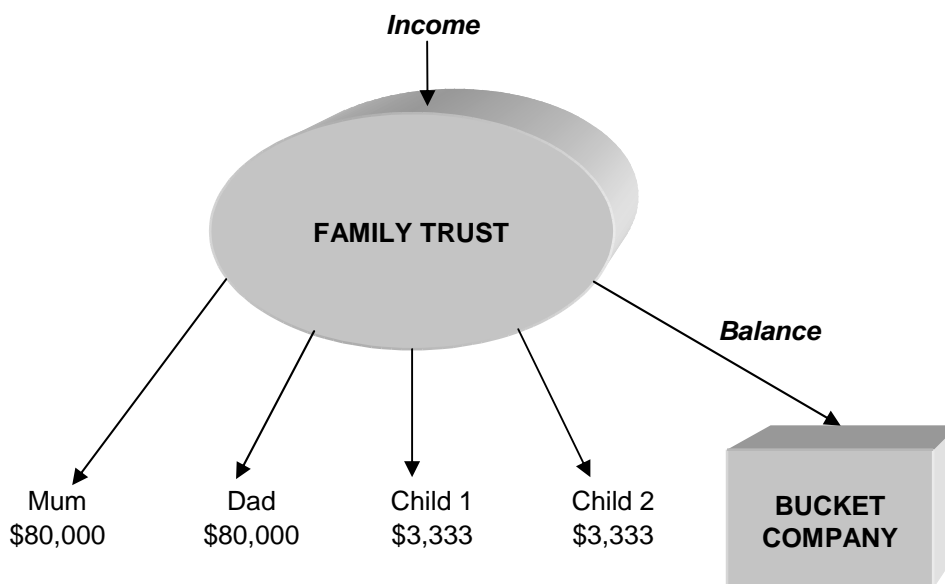


Tax Changes Affecting SMEs

For at least the last decade a discretionary trust has been considered the best structure to operate a small to medium enterprise (SME) in Australia. Recent changes mean this may no longer be the case.

The most common business structure for SMEs has been a discretionary trust (family trust) as the main trading entity with a corporate beneficiary (bucket company). The discretionary trust enables the streaming of income to individuals within the family group. Typically this was up to a maximum of \$80,000 (top of the 30% tax bracket) for mum and dad. For the year ended 30 June 2011, a distribution of \$3,333 is the maximum tax free distribution which can be made to beneficiaries less than 18 years of age. This reverts to \$416 for the year ended 30 June 2012. The balance of income is distributed to a corporate beneficiary who pays a flat rate of tax at 30%. In this way the marginal tax rate for the group is capped at 30%. Therefore mum and dad are not subject to the higher marginal tax rates which are 38.5% and 46.5% inclusive of the Medicare levy.

The diagram below represents the typical flow of distributions within this structure.



Typically in the above scenario the distribution of income from the trust to the company is not paid in cash. When this happens the cash is retained in the family trust for working capital in the business or it is invested. A company is not a good investment vehicle since it does not receive the 50% Capital Gains Tax (CGT) discount, which is available to trusts and individuals. When a distribution is made to a company from a trust and the cash is not paid across an un-paid entitlement (UPE) is created.

If a UPE exists and the beneficiaries draw cash from the family trust which has not been distributed directly to them, then **Division 7A** of the Income Tax Assessment Act (Tax Act) deems these drawings to be a dividend. This deemed dividend is taxed at top marginal rates and severe penalties may also be imposed. The result would be an effective tax rate of well over 50% - a scenario which should be avoided. Similarly if a shareholder draws money from the company which has not been paid out by way of dividend, a deemed dividend can also be imposed.

Until recently, a UPE between a trust and company created no tax issues provided the beneficiaries or shareholders did not draw funds they were not entitled to. The trust could retain the cash from profits distributed to the bucket company. Australian Taxation Office (ATO) **Ruling 2010/3** seeks to overturn this position.

ATO Ruling 2010/3 states that any UPE created post 16 December 2009 is a loan according to Division 7A of the Tax Act and will be deemed as a dividend if one of the following is not done:

1. The trust pays out the UPE by transferring cash to the bucket company. This is not always possible since the cash is often used as working capital in the trust. Further, there is the issue of how to invest the funds in the company since the CGT discount is not available.
2. Convert the UPE to a Division 7A compliant loan. This loan must charge a minimum interest rate set out by the ATO, which is currently 7.4%. The loan must include principal reductions each year. The maximum term for an unsecured loan is 7 years. A secured loan may have up to a 25 year term. The interest charges on this loan will be taxable income in the company. In addition there is a cashflow issue for the trust since principal and interest amounts must be paid every year.
3. A sub-trust may be created in the family trust which sets aside a specific asset for the benefit of the bucket company. The value of the sub-trust asset must be sufficient to cover the UPE balance. There are a number of requirements which must be satisfied for this sub-trust arrangement to be valid.
4. The company may "buy" assets such as plant and equipment from the trust to clear the UPE. The plant and equipment would then be leased back to the trust on a commercial basis. Depreciating assets in a company do not have the CGT disadvantages of investment assets in a company since they are written off each year and are not subject to CGT.

