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# PRACTITIONER ARTICLES

## [541] Can family members still use trust assets without triggering a Div 7A tax liability?

***by Nicole Sammel, Nicole Sammel Tax Lawyers***

Consider the following hypothetical situation:

- Private Company has a present entitlement to trust income of Family Trust; the entitlement remains unpaid at the date the trust's income tax return is lodged ("**Unpaid Entitlement**"); and
- during the income year, Family Trustee allowed an individual shareholder of Private Company ("**Shareholder**") to use a trust asset (eg a beachhouse) free of charge, for private purposes.

Does this arrangement give rise to a deemed dividend under Div 7A? The question will be relevant to many practitioners because:

- the situation described above ("**Hypothetical**") represents a common family group arrangement. (Appreciating assets such as holiday homes are often held in discretionary family trusts for asset protection purposes and so that the 50% CGT discount can be accessed);
- as a general principle, "payments" and "loans" between members of a family group can give rise to deemed dividends under Division 7A. However, under the historical Div 7A definitions of "payment" and "loan", the Hypothetical did not give rise to a deemed dividend;
- recently, the Div 7A meanings of each of the terms, "payment" and "loan", have been "expanded" as follows:
    - *Tax Laws Amendment (2010 Measures No 2) Bill 2010* (reported at 2010 WTB 11 [441]) extends the definition of "payment to an entity" to include "the provision of an asset for use by the entity" (eg, the provision of use of a beachhouse); and
    - Draft TR 2009/D8, in effect, extends the circumstances in which the relationship between a private company and a related family trust will be taken to constitute a "loan"; and
- consequently, practitioners will need to consider whether, in light of the new expanded definitions of "payment" and "loan", their clients' "Hypothetical-equivalent" arrangements will be caught by Div 7A.

The answer, in my view, (assuming that each of the final ruling and the enacted legislation is in substantially the same form as the draft ruling and the Bill, respectively), is that, as a result of the Bill and the Draft Ruling, the Hypothetical can potentially now give rise to a Div 7A deemed dividend:

- under s 109D of the ITAA 1936 (on the basis that there is a loan from Private Company to Family Trustee); or
- under s 109C in conjunction with the interposed entity rules in ss 109T and 109V (on the basis that there is an "indirect" payment from Private Company to Shareholder via the interposed trust); or
- under s 109XB (on the basis that Family Trustee makes a payment that satisfies the conditions in s 109XA(1)(b), to Shareholder).

However, as a practical matter, it should generally be possible to ensure that none of these taxing provisions are inadvertently triggered.

### *Draft TR 2009/D8*

Draft TR 2009/D8, released on 16 December 2009 (reported at 2009 WTB 52 [2533]), has been heavily criticised. However, there is no certainty that the final ruling will differ significantly from the draft.

Based on the Draft Ruling, for the purposes of Div 7A, the ATO is likely to treat the relationship between Private Company and Family Trustee in respect of the Unpaid Entitlement as a "loan" from Private Company to Family Trustee, unless:

- the Unpaid Entitlement is **not** recorded as a "loan" in the trust accounts; and
- either:
  - the Unpaid Entitlement arose before 16 December 2009; or
  - Family Trustee holds the Unpaid Entitlement on sub-trust for Private Company whereby Private Company is absolutely beneficially entitled to the income and capital of the sub-trust ("**Qualifying Sub-Trust**"). (Exactly what kind of sub-trust arrangement will qualify remains unclear. However, presumably a Qualifying Sub-Trust would exist at least if Family Trustee applied the Unpaid Entitlement to acquire, eg ASX listed shares, which were held on sub-trust for Private Company such that both the dividend stream and the capital growth accrued for the benefit solely of Private Company),

(from hereon, the "**Exceptional Circumstances**").

***The (No 2) Bill 2010***

One of the proposed amendments under the Bill is to extend the Div 7A definition of "payment". If the Bill is enacted in its current form, then, subject to certain exceptions (which are not relevant for current purposes), from 1 July 2009:

- "payment to" an entity will include "the provision of an asset for use by" the entity; and
- the amount of such a payment will be the arm's length value of the provision of the use (less any consideration for the use).

