# Choosing a Business Structure
# 14/02/2023

CCH Learning:

Hello everybody and welcome to today's webinar, Choosing a Business Structure. My name is Susannah Gynther from Wolters Kluwer, CCH Learning and I will be your moderator for today. A few quick pointers before we get started. In the handout section, you'll find the PowerPoint slide slides for today's presentation. If you're having sound problems please check your audio settings. Try and toggle between audio and phone, and just a reminder that within 24 to 48 hours a notification for the e-learning recording will be emailed to you. You can ask questions at any point during the presentation by sending them through the questions box. I will collect those questions and ask them at the Q and A towards the end of today's presentation. CCH Learning also offers a subscription service, which many people have termed Netflix for professionals. It provides members with access to our entire library of recordings as well as live webinars for a competitive flat fee, that's for over 500 hours of content. For CPD purposes, your viewing is logged automatically. Your presenter today is Mark Chapman, the Director of Tax Communications for H&R Block, Australia.

Mark has over 25 years experience as a tax professional in both the UK and Australia, specializing in tax for small businesses and individuals. He is a member of the Institute of Chartered Accountants in England and Wales. The Chartered Institute of Taxation, and is a fellow of CPA Australia. He also holds a Master of Taxation Law with the University of New South Wales. I will now pass you over to Mark to commence today's presentation.

Mark Chapman:

Good morning everybody and thanks for taking the time to come along to today's webinar. We're going to discuss choosing a business structure this morning. So basically the format will be that I will talk for 50, 55 minutes or so. If you've got any questions which arise as Susannah said, do please save them up for the end because we will run a bit of a Q and A session just to round off the session. So what are we going to cover today? Well, we'll talk about the factors to consider when structuring a business. We'll talk about the various different options for setting up a new business, sole traders, partnerships, companies, etc. We'll talk about the advantages and disadvantages of each of those. We'll also talk about some of the tax breaks which are possible if you are starting a new business. We'll talk through the tax implications of each structure for both the business and the owner. We'll obviously discuss asset protection, which is very often a driving factor behind these conversations and we'll talk about tax effectively moving from one structure to another.

That's very common when you first start a business, you're in a hurry to get going. You don't really give the structuring much thought but two, three, four years down the line you potentially look back and think was that actually a very good choice? Should I actually, instead of... For example, formed a company? Well, how do you move from one business structure to the other tax effectively? We'll talk about the restructure rollover and various other tax breaks there. Then at the end if we've got time there's a fairly comprehensive case study which covers a lot of the issues that we'll be talking about in today's session. So what are the options? Well, basically these are sort of the primary options. You've got a sole tradership, you can form a partnership or a unit or discretionary trust or you can form a company. There's a fifth option which covers all sorts of different combinations and that's simply a combination or a hybrid structure, which we'll talk about in a bit more detail further down the track. There are lots of factors to be considered when you're forming a business structure.

Obviously this is a tax webinar, so obviously you're going to consider the importance of keeping the tax bill down doing that legally including sheltering future CGT. So you want to be able to access the CGT concessions, but also you want to access the lowest possible tax rate right now in order to make a decent return on the business. In addition, there's then the question of loss utilization. If the business makes a loss, do want to be in a position where you can use that loss against your other personal income? Or are you happy to forgo that in order to get a more effective business structure? The questions of asset protection which need to be considered, particularly if you're in a fairly litigious profession such as the law or medicine. You don't want somebody coming after your house, so how can you structure the business in order to protect your personal assets? The various financing industry professional requirements. So for example, with a tax profession it isn't possible for a trust to get accreditation through the tax practitioner's board.

So it is often the case that professional partnerships are the way to go in certain industries such as accounting, law and tax. There are funding requirements, what actually is going to be the funding basis of your business? Are you going to be reliant on external business finance going forward? Because if so, then obviously a company can far more easily access the money markets and borrow in order to finance the business but as compared to say a sole trader. There are family considerations which need to be taken into account, what is the role of your family going to be in the business? Are they simply going to be passive investors? Are they not going to have a role or are they going to be actively engaged in running the business? That can potentially lead you down the track of, for example a trust like structure which would enable profits to be distributed out amongst a family group. There are questions about allowing for change, so you know you may further down the track want to reward your employees for example with an ownership stake in the business.

Clearly a company will be better for doing that than the sole tradership where it won't be possible. So you need to think about which will be the best mechanism to allow partners or staff or investors to enter the business structure or indeed to exit the business structure. There are then obviously issues around costs, compliance costs, administration costs, set up costs, etc. As a general rule the more complex the structure the higher those will be. The more straightforward the structure, the lower they will be. If you form a sole tradership for example, basically you're up and running immediately. You don't have to worry about setting up a structure as such. Whereas with a company you've got ASIC fees, audit fees, the initial setup costs, etc. Which can be quite substantial. So basically if there's one lesson to learn from that slide is, you shouldn't exclusively focus on tax. You can come up with a strategy which will keep your current tax bill down but will it be effective for you from an asset protection perspective? From a family perspective, etc?

