



THE TAX INSTITUTE

FAMILY BUSINESS SUCCESSION

Company and Trust Structures

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1 INTRODUCTION

The focus of this paper is the main issues to consider when deciding on the appropriate structure for a family-owned business. The intention is to provide guidance on the key attributes, benefits and limitations of three common business structures, namely:

1. A discretionary trust;
2. A company with shares owned by one or more discretionary trusts; and
3. A unit trust.

To minimise duplicating content that is to be covered by other presenters, the paper will not cover the detail of the significant developments affecting trusts and their taxation in the last two years, namely:

- The High Court decision in *Bamford*¹;
- The Commissioner of Taxation's (**Commissioner**) views in Taxation Ruling 2010/3 (**TR 2010/3**) on the circumstances in which unpaid present entitlements convert into 'loans' for the purposes of Division 7A of Part III (**Division 7A**) of the *Income Tax Assessment Act 1936* (Cth) (**ITAA 1936**);
- The recent amendments in the form of *Tax Laws Amendment (2011 Measures No. 5) Act 2011* (**TLAM5 Act**) aimed at enabling the streaming of capital gains and franked distributions and its juxtaposition with the more recent Administrative Appeals Tribunal decision in *Greenhatch*² which endorsed the view that the pre-TLAM5 Act statutory framework dealing with the taxation of trusts had embedded in it a conduit model³;
- The discussion paper on 'Improving the taxation of trust income'⁴ released by the Assistant Treasurer and Minister for Financial Services and Superannuation (**Assistant Treasurer**) in March 2011 and its wider implications in relation to the proposed rewrite of Division 6 of Part III (**Division 6**) of ITAA 1936 expected in the 2012 calendar year; and
- The implications of the High Court's refusal to grant special leave⁵ to the Commissioner to appeal the Full Court decision in *Clark*⁶ on the law of resettlement and the Commissioner's Statement of Principles⁷.

¹ *FCT v Phillip Bamford & Ors; Phillip Bamford & Anor v FCT* [2010] HCA 10.

² *Greenhatch v Federal Commissioner of Taxation* [2011] AATA 479.

³ Refer to a summary of the AAT's findings and implications in R Jorgensen, 'Greenhatch v FCT: streaming – much ado about nothing!', *Taxation in Australia* Volume 46(2), page 49.

⁴ Australian Government, *Improving the taxation of trust income*, Discussion Paper, March 2011.

⁵ *FCT v Clark* [2011] HCATans 236.

⁶ *FCT v Clark* [2011] FCAFC 5.

⁷ *Creation of a new trust – Statement of Principles* August 2001.

The paper will also not deal in detail with the Federal Court decision in *Richstar*⁸ and the High Court decision in *Kennon v Spry*⁹ and the expansive view of property adopted in those decisions.

However where relevant the paper will draw from the developments and the cases mentioned above.

As the subject matter of this forum relates to family businesses the paper is directed at and mostly relevant to businesses that have an aggregated (associate¹⁰ inclusive) turnover of less than \$2 million annually and/or an aggregated (associate inclusive) net asset value of \$6 million or less, or in other words, business that should satisfy the aggregated turnover and/or maximum net asset value requirements of the first-level conditions in relation to accessing the capital gains tax (**CGT**) small business concessions (**SBCs**).

2 KEY CONSIDERATIONS

Business owners and advisers have to balance a number of considerations in deciding upon the most appropriate structure for a start-up business or a business in which a family group wishes to invest in as one of a few investors. The main factors are:

- Minimising the income tax payable on business profits;
- Maximising the flexibility to distribute income to a wide class of persons;
- Accessing the CGT SBCs on the disposal of business assets or the business structure;
- Raising and retaining sufficient working capital to meet the business' liquidity needs;
- Protecting the business' assets from third party claims;
- Exiting the business in a way that attracts the highest purchase price and minimises transaction taxes; and
- Controlling the succession of the business to the next generation.

There is no one optimal entity or structure that accesses the benefits of all factors. In making their decision, business owners should carefully balance the advantages and disadvantages of each structure from a commercial and taxation perspective.

⁸ *In the Matter of Richstar Enterprises Pty Ltd v Carey (No 6) [2006] FCA 814.*

⁹ [2008] HCA 56.

¹⁰ The word associate has been used in this paragraph as a general term to refer to entities that are 'affiliates' or 'connected with' the business entity for the purposes of Division 152 of the *Income Tax Assessment Act 1997* (Cth).

The principles should be revisited and considered again at critical stages during the life of a business particularly in planning for periods of revenue growth, stagnation, contraction or preparing for the retirement of an owner. Subject to weighing up the taxation implications of restructuring the ownership of a business and the ability to access the relevant rollover exemptions, it may be desirable from a commercial and future taxation perspective to transfer a business or control over it into a new structure.

As a general principle, the pitfalls of being 'stuck' with a structure that does not meet the commercial needs of a business and its owners can to some extent be mitigated by proper planning.

3 DISCRETIONARY TRUST

It is well-known that a properly drafted and structured discretionary trust has (and in some cases *had*) several distinct benefits as a business vehicle, including:

- The flexibility to distribute income (and capital) to one or more members of the beneficiary class including persons, companies and trustees of other trusts;
- The ability to minimise the overall income tax payable on business profits because of this flexibility;
- The ability to retain the cash the subject of any distribution within the trust structure to meet the liquidity needs of the business¹¹; and
- The ability to quarantine, to the maximum extent possible, the ownership of the business' assets from claims against the beneficiaries.

The main shortcomings are:

- That the exit from the business can only be achieved by selling the business assets (and cannot be achieved by selling the 'structure');
- It is not possible to introduce new equity partners or source capital other than by way of loans which limits the ability of growing the business;
- The complexity of the non-fixed trust rules and family trust election rules contained in Schedule 2F of ITAA 1936 that apply in relation to the deductibility of losses and debt deductions; and
- The fixed perpetuity period of a discretionary within which the trust property must vest in a beneficiary absolutely.

¹¹ The Australian Taxation Office requires compliance with strict 'loan' and investment rules under TR 2010/3 and practice set out in PSLA 2010/4.

