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Unpaid Present Entitlements – Final Practice Statement Released

The ATO has recently released its final practice statement on the application of its ruling on unpaid present entitlements (TR 2010/3).

The ATO's ruling and practice statement are concerned with setting out the ATO's view on when a private company will be taken to have made a "loan" to a shareholder or their associate for the purposes of Division 7A.

Background – Division 7A

Division 7A generally applies where a payment or loan is made by a company to either its shareholder or to a shareholder's associate.

Division 7A is designed to ensure that private companies are not able to distribute profits to shareholders by way of non-arm's length payments or loans rather than as taxable dividends.

Where Division 7A applies, such payments and loans are treated as unfranked dividends in the hands of the shareholders or their associates, provided the private company in question has sufficient distributable surplus at the time at which the loan is made.

Where a shareholder benefits under a trust, that trust will generally be an associate of the shareholder, so that any loans made to the trust by the company will be a "loan" for Division 7A purposes.

The ruling and the practice statement outline when the ATO considers that an unpaid present entitlement under the trust in favour of the private company beneficiary should be treated as a loan from the company to the trust for the purposes of Division 7A.

A consequence of treating an unpaid present entitlement as a loan under Division 7A is that, unless the loan satisfies certain requirements, the loan will be treated as a deemed dividend for tax purposes in the hands of the trust.

Broadly, under the ATO's ruling on unpaid present entitlements:

- A "section two loan" will come into existence if an unpaid present entitlement (UPE) is "converted" into a loan by either being classified as a loan in the accounts of the company and trust, or where the trustee has exercised a power under the trust deed to loan the amount to the trust for the benefit of the private company.
- Where an unpaid present entitlement has been so converted, the loan will be subject to Division 7A regardless of when it arose. The Commissioner will only be able to amend a taxpayer's return to reflect the making of such a loan within the standard amendment period except in the case of fraud or evasion.
- A "section three loan" will come into existence where a UPE that has come into existence in a period and has not been converted into a loan (i.e. a subsisting UPE) is permitted to remain on foot and the amount of the UPE is not held on sub-trust for the private company beneficiary. In such circumstances, the funds will generally have been used in conducting the business of the trust but may in some cases have been used to acquire private assets.
- Only UPEs that came into existence after 16 December 2009 are capable of becoming "section three" loans.

The practice statement sets out the manner in which the ATO intends to apply this ruling.

Under the final practice statement:

- Where a UPE has been deemed to be a 'loan' for the purposes of Division 7A, two self corrective mechanisms are available to taxpayers to either correct misstatements in the trust or company's accounts, or to

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self apply the Commissioner's discretion to disregard the deemed loan. These self corrective mechanisms will apply in very specific circumstances, so taxpayers should seek detailed advice on the tax consequences of this new practice statement if they are in this situation.

- Where a subsisting UPE may be otherwise deemed to be a loan, the amount can be put on sub-trust for the benefit of the private company beneficiary and either loaned back to the trust at a specified interest rate, invested in a specific asset of the trust or otherwise invested on commercial terms.

- The consequences of setting up a sub-trust which does not comply with the requirements set out in the practice statement may be that the subsisting UPE is deemed to be a loan to the trust and therefore potentially an unfranked dividend. As a result, affected taxpayers should seek specific guidance from their tax advisor in order to structure their tax affairs within the scope of the practice statement.

TO DO

Family trusts with unpaid present entitlements in favour of company beneficiaries should consult with their tax advisor to ensure that their tax affairs comply with the requirements of the ATO's newly released final practice statement

Research and Development Bill

The new research and development (R&D) bill was re-introduced into a newly formed House of Representatives this month. This Bill remains largely unchanged from its previous version, though minor clarifications have been made to ensure that 'development' activities will still be eligible for the R&D concession.

The passage of this Bill through Parliament is not expected to be smooth due to the nature of the minority Government, and if the passage of the Bill is delayed until the new Senate is formed in July 2011, the passage of the Bill through the upper house could be delayed further.

However, taxpayers should take note of the changes contained in the Bill, as it is due to take effect from 1 July 2010 and is therefore intended to affect the tax position of all entities engaged in research and development activities in the current income year.

The new Bill amends:

- which companies will be eligible for research and development concessions;
- the nature of the concession (which is being changed from a credit to a tax offset);
- the amount of the concession (businesses with a turnover of less than \$20 million will have access to an increased tax offset);
- the list of exclusions (i.e. activities that generally cannot be R&D activities for the purposes of the concession);
- the R&D concessions available for costs of software development activities.

As these changes are due to take effect on 1 July 2010, the eligibility for R&D concessions, as well as the amount and type of the concession (i.e. refundable or non-refundable offset rather than a credit) will likely be different for your 2011 income tax return as compared to your 2010 income tax return.