You've got to balance all of those factors in determining which structure to go with. I just want to briefly cover section 40-880 because this is a valuable section in terms of looking at the tax breaks which are available when you form a new business. Section 40-880 is sometimes called the black hole provisions and it basically says that the deduction will be available over five years for capital expenditure relating to a proposed business. In addition, there's an immediate deduction available in certain circumstances but we'll come onto that in just a few bullet points time. So 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 setup or operating structure of the business. Now expenditure could be deductible on section 40-880 for a whole variety of expenditure which is undertaken pre-business. So for example feasibility studies, market research, professional fees that are incurred in actually establishing a business structure itself.

They can all potentially qualify for a section 40-880 deduction. In order to claim the immediate deduction rather than the five-year one, you do need to be a small business entity for the income year that the expense was incurred. Or alternatively, you need to be either in a position where you're not carrying on a business and you're not connected or affiliated with a non-small business entity that carries on a business. Now that basically means that the deduction doesn't need to be claimed by the same entity that will ultimately run the business. So for

example, you yourself could go out and incur pre-business expenditure provided the business actually commences. If it's run out of a company or a trust or whatever, you can still claim the deduction because looking at those tests. Then you're not actually carrying on a business and therefore you do qualify for a section 40-880 deduction for costs incurred in relation to a proposed business. Even though that business is going to be undertaken by a different entity. Now let's look at the first of the possible business structures.

Sole trader, it's the most simple, the most straightforward, the least complicated business structure and quite simply the individual simply carries on in business in a personal capacity. Very simple to set up throughout without really any setup costs and very simple to manage. You do need to register a business name and obtain an ABN, but any income from the business is simply reported in the business section of your own personal tax return. Now, one potential downside is that you actually pay tax on your business profits at your own marginal rate. That's fine if you're not on one of the higher rates but if you are a taxpayer who's paying at the 45% rate, that can be a substantial chunk of your profits gone in tax. So if you're going to be in a position where you have income in excess of $180,000, you might want to look again at this business structure because you will be paying tax at up to 45% on your business profits. One advantage of being a sole trader is that you do get access to these small business income tax offset.

Now that was introduced four or five years ago, it's progressively become more generous. I say that in sort of air quotes if you like because it hasn't really become more generous. The percentage of net small business income has gone up and it's currently 16%, but unfortunately there's a maximum and always has been a maximum of $1,000. Which is the maximum offset which is available, so in effect the percentage is not really relevant. You really need to be just looking at that maximum of $1,000. It's available for unincorporated businesses, so sole traders and partnerships, etc, with a turnover of up to $5 million which will cover I would have thought most sole trader businesses. In terms of losses, very often in the early years of a business. The business may not actually make a profit, it may make a loss. There's a potential to access those losses against your own other income. So other business profits, investment income, rental income, etc. The problem there is that there are non-commercial loss rules which need to be considered.

So basically there's the potential to access the losses but there's a caveat there, so you do need to do a bit of work to work out whether the non-commercial losses rules will apply. There's the potential to access all four of the small business concessions, which is good. However on the downside, all of your personal assets are at risk from business creditors and litigants. This certainly isn't a business structure which I would follow if you're in a high profile business which is subject to potential litigation. So for example medical practitioners, disgruntled patients can be very litigious. So all of your personal assets are at risk if you do actively trade as a sole trader and arranging business finance can be difficult. The finance markets don't particularly like sole traders. So if you are intending to start a business and you're going to be entirely dependent on your own capital then it's probably fine. But if you're going to need to borrow then you probably might need to consider another structure. Now the second possibility is running a partnership.

Now a partnership doesn't have a separate legal identity, it's simply a case of two or more entities coming together and carrying on a business with a view to profit. Now the partnership can be a partnership of individuals or it can be a partnership of entities such as discretionary trusts. So most of what I'm going to talk about now assumes it's a partnership with individuals. But nevertheless, don't forget the possibility of having entities such as discretionary trusts as the partners. Certain specific professions do tend to gravitate towards partnerships, accounted some lawyers, etc. You do need to have obviously a considerable degree of trust in the other partners because the partners all have joint and several liability. Which means that any creditors of the partnership can pursue partners for losses caused by other partners. In addition, any partner can enter into contracts that bind the other members of the partnership. So it is vital to have that degree of trust preferably set out in black and white within the partnership agreement. In terms of asset protection, there isn't really any asset protection with a partnership.

