

Tax Events

Acis.

Redchip



Trusts v Companies

Tax Events Deep Dive Series 2

October 2022

Presented by Acis and Redchip

1. INTRODUCTION

1.1 OVERVIEW

For most of our small business clients, the cost of taxation is a significant consideration with the choice of business structure and the annual administration of our client's commercial, taxation and family matters.

Our clients seek our advices to navigate the myriad of business, taxation and investment issues that arise with their business. In that regard being able to provide advices that ensure compliance with the relevant taxation laws and ensuring at the same time that the "appropriate" amount of taxes are being paid, is a difficult task.

The task is being made more difficult by:

- the changing interpretation of existing laws; and
- the economic imbalance within our taxation system that practically limits a taxpayer's ability to contest these interpretation changes/modifications.

1.1. IMPACTFUL CHANGES

Consider the following changes with the ATO's interpretation of the following trust and company matters and ask what impact these have created with the advices sought and provided to your small business clients:

- PCG 2021/14 – Allocation of Profits within professional firms;
- TR 2021/D2 - Personal services income and personal services business;
- TD 2022/11 – Division 7A ITAA 1937 which deals with the application of subsection 109D (3) "loans" for UPEs and sub-trust arrangements;
- TR 2022/D1 – section 100A ITAA 1936 reimbursement agreements.
- Section 99B – guidance document will be provided shortly

In addition to the above ATO rulings, the Courts have added to the vagaries of what is the law:

- Guardian AIT Pty Ltd ATF Australian Investment Trust v FCT [2021] FCA 1619 which dealt with section 100A and in many respects the Federal Court's decision provides a different interpretation of section 100A to that provided by TR 2022/D1 (note the Commissioner has appealed the decision);
- Commissioner of Taxation v Carter [2022] HCA 10 which dealt with the effectiveness of a default beneficiary's disclaimer of the trust distribution with regard to the application of section 97 ITAA 1936;
- Peter Greensill Family Co Pty Ltd (Trustee) v Commissioner of Taxation [2021] FCAFC 99 which considered the application of section 855-10 ITAA 1997 to a non-resident's share of a capital gain

attributable to “non-taxable Australian property” and the implications of the Division 6E ITAA 1936 amendments.

- *Minerva v FCT* [2022] FCA 1092. In this matter, the taxpayer restructured their business and assets for the purpose of an intended IPO. As a consequence of the restructure, the relevant trustee distributed its trust income, pursuant to the wide discretionary powers provided by the trust deed, to an entity which ultimately provided taxation benefits. The Commissioner nominated the exercise of the trustee’s discretion to be subject to Part IVA. The Court agreed with the Commissioner’s Part IVA determination; and
- *BBlood Enterprises v FCT* [2022] FCA 1112. In this case, the Commissioner, *inter alia* applied section 100A to an arrangement which included a share buyback of a private company shares held by a trust. As part of the “arrangement” the trust’s definition of trust income was amended to be “amounts that are ordinary income” *vis a vis* the previous definition being referenced to section 95 ITAA 1936. Accordingly, notwithstanding the amount received by the trust was assessable as a deemed dividend (section 159GZZP) and thus being part of the trust’s net income, the trust’s income excluded the share buyback proceeds (capital receipt). The trust income (only a modest amount of divided income) was distributed to a new corporate beneficiary, with the consequence that the corporate beneficiary was assessed on their share of the net income (albeit the attributable franking credits offset the tax otherwise payable by the corporate beneficiary, notwithstanding the “capital” amount was retained by the trust. The Federal Court concluded that section 100A applied. Interestingly, the Court provided a much broader interpretation of who might be the relevant comparative taxpayer when determining whether the arrangement had the necessary tax purpose.

Note all of these cases have been driven by the Commissioner arguing a position to limit the effectiveness of a discretionary trust.

All of the above matters have significant implications for the taxation advice provided in relation to the management and distribution of income generated by a discretionary trust.

In addition to the above taxation cases, I would also refer to the decision in *Owies v JJE Nominees Pty Ltd* [2022] VSCA 142 which questioned the validity of trustee’s income resolutions, notwithstanding the trustee had an “unfettered” power to determine which beneficiary would be nominated to receive the income of the trust. The Court determined that the trustee has a fiduciary obligation to give “real and genuine consideration” to the needs of the beneficiaries when making income distributions.

1.2. POTENTIAL TAX CHANGES

In addition to these changes, there are other matters that will impact the choice of entity decision:

- (i) Whether the present Division 115 ITAA general discount rate of 50% will remain at 50% in the future or if it will be reduced as is widely anticipated;
- (ii) Whether the present imputation regime will continue in its present form;
- (iii) Whether the Government accepts the Board of Taxation's recommendation provided to the then Treasurer in their 2019 report – "Review of Small Business Tax Concessions", which noted:

"The small business CGT concessions are among the most significant tax concessions available for small businesses to access and, consequently, are highly valued by small business stakeholders.

- *However, the Board believes that there are a number of concerns with the concessions – they are complex and costly to comply with, they can distort business decision-making, and they are not always well targeted.*
 - *Available ATO data on the up-take of small business CGT concessions also raises questions as to the long-term sustainability of the current regime.*
 - *The Board has identified a **reform pathway** designed to make small business CGT concessions simpler, fairer and more sustainable. The Board recommends:*
 - *integrating the eligibility criteria with the SBE regime by raising the aggregated turnover threshold to \$10 million per annum;*
 - *repealing the maximum net asset value test (net asset test), thereby having a single eligibility gateway; and*
 - *collapsing the 15-year exemption, active asset reduction and retirement exemption, and replacing them with **one CGT exemption subject to a cap**.*
- (iv) Whether and notwithstanding the Government's election promise not to tax trusts, this promise might be revisited in the guise of "tax reform". The Treasurer indicated during the election process that the Government would need tackle tax reform. Query, whether reform might include a change in the taxation of trusts given the perception with the Government is that trusts are used by the "wealthy" as a device to minimise tax.

