19 February 2010

Tim Pentony
Australian Taxation Office
GPO Box 9977
Box Hill Vic 3128

By email: TR2009-D8@ato.gov.au

SUBMISSION ON DRAFT TAXATION RULING TR 2009/D8

Dear Tim

The following professional bodies and associations (the joint bodies) welcome the opportunity to provide the attached detailed submission in respect of Draft Taxation Ruling TR2009/D8.

The joint bodies look forward to meeting with Senior Tax Counsel and management in the Australian Taxation Office to work through the many issues raised in our submission.

In the meantime, should you wish to further discuss any aspect of this submission, please contact Mark Morris, Senior Tax Counsel of CPA Australia on (03) 9606 9680; Yasser El-Ansary, Tax Counsel of the Institute of Chartered Accountants on (02) 9290 5623; Tony Greco, Senior Tax Adviser of the National Institute of Accountants on (03) 8665 3134; Angie Ananda, Tax Counsel of the Taxation Institute of Australia on (02) 8223 0010; Roger Timms, Head of Tax and Superannuation of Taxpayers Australia on (03) 8851 4505 or Gerry Bean, Partner of DLA Phillips Fox representing the Law Council of Australia on (03) 9274 5661.

Yours sincerely

Yasser El-Ansary
Tax Counsel
The Institute of Chartered Accountants in Australia

Mark Morris
Senior Tax Counsel
CPA Australia

Roger Timms
Head of Tax and Superannuation
Taxpayers Australia Inc

Tony Greco
Senior Tax Advisor
National Institute of Accountants

David Williams
President
Taxation Institute of Australia

Bill Grant
Secretary General
Law Council of Australia

cc: Mr Mark Konza, Deputy Commissioner of Taxation
Mr Des Maloney, Deputy Chief Tax Counsel

Joint Submission
Draft Taxation Ruling TR 2009/D8 Income Tax: Division 7A loans: trust entitlements

The professional bodies welcome the opportunity to provide comments in respect of Draft Taxation Ruling TR2009/D8 Income Tax: Division 7A loans; trust entitlements (the draft Ruling) which issued on 16 December 2009.

Our submission sets out our concerns on the following key issues:

1. the draft Ruling contradicts the underlying policy intent of Division 7A
2. the application of section two of the draft Ruling concerning the extinguishment of a unpaid present entitlement (UPE) and its conversion into a loan
3. the application of section three which provides that a subsisting UPE may amount to either the provision of financial accommodation or an in-substance loan under section 109D(3)
4. the residual application of Subdivision EA, and
5. certain adverse tax consequences which arise from the draft Ruling.

The collective view of the professional bodies is that the draft Ruling contradicts the underlying legislative purpose of section 109D and Subdivision EA of Division 7A, contains various arguments which are legally flawed, makes the operation of Subdivision EA effectively redundant and creates adverse tax consequences for trusts and corporate beneficiaries including double taxation. Accordingly, it should be withdrawn.

In our view the crux of the problem is the mechanics of Division 6 of the Income Tax Assessment Act (1936) (the ITAA(1936)) which requires a trustee to appoint income in favour of beneficiaries by 30 June. We believe there is widespread if not universal agreement that the structure of Division 6 is inappropriate for modern day trusts and warrants review.

As currently issued, the draft Ruling introduces ideas and concepts as to when a deemed dividend might arise where there is a UPE, but it importantly does not provide any clear and definitive interpretations which will enable tax practitioners and their clients to comply with Division 7A with any degree of certainty.

In particular, the draft Ruling does not provide any guidance as to the point in time at which a subsisting UPE will ‘flip over’ and be regarded as the provision of financial accommodation and hence a loan for section 109D(3)(b) purposes.

As the draft Ruling currently stands where a trustee resolves on or before 30 June to appoint the year’s income in favour of a corporate beneficiary, neither the trustee nor the corporate beneficiary (or their advisors) will be able to identify whether they have breached this ruling, unless the distribution is paid out on that day.

Such confusion will inevitably lead to systemic non-compliance and increased litigation.

If, despite the concerns expressed in our submission, the Commissioner of Taxation (the Commissioner) decides to proceed along the lines of the arguments suggested in the draft Ruling, we urge the Commissioner to apply this approach on a fully prospective basis, and to provide the additional clarity necessary for a workable degree of certainty as to the practical operation of this approach.

1. The divergence of the views expressed in the draft Ruling with the underlying policy intent of Division 7A

Prior to discussing our specific concerns with the draft Ruling, it is appropriate to discuss the policy intent underlying the relevant provisions of Division 7A of the the ITAA (1936).

With effect from 4 December 1997, Division 7A replaced former section 108 of the ITAA (1936). The Treasurer's Press Release No.45 introducing the new regime stated, inter alia, that the mischief to be remedied included the ability of private companies to distribute realised or unrealised profits in a tax free fashion by structuring distributions as loans to shareholders which were not on commercial terms. It stated further that the measures to be passed were likely to impact on tax minimisation practices used by some high wealth individuals; and would embrace the forgiveness by private companies of debts owed by shareholders and their associates.

Following the introduction of Division 7A certain deficiencies and inappropriate outcomes were identified which led to not insubstantial amendments. That included the replacement of section 109UB (which picked up loans that could arise through mere inadvertence and could not be corrected) after year end. For debts forgiven after 12 December 2002 section 109UB was replaced by Subdivision EA of Division 7A. It is not pertinent to detail the nature and substance of other amendments to Division 7A which both confined and clarified the operation of the statutory provisions.

Prior to February 2009 there had been no public pronouncement by the ATO that Division 7A may apply to UPEs in favour of a corporate beneficiary but not called for by the beneficiary and, in particular, that the existence of a UPE may fall within the definition of 'loan' in section 109D(3) of the ITAA (1936).

The professional bodies maintain that it has always been the clear policy objective of Division 7A of the ITAA (1936) that section 109D does not apply to treat a UPE owed to a private company beneficiary as a 'loan' as that term is defined under section 109D(3). The draft Ruling clearly contradicts the policy intent of Div 7A.

Moreover, we contend that section 109UB (and its successor provision Subdivision EA) were specifically inserted into Division 7A to bring certain arrangements concerning UPEs of a private company beneficiary within the scope of Division 7A, as it was not intended that section 109D would apply to such unpaid entitlements themselves.

Essentially, section 109UB formerly applied where a private company had a UPE and the trustee of the trust subsequently lent an amount to a shareholder or an associate of the shareholder. Similarly, Subdivision EA only applies where the trustee of a trust actually makes a loan or payment, or forgives a debt, to a shareholder or their associate, where a private company beneficiary is presently entitled to an amount from that trust.

In both cases the application of the provisions is predicated on there being a UPE owed to a private company which is not otherwise subject to the provisions of Division 7A including section 109D.

Accordingly, treating a UPE as a loan under section 109D(3), where no actual loan has been made, is contrary to the underlying legislative purpose of Division 7A. In this case the loan (as defined in Div 7A) must be something that is separate from the UPE itself. For the UPE to fall within the definition of a loan, it must first cease to be a UPE. There must be a payment by the trustee to the beneficiary and that payment being returned in some form by the beneficiary to the trustee, as long as the form of the return of that payment falls within the extended definition in section 109D(3). Moreover, treating a UPE as within the extended definition of loan in section 109D(3) involves artificial and strained reasoning.

In support of these view we refer to the memorandum titled 'History of Section 109UB/XA – Review of Documents supporting policy and understanding on the application of the provisions' which was prepared by Mr. Alexis Kokkinos and Ms. Natalie Wellard for the joint meeting of the National Tax Liaison Group and the Division 7A Working Party held on 25 September 2009. A copy of this memorandum is attached as Attachment 1 to this submission.

We believe that the memorandum accurately details the policy intent throughout the period between the effective commencement date of section 109D on 4 December 1997 to the issue of the Treasury Consultation Paper 'Improving fairness and integrity of the tax system –tightening the non-commercial loss rules in Division 7A of the Income Tax Assessment Act (1936)' issued on 5 June 2009.

As set out in the attached memorandum there is a clear inference from Government, the Board of Taxation and Treasury in the various explanatory material, press releases and consultative materials cited therein that UPEs have never been regarded as being loans for section 109D(3) purposes which is contrary to what is asserted in the draft Ruling.

Further, we believe that the policy underlying the application of Subdivision EA is maintained by the Treasury as reflected in the proposed amendments to that Subdivision and the proposed introduction of Subdivision EB under the Exposure Draft Tax Laws Amendment (2010 Measures No.1) Bill 2010: Division 7A which issued on 4 January 2010.

We note that if UPEs are regarded as loans for section 109D purposes all the legislative amendments introducing section 109UB and Subdivision EA would have been redundant as would be the above proposed amendments under the exposure draft legislation.

1(a) ATO acknowledgment of policy intent

We also believe that prior to the issuance of the draft Ruling the Commissioner has also consistently applied the view that UPEs do not constitute loans under section 109D in interpreting section 109UB and Subdivision EA.

For example, the Commissioner expressly acknowledged that section 109UB had been introduced to modify the application of Division 7A in Taxation Determination TD2004/63.

In paragraph 9 of the Determination the Commissioner stated:

> 'Section 109UB reflects a statutory regime which modifies the point or event on which Division 7A of Part III of the ITAA 1936 applies in relation to certain arrangements between private companies and trusts. **Instead of the unpaid present entitlement itself triggering the application of Division 7A**, there can be no deemed dividend unless and until the trustee makes a loan to a shareholder of the private company or an associate of such a shareholder. Where the unpaid present entitlement is no longer retained by the trust, the arrangement ceases to qualify for this modification' (emphasis added).

This ruling has not been withdrawn and is therefore still applicable, even though, following the reasoning in the draft Ruling, section 109UB's successor provision, Subdivision EA, would have virtually no application.

Further, in considering the application of section 109XA(1), Private Binding Ruling 94938 issued in December 2009 discusses the application of that provision in relation to the year ended 30 June 2010 without making any reference to a private company's UPE being regarded as a loan under section 109D.

1(b) Uncertainty for practitioners and the public

In the current circumstances both practitioners and their clients face considerable uncertainty as to how Division 7A should be applied given the existing provisions, proposed amendments and long standing ATO administrative practice, and the revised views on the Commissioner's application of section 109D and Subdivision EA set out in the draft Ruling.

This conflict in approach will confuse tax advisers who would reasonably expect to be able to apply these legislative provisions as they have been traditionally interpreted. Such confusion will inevitably lead to greater non-compliance and increased litigation.

