SPRING 2010

JR news

Editorial

This edition of JR News highlights some significant changes on the taxation and investment landscape for JR and its clients.

On a taxation front, the ATO has now issued their guidance on trusts with unpaid entitlements to private companies (through PSLA 2010/4). We touched on the looming complexity in our last issue of JR News, and in this issue we outline in detail the ATO's approach.

JR is of a view that obtaining an understanding of the commercial consequences of this change in the ATO approach is critical if a private company with trust entitlements is used within your structure.

The application of, and approach toward, dealing with PSLA 2010/4 will be different for each individual client circumstance. To assist clients JR will be running client information sessions on the implications of PSLA 2010/4 in the near future.

On the investment front, JR is pleased to announce the establishment of a new service offering to clients – JR Wealth Management (JRWM).

JRWM is 100% owned by the partners of JR, holds its own Australian Financial Services Licence and provides clients with independent investment advice.

Many of JR's partners are licensed investment advisors and we are joined by David Lane who has 20 years experience in stockbroking and wealth management.

Working alongside your usual JR partner, JRWM enables us to provide clients with a more holistic wealth creation and preservation service.

It is not all advisory at JR, we try and invest our time in the community as well. In 'What's Happening at JR' you'll find our recent fund raising efforts for AEIOU and other activities.

Once again we thank our affiliates, Pitcher Partners, for their contribution to material in this publication.

We hope you enjoy this edition of JR News.

Nigel Fischer
The Editor

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Private Companies with Unpaid Present Entitlements – ATO's Proposed Administrative Approach Now Finalised

Summary

In June this year, the ATO issued its Ruling on the circumstances in which a private company with an unpaid present entitlement ("UPE") from an associated trust may be taken to have made a loan to that trust within the meaning of Division 7A. In conjunction with the Ruling, the ATO issued a draft Practice Statement to provide guidance on complying with the Ruling. The ATO has now issued the long awaited final version of its Practice Statement, PSLA 2010/4.

Our overall view of the final Ruling and Practice Statement is that the ATO has used the proverbial 'sledgehammer to crack a nut' – its target is trusts that have used UPEs to acquire private 'lifestyle' assets for beneficiaries, but trusts that are using UPEs for bona fide business and investment activities will also be adversely affected.

As alerted to clients in the Winter edition of JR News, a UPE may now be treated as a loan for Division 7A purposes where:

1. It is in fact an ordinary loan as evidenced by the trust deed or the accounting treatment; or
2. While no ordinary loan has been made there is an "extended meaning" loan by reason that circumstances indicate the private corporate beneficiary has acquiesced to the use by the trust of the UPE for the trust's own purposes.

With respect to ordinary loans, the Practice Statement outlines several ways in which corrective action can be taken to prevent a Division 7A problem from arising.

With respect to "extended meaning" loans, the Practice Statement confirms the ATO will not touch pre 16 December 2009 UPEs, while providing the following specific options for managing post 16 December UPEs:

1. Interest only 7 year loan (at the Division 7A benchmark interest rate);
2. Interest only 10 year loan (at the RBA small business variable interest rate);
3. Specific investment option.

These options, which vary considerably from the draft Practice Statement, involve arrangements that provide for an effective investment return to the company in respect of its entitlement. A table that summarises these options is set out below.

	Option 1 – interest only 7 year loan	Option 2 – interest only 10 year loan	Option 3 – invest in a specific income producing asset or investment
Amount of the annual return	Main trust to pay interest calculated at the Benchmark interest rate to the sub trust.	Main trust to pay interest calculated at the Prescribed interest rate to the sub trust (RBA Small Business Variable Rate).	Sub trust is entitled to receive the share of net return (e.g. interest income or rental income) derived as a result of the specific asset or investment to the sub trust.
	Sub trust to pay annual return to the private company beneficiary by the lodgement day of the income tax return for the main trust except for the final payment of the annual return which must be paid to the private company when the investment or loan is due to be repaid.		
Nature of the annual return	Interest.	Interest.	Depends on the specific asset or investment.
Repayment of the funds representing the UPE (the principal)	The principal must be repaid at the end of the 7 year loan.	The principal must be repaid at the end of the 10 year loan.	The principal must be repaid by the lodgement day of the tax return of the private company beneficiary for the year in which the investment ends.
Deductibility of the annual return	Yes, the amount is deductible to the main trust provided that the trustee of the main trust satisfies section 8-1 of the ITAA 1997.	Yes, the amount is deductible to the main trust provided that the trustee of the main trust satisfies section 8-1 of the ITAA 1997.	No.
Assessability of the annual return	Yes, the amount is assessable to the private company beneficiary.	Yes, the amount is assessable to the private company beneficiary.	Depends on the specific asset or investment.
Sub-trust tax return	Not required.	Not required.	Required.

