



Discretionary Trust Update - June 2010

Trusts & Corporate Beneficiaries – 30 June 2010 and Beyond

In recent days, the ATO have made two announcements which will affect the way Discretionary Trusts are utilised going forward.

Announcements

1. The ATO released Taxation Ruling TR 2010/3 discussing how it will tax Trust distributions to Corporate Beneficiaries. Essentially from 16 December 2009, the ATO are of the view that unpaid trust distributions to companies are to be treated as a loan from the company that needs to comply with the tax anti avoidance provisions of Division 7A of the Tax Act or the actual distribution physically paid in cash by the Trust to the Company within 21 months of the distributions.
2. The ATO also released its Decision Impact Statement addressing how they will apply the High Court Decision in *Bamford v Commissioner of Taxation*. Basically, the flow through treatment of capital gains and dividends has been questioned as well as how those receipts are allocated to particular beneficiaries.

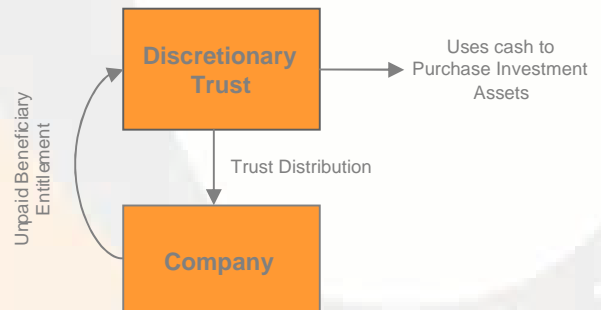
The following is our analysis of these announcements and the general position.

We will be considering the above for each existing client. Otherwise, please contact us if you wish to obtain specific advice from us concerning the impact these announcements will have on your own particular circumstances.

1. Trust Distributions to Corporate Beneficiaries

Trusts that distribute income to Companies are able to apply the 30% corporate income tax rate on such income. The Trust will not however pay the income distribution to the Company in cash, but create an “unpaid beneficiary entitlement” to the Company. The cash typically is then invested by the Trust.

Diagrammatically this can be viewed as follows:



Effective post 16 December 2009, it is the ATO view that trust distributions to Corporate Beneficiaries will now be subject to the requirements of the dividend deeming provisions of Division 7A of the Tax Act.

Division 7A essentially treats a loan from a company to a shareholder or an associate as a deemed dividend unless it is structured on arm's length terms (ie interest and repayments). Up until 16 December 2009, the ATO had previously stated (on several occasions) that an unpaid trust distribution is not a loan of that distribution back from the Corporate Beneficiary to the Trust.

Effective from 16 December 2009, the ATO have changed its view on the matter and consider unpaid trust distributions to corporate beneficiaries to be a loan back of that distribution by the corporate beneficiary in the year after the trust distribution is made.

Example:

If for the year ending 30 June 2010, a Trust distributes \$1,000 of taxable income to a Corporate Beneficiary, if the distribution remains unpaid, the Company will be taken to have lent that amount back to the Trust in a manner that needs to comply with the provisions of Division 7A for the year ending 30 June 2011.

The Trust will then have two options open to it:

a) Document the unpaid distribution on an arms' length footing (ie complying with the provisions of Division 7A) by the time the Corporate Beneficiary has to lodge its 30 June 2011 Tax Return; or

b) Physically pay the distribution to the Company (ie \$1,000) by the time the Company lodges its Tax Return for the year ending 30 June 2011.

Generally, this would occur sometime between March to May 2012. Effectively, in a typical case, this gives a Trust about 21 to 23 months to pay the distribution to a Corporate Beneficiary or put the distribution on a Division 7A footing.

In preparing Trust's Accounts for the year ending 30 June 2010, it would be prudent to quarantine all unpaid distributions to Corporate Beneficiaries made up to 16 December 2009 and classify distributions to corporate beneficiaries pre and post 16 December 2009 separately. The ATO's position is grandfathered. The ATO have stated that they will not address unpaid trust distributions to Corporate Beneficiaries that have occurred prior to 16 December 2009.