The level of risk simply flows back to the individual partners, but it is worthwhile considering covering one or more companies or trusts as partners to introduce that element of asset protection. The way that partnerships are taxed is that they're not taxed essentially. The individual partners are taxed on their share of the partnership income, which means that they pay tax on that share at their marginal rates in whatever marginal rate they currently have. Because of that, so-called salaries and drawings aren't tax-deductible. So partners are entirely taxed on their share of partnership income, you need to add back salaries and drawings first. Partners do have access to the small business income tax offset, at least individual partners do. So in that sense, that particular tax break is still available. Now a partnership does need to submit a tax return to the ATO but it doesn't really achieve anything. Because the partnership as I say doesn't actually pay tax, the reason for those partnership tax returns is largely as a data matching tool.

Which is used by the ATO to match the income of the partnership with the personal tax returns of the partners to make sure they are actually declaring their partnership interest in the first place. Now the individual partners are entitled to all four of these small business concessions. Obviously that depends on the particular tax profile and the identity of each individual partner. It is worth bearing in mind that 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 partnerships assets when applying the $6 million net asset value test. So they don't the entire value of the partnership, they simply include their own proportion of the partnerships assets. However, where the partner actually controls the partnership which means that at least 40% of the profits are distributed to them or alternatively where the partners are affiliates of each other. The total assets of the partnership will be taken into account for the maximum net asset value test. In terms of losses, if the partnership makes a loss that's simply look through and applied at a partner level.

So therefore partners can make use of their share of partnership losses in the same way that they're taxed on partnership profits so they can use those losses against their other income. Again, however there's the possibility of the non-commercial loss, anti avoidance rules kicking in there. So that's coveted but there is certainly the potential for losses to be used at the partner level. There does need to be a partnership agreement which should be drawn up before the partnership commences. It should cover for example the rights of all the parties, the responsibilities of all the parties. It should cover the procedure for the introduction of new partners and it should cover the obligations of both the partnership and the partner on exit. It is definitely worthwhile having that in place before the partnership commences so that everybody knows exactly how the partnership will work. The room for misunderstanding is removed and the room for conflict further down the track is also hopefully removed. Now joint ventures, you occasionally come across these things called joint ventures. What are they and are they actually partnerships?

Well a joint venture is not necessarily a partnership, but it could well be depending on the terms of any agreement between the parties. Basically where parties to a joint venture simply share in the output of the operation, this isn't a partnership. However, where the output of the joint venture is to be sold and the profit distributed to members of the joint venture this typically would constitute a partnership. What I mean by those final two bullet points, say for example I form a joint venture with some other people and we go out and develop some properties. We build some properties somewhere and at the end of the joint venture the properties are split between the joint ventures and I take one or two of those properties as a reward for my involvement in the joint venture. Well that is sharing in the output of the operation. So effectively in that situation there isn't a partnership. If however, at the end of the operation the joint venture simply sells the properties on the open market and the profits are distributed to the individual partners then that typically would be a partnership.

Now we're going to look at trusts over the course of the next few slides. So just to get us in the mood, here's a poll question for you. The question is, which of the following statements is not true of discretionary trusts? Is it A, trust losses are trapped within the trust and cannot be distributed to beneficiaries? Is it B, creditors generally have no claim against trust beneficiaries? Is it C, the trustee has complete discretion as to which beneficiaries

receive distributions and the amounts to be distributed? Or is it D, capital gains/losses in trusts must be distributed equally to each beneficiary. Which one of those is not true of discretionary trusts? I'll just give you a moment to consider that and then we'll look at the answer before we go on to consider trusts in more detail.

CCH Learning:

Thanks for that Mark. So yes, just have a quick look and then I will launch the poll and you can all vote on the pole. Okay, so I'm glad you've all had a thought. So I'm going to launch the poll. So please click in the radio button next to the answer that you think is correct and then we will look at the answers in a moment. Just a reminder that if you do have any questions, please put them into the questions box and we'll get to them in the Q and A session at the end of the presentation. It's great to see everybody voting, I'll just give you a few more moments to vote and then I will close the poll. Okay, I'm going to close the poll now. All right, let's have a look and see what people thought. Well, 92% thought the answer was D. Then we had 4% for B, 2% for A and 2% for C. Thank you, back to you Mark.

Mark Chapman:

Okay. So 92% of you were absolutely right and 8% of you were unfortunately off the mark. Capital gains and losses in trusts don't have to be distributed equally to each beneficiary. Because it's a discretionary trust and the trustees have discretion as to how and how much of the capital gains and losses and indeed of any trust income needs to be distributed to each beneficiary. So in terms of trusts, well what is it? What is a trust? A trust is a relationship between the trustee and the beneficiaries evidenced hopefully by a legal agreement which is trusteed. I have encountered some trusts where there's no legal agreement which is awkward and there are four elements to a trust. First of all there's a trustee who actually oversees the trust, ministers the trust if you like. Then there is the object of the trust, the people for whom the trust has been set up in the first place, the beneficiaries if you like. Then there is a subject of the trust which is basically the trust property and finally there are obligations in relation to the trust property which the trustee has to meet.