This complexity is undesirable especially the lack of practical guidance on various key concepts in the draft Ruling especially the time at which a subsisting UPE will supposedly 'flip over' and be regarded as the provision of financial accommodation and hence a loan for section 109D(3)(b) purposes. Such an outcome will be practical nightmare for any taxpayer seeking to follow and apply the ruling.

Accordingly, we recommend that the draft Ruling be recalled and if the ATO wishes to tax UPEs under Div 7A that legislative change be sought by it.

2. The application of section two of the draft Ruling concerning the extinguishment of a UPE and its conversion into a loan

2(a) Background

Prior to examining the technical merits of the arguments we believe that it is prudent to recap on the distinction between a 'loan' and a 'UPE' for Division 7A purposes.

2(a)(i) What is a loan?

Section 109D(3) defines a 'loan' to include

> '….
> (a) An advance of money;
> (b) A provision of credit or any other form of financial accommodation;
> (c) A payment of an amount for, or on account of, on behalf of or at the request of, an entity, if there is an express or implied obligation to repay the amount; and,
> (d) A transaction (whatever its terms or forms) which in substance effects a loan of money.'

As this definition is inclusive the term 'loan' takes on in addition its ordinary meaning. Resort to dictionary definitions is not decisive. At general law the essential element of a loan is an obligation upon the borrower to repay the amount advanced by the lender. Usually there are terms and conditions as to when and with what frequency the principal amount is to be repaid; as to the calculation and quantum of interest payments thereon; and as to the provision of security.

In his text book entitled 'The Law of Money Lenders in Australia and New Zealand' (1964), at page 6, Dr. C L Pannam cites a number of authorities for the proposition that in general terms a loan consists of a simple contract whereby the lender agrees to pay a sum of money in consideration of a promise by the borrower to repay the money upon demand or at a fixed date, which may or may not be coupled with a promise to pay interest. The essence of the transaction is the payment by a person and promise of repayment to that person; see generally, Ferguson v O'Neil (1943) VLR 30, at page 32, per Lowe J; and Brick and Pipe Industries Ltd v Occidental Life Nominees Pty Ltd (1992) 2 VLR 279, at pages 321 to 323, per Ormiston J.

2(a)(ii) What is a UPE?

The nature of what constitutes a UPE has not been the subject of judicial scrutiny in Australia. However, the matter was considered by the Court of Appeal in New Zealand in CIR v Ward 69 ATC 6050 which concerned the distribution of monies to an infant beneficiary. At page 6071 of the report, McCarthy J stated that the rights of beneficiaries arise out of trusts created by the trust deed and that they are entitled to invoke the power of the court by reason of a new title consisting of the exercise of the trustee's discretion in their favour. Those rights do not arise out of debt or contract.

The UPE is an equitable charge or lien on the trust fund (albeit a lesser right than, and one that is deferred to, the trustee's right of indemnity).

A trust or sub-trust can be created over an asset or cash representing the UPE if the trustee separates the asset or cash (i.e. identifies or divides it from the trust fund so that the trust law requirement of certainty of trust property is satisfied).

It is submitted that for the purposes of the ITAA (1936) a UPE consists of the allocation of the whole or part of the net income of a trust estate to a corporate beneficiary who thereby becomes presently entitled to the income so allocated and can call for that amount to be paid to it. Net income is an accounting concept. The net income a trust is not a severable identified commodity (i.e. it is an amount that is represented by assets forming part of the trust fund). If the trustee does no more than create a present entitlement in favour of a beneficiary, a trust or sub-trust over any specific part of the trust property cannot be created.

The correct juristic analysis of a UPE is that there is no loan by the corporate beneficiary to the trustee. A loan requires an advance and for the beneficiary to make an advance there must first be a payment by the trustee. That is, there is no payment made by a corporate trustee to the beneficiary, and there is no payment by the corporate beneficiary to the trustee (see R M Goode 'Payment Obligations in Commercial and Financial Transactions' (1983) Ch 1) and the trustee has not promised to repay any amount to the beneficiary. Given there is no initial payment, there can be no loan.

It is submitted that there can be little or no doubt that the UPE of a corporate beneficiary resulting from the distribution decision but not payment of the whole or part of the net income of a trust estate does not fall within the general law meaning of loan. A contrary view has not ever been advanced either judicially or in respected academic writing.

2(b) Loan instead of or in satisfaction of a UPE

Essentially, section two of the draft Ruling sets out the following three ways in which a private company beneficiary's UPE can be extinguished and converted into a loan back by the private company beneficiary to the trust:

a) Where the private company beneficiary enters into an agreement to lend funds to the trustee on behalf of the trust which can be effected by way of an agreed set-off of the loan against the trustee's obligation to pay the private company beneficiary its trust entitlement (see first bullet point in paragraph 8);

b) Where the trustee credits an amount to a loan account held in the name of the private company beneficiary with the authorisation of the private company beneficiary. Such authorisation may arise through acquiescence with full knowledge of what the trustee has done on the basis that the trust and beneficiary form part of the same family group (see second bullet point in paragraph 8); and

c) Where the trust funds are applied on behalf of a private company beneficiary by way of a loan where the trustee is acting pursuant to the terms of a trust deed which permits the trustee to pay or apply money to or for the benefit of the beneficiary, and the trustee has the power to credit such amounts for the benefit of the corporate beneficiary as a payment or application of trust funds (see paragraphs 9 and 10).

Paragraph 12 also contends that any conversion of a UPE to a loan under the above scenarios will ensure that Subdivision EA does not have any residual application as the trust entitlement has been effectively paid upon such a conversion taking place.

However, case law shows that a UPE cannot become a loan until the end of the trust. The case law indicates that a trustee cannot become a debtor by stating an account or admiting that a certain sum is immediately due and payable until the end of the trust.

The case of Bartlett v Diamond (1854) 14 M & W 49 relied upon in Tindon Pty Ltd v Adams and Window Concepts Pty Ltd [2006] VSC 172 clearly indicates that only if the trust ends can the trustee become a debtor at common law. We note 'Trust & Estates : Taxation and Practice' (B Marks) incorrectly states the position in that text. The case relied on R v Brown (1912) 14 CLR 17 actually states the correct position (note the words used at page 25- 'if nothing remained to be done') but the wrong conclusion is drawn from it. Also, Ford & Lee 'Principles of the Law of Trusts' also do not correctly state the position while citing the correct authority. The Tindon case clearly states the principle, that allows a trustee to convert a UPE to a loan by recognising the UPE as a debt, does not apply to continuing trusts. We note the draft Ruling refers to the Space Investments case. However, that was case where the trustee was empowered to borrow the trust fund, and is not relevant to the usual types of trusts found in practice.

We note that Hill J in East Finchley Pty Ltd v FCT 90 ALR 457 considered that on the facts if there was a UPE but also a demand for payment (at p. 470), the UPE could be replaced with a common law debtor creditor relation under the principle in Spargo's case. However, the remarks are dicta as Hill J. was considering whether there was a 'payment' for section 100A purposes, not whether a UPE can be converted into a loan per se.

2(b)(i) Loan arising from a set-off

Given the approach in East Finchley by Hill J. in our view the only scenario which will potentially constitute a conversion for the purposes of section two of the draft Ruling is where the private company consciously makes a demand for payment of a UPE and then agrees to 'set-off' the amount of the UPE by making a loan to the trustee of the trust. We say "potentially" here because the principle in Spargo's case relates to extinguishment of a pre-existing debt and a UPE is not a pre-existing debt at law (see Tindon's case).

In any event. no detailed guidance is provided in the draft Ruling as to what the term 'set-off' means in the context of section two and related examples 1 to 4 of the ruling.

To the extent the term 'set-off' is discussed in paragraphs 106 and 107 of the draft Ruling it appears that there must be some 'conscious' knowledge and agreement between the parties before the offset will be effective.

Paragraph 107 of the draft Ruling states that:

> 'In Manzi v. Smith(51) the High Court reiterated that payment by journal entry, such as in set-off cases, will only be effective with the knowledge and agreement of the parties, Barwick CJ stating:
>
> '... the appellants were not shown to be in any wise privy to the said entries in the company's books, or for that matter had any knowledge of them. They had certainly not adopted them.
>
> We were referred to cases in which a payment of money was held to have been made by means of entries in books of account. But in those cases the entries represented the agreement of the appropriate parties e.g. Eyles v. Ellis(52) ... Spargo's Case . These decisions, quite clearly, are not authority for the proposition for which they were advanced, namely, that a payment of money was made by the making by the company of a journal entry in the books of account without reference to, or without the agreement of, the persons said to be the recipients of the money (53)'.

The application of this principle is complicated by the fact that the draft Ruling does not clarify what will be an 'agreement' for the purposes of the draft Ruling even though that expression is used frequently in the binding and non-binding parts of the ruling.

However, we concur with the view expressed in paragraph 107 that a 'set-off' will only be effected where the parties know and mutually agree to the terms of the 'set-off'.

In our view an agreement can only be said to arise where there has been some positive act by the private company beneficiary in knowingly agreeing to the terms of the set off under some written or verbal agreement. As set out below we do not agree with the view that knowledge of the trustee of the trust can be attributed to the private company.

Accordingly, there cannot be an agreement where the set off is effected unilaterally by the trustee of the trust without the express concurrence of the private company beneficiary.

If the Commissioner does not with draw the draft Ruling, the scope of section two should therefore be strictly restricted to the above scenario where both parties know and consciously agree to the terms of the agreement.

2(b)(ii) Loan arising through acquiescence

Paragraph 8 of the draft Ruling provides that a loan will arise where the trustee credits a loan account in the name of the private company beneficiary with the authorisation of the private company.
It is contended under paragraph 112 that such an authorisation may arise through acquiescence with knowledge of what the trustee has done.

We consider that this is incorrect and that without payment to the beneficiary there can be no loan by the beneficiary to the trustee.

If the Commissioner does not accept this position, we note that there is no judicial or academic view that expressly supports the view that a UPE can become a loan due to acquiescence of the beneficiary. Adopting the logic or the draft Ruling, we believe that for an authorisation to occur there must be first be a demand for payment by the beneficiary and then a ‘conscious’ acquiescence of what the trustee has done by the private company in order for such a loan to be knowingly authorised.