Two recent developments in relation to the taxation of trusts have, to a significant extent, eroded the commercial attractiveness of a discretionary trust business structure.

3.1 Recent developments

3.1.1 TR 2010/3 and its impact on the retention of capital

It was a common practice for trustees to distribute trading income to a 'holding' company, the company pay income tax on that income at the corporate rate and the trustee retain the cash within the trust structure for the purposes of the business. In TR 2010/3 the Commissioner has directly targeted this practice through the Division 7A regime.

In specific circumstances, the Commissioner takes a view that where a trustee has made an unpaid distribution, or that is, created an unpaid present entitlement in favour of, an associated private company beneficiary, the trustee is taken to have made a 'loan' to the company for the purposes of section 109D of Division 7A. In the circumstances, the company is deemed to have made an unfranked dividend to the trustee which is assessable income in its hands.¹²

The specific circumstances in which the Commissioner takes this view are:

- If under a written or implied agreement the company agrees to lend the whole or a part of the unpaid present entitlement to the trustee in satisfaction of the payment of the amount (including by way of a set-off arrangement or journal entries); or
- Where the company has knowledge that the funds representing the unpaid present entitlement (made on or after 16 December 2009) are being used by the trustee for the purposes of the trust rather than for the sole benefit of the company.

Where the funds representing a post-16 December 2009 unpaid present entitlement are to be retained in the trust structure (with the knowledge of the company's directors), the funds must be placed on an interest only 7 or 10 year 'loan'¹³ or held on a 'sub-trust' and invested in a specific income producing asset in compliance with strict requirements under practice guidelines provided in PSLA 2010/4.

¹² The correctness at law of the views presented in TR 2010/3 and in particular that an unpaid present entitlement could give rise to a 'loan' for the purposes of Division 7A has been the subject of significant criticism. Refer to, for example, R Jorgensen, 'Division 7A – UPEs, The Red Wine Experiment', paper presented at the 26th National Taxation Institute of Australia Convention on 3 March 2011.

¹³ The uncertainty surrounding the Commissioner's interpretation of what constitutes a loan for section 109D of Division 7A means that at a practical level when implementing one of the corrective action options care should be taken to ensure that affected parties are not disadvantaged in the event that a Tribunal or Court subsequently rules that the Commissioner's interpretation is not correct.

3.1.2 Taxation of trust income

The taxation of trust income landscape has also changed significantly since the *Bamford* decision. On 16 December 2010, the Assistant Treasurer stated that he would seek advice from the Board of Taxation and consult the public as a precursor to updating the taxation of trust provisions in Division 6 and 'rewriting' them into the *Income Tax Assessment Act 1997* (Cth) (**ITAA 1997**). In March 2011, the Assistant Treasurer released a discussion paper in relation to amending the law to:

- Better align the concepts of distributable income and net income; and
- To ensure that capital gains and franked distributions (including the attached franking credits) can be streamed to particular beneficiaries.¹⁴

The TLM5 Act was passed on 29 June 2011. A substantial part of the amending legislation was directed at enabling the streaming of franked distributions and capital gains and providing a methodology (that incorporates an amended Division 6, Subdivision 207-B of ITAA 1997 and Subdivision 115-C of ITAA 1997 and a new Division 6E) by which, broadly speaking, the assessable income of a beneficiary can be determined by reference to a 'specific entitlement' to a trust's capital gains and franked distributions and the relevant proportionate amount of any other distributable income. Except for the introduction of specific anti-avoidance rules that target the use of exempt entities to inappropriately reduce the tax payable on the taxable income of a trust, the government decided to 'defer consideration of the income alignment proposal until the broader update and rewrite of Division 6'.¹⁵

The amendments in the TLM5 Act have added another layer of complexity to Division 6 increasing the annual compliance burden in administering the distribution of income. This coupled with the uncertainty of the changes that might arise from the Division 6 rewrite has compounded the present difficulty with utilising a trust structure in general. The uncertainty is unlikely to be addressed until the 2012 calendar year.

3.2 Asset protection

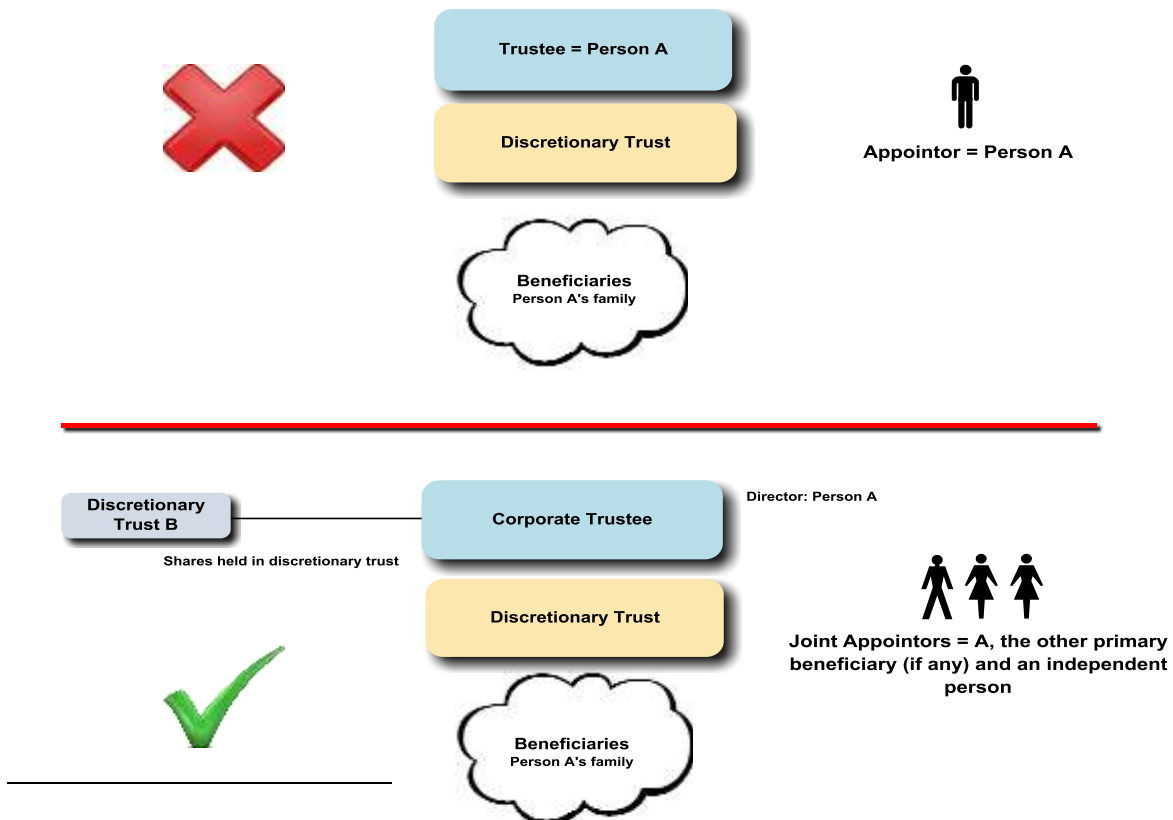
As mentioned earlier, asset protection is and remains a key advantage of a discretionary trust. This is because the modern discretionary trust is a relationship between a trustee and a beneficiary pursuant to which the trustee holds the property for the benefit of a class of beneficiaries. A necessary element of this relationship is the separation of legal and beneficial ownership of the property.