## Can Division 7A apply?

What, then, is the impact of the Draft Ruling and the Bill for the Hypothetical? Will Draft TR 2009/D8, the Bill, or their combined effect, trigger a deemed dividend under Subdiv B or Subdiv EA of Div 7A?

(The comments which follow assume that the views expressed in Draft TR 2009/D8 will be maintained in any final ruling and that the Bill will be passed without any significant changes. Further, the comments should be read subject to the distributable surplus rules in s 109Y and the various exemptions and discretions available under Div 7A.)

***Subdivision B***

*Non-complying loan from Private Company to associate of Shareholder*

Family Trustee is an "associate" of Shareholder (under the definition in s 318 (1) of the ITAA 1936).

Therefore, after Draft TR 2009/D8, (unless the Exceptional Circumstances exist), a dividend can arise under s 109D on the basis there is a loan from Private Company to an associate of one of its shareholders.

A s 109D deemed dividend can be avoided, however, if the relationship is documented as a "complying" loan from Private Company to Family Trustee in accordance with s 109N(1).

*Indirect payment from Private Company to Shareholder*

However, if a s 109N(1) complying loan agreement is entered into, there is potential for a deemed dividend to arise instead under s 109C in conjunction with s 109V (due to the requirements in s 109T being satisfied) on the basis that Private Company makes an "indirect" payment to Shareholder. At least 3 of the 4 conditions in s 109T will be satisfied because:

- Private Company makes a loan to a second entity, namely, Family Trustee (s 109T(1)(a));
- the loan from Private Company to Family Trustee, being a s 109N(1) complying loan, does not give rise to a deemed dividend under s 109D (s 109T(3)); and
- Family Trustee makes a "payment" to Shareholder by providing use of the beach house (s 109T(1)(c)).

The 4th condition in s 109T is that, "a reasonable person would conclude (having regard to all the circumstances) that [Private Company] made the … loan solely or mainly as part of an arrangement involving [the provision of the use of beachhouse to Shareholder]" (s 109T(1)(b)).

Whether this 4th condition is satisfied will depend on the specific circumstances surrounding the loan and the provision of the use of the beachhouse. However, as a very general proposition, it may be easier to show that a loan and payment are **not** part of the same arrangement where the payment is in the form of the provision of the use of an asset (as per the Hypothetical), than where the payment is an "ordinary" payment. This is because, at least where the trust asset is acquired long before the loan is made, and is never used for income-producing purposes (eg a family beachhouse purchased many years previously which has only ever been used by family members for no charge), there is no obvious basis for concluding that the loan is made in connection with the trustee allowing family members to use the asset. (If the trustee instead made a *cash* payment to a family member, all else being equal, a reasonable person might more readily conclude that the loan and the payment were connected.)

***Subdivision EA***

*Subdivision EA does not apply if there is a "loan" from Private Company to Family Trustee*

According to Draft TR 2009/D8, the Hypothetical can give rise to a deemed dividend under Subdiv EA only if the relationship between Private Company and Family Trustee does **not** constitute a "loan" for Div 7A purposes (see para 165 of Draft TR 2009/D8).

On that basis, Subdiv EA can apply only if the Exceptional Circumstances exist.

*Does Family Trustee make a payment/loan etc?*

For Subdiv EA to apply, it is also necessary that Family Trustee makes a payment or loan to, or forgives a debt owed by, a shareholder, or an associate of a shareholder, of Private Company.

This requirement will be satisfied on the basis that Family Trustee makes a "payment" to Shareholder, namely, the provision of the use of the beachhouse.

*Is the payment an "Eligible Payment"?*

Finally, Subdiv EA can apply only if Family Trustee's payment to Shareholder is an "Eligible Payment" (my terminology).

The payment Family Trustee makes to Shareholder will be an Eligible Payment if it is a "discharge of or a reduction in a present entitlement of [Shareholder] that is wholly or partly attributable to an amount that is an unrealised gain" (s 109XA(1)(b)).