Whilst there is no guidance in the draft Ruling as to what will constitute ‘conscious’ acquiescence it would require something considerably more than a company director or a corporate trustee passively signing off a set of accounts which incorrectly discloses a UPE as a loan. Incorrect accounting entries cannot of themselves change the nature of a UPE.

Hence, if the draft Ruling is not withdrawn, we suggest that the draft Ruling be amended to make it clear that there must be some contemporaneous documentation to evidence the conscious acquiescence of the directors of the private company to establish that they had full knowledge that a UPE would be converted to a loan.

We note that there is significant reliance in the draft Ruling on the argument that knowledge can be attributed from the trustee of the trust to the private company beneficiary because they are members of the same family group with the same ultimate controllers.

We do not believe that draft Ruling identifies sufficient technical support for the proposition that the knowledge of one entity can be attributed to another entity. In our view, the better characterisation is that a trustee and private company beneficiary are separate legal persons with their own respective governing minds.

Nevertheless, we note that the draft Ruling does attempt to provide some legal basis for attributing knowledge between separate entities at paragraphs 115 to 119.

The draft Ruling contends at paragraph 115 that:

> ‘In considering the knowledge the private company may have of the trustee’s actions, it is relevant that the arrangements being considered in this draft Ruling are those where both the trustee and the private company beneficiary are entities within the same family group that share the same ultimate controllers’.

Paragraph 116 attempts to provide legal support for the contention as follows:

> ‘In Re Rossfield Group Operations Pty Ltd(58) it was held that ‘A company can be fixed with the knowledge of any person or entity who at the acquiescence of its board has assumed control of the company’(59). Anyone to whom an entity’s managing body defers control may be taken to practically control that entity, and the entity will be taken to share the knowledge of that controlling person or entity’.

A reference is provided for the cited passage. However, upon reading the judgement in Re Rossfield Group Operations Pty Ltd (1981) Qd R 372 it appears that the cited passage does not exist.

The case of Endresz v Whitehouse (1997) 24 ACSR 208 includes the following passage from Ford’s Principles of Corporations Law:

> ‘A company can be fixed with the knowledge of a person who at the acquiescence of its board has assumed control of the company; Re Rossfield Group Operations Pty Ltd [1981] Qd R 372 at 377’.

Turning to Ford’s Principles of Corporations Law, paragraph 16.200 of that text does indeed include the following commentary:

> ‘A company can be fixed with the knowledge of a person who with the acquiescence of its board has assumed control of the company: Re Rossfield Group Operations Pty Ltd [1981] Qd R 372 at 377; (1980) 5 ACLR 237 at 242; (1980) CLC 40-710’.

Accordingly, it appears the draft Ruling may have incorrectly taken this excerpt from Endresz v Whitehouse - which is itself merely a statement taken from a commentary - and cited it as being directly taken from the judgement in Re Rossfield Group Operations Pty Ltd.

It is incumbent on the Commissioner to clarify this point.

Apart from this issue, we also do not believe that Re Rossfield Group Operations Pty Ltd establishes a principle that knowledge can be attributed from a trustee of a trust to a private company where they have the same ultimate controllers.

In Re Rossfield Group Operations Pty Ltd, a decision of the Supreme Court of Queensland, Connolly J did find the knowledge of one company, Austral Motors Holdings Ltd (AMH), could be attributed to another company, Austral Group Limited (the Respondent).

The facts of the case involved the directors of AMH incorporating the Respondent for the purpose of acquiring shares in AMH under a takeover in order to frustrate a takeover attempt by another bidder who planned to strip AMH of its assets. The directors of AMH were identical to the directors of the Respondent.

At issue was whether the Respondent had knowledge of a contingent liability of AMH. Connolly J concluded in Re Rossfield Group Operations Pty Ltd (1980) 5 ACLR 237 at 241 and 242 that the Respondent did have such knowledge:

> 'The next question is whether the information in question was within the knowledge of the respondent. I have already said that it is clear that the respondent was incorporated by the directors of A.M.H. for the purpose of countering the applicants' take-over by making the take-over offer which has given rise to these proceedings. The Part A statement which is here under attack describes the principal activity of the respondent as being to acquire and hold stock units in A.M.H. The plan was carried through by the directors as a body. To use the graphic phrase of Denning L.J. in H. L. Bolton (Engineering) Co. Ltd. v. T J. Graham and Sons Ltd. [1957] 1 Q.B. 159 it was carried through by the brain and nerve centre of A.M.H., its directing mind and will. The knowledge which this directing mind had of the affairs of A.M.H. was essential to the only business for which the respondent was incorporated. Upon its incorporation they likewise became the brain and nerve centre, the directing mind and will of the respondent. There may well be situations in which it would not be right to impute to one company the knowledge which one or more of its directors happen to have by reason of his or their dealings with or position on the board of another company. That is not this case. Whether the theory to be applied is the organic theory or that of principal and agent, the result must in my judgment be the same. Both A.M.H. and the respondent have identical boards and knowledge of the affairs of A.M.H. is an essential function of each board. I hold therefore that the information was within the knowledge of the respondent offeror. Cf. Universal Telecasters (Qld) Ltd. v. Guthrie [1978] 18 A.L.R. 531 at p. 535per Bowen C.J.; Tesco Supermarkets Ltd. v. Nattrass [1972] A.C. 153'.

This case can be restricted to its facts, that is, a case where one company is set up solely for the purpose of acquiring another company such that knowledge of the affairs of the target company is an essential function of the board of the acquiring company. This is quite different to the situation of a trustee and a corporate beneficiary. The corporate beneficiary is not set up for the purpose of knowing the affairs of the trust or trustee.

Paragraph 117 of the draft Ruling then states:

> 'In circumstances where a number of entities share a common controller, the controller's knowledge of one of the group's affairs can generally be attributed to another member of the same group. In Endresz v Whitehouse(60) it was accepted that where a director is a controller of two companies, each company will know what the other knows because they have the same directing mind and will(61). It was suggested by the Court that the attribution of the director's knowledge to each company did not depend on the fact that the director was common to both entities but that the director was the controller of both companies'.

The draft Ruling includes a citation in support of paragraph 117. The citation refers to parts of the judgement of Hansen J in Endresz v Whitehouse 24 ACSR 208 at pages 228 and 229 whereas we understand that the judges in this Supreme Court of Victoria - Court of Appeal decision were Tadgell, Ormiston and Charles JJA and not Hansen J.

In any event, pages 228 and 229 of this decision (which form part of Ormiston JA's decision) refer to passages from Ford's Principles of Corporations Law and includes the following excerpt from the commentary:

> 'A distinction has to be drawn between the case where the director is a controller of two companies and where the director is only one of several directors of two companies. In the former case each company

> will know what the other knows because they have the same directing mind and will: attribution of the director's knowledge to each company does not depend on the existence of duty but on the director being identified with each company as its directing mind and will'.

In our view, Ormiston JA does not approve this passage as being the law. He decided the case without needing to make a determination about this issue at page 229:

> 'If it were necessary to decide it, it would seem that the principle applicable to controlling directors might be more appropriate to the present circumstances, having regard to the fact that CTC was effectively the applicant's company and that it had recently taken over Emu Hill and placed in control its own board of directors, with the applicant as chairman.
>
> However the question may be more simply resolved.'

Interestingly, the current edition of Ford's Principles of Corporations Law includes the same passage at paragraph 16.220 and cites Endresz v Whitehouse in support of it. This seems somewhat circular; as if the commentators have used the reference to the passage in the Endresz decision as being support for its accuracy.

Given the above limitations the draft Ruling does not identify sufficient support for the proposition that the knowledge of one entity can be attributed to another entity.

Moreover, the principle that a loan can be created by the acquiescence of the private company is vague and commercially impractical as well as contrary to interpretations held by tax practitioners and clients since the effective commencement of Division 7A on 4 December 1997.

2(b)(iii) Loan through application of trust funds by action pursuant to a term of the trust deed.

Paragraphs 10 and 122 assert that a private company beneficiary will be regarded as making a loan to a trustee where an amount has been credited to the loan account in the name of the corporate beneficiary, and the trustee has the power to credit such amounts for the benefit of the beneficiary as a payment or application of trust funds under the trust deed. The draft Ruling indicates that the Commissioner will form this view unless there is evidence to the contrary.

In addition, paragraphs 9, 120 and 121 appear to indicate the amount does not need to be credited to a 'loan account' in the trust accounts for it to be treated as a loan. For example, where the relevant account is called an 'unpaid beneficiary entitlement account', and the trustee has the power to credit such amounts for the benefit of the beneficiary as a payment or application of trust funds under the trust deed. We have been informed by telephone conversations with the ATO contact officer for the draft Ruling that in these cases the Commissioner will also form the view that the private company beneficiary has made a loan to the trustee and the UPE has been extinguished by making the loan unless there is evidence to the contrary.

We believe that both characterisations are incorrect for the reasons detailed below. Additionally, the proposed breadth of this section of the draft Ruling, as highlighted in discussions with your office, is of the gravest concern, having regard to the proposed retrospectivity of section two of the draft Ruling.

First, the draft Ruling makes the point that certain trust deeds allow the trustee to apply unpaid entitlements on behalf of beneficiaries. It therefore argues that a trustee can create a loan to itself by applying the unpaid entitlement.

This argument is based on a false premise.

The UPE is an equitable entitlement in that the beneficiary has been granted a right to call for an amount to be paid to it. This gives rise to an equitable lien or charge over the trust fund until the beneficiary calls for the amount to be paid to it, or at the beneficiary's direction. Accordingly, the trustee cannot simply remove the beneficiary's equitable entitlement and replace it with a loan (i.e. a common law entitlement).

Secondly, in our experience a very high proportion of trust deeds allow trustees to apply entitlements which is intended to allow the trustee to purely expend monies for the benefit of beneficiaries by paying their living expenses, school fees and like expenses. Applying moneys on behalf of beneficiaries involves actual payment at the direction of the beneficiary or otherwise under the terms of the trust deed, and is far removed from treating a UPE as loan. In fact such a payment at the direction of the beneficiary is a reduction of the UPE (i.e. it is part payment).

In our view, the draft Ruling inappropriately and incorrectly stretches this concept by arguing that a trustee applies amounts on behalf of a company beneficiary by converting unpaid entitlements to loans back to itself.

In addition, paragraph 122 of the draft Ruling appears to infer that the above accounting treatment will in fact crystallise the exercise of a power to credit amounts for the benefit of the private company even though the Commissioner qualifies his analysis by stating that the accounting records evidence a transaction rather than determine the character of the transaction itself.