Now they're often used in a family situation, trusts basically fall into two particular buckets if you like. There are fixed trusts which are common outside family situations where the beneficiaries have fixed proportions of trust income such as unit trusts, I'll come onto those in two slides time. Then there are discretionary trusts which are very common indeed in a family situation, they're sometimes simply referred to as family trusts. Whether a trustee has discretion as to whether to distribute amongst the beneficiaries each year, to whom and indeed how much. There is a third type of trust, which is sometimes called a hybrid trust which has discretionary and fixed elements. The fact that it does have discretionary elements tends to put them in the discretionary trust bucket. So I'm really not sure that they're terribly wise. So the ATO are often on the lookout for hybrid trusts and I tend to take the view that they are best avoided. Now like partnerships, trusts... Although a trust does have a legal identity, trusts are not generally taxed.

So the profits of the business simply flow through to the beneficiaries in accordance with the trustees discretion and that the beneficiaries are taxed on their share of trust income. Now that's not always the case, I will talk on the next slide about a few instances where it's not the case. But generally speaking the beneficiaries will be taxed on their share of trust income. Now the great advantage of trusts is their potential tax effectiveness. The trustees can basically split income between trust beneficiaries. So if there are beneficiaries with lower marginal tax rates, a trustee can potentially guide distributions towards those lower income beneficiaries away from higher income beneficiaries for example. In addition, franked dividends and capital gains can be specifically streamed to particular beneficiaries. So for example, if there are beneficiaries with capital losses it makes sense for the trustees to distribute capital gains to them rather than to somebody else who may pay more tax. One of the big

disadvantages of trusts is in relation to losses because trust losses will be trapped in the trust and they can generally only be offset against future income of the trust.

Even there, there are very stringent anti avoidant rules to prevent abuse, which can ultimately lead to trust losses not being available at all. Now I said on the previous slide that the beneficiary is generally the taxpayer in this situation. So the income simply flows through the trust and the discretion of the trustee to the beneficiary. However, in certain situations the trustee themselves can be taxed and usually that's at the highest marginal income tax rate. The sorts of situations I'm talking about is where the income of the trust isn't distributed in the first place. So the trustee either deliberately or accidentally doesn't distribute the income of the trust. The second situation is where the beneficiary is under a legal disability, for example they're under 18. The third situation is where there's non-resident beneficiary and in that situation the trustee again can be taxed. In terms of the risks associated with income of the trust not being distributed, it can well be worthwhile putting into the trusteed a specific class of default beneficiaries. So you know you can have your primary beneficiaries who or generally speaking receive distributions according to the trustees' discretion.

But then you can have a second class of default beneficiaries and if the trustee either accidentally or deliberately doesn't distribute the income of the trust. They can automatically receive a distribution and that therefore prevents income being trapped in the trust and therefore it prevents tax arising at those higher trustee rates. Trusts can be quite effective from an asset protection perspective. In particular it's well worthwhile considering a corporate trustee because creditors can then only have recourse against the corporate trustee in the first instance and then against the assets of the trust itself. So beneficiaries personal assets are protected. The other kind of trust is a unit trust and these are commonly used when unrelated parties enter a business together. So people who don't have a family relationship who may not previously know each other, choose to enter a business then a unit trust can be a way to go. Now units are very similar to shares in a company. Each one represents each unit holder's proportionate ownership interest in the underlying assets of the business. Unlike the previous type of trust, discretionary trust the unit holder's interest is fixed.

So the trustees have no discretion at all as to how the income is distributed. So each unit holder will be assessed on their proportionate share, the trusts income for the year. As I say this is very similar to a shareholder in a company, so they're actually quite similar. Now these are often used for multiple family groups to own investments or a business with units then owned by the family trust of each of the particular families. Now the units within the unit trust can be sold to other investors, whatever the unit holder chooses. However, one potential downside is that there's a potential CGT event E4 which arises where non-accessible payments are made to the beneficiaries in relation to their interest in the trust. CGT event E4 means that the cost base of the recipients unit is reduced and any excess over the cost base will give rise to a capital gain to the beneficiary. Now payments which could be affected by the possibility of CGT event E4 is where there are payments relating to the... For example, the small business, 50% reduction, depreciation. That's division 40 depreciation and also capital works deductions division 43.