Of these remedies, option 2, the Division 7A loan is by far the most commonly employed. The problem with this option is that a new loan is required each year. At the end of 7 years there could be 7 separate loans in place, each one requiring principal and interest payments. This would become administratively very difficult to deal with.

Further Division 7A loans are often repaid by way of declaring dividends from the bucket company. These dividends are taxable income in the hands of the business principals, since they are usually the shareholders in the bucket company. The tax impact of declaring these dividends over time becomes worse than the tax that would have been paid if no distribution was made to the bucket company in the first place.

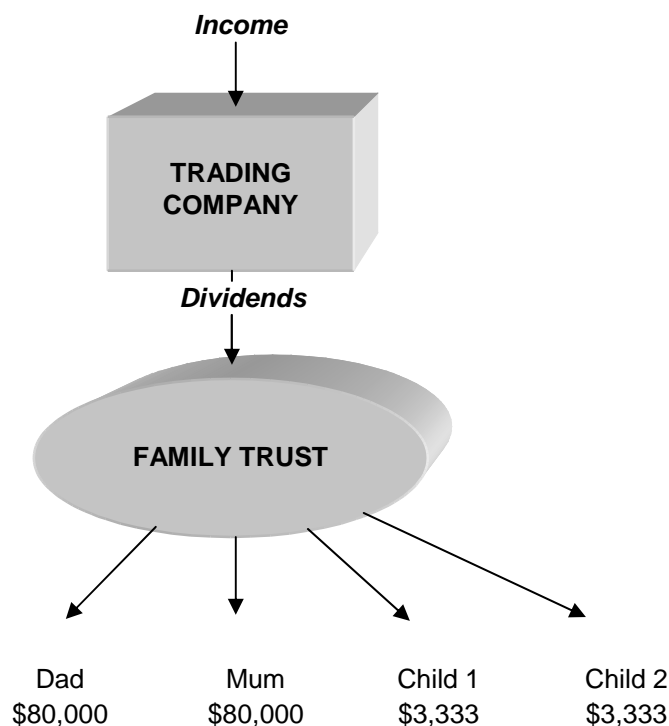
As I am sure you can now appreciate this is a complex and difficult scenario to deal with. Unfortunately most of the SME businesses in Australia will be impacted by the above changes in some way.

A solution is to transfer the business out of the trust structure and into a company structure. The shares in the new trading company should be held by the family trust. Under this structure business profits are taxed at the flat corporate rate of 30%. Any cash drawings required by the business proprietors must be paid out by a dividend from the company to the trust. This dividend income is then distributed out of the trust to the beneficiaries. These trust distributions may be streamed in the most tax effective manner, provided the Trust Deed allows.

It is important the trust holds the shares since dividends paid from a company are fixed in proportion to the shares held. Therefore it is not possible to stream dividend income which comes directly from the company.

Under the current marginal tax rates it is possible to pay a gross dividend of \$166,666 to mum, dad and 2 children without exceeding the 30% marginal tax rate. The cash component of this dividend assuming it is fully franked is \$116,666. The balance of the dividend is imputation credits of \$50,000. These imputation credits should more than cover the tax resulting from the dividend, provided mum, dad and the children do not have significant other income.

Under this new structure the flow of income through the group is as follows:



When transferring the assets from the trust to a company there are CGT rollover provisions which provide relief from the taxation consequences. Other issues such as the stamp duty on asset transfers and existing contract arrangements should also be considered before any decision to roll over into a company structure are taken.

Using this structure the tax implications of ATO Ruling 2010/3 and Division 7A may be avoided. The major disadvantage of this company structure is the capital gains tax implication if the business is sold.

When a business is sold the purchaser can either buy the assets out of the structure or alternatively they can assume control of the existing structure by purchasing the shares or units. Typically when an SME business is sold the purchaser buys the business assets out of the structure. This is because a structure retains its history when a new owner takes over. The purchaser does not want the exposure to any legal consequences which may result from this history. The way to ensure there is no exposure is to buy the assets only and place them in a fresh structure.

When selling a business out of a trust structure it does not matter either way since the CGT 50% discount is available under both scenarios. In a company structure however the 50% CGT discount is only available if the shares are sold. This is because the trust owns the shares therefore it is the trust's capital gain, which has access to the 50% discount. If however the company sells the assets then the company makes the capital gain and no discount is available.

Over time it may become more commercially acceptable for purchasers of an SME business to buy the shares in a company. This change will be due to the above tax issues which will drive more SME businesses into operating through a company structure.

Every business and family circumstance is different, therefore it is critical professional advice is sought before any decision to alter your businesses structure is taken. The proposed restructure will not be appropriate in some situations.

The taxation issues created by ATO Ruling 2010/3 should not be ignored. The impact of a deemed dividend would be threefold, firstly 46.5% income tax, secondly penalties imposed by the ATO and thirdly general interest charge levied on the outstanding tax balance.

For more information about how Div 7A may impact your business, please contact your McLean Delmo Partner or call Jamie Bishop on 03 9018 4666 or email jamie.bishop@mcleandelmo.com.au