There is a great deal of judicial exposition as to whether, and if so in what manner. a journal entry in the accounting records of a company (or any other entity) may create or constitute a transaction that is, for relevant purposes, a payment, a loan or forgiveness of a debt.

It is clear that such a journal entry per se may constitute evidence of a transaction; however, absent the existence of other material which establishes the common intention of the parties by overt conduct or express words a journal entry does not create an indebtedness of a shareholder (or likewise a trustee) for the payment of any money which discharges such indebtedness.

In Brookton Co-Operative Society Ltd v FCT 81 ATC 4346, at page 4354, Mason J stated that it is well settled that the making of an entry in the books of a company does not establish a payment to the shareholder. In that case a resolution passed by the directors did not evidence any agreement to lend monies to the shareholder; on the contrary, it indicated that the taxpayer was awaiting payment so as to enable it to make an investment of the funds on fixed deposit. Mason J cited Manzi v Smith (1975) 132 CLR 671 in support of those propositions. The same principle emerges from FCT v I. Pori & Sons Pty Limited 87 ATC 4775, at page 4788, per Beaumont J, where his Honour (sitting as a member of the Full Court of the Federal Court of Australia) held that the journal entries relied upon in that case were not underpinned by a valid agreement to the effect that payment of certain contributions had been accepted by the trustee in a form other than by actual cash or by cheque.

The nature and legal effect of journal entries was the subject of comment by the Full Court of the Federal Court of Australia in Temples Wholesale Flour Supplies Pty Ltd v FCT 91 ATC 4387, at page 4393, where the Court stated that the mere act of making entries in the company’s books, to debit the amount of the dividend to the profit and loss appropriation account and credit that amount to the appellant’s loan account did not increase the appellant’s assets or diminish his liabilities. The appellant received nothing that was equivalent to payment. In that case the Court cited with approval what had been stated by Gibbs J in Re Associated Electronic Services Pty Limited (In Voluntarily Liquidation) (1965) Qld R. 36.

A further principle that can be extracted from the authorities on this topic is that an erroneous categorisation of an amount as a loan in the accounts of an entity does not create or constitute a loan so that the practice of journalising a UPE as a loan does not determine what is the correct treatment of the entry for tax purposes.

To that end the comments of Davis J in FCT v Dunn 89 ATC 4141, at page 4148, are relevant where his Honour cited with approval the principle emerging from the judgment of Dixon J in Carden’s case (1938) 63 CLR 108 and from the joint judgment of Barwick CJ and Kitto and Taylor JJ in Arthur Murray (NSW) Pty Ltd v FCT (1965) 114 CLR 314 namely, that ordinary accounting principles in practice are not determinative of a legal issue although they may be relevant and can be influential depending upon the facts and circumstances of a particular case.

Further, we also note that paragraphs 100 and 101 of the draft Ruling itself refers to the decision in Case 5/94 94 ATC 130 which recognises that the making of a journal entry by an accountant transferring the share of net income to a loan account does not change the trust arrangement to one of a loan if the true substance of the arrangement is different.

It is therefore submitted that it should be concluded that absent an express agreement between the corporate beneficiary and the trustee which involves a payment and creates an obligation to repay a principal amount either on demand or at a fixed date, booking entries in the accounts purporting to record the existence of a loan are not determinative of the existence of a loan for general law purposes or within the meaning of section 109D(3) of the ITAA(1936).

Finally, we note that many tax practitioners refer to a UPE as a 'loan' in journal entries and financial statements. This occurs notwithstanding that the trust deeds may provide that a UPE is to be held on a sub-trust. Indeed, we understand that it is common practice for many accountants to incorrectly record a UPE as a loan in both the trustee's accounts and the private company beneficiary's accounts for reasons of consistency where both sets of accounts are prepared by the same accountant. Moreover, we understand that some accounting software will compel practitioners to record the UPE as a loan in their accounts.

In these circumstances the tax practitioner or accountant will merely have incorrectly labelled the nature of or effect of the transaction.

2(c) Retrospectivity

Paragraphs 54 and 57 of the draft Ruling provide that the Commissioner's views on the three scenarios set out under section two of the draft Ruling will apply both before and after the date of any finalised ruling.

The rationale for this treatment is that the three circumstances considered in section two of the draft Ruling involve the making of an actual loan and are not subsisting UPEs subject to section three of the draft Ruling.

For the reasons detailed above we strongly contend that we believe that there should be any retrospective application of section 109D in the three situations discussed in section two of the draft Ruling.

Accordingly, should the Commissioner proceed with issuing the draft Ruling as a final ruling, we recommend that its application in relation to the three situations in section 2 of the draft Ruling should be wholly prospective in nature as it would be highly inequitable for the Commissioner to treat these facts situations as loans under Div 7A as they would not currently be considered as such by tax practitioners or their clients.

We reiterate that section 109D has applied since 4 December 1997 with no suggestion that the Commissioner would treat such amounts as a 'loan'. Accordingly, we believe that the views expressed in the draft Ruling reflect a major change in the Commissioner's policy and interpretation and that any retrospective application of the draft Ruling in these circumstances is highly inappropriate.

We also wish to emphasise that many taxpayers operated through trusts have UPEs, and the funds representing those UPEs have provided de facto working capital for the businesses. In these circumstances there is no ulterior motive to distribute disguised company profits to shareholders or their associates for private purposes but rather there is a use of self-generated funds to help finance a business.

The ramifications of widespread retrospectivity of application cannot be overstated. With a retrospective application, affected trustees are faced with two unenviable alternatives:

(a) taking immediate corrective action that might permit the Commissioner's discretion to be exercised under section 109RB. This would invariably necessitate the payment by the trustee of the required minimum annual payment amounts which has the potential to cause significant financial distress and business disruption to the trustee and the trust. In these circumstances obtaining third party funding will present major, possibly even insurmountable, challenges for many trusts. Accordingly, for investment trusts, there may be a forced realisation of investments at a loss to fund the required repayment amounts necessary to satisfy the "corrective action" precondition for this discretion which will be highly challenging in the current economic climate. In the case of trading businesses, which may well have these funds locked up in working capital or other business assets, the potential for financial disruption to the business in the current economic climate is enormous; or

(b) the derivation of a deemed dividend under Division 7A (with the potential application of penalties and GIC), which would effectively means that the same amount of income is assessed more than once – once to the corporate beneficiary and again to either the trustee or the beneficiaries (which may include the corporate beneficiary itself), depending on the circumstances in the year in which the deemed dividend arises.

Accordingly, the proposed retrospective application would be profoundly unfair to a potentially huge number of family and private business taxpayers as those entities did not intend to enter transactions whereby outstanding UPEs would be regarded as 'loans' for section 109D purposes.

If the Commissioner does not withdraw the draft Ruling, section two of the draft Ruling should only apply to loans arising from or after the date the draft Ruling is issued as a finalised ruling.

In these circumstances we also strongly recommend that taxpayers be given sufficient time after the issue of the final ruling to restructure their affairs to enable them to finance the working capital that would otherwise be provided by UPEs.

In the current economic climate if small to medium sized enterprises are required to borrow funds to pay out a UPE it could force a significant amount of trusts to cease carrying on a business as they may not be able to access sufficient third party funds to finance the payment of the UPE.

3. The application of section three which provides that a subsisting UPE may amount to either the provision of financial accommodation or an in-substance loan under section 109D(3)

Paragraph 3 of the draft Ruling defines a ‘subsisting UPE’ to mean a UPE that has not been satisfied, including by being converted into a loan.

We contend that a ‘subsisting UPE’ should be interpreted as including unpaid entitlements which the Commissioner is currently seeking to characterise as a loan under section two of the draft ruling other than where the private company consciously agrees to ‘set-off’ the amount of the UPE by making a loan to the trustee of the trust.

3(a) Subsisting UPEs do not constitute loans

Essentially, section three of the draft Ruling provides that a subsisting UPE may amount to either the provision of financial accommodation or an in-substance loan under the extended definition of ’loan’ under section109D(3).

We submit that the private company beneficiary’s equitable right to receive its trust entitlement will not be discharged where the trust deed does not provide that such an entitlement is held on a sub-trust for that beneficiary.

Furthermore, we do not accept that a UPE amounts to either the provision of financial accommodation or the making of a transaction that is an in-substance a loan.

Each of these matters is detailed below.

3(a)(i) Application of equitable principles

We do not agree with a fundamental tenet of the draft Ruling that a beneficiary’s equitable right to receive its amount from the trust is discharged on the basis that trust property is automatically settled on a sub-trust.

Paragraph 61 of the draft Ruling correctly states:

> ‘When a beneficiary is made presently entitled to an amount from a trust estate, it will have an equitable right to that amount. That is, the beneficiary has rights in equity and not, without more, as a result of any debtor-creditor relationship(7).‘

However, paragraph 62 of the draft Ruling notes states that such an equitable right is effectively discharged when trust property is settled on a sub-trust:

> ‘When a beneficiary is made presently entitled to an amount but not paid that amount, trust property representing the UPE will typically be settled on a sub-trust. In these circumstances, the beneficiary's right to demand payment of its UPE from the trustee of the main-trust is discharged and replaced with a UPE to the whole of the estate of the sub-trust (when the sub-trust is first settled, its estate will comprise only corpus). The trustee will typically continue to legally hold property so settled on sub-trust, but in its capacity as trustee of the sub-trust rather than of the main-trust’.

This statement is not correct.
Where a beneficiary is allocated an amount of net income, for that amount to be held on a sub-trust, the sub-trust must have the hallmarks of a trust. The first requirement is intention to create a trust. The second is that there must be identifiable trust property that has been separately identified as the beneficiary's property.

The net income of a trust is an accounting concept, and a person cannot point to any particular asset (including cash) and say that the asset represents net income or the beneficiary's allocation of, or share of, the net income.

However, where the trustee sets an amount aside for the beneficiary (i.e. the trustee does separate and hold money or an asset as belonging to that beneficiary), a sub-trust can arise. For a sub-trust to arise the sub-trust must be first created by the separation and identification of the asset forming the trust property. If the assets are not so separated and identified then no trust is created: Hemmens v Wilson Browne (a firm) [1995] Ch 223 and MacJordan Construction Ltd v Brookmount Erostin Ltd (in liq) [1992] BCLC 350.

