TECHNICAL UPDATE

TRUST DISTRIBUTIONS CAN BE TAXED AT 49% IF PAID AS PART OF A REIMBURSEMENT AGREEMENT

ATO HAS RELEASED AN INFORMATION PAPER ON THE OPERATION OF THE TRUST 'REIMBURSEMENT AGREEMENT' PROVISIONS IN SECTION 100A OF THE INCOME TAX ASSESSMENT ACT 1936.

One of the main targets of this information paper is perpetual repayment mechanisms that ensure Division 7A private company deemed dividends do not apply to trust Unpaid Present Entitlements (UPE). Where a reimbursement agreement is present, the net income of the trust will be taxed to the trustee at the maximum marginal rate (49%) rather than being assessed to the beneficiaries who are presently entitled to the income of the trust.

The Information Paper observes that a reimbursement agreement generally involves making someone presently entitled to distributable income of a trust in circumstances where **both**:

- Someone else actually benefits from that income, **and**
- A purpose of a party to the agreement is obtaining a tax benefit.

The Information Paper concedes that if an arrangement was entered into in the course of an ordinary family or commercial dealing, s100A will have no application.

Perpetual motion structure

The Information Paper includes a number of examples involving UPE's. One of the examples involves a common arrangement that ensures Division 7A deemed dividends do not apply to UPE's from a trust to a private company.

This example involves what is known as 'perpetual motion' structure, where the tax rate that applies to accumulations in a trust structure is effectively capped at the corporate tax rate rather than the maximum marginal rate that would apply under s99A. Under the scheme, in year one, the trust distributes a UPE to a wholly owned company which is also a beneficiary of the trust. The company includes its share of the trust taxable income in its assessable income for year one and pays tax at the corporate rate. The year one trust income is distributed to the company in year two prior to the lodgement of the company's year one income tax return, avoiding the application of Division 7A. The company pays a fully franked dividend to the trustee in year two, sourced from the trust income. The arrangement is repeated over a number of years, which effectively refreshes the UPE each year.

The Tax Office considers such perpetual circulation of funds serves no commercial purpose and considers section 100A would apply to assess the trustee on the UPE at 49%.

Ordinary family and commercial dealings

The Information paper gives some other examples where the 'ordinary family or commercial dealings' exemption may or may not apply.

SECTOR

Tax

CONTACT

MARCUS LEONARD
National Leader, Tax
Tel: +61 2 9240 9771
marcus.leonard@bdo.com.au

LISA PRITCHARD
Partner, Adelaide
Tel: +61 8 7421 1418
lisa.pritchard@bdo.com.au

MARK MOLESWORTH
Partner, Brisbane
Tel: +61 7 3237 5999
mark.molesworth@bdo.com.au

ERIC OLUFSON
Partner, Cairns
Tel: +61 7 4046 0000
eric.olufson@bdo.com.au

MAL SCIACCA
Partner, Darwin
Tel: +61 8 8981 7066
mal.sciacca@bdo.com.au

BRETT SKIRVING
Partner, Hobart
Tel: +61 3 6234 2499
brett.skirving@bdo.com.au

DAVID BLAKE
Partner, Melbourne
Tel: +61 3 9603 1709
david.blake@bdo.com.au

JAMES MASSIE-TAYLOR
Partner, Perth
Tel: +61 8 6382 4600
james.massie-taylor@bdo.com.au

The obvious example where the ordinary family and commercial dealings exemption does apply is a trust established under a will for the benefit of the deceased person's grandson where the income of the trust is accumulated until he reaches 25 years of age. The Information paper indicates this would be an ordinary family dealing and more generally, it states that "section 100A does not apply in relation to the entitlement to income of a beneficiary who is a minor".

The other examples are not as obvious and the outcome will depend on whether the factors in the arrangement indicate it was entered into in the course of an ordinary commercial dealing. One such example is:

- The trustee of a trust estate makes a beneficiary entitled to distributable income
- The presently entitled beneficiary's assessable income includes a share of the trust's taxable income
- Instead of paying the amount of distributable income to the presently entitled beneficiary, the trustee gives, or lends on interest-free terms, the money to another person
- The other person benefits from the distributable income of trust, but is not assessed on any part of the trust's taxable income.

The Information Paper states that if this arrangement was not entered into in the course of an ordinary family or commercial dealing, it will generally be a reimbursement agreement if it was intended that the beneficiary who was made presently entitled to the distributable income pays a lower amount of tax than would otherwise have been payable. The paper gives no guidance as to which side of the ordinary family or commercial dealing boundary such an arrangement would generally fall on but it does concede that 'loans made in the course of ordinary family dealings are often not as commercial loans – for example where money is lent by the trustee to a family member on terms that require repayment of principal only … this could still indicate an ordinary family dealing…'

However the Information paper blurs this conclusion in a later example that has the trustee lending to a family member on commercial terms as the reason why Section 100A does not apply.

Division 7A and Section 100A

In relation to trusts with UPEs distributed to Australian resident companies, the Information paper states that both Division 7A and Section 100A could apply. However it says, where all entitlements of the companies' are placed on Division 7A complying loan terms or sub-trust arrangements that comply with the options in PS LA 2010/4 and retained in the trust as working capital (and in the absence of other factors) the Commissioner of Taxation would not consider this arrangement to be a reimbursement agreement.

Outside of examples, little guidance is provided about what would comprise ordinary family or commercial dealings for these purposes.

BDO Comment

The Information Paper is welcome, as it provides some guidance on the circumstances where UPEs will lead to the penal application of s100A. However, as the examples where there is found to be an ordinary family or commercial dealing all involve the UPE being retained by the trust as working capital, no guidance is given on situations such as that depicted in the first example where UPEs are loaned to other beneficiaries.

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