Choosing a Business Structure

Mark Chapman

Wednesday 8 February 2023

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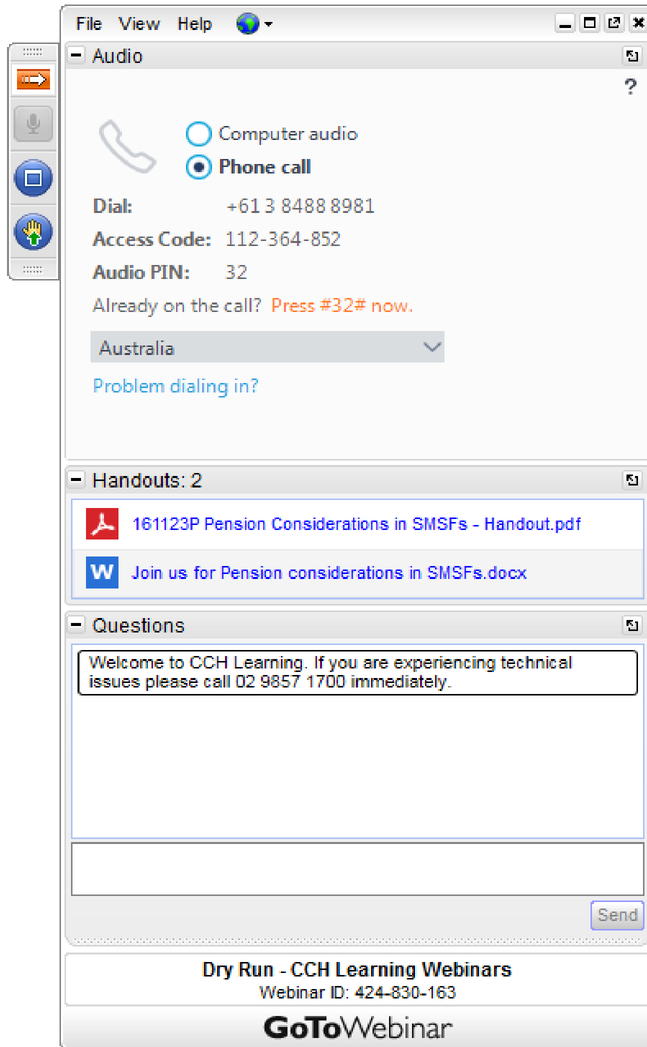

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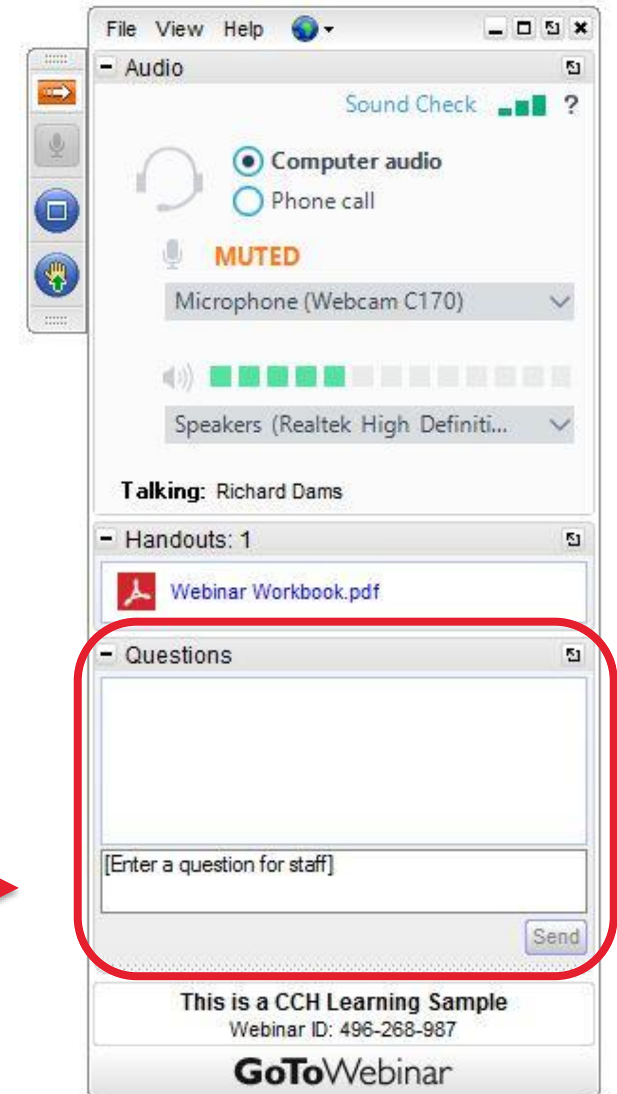

