Tax Implications of Business Structures
14/03/2024

CCH Learning:

Hello everybody and welcome to today's webinar, Tax Implications of Business Structures. I'm Susannah Gynther from Wolters Kluwer CCH Learning and I will be your moderator for today.

A few quick pointers before we get started. If you're having sound problems and can't actually hear me, please toggle between audio and phone. Hopefully you can see that instruction on the screen. If you're looking for the PowerPoint for today's session, it is saved in the handout section on the GoTo Webinar panel. And just a reminder that shortly after the session, you will receive an email letting you know the e-learning recording is ready to be viewed.

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&A towards the end of today's presentation.

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Your presenter today is Bruce Collins, founder and principal solicitor of Tax Controversy Partners. Bruce is currently helping clients to resolve all types of tax issues with the ATO and SROs. Before moving into private practise in 2017, Bruce worked for over 35 years in the tax office, 1/3 of his time as a senior executive in what is now client engagement group covering most ATO functions. Bruce was the leader of the technical and case leadership area in aggressive tax planning and then private wealth for several years prior to leading the ATO, as well as having previously been the strategic and technical leader for many of the ATO's compliance programmes. In those roles, Bruce was heavily involved in many ATO compliance and law interpretation strategies, targeting income tax risks and issues for business structures being used by taxpayers.

I will now hand you over to Bruce to commence today's presentation.

Bruce Collins:

Okay. So hopefully people can see my screen. So well, today's session, we're going to have a bit of a wild coverage of the various options for business structures and what they mean from an income tax perspective. We'll talk about general law partnerships, tax law partnerships, which are different, limited partnerships, which are another type of different thing with the word partnership in it, discretionary trusts, unit trusts, private companies limited by shares, companies limited by guarantee. We'll look briefly at the personal services income rules or that's a whole session by itself, the debt equity rules as they apply to investments in our company structures. And again, that's a bit of a helicopter view. We'll look at the professional firm allocation guidelines from the ATO and we'll look at offshore and non-common law entity types. So essentially, we should be able to cover those in a little bit of detail as we go through.

So before we start, we just want to get a sense of who was in the audience and what was happening with our people. So the first question, which Susannah will moderate, is whether people are accountants or tax agents, lawyers, financial planners, students or other. So back to you, Susannah.

CCH Learning:

Thank you Bruce. You might just want to move your slides through. Yep, thank you for that Bruce. All right, so let me-

Bruce Collins:

I already had.

CCH Learning:

Oh, okay,

Bruce Collins:

Maybe there's a lag.

CCH Learning:

Yes, I think there might be. That's okay. So what I'll do is I'll just launch that poll. So if you could please put a click in the radio button next to the answer that best describes your situation, that would be really great. Thank you.

Just a reminder also that if you do have questions, please put them into the questions pane and we will get to those questions at the end of the presentation. I'll just give you a few more moments to work your votes in. Okay, let's have a little look. We'll close it and we will share the results. So 92% are accountants or tax agents with 8% lawyers. Back to you, Bruce.

Bruce Collins:

Thanks for that. So next question is actually about with the people who are in private practise with experience in setting up structures, private practise with no or little experience in setting up structures, or in public practise including at the ATO. Wow, that's amazing. It just actually moved all by itself. Or whether you're in an economist other category. So back to you again, Susannah.

CCH Learning:

Not a problem. So I'm just going to launch that. And again, if you could please put a click in the radio button next to the answer that best describes your situation, that would be wonderful.

I'll just give you a few more moments to get your votes in. And then I will be closing the vote. Thank you to everybody who has voted. I'm just about to close it. So let's have a little look at our people. So 71% are in private practise with experience in setting up structures. 21% are in public practise. And we have 7% in private practise with no experience setting up structures. Back to you, Bruce.

Bruce Collins:

Okay. Well, thanks very much for that, Susannah. And thanks everyone for voting. That gives a bit of a pitch. People therefore have a bit of experience, but not everybody. And there's some ATO people probably in the audience as well.

So moving along, choosing the right structure is actually about, in a sense, understanding the client's needs. So clients will need things to be done for business reasons. It's not all about tax. Some people have trouble understanding that. But the idea is to understand what the options are before you can actually choose the right structure. So looking at that, you need to look at what the purpose or goals for the client are and then look at what stage in the life cycle of their ownership structure and their life they are at. And as we'll talk about, there might be changes which happen or are required as a business grows and evolves, what might be fine for a partnership with mom and dad, or mom and mom, and dad and dad are working on something small scale might not be really a good idea when they've got a hundred employees and $5 billion worth of property invested.

So the life cycle it needs to be taken into account. And looking at particularly as a lot of the people in the private wealth space are ageing, as we all do, a lot of family and succession planning is occurring at the moment. So people who had older structures are actually now having to look at how to get that into the hands of their kids or they're looking to sell out and move to a different lifestyle as they age. So it's important to recognise where in that life cycle people are at and what they might need therefore to do in terms of making changes to their structures or establishing fresh structures for new things.

So as I said, partnerships are a starting point here. They're a relationship between people, either natural people or legal entities. They can carry on a business in a general or partnership with the view of making a profit. They're not a separate legal entity like a company. Each partner is jointly and separately liable for all liabilities and there are risks therefore that personal assets will be affected by that.