Wherever they arise within a unit trust, you need to consider the potential application of CGT event E4 and they're not by any means unusual events. So you do need to keep a close eye on those. However, it doesn't affect the general 50% discount. The small business 15 year exemption or the small business retirement exemption. Now next we're going to consider companies as a business structure but just in advance of that, I just want to run another poll question to wet you appetite. Question is, which of the following statements is not true of companies? Is it A, a trading company with a turnover less than $50 million would generally pay tax at a rate of 25%? Is it B, tax tax losses are automatically carried forward on the sale of a company? Is it C, companies cannot pass on the benefit of the 50% anti asset reduction on the sale of assets without further tax consequences for shareholders? Or is it D creditors cannot access the assets of shareholders except up to the level of unpaid share capital?

So I'll just give you a moment to consider that and then we will go on to look in more detail at companies.

CCH Learning:

Thank you Mark. So yes have a moment, think about what answer you're going to choose and then I will launch the poll. All right, so what I'm going to do is I'm going to launch the poll now. So please put a click in the radio button next to the answer that you think is correct. All I should say is not true of companies and we'll give you some time to answer those polls. Just a reminder that if you do have a question, please put it into the questions box and we will get to those questions at the end of the presentation. It's great to see everybody voting, so please keep up voting. I will close the poll in just a few more moments. Okay. I'm going to close the poll, just get in those last minute votes. I'm closing the poll now, let's have a little look at the answer. So which of the following statements is not true of companies? 65% of you said B, 24% said C, 8% said D and 2% said A. Back to you Mark.

Mark Chapman:

Okay. So the answer is B, tax losses aren't automatically carried forward on the sale of the company. The company needs to achieve a pass in one of two tests. The continuity of ownership test or the business continuity test. So there's nothing automatic about tax losses being carried forward on the sale of a company, as we shall see in just a moment. So companies are a separate legal entity, the shareholders of the company actually own the company and the directors run it. Now, often with small companies in particular shareholders and directors are the same people but there's no reason why they need to be. Particularly with larger companies, there are often differences in terms of the shareholders and the directors. Companies have a relatively low flat tax rate, which is 25% or 30%. Which one it is depends first of all on the turnover of the company, if the turnover is less than $50 million there's a possibility that the tax rate could be 25%. If the turnover is greater than $50 million it will be 30% and it also depends on whether the company's base rate entity as well. We won't get into that.

Typically, however most of the smaller turnover companies will have a tax rate of 25%, which makes them very attractive. If the individual shareholders have a personal tax rate, for example of 45%. The company can be very effective as a tax saving mechanism provided the profits actually remain within the company. So if the profits don't remain within the company they're paid out by franked dividends with a tax credit for the company tax paid. Now there are considerable tax benefits in the startup phase which are only available to companies. So if you want to claim for example the R and D tax incentives you do need to form a company in order to do that, you can't do it with a other business structure. Now companies obviously are very commercially well understood, not just in Australia but worldwide. Everybody understands the way the companies work and therefore they enjoy easier access to finance and capital raising. So again, if you're planning to run a business using borrowed capital then a company could be the way to go. The owners of the company can sell their shares to somebody else at will.

There are however considerable compliance obligations which can end up incurring a great deal of the director's time as well as the company's money. So in terms of ASIC, the audit, etc, which makes companies potentially burdensome particularly for very small businesses. Now companies aren't eligible for the 50% CTT discount, which means that if a company is selling a business asset then it isn't necessarily going to be the most effective vehicle. So there's no 50% discount. In an exit scenario the small business active asset discount is in effect negated since it can only be paid out of the company via a dividend. So if the company sells for example a business asset and the company claims the small business active asset discount, then that isn't really particularly useful. Because the funds which arise need to be paid out of the company and that is done by a dividend which will obviously have tax consequences for the ultimate shareholder. Company losses aren't available for distribution, company losses are instead carried forward and offset against future profits or since 2019 they can potentially be carried back to create a refund of previously paid tax.

However, on ultimate sale of the company losses are only relieved in the company where either continuity of ownership test or the business continuity test is passed. So you do need to consider that if you're selling the company with losses. In terms of asset protection, creditors generally only have recourse to the assets of the company and shareholders are exposed only up to the extent of their unpaid share subscription. Now, it used to be the case that companies were entirely dependent of their shareholders or their directors. It wasn't possible to sue the directors of a company. So company directors can in certain circumstances be personally liable these days. So for example, when a company trades whilst insolvent or where a director's penalty notice is imposed for unpaid superannuation guarantee or PAYG withholding. So the directors do need to be careful because they can be personally liable in certain situations. In terms of succession planning, for example on the death of a shareholder. Well the company's assets won't be included in the deceased's estate, instead the value of the company shares is included.

