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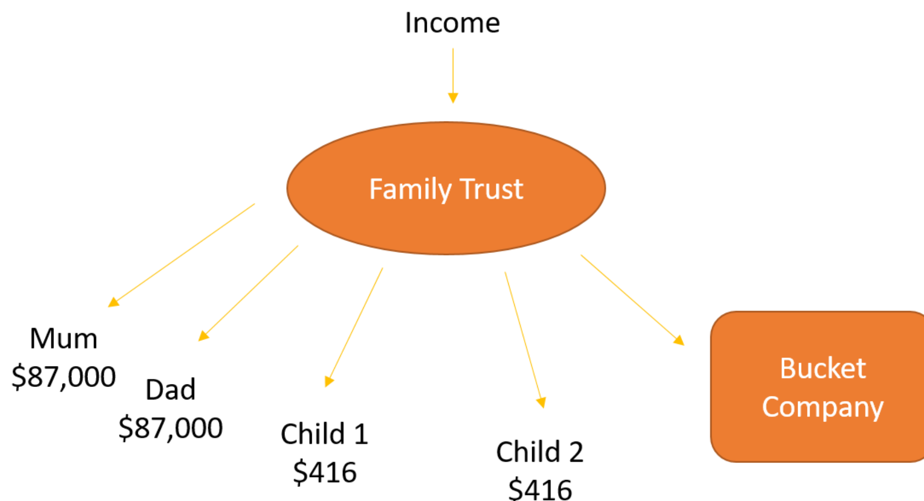
Trusts and Bucket Companies

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. Division 7A changes in 2009 mean this may no longer be the case.

The most common business structure for SMEs is 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 $87,000 (top of the 34% tax bracket) for each adult. A distribution of $416 is the maximum tax free distribution which can be made to beneficiaries less than 18 years of age. The balance of income is distributed to the corporate beneficiary who pays a flat rate of tax at 30%. In this way the marginal tax rate for the group is capped at 34%. Therefore mum and dad are not subject to the higher marginal tax rates which are 39% and 49% inclusive of the Medicare levy.

The following diagram 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 present 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 tax act de ems these drawings to be a dividend. This deemed dividend is taxed at top marginal rates and severe penalties may also be imposed. The result could 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.

Before 19 December 2009 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.

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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.
2. Convert the UPE to a Division 7A compliant loan.
3. A sub-trust may be created in the family trust.
4. The company may “buy” assets such as plant and equipment from the trust to clear the UPE.

This is a complex and difficult scenario to deal with. Unfortunately most of the SME businesses in Australia are impacted by the above changes in some way.

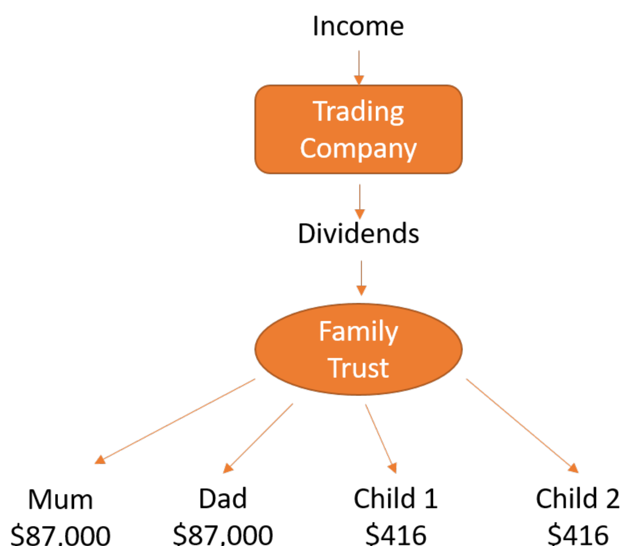
A Variant on Structuring

One possible 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 a family trust. Under this structure business profits are taxed at the flat corporate rate of 27.5% for small business. 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.

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 $174,832 to mum, dad and 2 children without exceeding the 34% marginal tax rate. The cash component of this dividend assuming it is fully franked is $126,753.20. The balance of the dividend is imputation credits of $48,078.80. The income tax payable on this income to mum and dad would be $43,124 inclusive of the Medicare levy. Therefore, an income tax refund of at least $4,954.80 would result, provided mum, dad and the children do not have other income.

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



Using this structure the tax implications of ATO Ruling 2010/3 and Division 7A can be avoided, whilst retaining significant profits in the trading company.

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

It is also imperative that a full review of a trust deed is made prior to making distributions to ensure any intended for the bucket company are allowed under the rules of that deed.

The taxation issues created by ATO Ruling 2010/3 should not be ignored. The impact of a deemed dividend may be threefold, firstly 47% income tax, secondly penalties imposed by the ATO and thirdly general interest charge levied on the outstanding tax balance.

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