The following principles (which are not intended to be an exhaustive list) should be taken into consideration when drafting/structuring a discretionary trust to ensure that the assets are protected to the maximum extent possible:

¹⁴ Australian Government, Improving the taxation of trust income, Discussion Paper, March 2011.

¹⁵ See <http://www.ato.gov.au/content/00274021.htm>.

- The trust is a 'pure' discretionary trust, that is, the trustees have a power to select a member from within a class of beneficiaries to which distributions of income and capital are to be made (compared with a 'hybrid' variation which may fix an entitlement of a beneficiary to a distribution of income or capital potentially changing the nature of the interest held by that beneficiary in the assets of the trust);
- Avoid where possible the appointment of a sole person as trustee in preference to a corporate trustee with at least one director with another discretionary trust owning the (at least two) shares in the corporate trustee (which facilitates the succession of control of the corporate trustee to the next generation);
- Avoid where possible the appointment of the primary beneficiary as the sole appointor and also as the trustee¹⁶;
- Avoid where possible the appointment of a sole person as an appointor in preference to joint appointors consisting of the primary beneficiary or beneficiaries and an independent person who can be trusted to act independently but in accordance with the interests of the beneficiary's family; and
- The trustee of the subject trust to avoid undertaking any commercial activities in its own right or as trustee of another trust as the assets of the subject trust will be exposed to the extent of the trustee's right of indemnity to be paid from the trust assets.



¹⁶ Kennon v Spry [2008] HCA 56.

3.3 Exiting

Exiting from a business operated by a discretionary trust is only possible by the partial or full sale of the business and its assets.

If the business has been conducted for a period of at least 12 months the trustee can apply the 50% CGT discount to reduce the net capital gain by half.

To apply any of the CGT SBCs the trust must satisfy the first-level or 'basic conditions'¹⁷. The entity must also satisfy conditions that are specific to the particular SBCs.

On the basis that the first-level conditions are satisfied, the CGT SBCs can also be applied as follows:

- the 15-year retirement exemption to disregard in full the gross capital gain (that is, without application of any capital losses) – see below for additional conditions; or
- the 50% active asset reduction to reduce the 50% CGT discounted gain (the 'once-discounted gain') by a further 50% (the 'twice-discounted gain'); and/or
- the rollover to defer all or a part of the once-discounted or twice-discounted gain; and/or
- the retirement exemption to reduce either the once-discounted gain or the twice-discounted gain by reference to a lifetime retirement cap of \$500,000 for each 'CGT concession stakeholder'¹⁸ of the trust – see below for additional conditions.

¹⁷ The basic conditions are contained in Subdivision 152-A of ITAA 1997. The conditions in respect of entities that carry on a business and where the asset in question is not a share or unit are:

1. The entity is an individual, partnership, company or trust that carried on a business with an aggregated turnover for the previous year that was less than \$2 million and for the current year is expected to be less than \$2 million (section 328-110 ITAA 1997). The aggregated turnover is the entity's annual turnover plus the annual turnover of any other parties that are the subject entity's 'affiliates' or that are 'connected with' the subject entity (as those terms are defined);
2. The entity satisfies the maximum net asset value test, that is, the aggregated net value of the CGT assets of the entity, entities 'connected with' the subject entity, 'affiliates' of the subject entity and connected entities (as those terms are defined) is \$6 million or less; and
3. The asset satisfies the active asset test, that is, the asset is used, or held ready for use, in the course of carrying on the business or a business carried on by a party that is an 'affiliate' or 'connected with' the subject entity (section 152-40(1)). Intellectual property, goodwill and other intangible assets are active assets if they are inherently connected with a business that is carried on by the entity or a business carried on by a party that is an 'affiliate' or 'connected with' the subject entity (section 152(40)(2)).

¹⁸ An individual is a CGT concession stakeholder of a company or trust if they are a significant individual or the spouse of a significant individual where the spouse has a 'small business participation percentage' in the company or trust at that time that is greater than zero. An individual is a significant individual in a company or a trust if they have a total (direct and indirect) 'small business participation percentage' in the company or trust of at least 20%. The small business participation percentage is determined by reference to the percentage of the voting power that the stakeholder is entitled to exercise, any dividend payment that the stakeholder is entitled to receive or any capital distribution that the entity is entitled to receive.

The 15-year retirement exemption can only be applied if, in addition to the first-level conditions, the trustee has continuously owned the CGT asset for at least 15 years, the trust had a significant individual for a total of at least 15 years and the significant individual is aged 55 or over and retiring (or is permanently incapacitated).

In circumstances in which the conditions for the 15-year retirement exemption are not satisfied, the trustee could apply the 50% CGT discount and also the 50% active asset reduction (if the necessary conditions are satisfied) to reduce the net capital gain by 75%.