We further note that paragraph 63 of the draft Ruling states that depending on the facts, a sub-trust can arise whether or not there is a specific clause providing for the creation of a sub-trust in the trust deed, citing the decision in Case U157 87 ATC 912 as an example of the creation of a sub-trust fund in the absence of a specific clause in the trust deed.

In our view, Case U157 and the AAT cases referred to in footnote [8] of the draft Ruling do not support the view expressed in the draft Ruling. That is, unless the trust deed provides otherwise, the trustee's determination and setting aside of an amount of a UPE does not create a separate trust fund of that amount or a separate trust over a trust asset.

Case U157 relies on the AAT decision in Case U111 87 ATC 912. In Case U157, the tribunal accepted (without any analysis of the case authorities) the Commissioner's submission that the specific provision in the trust deed in Case U111 merely set out what would be the position in any case by operation of law. However, in Case U111 the trust deed specifically provided for sums of income distributed to income beneficiaries were to be held by the trustee on separate trusts and the sums were dealt with in this way in the trustee's accounts. In our view, Case U111 was decided on the specific clause of the trust deed without regard to case authorities, and it does not support the broader contention that a separate trust is created whether or not there is a specific clause.

In our view, Corporate Initiatives Pty Ltd v Federal Commissioner of Taxation [2005] ATC 4392 states the correct position on this issue. In this case, the Full Federal Court rejected the taxpayer's argument that the beneficiary's share of net income was held outside the trust fund:

> ' it cannot be said that the resolution by Eldersmede as trustee of EDT to distribute $859,806 to SBS as trustee for CUT conferred on the latter any proprietary right, equitable or otherwise, in any particular asset of EDT. The amount of $859,806 was not an identifiable asset, such as money in a particular bank account, but simply a figure which corresponded to SBS's accumulated losses. … This was therefore not the case where a beneficiary presently entitled could call for a transfer of property under the rule in Saunders v Vautier …' (at p.22)
>
> 'As already noted, the resolutions for distribution did not confer on SBS as trustee for CUT any proprietary rights in any assets of EDT. Eldersmede was free to deal with those assets for trust purposes including, although not limited to, funding the distribution to CUT. Therefore it cannot be said that Eldersmede anyway could not make use of money it was holding for somebody else and thus was in no better position by reasons of SBS's failure to make demand.' (at p.24)

Accordingly, where there is no specific clause in the trust deed, a separate trust is not created over money or other trust property representing the beneficiary's UPE. In any event for such a sub-trust to arise assets representing the UPE must be identified by the trustee and set aside for that beneficiary. A beneficiary's UPE is simply an amount which corresponds with the beneficiary's share of the net income. The trust fund is unaffected by the creation of the UPE,until the beneficiary demands payment of its entitlement whereupon the trustee may pay the beneficiary from cash reserves or borrowing, or from the proceeds of sale of trust property.

In these circumstances the beneficiary's right in equity will not be discharged in which case paragraph 61 of the draft Ruling should apply to that beneficiary.

3(a)(ii) Financial accommodation

Paragraph 15 of the draft Ruling provides that where the arrangement comprising the UPE only gives rise to an equitable right to payment of the distributed amount this will not amount to a loan within the ordinary meaning of that term or the extended definition of loan under section 109D(3)(a) and (c). Nor will it be regarded as the provision of credit in the extended definition of a loan under section 109D(3)(b).

However, paragraph 16 of the ruling states:

> ‘A private company beneficiary will be said to have provided financial accommodation to a trust in which it has a UPE if that private company has, under a consensual agreement:
>
> - supplied or granted some form of pecuniary aid or favour to the trust; and
> - a principal sum or equivalent that is ultimately payable.’

We contend that the above construction is incorrect, and that the concept of ‘financial accommodation’ is limited to arrangements where payments and repayments are required or a debtor and creditor relationship arises.

We note that in paragraphs 85 to 87 of the draft Ruling, the individual dictionary definitions of ‘financial’ and ‘accommodation’ are combined to define ‘financial accommodation’ as a supply or grant of some form of pecuniary assistance or favour.

We contend that a combination of definitions to determine a phrase’s ordinary meaning is an incorrect approach to the interpretation of a statutory definition. As explained in DC Pearce and RS Geddes, Statutory Interpretation (6th ed) at [3.30]:

> ‘Somervell LJ in Lee v Showmen’s Guild of Great Britain [citation omitted] counselled that care must be taken when considering a compound expression not to look up the meaning of each word and from that construct the meaning of a phrase which may, in fact, have acquired a special meaning.’

In paragraph 93 of the draft Ruling, it is recognised that the combination of the term ‘financial accommodation’ with the other terms in the context of the definition of a loan has a narrowing effect.

We agree that the term ‘financial accommodation’ should not bear its widest meaning; nor should the term enlarge the definition of ‘loan’.

The overarching relevant statutory interpretation principle is the principle noscitur a sociis, meaning a word is known by the company it keeps or its associates. This principle includes the sub-principles of ejusdem generis (of the same kind, class or nature). As Lord Kenyon CJ once put it, where a word ‘stands with’ other words it ‘must mean something analogous to them’ (see Evans v Stevens (1791) 4 Term Rep 224; 100 ER 986 at p.987).

The High Court has said that the principle noscitur a sociis applies where there is a case of ambiguity or doubt (see, Federal Commissioner of Taxation v Whitehouse (1961) 104 CLR 25 at p 31), which is relevant here as the meaning of ‘financial accommodation’ (and also of ‘transaction") are ambiguous.

The principle of ejusdem generis is applicable to interpreting section 109D as it applies where a list of objects which share some key common feature is followed by a general ‘catch-all’ phrase. The general catch-all phrase will be limited to things of the same type (ejusdem generis) as the preceding genus.

It is essential for the application of the ejusdem generis rule that some common characteristic capable of being described as a genus is able to be identified. (See R v Regos and Morgan (1947) 74 CLR 613 at 624; Cody v J H Nelson Pty Ltd (1947) 74 CLR 629 at 648.)

The relevant phrase used in section 109D(3)(b) is ‘any other form of financial accommodation’. This phrase is used to supplement the phrase ‘provision of credit’ in the context of what is a loan. The phrase ‘any other form of financial accommodation’ ought to bear a narrower meaning having regard to its context in the definition of ‘loan’. For a provision of credit or something akin to credit to arise- in the context of a UPE for there to be credit, the beneficiary must demand payment and that demand not be satisfied by the trustee. Credit or financial accommodation can only be said to arise where post-demand the beneficiary gives the trustee time to pay the UPE.

As an example of the correct approach, the majority of the High Court in Handevel Pty Ltd v Comptroller of Stamps (Vic) 85 ATC 4706 held the phrase ‘any other securities of a corporation’ included in the statutory definition of ‘debenture’ was limited by reference to the preceding words in the definition to securities commonly understood to be debentures.

Notwithstanding the acceptance that the term ‘financial accommodation’ has a narrowing effect in the context of the definition of ‘loan’, paragraph 93 of the draft Ruling adopts the widest meaning of the term determined by the combination of the dictionary definitions under paragraph 87.

We submit that there cannot be a financial accommodation under section 109D(3)(b) unless there is a demand by the beneficiary for payment of the UPE and that demand is not satisfied. The fact that a UPE may provide a "benefit" in that the trustee retains the trust fund and can use the trust fund (as working capital or for investment) does not mean that this (so called) benefit is a form of financial accommodation.

As discussed, paragraph 16 of the draft Ruling provides that a private company beneficiary will be taken to have provided financial accommodation if that private company has supplied or granted some pecuniary aid or favour under a ‘consensual agreement’. This interpretation is strained and misconstrues the meaning of financial accommodation. Moreover, it broadens the meaning beyond what is justified by the context of section 109D.

This interpretation cannot be justified unless first there has been a demand by the beneficiary. And, even so, we consider that the Commissioner's view of what amounts to a consensual agreement does not tally with case law.

The Commissioner expresses the view in paragraph 18 that, in relation to the provision of financial accommodation, a consensual agreement ‘may’ arise where the private company authorises the continued use of trust funds by not calling for payment of a UPE or not calling for the investment of funds representing the UPE for the company’s absolute benefit. He then states in paragraph 19 that this is an authorisation that ‘would’ amount to a consensual agreement.

As discussed, such an authorisation cannot arise unless there is conscious acquiescence with knowledge for the reasons detailed above. Accordingly we do not accept the view that the failure of a private company beneficiary to call for payment of a UPE is sufficient in itself for there to be ‘consensual agreement’ where there is common control of the trustee and the private company beneficiary.

Moreover, there is no discussion in the draft Ruling as to what is meant by the term ‘consensual’.

The Oxford dictionary defines ‘consensual’ as relating to or involving consent. ‘Consent’ is then defined as to ‘give permission’ or ‘agree to do’.

The draft Ruling provides no technical support for the claim that not doing something, even between commonly controlled entities, is ’consensual’ for the purposes of whether there is a provision of financial accommodation.

In our view the expression ‘consensual agreement’ should be interpreted according to its meaning under contract law where it is typically regarded that there must be some positive acts by the parties in order for there to be a consensual agreement.

This needs to be clarified.

3(a)(iii) Transaction that is an in-substance loan

Paragraph 22 of the draft Ruling asserts that the private company beneficiary’s authorisation (or acquiescence with knowledge) that funds representing the UPE can be used by the main trust is a transaction which effects an in-substance loan to the trust under section 109D(3)(d).

Paragraph 148 further provides that whilst a UPE may not involve a payment and repayment, a UPE that a beneficiary has allowed to remain outstanding for use by the trustee for trust purposes is practically the same as a UPE that is paid to the beneficiary and lent back to the trust.

As indicated above the ejusdem generis principle of statutory interpretation would be applied to the phrase "a transaction… which in substance effects a loan of money". Taking s109D(3) as whole it is clear there must be a some positive act by the "creditor" such as (a) an advance, (b) a provision of credit, or (c) a payment, which forms the essence of the thing that will be the loan for section 109D purposes. Thus the 'transaction' must involve some positive act for section 109D to apply. A failure to call for a UPE is not a positive act and section 109D(3) will therefore not apply.
In Grimwade v Federal Commissioner of Taxation (1949) 78 CLR 199), the Court considered the meaning of 'transaction' in the context of the Gift Duty Assessment Act 1941-1942 (Cth) (the Gift Duty Act). The Gift Duty Act stated that:

> ' a 'disposition of property' ... includes any transaction entered into by any person with intent thereby to diminish, directly or indirectly, the value of his own property and to increase the value of the property of any other person'.

