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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 issues in the week before Christmas may create some additional headaches for 2010.

In a spirit of Christmas goodwill and cheer the Tax Commissioner released Draft Ruling TR2009/D8. The 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 have 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.

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.

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Quote of the Month

“Change is the law of life. And those who look only to the past or present are certain to miss the future.”

John F. Kennedy

Our Mission

To help **grow** and realise the **profit** improvement potential, **business value** and **lifestyle** choices of our clients through **innovative** application of **wealth** creation strategies.

Compliance Corner

Tax Change May Make 2010 Tougher for Trusts, cont

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 a 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.

Superannuation Funds & Property Development

A longstanding question is whether an SMSF trustee may run a business. Naturally, few trustees want to run a regular trading business. However, a significant number do want to run a real estate development business.

Two of the main issues to be determined are:

- ◆ Can an SMSF trustee run a business?
- ◆ When will property development constitute a business?

The legislative position

As the ATO correctly states, there is nothing in the superannuation legislation to prevent an SMSF trustee from running a business. However, there are a number of provisions that trustees must be aware of, including:

- ◆ **Investment strategy** — the trustee must formulate and give effect to an investment strategy that has regard to the whole of the circumstances of the entity including issues such as diversification.
- ◆ **Remuneration** — no trustee of an SMSF may receive any remuneration from the fund for any duties or services performed in their role as trustee in relation to the fund. This might prove problematic if the trustees were working in the business and required a wage for day to day living expenses yet were under their preservation age.
- ◆ **Financial assistance and arm's length requirements** — an SMSF trustee must not give any financial assistance using the resources of the fund to a member or a relative. Furthermore, an SMSF trustee must only deal with related parties on an arm's length basis. This is important to bear in mind if a related party is being engaged to work for the fund.
- ◆ **Charges** — the trustee must generally not give a charge over a fund asset. Many common business arrangements involve charges.

However, the most important legislative provision raised by the ATO is the sole purpose test. This requires that each Trustee must ensure the fund is maintained solely for certain core and ancillary purposes. Naturally, these include purposes such as the provision of benefits for members upon retirement.

When will real estate development not constitute a business?

There is no hard and fast test for when real estate development will constitute a business. However, there are a number of salient features that are relevant. These features include:

- ◆ whether there is repetition and regularity of the activities;
- ◆ whether the activities are of the same kind and carried on in a similar manner to that of the ordinary trade in that line of business; and
- ◆ the size, scale and permanency of the activity.

Practical implications

The legislation does not prohibit an SMSF trustee from carrying on a business of property development, but it does contain a number of provisos that must be born in mind if carrying on such a business. In particular:

- ◆ the fund should ensure its deed, investment strategy and related documents are carefully reviewed to ensure they authorise the activity;
- ◆ in many cases property development exposes a fund to commercial risks, for example cost overruns, illiquidity of a builder/contractor/tenant;
- ◆ building contracts have to be checked and their payments should be excluded; and
- ◆ joint venture development activities give rise to a range of other issues that are outside the scope of this article.

Even if these provisions are met, carrying on a business may still entail an element of risk. In light of the above risks, an SMSF trustee might well consider engaging another entity to carry out the development leg work so that any vacant land that that forms part of the SMSF assets would still be developed, but the SMSF trustee would merely realise an asset rather than carry on a business. Moreover, the arrangement with the developer should be benchmarked with competitive quotes and otherwise reflect arm's length terms.

Employment Taxes Update

When did you last look at your Employment Taxes?

In recent months there has been a noticeable increase in the level of compliance activity being conducted in the area of Employment Taxes, both at the Federal and State levels. Employment Taxes means Fringe Benefits Tax ('FBT'), Payroll Tax ('PRT'), Superannuation Guarantee ('SG'), PAYG Withholding ('PAYGW') and Workers' Compensation ('WC'). This coupled with enhanced data matching capabilities, greater liaison between the ATO and State Revenue Authorities, means that there has probably never been a greater risk of a business having one or more of its Employment Taxes subject to close scrutiny.

Employment Taxes are often the 'poor relation' when it comes to consideration of tax exposures. However, with the inter relationship between some of the Employment Taxes and the commonality of some issues between the obligations, often an error in one area has a flow on effect to another. Similarly, an error in one year is often repeated year upon year if not identified. When this is considered in conjunction with what is generally a 4 year amendment period, penalties and interest, amended assessments can be very costly. However, it should not all be seen as bad news. It is our experience that businesses often make errors that result in the overpayment of their obligations, especially FBT, PRT and WC. Therefore a detailed review of these areas could result in refunds and ongoing savings.

Why has compliance activity increased?

It has been noted by the ATO and some of the State Revenue Authorities that in difficult economic times it is evident that

some businesses do not have sufficient cash flow and may use funds that would otherwise pay tax liabilities as working capital. It is also recognised by the authorities that whilst income tax is generally handled by tax agents, many business seek to self administer their Employment Taxes. In this regard many businesses have neither the resources not the knowledge to appropriately handle these obligations. It is also a fact that Governments need to ensure that their revenues are not diminished and seek to maximise their returns. Whilst these concerns apply to all businesses they are particularly focused on the SME segment. A list of some of the current Compliance Programs being conducted by the relevant authorities is below.

