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Trusts – Dividends and capital gain
streaming,
Tax File Number Reporting and
Company Beneficiaries

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Overview

Three recent changes for trusts:

- Tax Laws Amendment (2011 Measures No.5) Act 2011:
Schedule 3 Interim changes to the taxation of trust income.
The provisions
Example calculations.
- The implementation of Tax File Number Reporting for distributions to beneficiaries, and
- A change in the approach by the ATO to the application of Division 7A to unpaid present entitlements owed to private companies.

This presentation will provide an insight into what the changes are and how to deal with the issues that arise from the changes.



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Trust income changes

Full re write of the Division 6 provisions relating to the income of trusts deferred:

- TLA (2011 Measures No.5) Bill provides an interim measure for the 2011 year (and potentially beyond) and until the full changes are developed
- Law and its interpretation still WIP – education bodies are only just rolling out presentations and what it means
- Provisions passed before 30 June 2011 (Royal Assent 29 June 2011!) and therefore apply to the 2010/2011 year and are relevant to resolutions that needed to be made by 30 June
- Accordingly they recommend consideration of these provisions
- Note EM states low compliance costs expected!



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Trust income changes

Summary:

- Under the revised approach
 - Quantum approach for specifically entitled franked distributions and capital gains and allows for streaming of them
 - But note that for old deeds that do not include capital gains in the income of the trust or have a re-characterisation clause, the capital gain streaming provisions can be applied
 - Franked distributions need to be recognised under the deed to be streamed
 - Balance of income proportionate
- Anti avoidance provisions for use of exempt entities
- Compare to old law (ATO view) that all income assessed proportionately to all beneficiaries that are entitled to the income of a trust



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Trust income changes

- Amends Divisions 6 (ITAA36), Divisions 115-C and Subdivision 207-B (ITAA97)
- Inserts a new Division 6E into the ITAA36
- Three steps for franked distributions and capital gains to be streamed
 - Step 1 - Apply Division 6 as per previous practice
 - So still need positive trust law and tax law income
 - Streaming still needs to be permitted by the trust deed
 - Step 2 - Beneficiaries assessed on specifically entitled capital gains and franked distributions
 - Step 3 - Division 6E removes Step 2 amounts from the Division 6 amounts that are assessable to beneficiaries



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Trust income changes

More detailed overview of the provisions

- Capital gains and franked distributions (and the attached franking credits) that beneficiaries are **specifically entitled** to are streamed on a quantum basis, along with their tax attributes
 - Amounts to which no beneficiary is specifically entitled to will flow proportionately
 - Dividends will be reduced by **directly relevant expenses**
 - Capital gains and franked distributions on an item by item basis
 - Offset capital losses when determining capital gains – remembering the ability to choose which specific gains a loss will be offset against
 - Not able to treat franking credits separately or CGT discount
- After adjusting for capital gains and franked distributions (net of directly relevant expenses), general expenses are offset against the other income and it is taxed proportionately



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Trust income changes

Problem areas

- Specific entitlement
- Directly relevant expenses
- Where taxable income is less than combined sum of capital gains and franked distributions



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Trust income changes

- Specific entitlement
 - Must receive the financial benefit (in amount)
 - Needs to be recorded in the accounts
 - Can group but essentially a distribution by distribution and capital gain by capital gain allocation
 - Refer examples on pages 25 and 26 of the EM
 - Cannot be specifically entitled to a deemed gain
 - Refer examples on pages 31 and 32 of the EM re clauses
 - Entitlement to an unspecified amount such as the balance of trust income, this is not sufficient (not the same as the balance of a defined capital gain or class of franked distribution)
 - Can create through a chain of trusts – need to apply provisions at each step in the chain



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Trust income changes

- Directly relevant expenses
 - Applies to franked distributions only
 - E.g. borrowing costs, portfolio management fees
 - If directly relevant expenses exceed income, cannot distribute (i.e. For negatively geared shares)
 - Note examples 2.4 and 2.5 on pages 29 & 30 of the EM