1.3. ENTITY CHOICE

Accordingly, the question presently to be considered is whether a discretionary trust is the most appropriate form of entity for our small business clients, particularly where the business and/or investments require ongoing funding from the profits generated by the income earning activities.

Whilst there is no "off the shelf" solution that can be readily offered as a solution to each and every small business situation, there are some primary requirements that impacts the choice of entity, including inter alia:

- Risk management strategies;
- Isolation of private assets from business risk;
- Flexibility of distributions, albeit income and/or capital;
- Maximisation of funding opportunities by “reinvesting” the after-tax profits to assist with the entity’s business/asset growth;
- Access to the various CGT concessions; and
- Taxation certainty.

As has often been stated by myself, the selection of an entity structure, needs to facilitate both the immediate and longer-term strategies of the small business client. Further the choice of entity should to some major extent be driven by commercial factors

Unfortunately and respectfully to those who have a different view, it is my understanding that the role of the ATO is not a law maker (in disguise) but rather the ATO is an administrator of the law. Notwithstanding this perception what is apparent from the ATO’s recent interpretation changes and the matters the Commissioner argued before the Courts, is that the ATO’s application of tax laws relating to discretionary trusts is uncertain and is evolving at the behest of the ATO with the primary purpose to limit the flexibility and the effectiveness of the use of a discretionary trust. Alternatively, it might be argued that the Commissioner is simply clarifying what the law is and has always been and there is no change in the law!

2. PRESENT ISSUES IMPACTING THE USE OF A DISCRETIONARY TRUST FOR A BUSINESS ACTIVITY

2.1. OVERVIEW

It is readily acknowledged that a discretionary trust and/or a company have their specific benefits and disadvantages. These factors would include:

Advantages:

- Flexibility;
- Taxation concessions;
- Asset protection; and
- Family succession options.

Disadvantages:

- Annual distributions required;
- Commissioner’s recent rulings;

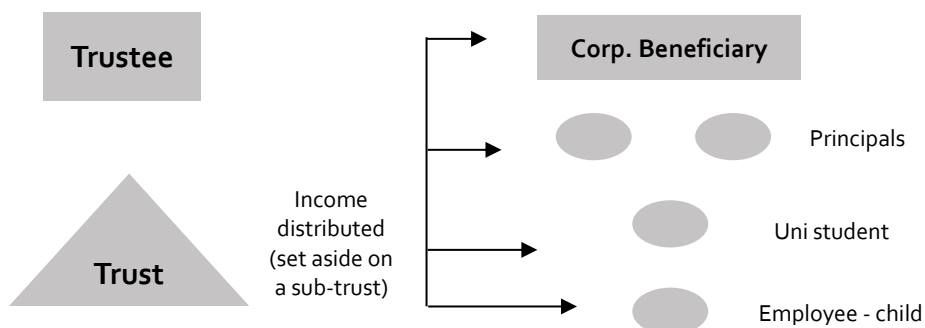
- Estate planning which envisages the transfer of assets;
- Limited opportunities for the introduction of third-party equity; and
- Limited options on the disposal of the business.

It is not intended to detail all of the pros and cons for either entity form, it is taken that these factors are generally well known. However, what is intended, is to consider a hypothetical fact scenario and apply the current tax changes to that scenario to illustrate the comparison.

2.2 HYPOTHETICAL FACTS

- The client has a successful and growing business which requires on-going funding to support the business. The funding is provided by the retention of any post taxed profits;
- They started the business 10 years ago;
- There is an element of business risk associated with the business activities;
- The business has a turnover of \$20m and the business entity and its “connected entities” satisfy the maximum net asset test¹;
- The business generates a net profit of approximately \$500,000 after commercial salaries paid to the principals;
- The principals of the business have 2 adult children, one of which works in the business. It is intended that at some time in the future he will “take over” the business. The other child is studying at the University and has no employment or investment income;
- The longer term (10 years) business strategy is for the principals to retire from the business and either transfer the business to their child or sell the business to a third party

2.3 STRUCTURE SCENARIO 1 – USE OF A DISCRETIONARY TRUST FOR THE BUSINESS WITH A CORPORATE BENEFICIARY



¹ Section 152-15 ITAA 1997

The relevant post 1st July 2022 taxation factors to be considered where the discretionary trust carries on the business, are:

- (i) The trustee must distribute the all of income of the trust annually and ensure that the effect of the resolutions is to make the nominated beneficiaries “presently entitled” to the income;
- (ii) Subject to the terms of the trust deed, the distributions that are not paid (UPEs), will generally be put on a sub-trust arrangement (ACIS standard deed makes this provision - the deed provides that a trust distribution set aside is held absolutely for the benefit of the nominated beneficiary and ceases to be part of the main trust);
- (iii) The distribution made to the corporate beneficiary will be deemed to be a section 109D(3) ITAA 1936 “loan” where the circumstances outlined by paragraph 55 of TD 2022/11 apply:

“..., if the funds are used by the trustee in its capacity as trustee of the main trust, used for the benefit of the main trust or otherwise used by or for the benefit of another shareholder or associate of a shareholder of the private company under a consensual agreement with the private company beneficiary, this may amount to the provision of financial accommodation by the private company beneficiary.”

- (iv) Based on the fact scenario if the distribution made to the corporate beneficiary is held on a sub-trust arrangement (as per the ACIS deed) and the amount is retained by the main trust for its use, the amount so used by the main trust will be treated as a loan for the purposes of subsection 109D(3) and required to be:
 - o Treated as a deemed dividend to the trust pursuant to section 109D ITAA 1936;
 - o Paid by the trust to the sub-trust/corporate beneficiary by the due lodgement date of company's tax return; or
 - o Subjected to a loan arrangement on terms that satisfy the section 109N ITAA 1936 requirements – that is principal and interest over a 7-year term (25 years if adequate security is provided)

TD 2022/11 represents a fundamental change to the use of a corporate beneficiary where the distribution (after tax) is retained by the trust. The withdrawn PSLA 2010/4 will result in a significant cash flow alteration by using a corporate beneficiary. No longer can Division 7A be avoided by placing the distribution on a PS LA 2010/4 sub-trust – interest only arrangement (plus the advantage of PCG 2017/13 arrangement for the treatment of the payment of the principal amount at the end of the PS LA 2010/4 term)

If this fact situation applies, over time, the trust will need to cash flow the repayment of the section 109D loan. Consequently, the cash will be eventually be held by the corporate beneficiary.