Background

For the purposes of Division 7A, a loan (a 'Division 7A loan') includes:

- a loan within its ordinary meaning, consisting of a payment and an obligation to repay;
- an advance of money ahead of a due date or with an expectation of repayment;
- the provision of credit or any other form of financial accommodation (i.e. the supply or grant of some form of pecuniary assistance or favour under a consensual agreement where a principal sum or its equivalent is ultimately payable);
- a payment of an amount for, on behalf of, on account of or at the request of an entity, where there is an obligation of repayment; and
- transactions that in substance affect such a Division 7A loan of money (as described in any of the above dot-points).

UPE becomes an ordinary loan

A private company beneficiary's UPE is not itself an ordinary loan to the trust. However, according to the ATO, it may (unintentionally) be extinguished and converted into a Division 7A loan via either an implied loan agreement or the automatic exercise of power under a trust deed.

Loan agreement

- A private company may make a loan to a trust by providing moneys to the trustee pursuant to an express or implied loan agreement. Such a loan from the private company may be affected by an agreed set-off in satisfaction of the trustee's obligation to pay the private company its trust entitlement. This will result in an ordinary loan being made to the trustee.
- The ATO considers that an express loan agreement will arise where it is evidenced by a written agreement, trust resolution or another document.
- The ATO considers that an implied loan agreement will arise if the amount is recorded in the financial accounts of both the private company and the trust as a loan. This will be taken as evidence that the private company has knowledge that the trustee has adopted this treatment and has consented to that loan being made.
- The ATO will not, however, (without additional evidence) consider a loan agreement to be in existence if either one or both of the parties record the amount as a UPE.

Exercise of power under the trust deed

- A trustee may make a loan on behalf of the private company beneficiary by acting pursuant to a term of the trust deed which permits the trustee to pay or apply money to or for the benefit of the beneficiary. The application of trust funds for the benefit of the private company by crediting a loan account will result in the company being taken to make a loan to the trust.
- The ATO will not, without additional evidence, consider that a loan is in existence if the financial accounts of the trust record the amount as a UPE.

Corrective action for UPEs that become ordinary loans

Incorrect Financial Accounts

Where a UPE has been misclassified as a loan the ATO will allow a private company or trust until 31 December 2011 to correct their financial accounts – conditions apply however, and they must all be satisfied:

a) the financial accounts of the trust and/or the private company have incorrectly classified the UPE as a loan from the private company to the trust;
b) with the exception of the financial accounts – refer below – all available evidence supports the view that the amount is in fact a UPE;
c) the private company has never included the amount of the UPE in calculating the amount of a loan reported at Label 8N of the private company's income tax return (i.e. the label marked 'loans to shareholders and their associates');
d) the trust has not paid or credited any interest on or in respect of the UPE;
e) the 'loan account' in which the UPE is included is entirely comprised of amounts relating to UPEs, and repayments of such UPEs, between the trust and the private company (that is, its balance is not affected by any non-UPE transactions);
f) on or before 31 December 2011 the financial accounts of all relevant entities are amended to properly classify the amount as a UPE; and

g) on or before 31 December 2011 the trustee/public officer of the trust, or public officer of the company, signs and dates a declaration setting out that all of the above conditions have been met.

As 'financial accounts' are restrictively defined in the PSLA as the "finalised accounts for the income year whether audited or unaudited" (emphasis added), condition (b) above may be problematic. For example, if the journal entries and/or trial balance underlying the finalised accounts (i.e. on which those accounts are based) are regarded as separate from those accounts, then there will be evidence that does not support the view that the amount is a UPE – we will be seeking clarification from the ATO on this point and submitting that the ATO needs to adopt a pragmatic interpretation of the phrase 'financial accounts'.