Deemed Loan if Trust Accounts describe the Trust Distribution as a "Loan"

Unpaid trust distributions to Corporate Beneficiaries that have been incorrectly described as a "loan" in the Trust's or Company's Accounts will be treated as a "loan" for Division 7A purposes from the Corporate Beneficiary back to the Trust in the year the amount was first described as a "loan" in the Trust's or Company's Accounts.

The effect will be to deem the Corporate Beneficiary to have paid a dividend back to the trust equal to the value in the "Loan" account. The ATO has backdated that measure and will seek to review all pre 16 December 2009 loan balances in the Trust Accounts that are payable to Corporate Beneficiaries.

Action Required

- a) Cooper Partners policy has always been to describe unpaid Trust distributions to Companies as *unpaid present entitlements* in the Trust's Accounts unless we are instructed otherwise by the client. If, however, in the past you have come to our Firm from another Accountant who has not followed that practice, then it is important to review the prior year Income Tax Returns to quantify any risk exposure and consider how best to manage that exposure.
- b) Starting with the year ending 30 June 2010, the ATO state that any distribution to a Corporate Beneficiary can only remain unpaid for a period of approximately 21 months. The period can be slightly longer or shorter depending on when the Corporate Beneficiary is due to lodge it's income tax return. As such, in deciding to distribute to a Corporate Beneficiary, it is important to be conscious of the fact that any distribution may need to be paid or loaned back to the Trust on terms that comply with Division 7A. Broadly, the loan is at interest with principal and interest repayments made over a 7 year period.
- c) If the distribution is put on a Division 7A footing and the money is used in the Trust for investment purposes, the Commissioner does allow a tax deduction for the interest paid by the Discretionary Trust on that Division 7A Loan from the Company. Hence the need to examine the different alternatives available to a Trust and consider the most appropriate course of action.
- d) It is important to ensure that the distributions comply meticulously with the terms of the Trust Deed. A failure in applying the Trust Deed in any way may result in the Commissioner deeming the distribution to be a loan from the date it is made.
- e) In preparing Trust Accounts, we will be suggesting that any unpaid distributions to Corporate Beneficiaries that have occurred prior to 16 December 2009 are quarantined and shown in separate accounts. The Commissioner has stated that he will not require those distributions to be put on a Division 7A footing at any time unless some positive action has been taken to convert those unpaid distributions into loans from Companies to Trusts.
- f) Consequently, we will be recommending changes to the chart of accounts that clients may have on their MYOB files and other accounting packages to enable the separation of Trust distributions for the year ended 30 June 2009 and prior years from any future distributions to Corporate Beneficiaries that occur post 16 December 2009.

2. Trust Distributions, Capital Gains, Dividends & Bamford's Case

As a result of the ATO's Decision Impact Statement concerning the High Court decision in *Bamford v Commissioner of Taxation*, the distribution of capital gains, dividends and large one-off amounts has now become more complex. The decision stands for the principle that a trust deed can redefine capital receipts as income for the purposes of making distributions from a Trust. A beneficiary is taxed on

the taxable income of the trust based on their share of the trust income allocation (which could now include a capital sum).

Previously, the ATO acted in a concessional manner by taxing beneficiaries that are entitled to distributions of capital gains under the capital gains tax rules. Nevertheless, a strict application of the tax law would mean that an income beneficiary would be taxed on a capital gain even if they had no rights to call for the capital gain to be paid to them.

Since the Bamford decision, the ATO now have stated that they will review their concessional treatment of capital beneficiaries receiving distributions of capital gains. It will also review whether trusts can stream capital gains, dividend and other income to particular beneficiaries. In a nutshell, all "bets are off" and the ATO intend to strictly apply the tax law and the terms of the Trust Deed in taxing beneficiaries.

Action Required

With respect of capital gains and dividends, significant capital gain or dividend derived by a Trust will now need to be reviewed closely to ensure its tax treatment is properly understood and followed. Hence, if a significant capital gain or dividend has been derived by a Trust during the year ending 30 June 2010, we will need to examine closely how that receipt is to be distributed and discuss your options concerning how each amount is taxed in the hands of a beneficiary of a trust.

If you have any queries, or would like advice in relation to any matters outlined above, please contact either Michelle Saunders or Marissa Bechta on (08) 6311 6900.

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