- (v) With regard to the fact scenario, the circumstances also raise the spectrum whether section 100A ITAA 1936 will be a factor to be considered. Noting of course that if section 100A applies, the trustee is assessed on the trust distribution and not the beneficiary.

Given the broad generality of the potential ATO compliance issues (refer to TR 2022/D1 & PCG 2022/D1), where the distribution is not paid to, or applied for the benefit of the beneficiary, section 100A has potential application.

Section 100A will apply where:

- There is an **"agreement"** that involves financial benefits being provided to another entity (other than the beneficiary) in anticipation of the distribution being made to a beneficiary;
- There is a **"tax purpose"** for the distribution being made to the nominated beneficiary (the beneficiary has a lower tax obligation to the tax position of the entity receiving the economic benefits); and
- The arrangement is not excluded by **"ordinary family or commercial dealing"** factors.

Having regard to the current uncertainty about the eventual application of section 100A (that is, whether the Full Federal Court's appeal decision in Guardian AIT will moderate the Commissioner's wide application of the provision), applying the draft ruling and PCG to the hypothetical facts. It is also hopeful that the taxpayer will appeal the decision in BBlood Enterprises so that we can gain some a better understanding of which entity is to be the counterfactual to ascertain whether the arrangement has the requisite "tax purpose".

2.3.1 DISTRIBUTION TO THE CORPORATE BENEFICIARY:

If the distribution is used by the main trust and that use was anticipated prior to the distribution being made, prima facie there is a section 100A issue.

However, based on the hypothetical facts presented here, PCG 2022/D1 provides an exception to the application of section 100A.

Note the exclusion provided ("green zone") to the arrangements is merely an assertion that the Commissioner will not devote compliance resources. That is, importantly, the green zone arrangements are within the ambit of section 100A, BUT the Commissioner has stated the compliance resources will not be applied. There is a significant risk with the Commissioner's approach adopted by the "green zone" categorisation. It would have been preferable if the Commissioner had ruled that the types of green zone

arrangements were “ordinary family or commercial dealings” to ensure that they were specifically excluded by the statutory provisions rather than the compliance approach.

Note the conditions provided by paragraphs 20 & 21 and relate them to our facts

*“20. A beneficiary that is an individual or a private company is made presently entitled to income of the trust estate and there is a **'trustee retention of funds'** where **all** of the following is satisfied:*

- *the **'use of funds condition'**;*
- *none of the factors set out in paragraph 26 of this Guideline are present*

...

- *if that beneficiary is a private company*
 - *the company is controlled by an individual who also controls the trust, and*
 - *the company's entitlement is made available to the trustee **on terms that satisfy section 109N.***

21. For the purposes of this scenario:

*(a) **'Trustee retention of funds'** refers to the beneficiary allowing the trustee to retain funds for a period of time or indefinitely that they would otherwise receive in satisfaction of their entitlement. This could be in the form of lending the funds representing their entitlement back to the trustee, or by not yet calling for that entitlement to be satisfied.*

*(b) The **'use of funds condition'** means that the trustee, as permitted by the trust deed, uses the funds (in its capacity as trustee) that represent the beneficiary's entitlement only:*

- (i) in the working capital of a business that it actively carries on*
- (ii) for the acquisition, maintenance or improvement of investment assets of the trustee, and/or*
- (iii) to lend the funds to an associate, on terms that satisfy section 109N, and the associate uses the funds in a way that satisfies either of the criteria above.*

(c) The use of funds condition is not satisfied if any associate of the trust benefits, except as described at paragraph 21(b)(iii) of this Guideline, from that use of funds (for example, being able to use a trust asset for less than market value consideration).

Accordingly, if the amount distributed to the corporate beneficiary is:

- (i) Retained by the main trust;

- (ii) Used by the main trust for the relevant purposes (working capital or investment asset acquisition; and
- (iii) The amount is subjected to a section 109N loan arrangement

section 100A will not apply.

2.3.2 DISTRIBUTIONS TO THE INDIVIDUALS

The PCG also provides some limited exclusion for the treatment of retained trust distributions. Other than the requirements provided by paragraphs 20 & 21, in the case of the individuals – the principals (spouses), the employed adult child and the adult university student, the section 100A situation is to be considered having regard to the following requirements:

- (i) The trustee retention of funds factor, that is the funds are used by the trustee for working capital or investment asset acquisition; and
- (ii) "...if that beneficiary is an individual, either
 - the individual and/or their spouse is a trustee of the trust or controls the trustee of the trust
 - the individual is employed in the management of a business that the trustee conducts..."

Accordingly, with the hypothetical fact scenario, the "green zone" section 100A would ensure that:

- the distributions to the principals will satisfy the conditions and not be subject to section 100A compliance activity;
- the distribution to the adult child employee will satisfy the conditions and not be subject to section 100A compliance activity; adult child university student will not satisfy the conditions and prima facie will be subject to section 100A compliance activity.

In the latter instance, the issue will be whether the arrangement would be excluded by the "ordinary family or commercial dealing" condition. If Logan J's decision in Guardian AIT is maintained there is a very strong likelihood that the distribution to the adult child and payment made to the parents will not be subject to section 100A. However, the question will, in my opinion, be determined by the amount involved. The larger and disproportionate amount relevant to the adult's child cost of living will increase the possibility that section 100A will apply.