The trustee could then:

- rollover the once- or twice-discounted gain¹⁹; and/or
- if the relevant conditions are satisfied, elect to disregard the once- or twice discounted gain under the retirement exemption.

The relevant conditions in relation to the retirement exemption are:

- the choice to apply the exemption is made in writing;
- the CGT retirement exemption limit of \$500,000 of each CGT concession stakeholder is not exceeded;
- the exempt amount is specified in writing by reference to the percentage of the asset's exempt amount that is attributable to each CGT concession stakeholder; and
- the relevant amount of the proceeds is paid to the relevant CGT concession stakeholders within 7 days of the later of the trust making the choice or the trust receiving an amount of the capital proceeds or, in the case of a CGT concession stakeholder who is under the age of 55 at the time of the payment, paid into a superannuation fund of that person (and appropriately notify the trustee of the superannuation fund).

The sale of the business may give rise to taxable income as a result of a sale of the trading stock and possibly the recoupment of previously claimed capital allowances.

The sale or transfer of any land (and certain interests in land)²⁰ will trigger a transfer duty liability in the relevant state or territory in which the land is located. The sale or transfer of certain (non-land) business assets may be dutiable in New South Wales, Northern Territory, Queensland, South Australia and Western Australia to the extent they are located or deemed by the relevant duties legislation to be located in those states.

¹⁹ Where the trustee satisfies the conditions for applying both a replacement asset roll-over under Subdivision 124-B and the small business roll-over, the trustee can elect which roll-over is to apply (ID 2009/147).

²⁰ And, in the case of some states, goods the subject of a transfer of land.

3.4 Succession

The transfer of control over the business to the next generation can generally be dealt with by structuring around the role of the appointor and trustee, such as, for example:

- providing for the succession of the role of appointor such that in circumstances that the current appointor(s) dies or is incapable of acting as appointor the power to remove and/or replace the trustee is inherited by the legal personal representative or for example the partner or child (reaching a certain age) of the relevant person²¹;
- providing for the passing on of control of the discretionary trust that owns the shares in the corporate trustee including the possibility of a share split in the corporate trustee; and
- where necessary and required, careful drafting of the corporate trustee constitution and the family constitution.

4 COMPANY OWNED BY A DISCRETIONARY TRUST

It is well-known that an incorporated company has limited liability. A shareholder is exposed only to the extent of the amount invested in the company. A director may however be personally liable for company debts in circumstances such as where:

- the director has given a personal guarantee to repay the debt of a company to a creditor;
- the company incurs a debt that it cannot pay at a time when the director knew or should have known that the company was insolvent;
- a director breaches a duty under the *Corporations Act 2001* (Cth) (**Corporations Act**)²²;
- the company enters into a transaction that reduces the amount available to pay priority employee entitlements; or
- the company has not paid its withholding tax liability (and based on exposure draft legislation, potentially superannuation guarantee obligations²³) and the Australian Taxation Office issues a director penalty notice to the director.

²¹ In this regard the recent case of *Scaffidiv Montevento Holdings Pty Ltd [2011] WASCA 146* is instructive of the family difficulties which might arise where no proper consideration is given to the succession of appointors and trustees.

²² See, for example, recent case of *Phoenix Constructions Queensland Pty Ltd v Coastline Constructions Pty Ltd and McCracken [2011] QSC 167* where a director was held to be liable in respect of a debt owed by a company under section 1324(1) of the *Corporations Act* for a breach of a section 182 duty (being improperly using their position to gain an advantage for themselves or someone else or cause detriment to the corporation).

The common situation of a natural person(s) owning shares in a trading company should be avoided as the shares will be exposed to any claims made against the person.

The trustee of an appropriately structured discretionary trust that owns the shares in the company will, to the maximum extent possible, protect the shares from claims made against the trustee. See the section on 'Discretionary Trusts' for more information.

4.1 Distributing income and 'deemed dividends'

This structure can also provide flexibility in the ultimate distribution of income. The distribution of income can also be effectively managed with the business' retention of working capital requirements. Distributions made by a company to a trust shareholder are frankable.

On the basis that the only source of the trustee's income is the ownership of the shares, the trustee will have the flexibility of distributing a franked distribution (with attached franking credits) to a specified beneficiary or beneficiaries or a corporate beneficiary (assuming a valid family trust election has been made). This enables the trustee to minimise to the maximum extent possible the total income tax payable on the total trust income.

If the trustee also earns income from other sources (which should be avoided from an asset protection point of view²⁴) the trustee could stream²⁵ the franked distributions (including the attached franking credit) to a specified beneficiary or beneficiaries (assuming a valid family trust election has been made).

To the extent that the company confers an economic benefit on a shareholder or an associated person of the shareholder that is not by way of declaring a dividend, Division 7A could operate to deem an unfranked dividend in the hands of the shareholder or the associated person (to the extent of the company's distributable surplus). Such an economic benefit could be conferred on a shareholder or an associated person of the shareholder by way of:

- a payment of cash from the company;
- a transfer of property from the company;
- the granting of an uncommercial loan by the company; or

²³ *Tax Laws Amendment (2011 Measures No. 7) Bill 2011: Companies' non-compliance with PAYG withholding and superannuation guarantee obligations* released as part of a Government discussion process.

²⁴ From a legal perspective, this is only of concern where a shareholder trust has guaranteed or may be required to guarantee the obligations of the company to its creditors (such as for example the company's primary lender).

²⁵ Streaming income of a particular class is only effective if the terms of the trust confer the appropriate streaming power on the trustee.

- the forgiveness of a debt owed to the company.

4.2 Raising capital and loans

A company can raise capital by issuing new shares or allotting shares to existing shareholders. It can also raise capital by obtaining a loan. As explained above, directors should avoid providing a personal guarantee of the obligations of a loan made to the company of which they are directors.

Any loans from a related party should be secured by a mortgage debenture and a charge registered with the Australian Securities and Investments Commission within 45 days²⁶ to ensure that, to the maximum extent possible, the related party has priority over other claimants or creditors in the event of a priority dispute upon the liquidation of the company.