What can you do?

As a first step it would be prudent to review the list of Compliance Programs to determine whether any of them are likely to highlight your business. The next step would be to consider reviewing your compliance with these obligations and ensuring that any potential issues can be explained and addressed. Where it is identified that potential issues exist you should contact BHT Partners to discuss the situation.

Can BHT Partners assist?

BHT Partners has a team of specialist advisers in the area of Employment Taxes. Our team has experience in providing services to all levels of business in relation to these obligations. We have experience in assisting clients in handling audits from Revenue Authorities, seeking private rulings and handling compliance issues.

Current Compliance Programs

Australian Taxation Office

Employer Obligation Reviews: The ATO has set up a specialist group to focus on PAYGW, FBT and SG compliance. Whilst this group has existed for some time, it is only now that we have witnessed a significant number of these reviews. Each of the three obligations is looked at in some detail. Some of the reviews have been randomly selected and others have been selected due to some apparent anomaly (eg. significant reduction in PAYGW, cessation of FBT registration, etc).

The ATO has released the following result of its Employer Obligations reviews conducted in 2008/09:

Micro Enterprises	27,500 reviews conducted	\$381.6m revenue raised—average \$17,700 per review
SMEs	6,000 reviews conducted	\$153.1m revenue raised—average \$25,500 per review
Large Enterprises	286 reviews conducted	\$5.0m revenue raised—average \$17,500 per review
Non Profit Organisations	1,359 reviews conducted	\$25m revenue raised—average \$18,400 per review

FBT

FBT Motor Vehicles: Cars make up the majority of the FBT paid by businesses and as such is an obvious area of attention. The ATO is sourcing data from state motor registration bodies, salary packaging organisations and fleet providers. Data has been obtained regarding luxury vehicles, utes and twin cabs and all cars with a value in excess of \$10,000. This is being matched against FBT returns and used to source a number of separate review programs. These programs are focusing on the non declaration of car benefits, the incorrect application of the exemption for vehicles such as utes and the valuation of cars under the log book method.

Employment Taxes Update, cont

PAYGW

Micro Enterprises: Businesses with turnover of less than \$2m are considered higher risk in terms of PAYGW (non remittance, payment of cash, etc) and SG obligations, and will continue to receive ongoing scrutiny from the ATO in these areas. Concerns include payment of cash wages, use of ABNs to 'mask' employment relationships and the non payment of SG.

Superannuation Guarantee

Complaints: Many reviews result from employees making complaints of insufficient contributions being made. Generally, these occur when employees leave employment involuntarily. With redundancies having increased over the last year it is expected that complaints and therefore also reviews are likely to increase. The ATO follows up on all such complaints.

The ATO recently noted that in excess of 70% of all FBT reviews identify some non compliance. The average assessment from these reviews is in the order of \$70,000 plus \$20,00 in interest. Furthermore, in the micro enterprise segment, of the 4,300 high risk reviews conducted in the last year, approximately 78% had not complied with PAYGW obligations and almost 50% had not complied with SG obligations.

State Revenue Office (Victoria) PRT

WorkCover Data Match: Due to considerable commonality between PRT and WC, many SRO's regularly obtain reports from the WC Authorities which show businesses that are paying wages in excess of the relevant PRT threshold; these are matched against the PRT database to identify unregistered businesses. The reports are also used to identify cases where the wages declared for PRT are substantially less than those declared for WC. Reports are also obtained showing workplace addresses where multiple businesses are registered. These are used to identify potential PRT groups.

Business Development

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 base is consumers the news isn't that much better.

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 (business to business) or B2C (business to customer) 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.

Fair Work Act—Is Your Workplace Ready

On 1 January 2010 several important changes to Australia's workplace laws commenced. These changes affect all employers and employees in the national workplace relations system, irrespective of the business type or organisation structure.

The changes include the commencement of the National Employment Standards (NES), many employers in NSW, Queensland, Tasmania & South Australia moving into the national system (Victoria was already under the national system) and the commencement of Modern Awards.

Employers need to be well prepared for these changes.

National Employment Standards (NES)

The Fair Work Act provides a safety net of 10 enforceable minimum employment terms and conditions through the NES. A summary of the entitlements created by each of the standards follows.

Maximum weekly hours — normal working hours should not exceed 38 hours per week, but an employer may request/require "reasonable additional hours" to be worked. The Hours standard also contemplates that hours could be averaged over a work cycle.

Requests for flexible working arrangements — this part of the Standard does introduce something new for most employees. It provides that parents with care of child under school age or care of a child with a disability under the age of 18 can request changed work arrangements to help cope with their family responsibilities. This might for example involve a request to work for part of the week from home or to vary start/finish times. It only applies to employees with at least 12 months service and any request must be in writing. An employer is not bound to agree to every request but should only refuse on "reasonable business grounds."