2.3.3 IMPLICATIONS FOR THE CORPORATE BENEFICIARY

Other than the above flow on applications of the trust distributions to the company, the general tax and commercial implications are as follows:

- (i) The company will be a “base rate entity”² and be taxed at the current rate of 25% with franking credits based on that rate of tax;
- (ii) The trustee’s distribution will be most probably be held on a sub-trust arrangement and be subject to TD 2022/11;
- (iii) With the application of TD 2022/11 the company will receive the cash from the section 109N loan repayment; and
- (iv) With the build-up of funds in the corporate beneficiary, the decision as to how to use or apply those funds in the business will be an important decision.

2.3.4 SUMMARY OF IMMEDIATE TAX OUTCOMES OF SCENARIO 1:

Based on the above analysis, the implications of this structure configuration are:

- (i) If the funds are required for funding of the business or investment asset acquisition, the problems are:
 - a. The funds will over time be held by the corporate beneficiary; and
 - b. The Division 7A cycle will continue;
- (ii) The section 100A will be limited to distributions to the “non-business” beneficiaries (subject to the exclusion provided by the “ordinary family or commercial dealing” factor; and
- (iii) The use of the corporate beneficiary to receive the trust distributions will ensure the lower rate of base rate entity tax

Accordingly, if the primary objective is to minimise the tax payment but maximise the retention of funds for business growth, the business trust scenario has some limitations.

2.4 LONGER TERM ISSUES:

In choosing a business structure, the decision should be based not only on the immediate tax consequences but also the longer-term requirements.

With the hypothetical fact scenario provided, the long-term factors to consider would include:

² Section 23AA & 23AB Income Tax Rates Act 1986

- (i) The availability of the various CGT concessions – primarily Division 115 ITAA 1997 and Division 152 ITAA 1997;
- (ii) The ability to deal with the family succession plan;
- (iii) Estate planning; and
- (iv) The taxation and commercial implications on the sale of the business.

In brief, the matters generally considered:

(i) CGT Concessions:

- The discretionary trust is entitled to use Division 115 as distinct to a company;
- Both a discretionary trust and a company can access Division 152 if the entities satisfy the basic conditions, **however** the subdivision 152-C concession is only tax effective for a company if the company is liquidated;
- a company provides the alternative sale options – the business or the shares, however in this instance the corporate entity is irrelevant.

(ii) Succession planning:

Discretionary trust:

- relies on changing the ownership and control of the trustee to pass the control to family members;
- has a life of 80 years at most; and
- not possible with non-family members.

Company:

- Facilitated by the transfer of shares – CGT consequences;
- Can introduce “control” factors when transferring shares to over family members.

(iii) Estate planning:

- As a beneficiary of a discretionary trust has no interests in the assets of the trust, there is no ability to make any testamentary choices (other than the shares in the trustee company);
- Shares in a company can be transferred by a testamentary choice and attract the deferred tax benefits provided by Division 128 ITAA 1997.

(iv) Sale of business:

- With a trust, a sale of the business can only be facilitated by the sale of the business assets;

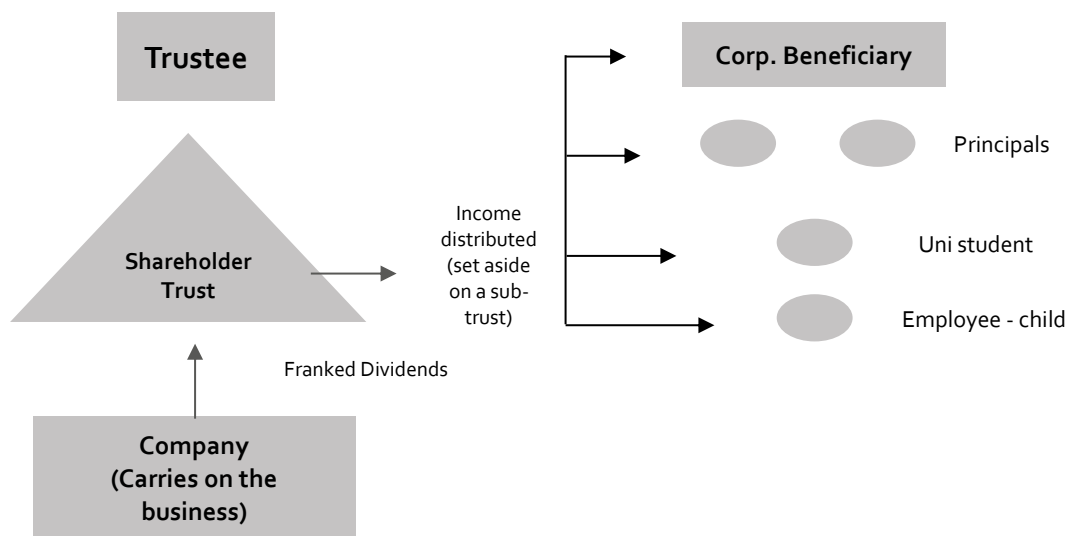
- With a company, the taxpayer has the options of selling the shares (with typical legal caution) or selling the assets. Note that any gain on the sale of the shares can be reduced by Division 115.

With the facts provided in scenario 1, the selected would be determined by what is perceived to be the more important factor – sale option, CGT implications, or how to pass control to the designated family member.

3. STRUCTURE SCENARIO 2 – USE OF A COMPANY TO CARRY ON THE BUSINESS WITH A DISCRETIONARY TRUST AS THE SOLE SHAREHOLDER

The fact variation provided by this structure configuration is to have the business conducted by a company and the discretionary trust as the shareholder.