Loans from the company to a related party should be avoided as the related party will be exposed to the extent of the unpaid principal sum and interest payable and Division 7A may be breached.

4.3 Operating structure

Depending on the nature and the turnover of the business, it could be operated by one company or a group of companies. The operating structure could also consist of one or more holding companies subject to a consideration of the benefits and risks of incorporating a holding company. The benefits which are explained further below are that the incorporation of a holding company facilitates the retention of working capital within the operating structure and enables the consolidation of the group of companies for tax purposes.

However a risk of a holding is the potential application of section 588V of the *Corporations Act 2001* (Cth). In the event of the liquidation of a subsidiary, the subsidiary's liquidator may under section 588V recover from the holding company a debt due to the subsidiary if the management or directors of the holding company had knowledge of and allowed the subsidiary company to incur a debt whilst it was insolvent or that resulted in it becoming insolvent.

Operating entities could undertake particular operating arms of the business. The operating structure could be organised by:

- state (suitable for national businesses with operations across different states and territories);
- industry or sector (suitable for businesses that operate across different industries such as for example manufacturing and retail);
- products or services (suitable for businesses that produce distinct products or services);

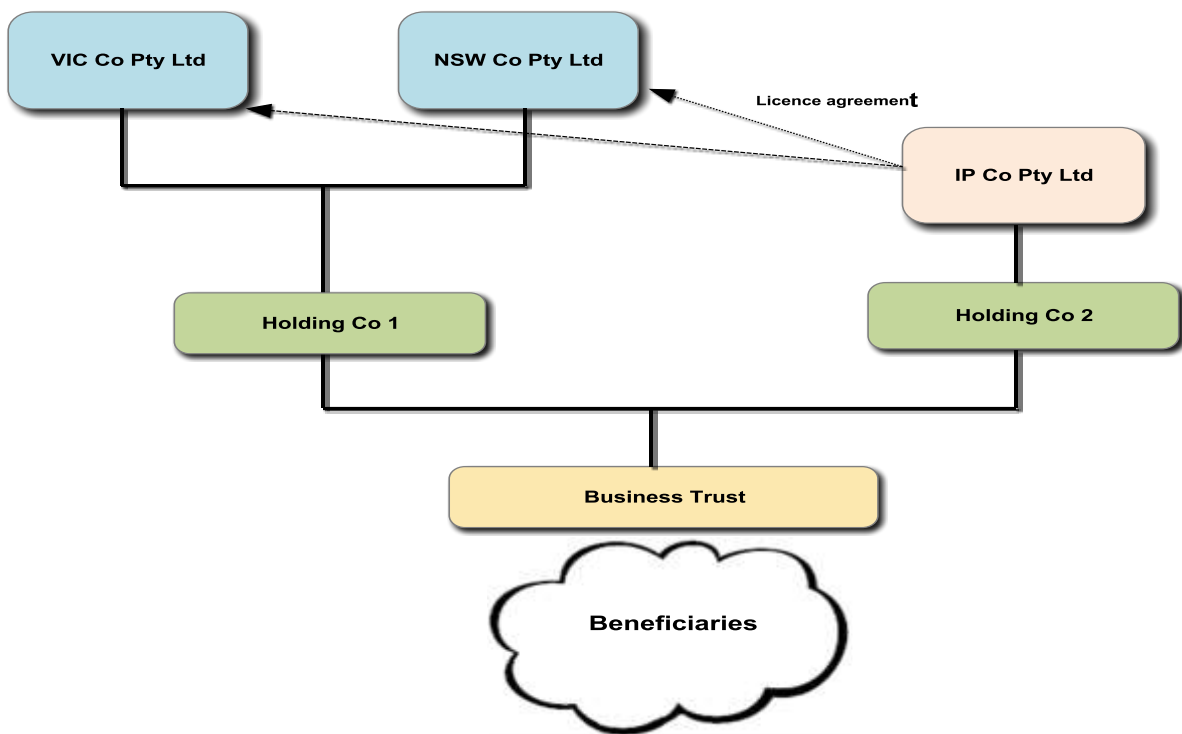
²⁶ Section 263, *Corporations Act 2001* (Cth).

- projects or high value projects; or
- a combination of one or more of the above.

The incorporation of companies to operate distinct parts of a business will assist in quarantining the risks associated with the operation of those parts however it will have to be weighed up against the administrative, compliance and reporting obligations a large structure may create.

A business with significant value in intellectual property (or the potential for a significant increase in the value of intellectual property) should ensure that it is owned by a special purpose 'IP' company. The IP company would license the use of the intellectual property to the operating entity or entities. A business could also have a separate entity providing the administrative service needs of the operating entity or entities. The licensing of the intellectual property and provision of the administrative services should be undertaken on a commercial basis (that is, for an appropriate fee). To ensure that the operational risk of the business is quarantined from the ownership of the intellectual property and administrative entity, a separate holding company could own the shares in these companies.

An example of the corporate and ownership structure of a business that operates in Victoria and NSW is set out in the diagram below:



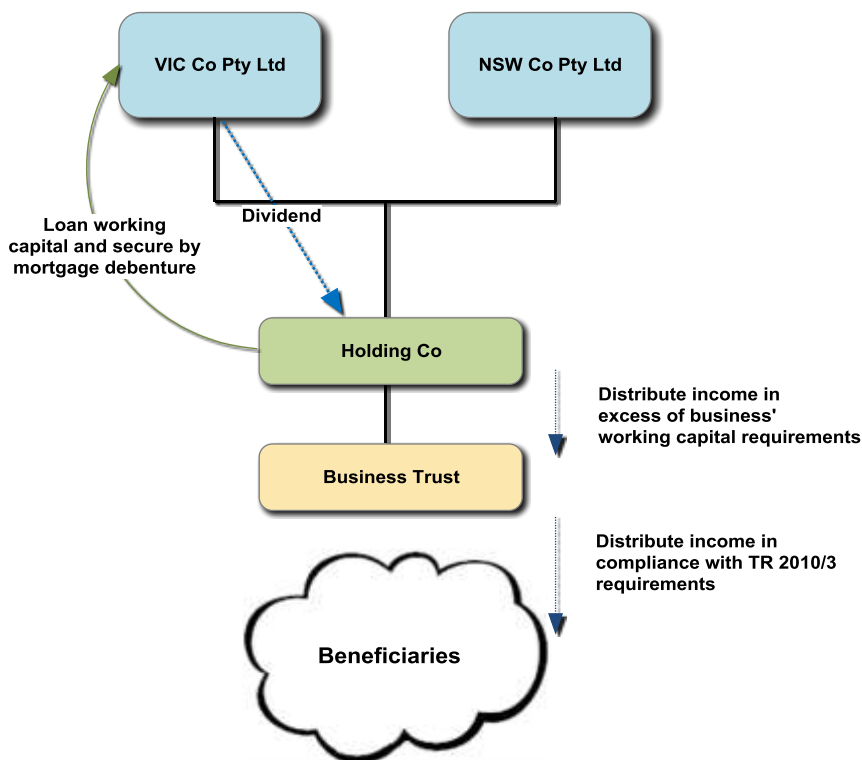
A clear tax advantage of establishing a holding company is the ability of the group of companies headed by a holding company to consolidate as one entity for tax purposes. In the diagram above, Holding Co 1, Vic Co Pty Ltd and NSW Co Pty Ltd could elect to consolidate as a group for tax purposes. This will also prove as a benefit when it comes to selling the shares in the holding company as having the election to consolidate would be attractive to a purchaser.

4.4 Interposing a new holding company

If as part of a restructure a new holding company is to be interposed between the operating company and its shareholders, roll-over relief is available to defer the CGT consequences when all of the shares in the original holding company are exchanged for shares in the new holding company.²⁷ The shares issued in the interposed company must not be redeemable shares. Under Subdivision 124-G the tax characteristics of the shares in the new company (cost base and acquisition date) will match those of the shares formerly held in the original company.

4.5 Retention of working capital

In a group structure, for asset protection purposes, all income earned by the operating entities could be distributed as a franked dividend to the holding company. From the funds distributed the holding company could then loan the amount necessary to meet the ongoing capital requirements of the operating entity. The loan could be secured by a mortgage debenture that is registered with ASIC within 45 days to obtain priority of repayment. The funds in excess of the working capital requirements could be distributed as a franked dividend to the discretionary trust(s) holding the shares.



²⁷ Subdivision 124-G of ITAA 1997. Subdivision 124-H provides a similar rollover to interpose a holding company above a unit trust.

4.6 Exiting

The business owners can elect to exit from the business by either selling the shares in the operating or holding company or selling the business.

A sale of the shares in the trading company (or the holding company if one was established) by a trust is eligible for the 50% CGT discount and potentially eligible for the CGT SBCs. The trust will have to satisfy:

- the maximum net asset value test;
- the active asset test; and
- the small business participation test.

A discretionary trust holding shares in a trading company will satisfy the active asset test if the company is a resident company and, at the relevant time, at least 80% of the company's assets are active.

The small business participation percentage test will be satisfied if the direct and indirect interests in the company is 80% or more.

The satisfaction of these tests ensures that in addition to the availability of the 50% discount on any capital gain that is triggered, the discretionary trust will also have the possibility of accessing the CGT SBCs.

The transfer of shares as a sale strategy is likely to be more tax effective for the vendors than the transfer of the business assets. The transfer of shares in a private company is dutiable in New South Wales and South Australia at a rate of 0.6% if the company was incorporated in those jurisdictions. A transfer of shares in a company that owns land in a state or territory could trigger 'land holder' or 'land rich' duty in that state or territory and it should be considered in detail. Land also includes certain interests in land such as fixtures.

4.7 Succession

In considering the succession of a business it is important to consider the passing on of control of the business rather than ownership. In this regard the discretionary trust owning the shares in the operating or holding company (as the case may be) should be structured to ensure that there is a succession plan in place for the offices of the trustee and the appointor.

5 UNIT TRUST

A modern unit trust is one where the deed establishing the trust provides that the beneficial ownership of the trust fund is divided into units that are held by the unit holders and where each unit entitles the holder to receive a set or fixed proportion of the distribution of the income and/or capital of the trust. The deed provides that the units confer an interest in the trust (or trust fund) as a whole but not in any specific underlying trust assets or property.²⁸

A unit confers certain rights or entitlements upon the holder in relation to the property held in trust. In *CPT Custodian*²⁹ the High Court held that the nature of the interest held by a unit holder depends on the terms of the particular trust deed. On the terms of the particular unit trust deed before it, the High Court held that although the unit holder was the only beneficiary of the trust the unit holder could not be said to be the equivalent of the owner of the assets of the trust as the trustee had a right of indemnity against the trust. This could result in the assets being sold to satisfy the right of indemnity and accordingly the unit holder did not have a proprietary interest in the assets of the trust, but merely an interest in the amount remaining in the trust fund after satisfaction of any indemnity.³⁰

The terms of the trust will also usually provide for the issuing and recording of the ownership of its units including new units issued after the trust has been created, for the transfer of units and for the redemption of units. A unit is a CGT asset for the purposes of the CGT provisions.

A non-public or closely-held unit trust structure is effective for a business being operated by investors in the one family or by investors from multiple families. Units are typically issued to investors in proportion to their investment of capital; however, units can also be issued to persons who are providing intellectual property by way of a specialist commercial skill (such as the requisite skills and experience to manage a financial services or property development venture) or management experience.

A significant advantage of the structure is that raising capital can be facilitated by the issue of new units for equity or the proportionate injection of capital by the existing unitholders in proportion to their interests. It is important to note that for a unit trust to qualify as a fixed trust for the purposes of the trust loss rules, units can only be redeemed or issued at a price determined on a net asset value in accordance with Australian accounting principles.³¹

The ability to issue units with different characteristics provides a degree of a flexibility that will suit the preferences of certain investors. For example:

²⁸ It is possible to have, and in fact most unit trusts in practice are, 'hybrid' unit trusts providing the trustee with a discretion as to income or capital entitlements. However for the purpose of this paper we treat a unit trust as synonymous with a fixed trust.