It's easy to set up a partnership. In fact, some people set up partnerships without realising it. If you simply do something with somebody else with a view to making a profit even without a formal written agreement, you can still have a partnership for general law purposes. But it's not a tax paying entity. So the transactions flow through mostly to each of the partners. So there are disadvantages, there are limitations in the partnership act in each state and territory around size, where partners enter or exit legally they become a new entity structure and they therefore, if you've got a lot of people exiting and leaving, it would be a nightmare. So the ATO does have administrative concessions. And there is unlimited liability unlike the separate legal liability of companies.

Now, there's a bit of complexity because some issues are dealt with at the partnership level while others are dealt with solely at the partner level. So the definition of a tax law partnership is in the tax act. Essentially, it's two people who are actually receiving income jointly or carrying on a business. And effectively, it is anybody who's receiving income jointly as the most frequent one. So it includes but is not limited to general law partnerships or limited partnerships.

Now, the idea is that in a tax law partnership, the net income is being received jointly. Therefore there won't be any sort of agreement normally as to what happens. So if you've got two people that own say a rental property, they're in effect operating a tax or partnership. But two people who are engaged in owning term deposits, they're actually in a taxable partnership. And there won't be the ability to modify the normal expectation that those jointly held assets are actually held in a 50/50, or of this three people 1/3, 1/3, 1/3 basis.

Now, there's a whole bunch of provisions that deal with how things are taxed from an income tax perspective and they're listed here. I'm not going to read through them. But there are a few things that are worth highlighting. Capital gains are assessed to the partners because they have a traceable interest in the partnership assets. If there's a dividend, it'll actually be proportionately sharing the franking credit at the imputation amount with each partner's share of the relevant dividend flow. There are a bunch of deductions which are not allowable at the partnership level, but instead dealt with the partners. And there's also things that look like there might be deductions which are not dealt with at the partnership level because of the fact that unlike a company which is paying salaries, the salaries or the amounts paid to the partners are actually regarded as being drawings, they're their money. So there's some complexity that flows from there, which is listed in the slide.

Now, capital gains in partnerships are actually an interesting topic because essentially each person has a traceable interest in the partnership assets and therefore the consequences of that will flow through the partner. So if it's an individual taxpayer or a trust or a trustee rather acting as a partner, then they'll be eligible for the 50% discount on long term more than 12 month assets. The small business CGT concessions are available. And if there is an exit or an entry to a partnership, there's some complexity around when somebody acquires the interest in each of their partnership assets. Effectively, if you have somebody who leaves and the asset remains, everybody's interest in the underlying assets of the partnership increase proportionately. It's a bit like the general value shifting rules. There's an up interest and a down interest. The exiting partner has a down interest and the remaining partners have an up interest.

When a new partner joins, everybody has a down interest because of the fact that the new partner is taking on a proportionate share in the assets of the partnership. And so the other partners will actually have some adjustment there. And then it becomes somewhat complicated in terms of looking to cost base of those assets. Fortunately, it's not a part disposal, it's so much as an impact on the cost base.

Now, trading stock as an asset of the business and also the depreciable assets of the partnership will also be adjusted at various points. And so changes in the partnership structure will result in notional disposal of trading stock at market value. The way that that's calculated is at least if 25% is retained by the previous partners, they can elect to use the book value for disposal purposes. And similarly for depreciable assets, there's a balancing charge or a balancing adjustment they call it now, sorry, I'm old-fashioned, which is required and they can instead elect to use the deemed disposal to be at current written down value rather than the market value. So those things are a bit of that complexity I referred to.

Now there's also forms of limited partnership called corporate limited partnerships. Australian based ones are dealt with here. It's essentially halfway between a partnership and a company, but for most purposes, nowadays it's treated as being like a company, but it has these particular factors and it allows greater flexibility about the admission and retirement of partners than any standard partnership does. There was a bit of tax planning using corporate limited partnerships as we'll talk about later on, but they generally are taxed as a company. And that means that some of the things that happen to partners with the transparency of assets, there's actually a treatment at the company level, the corporate limited partnership level rather than flowing through those partners. So changes in partner doesn't trigger the same sorts of issues. So there are no CGT consequences for the individual partners. So there's actually an advantage in using one of these.

Now there was some tax planning a few years ago till about 2009 I think it was where Div 7A was viewed as not applying to corporate limited partnerships and now it expressly is, and if they're considered closely held at least. So the idea of corporate limited partnerships is that they're an alternative to a standard general law partnership which has the ability to be treated as a company and therefore drawings are treated as dividends in that process. So it's a good option to consider in those circumstances where somebody wants to have a partnership that wants to be treated as a company. So it's sort of like halfway between.

Now, private companies are the paradigm example of a business structure. The majority of businesses in Australia are handled as private companies. And that includes private companies operating as corporate trustees for trusts. And again, there are advantages to doing that. So it is a separate legal entity. It pays tax at the company level if it's operating in its own right. And if it's operating as a trustee, obviously it's treated as a trustee, which we'll talk about trust in a moment.

The amounts that are paid are treated as dividends and of course you've got Div 7A risks which we'll touch on in a while. But the ability to frank those dividends is very important. The company gives the option to be able to collect investment through the issue of shares and other instruments, which we'll talk about later about debt equity. So there's ways in which companies are actually quite beneficial. Separate legal entity status and the protection of assets is a major one. So it's important to remember where we're at with that sort of thing.

