is a minor loan and a large distributable surplus.

Position after changes

All loans made by the trust to shareholders and associates of the shareholders of the company on or after 12th December 2002 should either be repaid within the time limits specified or put on ‘arm’s length’ terms if there is an indefeasible entitlement with the company at the time the loan came into existence. If these loans come into existence on or after 19th February 2004 and prior to the creation of the indefeasible entitlement, care will be required as you may also need to repay these loans or put them on “arm’s length” terms to avoid a deemed dividend.

This risk could also be solved by paying out the indefeasible entitlement due to the company or ensuring there is not distributable surplus left in the company. Taxpayers and advisors should consider the quantum of the loan, the outstanding indefeasible entitlement to the company and the distributable surplus of the company in working out the cheapest solution. Where you choose to repay the loan or put it on “arm’s length” terms, the whole of the loan must be dealt with and not just the portion of the loan at risk.

Where indefeasible entitlements with shareholders and associates exist or are created on or after 12th December 2002 and they include unrealised amounts, provided they are not converted into loans and remain indefeasible entitlements, there will be no exposure under the new laws. However you will need to ensure that these entitlements are not forgiven or deemed to be forgiven due to the application of the statute of limitations.

Provided these unrealised indefeasible entitlements were converted into loans prior to 12th December 2002, the new provisions will not apply. However the ATO may still want to apply the anti-avoidance provisions against these in any event.

Where indefeasible entitlements to a company exist, make sure that the trust does not make excessive payments to shareholders and associates and does not forgive any debts owed by the trust to shareholders and associates. All debts should be regularly re-affirmed to ensure the statute of limitations does not apply. We suggest that you get the shareholders and associates of shareholders to confirm and affirm loans in writing on an annual basis when you prepare the accounts.

Prudentially, where unrealised gains are included in indefeasible entitlements, it may be prudent to convert the unpaid distributions made to a company into a loan with the company and then to convert the other indefeasible entitlement amounts into loans with the trust. However the loans from the company to the trust will then need to be put on seven year arm's length terms. As well, the back to back loan provisions in Division 7A may then apply requiring the loan from the trust to the shareholders and associates of shareholders to be put on seven year arm's length terms. The cost of this approach may be prohibitive compared to the benefits achieved.

A further suggestion is to physically pay all distributions made to companies across to the company. However this may cause cash flow problems. As well, where the trust needs to borrow to fund this payment, the interest on the borrowing may not be deductible. After all, the entitlement represents income of the trust. Under the tracing rules for interest, how will the monies borrowed by the trust to pay out profits be used for the purpose of generating assessable income or in carrying on a business?

Interestingly, where the loans in the trust arising on or after 12th December 2002 from the conversion of indefeasible entitlements exceed the distributable surplus of the company or the indefeasible entitlement owed to the company, the whole loan will need to be repaid or put on "arm's length" terms even though the exposure to a dividend is much less.

Other planning techniques may arise once the law is analysed further.

Legislation still must be passed

Clearly, these provisions will only have their retrospective impact once assented into law. As well, the provisions may be amended in their travels through parliament. Taxpayers and advisors would be well advised to act as if these provisions were already passed in the interim period as it is unlikely at this time that there will be any resistance to these provisions in the Senate.

Taxpayers and advisors should also keep in mind that approximately eleven pages of legislation have replaced one small section. We are still analysing the impact of these new provisions which may be far wider than set out in this publication. Care and prudence should be the "watch words" when finalising trust, beneficiary and company returns for the 2003 tax year and beyond.

Taxpayers should be reminded that the use of companies as income beneficiaries of trusts usually only provides a tax deferral mechanism and eventually the income passed to these companies must be passed onto the shareholders. Where the shareholders want to access those monies, they are virtually faced with the alternative on borrowing the money on arm's length terms or taking dividends. It is now significantly harder to give them access to these monies without them paying the additional top up tax involved. Ideally, income distributed to companies should be paid across to these companies and left in them (and invested) until the shareholders require access to those funds. At that time the monies should either be paid as dividends or lent as loans on commercial arm's length terms.