As such, if you have in the past claimed the R&D tax credit, or suspect you may be eligible to do so in the future, you should consult with your tax advisor to identify the challenges and opportunities for you arising from the new Bill.

TO DO

Taxpayers that currently claim research and development concessions, or suspect they may be eligible to do so in the future, should consult with their tax advisor to clarify their tax position under the new Research and Development Bill.

Taxation of Earnouts

Treasury is currently undertaking consultation in relation to new legislation to overhaul the taxation of earn-out arrangements.

An earn-out is broadly a right to ongoing payments from the purchaser after the sale of a business or asset. Such payments are generally based on the earnings or revenues of the business or asset after sale, and typically represent a form of deferred consideration on disposal of the business/asset i.e. as the ongoing payments are contingent on performance, the total consideration paid to the vendor is generally intended to be based on the profitability of the business.

This consultation was initiated as a result of the Commissioner's draft ruling on earnouts, which sets out the Commissioner's draft view that where a disposal is subject to an earn-out right, the consideration on disposal constitutes the cash amount as well as the "market value" of the earn-out right, and the excess of this consideration over cost base is taxed as a gain to the vendor at the time of the disposal.

The treatment set out in the ATO's draft ruling requires vendors to pay tax on an amount that they have not yet received (or may never receive) and potentially miss out on the CGT discount in relation to earn-out payments.

The new legislation is intended to prevent this outcome, and will apply from the date of Royal Assent. Taxpayers intending to dispose of or acquire an asset or business that is subject to an earn-out arrangement should consult their tax advisor in order to identify challenges and opportunities posed by the planned reform of these rules.

NOTE

Taxpayers intended to acquire or dispose of a business or asset subject to an earn out payment should seek advice from their tax advisor as to the tax consequences of such an earn-out.

Primary Production Trusts

The ATO has withdrawn its tax ruling in relation to the averaging of income derived by primary production trusts in response to the High Court's decision in *FC of T v. Bamford Ors; Bamford Anor v. FC of T* [2010] HCA 10; 2010 ATC 20-170; (2010) 84 ALJR 266.

Under this ruling, the income of such a trust was permitted to be averaged so that beneficiaries under the trust may be taken to be carrying on a business of primary production even where the trust has nil income or a loss in a particular income year.

This ruling was withdrawn, effective from 30 June 2010. As a result, the ruling will apply to arrangements begun to be carried out on or before that date, but not afterwards.

With the withdrawal of this ruling it is now unclear whether such beneficiaries will be taken to have carried on a business of primary production in an income year during which the trust is in a nil income or loss position.

As a result, taxpayers who conduct a primary production business through a trust should seek advice from their tax advisor on how the withdrawal of this ruling may affect their tax obligations.

NOTE

Beneficiaries under a trust that carries on a business of primary production should consult with their tax advisor, following the Commissioner's withdrawal of his ruling on averaging of income for such trusts.

Superannuation

Research on community attitudes into superannuation

The Minister for Financial Services and Superannuation recently released the results of a national survey conducted by independent market research company Colmar Brunton into community attitudes towards superannuation.

Among other findings, the research established that Australian taxpayers find superannuation complex, and are generally "confused and disenchanted". The frequency of reform in this area has also caused concern.

We understand the community's attitudes towards this particularly difficult area of tax law.

As increasing numbers of taxpayers establish self managed super funds (SMSFs) to obtain the tax advantages that may be gleaned from this form of investment for retirement, the complications and compliance burden faced by taxpayers increases on a yearly basis.

In addition, the potential consequences of breaking the rules in either setting up, maintaining or winding up a SMSF are significant.

If you are considering setting up or changing any of the particulars in relation to your SMSF, please ensure you

obtain tax advice from a registered tax agent in relation to your plans.

Superannuation Guarantee Surcharge

Employers should consider the impact that an increase in the Superannuation Guarantee Surcharge may have on their business as the current Government has made this issue one of their priorities.

ATO warns of deviant behaviour by SMSFs

The ATO is targeting the provision of financial assistance by an SMSF to its members through an unrelated trust (such as by way of investing funds in a trust which trust will then use the funds to on-lend to a member of the SMSF).

The ATO has warned that such activity may result in the funds being non-compliant and subject to tax at the rate of 45%.

The penalties for such behaviour are also significant:

- Trustees of super funds who provide financial assistance in this way face penalties of up to \$220,000 and/or jail terms of up to 5 years for individuals.
- Corporate trustees face fines of up to \$1.1 million.

NOTE

Superannuation is complex and confusing. Please see your tax advisor to obtain tax advice on dealings with your super fund if you are unsure about the consequences.