Now, companies are residents of Australia. There's an important set of tests for determining whether a company is resident in Australia or not. And the major one is obviously central management and control. The second one though is around voting power. So even if you've got something that's incorporated overseas, which you'd think wouldn't be an Australian resident, if it's centrally managed and controlled from Australia or it has the voting power controlled by shareholders who are Australian residents, by force of attraction, it will be made a resident of Australia under the definition. And therefore if it is a resident of Australia, it becomes taxable on Australian sourced and worldwide sourced income globally. So that can have a big impact on a company. And you've got to plan around not only the establishment of the structure but its maintenance and management over time. So that central management control and voting power thing is something that needs to be managed as the company progresses.

Now, the private company's liability is really limited to the equity in the company in general, but the director penalty regime and some other parts of the corporation's law can actually mean that directors can still be liable if they breach 588G of the Corp Act, for instance, and trade law insolvent that can leave them vulnerable.

The director penalty notices are an important issue where if there's PAYG withholding GST or other indirect taxes like WET or LCT or superannuation guarantee, that means that that corporate file can be pierced. And if that's pierced, then the directors are liable if the company doesn't pay its liabilities.

Now, there are costs with establishing and managing a company and that needs to be taken into account, particularly to start stacking them together. Like you've got a company which is say established and it's got shares held by discretionary trust with a corporate trustee and then you've got a bucket company up below the trust. So effectively, you end up with three companies and a trust which are actually established. It's not an uncommon sort of structure. You've got three companies worth of regulatory requirements and costs and then you've got the trust ones as well.

Now effectively, a private company is one that's not a public company, so it's a sort of exclusive definition and the tests for that are there. But essentially, if it's not a public company, it's generally a private company. So worth having a look at those tests in 103A in the '36 Act.

Company losses. Now company losses are locked into the company. Unlike losses for partnerships which flow through to the partners, you're actually quarantining those losses within the company in a sense. So there are tests for the continued availability of those losses for that company. The same or similar business test is effectively that and the continuity of ownership tests as well. So it's important to recognise that those tests are also mirrored in the bad debt write off provisions because if you write off a debt this year and you didn't own the company the year before, you're actually getting a deduction for an amount of income that was returned in the previous year by the previous owners. So it's important to recognise that that also applies there. And lost trafficking and lost trading and bad debt issues are important to sort of keep in mind when you're running these structures over time and thinking about how they're going to be run when you're establishing them.

Div 7A is a session or 7 in its own right. It's a complicated regime that is intended to be draconian. It's intended to be a disincentive for people taking informal distributions in the form of loans or transfers or use of property. So it treats that loan or transfer of property to a shareholder or an associate of a shareholder as if it's a dividend deemed to have been paid if Div 7A isn't complied with. You have to have a complying loan agreement, it has to have minimum repayments met and it has to also have the minimum interest rate applied each year. There has to be a written agreement saying all that. So there's also triggers where debts are forgiven in some other circumstances as well.

So it's important to remember that Div 7A is something that applies to companies. But Div 7A doesn't apply to companies that transfer money to other companies except if there's an interposed entity. So it's important to remember that there are ways of arranging things so that you've got company to company loans and that won't be a sort of issue. But the problem is, if you learn from a company to a trust, suddenly you've got your Div 7A problem. We see lots of those where people haven't really taken that into account when they've been structuring their affairs and designing transactions.

Now there's a rarer form of company, which is a company is limited by guarantee. They don't have shares, they've got guarantee interests. They've guarantors who have an interest in the company. This can be used for tax planning purposes, but the ATO's general approach is they treat as if some guarantee interests for part 4A purposes will be substantially viewed as being effectively shares. But generally speaking, if you're a director of a company limited by guarantee, you're still a director of a company, therefore you'll still be subject to director penalty notices and other issues. And you're still subject to all of the Corps Act director duties.

Now, they're taxed as public companies but have access to a variety of exemptions and concessions if they're registered charities. So lots of charities are companies limited by guarantee. So you do tend to see that happening quite frequently.

So the next most common form of structure in ownership in the tax system is trusts. Now, trusts are effectively a legal and equitable construct where there must be a trustee who holds some property on behalf of beneficiaries who may be objects and that thus potential beneficiaries. And that trust property is held subject to equitable and fiduciary obligations on the trustee for the trust property to benefit the potential or actual beneficiaries.

Now, it's not a separate legal entity. It's a legal and equitable relationship between the trustees and those beneficiaries. There are different sorts of trusts and fixed trusts including unit trusts, so ones where each person who has an interest in the trust has a traceable interest in the trust property. It may be one person, it may be a series of persons. Discretionary trusts conversely as we'll talk about, the trustee holds the property on behalf of a set of objects, a class of people who may receive a distribution subject to the exercise of the discretion. And that means that they don't have an individual traceable interest in the property until that discretion is exercised, at which point they have a present entitlement to receive the other relevant items of capital or income. And then there are service trusts which are usually a form of a trust used to facilitate business operations, and we'll talk about those in a moment.

Now, fixed trusts, as I said, have a fixed interest by the beneficiaries and a fixed entitlement to income. So the assets can be one set of beneficiaries and the income can be another. You sometimes have capital units and unit trusts and revenue units and unit trusts for instance as an example of that sort of fixed interest in trusts.