Self-assessing the exercise of an ATO discretion

If the requirements to correct the financial accounts are not able to be met, or for some other reason a Division 7A deemed dividend has arisen because the UPE has become an ordinary loan, the trust may be able to self-assess on the basis of undertaking its own corrective action. This requires all of the following conditions to be met:

a) the breach of Division 7A was the result of an honest mistake or inadvertent omission;
b) the trust and the private company are "small business entities" i.e. they must carry on a business and have a turnover (together with certain related parties) of less than $2m;
c) the loan was used for business purposes by the trust;
d) corrective action, including entering into a complying loan agreement, is taken and the trust makes "catch up" interest and principal payments to the private company;
e) the private company and the trust have lodged all required income tax returns and have a good history of tax compliance; and
f) the trustee of the trust is not a shareholder of the private company.

As this option to self-assess corrective action is limited to small business entities it will exclude many taxpayers.

Division 7A loans within the extended meaning

According to the ATO a private company beneficiary will be said to have provided financial accommodation to a trust in which it has a UPE if that private company has, under a consensual arrangement:

- supplied or granted some form of pecuniary aid or favour to the trust; and
- a principal sum or equivalent is ultimately payable to the trust.

Enabling the funds representing a UPE to be used for trust purposes is the provision of pecuniary support to the trustee of the trust. If this happens with the knowledge and acquiescence of the private company a benefit is provided to the trust.

Funds will be considered to be used for trust purposes if:

- the trustee of the main trust does nothing other than record in its books of account the private company's entitlement; or
- the UPE is held in a 'sub-trust', but the trustee of the sub-trust allows the funds to remain intermingled in the main trust on terms that do not entitle the private company to the sole benefit of any income generated by the use of those funds.

As the trust and beneficiary form part of the same family group, the ATO will form the view that the private company has knowledge of the trustee's use of the funds for trust purposes, subject to sufficient evidence to the contrary.

UPEs that are not Division 7A loans

If funds representing the UPE are used only for the private company's sole benefit the private company does not provide financial accommodation. This will be the case if the funds remain with the main trust but are held on terms entitling a sub-trust to (i) all the benefits from the use of the funds and (ii) repayment of the principal.

The ATO will consider the following to evidence the existence of a sub-trust:

- the UPE is set aside separately in the accounts of the main trust as being held on trust for the private company;
- separate accounts are prepared for the sub-trust; or
- a separate bank account is opened in the name of the trustee for the private company beneficiary in respect of the funds within the sub-trust.

Where the funds in the sub-trust are invested back into the main trust, the taxpayer must show that all the benefits from the use of the funds flow back to the sub-trust.

The Practice Statement provides that, if the funds are invested in the main trust using one of the following investment options, the ATO will consider that the funds in the sub-trust are held for the sole benefit of the private company beneficiary.

Option 1: Funds invested on an interest only 7 year loan at the Division 7A benchmark interest rate

The funds invested must be repaid within 7 years to the private company. The benchmark interest rate is currently 7.4%.

This option can be distinguished from the conversion of the UPE to a conventional Division 7A loan between the private company and the main trust in that principal need not be repaid throughout the investment period but rather can be deferred to the end of the 7 year investment period.

Option 2: Funds invested on an interest only 10 year loan at the prescribed interest rate

The funds invested must be repaid within 10 years to the private company. The prescribed interest rate is the RBA Small Business Variable Rate which is currently 10.3%.

Option 3: Funds invested in a specific income producing asset or investment

The funds invested must be paid to the private company or reinvested for the benefit of that company if the asset or investment is disposed of. A separate tax return must be lodged by the sub-trust.

Under Option 1 and 2 the Practice Statement indicates that the interest payable by the trust would be expected to be deductible as long as the requirements for deductibility have been satisfied.

Under each option, if the calculated return is not paid out to the private company, the ATO will treat the investment as a loan that is subject to Division 7A.

Timing – UPEs arising between 16 December 2009 and 30 June 2010

According to the ATO, the parties will have until 30 June 2011 to decide to place the UPE on a sub-trust using one of the three options.

If an investment is made, the first liability to pay interest or to distribute income to the private company will arise on 30 June 2012. However, the actual payment of the interest by the main trust, or income distribution by the sub-trust, will not be required until lodgement day of the relevant trust's 2012 tax return – for example, 15 May 2013.

If an investment is not made, the parties will have until lodgement date of the company's 2011 income tax return to either repay the loan or enter into a complying Division 7A loan agreement.