²⁹ *CPT Custodian Pty Ltd v CSR (Vic)* [2005] HCA 53.

³⁰ In comparison a share confers upon the holder no legal or equitable interest in the assets of a company.

³¹ Schedule 2F of ITAA 1936.

- More than one class of units can be issued in respect of a unit trust with each class have a different combination of one or more of voting, income or capital distribution rights;
- Units can be issued on different payments that is on a fully-paid or partly-paid basis; and
- With terms regarding redemption and buy back that are tailored to meet the requirements of particular investors.

Some of the draw backs are that widely-held trusts (which are considered to be corporate unit trusts or public trading trusts) are taxed like corporates (which could limit the potential growth of the business), the application of a number of fixed trust specific CGT events, including CGT event E4 and the limitations imposed on self-managed superannuation funds (**SMSFs**) which invest in unit trusts. Additionally, franking credits can only flow-through the unit trust to its beneficiaries if the unit trust is a fixed trust or a family trust election has been made.³² In this regard, it is worth noting that the legislation requires that the beneficiary (unit holder) have a 'fixed interest' in the trust holding,³³ however, what constitutes a fixed interest for franking credit-flow-through purposes is still to be decided by the Courts. Some commentators have suggested that until such time as the courts bring clarity to the issue, the Schedule 2F trust loss jurisprudence regarding "vested and indefeasible" interests might be applicable to the flow-through of franking credits.

5.1 Investors

Asset protection can be afforded to the owners by the units being held by discretionary trusts of the investors or companies the shares in which are held by discretionary trusts.

A trustee of a SMSF looking to invest in a unit trust must ensure that it does not breach the in-house asset rules in the *Superannuation Industry Supervision Act 1993* (Cth) (**SISA**) and the non-arm's length income provisions in ITAA 1997.

An in-house asset of a superannuation fund includes an investment in a 'related trust'.³⁴ A trustee of a superannuation fund is prohibited from acquiring an in-house asset if the market value of the fund's in-house assets exceed 5% of the fund's assets (section 83). In addition, if the fund breaches the non-arm's length income rules contained in section 295-550 of ITAA 1997, any non-arm's length income received by the fund will be taxed at the highest marginal rate of 45 per cent (rather than the concessional rates of 15 percent or 0 per cent). Income derived by a fund is non-arm's length income of the fund if (1) it is income that is derived other than because of a holding of a fixed entitlement to the income (2) even if the fund holds a fixed entitlement the fund acquired the entitlement under a scheme or the income was derived under a scheme the parties to which were not dealing with each

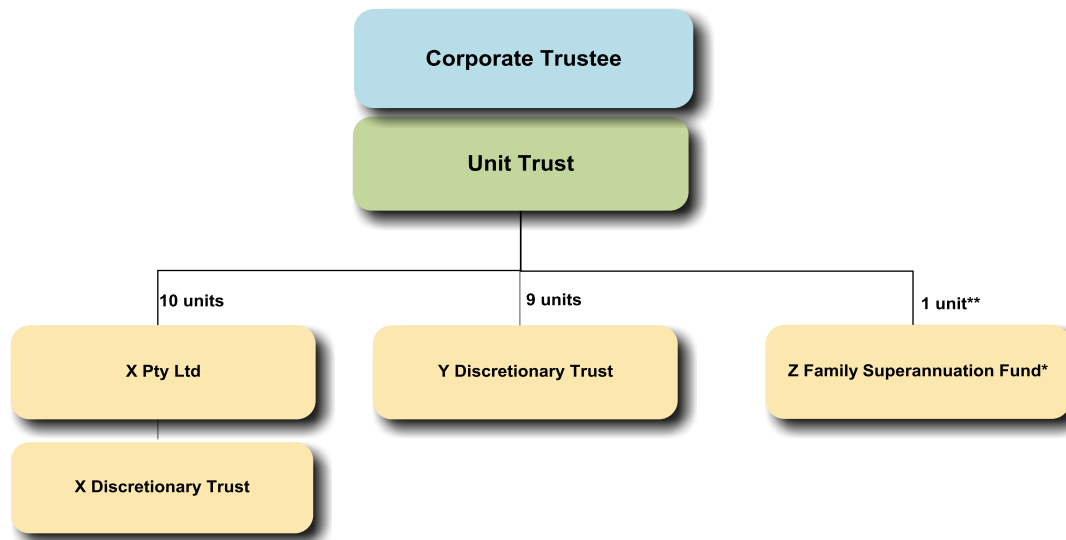
³² Section 207-150(1) of the ITAA 1997 and the requirement that the unit holder be a "qualified person" under the ITAA 1936..

³³ Subsection 160APHL(1) of the ITAA 1936.

³⁴ Section 71, SISA. A trust will generally be a related trust if a member of the fund controls the trust within meaning of section 70E of SISA. Note also the anti-avoidance provisions in subsection 71(2) of SISA. There is an exception for trusts which are instalment trusts (section 10(1) of SISA), widely held trusts, pre-11 August 1999 trusts and an instalment warrant trust.

other at arm's length and the amount of the income is more than the amount that the fund might have been expected to derive if those parties had been dealing with each other at arm's length.

In finding that a capital gain was special income of a super fund in the recent decision of *Allen's Asphalt*³⁵ the Full Federal Court also held that 'the Super Fund acquired the fixed entitlement to income and subsequently derived the income under an arrangement, where some or all of the parties were not dealing with each other at arm's length'.



* ensure that investment does not breach SISA 'in house asset' rules and ITAA97 'non-arm's length income' rules

** superannuation fund should hold less than 20% of the units in the unit trust to ensure that the unit trust is not a public unit trust and taxed at the corporate rate

5.2 Taxation of Business Profits

With the exception of corporate unit trusts and public trading trusts, the taxation of a unit trust's income is governed by Division 6 and the rules of present entitlement. A unit trust is a flow through vehicle.³⁶ The income retains its character as it flows through the structure and the unit holder can access any of the tax attributes of the income such as foreign tax credits attaching to the foreign income. To access franking credits the unit trust must be a fixed trust or have made a family trust election.