Now, beneficiaries of such trust, like all trusts, have access to the general discount on capital gains if they are themselves individuals or trustees. The trust is unable to accumulate income because of the fact that it's required as a fixed interest to distribute that to the relevant beneficiaries who hold the income units or the income entitlement under the fixed trust. It can be used to protect assets because they're held by a person in the capacity as trustee. There are some land tax advantages from a state revenue perspective. And they're unable however to

distribute losses. So if there's a loss, there's nothing to distribute. That has to be carried forward by the trustee and then allocated against the next amounts of income before the income unit holders or fixed trust entitlement holders receive it. And there's no discretion usually in a fixed trust.

There are hybrid trusts as well that are a bit discretionary as well, but we decided not to deal with them because they're a bit too complicated. But you can have fixed and discretionary obligations in one trust deed, but it makes life quite complicated as to whether it's a wholly fixed trust. And most of the tax code differentiates between fixed trust and discretionary trust. So if you have any discretion at all, you can't be a fixed trust. Now importantly, fixed trusts and including unit trusts can be consolidated for income tax purposes if there's unity between the fixed entitlements, but discretionary trust can't be.

Now unit trusts are a subset of fixed trusts where the interest of each of the beneficiaries is effectively reduced to a unit interest. Now, trustee retains some discretion as to how and when to distribute, but when they do, it'll actually flow through to those unit holders. And again, they can have capital units and revenue units, sometimes they're both. And that can lead to a bit of complexity and some planning opportunity and some characterization questions about whether something's truly capital versus revenue.

Now, there are fewer asset protection advantages to fixed trusts, unit trusts as well as each unit holder has a traceable interest in the assets of the trust and anybody who has a fixed trust interest has the same problem. Now these are often used as unit trusts are to behold assets between unrelated parties where they don't trust the discretionary aspects of discretionary trust. I mean, who's going to put money in an investment with an unrelated party where somebody has the choice of whether the unrelated party gets the money or you do? But unit trusts are almost always used by self-managed super funds for joint investments and the purchase of business real property because they have that traceable interest of the smurf flowing through to the asset that they hold.

Now, there is capacity to add more unit holders, but that actually results in an up and down interest from a general value shifting perspective, which can lead to complexity and difficulty. Discretionary trusts are very, very, very popular, particularly in private and family groups. They're probably the most common structure that you see in those other than simple private companies. Trustee has flexibility of distribution subject to the duties imposed on them by the deed. And there'll be a set of objects specified in the deed as being potential recipients of the discretion to make them beneficiaries and thus become presently entitled to income or capital.

Now, beneficiaries don't have a specific equitable or property interest in the trust property. They've only got a mere expectancy or right to be considered for potential distribution each year. And you'll see some cases in the trust law field where the case is about whether somebody who is properly considering whether a beneficiary could receive such a distribution by being made a subject to that discretion. But you can't actually enforce the right to be made a discretionary because of the fact that the trustee usually is given very wide scope. Only ones which really succeed tend to be ones where there's a misuse of power by the trustee perhaps for their own benefit or for a related party.

Now, there are regulatory burdens and costs in running discretionary trust. You've got a lodge tax returns for the trust if it's receiving income or carrying on an enterprise. You've got other issues in terms of land tax and other things where you've got to manage those issues. You can produce asset protection benefits, but there's still some potential that if you've settled a trust, it could be clawed back under bankruptcy or corporate insolvency law. But generally speaking, if you have legitimately severed your ownership of the assets settled on the trust, it won't generally be subject to those issues.

There is scope within tax code to actually use family trust election processes to access franking credit and carry forward losses. You can get the income being accumulated in the trust but you don't want to because it'll be taxed at 47%. It's a very common estate planning tool to have trusts. So you also see testamentary trusts with discretion as well as some testamentary trusts that are actually fixed trusts.

Now, the idea is the trust property is generally not an asset of the individual from bankruptcy or liquidation of a company, but there is the potential of a clawback in some circumstances. Now there is a complicating factor around trusts, which is around vesting dates. So trusts vest when they cease to be, and they cease to be when they vest. So there's usually a period of rule against perpetuities which says that it's something like 80 years. So there's a bit of complexity there about managing those vesting dates and for long held trusts to monitor what the deed says about the vesting date. Some people don't realise their trusts have already vested. Some people want to vest the trust and they find that they don't have discretion to vest early. So read the deed. The deed is paramount. If there's one thing I tell everybody, it is read the deed. Every time you look at a trust issue, have a look at the deed.

Now, discretionary trust, as I mentioned before, can't be consolidated unlike fixed or unit trusts. So that leads to problems with structures which have lots of entities trading with each other, which would be washed out if they were done through a consolidated group. But because they're all discretionary trusts, you can't do that. So some people are looking at making changes to their structures to try and deal with this better.

Now, service trusts are a curious sort of structure. I remember talking with Ian Phillips, the person who is the Phillips case taxpayer. Effectively, the structure there was set up as part of a professional firm to allow the accumulation of monies to associates of the professional firm to allow those associates to receive some of the money rather than the partners in the partnership. So it was particularly prevalent with partnerships, but it's not exclusively a partnership structure. You can have a service trust associated with a business company.

Now there's some restrictions on assigning existing things, like assets, including assets like existing contracts or plant equipment and things like that to the service trust because triggering a CGT event when you do so. And of course, there are things like ever assignments which are the professional firm allocation guidelines deal with.