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Your Presenter

Mark Chapman
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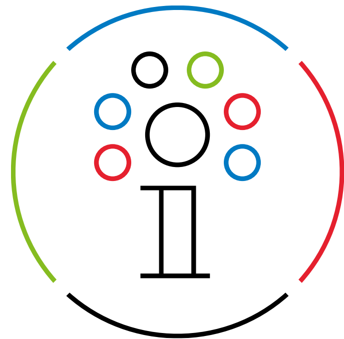
Today's session will cover



Choosing a Business Structure

- Factors to consider when structuring a business
- The options for setting up a new business
- Advantages and disadvantages
- Tax breaks for starting a new business
- Tax implications of each structure for business and owner
- Asset protection
- Tax effectively moving from one structure to another – restructure rollover and other tax breaks
- Case study

The Options

- Sole trader
- Partnership
- Unit or discretionary trust
- Company
- Combination or hybrid structure

Factors to consider

- Keeping the tax bill down, legally, including sheltering future CGT
- Loss utilisation
- Asset protection
- Financing, industry or professional requirements
- Funding requirements
- Family considerations
- Allowing for change (eg, allowing parties to enter or exit the structure)
- Compliance costs
- Administration
- Set-up costs
- Don't focus exclusively on tax!

Tax breaks for forming a new business

- *Section 40-880 (black hole provisions)*
- Deduction available over 5 years for capital expenditure relating to a proposed business.
- An immediate deduction is available is available in certain circumstances.
- To qualify, the capital expenditure must relate to a proposed business. It needs to be incurred in obtaining advice or services for the proposed structure or operation of the business. Alternatively, it must be a fee, tax or charge paid to an Australian Government agency relating to the set up or operating structure of the business.
- Expenditure may be deductible under s 40-880 for pre-business expenditure on feasibility studies, market research or establishing a business structure.
- In addition, the taxpayer must be a small business entity for the income year the expense was incurred. Alternatively, for the year the expense was incurred, the taxpayer must neither: (i) carry on a business; nor (ii) be connected or affiliated with a non-small business entity that carries on a business.
- Deduction does not need to be claimed by same entity that will ultimately run the business

Sole Trader

- Individual carries on business in a personal capacity
- Simple to set-up, simple to manage
- Need to register business name and obtain ABN
- Income is reported in business section of individual tax return
- Tax payable at taxpayer's marginal rate (at up to 45%)
- Access to small business income tax offset
  - 16% of net small business income up to a maximum of $1,000 for unincorporated businesses with turnover up to $5 million
- Potential access to losses against other income of the taxpayer (subject to non-commercial losses rules)
- Potential access to all 4 small business concessions
- Personal assets at risk from business creditors and litigants
- Arranging business finance can be difficult

Partnership

- No separate legal identity
- Two or more entities carrying on a business with a view to a profit
- Can be established between individuals, or entities (eg discretionary trusts)
- Suitable for specific professions (eg accountants, lawyers)
- Partners have joint and several liability
  - Creditors can pursue partners for losses caused by other partners
  - Any partner can enter into contracts that bind the other members of the partnership
- Asset protection
  - Consider having one or more companies or trusts as partners
- Partnerships do not pay tax. Partners are taxed on their share of partnership income
  - Partners pay tax at their marginal rates on their share of partnership income
  - Partners "salaries" and drawings are not tax deductible
  - Partners have access to the small business income tax offset
- Partnership tax returns are required but they largely serve as a data-matching tool for the ATO

Partnership

- The individual partners are entitled to all 4 small business concessions, depending on the identity and tax profile of each partner
  - If the taxpayer is a partner in a partnership and the partnership disposes of a CGT asset, the partner only counts their proportion of the partnership's assets when applying the $6 Million Net Asset Value Test
  - Where the partner controls the partnership (with at least a 40% distribution of profits or to the extent that the partners are 'affiliates' of each other) the total assets of the partnership will be taken into account for the MNAV or the $2 Million CGT Turnover Test.
- Partners can potentially make use of their share of partnership losses against their other income, subject to the non-commercial loss rules
- Partnership agreement should be drawn up before the partnership commences covering:
  - Rights of all parties
  - Responsibilities of all parties
  - Introduction of new partners
  - Obligations of both the partnership and the partner on exit

Partnership v Joint Venture

- A joint venture is not necessarily a partnership (but could be depending on the terms of any agreement between the parties)
- Where parties to a JV simply share in the output of the operation, this is not a partnership.
- However, where the output of the JV is to be sold and the profit distributed to the members of the JV, this would constitute a partnership.

