

JOINT SUBMISSION BY

CPA Australia, the Institute of Chartered Accountants in Australia, National Institute of Accountants, the Taxation Institute of Australia and Taxpayers Australia

Draft Taxation Determination TD 2010/D9

Income tax: Division 7A – unpaid present entitlements – factors the Commissioner will take into account in determining the amount of any deemed entitlement arising under section 109XI of the Income Tax Assessment Act 1936

Date: 4 February 2011

The Professional Bodies welcome the opportunity to comment on Draft Taxation Determination TD 2010/D9 (the Draft Determination).

GENERAL COMMENTS

We commend the Commissioner on the timely issue of the Draft Determination as it provides much needed clarity of the factors that will be considered in determining the amount that a private company beneficiary is taken to be entitled to, or will become entitled to, the net income of a target trust under section 109XI(4).

In particular, we welcome confirmation that the amount determined under section 109XI(4) at the determination time will be the lowest of any unpaid present entitlement where one or more trusts is interposed between the private company beneficiary and the target trust, and there are no other additional considerations which need to be taken into account.

Such clarity is of crucial importance to closely held groups wishing to ensure that any existing unpaid present entitlements are discharged by the lodgement date of the target trust's income tax return for the year ended 30 June 2010 in order to ensure that a deemed dividend did not arise under Subdivision EA especially as section 109XI commenced to apply from 1 July 2009.

SPECIFIC COMMENTS

Notwithstanding the above we make the following specific comments in relation to particular aspects of the Draft Determination which we believe require further clarification.

Example 1

In paragraph 9, the loan made to the shareholder (i.e. Richard) of the private company beneficiary (i.e. Diamond Pty Ltd) is stated to be used for private purposes. We note that it is irrelevant that the loan is used for private or income producing purposes for a section 109XA(2) loan to arise, and that accordingly the conclusion reached in paragraph 15 would remain the same regardless of the how the shareholder applied the loan funds.

We therefore suggest that the reference to the private use of the loan funds be excised from the example, and that the commentary emphasise that a section 109XA(2) loan may arise irrespective of how the loan funds are applied by the shareholder of the private company beneficiary. This is an important distinction as there may be a common misconception amongst many taxpayers that a potential Subdivision EA liability will not arise where the funds are used for an income producing purpose by the shareholder of the private company beneficiary.

As an aside, on the website version of the Draft Determination we note that Diagram 2 has been inadvertently replicated twice and that the scenario set out in Example 1 is not currently diagrammatically set out in the Draft Determination.

Example 4 and Paragraph 3(d)

We have some difficulty understanding the meaning of paragraph 3(d) of the Draft Determination, and the reasoning underpinning it, particularly given Example 4.

The Commissioner indicates in paragraph 3(d) that one of the factors that he will take into account in determining the amount of a deemed unpaid present entitlement pursuant to section 109XI is, *'whether any payment of a present entitlement is a genuine transaction and not designed to avoid the application of Subdivision EA otherwise than as envisaged within the scheme of Division 7A (such as genuinely and in substance paying an entitlement by the relevant lodgment date or putting a relevant loan under a loan agreement as described in section 109N).'*

In Example 4, the Brown Business Trust has \$20,000 liquid funds. The Trustee of this trust contracts to buy a \$10,000 property from the Brown Investment Trust. A loan of \$10,000 is also to be made from the Brown Business Trust to Belinda and (evidently) at around the same time as this loan is made, an agreement is reached that the payment for the amount outstanding on the property acquisition is to be deferred. The Brown Business Trust then applies \$10,000 of its cash funds to discharge the unpaid present entitlement due to the Brown Investment Trust, whilst the remaining \$10,000 of the liquid funds held by the Brown Business Trust is presumably held in reserve for the purpose of making a loan to Belinda.

The assertion is made in the Draft Determination that the deferral of payment terms on the property acquisition has *'...allowed the distributable income of the Brown Business Trust to be loaned to Belinda as well as the present entitlement of the Brown Investment Trust to be fully discharged. The entire arrangement was conceived to allow Belinda Brown access to the net income of the Brown Business Trust by way of a loan from the trustee of the Brown Business Trust instead of as a distribution of company profits from Brown Pty Ltd.'* The Draft Determination goes on to state that, *'...the Commissioner would determine that the amount Brown Pty Ltd was taken to be entitled to is not the lesser of the amounts that remained unpaid at the determination time. There has been an attempt to circumvent Subdivision EA by the Brown Investment Trust replacing its equitable entitlement to receive an amount from the Brown Business trust with a contractual entitlement to be paid an amount from that trust.'*

With respect, we have considerable difficulty with the conclusion reached in Example 4. In our view, there is no valid basis for concluding that there has been an attempt to circumvent the operation of Subdivision EA. The Brown Business Trust had \$20,000 in liquid funds available to it, and applied \$10,000 of these funds to legitimately discharge the unpaid present entitlement due to the Brown Business Trust. With the remaining \$10,000 it chose to loan these funds to Belinda, rather than to pay for the purchased asset. Whilst the result of discharging the unpaid present entitlement results in the loan made by the Brown Business Trust to Belinda not being subject to Subdivision EA under an application of section 109XI, the deferral of the purchase price payable for the asset means that the \$10,000 owing from the Brown Business Trust to the Brown Investment Trust will itself be a loan by the Brown Investment Trust that is subject to section 109XA(2) of Subdivision EA. The reasoning underpinning the conclusion in the example appears to neglect this fact altogether.

