ATO releases guidance on the repayment of UPE investment agreements

20 July 2017

In brief

In the context of the deemed dividend rules which apply to private companies, the Australian Taxation Office (ATO) has released Practical Compliance Guideline PCG 2017/13 in relation to the repayment of unpaid present entitlements (UPEs) owing from a trust to a private company beneficiary which have been invested under an seven year interest only loan and are due to mature on or before 30 June 2018.

In a welcome move, the ATO has confirmed that if the loan principal is not repaid on or before the date of maturity, a seven year Division 7A complying loan agreement may be put in place between the trust and the private company beneficiary. This effectively allows a further seven years for the amount to be repaid, with periodic payments of both principal and interest.

In detail

Family groups with discretionary trusts and private company beneficiaries will be familiar with the ATO's views in relation to the application of the deemed dividend provisions in Division 7A of the *Income Tax Assessment Act 1936* to UPEs.

Where a trust has distributed income to a private company beneficiary, the entitlement to which remains unpaid (i.e. a UPE), the ATO has previously indicated that it will not seek to apply Division 7A to the UPE, if the funds representing the UPE are held on sub-trust for the sole benefit of the private company beneficiary (Taxation Ruling TR 2010/3).

The ATO's Practice Statement PSLA 2010/4 states that the ATO will consider that the funds in the sub-trust are held for the sole benefit of the private company beneficiary if they are lent to the main trust under a "7-year interest only loan" (Investment Option 1).

Other options are also available under PSLA 2010/4, such as entering into an interest only 10-year loan (Investment Option 2). However, PCG 2017/13 only applies where a UPE has been dealt with in

accordance with Investment Option 1 and the repayment of the principal of the loan is required to be made in the 2017 income year or 2018 income year.

Where an Investment Option 1 arrangement was entered into on, or before, 30 June 2011, the loan principal will be due for repayment on or before 30 June 2018.

In PCG 2017/13, the ATO confirms that when an Investment Option 1 arrangement matures on or before 30 June 2018, any unpaid principal of the loan at the end of the loan term will be treated by the Commissioner as the provision of financial accommodation and therefore a Division 7A loan.

However, if all, or part, of the principal of the loan is not repaid on or before the date of maturity, PCG 2017/13 states that the ATO will accept that a seven year complying Division 7A loan agreement may be put in place between the trust and the private company beneficiary prior to the private company's lodgment day.

For example, if an Investment Option 1 arrangement is due to mature on 30 June 2018 and has not been repaid in full by that date, the private company beneficiary and the trust will have until the lodgment date of the private company's 30 June 2018 tax return (which for many will be 15 May 2019) to put a seven year complying Division 7A loan agreement in place in relation to the unpaid principal. This will avoid Division 7A applying to the arrangement and effectively allows a further seven years for the amount to be repaid albeit with periodic payments of both principal and interest.

Importantly, PCG 2017/13 confirms that in these circumstances, the Investment Option 1 arrangement will be taken to have been repaid for the purposes of the Division 7A loan repayment rules. Whilst this confirmation is welcome, we do question whether these loan repayment rules should actually apply in the first instance as by their nature Investment Option 1 arrangements are not considered loans for the purposes of Division 7A.

If a complying Division 7A complying loan agreement is not put in place by the private company's lodgment day, a deemed Division 7A dividend will arise at the end of the income year in which the loan matures.

Disappointingly, the ATO has not provided taxpayers with the option of placing the maturing Investment Option 1 arrangement under a 25 year Division 7A complying loan agreement in these circumstances.

PCG 2017/13 states that the Commissioner may go back beyond the standard period of review when considering the application of Division 7A if there has never been an intention to repay the Investment Option 1 principal at the end of the 7-year interest only loan (i.e. on the basis that the purported arrangement was a sham, and/or that there was fraud and evasion). This approach is consistent with recent ATO dealings on the application of Division 7A.

The takeaway

This is welcome news for family groups who are managing the repayment and servicing of UPE investment agreements as it provides them with much needed breathing space.

However, this is clearly a quick fix to deal with those investment agreements that are maturing within the next 12 months. It ignores those agreements maturing post 30 June 2018 or those taxpayers that entered

into Investment Option 2 (i.e. 10 year interest only) arrangements, potentially leaving many taxpayers disadvantaged.

What has not yet been considered is the impact the promised legislative reforms to the Division 7A deemed dividend rules will have on the treatment of UPEs. These changes were announced in the 2016-17 Federal Budget and are to be based on the Board of Taxation's 2015 Post-Implementation Review into Division 7A. They are intended to provide clearer rules for taxpayers and to assist in easing their compliance burden. However, with the 1 July 2018 start date looming, and with no specific details or draft legislation yet available, taxpayers are still in the dark as to what benefits these reforms will provide family groups and whether they will address the complexities surrounding the treatment of UPEs.

Let's talk

For a deeper discussion of how these issues might affect your business, please contact:

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