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Trust income changes

- Where taxable income is less than combined sum of capital gains and franked distributions
 - Will arise if say negative geared property or general expenses that are not directly relevant to capital gains or dividends
 - Approach is a rateable reduction of the franked distributions and capital gains so that the taxable amount is limited to the taxable income under the ordinary application of Division 6
 - Formula – multiply by
 - Taxable income of the trust (excluding franking credits)/(net capital gain of the trust + net franked distributions)



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Trust income changes

- Example (based on Example 2.26 facts from the EM)
 - Deed defines income as ordinary income plus net capital gains (specific example 2.29)
 - Net rent \$100,000 – no specific entitlement
 - Fully franked dividend of \$70,000, \$50,000 of direct expenses – Claire specifically entitled to the net dividend of \$20,000
 - Another fully franked dividend of \$70,000 – no directly relevant expenses and no specific entitlement
 - Discount capital gain of \$100,000 (after discount) –Ash specifically entitled to 50% of the discount gain
 - Non discount capital gain of \$100,000, offset by capital loss of \$50,000 – Bradshaw specifically entitled
 - Ash also entitled to another \$50,000
 - Dawson gets the balance (\$120,000)
 - Taxable income is \$400,000
 - Distributable income is \$340,000 (\$400,000 less \$60,000 franking credits)



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Trust income changes

Example outcomes

- Specifically entitled amounts – taxable income
 - Ash taxed on \$50,000 of discount gain
 - Bradshaw is taxed on a non-discount net capital gain of \$50,000
 - Claire is taxed on a net dividend amount of \$20,000 plus \$30,000 of imputation credits = \$50,000
 - Total taxable amounts so far = \$150,000
 - Leaves \$250,000 to be allocated (Other \$50,000 of discount gain, \$100,000 net rent and \$100,000 fully franked dividend) (Represent \$220,000 in trust income –difference is the franking credit)
- Unallocated capital gains and dividends
 - Ash entitled to \$100,000 – so he has a 45.5% interest in the remaining items
 - Dawson is therefore entitled to \$120,000 = 54.5%



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Trust income changes

- Extra amount to allocate \$250,000 for tax
- Remaining discount gain of \$50,000
 - 45.5% to Ash = \$22,750
 - 54.5% to Dawson = \$27,250
- Remaining dividend \$100,000 (\$70,000 + \$30,000)
 - 45.5% to Ash = \$45,500 (\$31,850 + \$13,650)
 - 54.5% to Dawson = \$54,500 (\$38,150 + \$16,350)
- Now apply Division 6E
 - Initial Division 6 tax amount \$400,000
 - Less distributed dividends and capital gains \$300,000
 - Amount remaining \$100,000
- Ash gets 45.4% = \$45,400 (\$150,000 - \$72,750 - \$31,850 = \$45,400)
- Dawson gets 54.6% = \$54,600 (\$120,000 - \$27,250 - \$38,150 = \$54,600)



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Trust income changes

- Summary

	Ash	Bradshaw	Claire	Dawson
Dividend \$50,000			\$50,000	
Dividend \$100,000	\$45,500			\$54,500
Discount gain \$100,000	\$72,750			\$27,250
Net non discount gain \$50,000		\$50,000		
Net rent \$100,000	\$45,400			\$54,600
Total	\$163,650	\$50,000	\$50,000	\$136,350



TFN reporting

The Problem

- Closely held trusts from 1 July 2010 are now required to withhold tax from beneficiaries that do not quote their TFN.
- Trusts need to comply with the new requirements for obtaining TFN's of beneficiaries or withhold tax from distributions and pass this on to the ATO.

ATO guidance

ATO guidance can be found at:

www.ato.gov.au/individuals/content.asp?doc=/content/00247255.htm



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TFN reporting

- The measures apply from 1 July 2010, so applies to distributions for the year ended 30 June 2011.
- For the 2011 year, the notification requirements can be achieved by lodging the details of the tax return for the year ended 30 June 2010
- If new beneficiaries are to be added for the 2011 year (based on those in the 2010 year) Tax file numbers should be collated for all potential beneficiaries and lodged by early July 2011 - notification for collected TFN's due by 31 July 2011.
 - The ATO advised this date will be extended to lodgement date in certain circumstances



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TFN reporting

Trustee's obligations

1. Storing TFNs.
2. Lodge a TFN report.
3. Withhold if TFN not provided at the top marginal rate (45%) plus Medicare levy.
4. Pay amounts withheld to ATO by the 28th October.
5. Lodge an annual trustee withholding report.
6. Lodge an annual trustee payment report.
7. Issue a payment summary to beneficiaries.



