



December Newsletter - 2009

TAX UPDATE – 2010 IS HOTTING UP



2010 is hotting up to be a year of significant change in Tax.

The highly anticipated **Henry Review** is days away from being released to the Federal Government.

It is tipped by Sydney's Courier Mail Newspaper to recommend:

- A National "Land Tax" to replace Stamp Duty and other property based taxes at the State level.
- A National Payroll Tax to replace the Individual State Payroll Taxes.
- A reduction in Capital Gains Tax and Fringe Benefits Tax Concessions.
- A reduction in GST.
- Increases in resource based taxes.
- A Road Congestion Tax.

We will keep you abreast of the events as they unfold.

Division 7A Trusts and Companies

The ATO decided to "get in early" by releasing Draft Taxation Ruling TR2009/D8 which focusses squarely on unpaid Trust Distributions to Corporate Beneficiaries. As a general principle, Companies with retained profits cannot "lend" those retained profits to shareholders or associates of shareholders without the anti avoidance provisions of Division 7A of the Income Tax Assessment Act 1936 (1936 Act) applying to them. Essentially, Division 7A treats such a loan to be an unfranked dividend and taxes it at marginal rates in the hands of the recipient of the loan.

There are exceptions to Division 7A which include placing the loan on a "commercial" footing as prescribed by the 1936 Act. The 1936 Act broadly requires that principal and interest repayments be made each year so that the loan is paid off within 7 years.

Since Division 7A was introduced (4 December 1997) the ongoing issue was whether distributions of profits made by Trusts to Corporate Beneficiaries are "loans" for the purposes of Division 7A.

When a Trust distributes income to a Company, that distribution is classified in the Accounts of the Company as an "unpaid present entitlement" and represents a distribution of Trust profit to the Company that remains unpaid.

For Trust Law purposes, any distributions made to a beneficiary are treated as a "gift" of the profit to the beneficiary. The fact that the "gift" represented by the unpaid present entitlement is unpaid, signifies that the Company can legally enforce the gift and call for it to be paid to it at some future point in time.

Until recently, the ATO repeatedly stated that such unpaid present entitlements were not treated as "loans" for the purposes of Division 7A and could remain unpaid until the Trust Law required them to be paid to the beneficiaries.

Last Thursday, 17 December 2009, the ATO publicly announced that it has changed its mind and now considers those distributions to be loans caught by Division 7A. In effect, when a Trust distributes its profits to a Corporate Beneficiary, the ATO will require that distribution to be placed on "commercial terms" payable within 7 years. The loan will be at a statutorily prescribed interest rate and the repayments must include principal and interest.

Otherwise, the distribution to the Company will be treated by the ATO as a deemed unfranked Division 7A dividend and taxable at 46.5%.

The ATO have stated that the Draft Ruling is "prospective" in most cases and will apply to Trust distributions from the year ended 30 June 2010 forward. However, there are aspects of the Ruling that are stated to be "retrospective". That is where the Company has taken some action that has "converted" the unpaid Trust Distribution into a loan. Further, although the ATO state that they will apply the Ruling prospectively, the ATO can dishonour that commitment if it sees fit to do so.

Our view is that the ATO are incorrect with its approach. This is because there are specific provisions in Division 7A that are intended to address Trust Distributions to Companies. The "back flip" ought to be legislatively introduced rather than given effect to by means of a Draft Ruling that is contrary to 12 years

worth of statements that the ATO has made confirming that unpaid Trust Distributions to Companies were not loans under Division 7A. It is only a draft Ruling at this stage so no action is required until further clarification and industry feedback is provided.

Other Tax Changes

On a positive note, the Federal Government has released draft legislation to repeal the Foreign Investment Fund Rules ("FIF" Rules). The FIF Rules applied to investments by Australian Resident Taxpayers in Foreign Companies and Trusts. The typical case that the Foreign Investment Fund Rules caught were investments in a Foreign Managed Investment Fund or Foreign Partnership that included investments in Companies and Trusts.

When the FIF Rules applied, taxpayers were potentially taxable on the increases in the market value of their investments.

There were exceptions to the FIF Rules which excluded most arm's length investments but not all. As the FIF Rules were complex and technical, the Government decided to repeal those rules and replace them only with an anti avoidance rule.

No decision has been made as to when the abolition of the FIF Rules will apply. The Draft Legislation is silent on the commencement date. However, our expectation is that the FIF Rules will cease to apply after 30 June 2010.

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

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