Poll Question: Which of the following statements is not true of discretionary trusts?

a) Trust losses are trapped within the trust and cannot be distributed to beneficiaries.
b) Creditors generally have no claim against trust beneficiaries
c) The trustee has complete discretion as to which beneficiaries receive distributions and the amounts to be distributed
d) Capital gains/losses in trusts must be distributed equally to each beneficiary.

Trusts

- Trust is a relationship between the trustee and the beneficiaries, evidenced by a legal agreement (the trust deed). Four elements to a trust:
  - Trustee
  - Object of the trust (the beneficiaries)
  - Subject of the trust (the trust property)
  - Obligations in relation to the trust property
- Often used in a family situation
- Fixed trust
  - Beneficiaries have fixed proportions of trust income (eg unit trusts)
- Discretionary trust
  - Commonly family trusts
  - Trustee has discretion as to whether to distribute amongst the beneficiaries each year, to whom and how much
- Hybrid trusts
  - A trust which has discretionary and fixed elements
- Trusts are not generally taxed but the beneficiaries are taxed on their share of trust income

Trusts (cont'd)

- Potentially tax effective – ability to split income between trust beneficiaries and stream franked dividends and capital gains to particular beneficiaries
- Trust losses trapped in trust and can generally only be offset against future income of the trust (with stringent anti-avoidance rules to prevent abuse)
- Trustee can be taxed in certain situations (at highest marginal income tax rate)
  - Income of the trust not distributed
  - Beneficiary under legal disability (eg under 18)
  - Non-resident beneficiary
- Asset protection
  - Consider corporate trustee. Creditors can then only have recourse against the corporate trustee in the first instance and then against the assets of the trust. Beneficiaries are protected.
- Consider default beneficiaries
  - Prevents income being trapped in trust and subsequently taxed at trustee rates

Unit Trust

- Commonly used when unrelated parties enter a business together
- Units represent each unitholder's proportionate ownership interest in the underlying assets of the business
- Unit holder's interest is fixed – trustees have no discretion
- Each unitholder assessed on their proportionate share of trust's income for the year
- Often used for multiple family groups to own investments or a business (with units owned by the family trust of each of the families)
- Unit trust holders can sell their interest (the units) to other investors
- Potential CGT event E4 where a non-assessable payment is made to the beneficiary in relation to their interest in the trust:
  - The cost base of the recipient's unit is reduced (but not below nil). Any excess over the cost base will give rise to a capital gain to the beneficiary.
  - Affects payments relating to the small business 50% reduction, depreciation (Div 40) and capital works deductions (Div 43)
  - Does not affect the general 50% discount, the small business 15 year exemption or the small business retirement exemption

Poll Question: Which of the following statements is not true of companies?

a) A trading company with a turnover less than $50m will generally pay tax at a rate of 25%

b) Tax losses are automatically carried forward on the sale of a company

c) Companies cannot pass on the benefit of the 50% active asset reduction on the sale of assets without further tax consequences for shareholders

d) Creditors cannot access the assets of shareholders except up to the level of unpaid share capital

Company

- Separate legal entity
- Shareholders own the company and the directors (who may be the same people) run it
- Relatively low flat tax rate (25% or 30%)
- Company profits paid out by franked dividends with a tax credit for the company tax paid
- Some tax benefits in start-up phase are only available to companies, eg R&D tax incentives
- Companies are commercially well understood and enjoy easier access to finance and capital raising
- Owners of the company can sell shares to others
- Compliance obligations (ASIC, audit, etc)
- Companies not eligible for the 50% CGT discount and can be less tax effective in an exit scenario (small business active asset discount is effectively negated since it can only be paid out of the company via a dividend)

Company (cont'd)