Rich J considered the dictionary meanings of 'transaction' which defined a transaction as 'an act, doing, negotiation or dealing', 'Negotiation: dealing between man and man: management; affairs; things managed'. His honour then held at p.22

> 'Whatever may be the precise meaning of the word in s. 4 (f), it should in my opinion be construed as meaning some act, doing, negotiation or dealing by a donor in favour of a donee, whether by a direct or indirect method'.

In Grimwade, it was held that 'a transaction by a person must be a transaction with some other person'. In that case it was held that action of Grimwade in voting for a reduction of capital did not constitute a transaction as there was no evidence that there was an agreement with another party that Grimwade would vote in this manner.

In Gorton v Federal Commissioner of Taxation (1965) 113 CLR 604 in considering legislation similar to the Gift Duty legislation, it was held that there was a 'transaction' within the meaning of the legislation, and it was not merely unilateral acts on the part of one person.

In Grimwade, it was further stated by Latham CJ and Webb J at p.220 that:

> 'All these contentions interpret the words "enter into a transaction" as if they had the same meaning as "do an act or abstain from doing an act." Such an interpretation gives no real effect to the words "enter" and "transaction.'

Thus the "transaction" must involve some positive act for section 109D to apply and a failure to call for a UPE to be paid is not such a positive act

3(b) Application issues When does a UPE 'flip over' to a loan?

Should the Commissioner's views in section three prevail (which is not conceded) we note that there are significant prospective and retrospective issues that would need to be addressed as discussed below

3(b)(i) When does a UPE 'flip over' to a loan?

Our first concern is to clarify how the draft Ruling would prospectively apply in relation to converted loans.

Section three of the draft Ruling provides no guidance as to trigger point as to when a subsisting UPE under Subdivision EA will 'flip over' and be converted to a loan subject to section 109D(3).

Given the Commissioner's view that a UPE can be converted into a loan where there is acquiescence with knowledge it appears that there is an argument that such a conversion arises upon such acquiescence taking place. As the ruling asserts that acquiescence can also arise where the beneficiary does not call for payment of the UPE or the investment of the funds representing the trust entitlement it appears that the UPE may flip over and be converted at the time of that inaction. If so, it would prima facie appear arguable that the above conversion takes place at the time the beneficiary first becomes entitled to an amount from the trust.

Whilst we would refute this approach on technical grounds it will be imperative that this timing issue is appropriately addressed if the draft Ruling is finalised.

3(b)(ii) Retrospectivity

Assuming the views in section 3 prevail (which is not conceded) the ruling should be amended so that it only applies prospectively from the date on which the ruling is finalised, and not from the date of issue of the draft Ruling.

Further, the ruling should be amended so that any UPEs in existence before that time do not have to be paid out or put on a section 109N complying basis after that time. That is, confirmation should be provided that all such UPEs are fully grandfathered so as to be permanently outside the scope of any finalised ruling.

4. The residual application of Subdivision EA

Should sections two and three of the draft Ruling be finalised in their current form we believe that there will only be a minor residual role (if any) left for Subdivision EA as the vast majority of UPEs will be subject to section 109D.

As discussed, such an outcome would be totally at odds with the underlying policy intent of Subdivision EA.

Paragraph 26 of the draft Ruling highlights the proposed restricted application of Subdivision EA as follows:

> 'In some instances, funds settled on sub-trust may be lent back to the main-trust for a return. In these instances, Subdivision EA will operate to treat that loan from the sub-trust to the main-trust as a dividend(3), but only to the extent to which the private company has a present entitlement to an amount of the net income of the sub-trust estate (where the other provisions of section 109D are satisfied and the private company has a distributable surplus within the meaning of section 109Y as modified by subsection 109XC(7))'.

The application of paragraph 26 is illustrated in example 6 of the draft Ruling where a trustee of a trust sets aside the amount of the UPE on a sub-trust, and the main trust invests those funds on sub-trust on terms entitling the sub-trust to all the benefits that flow from the use of those funds by the main trust. Accordingly, the private company beneficiary will be entitled to any income derived by the sub-trust from this investment.

Assuming the terms of example 6 apply as drafted there are an array of complex compliance issues for tax practitioners and their clients which need to be clarified.

For example, it is unclear whether it would be necessary for the trustee of the main trust to apply for a separate tax file number and prepare a separate income tax return on behalf of the sub-trust, or whether all relevant income tax issues can be dealt with in the income tax return of the main trust. Alternatively, could all of the income generated by the sub-trust be directly attributed to the private company beneficiary in order to reduce complexity?

It is also unclear whether it will be necessary for separate accounts to be maintained in respect of the sub-trust especially if the original funds set aside in the sub-trust accumulate over time so that it is necessary to annually trace the income derived by the sub-trust and monitor what trust assets are held in the sub-trust.

Clarification will also need to be obtained as to how this process would work where the trustee of the main trust otherwise allocates income across all the beneficiaries of the main trust in accordance with the proportionate approach.

All of these practical issues need to be clarified in any finalised ruling so that tax practitioners and their clients have some guidance as to how 'example 6' can be appropriately complied with in practice.

5. Certain adverse tax consequences which arise from the draft Ruling

Apart from the considerable uncertainty generated by the draft Ruling it could have two other very serious consequences for taxpayers being the potential incidence of double taxation and the denial of interest deductions on funds borrowed to finance the repayment of a UPE.

Each of these issues is discussed below.

5(a) Double Taxation

We believe that the draft Ruling could result in double taxation.

A private company beneficiary will be subject to tax at a rate of 30% on any distribution of net income distributed by the trustee even where the amount of that trust entitlement remains unpaid.

By subsequently deeming UPEs to be section 109D loans and therefore, deemed dividends, the same amount of trust income will be taxed a second time albeit as the net income of the trust.

For example, a declaration of $100 trust income would be fully assessable to the private company beneficiary who would suffer tax of $30 on the amount with the $70 being left in the trust to help finance its working capital needs. Assuming the company funds the payment of its own $30 tax liability it will then be deemed to have provided a 'loan' for the $100 amount of the UPE at some undefined time to the trustee of the trust which will be a deemed dividend under section 109D(3) applying the terms of the draft Ruling. This will increase the assessable 'net income' of the trust without any commensurate increase in the income of the trust estate. Assuming the proportionate view prevails all beneficiaries will receive a proportionate share of the $100 deemed dividend without any cash distribution to finance the payment of their share of the deemed dividend.

In certain circumstances a total tax rate of up to 76.5% (30%+46.5%) could apply in relation to the same amount being 30% borne by the private company beneficiary and up to 46.5% on the deemed dividend depending on whether the trustee, an individual beneficiary or the company suffers tax on the deemed dividend.

We note that this punitive rate of tax will apply even though there is no tax avoidance involved and that this practice has been accepted since the inception of Division 7A.

Measures to prevent the potential incidence of double taxation must be set out in any finalised ruling.

5(b) Interaction of TR 2005/12 with the draft Ruling

Assuming that the ruling is finalised as drafted many affected trusts will be compelled to borrow funds at interest to pay out a UPE to avoid a deemed dividend arising under section 109D(3) especially if section two of the draft Ruling continues to have a fully retrospective application.

From a practical perspective many of these trusts will be hard pressed to obtain such borrowings especially during the current downturn where third party finance is very difficult to obtain.

In these circumstances it needs to be clarified whether the Commissioner will apply Taxation Ruling TR2005/12 to deny an income tax deduction for any interest paid to finance the repayment of a UPE 'loan' by the trustee of a trust.

We submit that to apply the draft Ruling in these circumstances would be highly inequitable especially where the funds representing the UPE were being used as working capital in a business carried on by the trustee of the trust.

We contend that such a result is another reason why the application of any finalised ruling should be wholly prospective in nature.

Conclusion

Our considered view is that the draft Ruling

- contradicts the underlying legislative purpose of section 109D and Subdivision EA of Division 7A;
- contains various arguments which are legally flawed;
- makes the operation of Subdivision EA effectively redundant, and
- creates adverse tax consequences for trusts and corporate beneficiaries including double taxation.

Moreover, the proposed retrospectivity of application is unacceptably harsh especially given the uncertainty concerning the various concepts set out in section two of the draft Ruling.

We therefore strongly recommend that the draft Ruling be withdrawn.

Attachment 1

History of section 109UB / XA

Review of documents supporting policy and understanding on the application of the provisions

1. Purpose of document

1.1 On 17 July 2009, the ATO held a meeting with members of the National Tax Liaison Group Division 7A working party [the NTLG subgroup] to outline its view on the potential application of section 109D to unpaid present entitlements [the ATO view]. At that meeting, the ATO requested feedback as to "how a situation had evolved" where members did not appreciate this ATO view.

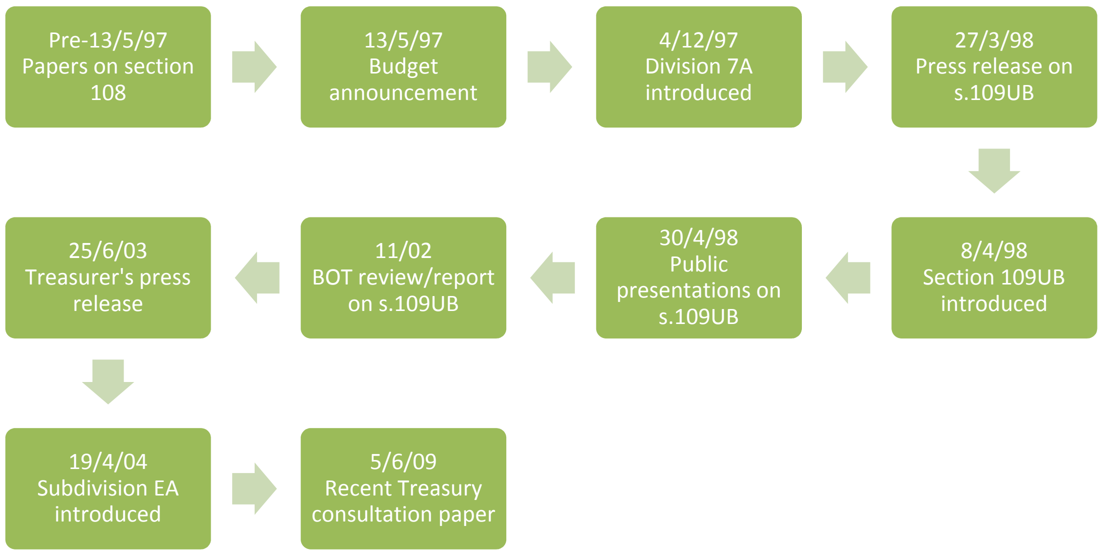
1.2 This memorandum has been prepared for the sole purpose of considering this "evolution" question posed by the ATO. From our analysis, the documents reviewed in this memorandum present a clear policy objective contained in Division 7A – that section 109D was not intended to cover unpaid beneficiary entitlements and that section 109UB was inserted as a measure to deal with the arrangement.

