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Relief for maturing sub-trusts ...

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The Australian Tax Office (ATO) will provide some welcome relief for certain trust structures that have 2010 distributions owing to a company.

Trust structures have been popular in Australia for generations of businesses. When used appropriately, they can have asset protection and tax advantages.

At times it can be advantageous for the trust to distribute income to a corporate entity, where the company pays tax on the distribution. However, the distribution isn't always paid to the company immediately. The trust instead may retain the cash to reinvest in the business.

To reduce tax planning opportunities with privately owned companies, the ATO introduced anti avoidance legislation in the 1990's known as Division 7A. However, in 2010 the ATO changed its interpretation of Division 7A so that unpaid distributions to companies could no longer be left as such, without consequences.

The introduction of sub-trusts

With the change of interpretation, the ATO introduced the new concept of a sub-trust, which effectively allowed a trust to set aside a distribution owed to its beneficiaries – known as an Unpaid Present Entitlement (UPE) – such that the principal didn't have to be immediately repaid. At the time, the ATO allowed three different options for sub-trusts:

1. **A seven year interest only loan** whereby the earnings were to be paid to the beneficiary each year and the principal balance was to be repaid at the end of the agreement
2. **A ten year interest only loan** under similar terms to the seven year agreement, with a higher interest rate to coincide with the longer term
3. **An investment in a specific income producing asset or investment**

At the time sub-trusts were introduced, it was thought that the entire principal balance may have to be repaid in full at the end of the loan term.

The ATO has now recognised that the requirement to "pay down" the sub-trust could have a detrimental impact on some businesses.

The ATO's new stance

The ATO has released guidance in relation to those sub-trust agreements maturing in the 2017 and 2018 financial years – that is, those 2010 distributions put onto a seven year interest only loan. Where the principal of a seven year interest only loan is not repaid upon maturity in 2017 or 2018, any unpaid principal will be treated by the Commissioner of Taxation as a Division 7A loan.

What does this mean in practical terms?

Generally, where a trust with an amount that has previously been put onto a binding seven year sub-trust agreement on or before 30 June 2011 and the principal is not fully repaid before maturity, the Commissioner will accept that a seven year Division 7A loan can be put in place between the trust and the beneficiary.

This provides a further period of seven years during which time principal and interest repayments must be made on the Division 7A loan on an annual basis.

What if I don't take action?

If the original 2010 distribution is not paid and the Division 7A loan agreement isn't put in place prior to the lodgement due date of the private company's tax return, a deemed dividend may arise at the end of the income year in which the loan matures, resulting in a potential tax liability.

What next?

Those taxpayers who entered into a seven year interest-only loan must now consider whether they wish to repay the remaining principal balance in full, or convert the remaining balance to a further seven year Division 7A loan agreement. You have until the lodgement due date of the private company's tax return to take action.

In the meantime, should you have any queries, please contact your Fordham Partner.

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