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FACT SHEET

Unpaid Distribution Entitlements – Rules affecting distributions to Corporate Beneficiaries

Why Use Corporate Beneficiaries?

If your family group includes a trust, an effective tax strategy has often involved setting up a corporate beneficiary to receive trust distributions in place of individuals with high marginal tax rates. The company serves to cap the tax payable on trust income at the company tax rate, and provides the opportunity to distribute the income from the company in the form of franked dividends at a future date more suitable to shareholders' tax positions.

As with any trust distribution payable to a beneficiary, the distribution does not need to be paid across to a corporate beneficiary in order to be recognised for tax purposes. Where such a distribution entitlement is not paid across (or not paid across in full), an Unpaid Distribution Entitlement (UPE) arises between the trust and company.

What are the rules impacting distributions to Corporate Beneficiaries?

Legislation exists to recognise UPEs due to corporate beneficiaries as loans. As a result, UPEs due to corporate beneficiaries are caught in the Division 7A net depending on when the UPE arose.

Division 7A essentially treats certain loans as deemed dividends (i.e: income) in the hands of the borrower if they are not repaid by a certain date[1], unless certain conditions are satisfied. The most common of these conditions involves treating the loan as an interest-bearing loan complete with a complying loan agreement, prescribed interest rate and a finite repayment period set out in accordance with ATO guidelines.

Therefore, unless certain conditions are satisfied trusts will automatically become assessable on any distribution entitlements due but not paid to the corporate beneficiary by a certain date[1]. The income assessed will take the form of an unfranked dividend, and will be assessable to the trust in the subsequent year.

When does Division 7A apply to Unpaid Distribution Entitlements due to Corporate Beneficiaries?

Division 7A potentially applies to UPEs payable to corporate beneficiaries arising:

- On or after 16 December 2009, and
- Before 16 December 2009 in certain circumstances

When does Division 7A apply to Unpaid Distribution Entitlements due to Corporate Beneficiaries arising before 16 December 2009?

Division 7A potentially applies to UPEs payable to corporate beneficiaries arising before 16 December 2009 where:

- There is an express loan agreement converting the UPE to an ordinary loan
- There is an implied loan agreement which has the effect of converting the UPE to an ordinary loan. The ATO will deem situations such as the following to constitute an implied loan agreement:
    - UPE is disclosed as a "loan" in the financial statements of the trust and company as opposed to an "Unpaid Distribution Entitlement"
    - Interest is charged on the unpaid distribution entitlement
    - UPE is disclosed as a "loan to associate" in the company's income tax return
    - Unrelated cash or kind transfers between the trust and company are co-mingled against the UPE balance in the accounts of the trust and company

1 Certain date is the date the borrower's income tax return is lodged or due to be lodged, whichever is earliest

**Disclaimer: The information contained in this fact sheet is not intended as specific advice.
Please contact Enspira Financial to discuss your individual situation.**

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How can I avoid the application of Division 7A in this situation?

Trustees can avoid the application of Division 7A in relation to UPEs due to Corporate Beneficiaries provided one of the following actions is taken by the time the trust's income tax return is lodged, or is due to be lodged:

- The trust pays the UPE due in full
- A "sub-trust" arrangement is put in place for the benefit of the corporate beneficiary in relation to the UPE. Sub-trust arrangements are discussed below

If neither action is taken, the UPE converts to a Division 7A loan on the date the trust's income tax return is lodged or is due to be lodged, whichever is earlier. If the UPE is created in Year 1, the trust is then regarded as having received an unfranked dividend equivalent to the amount of the Division 7A loan in Year 2 unless:

- The loan is repaid prior to lodgement of the corporate beneficiary's Year 2 income tax return (sometime in Year 3), or
- The trust and corporate beneficiary enter into a complying Division 7A loan agreement prior to lodgement of the corporate beneficiary's year 2 income tax return (sometimes in Year 3), or
- The corporate beneficiary has insufficient retained profits to pay the deemed dividend

What is a Sub-Trust arrangement?

A sub-trust arrangement in this context basically means funds or assets with value equivalent to the UPE are being held separately and in trust for the sole benefit of the corporate beneficiary. The trust deed may implicitly allow a UPE to trigger a sub-trust – if not the trustee needs to make a resolution to create the sub-trust. A UPE relegated to a sub-trust may be invested in accordance with one of the following options:

- A 7-year interest-only loan
- A 10-year interest-only loan
- Investment in an income-producing asset on commercial terms for the sole benefit of the corporate beneficiary

The detailed mechanics and requirements of each of the above options are summarised and compared in the table in Appendix 1. Regardless of the investment option chosen the arrangement must be for the sole benefit of the corporate beneficiary and:

- The sub-trust must be established by the time the trust lodges its' income tax return (or is due to lodge its income tax return)
- The investment option cannot be switched once the sub-trust is established
- A separate sub-trust must be established for different corporate beneficiaries in order to comply with the "sole benefit" requirement. The same sub-trust can be used however for a unique corporate beneficiary year after year

What Next? If planning to use a corporate beneficiary as part of your trust distribution strategy:

- If you wish to avoid the application of Division 7A to corporate beneficiary UPEs, ensure the UPE is settled or a sub-trust is put in place by the time the trust's income tax return is lodged (or is due to be lodged). If a sub-trust is put in place, ensure required documentation is prepared
- Review the trust deed to ensure that a sub-trust is permitted, if that option is relevant
- If Division 7A is triggered, put a complying loan agreement in place by the time the company's Year 2 income tax return is lodged in order to avoid the loan being deemed a dividend. Minimum interest must be charged on the loan and it must be repaid within 7 or 25 years, depending on whether the loan is secured by real property or not