The income of a public unit trust (being either a corporate unit trust³⁷ or a public trading trust³⁸) is taxed at the corporate rate with unit holders taxed on distributions as dividends which are frankable. In relation to the investments by superannuation funds, a unit trust will be a public unit trust if the

³⁵ *Allen's Asphalt Staff Superannuation Fund v Commissioner of Taxation* [2011] FCAFC 118

³⁶ *Greenhatch v Federal Commissioner of Taxation* [2011] AATA 479.

³⁷ Division 6B of Part III of ITAA 1936.

³⁸ Division 6C of Part III of ITAA 1936 (currently under view as part of the proposal for a managed investment trust regime).

superannuation fund holds a beneficial interest in 20% or more of the property or income of the trust. A unit trust could also be a public unit trust in a particular income year if in that year it was paid 20% or more of the moneys paid by the trust to unit holders, or an arrangement exists whereby such an entity could have been given such a holding during the year or could have been entitled to 20% or more of any moneys paid to unit holders during the year concerned.

5.3 CGT Event E4

Various CGT issues arise as a result of distributions to trust beneficiaries of amounts not assessable to them (e.g. due to the small business CGT concessions enjoyed by the trustee when assets are sold). CGT event E4 is an example, in that it may cause such non-assessable distributions to be subtracted from the beneficiaries' trust interests cost base, and if such non-assessable amounts exceed the cost base, for capital gains to arise. CGT event E4 provides a "claw-back" for concessions such as the CGT general discount and 50% small business concession; however, CGT event E4 may nonetheless result in a reduction or elimination of cost base and a capital gain, in part due to such concessional treatment.

5.4 Exiting

This structure presents the ability to undertake partial or full exits from the business which is not dissimilar to a corporate entity. As it is possible to sell a portion of the issued units, proprietors can partly sell down their equity without actually selling part of the business into a partnership.

Unitholders have access to the active asset concession and the 12 month discount concession. Both concessions are available in respect of either the sale of the business or sale of the units.

An Australian resident unit trust can be a member of a tax consolidated group for income tax purposes, provided that it is not a complying superannuation fund³⁹ and the ultimate beneficial owner is the head entity.⁴⁰ Only public trading trusts and corporate unit trusts can be the head entity.

However, CGT event E4 is a potential pitfall in the sense that it may potentially reduce the CGT concessions afforded under the active asset 50% reduction. The potential for additional taxation undermines the merits of a unit trust structure, unless the vendors are able to sell the units in the trust in which case the sale proceeds will not be subject to CGT Event E4, and consequently will not limit the benefits of the active asset concession.

Upon the sale of assets by a unit trust structure access may be available to the 50% discount, and subject to satisfaction of the conditions for relief (discussed in the preceding sections) the 50% active

³⁹ Section 703-20 of ITAA 1997

⁴⁰ Section 703-40 of ITAA 1997 provide rules for treating a discretionary trust as a fixed trust where it is interposed between a head entity and an entity that would otherwise have qualified as a member of the tax consolidated group.

asset reduction, the 15-year exemption, the retirement exemption and roll-over concessions. However, as noted, CGT event E4 may limit the benefit obtained from the 50% active asset reduction.

The sale of the units in the unit trust is eligible for each of the concessions mentioned previously, with respect to an asset sale, save that CGT event E4 will not be applicable. .

6 RESTRUCTURING

Faced with the increasing uncertainty in using a discretionary trust, and the exponential increase in annual compliance required, to operate a business many clients and their advisors are considering 'corporatizing' the operating structure of the business.

In this regard it is worth bearing in mind the CGT roll-over concessions provided under Division 122 and Subdivision 124-N. Importantly, no roll-over relief is provided for trading stock and this may prove a disincentive, as might stamp duty considerations.⁴¹ Subdivision 122-A deals with the disposal of assets by an individual or a trustee to a wholly owned company. Subdivision 122-B sets out the concessional relief afforded a partnership on the disposal of its assets to a wholly owned company. In brief, the taxpayer replaces the asset disposed of with shares in the company; if a pre-CGT asset is rolled over, the shares in the company are also taken to be pre-CGT assets.

Alternatively, an optional roll-over is available, under Subdivision 124-N, where a fixed trust disposes of all of its assets to a company and the beneficiaries' interests in the trust are exchanged for shares in the company. Both the trust and its beneficiaries can access the roll-over. Under this roll-over the trust must cease to exist within six months from the disposal of the first asset to the company (or longer if the reasons for the delay are beyond the trustee's control). Where the requirements for the roll-over are met, the trust can disregard the capital gain or loss and the trust's cost base of the CGT asset becomes the first element of the cost base for the company. If the original asset acquired by the trust is a pre-CGT asset, the asset acquired by the company will be treated as a pre-CGT asset. If the beneficiaries trust interests are pre-CGT interests, their company shares will likewise be treated as being pre-CGT assets; post-CGT interests will inherit their cost base from the trust interests being replaced.

With respect to ownership reorganisations, we caution that the value shifting provisions may be applicable and have the potential to impact all of the entities discussed in this paper. The provisions are likely to apply where transactions, arrangements or schemes result in the value of an asset being reduced and a consequential increase in the value of another asset. However, we draw your attention to the fact that there are situations where the value shifting provisions apply where assets decrease in value without a compensating increase in value of another asset.

⁴¹ Limited corporate reconstruction relief is afforded for stamp duty purposes; however, the stamp duty relief and CGT relief requirements do not always align.

7 CONCLUSION

The most appropriate structure for a business or an investment in a business will depend on a proper consideration of the priorities of the business and the owners taking into account the factors that have been mentioned and discussed above.

In the post-TR 2010/3 environment, a small business that has as one of its top commercial priorities the retention of capital within the business structure will benefit from a corporate structure that is owned by a discretionary trust. This will also provide flexibility in relation to the distribution of income and the minimisation of income tax. Company and unit structures also enable the raising of new equity and the introduction of new investors. Proper consideration should also be given to the exit and/or succession plan.