YOUR Knowledge

Xmas tax change may make 2010 tougher for Trusts

If you operate a discretionary trust and distribute some of the income of the trust to a related company then a draft tax ruling issued in the week before Xmas may create some additional headaches for 2010.

In a spirit of Xmas goodwill and cheer the Tax Commissioner released Draft Ruling TR2009/D8. This ruling says that where a trust has appointed income to a company beneficiary but has not actually paid the company the appointed amount, then these distributions made after 16 December 2009 will be deemed to be a loan from the company back to the trust. The effect of this, in most cases, is that the loan will be captured under Division 7A of the Tax Act. This is the section that says where a company makes a loan to a shareholder or an associate of a shareholder, that loan will be deemed to be an unfranked dividend unless the company and the shareholder has entered into a complying loan agreement and interest and principal is being paid on the loan.

The Tax Office has been concerned for some time about trusts distributing income to a company but not physically paying the company the income distributed. Once the income is appointed by the trust to the company, it is regarded as an unpaid present entitlement. Payment of the money by the trust will discharge this entitlement. In many cases, the trust will not have paid the company because it does not the available funds to meet the distribution. The money may be tied up in business working capital, committed to other assets, or even used in part to buy property within the trust. Irrespective of the reason the funds were not available at the time. Most private company owners have to deal at times with the difference between accounting profits and available cash. Using a company as a beneficiary of the trust had the advantage of capping the tax payable in that year to the company tax rate.

It has been common practice for many companies to build up a significant unpaid present entitlement account over a number of years. While the company has paid tax at the company tax rates on the distribution amounts, this is less than the tax payable if it had been to an individual beneficiary. The difference is mainly a timing issue. Ultimately, the money will flow from the trust to the company and then out of the company, generally in the form of dividends.
Continued over the page

Why February is cash flow hell...and what to do about it

If you listen to the news reports Australia survived the economic crisis relatively unscathed.

But behind the news, companies are still failing and this February will be a vital test of our economic optimism. The number one reason why companies fail is cash. Don't be deceived by the simplicity of this problem – some of the mightiest companies have simply run out of cash or their rate of growth has outpaced their capacity (or their banker's willingness) to fund the additional investment.

The balance between growth and cash flow is always a delicate one. All it takes is for a few major customers to either slow down or stop paying you and your cash flow is suddenly compromised.

February is traditionally the worst cash flow month in the calendar. Last month *Dun & Bradstreet* released data showing that business to business payment days have again risen and now sits at 53.9 days. Large companies are the worst payers with smaller companies, previously the fastest payers, now slowing their payment cycles. With another interest increase and BAS payments due, many will pick and choose who they pay.

If your customer case is consumers the news isn't that much better.
Continued over the page.

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Xmas tax ruling may make 2010 tougher for trusts

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Historically, unpaid present entitlements have not been caught by Division 7A. The ATO had previously taken the position that an unpaid present entitlement did not create a loan relationship between the parties to which Division 7A would apply. This interpretation has now changed. The ruling is both retrospective and prospective. The key date however is 16 December 2009. The ATO says that where a trust had made distributions to a company prior to this date, and maintained them as an unpaid present entitlement, then this ruling interpretation will not apply and you are able to rely on past statements made by the ATO. So, if you have unpaid present entitlements between your trust and a company you will need to quarantine those that are pre 16 December. This will need to be clearly recorded inside the accounts of the company and the trust.

It is important to note that this is a draft ruling. It does not have the effect of law. It represents the Commissioner's view – a view not necessarily shared by all tax professionals. In the ruling the Commissioner says that he will not apply the ruling until it becomes a final ruling. The draft ruling is currently open for comment until later this month. Once those comments are received, the Commissioner may proceed to issue his final ruling. The time frame for this is not known. While the Commissioner will not apply the ruling until it is a final ruling, he has put us on notice now. Unless you want to argue the position with him you need to work on the basis that this interpretation will dominate. Otherwise, the retrospective nature of the ruling could come back to bite you.

If the Commissioner continues in this view and it becomes final ruling, then trusts who have used corporate beneficiaries to limit tax payable on distributions, but where distributions have not been paid will need to change strategy. Otherwise, they will trigger an additional tax liability. Even in final ruling form this does not have the effect of law. However, if you did not accept the position you would need to be prepared to fight the Commissioner through the Appeals Tribunal or the Courts. Most business owners will not want to take that course of action.

Unfortunately, we are going to be in a 'wait and see' position for some time. There is no certainty that we will have a final position on this before June 30. Where you do operate a trust and utilise a corporate beneficiary, it would be a good idea to catch up for a tax planning meeting early in the year. This will allow some time to work through the strategy most appropriate for the current year.

Why February is cash flow hell

Continued from page 1

A separate *Dun & Bradstreet* analysis shows that up to four in ten Australian's will now need to use their credit cards to pay bills. The 18 to 24 age group and families with children appear to be faring worse now than they did at the height of the financial crisis. And, this is without factoring in an interest rate increase.

The risk of default, regardless of whether you are a B2B or B2C business, is high.

So what can you do to reduce your risk?

Manage your debtors -Set your payments terms and stick to them. Have a strong follow up process. In an environment where the first bill to be paid is the one judged to be the most urgent, it's worth speaking up and asking for what is owed to you.

Plan -Take a look at the cash requirements of your business and what investments need to be made. Make sure forecasts are not overly optimistic and performance measured closely. To use a term borrowed from the cavemen, in the current economic climate unless you are rolling in cash you can only eat what you kill.

Explore - Spend some time looking at efficiency. Not so much cost cutting (we've probably all done this) but where gains can be made without sacrificing resources.

Quote of the month

"Glory is fleeting, but obscurity is forever."

Napoleon Bonaparte

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