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TRUSTS AND COMPANIES: ARE FUNDS INTERMINGLED?

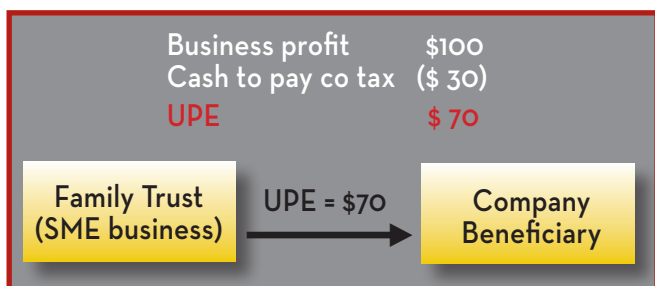
Trusts are a popular business structure used by many Small to Medium Enterprises ('SME's'). Some SME structures include using a company as a beneficiary of the trust, where the trust distributes income to the company which pays tax at the rate of 30%.

Often cash does not necessarily follow the income distribution from the trust to the company, but typically remains intermingled with funds of the trust and is used by the business owner to fund business expansion, working capital or investments. The effect of this is that an unpaid present entitlement ('UPE') arises.

The Australian Taxation Office has finalised its ruling TR 2010/3 "Division 7A loans: trust entitlements" which has implications for owners of SME's that use this structure. In simple terms the impact is that UPEs from a trust to a company are treated as "loans".

The ATO considers that intermingled funds represented by a UPE are a loan, as the company has provided financial accommodation to the trustee of the trust. The notion of a UPE being considered to be a loan in substance brings transactions within the realms of the deemed dividend provisions.

The example below illustrates that \$100 business income earned by a trust where the trustee resolved to distribute to a company, after paying company tax of \$30 would result in a UPE of \$70. The amount of the UPE may be treated as deemed dividend if no corrective action is taken.



The view of the ATO is somewhat controversial, there has been much commentary from the tax profession regarding the interpretation adopted. In practice many accountants and lawyers have never regarded UPE's to be a loan.

Trust law and the application of the taxation rules is complex, for SME's the key is to seek advice from your tax advisor on the application of the ruling. Issues to review would be:

- Your trust and business structure moving forward;
- Cash-flow implications on your business; and
- Potential exposures for non-compliance.

If no action is taken a deemed dividend may arise equal to the amount of the UPE.

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