3.1. STRUCTURE DIAGRAM



3.2 COMMERCIAL AND TAXATION IMPLICATIONS OF THIS STRUCTURE CONFIGURATION

3.2.1 COMPANY

Using the same hypothetical facts consider the tax and commercial implications of this structure configuration, noting the following matters post 1st July 2022:

(i) Funding

- To the extent that the principals want to retain the post-tax profits for business growth, this the post-tax income to the shareholders;
- There are no Division 7A implications if the funds are retained in the company for business use;
- Suffice to say that any loans (section 109D) or payments (Section 109C) made to the trust and/or the "associates" of the trust will require the compliance with Division 7; and
- The company does not have any section 100A implications.

(ii) Third party equity

- Other than internal funding considerations, this structure configuration allows for the introduction of third parties to take an equity stake in the company, albeit by:
 - A share sale arrangement; or
 - Issue of share equity

(iii) Taxation

- There is less tax controversy with the use of a company to conduct the business with the ownership by a discretionary trust;
- The company will be a "base rate entity" and be taxed at the current 25% tax rate;
- The payment of tax will generate franking credits;
- Dividends paid to the shareholder trust are required to be grossed up to determine the assessable income of the trust; and
- The requirements to claim deductions for carried forward revenue losses are less onerous – COT and SBT are easy to apply vis a vis the trust loss provisions on Schedule 2F

To ensure the franking credits are available to the beneficiaries of the trust, the trust must elect to be a "family trust" in accordance with Schedule 2F ITAA 1936.

(iv) Income distributed to - Principals and family members

- To the extent that it is desired to make income distributions to either the principals and/or the adult children, the company can make a fully franked distribution to the discretionary trust which then streams the franked distributions to the nominated beneficiaries;
- The significant difference in the two scenarios is that with scenario two, the need to make distributions to family members is not a result of either:
 - The need to make annual distributions as with a discretionary trust; or
 - Any statutory obligation.

- There are no section 100A issues with the distributions from the company to the trust. However, to the extent that the trust distributes its income, there might be consequential section 100A implications. This issue will be considered separately below

(v) Asset protection

- This structure configuration provides for the necessary separation of the private assets of the principals from the business risk;
- To the extent that the company accumulates reserves within the company, there is still a risk that those accumulations are at risk from the business activities; and
- If there is a need to dispose/transfer the accumulated reserves this can only be achieved by distributing the amounts by way of dividend distributions to the trust.

(vi) Succession Plan

There are **two methods** to facilitate this with this structure configuration:

- (a) The company could issue shares to the employee adult child.

However, unless the shares are issued at their market value, Division 83A ITAA 1997 will assess the adult child on the amount of the discount at the time the shares are issued (subject to the deferral rules in subdivision 83A-C ITAA 1997).

The company could finance the acquisition of the shares and negate the Division 83A taxation issues. A company is permitted to finance a share acquisition if the share issue is in connection with an Employee Share Scheme.

or

- (b) The trust could facilitate a sell down arrangement with the adult child.

Suffice it to note, that the trust would have a capital gain (CGT Event A1) based on the difference between the cost base of the shares and the capital proceeds or the deemed capital proceeds³.

However, any such capital gain will be able to be reduced by Division 115 and Division 152 ITAA 1997.

³ Section 116-30 ITAA 1997

Further, the trust could also structure the acquisition of the share by offering vendor financing of the to the adult child and retain some “debt related” control over the adult child.

(v) Estate Planning

This configuration whereby the company’s shares are held by the trust, still involves the difficulty that on the death of the principals there is no direct way of dealing with the shares via a testamentary bequeath.

The indirect methods referred to above, whereby the shares and directorship of the trustee company are dealt with via the Wills of the principals.

(vi) Sale of business

The further matter to be considered is if the business is to be sold and the CGT implications of that situation.

With this structure configuration there are two methods to affect the sale:

- (a) sale of the business assets by the company; or
- (b) sale of the shares in the company (sanitised to exclude non-business assets)

COMPANY SELLS THE BUSINESS ASSETS:

The primary taxation consequences would be:

- Division 152 ITAA 1997 would available if the section 152-10(1) basic conditions are satisfied however unless the company is liquidated the subdivision 152-C is locked in the company and/or will be a dividend if paid out.

On the liquidation of the company, for the purposes of section 47 ITAA 1936, the subdivision 152-C amount is treated as the “capital proceeds” in relation to the relevant CGT Event (C2 or G1);

- No Division 115 concession available;
- Any revenue asset (depreciable assets and trading stock) are assessed pursuant to Division 40 and Division 70.

TRUST SELLS THE COMPANY SHARES

- Division 152 ITAA 1997 will be available to reduce the capital gain if both the subsection 152-10(1) basic conditions and the subsection 152-10(2) additional conditions are satisfied;
- The subdivision 152-C issue, noted above, is not relevant with the sale of the shares;

- The sale of the shares is a capital transaction and accordingly the entire proceeds is attributable to the CGT Event; and
- There is no State duty payable by the purchaser on the sale of the shares (assuming not a “land rich” entity)

The invariable issue is whether the company is in a “form” that allows the shares to be sold.

3.2.2 DISCRETIONARY TRUST AS THE SHAREHOLDER

3.2.2.1 OVERVIEW

Whereas one of the principal disadvantages of the current Division 7A and section 100A complications are overcome by this structure scenario, if for whatever reason:

- dividends are paid to the discretionary trust; **and**
- Those dividends are streamed through the trust,

it is relevant to consider the consequences of the following possibilities:

- Whether section 100A could apply;
- What, if any, Division 7A issues arise; and
- Other taxation consequences.

3.2.2.2 SECTION 100A

With the use of this structure configuration it would be unusual if the company’s dividends are distributed to the nominated beneficiaries by the trust that the distributions would be retained by the trust rather than cashed out to the beneficiaries. Accordingly, it is unlikely that there would be any section 100A concerns.

However, if the circumstances are that the distributions are accounted for as with scenario 1:

- **Trust distribution to the company and retained by the trust:**

It is arguable that the section 100A exclusion will not apply, because and notwithstanding that in accordance with TD 2022/11, the retention of the distribution by the trust would need to be made subject to a section 109N complying loan agreement, the “use of funds condition”⁴ would not be satisfied.