- Company losses are not available for distribution
  - On sale, losses are only relieved in the company where either the continuity of ownership test or the business continuity test is passed
- Asset protection
  - Creditors generally only have recourse to the assets of the company
  - Shareholders are exposed only up to the extent of their unpaid share subscription
- Company directors can be personally liable
  - Eg, when company trades whilst insolvent or where Director Penalty Notice is imposed for unpaid Superannuation Guarantee/PAYG withholding
- Succession planning
  - Company assets are not included in the deceased's estate. Instead, the value of company shares is included

Advantages and Disadvantages

- Individuals and partnerships
  - Tax losses can be used against other income, subject to non-commercial loss rules
  - Access to CGT 50% discount and small business concessions
  - No income splitting
  - No asset protection
- Discretionary trust
  - Income can be distributed tax effectively
  - Asset protection, especially where corporate trustee involved
  - Tax losses trapped in trust with complex anti-avoidance rules in place

Advantages and Disadvantages

- Company
  - Lower tax rate
  - Asset protection – limited liability
  - Tax losses subject to company loss rules (Continuity of Ownership test and Business Continuity Test)
  - Greater flexibility in funding
  - Enables employee participation
- Unit trust
  - Asset protection
  - Tax losses trapped (see discretionary trusts)
  - CGT implications

Mixed structure to maximise asset protection

- Using mixed structures to spread risk and minimise liability to business owners can be worth considering, especially where the business owns property (such as trading premises) and the nature of the business is inherently high risk (eg, medical practitioner)
- Consider:
  - Set up Discretionary Trust 1 to carry on the business, with corporate trustee who is the business principle
  - Set up Discretionary Trust 2 to acquire assets used in the business (eg premises, valuable plant and equipment) with corporate trustee who is the spouse of the business principle
  - Trust 2 leases assets to Trust 1 to use in the business.
  - Assets are protected in the event of a claim against the business

Mixed structure to maximise asset protection

- Other examples:
  - discretionary trust with a corporate beneficiary
    - potential Division 7A issues if there is an unpaid present entitlement between the trust and corporate beneficiary
  - a partnership of discretionary trusts
    - Includes an extra layer of asset protection compared to a partnership of individuals
  - a company whose shareholders include discretionary trusts
  - an SMSF holding business assets
  - service entities (eg in an incorporated medical practice)
    - Service entity provides particular services (eg labour) and owns assets (eg the practice building, plant and equipment) and charges a fee (cost plus mark-up) to the practice for providing these
    - Must be a commercial reason for it to exist and a service agreement (see TR 2006/2)

Changing structure at a later date

- It is possible to change a business structure at a later date as the business grows and changes
- Restructure may trigger tax costs and professional fees
- Rollovers may be available to mitigate tax
  - Small business restructure rollover
  - CGT small business concessions (particularly the replacement asset rollover)

Small Business Restructure Rollover

- Allows small businesses to transfer assets from one entity to another without income tax liabilities
  - CGT, transfer of depreciating assets and trading stock all included
- Does not shelter GST, stamp duty, etc
- Defers gains or losses that would otherwise be triggered by the restructure
- Consider commercial and legal implications of restructure
- Must be a 'genuine restructure', ie in the three years after the transfer
  - No change in economic ownership of assets of the business (excl trading stock)
  - Assets continue to be active assets
  - No significant or material use of those assets for private purposes

Genuine restructure of an ongoing business

- The ATO highlights the following features which may indicate the transaction is part of a genuine restructure:
  - It is a bona fide commercial arrangement undertaken in a real and honest sense to facilitate growth, innovation and diversification, adapt to changed conditions, or reduce administrative burdens, compliance costs and/or cash flow impediments.
  - It is authentically restructuring the way in which the business is conducted as opposed to a "divestment" or preliminary step to facilitate the economic realisation of assets.
  - The economic ownership of the business and its restructured assets is maintained.
  - The small business owners continue to operate the business through a different legal structure.
  - It results in a structure likely to have been adopted had the small business owners obtained appropriate professional advice when setting up the business.