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Division 7A and UPEs

The issue

- The problem has arisen as the ATO have changes their long held and publicised view.
- The changes have been provided under a ruling TR 2010/3 and PS LA 2010/4.
- No underlying mischief in the majority of cases.
- Creates additional considerations for the use of trusts for business as compared to companies.
- If not pay deal with the UPE under one of the following options, the deemed loan amount will become a deemed dividend for Division 7A purposes to the trust (and subsequently income of the trust beneficiaries)



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Division 7A and UPEs continued

Taxation Ruling TR 2010/3

- This ruling considers that Division 7A potentially applies where:
 - ❖ The trust and the company are part of the same “family group”;
 - ❖ The trustee is an associate of a shareholder of the company;
 - ❖ The company is entitled to an UPE from the trust, and
 - ❖ The UPE funds remain intermingled in the trust or are used for trust purposes.



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Division 7A and UPEs continued

Taxation Ruling TR 2010/3

- The ruling identifies two categories of loans potentially caught by Division 7A:
 - ❖ Arrangements that are loans within the ordinary meaning
 - Referred to as “**Section two loans**”.
 - ❖ Arrangements that are loans within the extended meaning of “loan” within Division 7A – i.e. the trust has the use of the UPE funds and they are not applied solely for the benefit of the company beneficiary
 - Referred to as “**Section three loans**”.



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Division 7A and UPEs continued

Taxation Ruling TR 2010/3

- Section 2 loans
 - ❖ Arrangements within the ordinary meaning of “loan” Commissioner says that these have always been caught and there is no change of approach.
 - ❖ Division 7A applies to such loans whether before or after 16 December 2009.
 - ❖ ATO will only review such loans made within the ATO’s period of review.
 - ❖ A section two loan arises when the loan is made
 - It becomes a Division 7A issue in accordance with the normal timing rules for Division 7A loans.



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Division 7A and UPEs continued

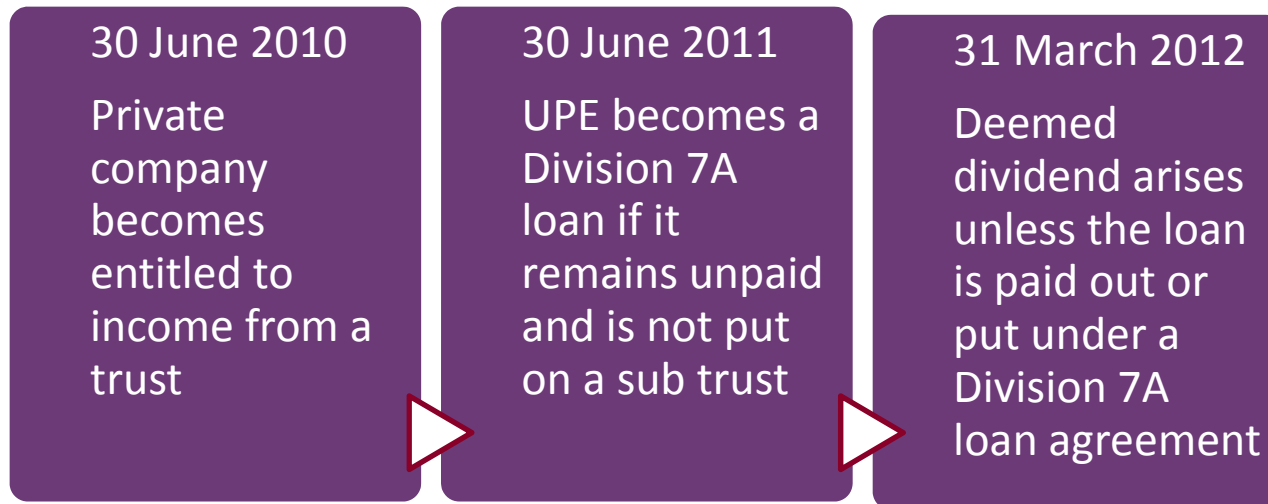
Taxation Ruling TR 2010/3

- Section 3 loans
 - ❖ Arrangements only within extended definition of “loan”, i.e. the provision of credit or any other form of financial accommodation.
 - ❖ Commissioner accepts that in this area there is a change of ATO practice.
 - ❖ Commissioner will only apply Division 7A to such cases if the UPE arises after 16 December 2009.



