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**TAX OFFICE OVERSTEPS ITS MARK CHANGING DEEMED DIVIDEND RULES FOR TRUST DISTRIBUTIONS WITH MANY BUSINESSES ‘WORSE OFF’**

The Australian Taxation Office has overstepped the mark in its attempt to change tax policy and tax law, with respect to deemed dividend rules for trust distributions, which will result in a significant increase in tax for many businesses and investors – with many being worse off – and add to the complexity of tax laws, said Ray Cummings, tax partner at Pitcher Partners.

Mr Cummings said in issuing draft ruling TR2009/D8, the ATO has “single handedly” sought to change the law in relation to unpaid distributions by trusts to corporate beneficiaries and thereby increase the tax impost on many private business owners. He said there has not been any actual change to the law, rather the outcome simply results from a changed interpretation by the ATO of existing law.

“The function of the ATO is to administer the law. It is up to the Government and not the ATO to change tax policy and tax law,” he said.

Mr Cummings said prior to the draft ruling, a trust could distribute income to a corporate beneficiary which would be taxed at 30%. Instead of making the actual distribution to the company, the after tax amount of cash was often retained by the trust for business working capital or investment purposes. “There was no need for a Division 7A compliant loan agreement and no additional tax was required to be paid unless the company paid a dividend.”

“From the date of effect of the draft ruling (16 December 2009), if a trust has declared a distribution to a company and has not actually paid that distribution to the company, the unpaid present entitlement will be regarded as a loan by the company back to the trust and this loan will need to comply with the Division 7A provisions. This will require a written loan agreement and annual principal and interest repayments.

“In many cases this will result in an increased tax impost as tax will now have to be paid at a rate of 46% rather than 30% even though the funds are used in the trust for working capital or investment purposes.

“At this stage, we understand that unpaid present entitlements arising prior to 16 December 2009 will not be affected. However, due to legislative amendments affecting distributions through multiple trusts, care needs to be taken with future transactions such as loans; where distributions have been made in the past through a chain of trusts to a corporate beneficiary.

“ By way of example, assume Trust A distributed to Trust B which distributed to Company X but the cash was retained in Trust A. There is no issue if the cash is retained in Trust A. However, our current understanding is that a loan by Trust A to Trust C (that is an associate of Company X) will become subject to Division 7A because of the unpaid entitlement of Company X.

“Why the change in interpretation by the ATO?”

“The ATO change in view appears to have been formed as a consequence of issues identified during many high wealth audits. They appear to be particularly concerned about funds being accessed by the controllers of the trusts for private purposes rather than being used within the trust. However, the new approach is somewhat curious and indeed not necessary as amendments were made to Division 7A many years ago which already capture such situations. This has been drawn to the ATO's attention to no avail.

“ Furthermore, the ATO has extended their view in considering that there is still an issue, even where the funds are used within the trust for business or investment purposes and are not used outside the trust for private purposes,” Mr Cummings said.

### **Implications for taxpayers?**

Mr Cummings said taxpayers will need to seriously consider their options in terms of distributions for 2010 and beyond. Scenarios will include the following:

\* The deemed loan from the company to the trust must be put on Division 7A compliant terms. This essentially means that the original unpaid distribution from the trust to the company will become subject to tax at the marginal tax rates of the shareholders in the company. In many cases this will be the top marginal tax rate of 46%.

\* Business owners may decide not to distribute to a corporate beneficiary but distribute to themselves and invest the after tax money back in the business owned by the trust. Again, this will give rise to a 46% tax rate in many cases.

\* Others may decide to make the distribution but send the cash to the company rather than retain it in the trust. The distribution is not then subject to the 46% tax rate (although it still potentially is in the longer term when a dividend is paid out). However, if a capital asset is acquired by the company, the effective tax rate on any profit on disposal of that asset increases as a company is not eligible for the 50% CGT discount whereas a trust would be able to flow that benefit to individual beneficiaries. In effect, the end tax rate on CGT assets would double from 23% to 46%.

He said under the new interpretation, many taxpayers will be clearly worse off as they will be paying the top marginal tax rate on profits reinvested into their business to fund working capital needs, capital expenditure, debt repayments, or investment assets held by trusts. To the extent that they change their approach and have the funds invested by the company, the tax payable on income will not change but they will lose the benefit of access to the 50% CGT discount.

### **A change in policy?**

“The ATO has maintained that this change in approach is simply an administrative change in interpretation. However, the change in approach actually results in a significant change in policy.

“By way of example, if a person invests in a public company, they are able to access the corporate tax rate in relation to the earnings of the company, pay tax on any dividends received and are able to access the 50% CGT discount by selling the shares in the company.

“Prior to this change, a business operated through a discretionary trust was able to achieve the same outcome. The earnings could be distributed to the corporate beneficiary and taxed at 30% but retained within the business owned by the trust. The trust could then sell the business and access the 50% CGT discount. There was policy equity between the public and private business on both income and capital gains. This is no longer the case.

“The ATO may respond that private businesses should now incorporate rather than be run through a discretionary trust if they want to access the corporate tax rate. However, this does not achieve policy equity as shareholders in private companies are not always able to sell the shares in their businesses to be able to access the CGT discount. More often than not a purchaser will only be willing to acquire the underlying business and this means there is no access to the 50% CGT discount so the effective tax on exit is 46% not 23%.

“Clearly, the ATO has overstepped the mark as its function is to administer the law, not change it.

“We will continue to lobby strongly on this matter and against the approach adopted by the ATO to disregard the law and change tax policy,” Mr Cummings said.

*Pitcher Partners is an association of independent firms. An independent member of Baker Tilly International.*

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