Construing this requirement with reference to the Explanatory Memorandum which accompanied the introduction of *Tax Laws Amendment (2004 Measures No 1) Bill 2004*, it seems to me that the provision by Family Trustee, to Shareholder, of the use of the beachhouse, can constitute an Eligible Payment only if:

- Shareholder has a present entitlement to an amount that is an unrealised gain of the Family Trust ("**EP Requirement 1**"); and
- Family Trustee discharges the present entitlement by allowing Shareholder to use the beachhouse. (In other words, it must be the case that Family Trustee provides use of the beachhouse as a means of satisfying Shareholder's present entitlement to an amount that is an unrealised gain. If use of the beachhouse is provided, instead, in discharge of some other entitlement of Shareholder, the "payment" to Shareholder will not be an Eligible Payment) ("**EP Requirement 2**").

Intuitively, one senses that these conditions are unlikely to be satisfied. However, to clearly articulate why (which would be necessary if the ATO ever asserted otherwise) is not so easy.

*EP Requirement 1*

For a shareholder to have a present entitlement to an unrealised gain of the trust:

- an unrealised gain must exist;
- the trust deed must empower the trustee to create an entitlement to the unrealised gain; and;

 

- the trustee must exercise its power to create a present entitlement in the shareholder to an unrealised gain (see, eg, ATO ID 2005/539, PBR 89122, PBR 87125, PBR 87126, and PBR 94938).

As regards the 3rd requirement, query whether a trustee will be regarded as having exercised its power even where it does not first "declare" an entitlement but simply proceeds to provide a benefit to a beneficiary. The ATO has expressed the view, in various non-binding publications, that, absent a declaration of present entitlement, there will be no present entitlement for the purposes of Subdiv EA. For example, edited private rulings PBR 87215 and 94938 both include the statement that,

"*… the trustee has not declared any present entitlement to unrealised gains. Accordingly, [there does not exist] any present entitlement in unrealised gains*".

(Treasury, however, may take a different view – see the final paragraph in Pt 6 of Ken Schurgott's 2004 paper, "The New Section 109U(X)B – Squib or Double Bunger?", presented to the TIA NSW Division in March 2004.)

Thus, it seems unlikely that the Shareholder will be taken to have a present entitlement to an unrealised gain, unless Family Trustee has declared such an entitlement.

*EP Requirement 2*

Assuming Shareholder does have a "present entitlement to an unrealised gain", will the provision by Family Trustee of the use of the beachhouse constitute a reduction or discharge of that present entitlement?

Generally, this will be left up to Family Trustee to determine in its discretion. The 2004 EM states that:

"*8.15… the rules do not interfere with the outcome of a trustee's decision … . Therefore, if a trustee determines that a payment is to be applied to reduce a beneficiary's entitlement to a **realised** gain, [Subdivision EA does] not apply to the extent that the payment is applied to that entitlement.*

*8.16 However, if the trustee identifies the payment as reducing or discharging an entitlement to an **unrealised** gain, [Subdivision EA] will …potentially apply*." [Emphasis added]

However, in 2 special situations, the Family Trustee's discretion might not be determinative. They are (at para 8.16 of the 2004 EM):

- "*where the trustee is unable to identify the nature of the entitlement to which a payment is being applied, or*
- *where the trust's financial records suggest that, as a result of the payment (and reduction or discharge of the beneficiary's entitlement), the trust appears to have negative corpus*."

It seems to me that the Hypothetical should not fall within either situation provided that Family Trustee:

- declares it will permit Shareholder to use the beachhouse, (thereby creating an occupancy entitlement in Shareholder ("**Occupancy Entitlement**")), and
- treats its provision of the use of the beachhouse to Shareholder as a discharge of Shareholder's Occupancy Entitlement (rather than as a discharge of Shareholder's present entitlement to an unrealised gain).

If the Family Trustee takes these steps, then:

- the trustee will be able "to identify the nature of the entitlement to which [the] payment is being applied". Specifically, the trustee will have identified the Shareholder's Occupancy Entitlement as the entitlement to which the payment (being the provision of the use of the beachhouse) is being applied; and
- "the trust's financial records [will not] suggest that, as a result of the payment … the trust appears to have a negative corpus". Since the mere provision of use of the beachhouse should not cause any reduction in the corpus of Family Trust, the payment should not result in a negative corpus.