So if a company for example, owns a property and the shareholder dies that property doesn't enter the individual's estate. However, the value of the company shares is included and that typically will include the value of the company of the property. So to sum up in terms of advantages and disadvantages of all each of those four structures in terms of individuals and partnerships. There's an advantage the tax losses can be used against other income, but again that is subject to the non-commercial loss rules. So it's suddenly a possibility that can be used against other income. The individuals have access to the CGT 50% discount and the small business concessions. On the downside, there's no income splitting. So it isn't possible to divert profits across to lower income say family members and there's very little asset protection. Well no asset protection really if we're talking about a sole tradership or a partnership of individuals. With a discretionary trust, they have the advantage that income can distributed very tax effectively. There's also a high degree of asset protection, especially where a corporate trustee is involved.

On the downside there are tax losses, any tax losses will be trapped within the trust and there are then complex empty avoidance rules in place be which need to be satisfied before those losses can actually be used in future. With a company they have the enormous advantage of an immediate lower tax rate. If you're a 45% tax rate taxpayer, then you could potentially save 20% tax immediately by trading through a company. There's a fair degree of asset protection cause the company is a limited liability company. However, tax losses are going to be subject to the specific company loss rules which will kick in the event that the company is sold. So there's two of those continuity ownership tests at the business continuity test. There's considerable flexibility in funding, which is a great advantage and they also enable employee participation. So for example, if you want to bring your employees into the business in an ownership capacity, then you can sell or otherwise reward the individuals with shares. Which is obviously won't be possible with other business structures and with unit trusts.

Again, there's the advantage of asset protection and the disadvantages of trapped tax losses. Obviously that is a similar rule to discretionary trusts and there are also those CGT implications, in terms of CGTE four which need to be considered if there's an intention to use a unit trust. Now those are the basic possibilities of forming a business structure. However, it may well be that you choose to implement a mixed structure in order to for example maximize asset protection. Now using mixed structures to spread risk and minimize the liability of the business owners can be well worth considering. Especially where the business owns property such as trading premises and the nature of the business is inherently risky, for example medical practitioners. So to give an example, you can for example set up discretionary trust one to carry on the business with a corporate trustee who's the business principal. You can set up discretionary trust two to acquire assets used in the business such as premises valuable and equipment etc.

With a corporate trustee who is the spouse of the business principle, and then trust two can lease its assets to trust one to use in the business. Now by doing that, the assets are protected in the event of a claim against the business. Some other examples of a mixed structure, there are lots of them these are just a few. There's discretionary trust with a corporate beneficiary. There are potential Division 7A issues there. If an unpaid present

entitlement arises between the trust of the corporate beneficiary, just be aware of that. You could have a partnership of discretionary trusts, which includes an extra layer of asset protection compared to a partnership of individuals. You could have a company whose shareholders include discretionary trusts. You could have an SMSF holding business assets or you could have a service entity in certain business structures such as an incorporated medical practice. The service entity provides particular services, so typically labor hire, etc and owns assets such as the practice building any plant and equipment and charges a fee which is cost plus markup to the practice for providing those services.

There must be a commercial reason for it to exist and there must also be a service agreement. The requirements around service trusts or service entities are set out in taxation ruling 2006/2. We also need to consider the possibility that you might want to change your business structure at a later date. As I said at the start, it's quite possible to go into a business structure without giving it much thought and ultimately two, three, four years down the line you might actually regret your original choice and you want to develop a alternative instead. But that typically will bring really tax charges on the disposal of assets from one entity to the other. So how can we avoid those tax charges? Well there are rollovers available to mitigate tax in that particular situation. There's a small business restructure rollover and there are the CGT small business concessions and I'm thinking particularly after a replacement asset rollover, which can be very useful in that situation. So the small business restructure rollover simply allows small businesses to transfer assets from one entity to another without income tax liabilities.

It covers for example any CGT which arises on the transfer of CDT assets from one entity to another. It covers the transfer of depreciating assets and prevents a tax charge arising on a transfer of trading stock. It doesn't however filter GST or stamp duty so they need to be considered separately. That may well be GST or stamp duty implications even where the small business restructure relief is available for income tax purposes. So the effect of the small business restructure rollover is that gains or losses that would otherwise be triggered by the restructure are simply deferred. Obviously you need to consider the commercial of legal implications of the restructure. You don't simply do it from a tax perspective. For example, if you have a property within the business and there's a mortgage with the bank then clearly you need to negotiate with the bank as well to get that mortgage transferred across. So there's more to this than simply saving tax. You do need to consider the commercial and also the legal implications as well.