Parental Leave — this part of the Standard builds on existing parental leave entitlements. It enables both parents to take up to 12 months unpaid leave following the birth of a child although not at same time, except for 3 weeks at time of birth. It also allows one parent to request to extend the leave period by a further 12 months. Any request must be made at least 4 weeks prior to end of leave. An employer is bound to agree unless there are "reasonable business grounds for refusing."

Annual Leave — most employees have an entitlement to 4 weeks leave or 5 weeks for shift workers, as defined in awards. The entitlement accrues progressively. Any ability to "cash out" will be left to awards to define.

Community Service Leave — employees are entitled to be absent from work if engaged in "eligible community service activity" such as voluntary emergency management activity like the CFA or SES. The absence must also be "reasonable".

Personal/Carer's/Compassionate Leave - confirms what already exists for most full time, non-casual employees being 10 days paid personal/carer's leave which accrues progressively and is cumulative if unused plus 2 days unpaid carer's leave and 2 days paid compassionate leave. Casual employees will be entitled to two days unpaid personal/carer's leave and two days unpaid compassionate leave.

Long Service Leave — this confirms that existing award or State based entitlements will continue to apply as entitlements that cannot be done away with.

Public Holidays — employees are entitled to be absent on the designated public holidays unless they have been asked to work. In such cases they may refuse to work if "the request is not reasonable OR the refusal is reasonable".

Notice of Termination and Redundancy Pay—written notice of termination required. Scale of redundancy payments based on length of service ... but does not apply if less than 15 employees, or serious misconduct involved.

Fair Work Information Statement — from 1 January 2010 all employers have an obligation to give each new employee a Fair Work Statement before, or as soon as possible after, the employee starts employment.

Modern Awards

From 1 January 2010 modern awards replace existing awards in most industries providing enforceable minimum employment standards which apply in addition to the NES.

Modern awards cover all employers and employees who perform work in those industries or occupations covered by a particular modern award. Modern awards will not apply to employees who:

- are covered by an enterprise agreement.
- are managerial or senior employees who have not traditionally been considered award employees.
- are high income earners who earn over \$108,300 per annum and who have entered into a guarantee of annual earnings.

Preparing for Modern Awards

As the modern awards replace thousands of federal and state-based awards, the impact of the wages and conditions in the modern awards vary between states, industries and employers.

To lessen the financial impact of the new arrangements, modern awards may contain transitional provisions which allow increases and decreases in minimum conditions to be progressively phased in.

Employers need to determine which modern award applies to them and to ensure that they are aware of the substance and timing of the new terms and conditions that apply to their business.

All policies and contracts of employment should be reviewed to ensure that they do not provide entitlements less favourable than the relevant modern award.

If employers want to exclude high income earning employees from award coverage they must enter an agreement to do so.

Further information on the Fair Work Act, National Employment Standards and the Fair Work Statement can be obtained from Fair Work Online — www.fairwork.gov.au or phone 13 13 94.

Estate Planning Update— *Parent to Child Loans*

What starts as a loan or a gift from a parent to a child (eg. to help a child purchase a home in days when housing prices are a much greater multiple of average salaries than was the case a generation previously) can at a later date become any of:

- a bonus for the child's estranged domestic partner (whether married or de facto, heterosexual or same sex);
- a bonus for creditors of the parent or child's business;
- a barrier to a means tested pension for the parent or child;
- the subject matter of a family provision dispute when the parent dies.

Without forward planning (often needing to occur at the time a loan or gift is made):

- the Family Court can view a loan as a disguised gift (providing that a loan with non-commercial terms only has to be repaid on the breakdown of a relationship can also be seen by the Family Court as indicative that the loan is a disguised gift);
- a trustee in bankruptcy can relegate repayment of the loan to the low or zero priority of an unsecured creditor;
- Centrelink can deem the loan to be an asset of the aspiring pensioner;
- the loan can form part of the deceased estate or notional estate of the lender;
- where interest is charged on the loan, the interest received can be assessable for the parent, but the interest paid may not be deductible for the child.

When a loan is made, but not documented, a child can also get selective memory and recall that it was a gift that was made, rather than a loan, notwithstanding the parent's protestations. For all these reasons, care needs to be paid to identifying the terms of the loan. The treatment of the loan can be very different if interest has been paid, there is a realistic repayment, the domestic partner of the child has acknowledge the loan or the loan is secured.

Source: Moores Legal, Estate Planning & Succession Update

BHT PARTNERS

Suite 11, Midway Arcade
974 Main Road, Eltham
PO Box 588, Eltham

Tel: (03) 9431 3000

Fax: (03) 9431 1618

Email: bhttpl@bhtpartners.com.au

Web: www.bhtpartners.com.au

Brian Taylor

Director of Business Development Services
Email: btaylor@bhtpartners.com.au

Jim Tyrrell

Director of Accounting & Compliance Services
Email: jtyrrell@bhtpartners.com.au

Melinda McAllister

Director of Audit & Assurance Services
Email: mmcallister@bhtpartners.com.au

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