21. For the purposes of this scenario:

⁴ Paragraph 21 PCG 2022/D1

- (c) *'Trustee retention of funds' refers to the beneficiary allowing the trustee to retain funds for a period of time or indefinitely that they would otherwise receive in satisfaction of their entitlement. This could be in the form of lending the funds representing their entitlement back to the trustee, or by not yet calling for that entitlement to be satisfied.*
- (d) *The 'use of funds condition' means that the trustee, as permitted by the trust deed, uses the funds (in its capacity as trustee) that represent the beneficiary's entitlement only:*
 - (i) *in the working capital of a business that it actively carries on*
 - (ii) *for the acquisition, maintenance or improvement of investment assets of the trustee, and/or*
 - (iii) *to lend the funds to an associate, on terms that satisfy section 109N, and the associate uses the funds in a way that satisfies either of the criteria above.*
- (c) *The use of funds condition is not satisfied if any associate of the trust benefits, except as described at paragraph 21(b)(iii) of this Guideline, from that use of funds (for example, being able to use a trust asset for less than market value consideration).*

With regard to the above, of the trust's distribution to the corporate beneficiary and put on a sub-trust arrangement is lent back to the business company on commercial terms, as an asset protection strategy (that is the loan from the trust becomes a liability of the business company), it would be argued that section 100A would not apply.

Nor would Division 7A apply, as there is no UPE to support a subdivision EA issue and the arrangement between the trust and the corporate beneficiary is already subject to Division 7A

- **Trust distribution to the individuals**

Again, if the circumstances are that the trust distributions to the individuals are retained by the trust and/or in the instance of the adult child student, the section 100A concerns will be governed by PCG 2022/D1. As the trust is not carrying on the business, paragraph 20 would not provide the individuals with the "Green zone scenario 3 - retention of funds by the trustee"

Accordingly, if the elements of section 100A are met prima facie there will be an issue unless either:

- (a) The trust actually pays the distributions to the individual beneficiaries; or
- (b) The "ordinary family or commercial dealing" exclusion applies.

3.2.2.3 DIVISION 7A

The Division 7A issues for the trust distribution to the corporate beneficiary has already been discussed above.

If the trust distributes the income to the beneficiaries and those monies are retained by the trust there are no Division 7A issues.

The only circumstance where Division 7A might apply will be, if subdivision EA applies. That is:

- the company loans monies to the individuals;
- the trust has an UPE owing to a company;
- the individuals are “associates”⁵ of the trust; and
- the company has a “distributable surplus”⁶

3.2.2.4 OTHER TAXATION CONSEQUENCES

As has been noted the business company will be a “base rate entity” based on the hypothetical fact scenario.

Accordingly, the business company would be taxed at the rate of 25% and its distributions will be franked at that company tax rate.

However, if the trust streams that franked dividend to a corporate beneficiary, the corporate beneficiary will not be deemed to be a base rate entity, as the corporate beneficiary’s income will be “base rate passive income”⁷. The streamed dividend to the corporate beneficiary is treated as passive income as it is not “a non-portfolio dividend”.

Consequently, the corporate beneficiary would have “top-up” tax to pay of the difference between the general company tax rate (30%) and the franking credit (25%)

⁵ Section 318 ITAA 1936

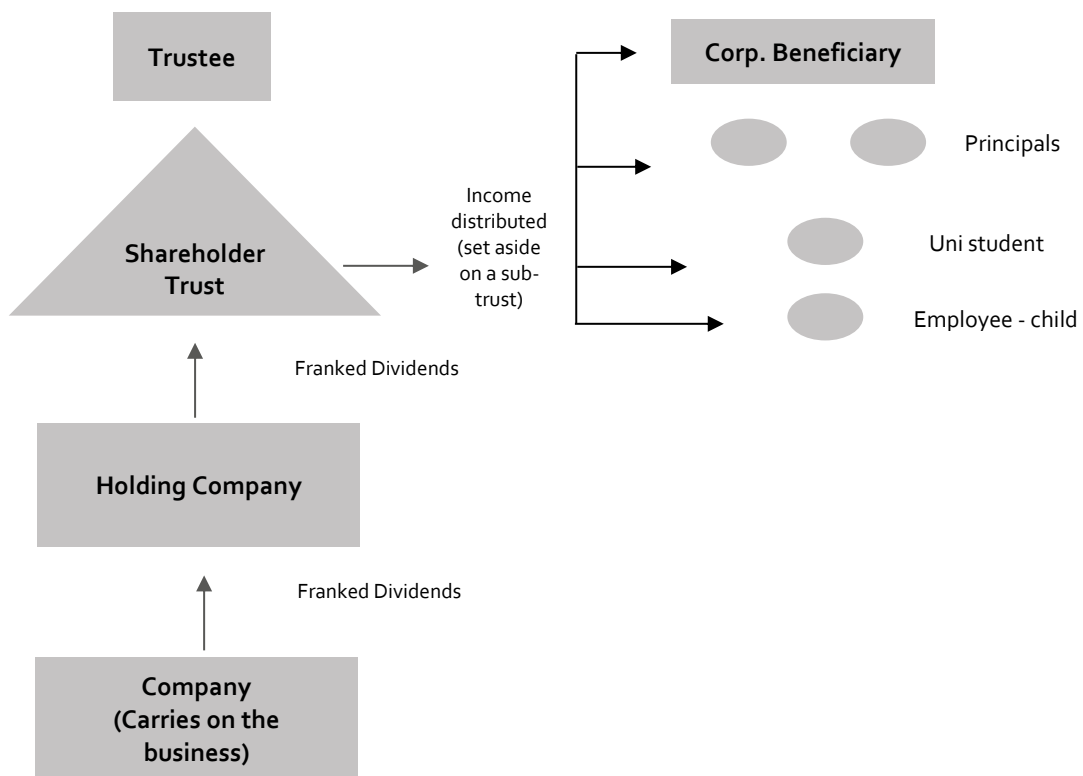
⁶ Section 109Y ITAA 1936

⁷ Section 23AB Income Tax Rates Act 1986

4. STRUCTURE SCENARIO 3 – USE OF A COMPANY TO CARRY ON THE BUSINESS WITH A HOLDING COMPANY WHICH HAS A DISCRETIONARY TRUST AS THE SOLE SHAREHOLDER

The fact variation provided by this structure configuration is to have the business conducted by a company and the discretionary trust as the shareholder.