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Division 7A and UPEs continued



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Division 7A and UPEs continued

Recording in financial statements

- In distinguishing between “Section 2 loans” (Div 7A applies before and after 16 Dec 2009) and “Section 3 loans” (Div 7A only applies after 16 Dec 2009), how the amount is recorded in financial accounts is important.
- Ideally it is recorded, not as “loan”, but as “UPE” or “receivable” or similar.
- If errors in past years recording, self corrective options are available to correctly records balances so no Section 2 loan will be regarded as being created.
- Note specific qualifying criteria here



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Division 7A and UPEs continued

Alternative courses of action

- Still distribute to companies and manage the Division 7A issues:
 - ❖ Enter into complying loan agreements and meet the annual loan repayment and interest conditions.
- Pay the UPE to the company and have the company invest.
- **Make sure the UPE funds are held for the sole benefit of the corporate beneficiary (the “sub-trust” solution).**
- **Restructure into a company.**



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Division 7A and UPEs continued

The sub-trust option

- PS LA 2010/4 sets out guidance on when the ATO will accept that such an arrangement exists.
- It provides 3 options:
 - ❖ Option 1 requires that the UPE amount be held on a separate trust for the sole benefit of the corporate beneficiary.
 - ❖ Option 2 allows for a 7 year interest only loan at the benchmark interest rate (principal repaid at the end of 7 years).
 - ❖ Option 3 allows for a 10 year interest only loan at the prescribed interest rate (principal repaid at the end of 10 years).



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Division 7A and UPEs continued

PS LA 2010/4

Option 1

- Trust earns income of \$100.
- Trustee confers entitlement to that \$100 on corporate beneficiary, but retains the funds on a sub-trust for the benefit of the corporate beneficiary.
- The Trustee invests that \$100 in a specific asset, eg in an interest bearing account or income producing asset.
- **All income and capital gains from the investment must be paid to the corporate beneficiary each year.**
- The \$100 base UPE amount must ultimately be paid to the corporate beneficiary.
- Separate TFN
- Separate Accounts
- Separate Tax Return for the sub trust



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Division 7A and UPEs continued

PS LA 2010/4

Option 2

- Trust earns income of \$100.
- Trustee confers entitlement to that \$100 on corporate beneficiary, but retains the funds on a sub-trust for the benefit of the corporate beneficiary.
- **The \$100 UPE is intermingled with the remainder of the main trust (eg used for working capital).**
- Benchmark interest rate arrangement put in place. Division 7A rate used.
- **Each year, the main trust pays the sub-trust that year's benchmark interest rate on \$100. Must be paid to the corporate beneficiary.**
- After 7 years, the \$100 must be paid to sub-trust and to the corporate beneficiary.
- Part of the same trust – same accounts and tax return
- Capital gains do not have to be distributed to the corporate beneficiary.
- Potential deduction for interest on 'loan'.



Division 7A and UPEs continued

PS LA 2010/4

Option 3

- Trust earns income of \$100.
- Trustee confers entitlement to that \$100 on corporate beneficiary, but retains the funds on a sub-trust for the benefit of the corporate beneficiary.
- **The \$100 UPE is intermingled with the remainder of the main trust (eg used for working capital).**
- Prescribed interest rate arrangement put in place. Uses Reserve Bank indicator rates.
- **Each year, the main trust pays the sub-trust that year's prescribed interest rate on \$100. Must be paid to the corporate beneficiary.**
- After 10 years, the \$100 must be paid to sub-trust and to the corporate beneficiary.
- Part of the same trust – same accounts and tax return
- Capital gains do not have to be distributed to the corporate beneficiary.
- Potential deduction for interest on 'loan'.