Timing – UPEs arising after 30 June 2010

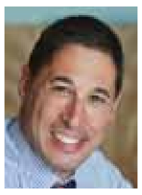
In subsequent income years, the parties will have until lodgement date of the tax return to place the UPE on a sub-trust.

If an investment is made, the first payment of interest or income distribution will be required to be made by lodgement date for the tax return for the following income year.

What action should you now be taking?

With respect to any trust that distributes to a corporate beneficiary clients need to consult with their JR advisor to consider, at a commercial level, the medium term business or investment strategy for the trust including how it will be funded.

From there, a strategy needs to be developed on how best in your particular circumstances, any current (or future expected) unpaid company entitlements be dealt with.



Peter Camenzuli
Business Advisory Services Partner

The Roaring Aussie Dollar

The September quarter was the strongest quarter ever for the Australian Dollar (AUD), rising 15%. In the late evening of Friday 15 October, the AUD reached parity with the US Dollar (USD). The "parity party" was only briefly lived, as it traded at $1.0003 for a mere 10 seconds.

What moves currencies?

A whole range of issues come into play in the pricing of a country's currency. These factors include economic growth forecasts, inflation, interest rates, unemployment and the movement of imports and exports. In Australia's case, one of the biggest influences on the movement of our currency is the movement of commodity prices.

Australia is currently benefiting from a "perfect storm" of positive influences. In comparison to the major developed nations against which our dollar is priced, we have low unemployment, rising inflation, rising interest rates, strong GDP growth, healthy exports and rising commodity prices. With expectations for all of these influences to continue, most pundits expect the AUD to remain strong for some time.

It needs to be said that currencies are a relative measure, in that the AUD is priced against those of other nations. Hence, the strength of the AUD is as much a reflection of the weakness of the USD and the US economy. Similarly, the AUD has reached a 25-year high against the British Pound (GBP), further reflecting the strength of the global sentiment towards the Australian economy.

The impact of China

We are not doing it on our own. In addition to the weakness of the Northern Hemisphere, our currency is being supported by the economic expansion of China, India and other Asian nations. Demand for Australian raw materials – coal, iron ore, copper and gold – helps to underpin the forecasts for our growth and the for the AUD strength.

Adding to the mix is the fact that China does not have a floating currency. Rather, the Yuan is pegged to a basket of world currencies. Given the strength of the Chinese economy compared to most others, the pegged currency is increasing their global competitiveness. The US have little room to move from a monetary policy perspective, and are hoping China agrees to appreciate their currency to compensate.

Hence, there is increasing political pressure on the Chinese to revalue the Yuan, from the US, Europe and Japan.

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Should the Chinese not revalue to the extent hoped for by the US, the Federal Reserve may be forced to embark on more "quantitative easing". Effectively, this means printing more money – or adding more liquidity to the system – by buying more US Treasuries.

The People's Bank of China's unexpected increase in 1 year lending and deposit rates by 0.25% had a swift and dramatic impact on currency markets, with the USD and Japanese Yen rallying strongly against other currencies. The AUD fell over 2% in one night following the announcement, and recovered half of the decline the following day. Such is the volatility of currencies.

Either way, these moves – combined with the likelihood of another interest rate rise in Australia before year end – indicate the AUD strength may continue for some time.

What are the experts saying?

Many currency forecasters have recently upgraded their short and medium term outlooks for the AUD. Not only are they now anticipating a more sustained move to parity between AUD and USD in the near term, many have revised their forecasts over $1.00 in 2011.

Goldman Sachs have upgraded their 3 month forecast of the AUD to $1, their 6 month forecast to $1.03 and their 12 month forecast to $1.05. Similarly, Westpac have a near term forecast of $1.02, medium term of $1.05, but believe that the dollar will fall to around $0.95-$1.00 by the late 2011. The Commonwealth Bank are not as bullish on their AUD outlook, but still believe the AUD will reach $1.02 in 2011 before settling down around $0.94 by year end.

The fundamental analysts at NAB have calculated a fair value model range of $0.90-$0.98 (fair value of $0.94). However, NAB's technical analysts (those that follow the charts) have said that "the $A's upside momentum could well surprise". Their next major target is in excess of $1.10.

Shane Oliver from AMP Capital Investors also believes the dollar will trade up to $1.10, citing Australia's strongest terms of trade since the 1950's, and the continuing weakness in the USD.