1.3 We note that this memorandum does not focus on any comments made publicly by the ATO on the current issue. Two documents prepared by Mr Theo Sakell of Pitcher Partners [reference numbers 135781_1 and 136335_1], which have been circulated to the NTLG subgroup, provide an excellent summary of those documents. I also refer to the letters circulated by Mr Mark Leibler [dated 01/9/09 and 21/09/09], which provides a critical review of the operation of Division 7A to unpaid present entitlements.

1.4 While this memorandum is not intended to revisit any of the findings contained in those documents, it is important to note that the findings and conclusions contained in this memorandum is both consistent with and supports those contained in the letters provided by both Mr Sakell and Mr Leibler.

2. Relevant time line

2.1 This memorandum considers documents that were publicly released at the times contained in the following time line.



3. Pre 13 May 1997: Before Division 7A

3.1 Prior to the introduction of Division 7A, section 108 was the main provision contained in the 1936 Act that dealt with loans to shareholders. A common issue, that was highlighted in a number of publicly available articles at the time, was whether section 108 could apply where there was an unpaid present entitlement from a trust to a corporate beneficiary.

3.2 We note, that this issue was raised publicly on numerous occasions by various commentators. For example, prior to the Government's announcement on Division 7A, the issue was discussed in the 1996 paper presented by Walker J Tieleman at the TIA State Convention WA Division. In this paper, the following statement was made[1]:

> 'A common predicament for taxpayers using corporate beneficiaries is the potential for the application of s.108 in the case where they do not draw trust distributions made in their favour. Can it be said in these instances that the undrawn distribution represents the payment of an amount to an associated person by way of advance or loan?'

3.3 A number of additional articles at the time considered the potential application of section 108 to unpaid present entitlements[2], which are still available on the Tax Institute of Australia's database.

3.4 Having regard to the number of articles written on this issue at the time, it is reasonable to assume that these arrangements would have been considered at the time of drafting section 109UB.

4. 13 May 1997: 1997-1998 Budget announcement

4.1 On 13 May 1997, the Government made its budget announcement, whereby private company loans would be deemed to be unfranked dividends.[3] The budget measure was titled "Taxation of distributions disguised as loans from private companies".

4.2 It is noted that the budget paper did not specifically make reference to unpaid present entitlements and did not provide sufficient detail on the proposed definition of a loan. Accordingly, at this time, it was uncertain whether the proposed measures would apply to unpaid present entitlements.

5. 4 December 1997: Legislation introduced

5.1 *Taxation Laws Amendment (No.7) Bill 1997* was introduced into Parliament on 4 December 1997. The Bill as introduced did not contain section 109UB.

5.2 The definition of a "loan" as contained in section 109D(3) of the original Bill has not changed since its introduction in TLAB 7[4]. Despite public commentary provided on the issue of unpaid entitlements, the legislation, as introduced, failed to address the treatment of unpaid entitlements under Division 7A.

6. 27 March 1998: Assistant-Treasurer Kemp's press release

6.1 On 27 March 1998, Assistant Treasurer Kemp announced additional amendments to Division 7A[5]. Specifically he stated that:

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[1] Tieleman, WJ., & Tieleman, M., "Section 108 – Deemed Dividends", TIA State Convention, Western Australian Division, 17 May 1996, page 7.

[2] Refer for example to Robertson, M., "Section 108 – existing and proposed legislation", 1997, which considers the application of section 108 to unpaid entitlements prior to the release of Division 7A. The TIA website contains numerous examples of such articles.

[3] 1997-98 Budget Paper No.2, page 173.

[4] Taxation Laws Amendment Bill (No. 7) 1997.

[5] Hon Rod Kemp, "Taxation of distributions disguised as loans from private companies, Press Release No.011, 27 March 1998

> 'It has been argued that the proposed legislation does not apply to arrangements where a corporate beneficiary has become presently entitled to net income of a trust and the amount is not paid by the trustee to the corporate beneficiary, but continues to be held by the trustee who then provides a loan to a shareholder (or their associate) of the corporate beneficiary' [emphasis added].

6.2 There are a number of important statements made in the press release. The first is that press release begins with "it has been argued". The argument that Division 7A would not apply to the "arrangement" as described was highlighted in a number of articles written by the profession at the time. One noticeable article, by John Middleton in relation to the TIA Queensland State Convention, stated the following[6]:

> 'As originally drafted, the tax profession took some delight in pointing out that Div 7A would not apply to a "loan" to a discretionary trust by a corporate beneficiary (care is needed in the use of the term "family" trust due to the growing meaning that term is taking from the trust loss and dividend streaming provisions).'

6.3 Accordingly, the first aspect of the press release acknowledges that section 109D would not apply to unpaid present entitlements. The press release then went on to appropriately describe the arrangement that would be covered by [the new] section 109UB. Importantly, the arrangement, as described, only appeared offensive if the "amount" was subsequently provided as a loan to a shareholder or associate of the corporate beneficiary. Implicit in this press release is the case that the arrangement would not have been offensive if the cash was retained on trust and used in (say) working capital of the trust.

6.4 A number of articles that were released at that time (and subsequently) also support this statement contained in the press release, being that the legislation would not apply to "unpaid present entitlements" where the underlying cash was retained in the trust. We note that the article by John Middleton also provided some commentary on the "sub-trust" approach as follows:

> **'The Sub-Trust approach**
> There is no loan from a corporate beneficiary back to a discretionary trust where the discretionary trust distributes money to the corporate beneficiary. Where the distribution is not actually paid to the company, those monies are in fact held on a separate sub-trust for the benefit of the company, and are not treated as a loan at all. Of course, it is quite possible to turn it into a loan, and payment of interest on monies outstanding may well be sufficient to do this. However, for the most part, it will acquire something more than mere journal entries to create a loan in this circumstance.'

6.5 In relation to the John Middleton article, we highlight that the article was written in response to the Open Forum of the Taxation Institute of Australia's 1999 Queensland State Convention. Interestingly, the ATO were present at the open forum and according to John Middleton provided feedback in relation to certain questions raised. In his article, John states:

> '…an ATO representative confirmed the ATO view that s 109UB (contained in Div 7A) is even harsher than originally thought, which has implications for all trusts with a corporate beneficiary.'

6.6 The comment is made in relation to the ATO view provided on an example presented to the ATO. The example is repeated below:

> 'Since October 1996, a private company has been entitled to a distribution from a discretionary trust, but this distribution has never been paid. No further unpaid distributions have been made to the company since October 1996. On 1 June 1999, the discretionary trust makes a loan to a shareholder of the private company for $500,000. This loan is fully repaid to the trust within 2 weeks (and certainly by 30 June).
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> In this situation, as far as the ATO is concerned, the shareholder has received a $500,000 unfrankable dividend. In the ATO's view, it does not make any difference if the present

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[6] Middleton, J., "Division 7A – is the corporate beneficiary dead?", ATP, Weekly Tax Bulletin, Issue 22, 24 May 1999.

entitlement to the corporate beneficiary is fully paid by 30 June (ie the repayment of the monies to the trust is then paid by the trust to the company in satisfaction of the present entitlement).'

6.7 We believe that it is important to note that the example presented to the ATO above highlighted a retention of trust funds for a period of three years. In the ATO response to the question, the only provision considered was the application of section 109UB. That is, section 109D was not raised as a concern in response to the example provided.

7. 8 April 1998: Introduction of revised Bill

7.1 On 8 April 1998, a revised Bill was introduced into the House of Representatives. The revised Bill contained section 109UB. The explanatory memorandum contained very little by way of background to the new provisions. However, the following comments were made:

> **'Certain trust amounts treated as loans**
> 9.82 New section 109UB will apply if a private company, as a beneficiary of a trust estate, is or has been presently entitled to some or all of the net trust income which has not actually been paid. In such a situation the amount to which the company is presently entitled is held on a secondary trust for the benefit of the company. The provision applies to any subsequent loan by the trustee to a shareholder (or associate) of the company.
>
> 9.83 The loan from the trustee is treated as a loan by the private company to the shareholder (or associate) of an amount not exceeding the amount of income held on trust for the company, reduced by any amounts previously treated as a loan by new section 109UB in relation to the trust amount. [New subsection 109UB(2)]'

7.2 It is noted that the discussion of the "sub-trust" issue in the EM accords with many of the articles written at the time, whereby it was accepted that the sub-trust relationship did not result in a loan under section 109D [see for example comments by John Middleton at paragraph 6.4 of this memorandum].

8. 30 May 1998: TIA New South Wales State Convention

8.1 The proposed application of Division 7A was discussed at the TIA's New South Wales State Convention on 30 May 1998, after the introduction of the new Bill containing the section 109UB amendments. At this convention, Patrick Mayes' made a number of observations on unpaid entitlements[7]:

> ' … the obvious weakness in the original legislation regarding advances by trusts to beneficiaries (quasi shareholders and their associates) out of funds which essentially relate to private company beneficiary entitlements have been brought within the ambit of the Division …
>
> Section 109UB at last recognises a previous total failure by the ATO to recognise the realities of the real world as it relates to the crediting of trust distributions to corporate beneficiaries where those corporate beneficiaries do not actually receive the trust distribution for which they are beneficially entitled but leave those funds in the Trust which then in turn advances the money to persons who may be shareholders or associates of shareholders of that corporate beneficiary. …
>
> It is interesting that this provision [section 109UB] may, in itself, acknowledge that the previous arrangement was ineffective insofar as its application under section 108 was concerned.'

8.2 The TIA convention was one of the first conducted after the introduction of section 109UB. The presentation and paper provided a contemporaneous review of what was considered (at the time) to be the ATO view on the application of section 108 and Division 7A to unpaid present entitlements. The presentation covered the arrangement whereby funds would be retained in a discretionary trust where a corporate beneficiary was used. The paper covered commentary on the application of Division 7A, absent section 109UB.

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[7] Mayes, P., "The New Deemed Dividend Rules", TIA State Seminar NSW Division, 1998, page 2.