Division 7A and UPEs continued

Which of the 3 “sub-trust” possibilities will be the best?

This will depend on:

1. The extent to which you are trying to stream capital gains to individuals and away from the company.
2. Whether the “interest” paid by the main trust to the sub-trust will be deductible to the main trust.
3. The length of time you desire to defer having to pay the UPE to the company .
4. The hassle of recording and accounting for it all.
5. The amount of debt levels and funding principal repayments.
6. Investment horizons and the ability to repay loan principal balances when required.

All need to be balanced and an appropriate decision made.



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Division 7A and UPEs continued

Factors to consider when deciding between Division 7A loan and sub-trust arrangements

- Dependant on specific circumstances.
- No one approach is better than the others.
- For 10 years sub-trust option, the higher interest rate and longer term will create greater cash flow issues but the principal will be repaid later.
- The Division 7A option will decrease the interest payable, and principal reductions are required each year, rather than at the end of the period.
- Pure sub trust will lose the benefit of CGT discounts on disposal and is most likely the worst option generally.
- The required analysis needs to compare the options, considering the annual cash flows and investment horizon – the numbers will show the way.



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Division 7A and UPEs continued

Change to a company structure

- Consider the use of the CGT rollover under Subdivision 122-A.
- Consider the use of the Small Business CGT concessions.
- Stamp duty needs to be considered.



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Division 7A and UPEs continued

Potential structures moving forward

- Will most likely see a move away from trusts and towards companies as a 'safe' option.
- Look to discretionary trust ownership of the shares.
- Look to a holding company and subsidiary company structure.

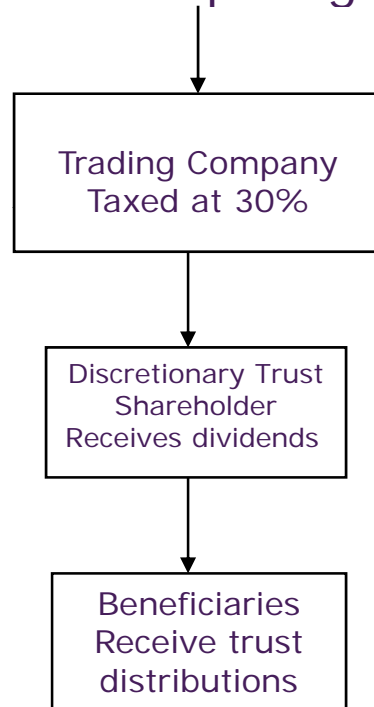


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Division 7A and UPEs continued

Potential structures moving forward - Simple structure

Income/capital gains



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Division 7A and UPEs continued

Potential structures moving forward - Simple structure

- Business operations are funded out of profits taxed at 30%.
- Only excess profits are directed as dividends through to the trust shareholder for distribution to beneficiaries.
- Flipping the structure prevents the Division 7A issues from arising other than in respect of amounts actually accessed at the beneficiary level and not treated as income.
- The trade off is that any capital gains made by the trading entity are now subject to tax at 30%, and the benefit of the general CGT 50% discount is lost at the trading entity level.
- Look to share sales to regain the benefit of the general 50% CGT discount.
- Can still potentially access the small business CGT concessions.

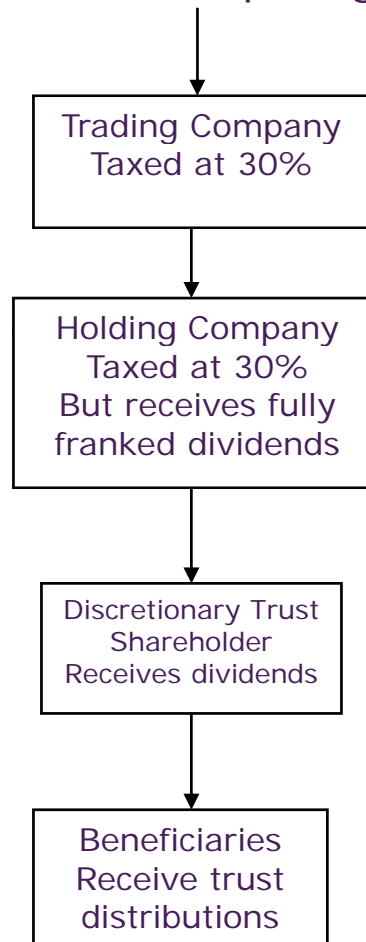


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Division 7A and UPEs continued