Genuine restructure of an ongoing business

- Examples of a genuine restructure of an ongoing business per LCR 2016/3:
  - Providing relevant parties with additional asset protection
  - Improving the ability of the business to retain key employees
  - Raise new capital to finance business expansion plans
  - Simplify the taxpayer's affairs (eg, eliminate unnecessary entities from the group)
- Examples that are not a genuine restructure of an ongoing business:
  - Where the restructure is done as a preliminary step to the disposal of the business
  - Where the restructure is undertaken by the taxpayer in the course of retiring from the business and facilitating the transfer of wealth to other family members (eg succession planning)
  - Where the restructure is primarily aimed at extracting wealth from the existing structure

Case Study (from Australian Practical Tax Examples)

- Marcus Hearn, an Australian resident for tax purposes, is a qualified dentist who acquired his own dental practice in 2010, together with the consulting rooms from which he operates his practice as a sole trader. He is 48 years old.
- The turnover of his business in both the 2021/22 and 2022/23 income years was less than $2 million.
- Marcus is concerned that his personal assets and his business premises may be exposed in the event of claims from disgruntled patients or creditors. He wishes to restructure his business so as to protect his assets. He also wishes to boost his superannuation savings since he is conscious that in recent years, he has tended to invest surplus funds back into his practice rather than making superannuation contributions.
- He wishes to transfer his business and all its assets into a discretionary trust, the Marcus Discretionary Trust (MDT), which has a family trust election in place naming Marcus as the primary individual.
- He also wishes to transfer the consulting rooms into a newly established SMSF, the Marcus SMSF, which will then lease the premises to the MDT for a commercial rent. He wishes to undertake the transfers on 30 June 2023 .

Case study

- The active assets of his business are the goodwill of the practice, the consulting rooms, the stock of medical and dental products on hand and various depreciating assets. The market value and cost base/adjustable value of those assets as at 30 June 2023 is:

	Market value	Cost base
Consulting rooms	700,000	350,000
Goodwill	400,000	100,000
Stock of dental/medical products	80,000	75,000
Depreciating assets	70,000	25,000 (adjustable value)

- What are the capital gains tax and other taxation implications of the proposed restructuring? What reliefs and concessions are potentially available to Marcus to reduce his tax liability?

Case Study

- In the absence of any further planning, Marcus will make a capital gain in relation to the transfer of the consulting rooms of $350,000 and a further capital gain in relation to the transfer of the goodwill of $300,000.
- In addition, he will make an assessable profit of $5,000 on the transfer of stock and $45,000 on the transfer of depreciating assets.

Case Study

- *Transfer of the business assets to the MDT*
- Marcus can choose to apply the Small Business Restructure Rollover in relation to the transfer of the assets to the MDT.
- This relief is available for the transfer of assets as part of a change of legal structure without a change in the ultimate legal ownership of the assets (Subdiv 328-G).
- The roll-over relief is available for gains and losses that arise on the transfer of CGT assets, trading stock, revenue assets and depreciating assets. The roll-over is available where the conditions set out in s 328-430 are satisfied.

Case Study

- The effect of applying the rollover is that a restructure is capable of being achieved in a tax- neutral way with regard to income tax. The CGT effect of applying the roll-over is as follows:
  - the CGT asset is treated as being transferred for an amount equal to the transferor's cost base of the asset just before the transfer, thereby preventing any capital gain or loss from arising (s 328-455(2)(a))
  - any pre-CGT asset transferred maintains its pre-CGT status (s 328-460)
  - for the purpose of determining whether there will be a discount capital gain in the future, the transferee will be treated as having acquired the CGT asset at the time of the transfer.
- Effective roll-over relief also applies to the trading stock, revenue assets and depreciating assets (s 328-455).
- Asset protection is specifically noted as a reason for a genuine restructure in LCR 2016/3. Therefore, Marcus can justifiably claim that the transfer of assets to the discretionary trust is part of a genuine restructure. Alternatively, or in addition, he can also rely on the three- year safe harbour provision. The other relevant conditions noted above are also satisfied based on the information provided.
- No gain or loss therefore arises on the transfer of the assets to MDT since the assets are transferred at their rollover cost. The MDT is taken to have acquired each asset at the time of transfer for its rollover cost, being the cost base of the goodwill ($100,000), the cost of the trading stock ($75,000) and the adjustable value of the depreciating assets ($25,000).