The ATO is policing the provision of financial assistance by SMSFs to members, either directly or through intermediate entities.

Compliance Activities – Cash Economy and Benchmarking

The ATO has renewed its focus on businesses operating in the cash economy, including in the form of understating income and payment of wages and other remuneration in cash in order to avoid superannuation, PAYG (withholding) and payroll tax obligations.

Benchmarks are used by the ATO to identify businesses that may be operating in the cash economy. The ATO benchmarks are financial indicators, such as the cost of goods sold margin, achieved by other businesses in the same industry.

Businesses that fall outside the benchmark for their industry may receive a letter asking for the relevant taxpayer to provide reasons.

While these benchmarks are drawn over a wide range, it is foreseeable that honest taxpayers who do not engage in fraudulent activities will still be sent such letters, especially where the business does not fall squarely into a specific business category, or the business operates in a geographical area which is not representative of the average population over which the benchmark is drawn.

Such letters are in some instances being sent directly to taxpayers rather than tax agents. Taxpayers who receive such a letter are encouraged to contact their tax advisor.

NOTE

Businesses that receive letters in relation to falling outside the ATO's benchmarks for their industry should seek advice from their tax advisor in formulating their response.

Compromised TFNs

The Commonwealth Ombudsman recently released his report on the ATO's treatment of taxpayers with complaints about compromised Tax File Numbers (TFNs).

The report considered 8 case studies of situations in which the taxpayer's TFN had either been compromised or incorrectly linked by the ATO to another person's TFN.

The Ombudsman noted in his report that "[t]he action taken by the ATO to deal with these complaints was unreasonable. Our investigations have shown a systemic failure by the ATO to properly recognise and respond to the issues faced by taxpayers".

"When this unique identifying number is compromised the impacts on a taxpayer can be significant. It can cause delayed refunds and payments, debts being incorrectly attributed to the taxpayer or problems with other agencies like Centrelink, where information is exchanged."

Such situations are of concern to many taxpayers, due to the potentially serious consequences. In addition, situations in which a taxpayer's TFN has been compromised as a result of ATO error are less likely to be quickly identified.

Taxpayers who are concerned that that they may have been affected should contact their tax agent or the ATO via its dedicated Call Centre, or should consult the ATO's fact sheet on this issue (available on www.ato.gov.au).

In accordance with the Ombudsman's recommendations, the ATO is currently:

- investigating measures by which to revise their systems to prevent such errors occurring in the future; and
- revising its response to taxpayers whose TFNs may have been compromised.

NOTE

If you are concerned that your Tax File Number may have been compromised, please contact either your tax advisor or the ATO.

Treatment of GIC for Division 7A purposes

The Full Federal Court has dismissed the Commissioner's appeal from the decision of the AAT in *Waffles Pty Ltd and Anor and FCT* [2010] AATA 78 (3 February 2010).

This case concerned the time at which a taxpayer's primary liability for income tax becomes a 'present legal obligation', for the purposes of calculating a company's distributable surplus for Division 7A purposes.

As above, Division 7A is designed to ensure that private companies are not able to distribute profits to shareholders by way of non-arm's length payments or loans rather than as taxable dividends.

In order to create a proxy for 'profits', Division 7A requires the calculation of the company's "distributable surplus".

A payment or loan may only be a deemed dividend under Division 7A to the extent that the company had sufficient distributable surplus at the end of the income year during which the deemed dividend would otherwise arise.

A company's distributable surplus is broadly equal to its net assets less share capital. In calculating a company's net assets, the company is required to deduct "present legal obligations" from its assets.

In the case at hand, the taxpayer company was disallowed deductions in relation to sham payments made to a Hong Kong company over a number of years.

The issue in question was whether the income tax liability arising in relation to each income tax year in which the taxpayer's deductions were disallowed became a present legal obligation at the end of the relevant income year (as argued by the taxpayer) or at the time that the tax was legally "due" for payment i.e. until an assessment is issued in relation to the year of income (as argued by the Commissioner).

This issue was relevant because if the tax payable was a present legal obligation (for Division 7A purposes) at the end of the year of income, the tax liability would be deducted from assets in calculating the net assets of the taxpayer company which would in turn reduce the amount of the deemed dividend on which the taxpayer company's shareholder was required to pay tax.

On consideration of the legislative context and purpose of Division 7A, the Court agreed with the taxpayer and dismissed the Commissioner's appeal to hold that for Division 7A purposes, income tax constituted a present legal obligation at the end of the year of income in relation to which the deductions were disallowed.

NOTE

When determining whether a loan or payment from a private company to a shareholder has resulted in a deemed dividend, the company's income tax liability in respect of that income year should be taken into account as a "present legal obligation" when calculating the company's distributable surplus.

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