Now we did an entire session on the professional firm guidelines, so we're not going to go into any detail about it, but it's worth recognising that a service trust is part of the distribution structure and it needs to be considered as part of the professional firm guideline risk assessment. Because if you've done everything else right and your service trust is out of whack, you can still breach those guidelines and must be subject to greater scrutiny.

Now, there are quite a few costs in administering a service trust, but it can be a good benefit to have attached to your ownership structure. Now, the arrangement needs to be well documented and you need to follow the legal form. I say this because sometimes people do one on paper and don't do it in actual reality. And when that happens, everyone deals with as if the employees remain employed by the original employer and there's payments going for things that are really being managed by the Friday night structure, not the Monday morning structure. And there's like an internal transfer pricing approach to determining what the value of the service charges should be. And there's methodology set out in the ATO practise statement on how they deal with these service trust arrangements.

Now, taxation trust income is that effectively if somebody's in a trust estate for general law, it'll be a trust estate for tax purposes. The trustee's only taxable if there's not a beneficiary is presently entitled to the amounts of ordinary statutory income. So it's very important to try and make sure that that income gets distributed so you don't pay the 47%. And there are some clawbacks of getting things wrong. There's also some problems if you simply drop the ball and don't exercise the discretion to distribute to somebody who is actually a beneficiary, or an object of the trust who can be made a beneficiary.

Now, there's also differences between trust income and accounting income. And there are people who do try to manipulate that difference at times, which can lead to tax planning detriments. Now the idea is there has to be a movement of actual cash as well as statutory or theoretical income to an actual beneficiary. There's questions about franking credits and whether they travel with dividends as to whether there's actually a movement of money and all of those issues which come from the taxation of trust. Have a look at Bamford if you want to know how many views there can be about how something works. But the other problem is section 100A, which we'll talk about in a moment.

Now, streaming of trust income is important. So effectively, you can direct dividends or capital gains to move to particular beneficiaries. The amounts that are in fact so distributed are not looked at as remaining income of the trust, therefore you don't pay the 47% on them. And they're accessible to the beneficiary in proportion to the amount that they're presently entitled to receive. Now, the normal assessing rules apply. Therefore, if you get a capital gain and the asset was held for more than 12 months, the beneficiary can claim the discount. And similarly, provided the franking credit trading rules are met, the imputation credits will actually flow to the beneficiary for the franking credits if it's a frank dividend. So that stuff is good.

And then you've got the restrictions on the carrying forward of trust losses and their allocation. So trust losses that are accumulated at the trust level can't be distributed, therefore they have to be counted by the trustee in a future year. Now if you're doing income injection schemes or other nasty stuff, then there's antitrust loss trading measures which are designed to restrict the ability to reclaim those losses in future years. And those rules are a bit onerous, but they're generally effective. And it's really only if you're trying to do an income injection scheme that you should come across the operation of those provisions in Schedule F. But you need to make sure you're familiar with those rules just to make sure you don't intend to do something that is going to trigger those rules. So I encourage you to have a look at Schedule F and 2655 in particular.

Now, there are various trust and avoidance provisions, but the major one that people are worried about at the moment is 100A. You've got the trust reimbursement agreement provisions where somebody is made presently entitled to an amount of trust income, but they don't actually receive it and somebody else gets the economic benefit. And that's as a result of a reimbursement agreement. It's going to be problematic for them. And then what happens is 100A turns off the distribution and leaves the money undistributed in the hands of the trustee that's subjecting it to 47% tax.

Now, the agreement must be a reimbursement agreement. It must precede the distribution and it must be done for the purpose, a purpose, any purpose of securing a reduction or elimination of income tax for a person who would otherwise have been subject to tax but for the agreement. And there's an unlimited period of review. This is one of the few exceptions to the normal period of review limitations aside from fraud or evasion, which applies more generally. So if you've got a 100A arrangement, you've got to be careful to make sure that you recognise the problems. And if you've got an arrangement that may be a 100A arrangement, you need to navigate to make sure that it isn't a problem. So be aware of how it works and what the HS doing with it.

Now there've been a couple of cases decided recently to Guardian case and the B Blood case. And on findings of fact, they're different, but in terms of the application of the law, they're equally applicable. So it's a nasty provision, draconian in its effect, designed as a disincentive for people doing what the arrangement targets. Whether the ATO is going too far with their strategy is a matter of debate, but it's definitely worth having a look at and trying to manage those risks if you've got somebody who might be theoretically receiving an amount and may not actually be getting it.

Now, the other problem is a similar issue where you've got effectively DIV 700A for trusts. So if you've got a trust that distributes money to a corporate beneficiary but doesn't actually pay the money to that company, the ATO's argument is that that unpaid present entitlement or UPE is actually going to be a problem. Now, in other words, they say that the company is effectively loaning the money back to the trust. There's a whole bunch of complicated sub-trust things that you have to be putting in place to reflect the idea that the amount that the trust holds on behalf of the company distribution they didn't make is actually separately an inset of that company and any income received by the trust would be proportionately taxable to the company under that sub-trust.