## Conclusion

In summary, as a result of the Draft Ruling and the Bill, the Hypothetical (which would not previously have attracted a tax liability under Div 7A) can potentially give rise to a deemed dividend as follows:

| **Taxing provision** | **Necessary conditions for deemed dividend to arise** |
|---|---|
| S 109D (loan from private company to associate of shareholder) | • Any of:<br>- Express loan agreement<br>- Unpaid Entitlement recorded as "loan" in trust accounts<br>- Unpaid Entitlement arises on or after 16 December 2009 and no Qualifying Sub-Trust; and<br>• No s 109N(1) complying loan agreement |
| S 109C (payment from private company to shareholder via interposed entity) | • Any of:<br>- Express loan agreement<br>- Unpaid Entitlement recorded as "loan" in trust accounts<br>- Unpaid Entitlement arises on or after 16 December 2009 and no Qualifying Sub-Trust; and<br>• Section 109N(1) complying loan agreement exists; and<br>• "Loan" is made mainly as part of an arrangement involving provision by Family Trustee to Shareholder of free use of beachhouse |
| S 109XB ("Eligible Payment" by trustee to shareholder of corporate beneficiary with unpaid entitlement) | • No express loan agreement; and<br>• Unpaid Entitlement **not** recorded as "loan" in trust accounts; and<br>• Either Unpaid Entitlement arises before 16 December 2009; or Qualifying Sub-Trust exists; and<br>• Family Trustee has created a present entitlement to an unrealised gain; and<br>• Family Trustee reduces or discharges that present entitlement by allowing Shareholder to use beachhouse free of charge |

In practice, generally it should be possible to ensure that a dividend does not arise. In short:

- where the Unpaid Entitlement is not recorded as a "loan" in the trust accounts; and either:
  - arose before 16 December 2009; or
  - is held on a Qualifying Sub-Trust,

the Hypothetical should be "dividend-free" provided Family Trustee has not declared an entitlement to an unrealised gain (or if it has, the trustee expressly identifies some other, distinct entitlement that it discharges through the provision of use of the beachhouse); and

- in all other cases, the Hypothetical should not give rise to a dividend provided:
  - the relationship between Private Company and Family Trustee is documented as a s 109N(1) complying loan; and
  - a reasonable person would not conclude that the loan was made mainly in connection with the provision to Shareholder of the use of the beachhouse. (Whether such a conclusion would be drawn will depend on the specific circumstances. However, at least where the beachhouse is acquired long before the loan is made, and is never used for income-producing purposes, there would be no obvious basis for concluding that the loan was made in connection with Family Trustee allowing Shareholder to use the beachhouse.)

# TAX PRACTICE UPDATE

## [542] Tax Inspector-General to review ATO audits of SMEs and wealthy individuals

On 7 April 2010, the Inspector-General of Taxation released the Terms of Reference [http://www.igt.gov.au/content/work_program/review_into_ATO_small_medium_enterprise_audit.pdf] for his inquiry into the ATO's audit and risk review policies, procedures and practices relating to SMEs (with annual turnovers between $100m and $250m) and high wealth individuals (HWIs). "SMEs, HWIs and their representatives have raised concerns in relation to fairness and equity with the ATO's audits and risk reviews," said Mr Noroozi. The concerns generally related to compliance costs stemming from the wide scope of ATO information gathering requests, delays, commercial awareness and conduct of ATO staff and the quality of ATO engagement on technical issues.

The IGOT said his review will seek to establish whether taxpayer concerns about SME and HWI compliance activities are justified. He said it will examine the appropriateness of the ATO's resourcing, information gathering, initial compliance decisions, management of technical issues, project management and conduct in SME and HWI reviews and audits.

Mr Noroozi gave an assurance that all submissions and identities would be kept strictly confidential and will not be disclosed to anyone, including the ATO. He said his aim "is for balanced thinking on the issues to lead to better outcomes for both tax administration and taxpayers alike" and encouraged submissions to outline both positive and negative aspects. As part of the inquiry, the IGOT will review the relevant ATO files and may interview ATO staff to identify the reasons for the ATO approaches, the steps the ATO took to minimise adverse outcomes for taxpayers and identify potential improvements.

Submissions are due by 31 May 2010 and can be sent to: Inspector-General of Taxation, GPO Box 551, SYDNEY NSW 2001 or email: sme@igt.gov.au.

*Source: Inspector-General of Taxation's media release, 7 April 2010 [http://www.igt.gov.au/content/media/023_ATO_audits_under_IGT_review.pdf]*

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