

DEMISE OF THE “BUCKET COMPANY”?

TAX BRIEF

COWELL CLARKE’S TAX & REVENUE GROUP

The Commissioner has released Practice Statement PS LA 2010/4 (“**Practice Statement**”) in relation to unpaid present entitlements (“**UPEs**”) and Division 7A. The Practice Statement is the finalised statement of Practice Statement PS LA 3362 (draft) (“**Draft Statement**”).

BACKGROUND

PS LA 2010/4 details how tax officers will administer Taxation Ruling TR 2010/3 (“**Ruling**”).

The Ruling describes when a private company with a UPE in an associated trust will be deemed to make a loan for Division 7A purposes to that trust, namely:

- when the express or implied actions of the parties are consistent with the UPE being treated as a loan (“**Section 2 loan**”); or
- when the company provides the trust with financial accommodation by either not calling for the UPE to be paid, or not calling for the UPE funds to be invested for the company’s absolute benefit (“**Section 3 loan**”).

The Commissioner contends that Division 7A has always applied to Section 2 loans. In recognition of the Commissioner’s change of position on Section 3 loans, these may be quarantined from loan treatment under Division 7A provided they arose before 16 December 2009.

THE PRACTICE STATEMENT

The Practice Statement includes a number of significant differences from the Draft Statement.

In relation to Section 2 loans, the Practice Statement introduces self corrective administrative options applicable until 31 December 2011. Provided certain conditions are met, these options allow taxpayers to:

- self correct accounts where a UPE that has been misclassified as a loan; or
- operate on the basis that the taxpayer may self-assess that the Commissioner would exercise his discretion to disregard a deemed dividend under Division 7A (section 109RB). This option involves taking “corrective action” including entering into a Division 7A loan agreement by 31 December 2011.

The Practice Statement confirms the Commissioner’s view that a UPE owing from a trust to a private company will be a loan subject to Division 7A where the trustee fails to hold the funds representing the UPE on sub-trust for the sole benefit of the private company beneficiary.

The Commissioner will consider funds held on sub-trust to be held for the sole benefit of the private company where those funds are invested in the main trust in one of the following ways:

- the funds are lent on an interest only basis for a term not exceeding seven years with interest being levied (and paid) at the ATO's benchmark interest rate¹ ("**Option 1**");
- the funds are lent on an interest only basis for a term not exceeding ten years with interest being levied (and paid) at the ATO's "prescribed interest rate"² ("**Option 2**"); or
- the funds are invested in a specific income producing asset or investment ("**Option 3**").

Where Option 1 or 2 are utilised, separate financial accounts and income tax returns are not required for the sub-trust.

PRACTICAL IMPLICATIONS

One positive aspect of the Practice Statement is the Commissioner's concession on Section 2 loans. This will provide some private groups with an opportunity to take corrective action.

In our opinion, the major downside of the sub-trust arrangements foreshadowed under the Practice Statement is that they are of more limited appeal than the previous sub-trust arrangements described in the Draft Statement. In particular, the requirement to pay a return based on a fixed rate of interest is likely to prove unduly onerous and impractical for many private groups. These factors combined with the surrounding uncertainty will mean due consideration will need to be given as to whether sub-trust arrangements are worthwhile. Private groups may instead choose to convert existing UPEs to complying Division 7A loans.

The Practice Statement provides that for UPEs arising between 16 December 2009 and 30 June 2010 the trustee has until 30 June 2011 to put the funds into a sub-trust. Alternatively, taxpayers have until the lodgement date of their 2011 tax returns to pay the UPE or enter into a Division 7A loan agreement. Accordingly, taxpayers may wish to refrain from immediate action in case the views of the Commissioner are subject to judicial challenge.

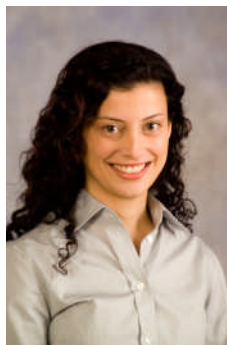
If you require further information in relation to the Practice Statement or Ruling please speak to any Partner in our Tax & Revenue Group.

Dated 18 October 2010.

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¹ 7.40% for the year ending 30 June 2011.

² Reserve Bank of Australia's indicator lending rate for small business variable (other) overdraft for the month of May immediately before the start of the income year. The rate for the year ended 30 June 2011 is 10.3%.