Now the problem with the UPE approach is that the ATO is definitely pushing forward with that view. The taxpayer one i [inaudible 00:41:24], the case side at the bottom of this side, but it's on appeal to federal court and it'll be the acid test for what happens with the treatment of those UPE amounts. And my prediction would be, if they lose, then there'll probably be a legislative amendment to fix it. But if they win, it'll just be a reinforcement of the ATO's UPE strategy.

Now as I mentioned earlier, unlike company to company loans that are exempt from Div 7A under 109K, private company and trust loans are subject to this Division 7A. So provided that the private company has made the loan to a trust and it has a distributor surplus, the trust will actually be potentially deemed to be receiving a dividend from that loan. Now, there's also the potential for some transactions going through a chain of entities to be regarded as interposed entities for the purposes of 109T and 109U. So effectively, there can be a chain of these things where Div 7A may apply and one of the entities in that chain with the flow through of the trust distributions on the loaned amount might actually be a trust and therefore be treated as being subject to Division 7A accordingly.

Now there's also the personal services income rules, which again is like a whole session, but it's important to recognise. [inaudible 00:42:59]. I just lost my slide. Can people still see that?

CCH Learning:

Yes, we can see your personal service business income rules slide.

Bruce Collins:

It just disappeared from the screen. I don't know why. Computers are weird. All right. So the thing is, there's a bunch of tests that determine whether if an individual is primarily providing their labour through a business structure to end users, that they might actually be taxed as if the company or business structure doesn't exist. And there are exceptions to that if you meet certain tests and they're listed on the side.

Now, one of the thing is agencies generate a particular degree of risk with that. So if you are getting all your money from one agency but you are servicing multiple end user clients, the agency's regarded as the source of the income. So you can actually fail the unrelated client test or the 80% source of income received from a single source test. But as I said, this is something worth looking at, but it's a session in its own right, so I won't go into too much more detail.

Now, the debt equity rules are actually something that does apply to investments in even small entities. And so it's important to remember that some of the other rules that people think apply only to multinational transactions like the Division 974 debt equity rules actually do apply to private transactions. We've got one the other day where they had issued debentures, which were convertible into shares and they gave voting rights. So it can actually mean that you've got something that's much more share like than being purely a dead instrument.

Now, debt instruments normally generate interest deductions pre-tax, whereas equity-like investments give you profits distributed as dividends post-tax. So interest deductibility is a major issue for debt instruments. And the definitions of what an equity interest will be versus what debt interest will be are contained in those provisions that decided here on the side. But it really depends on whether something is equity. Some people want it to be treated as interest bearing and therefore being deductible, but if there are enough equity like features in the instrument, you'll end up being treated as equity. And similarly, the converse is true. If you want it to be treated as equity, sometimes you'll have so many debt features in it that'll actually result in it being treated as if it's debt.

The idea is that there's almost an infinite array of circumstances which can be dealt with in terms of the structuring of instruments. You need to look at the stack of rights which are conveyed and work out whether in substance then more equity like than debt like or vice versa. And interestingly, if you've got one that meets both, effectively, if it's got all the features of both or many of the features of both, it'll be treated as a debt interest under Division 974.

Now, 974 is important for a variety of purposes, but one of them is interest deductibility obviously, but it also gets counted for thin capitalization calculation. It's also considered in terms of consolidation because you have to have unity of shareholding in order to be consolidated. But if you've got an equity-like instrument that is used to fund a subsidiary, it'll then affect whether that subsidiary can be consolidated. And so, "I'm getting it wrong, can I have [inaudible 00:46:55] consequences downstream?"

Now, there's also issues in relation to cross-border transactions where something is interest-like whether interest withholding tax will be subject to the arrangement. We've got one at the moment where there's a question about whether withholding tax applies to an investment or not, whether it's for other reasons. But it can apply to even moderate sized domestic arrangements where they've got an offshore funder and therefore there's a real question about how that all works. So in essence, the idea is that you've got to manage the debt equity rules if the instrument is not clearly just one or the other. If you just buy a share, share instruments issued for most private companies are going to be shares. But if you start getting into a redeemable preference shares or convertible notes and things like that, they become real questions about whether those are going to be treated one way or the other. So it's important to recognise these issues.

Now, the other point is that when you set up a structure which is going to deal with effectively employees, if you set up a company, you can have the owners as employees. If you set up a partnership, the owners aren't generally able to pay themselves as employees, they're simply the partners taking drawings. So there's a range of things that happen as soon as you start having a separate entity structure, whether it's a trustee or a company structure in particular. But you've got PAYG withholding, you've got super guarantee, you've got provisions for leave, you've got workers' compensation obligations, you've got employer versus contractor issues about working whether somebody is an employee or an independent contractor. And you've just got to look at any payroll tax case to work out how hard that is. Let alone the income tax cases. You've got fringe benefits tax if there are benefits being provided by the employer or an associate to an employee or an associate of the employee.

Now that's interestingly, FBT runs concurrently with Div 7A if the person is both an employee and associate and also a shareholder or an associate of the shareholder. So for people in the family of the controllers of a private company, it's quite frequent that there'll be both FBT and Div 7A potential application running concurrently. And there are advantages and disadvantages in doing either.

There's payroll tax issues for larger employers. And of course as we talked about earlier, there's direct penalty notices to not paying super guarantee or PAYG withholding. I mentioned workers' compensation before. There's also the tax payment reporting regime for certain sorts of industries. So it's recognising that you've got obligations to report those taxable payments. You've also got, of course, single touch payroll obligations as well to report what's happening online now.