Potential structures moving forward – tiered structure

Income/capital gains



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Division 7A and UPEs continued

Potential structures moving forward - tiered structure

- Same basic features as the simple structure.
- Added benefit of being able to remove excess profits away from the trading entity and to an effective bucket company until required at the beneficiary level.
- Funds can be loaned back to the trading entity, with the potential for security to be taken over assets, and no Division 7A issues arising on the loan.



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Division 7A and UPEs continued

What should I be doing now?

1. Pre-16 December 2009 UPEs

- Division 7A will only apply to pre-16.12.09 UPEs if something has happened to cause there to be an ordinary “Section 2 loan”, e.g. a loan agreement or the financial accounts describing the UPE as a “loan”.
- Check that pre-16.12.09 UPEs are correctly recorded as UPEs and not as loans. Check trustee resolutions or other documentation.
- If incorrectly recorded as loans, consider making corrections to record them correctly. Note the conditions for self correction.
 - ❖ If these conditions cannot be met, then a disclosure should be made to the ATO requesting the exercise of their discretion under Section 109RB and ruling TR 2010/8.
- Subdivision EA can still apply, so ensure that it is not triggered.



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Division 7A and UPEs continued

What should I be doing now?

2. Post-16 December 2009 UPEs

- Ensure that UPEs are correctly recorded as UPEs and not as loans – in financial records, trust resolutions and everywhere else.
- If looking to utilise the “sub-trust” arrangements permitted under PS LA 2010/4, take steps to record the sub-trust arrangement and how the sub-trust’s return on the UPE funds will be calculated. You cannot change once you have decided and you need to clearly evidence the choice made.
- For each year a “sub-trust” arrangement is in place, calculate the sub-trust’s return on its investment in the main trust in accordance with the selected option and **pay this amount to the corporate beneficiary.**



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Division 7A and UPEs continued

What should I be doing now?

2. Post-16 December 2009 UPEs cont'd

- A review of the Trust Deed may be needed to check that it supports any “sub-trust” arrangement.
 - ❖ This should be coupled with the trust deed review required following the Bamford decision referred to earlier.
- For good measure, the Trust Deed could explicitly state that the Trustee has no power to treat a UPE as a loan except if Trustee and beneficiary agree in writing.
- Consider other alternatives, particularly:
 - ❖ Is it still worthwhile distributing to a company? If not, avoid doing so.
 - ❖ Restructuring into a company structure – or starting afresh with a company structure if a new venture.



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Checklist of Things to Do

Trust income

- Have trust deed reviewed (and updated where required)
- Undertake a review of year to date income and estimated distributions before year end
- Ensure resolutions made before 30 June
- Ensure resolutions made in accordance with the trust deed terms
- Take the time to understand the provisions

TFN

- Collect TFNs for all potential beneficiaries
- Lodge TFN's with the ATO
- Lodge annual reports with the ATO
- Provide beneficiaries with distribution statements

UPE

- Review accounts for incorrectly recorded UPEs and Section 2 loans
- Review trust deed
- Determine if still going to use corporate beneficiaries
- If using, determine which alternative will be used
- If not using, consider if restructuring is required

Conclusion

The aim of this presentation was to highlight some specific issues in Trusts that require immediate attention.

The income tax consequences for trusts and the distribution to beneficiaries are under the spotlight and there is lots of uncertainty. Careful planning, understanding of the trust deed, have deeds changed where appropriate and planning ahead for the changes are required.

The TFN reporting requirements will add increased burdens on trusts to report details of potential beneficiaries within strict timeframes to avoid penalty rates of tax being imposed.

The change in the ATO stance on UPE's is quite significant and makes the process of using company beneficiaries to limit tax rates complex. The range of alternative options need to be considered specifically for each situation. There is no one size fits all approach.



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Questions



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