4.1. STRUCTURE DIAGRAM



4.2 COMMERCIAL AND TAXATION IMPLICATIONS OF THIS STRUCTURE CONFIGURATION

The principal opportunity and benefits this structure configuration provided relates to two fundamental business concerns nominated by the hypothetical facts, namely:

- (i) The retention of the post taxed profits to fund business growth and development; and
- (ii) The need for genuine asset protection.

The insertion or establishment of the Holding company, provides the following features:

(i) Funding issues

- The post-taxed profits of the business company can either be retained by that company, or alternatively distributed to the holding company;
- Any loans between the holding company and the business company have no Division 7A issues because of the application of section 109K (inter-company payments and loans are not treated as a dividend);
- The decision to distribute funds to the principals, is a discretionary matter for the principals. There is no mandate to make any payment to them, and if such a decision is made the funding can be made by a loan from either company (and subjected to a Division 7A loan) or by the trust streaming a franked dividend to the nominated beneficiary;
- If required, the trust can borrow if further funding is required by the business company. The new equity is issued by the holding company which on-lends the funds to the business company be acquired in the holding company (tax and asset protection benefits are provided); and
- Third party equity raising can be facilitated at the holding company level or at the business company level depending on the circumstances and needs.

(ii) Taxation

There are some additional taxation features with this structure configuration:

- A dividend distributed by the business company to the holding company is a “non-portfolio dividend”. Accordingly, the holding company, subject to any other income generated by the holding company, is a base rate entity and consequently the holding company will not have any top-up tax to pay on a fully franked dividend it receives it receives;
- Loans and payments transacted between the companies are not subject to Division 7A (section 109K exception);
- There is less tax controversy with the use of a company to conduct the business with the ownership by a holding company as most of the transactional activities are company to company – an ordinary commercial business environment;
- The holding company can elect to form a tax consolidated group, if there is a commercial need for that grouping structure. The benefits and costs associated with forming a tax consolidated group requires a separate decision-making process. The decision to form a tax consolidated group is generally determined by asset protection factors

(iii) Asset protection

There are a number of different factors that are provided by this structure configuration:

- Surplus after-tax profits can be distributed to the holding company as a dividend to reduce the available assets in the business company;
- The surplus after tax profits received by the holding company can be lent back to the business company on terms that commercially enhance the asset protection strategies for the group;
- If a tax consolidated group is formed (at a time that warrants), different asset holdings or business activities can be restructured within the consolidated group.

That is, the holding company would establish a wholly owned subsidiary and then transfers the assets/business to the subsidiary entity on acceptable commercial terms – sale of assets for “value”, create asset usage rights, redemption rights in the event of an extreme financial event and reviewable transaction details.

Also provides for ease of separate management of business and the sale of different asset/business activities within the Group.

(iv) Succession planning and estate Planning

This structuring configuration has no significantly different features to that of the previous structuring configuration.

If the adult child employee is to be introduced care needs to be exercised to determine whether his point of equity the holding company or the business company. Note that if the formation of a tax consolidated group is considered relevant, the point of entry should in the holding company.

(v) Third party sale

There are no significant taxation or commercial differences between scenario 2 and scenario 3 structure configuration.

- If the holding company shares are sold by the trust – Division 115 and Division 152 are available;
- If the shares in the business company are sold by the holding company, Division 152 will be available; and
- If the business assets are sold by the business company, the same taxation consequences as discussed with the previous structuring configuration will apply – Division 152 is available to reduce any capital gain and revenue assets are assessed pursuant to the relevant taxation regime.

5. RESTRUCTURING PROCESS & IMPLICATIONS: SCENARIO 1 TO 2 TO 3

5.1. OVERVIEW

For the purposes of the present discussion, it is intended to consider a restructuring process envisaging that the business is currently operated by a discretionary trust and it is decided to have the business operated by a company with the alternative ownership configurations.

Suffice it to state, that the usual choices would be:

- (i) **Sale of selected business assets** to a company for consideration, albeit on some form of vendor finance or share issue or a capitalisation by the trust to acquire shares in the company to acquire the business assets.

A sale of the business assets by the Trust will generate a capital gain (CGT Event A1) which could be reduced by Division 115 and Division 152

- (ii) **Use a CGT rollover** – usually a Subdivision 122-A ITAA 1997 rollover(s) although potentially subdivision 328-G ITAA 1997 could be used.

The duty issues for both restructuring methods will have similar duty issues.

5.2 SALE OF ASSETS

il the first the sale of the trust's business assets to business company will have the following taxation implications:

ASSESSABLE INCOME:

- Any gain, albeit Division 40, Division 70 or CGT Event A1 will have deemed proceeds based on the market value of the asset disposed;
- For CGT, the assessable gain will be determined by methodology provided by section 102-5 ITAA 1997 (Steps 1 & 2 capital losses, Step 3 Division 115 & Step 4 Division 152);

- To ensure access to Division 152 and in particular subdivision 152-D, the trustee can distribute the trust income and capital in a manner that ensures⁸ the principals are CGT concession stakeholders⁹;
- Note that there is a life time limit of \$500,000 for subdivision 152-D; and
- The capital gain can flow through to the nominated beneficiaries without any further taxation implications (CGT Event E4 is not applicable to a discretionary trust).