If the facts in example 4 were to be varied such that the Brown Business Trust used its remaining \$10,000 (after discharge of the unpaid entitlement due to the Brown Investment Trust) to pay for the purchase price of the asset (rather than to leave the amount unpaid on deferred terms) and the Brown Investment Trust then loaned the \$10,000 sum to Belinda, similarly, the Brown Business Trust would be removed from operation of Subdivision EA and it would be the loan made by the Brown Investment Trust to Belinda that would fall within Subdivision EA.

This outcome is consistent with what we regard as being the appropriate outcome for Example 4 – namely, once the unpaid entitlement due from the Brown Business Trust to the Brown Investment Trust is discharged, it should only be section 109XA transactions from the Brown Investment Trust that fall within the operation of Subdivision EA.

We therefore submit that

- Example 4 is incorrect and should be excised from any finalised Determination; and
- short of any further valid illustration or clarification being provided paragraph 3(d) should be deleted from the finalised Determination.

Additional example(s) requested – composite entitlements

In practice, the existence of what might be referred to as ‘composite’ unpaid present entitlements is commonplace.

The ways in which such composite entitlements can arise is best illustrated by the following example:

The Jones Discretionary Trust (‘JDT’) holds all the units in two unit trusts, the Jones Unit Trust (‘JUT’) and the Jones Investment Unit Trust (‘JIUT’). As at 30 June 2010, the following entitlements that have arisen from trust distributions remain unpaid:

- an unpaid present entitlement owing from JUT to JDT of \$10,000;
- an unpaid present entitlement owing from JIUT to JDT of \$8,000; and
- an unpaid entitlement owing from JDT to the company beneficiary of the Jones family group, Jones Pty Ltd of \$18,000. This unpaid present entitlement represents the downstream result of the distributions derived by JDT from JUT and JIUT that have been distributed by JDT to Jones Pty Ltd and which remain unpaid.

An interest free loan of \$5,000 is made on 31 March 2010 by the trustee of JUT to Tom, who is a shareholder of Jones Pty Ltd.

If, by the determination time (being the earlier of the time at which the 2010 income tax return of JUT is due for lodgement and the date of actual lodgement), JUT has paid \$10,000 to JDT to fully discharge the entitlement owing to JDT as at 30 June 2010, it is understood that the Commissioner would determine that the amount of the deemed unpaid present entitlement owing from JUT to Jones Pty Ltd under section 109XI would be nil. This is clear from the existing commentary and the existing examples in the Draft Determination.

Alternatively, in the event that JDT makes a payment of \$10,000 to Jones Pty Ltd to discharge \$10,000 of the composite unpaid present entitlement owing from JDT to Jones Pty Ltd by the determination time (as opposed to the payment from JUT referred to in the preceding paragraph), it is submitted that the Commissioner should reach the same conclusion. That is, it is submitted that the taxpayer should be permitted to nominate which component of the composite unpaid present entitlement owing from JDT to Jones Pty Ltd has been discharged in order to ensure that section 109XI is not triggered. The composite unpaid distribution owing from JDT to Jones Pty Ltd consists of two elements being the \$10,000 that has been sourced from JUT and the \$8,000 that has been sourced from JIUT. In this scenario the taxpayer is nominating in effect that the \$10,000 paid to Jones Pty Ltd is being applied to discharge the unpaid present entitlement that has been sourced from JUT.

Of course, the quantum of any unpaid present entitlement that is owed from JDT to Jones Pty Ltd would also be affected by any other income or expenses that JDT has in its own right that are unrelated to the distributions that it has received from JUT and JIUT. If, for example, JDT has funded its investments into JUT and JIUT with interest bearing debt, it would have

incurred interest expense in its own right that would have reduced the amount of distributable income available.

To modify the above example, assume that JDT has incurred interest expense of, say, \$3,000 over the relevant period, which means that the unpaid present entitlement owing to Jones Pty Ltd from JDT is reduced by a corresponding amount (from \$18,000 to \$15,000). The question then arises as to the extent that the interest expense is to be allocated against the two elements of the composite distribution. If, for example, the facts are that two thirds of the interest expense incurred by JDT relates to the distributions derived from JUT, with the balance relating to the JIUT distributions, this should mean that the two elements of the composite unpaid present entitlement of \$15,000 are respectively \$8,000 for the JUT component and \$7,000 for the JIUT component. Accordingly, given these modified facts, should a payment of \$8,000 be made by JDT to Jones Pty Ltd before the relevant determination time, this should mean that the deemed unpaid present entitlement owing from JUT to Jones Pty Ltd should be nil.

It is acknowledged that in practice there may be some complexities involved in determining the quantum of components that comprise a composite unpaid present entitlement. This will involve questions as to how to apportion expenses and losses between different income sources and other practical matters. It is also acknowledged that it would not be possible to deal with all possible permutations and combinations that might arise in this regard in the Draft Determination. However, it is considered very important that the Commissioner's views on composite unpaid present entitlements be made public, as this circumstance will be common in practice. Examples illustrating reasonably simple facts will give taxpayers considerable comfort in relation to this scenario as a matter of principle.