Even those who believe the AUD is overvalued, like Credit Suisse and Morgan Stanley, are not predicting a short-term decline in the dollar. Morgan Stanley's chief economist, Gerard Minack was recently quoted as saying "It's overvalued on most medium-term, long-term metrics. Just because it is overvalued, doesn't mean it's about to fall."

It should be noted that currency movements are extremely difficult to get right, given the amount of factors that have an impact on their movements. In addition to all of the measurable economic indicators, currency movements can be heavily influenced by sentiment.

Not a positive for all

Obviously, the strength of the AUD is not a positive for all. Although it means overseas holidays and imported goods will be cheaper, Australian exporters and manufacturers are negatively impacted by the rise of the dollar.

Domestic tourism is also expected to suffer, as Australia has become more expensive for overseas tourists and Australians are attracted by the appeal of an overseas holiday.

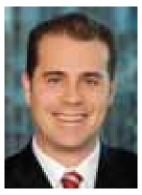
Continued strength in the dollar could have an impact on the investment decisions of international investors and companies, as Australian investments may be less appealing.

How will the roaring Aussie impact your business?

Clients of JR who regularly deal offshore will be acutely aware of the impact of currencies on their business. Those who import or outsource from the US or Europe will benefit, while exporters to these regions will not be hosting "parity parties".

An important component of the cash flow forecasting of businesses dealing offshore should be the management of foreign exchange risk. Irrespective of the short-term movement of the AUD, it is imperative that you understand your foreign exchange exposures, and the potential impact that currency volatility may have on your business.

Hedging, forward rate agreements and options contracts may be worth considering as part of your risk management. Be sure to speak to your JR advisor about the potential impact of currencies on your business.



David Lane
JR Wealth Management Director

What's Happening at JR

AEIOU Foundation – Take a Hike

On Sunday October 17th JR Partners Mark Nicholson and Nigel Fischer participated in the inaugural Take A Hike Challenge – a fundraiser for the AEIOU Foundation.

With the support of their colleagues, friends and supporters Mark and Nigel raised over $12,000 to be the 6th highest fundraising team.

Take A Hike involved walking a 40km loop of the Brisbane river (with a 15kg pack to represent the weight of a 3 year old child) to raise funds and awareness for the AEIOU Foundation and the work they do providing early intervention services for children with autism.

JR has proudly supported AEIOU from its inception which included JR Partner Peter Camenzuli acting as Treasurer of the Foundation for a number of years.

26 participants from different walks of life got involved in Take A Hike and collectively raised over $188,000. This has eliminated the funding deficit for over 18 child placements in the AEIOU program.

The AEIOU Foundation provides Queensland's only fulltime early intervention program for children with Autism. The program ensures each child receives 1,000 hours of therapy per year at a staff:child ratio of 2:1. Over 70% of the children in the program transition into mainstream education providing every opportunity for these children to reach their full life potential.

Each child placement in the AEIOU program costs approximately $40,000 per annum. $30,000 is provided through a combination of Government funding and parental fees. The remaining $10,000 is generated through fundraising initiatives such as Take A Hike. Many thanks to those who contributed, your contribution will have a lasting impact on the lives of many children and their families.

Global Corporate Challenge

JR recently participated in the Global Corporate Challenge, an event designed to increase fitness and activity of those who work in seated jobs. The aim was for each of the seven team members to walk 10,000 steps, or about 6km a day for 16 weeks, while the organisers tracked your movement as though you were walking around the globe. In 2010 close to 100,000 participants from around 1,000 workplaces in 55 countries took part in this corporate health initiative.

Internally JR took the competition in their stride. With pedometers on their hips, 49 JR staff members (7 teams) went out of their way to compete against each other. Some participants went travelling through Europe and didn't miss a day of wearing the pedometer; others walked the stair case in their lunch hour (from level 29 up to 40 then all the way to ground); while others walked home daily.

Jess Donsky in our Superannuation division walked the most steps with an average daily step count of 23,000. Overall the firm managed to walk a total 42,905kms in the 16 week challenge and improve their lifestyle, at least temporarily.

All the walking has got the office primed and ready for the upcoming sporting events. After a quick exit from the CA Beach Volleyball Tournament, everyone was prepared and ready for the CA Touch Football, which unfortunately to date has been delayed twice. However with third time lucky planned for the end of November we all have our fingers crossed for fine weather, and a smashing performance.