COST BASE

- The sale of the assets allows for the CGT assets, in particular, to be reset at the higher amount – being the market value of the assets;
- The higher cost base will reduce any future capital gain if and when the business is sold; and
- If there is the probability that the principals will form a tax consolidated group, having either a higher membership cost for the shares in the company or a higher liability (vendor finance liability) in the company enhances the ACA for consolidation purposes.

FUNDING

- Using a vendor finance arrangement provides some future repatriation of profits opportunities;
- Financing the share issue to fund the company for the business asset acquisition has advantages for subdivision 152-D and deductibility of the borrowing costs in the trust (albeit care needs to be taken to ensure there is no loss of franking credits (section 102UW ITAA 1936) or no ability to stream the franked distributions (section 207-58)).

5.3 CGT ASSET ROLLOVER

The “safe” rollover regime to use with a proposed transfer of assets from a discretionary trust to a company is to use subdivision 122-A ITAA 1997. The other alternative is to use the more ambiguous subdivision 38-G particularly if there is some real possibility that subdivision 152-B ITAA 1997 (15-year continuous ownership and sale is connected to the retirement of a CGT concession stakeholder) - subdivision 328-G preserves the continuity of ownership period unlike subdivision 122-A.

For the purposes of the present discussion, subdivision 122-A is considered:

SUBDIVISION 122-A ROLLOVER FEATURES:

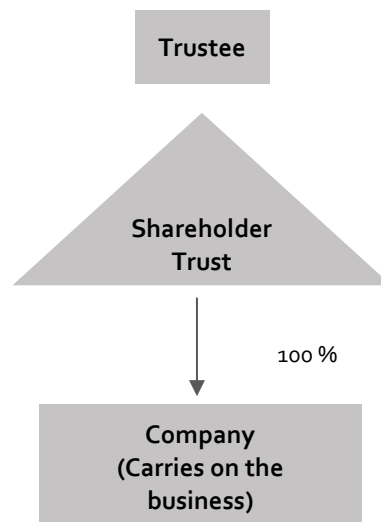
⁸ Section 152-70 ITAA 1997

⁹ Section 152-60 ITAA 1997

- Simple transaction – issue of shares (and assumption of related liabilities) is the sole consideration for the transfer of selected CGT assets;
- Note UPEs are not liabilities for the purposes of subdivision 122-A;
- Immediately upon the conclusion of the rollover the ownership of asset of the shares must be the same as the ownership of the assets - that is the discretionary trust will be the sole shareholder of the transferee company;
- Rollover will defer any CGT gain in relation to the CGT assets transferred and depreciable assets (section 40-340 ITAA 1997). **Note**, there is no rollover relief for trading stock (section 70-90 ITAA 1997 will apply);
- No cost base uplift for CGT assets transferred to the company and shares issued have a deemed cost base equal to cost base of CGT assets transferred; and
- The acquisition date for the shares and the transferred assets, for the purposes of Division 115 ITAA 1997, is referenced to the date the trust acquired the CGT assets.

STRUCTURE CONFIGURATION – 1st ITERATION

On completion of the initial subdivision 122-A rollover, the structure configuration will be:



STRUCTURE CONFIGURATION – 2nd ITERATION

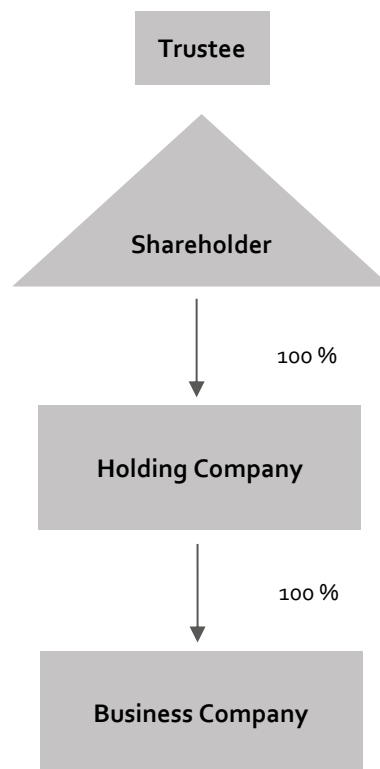
After the first restructure process which creates the above company/trust structure, the next stage is to facilitate the insertion of the holding company.

With regard to the next stage, a further subdivision 122-A rollover can be used. The transaction involves:

- The trust transfers (CGT Event A1) the business company shares to the holding company; and

- The consideration provided for the share transfer will be provided by the issue of the holding company shares to the trust.

Subdivision 122-A negates any immediate CGT consequence of the transaction, and the features of the rollover are as detailed previously.



The second stage of the restructure can occur at any time after the first restructure, either immediately or at some later time but preferable before year end and after the business company has paid its tax if a dividend is to be paid (for franking purposes)

Obviously, if the structure choice is being decided at the commencement of the business, I would give some thought to a different ownership configuration of the holding company (subject to risk profiles) – principals owning ordinary shares and a discretionary trust holding a redeemable preference Dividend Access Share.

5.4 DUTY ISSUES

The important duty transaction in relation to the proposed restructure process concerns the trust's transfer of the business assets to a company which is wholly owned by the trust.

5.4.1 QUEENSLAND

There is no duty payable, inter alia on a trust's transfer of business assets to a company where the following conditions apply:

- The shares are to be held by the trustee, the trustee must be the sole shareholder and all beneficiaries of the trust must remain the same;
- The business assets being transferred have an unencumbered value of not more than \$10 million;
- The transferor trust had an annual turnover of not more than \$5 million (the OSR may average the turnover for the previous 3 financial years); and
- The transferee company has not previously traded.

5.4.2 NEW SOUTH WALES

As from 1 July 2016, NSW abolished stamp duty for a sale of business assets (other than real property business assets).

5.4.3 VICTORIA

Under the Duties Act 2000 (VIC), duty is not charged on the transfer of business assets (other than real property), and there is no nominal fee on the sale of business agreement

Brian Richards

27th October 2022

This paper was prepared by Brian Richards, Richards Advisory.

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