9. November 2002: Board of tax review of section 109UB

9.1 During the next few years, many practitioners highlighted the inappropriate application of Division 7A in a number of circumstances. That is, many papers outlined the harsh consequences that would occur on applying section 109UB, as opposed to section 109D, to an interposed trust arrangement.

9.2 Subsequently, in November 2002, the Board released its report on the *Taxation of Discretionary trusts*[8]. Chapter 4 of this report discussed the application of section 109UB and, in particular, asked the following question:[9]

> 'Should the existing rules preventing the use of corporate beneficiaries to allow individuals access to the lower company tax rate be made more effective?'

9.3 In examining this issue, the Board report discussed the general application of Division 7A to unpaid entitlements. Importantly, paragraph 71 to 73 contained a description of arrangement that was the subject of section 109UB and Division 7A:

> '71 … The deemed dividend rules operate by deeming certain advances, loans and other benefits provided by private companies to shareholders (or associates) to be assessable dividends, to the extent that the company has a distributable surplus.
>
> 72 The ambit of the deemed dividend rules <u>is extended to trusts</u> by section 109UB of the ITAA 1936, which applies to a private company that is a beneficiary of a trust estate. A trustee can make a company presently entitled to trust income without distributing cash to the company. <u>This allows a trust to effectively accumulate income</u> that has been taxed only at the company tax rate. Section 109UB deals with the case in which a trustee:
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> - makes a company presently entitled to trust income (so as to access the company tax rate), and
> - then distributes the <u>underlying cash</u> to individual beneficiaries through loans (so that the beneficiaries avoid paying any 'top-up' tax that would be imposed on a distribution if the beneficiaries have a higher marginal tax rate).
>
> 73 Section 109UB deems the loan to have been made by the company, thus attracting the operation of the deemed dividend rules.' [<u>emphasis added</u>]

9.4 The observation of the Board clearly highlights the practice and ability to "accumulate income" in the trust, without triggering the operation of Division 7A. That is, the report indicates that the provisions [i.e. Division 7A] were only extended to trusts where a subsequent loan was made to the shareholders or associates. This is made clear in paragraphs 74 and 75, where the Board report outlines the ineffectiveness of section 109UB:

> '74 Section 109UB, however, does not cover a case in which:
>
> - the trustee makes a private company presently entitled to trust income, but does not pay the income to the company; and
> - the trustee then distributes the underlying cash to trust beneficiaries, but not as a loan.
>
> 75 In such circumstances, the individuals are able to access, without further tax liability, trust income that has been taxed only at the company tax rate.'

9.5 The reference to the use of the "underlying cash" and the description of the transaction by the Board is clear enough to establish that the Board review had considered the operation of Division 7A in the cases and examples that have been recently outlined by the ATO. The conclusion that only the "corporate tax rate" would apply is a clear indication that the Board concluded that Division 7A did not apply to the transaction. The discussion paper therefore strongly supports the view that both the [then] Government

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[8] Board of Taxation Report, "Taxation of Discretionary trusts", November 2002.

[9] Board of Taxation Report, paragraph 69.

(who commissioned the Board to perform this review) and the Board did not consider that such an arrangement would be covered by a provision outside of section 109UB.

9.6 We highlight that the Board included representatives from both the ATO and Treasury, as well as external members. Accordingly, had there been some uncertainty in relation to the application of section 109D to the arrangements covered in Chapter 4 (and in particular paragraph 74), we are certain that the Board would have highlighted the possible application of section 109D. The integrity concern presented in the Board paper did not consider the possible application of section 109D to unpaid entitlements as a (specific) resolution to the issue.

9.7 However, in response to the integrity concern highlighted, the Board considered that changes were needed to section 109UB to “improve the effectiveness” of the deemed dividend rules so as to more effectively prevent beneficiaries accessing trust income that had borne tax only at the company tax rate.

9.8 To achieve this outcome, the Board put forward two recommendations. This first option was contained at paragraph 81. The option suggested an amendment to section 109UB to improve the effectiveness of the provision. We note that this first option resulted in the replacement provisions contained in Subdivision EA.

9.9 Importantly, the second option outlined a proposal to repeal section 109UB, to be replaced with a provision that would limit the use of unpaid entitlements (irrespective of the use of the underlying cash). The option was contained in paragraph 82, and is repeated below:

> ‘Alternatively, section 109UB could be repealed, and replaced with a section setting out the consequences where a trustee makes a company presently entitled to the income of a trust, but does not pay the funds to the company within a reasonable period. The consequences could be either that the trustee would be assessed on the amount of the income as if there had been no distribution, or that the company would have to pay a top-up tax (which could create franking credits in the company).’

From this, it is clear that the Board report considered the policy underlying the operation of section 109UB and section 109D. The alternative approach put forward by the Board makes it clear that an unpaid present entitlement (even when not paid in a reasonable period) did not trigger the operation of section 109D. This conclusion stands in stark contrast with the ATO’s view about the operation of these provisions.

10. 25 June 2003: Treasurer’s media release

10.1 On 25 June 2003, the then Treasurer, Peter Costello, announced details of the Government’s amendments to section 109UB[10]. He stated that:

> ‘On 12 December 2002, I announced, in response to the recommendation of the Board of Taxation, in its report on the Taxation of Discretionary Trusts, that the Government would improve the effectiveness and fairness of the deemed dividend rules contained in Division 7A of the *Income Tax Assessment Act 1936’* [emphasis added]

10.2 It is clear from this press release, and the subsequent amendments to section 109UB (now contained in Subdivision EA), that the Government decided to proceed with the first recommendation of the Board – i.e. to amend section 109UB to improve the effectiveness and fairness of the section.

10.3 That is, the Government made a clear policy choice to allow trusts to retain the underlying cash in the trust by not proceeding with option two. Option two would have taxed the retention of funds to the trustee, while option one would only trigger a taxing point if the funds were later paid, loaned or distributed [by way of forgiveness] to the beneficiaries of the trust.

[10] Hon Peter Costello, “Taxation of discretionary trusts – replacement of section 109UB”, Media Release No. 055, June 2003.

10.4 We believe that this choice made by Government further demonstrates a clear intention of the policy of Division 7A and Subdivision EA. We also believe that this policy choice by Government makes it relatively difficult for the ATO to argue that section 109D was intended and drafted to apply to unpaid present entitlements to corporate beneficiaries.

11. 19 February 2004: TLAB (2004 Measures No. 1) Bill 2004

11.1 On 19 February 2004, *Tax Laws Amendment (2004 Measures No. 1) Bill 2004* was introduced into the House of Representatives. The Bill contained the amendments to section 109UB, being the introduction of Subdivision EA to the 1936 Act. The EM to the Bill provided an explanation of the purpose of the amendments. Importantly, the EM was consistent with the policy of the provisions as provided by the Board report in 2002:

> '8.2 The rules are designed to ensure that a trustee cannot shelter trust income at the prevailing company tax rate by creating a present entitlement to a private company <u>without paying it and then distributing the underlying cash</u> to a shareholder of the company. The rules replace the former section 109UB of the ITAA 1936 that had a similar, but more limited, application.' [<u>emphasis added</u>]

11.2 The EM is consistent with the integrity issue identified in the Board report. It specifically refers to the arrangement (being the retention of the underlying cash and subsequent distribution of the underlying cash) that was the subject to the new provisions. Accordingly, the background and policy discussion contained in the EM clearly indicates that Subdivision EA was specifically introduced to deal with the treatment of an unpaid present entitlement under Division 7A in limited circumstances, and that an unpaid present entitlement of itself was not considered by the Treasury or Government to be an arrangement otherwise within the ambit of Division 7A outside of Subdivision EA.

12. 5 June 2009 – Treasury consultation paper

12.1 In the recently released Treasury consultation paper[11], Treasury includes a number of comments on the current operation of Division 7A, as it applies to unpaid present entitlements. Under section 3, Treasury states:

> 'The rules in this part of Division 7A are designed to ensure that a trustee <u>cannot shelter trust income at the prevailing company tax rate</u>. This could occur by the trust creating a present entitlement in favour of a private company as a beneficiary, not paying the amount to the company, and <u>then distributing the underlying cash</u> to a shareholder of the company.
>
> To prevent this, Subdivision EA deems certain payments, loans, or forgiven debts by a trustee of a trust estate to a shareholder (or their associate) of a private company to be included in their assessable income as if it were a <u>dividend</u>, in situations where the private company is presently entitled to an amount from the net income of the trust estate and that amount has not been fully paid.' [<u>emphasis added</u>]

12.2 We believe that the consultation paper clearly highlights the Treasury view in relation to the current operation of Subdivision EA and its intended application to unpaid entitlements. If Treasury were of the view that section 109D was intended to apply to the above situation, we believe that Treasury would have included this comment in the Treasury paper.

12.3 To support this view, the Treasury paper provides two examples where (accordingly to the paper) Division 7A does not effectively capture certain arrangements. The examples contained in the Treasury paper are Examples 3.2 and 3.3. An analysis of the examples is provided below, which we believe clearly demonstrates that Treasury is not of the view that an unpaid present entitlement is a loan for the purpose of section 109D.

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[11] Treasury consultation paper, "Improving fairness and integrity in the tax system – tightening the non-commercial loan rules in division 7a of the income tax assessment act 1936", 5 June 2009.

12.4 Example 3.2 describes a situation where a second trust is interposed between the trust making the payment and the private company with the unpaid present entitlement. In this situation, the first trustee distributes an amount to the second trust, without paying the underlying cash to the second trust (i.e. creating an unpaid present entitlement). The second trust then distributes the amount to a private company, without paying the underlying cash to the private company (i.e. creating an unpaid present entitlement). In the paper, Treasury highlight a concern that Division 7A would not operate if the first trust then made a payment, loan or debt forgiveness to a shareholder or associate of the private company. Accordingly, amendments are suggested to cater for this arrangement.

12.5 However, we highlight that if Treasury were of the view that an unpaid present entitlement were a loan within section 109D, there would be no need for the proposed amendment. That is, the unpaid distribution from the second trust to the private company would be considered a loan from the company in question under section 109D. Furthermore, the loans between the various entities would also trigger the application of section 109T (the interposed entity provision).

12.6 A similar conclusion occurs in relation to Example 3.3, whereby the proposed amendment would not be required to Division 7A if the unpaid entitlements in the example were instead treated as a loan.

13. Disclaimer

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