Now, you can have employee share schemes and you need to comply with those rules if you're going to give them beneficial tax consequences. And lastly, you'll have issues with redundancy and termination payments and their characterization from an income tax perspective, whether they've modified their redundancies or whether their employment termination payments or they're just payments of salary and wages. So as a consequence, you have a range of those matters which are going to be matters as employers that the business has to take into account. Now, if you are setting up a structure, you want to consider all of those and a bunch of other things as well. Because if you're going to have employees, it's going to be necessary for those obligations to be managed. So in essence, taking on employees is important and a necessary part of running most small businesses, but it's also something that comes with those issues needing to be managed.

So overall, they're the big issues. There's also a slightly curly question which arises. Not every foreign entity fits very well within the Australian tax law categories that we just discussed. If you've got somebody who's got offshore structures, particularly longer term structures involving wealthier private groups, it's quite likely they might have an investment or 70A in offshore structures. If they're from Europe, they'll have a bunch of strange names like anstalts and stichtings and stifftungs and fondations and establissements.

If they've invested in countries that used to be small, usually sunny and having corporate and bank secrecy previously known as tax havens, now labelled offshore financial centres, they might have weird company structures like segregated sales or protected sale companies. Now, none of those have an exact parallel in Australian tax law. And how particular interests or investments in those structures will be dealt with, that presents some tricky issues.

During project [inaudible 00:52:31 the ATO encountered a lot of these structures in the tax haven sort of strategy that they dealt with. The serious financial crime task force is continuing to deal with a range of those at the moment from my understanding, from talking to other practitioners and our work. And where those arise, the ATO's tendency is to ignore the differences in the structure and go to the economic substance of what the person is doing. Sometimes they will argue that the structure is actually a bare trust on behalf of the Australian resident individuals or their ownership structure here. Sometimes they'll argue that the structure's a sham. And otherwise they will try to argue that there's some other legal relationship that makes a taxable and leave the taxpayer under the burden of proof in challenging these subsequent assessments in litigation to demonstrate that it's not accessible to them by showing that somebody else is actually the true economic owner.

And of course there's the control foreign company regime and the transfer of trust regime that exists as well for some of those types of arrangements if they're either company enough-like or trust enough-like to be treated. So in essence, if you've got some of those, you need specialist assistance from people like us in my firm because they're actually quite complicated. And the ATO's strategies for dealing with them are quite strong. So it's worth bearing that stuff in mind. And if you're doing [inaudible 00:54:01], I'd suggest getting specialist assistance if it's a substantial economic issue or if the ATO is coming in and asking some questions about those things.

But it's worth noting that the current generation doesn't always know what their predecessors in the family actually did. I've seen cases where families discovered that their now sadly deceased relative had $110 million in a Lichtenstein and they didn't know what to do about it. They didn't know how it should be dealt with. And I even had instances where the offshore administrator of the arrangement says, "We don't have to give it to you." They've had to go to court in the foreign country to get the money back. So it's complicated. It's worth asking for assistance on if you encounter it. It is novel, but if you encounter one, you probably do need help. All right, we might open up the questions now, Susannah.

CCH Learning:

Certainly, Bruce. Okay, thank you for that presentation. We will be spending the next few minutes taking questions, so if you would just like to type them into the questions plane and we'll get to those questions shortly.

To give you some time to type those up, I will mention some of our upcoming webinars. So coming up, we're looking at the latest developments around a lease accounting and IFRS 16. We'll be asking how to turbo-boost performance through high quality feedback. We have our monthly tax technical update for March happening on the 19th. And we'll be continuing our FBT series for 2024 by looking at Car Parking Essentials For Success. We'll also be looking at AML Phase 2 or anti-money laundering Phase 2, what we learned from New Zealand and the international market and how to prepare here in Australia. And we'll also be asking about the initial meeting to profitable client. If you are interested in any of these, please head to our website, have a look and see if any would be right for you.

So let's have a little look at our questions. I'll just make my questions pane a little bigger so I can see my questions. Okay, here we go. So we have a question from Asha. Asha was asking, "Hi, Bruce. Family Trust has the corporate trustee with beneficiaries. Trust is receiving dividends from the investments with franking credits. However, if the trust made a loss during the year, what will happen with the franking for that financial year?"

Bruce Collins:

Yeah, good question. If you don't end up with a net amount of income, the franking credit is refundable. But the question is where it gets refunded. If you don't distribute any income to beneficiaries, the trustee will actually claim it and it becomes an amount received by them. But if it gets distributed, the dividend proportionately travels to a beneficiary or some beneficiaries. The franking credit travels with it and they get to claim it. But if there's a net loss overall, then the trustee will claim it.

CCH Learning:

Thank you very much for that, Bruce. So there you go, Asha. I have a question from Sarah. Sarah was asking, "What's the best way to guide the conversation with a client that their sole trader or partnership structure is no longer fit for purpose despite the additional costs to establish a new structure?"

Bruce Collins:

Another really good question. This happens all the time. I think the separate legal liability is the thing I normally lead with. If you have an adverse business event and somebody tries to sue you, do you want them chasing your house? And moving the structure into a company allows you to do rollovers, which saves the transitional costs of CGT on the change. But separately, the liability is normally the best lead argument I find to explain what the benefit is.

