

UNPAID FAMILY TRUST DISTRIBUTIONS

It has been a popular, tax effective strategy for many years for a trustee of a discretionary trust to allocate some or all of the income of a trust to a related company at the end of an income year. That portion of the income which has been allocated to the corporate beneficiary attracts tax at the corporate tax rate (currently 30%), which could be up to 16.5% less than the individual tax rates.

In the majority of cases, the income that is allocated to the company is not physically paid across to the company from the trust and creates what is referred to as an "unpaid present entitlement". The Taxation Office has previously been of the opinion that this present entitlement does not create a loan relationship between the parties and has accepted this practice.

Shortly before Christmas, the Tax Office released a draft Tax Ruling (TR2009/D8) stating that these unpaid entitlements, in almost all circumstances, will be treated as a loan by the company back to the trust.

So, what does this mean?

There are a number of rules in the Income Tax Act, contained within Division 7A, dealing with the situation where a company makes a loan to a shareholder or an associate of a shareholder.

This commonly occurs where shareholders (or their relations)

pull money out of the company for private use in excess of what is drawn as wages or dividends. This division of the Tax Act deems the amount that the company has loaned to the shareholder to be an unfranked dividend – attracting tax in the shareholder's name at their marginal rate, potentially up to 46.5%.

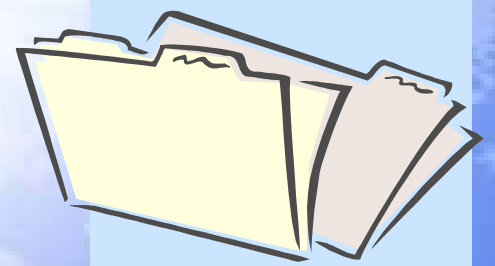
The impact of this can be minimised by the shareholder entering into an agreement with the company that the loan will be repaid over no more than 7 years and the company will charge interest at the benchmark interest rate advised by the Tax Office each year (5.75% for 2010).

As the Tax Office has always considered that a present entitlement is not a loan, the amount owing in unpaid distributions from the trust to the company, rarely created a situation that would cause Division 7A to be enacted. However, in this draft ruling it is clear that the Taxation Office is now intending to take the position that, except for limited situations, this entitlement is now to be treated as a loan, triggering the Division 7A provisions.

This means that the tax benefits that can be obtained by using a corporate beneficiary will be substantially reduced if not removed.

What should you do?

The first, and significant, thing to note is that this is just a draft ruling



and does not have the effect of law. It is a representation of the Commissioner's current view and until the ruling is finalised, we will not know what his exact position on these entitlements will be and the extent to which the Tax Office intends to apply the ruling retrospectively. Unfortunately at the moment we are adopting a 'wait and see' approach as to the impact of these changes.

Now is the time to plan ahead!

Where you are operating a corporate beneficiary, we recommend that you meet with us prior to 30 June to discuss your situation and the possible tax planning strategies available to you to reduce or limit your exposure to these changes.

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TRUST DEEDS AND THE BAMFORD CASE

Discretionary trusts have long been used as an effective business and investment structure for families as they can provide asset protection and easy transfer of wealth between generations.

Unfortunately, the view is often incorrectly taken by the media and Taxation Office that discretionary trusts are tax avoidance vehicles and as a result are often subject to much scrutiny.

One of the major subjects of contention over the years has been how Income Tax Law interacts with trust law, particularly in relation to the distribution of income by a discretionary trust. Often issues arise where the trust makes a capital gain or the trust's income for accounting purposes is different to its income for tax purposes, such as where the accounts report expenses that are not tax deductible (e.g. entertainment or penalties).

A recent decision by the High Court of Australia in the case of Bamford v Commissioner of Taxation has at last provided some clarity to these matters.

In the Bamford case, two main issues were considered by the court, the first in relation to capital gains made by the trust. As capital gains are not considered to be 'ordinary' income, the Commissioner argued that the capital gains made by the trust could not be included in the income of the trust estate. This interpretation by the Commissioner meant that the gains were not able

to be distributed out to the beneficiaries, resulting in the gains being taxed at the penalty tax rates of the trust (46.5%) rather than the beneficiaries' marginal tax rates.

Fortunately, the High Court disagreed with the Commissioner on this issue and confirmed that capital gains and other statutory income can form part of the income of the trust estate and be distributed to beneficiaries, where it is allowed under the trust deed.

The second issue considered in the Bamford Case was in relation to how income is to be apportioned between beneficiaries where there is an adjustment to taxable income. In this instance, the Tax Office had disallowed a deduction at a later date that the trust had claimed in the original tax return. As a result, the income of the trust was substantially more than the trustees had originally dealt with when they resolved how the income should be divided between the beneficiaries.

The Commissioner took the position that once the trustee determines the portion of total income of the trust that a beneficiary is entitled to receive, any adjustments to that income are to be applied in proportion to the share of the net income that the beneficiaries originally received. The High Court agreed with this position.

From a practical view point, this means that if two beneficiaries shared equally in the income of the trust and there was a subsequent

amendment to that income, the change in the income would also be shared equally between the beneficiaries.

The decision by the High Court in this case has been welcomed and at last provides clarity to some important aspects of family trust distributions. One of the most significant things that it has highlighted is the importance of the terms of the trust deed.

There have been many varied interpretations of trust income and trust distributions over the years. It is highly likely that while your trust deed may have met all of the necessary requirements when it was established, it may not provide you with the most effective or flexible vehicle for administering your trust today.

With this decision by the High Court, it is important to now look at your trust deed and consider if a review and rewrite is necessary. If you are operating a discretionary trust, we encourage you to contact our office to discuss whether your deed needs to be updated as soon as possible.

UPDATING YOUR DEED

Under a current arrangement with Porcaro Lawyers, we are able to offer an update of discretionary trust deeds for \$660 incl GST. The updated deed will modernise your existing deed to incorporate the Income Tax Law changes and will include a number of clauses that the banks now require in deeds.

IMPORTANT DISCLAIMER

This is not advice. Clients should not act solely on the basis of the material contained in this Bulletin. Items herein are general comments only and do not constitute or convey advice per se. We recommend that our formal advice be sought before acting in any of the areas detailed in this bulletin.