The big catch with the small business restructure rollover is that the ATO to stipulate that it has to be a genuine restructure. So in other words, in the three years after the transfer, there's no change in the economic ownership of the assets of the business, obviously excluding trading stock. The assets continue to be active assets and there's no significant or material use of those assets for private purposes. Now the ATO highlights a number of features which could indicate the transaction is part of a genuine restructure and they're set out on the slide there. Basically the ATO says that if it's a bonafide commercial arrangement undertaken in a real and honest sense to facilitate growth, innovation and diversification. Adapt to change conditions or reduce administrative burdens, compliance costs and or cash flow impediments it will be a genuine restructure. In addition, if it's authentically restructuring the way in which the business is conducted as opposed to a divestment or a preliminary step to facilitate the economic realization of assets, it'll be a genuine restructure. They go on to say that 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. A results in a structure likely to have been adopted had the small business owners obtained appropriate professional advice when setting up the business. All of those are indications that it will be a genuine restructure and they set out in their law companion ruling 2016/3 some examples of what they regard as genuine restructures and some examples of restructures which are not regarded as genuine. So the genuine ones are providing relevant parties with additional asset protection, improving the ability of the business to retain key employees. Raise new capital to finance business expansion plan or simplify the taxpayer's affairs, for example eliminate unnecessary entities from the group. Examples that aren't genuine include where the restructure is done as a preliminary step to the

disposal of the business. Whether restructure is undertaken by the taxpayer in the course of retiring from the business and facilitating the transfer of wealth to other family members. That's a typical succession planning type arrangement and where the restructure is primarily aimed in extracting wealth from the existing structure.

Now it's coming up to 10:30, so what I'll actually do I will actually end the presentation at this point. However, I would urge you to take a few moments to read the case study which goes on for the next three or four slides which is taken from a Australian Practical Tax Examples, which is the book that I write every year. So this is an example which illustrates the impact of first of all the small business restructure rollover, and also the small business concessions where somebody is looking to reorganize their business. So it brings out many of the themes of today's presentation quite effectively. However, because we don't have time I will leave you to read through those three or four slides at the end and I will now just flick to the end and I'm happy to take questions. Back to you Susannah, to wrap up and if you have any questions I'll deal with them.

CCH Learning:

Thank you very much for that Mark, I'll just take that back. So yes, as Mark said we are going to take some questions. We do already have some questions so we'll see how we go. But if we don't get to the end of all the questions today, Mark I'm sure would be willing to answer them offline and we will post them onto the e-learning so that you can access them because we do have quite a number of questions already. But don't let that stop you. But due coming up we are looking at salary packaging opportunities, ideas and insights. We're looking at financial law agreements, maintaining stamina and motivation for 2023. We're also looking at financial and sustainability reporting and next week we'll be looking at age care advice and of course kicking off our tax technical updates for the year. So let's have a look at some of our questions. So Mark, I have a question from George. George is asking, "What if you have a company and its shareholder is a family trust, are the entire fees of the company and the trust deductible?"

Mark Chapman:

The entire fees in what sense?

CCH Learning:

I don't know, it just says, "Are the entire fees company and trust deductible?"

Mark Chapman:

I think I probably need a bit more clarification about what fees we're talking about there and who's paying them.

CCH Learning:

Okay. So George, if you could just give us a bit of clarification on that we'll come back to your question. So in that case I'll move on while we wait to hear from George. So I just have a question from Asher. Asher was asking, "If the partnership made a loss during the year, can the partners claim the loss against their income during the financial year?"

Mark Chapman:

Yes, subject to the non-commercial loss rules. Yes, they can. Losses within a partnership are similarly distributed to the individual partners and they can use them against whatever their other income actually is.

CCH Learning:

Excellent, so there you go Asher. I've got a question from Amia. Amia is asking, "How do you deal with depreciation in a unit trust if the cash to be distributed is more than the income. How do you resolve this so not to reduce the cost base and pay double tax?"

Mark Chapman:

Okay, just run that past me again.

CCH Learning:

How do you deal with depreciation in a unit trust if the cash to be distributed is more than the income? How do you resolve this so not to reduce the cost base and pay double tax?

Mark Chapman:

Well how do you deal with the depreciation in the unit trust, you depreciate assets in the usual way. You claim depreciation and if that ultimately leads to the distribution of an amount of non-accessible income that will give rise to CTT event E4 unfortunately.

CCH Learning:

So then he asks how do you resolve this? So not to reduce the cost base and pay double tax? Or can you or can you not I suppose?

Mark Chapman:

Well, no you can't basically. That will give rise to CGT event E4, which will give rise to that additional tax charge at the unit holder's level.

CCH Learning:

All right. So there you go Amia, perhaps not quite what you were after. So I've got a question from Nayer. Nayer is asking, "In the case of discretionary trust, how important is it to prepare and issue a profit distribution statement before year-end?"

Mark Chapman:

Well it is very important, basically you do need to have that statement of profits certainly by shortly after the year-end. Because the trustees do need to distribute the income of the trust in order for the tax charge to not fall on themselves. So I would essentially say that, that is essential.

CCH Learning:

All right. So there you go Nayer, quite important there to make sure you do distribute that document. I've got a question from Dave. Dave is asking, "When a trust has a corporate trustee, is the director of the trustee company still be liable and their assets will also be exposed if the trust fails to pay super guarantee and PAYG withholding tax?"