Case Study

- *Transfer of the consulting rooms to the Marcus SMSF*
- One of the basic conditions for applying the SBRR is that neither the transferor nor the transferee can be a superannuation fund. Therefore, the SBRR is not available in relation to the transfer of the consulting rooms.
- However, Marcus may be able to apply the small business CGT concessions to the capital gain arising on the transfer. In particular, Marcus may be able to:
  - Reduce the capital gain by 50% using the general discount (reducing the gain to $175,000)
  - Further reduce the capital gain by using the 50% small business active asset reduction (so the total gain is reduced to $87,500 at this stage)
  - Reduce the balance of the gain to nil using the small business retirement exemption.
- As Marcus is under 55, he would be obliged to make a contribution of $87,500 into a complying super fund in order to meet the conditions for applying the retirement exemption. This will be treated as a non-concessional contribution unless Marcus elects to apply it against his lifetime CGT cap ($1,650,000 for 2022/23). Marcus could in addition pay further amounts from the sale proceeds into super up to his non-concessional contributions cap.

Questions

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- Mark Chapman
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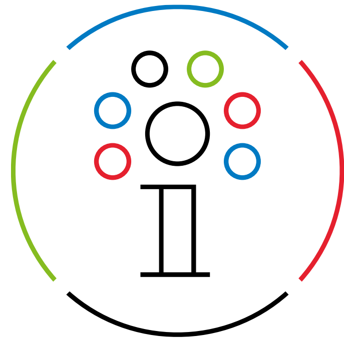

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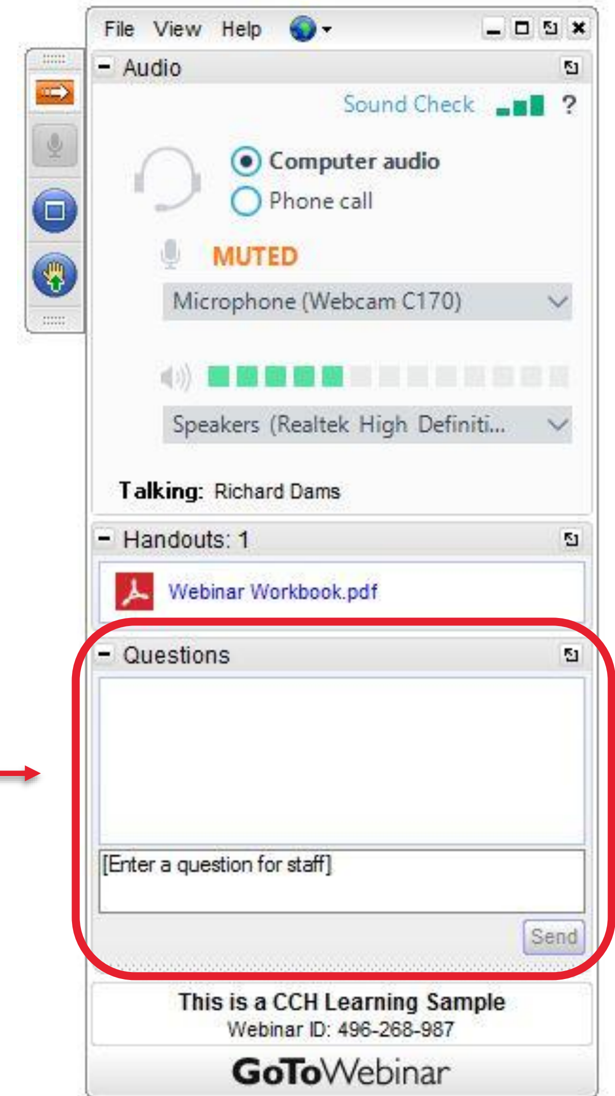

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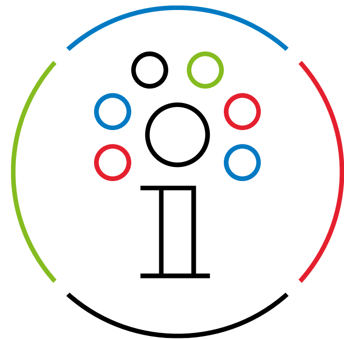

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Questions

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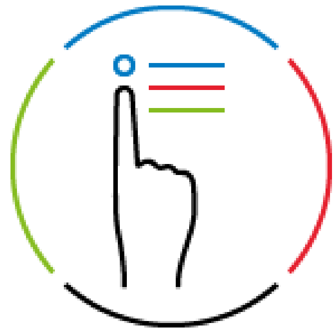

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