The fit for purpose thing is mostly partnerships and sole trading operations work for smaller businesses, but when you get to the point of having employees or planner and equipment and you're doing things that are risky, which you might generate claims against, you buy employees or for the accidents that happen using equipment or from large scale business operations, you're much better off having that separate legal liability as a shield to protect the controllers of the company versus them being completely at the mercy of whoever sues them.

I've had a conversation with plumbers and bricklayers, and yeah, they don't understand necessarily the sort of minute, but they understand that somebody will come after their house.

CCH Learning:

Thank you very much for that, Bruce. I hope that does help there, Sarah. I also have a question from James. James is asking, "Is there a good strategy on cleaning up an over complicated structure set up by a previous advisor? How do I explain additional taxes that may be involved in moving to a new structure?"

Bruce Collins:

Well, yeah, look, I think that if you're talking about a small business, you've got the business restructuring rollover for small businesses, which is actually quite a powerful tool to sweep up things without the transitional costs from a tax CGT perspective. So that rollover is probably a very good thing to keep in mind, but it's worth recognising that if you go through and show the... I've had clients who had 32 companies which were corporate trustees for a discretionary trust and each one had a bucket company. So when you looked at the structure, they had like 60 companies and 32 trusts that were all lodging returns. Just showing the accounting costs for doing each of those, and the asset registration costs for each of those, sort of explained that there was going to be a saving of like $100,000 a year by moving to a simpler structure.

But also when looking at the... For that particular example, looking at the transactional costs that could be washed out if the whole bunch were consolidated, became obvious that they needed to do something to do the restructure. And so it's about showing the complexity leads to bad outcomes for them that cost them money. And that's the pitch that you use. But also it makes it easy to understand what's happening. There's a view which is a valid one, that you have set up a separate legal entity for each of your business activity saying property development, and it makes sense to do that. And there's a view that people want discretionary trust so they can stream the income. But I mean, do you do that at the individual special purpose vehicle level or do you do it at the entity group level where you actually have a valve trust at the bottom, which gives you the same discretion to distribute to the same people, but from the whole, not from the bits?

And so if you go through and explain that in a rational fashion. And showing somebody in a diagram how complicated their structure is and then showing the costs for each one to meet its regulatory requirements can be a pretty powerful incentive for them to make the changes that a competent advisor would recommend.

There's also the fact that people buy structures or inherit them. So you can buy a structure when you buy a business. So you buy the company instead of buying the assets of the business. And if you do, you end up with somebody else's structure, which is hugely complicated and maybe not fit for your purpose. So after you buy, you've got to work out what you do with it to actually make it part of your structure. So the same things arise there. And again, explaining a competent transition strategy using the available CGT small business rollovers in particular if they're available. Or the other unlimited rollovers in other contexts can be quite a useful exercise and a good way to generate some fees at the beginning to restructure, but save the client money and future fees down the road. And actually, it generates friendship and a bit of goodwill on the part of the client if you can explain it that way.

CCH Learning:

Thank you very much for that, Bruce. I do hope that helps you there, James. We also just had a question from Dennis. Dennis was asking, "Can you provide guidance about how people can unwind discretionary trust structures such as to replace them with companies to enable consolidation?"

Bruce Collins:

Yeah, look, it's actually quite hard to do. In one sense, there's no rollover that aptly works to allow that completely. In a sense, you can do rollovers to move the assets from the trust to a company because the trustee simply rolls over, but the trust now owns the shares in the company. It doesn't really help you to then consolidate because you still need to have the unity of 100% ownership by the head company. And because you've got the legal obligations may sit with the trustee, the equitable ownership actually belongs to either specific beneficiaries or the objects of the trust. So in a sense, the only way to do that is really to vest the trust. Trust vesting can occur through the exercise discretion where you make particular beneficiaries presently entitled to the capital assets of the trust. And at that point there may be some sting in the tail, but it still is necessary to manage what happens next.

And if you've got, as I mentioned before, that example I gave, they had to vest the assets of the trust in order to consolidate for each of the 32, fortunately they were able to do that in a way which minimised the tax sting, but there was a bit of shuffling to do so. Unfortunately, there's no really apt rollover that allows the entirety of it to be done without any tax consequences other than the small business restructuring one. If you're too big, that one was too big, you're really a bit stuck. But if you can operate with the small business restructuring one, you can actually shift everything around. But most of the ones I've seen have actually been above the 6 million maximum net asset value, so it hasn't been possible to do that. But if you've got one that's smaller, you can use the total restructuring, one to just shift the pieces around. And that can actually work out beneficially. But if it's more than 6 million, which most of the ones I have seen are, then you're really investing at the assets that trust and trying to deal with accordingly.

CCH Learning:

Thank you very much for that, Bruce. I hope that does help you there, Dennis. Well, that does bring us to the end of our questions for today, but Bruce's details are there on the slide. So if you do have any further questions, please reach out and I'm sure Bruce will be able to help you.

So in terms of next steps, I would 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 shortly after today's session, you will be emailed, when enrolled, into the e-learning Recording, which can be watched multiple times and give you access to the PowerPoint transcript and of course the CPD certificate.

I would very much like to thank Bruce for the session today, and to you, the audience for joining us. We hope to see you back online for another CCH Learning webinar very soon. Please enjoy the rest of your day. Thank you very much.

Bruce Collins:

Thanks everyone.