Mark Chapman:

That's an interesting question. I would've thought that that would be the case, I'm not absolutely certain. But I know that the ATO is very keen to go after company directors where there are for example unpaid superannuation and PAYG liability. So I would assume that that would apply in the situation that has just been outlined. Yeah. That's just an assumption, but I'm not entirely sure. But I'll err on the side of caution there.

CCH Learning:

Well, there you go Dave. So I've got a question from Jason. Jason was asking if the business classified as BSB, would the trust structure have no benefit to the family at all?

Mark Chapman:

BSB?

CCH Learning:

Yes. BSB?

Mark Chapman:

What's BSB?

CCH Learning:

I'm not sure. It just says if the business classified as BSB, would the trust structure have no benefit to the family at all? Oh sorry, he said PSI/PSB [inaudible 01:05:52]. Sorry, that was a bit of a slip of the fingers there. So that's PSI or PSB.

Mark Chapman:

Okay, so what was the question again? Sorry.

CCH Learning:

So if the business classified as PSI/PSB, would the trust structure have no benefit to the family at all?

Mark Chapman:

That's absolutely right, it wouldn't have any benefit. Because in that situation there's an expectation that any income of the business ultimately ends up with the principal practitioner and therefore having a family trust involved in the structure simply doesn't achieve anything. Because you can't distribute anything to anybody else, it needs to go ultimately to the actual practitioner.

CCH Learning:

There you go Jason, so you were spot on with that one. So I have another question from Nayer. Nayer is asking, "Payment for a shareholder when they have an obligation to repay the amount classified as an amalgamated loan and comes under Division 7A. What will be the treatment in the case of a discretionary trust loan to the beneficiary?"

Mark Chapman:

You're going to have to run that one passed me again.

CCH Learning:

So the question is payment for a shareholder when they have an obligation to repay the amount classified as an amalgamated loan and comes under Division 7A. What will be the treatment in the case of a discretionary trust loan to a beneficiary?

Mark Chapman:

I'm going to have to consider that one. I think I probably need to get an email of that one and give it some thoughts and reply by email.

CCH Learning:

Yeah, not a problem on that one Mark. So Nayer, we can't quite answer that one off the cuff but we'll get an answer back to you on that. So we have a question from Cynthia. Cynthia is asking, "How does the rollover work in the situation where a two-partner partnership restructure/downsize to a sold trader. One of the partners wants to get out and the other one wants to stay on. What are the tax implications?

Mark Chapman:

Well the small business restructure rollover, which I just talked about at the end of that term, that session won't work in that situation. Because there needs to be commonality of ownership between the business beforehand and the business afterwards. So in that situation, there obviously won't because one of the partners is dropping out so they're going from two to one. So small business structure rollover won't be available. However, depending on the facts and circumstances the small business concessions for example could well be available to the departing partner.

CCH Learning:

All right, so there you go Cynthia. All right, so I have a question from Hong. Hong has the question, why do we need... Yep.

Mark Chapman:

I probably just need to make this the last question unfortunately, Susannah.

CCH Learning:

Okay, that's all right. As I previously mentioned, we'll make this the last one. But if you have put a question and there are a couple, we will pass them on and Mark will get our answers and I'll post them on the e-learning site. Why do we need to have two trusts rather than one trust to maximize assets protection?

Mark Chapman:

Well, we don't necessarily need two trusts. I assume you're referring to the example of the medical practitioner who forms two trusts, one with the business and one with the business assets. You don't have to do that. I mean you can simply do it all within one trust if you like. However, having the business assets, the premises, the plant and equipment, etc within a second trust, does actually provide an additional degree of asset protection for the business principle. Therefore, if the business principle is trading through the first trust and somebody sues the business principle, then the only exposure is to the assets of the first trust. There's no exposure of the assets in the second trust in that situation. There's no obligation for somebody to do that, it simply is quite common for the obvious reason that they are protecting their business assets.

CCH Learning:

Thank you very much, I hope that helps you there Hong. Well unfortunately as Mark says, we just have to cut it off there. We do appreciate everybody's questions and as I say, we will get those questions answered and post them onto the e-learning recording. So in terms of next steps, I would just like to remind you all to please take a moment to provide your feedback when exiting. We've asked you a couple of questions about today's webinar, so it's really important for us to hear your opinions. It's also a reminder that within 24 to 48 hours you will be enrolled into the e-learning recording. Which can be watched multiple times and have access to the PowerPoint transcript, any other supporting documentation and of course your CPD certificate. I would very much like to thank Mark for the session today and to you the audience for joining us. We do hope to see you back online for another CCH Learning webinar very soon. Please enjoy the rest of your day, thank you very much.