Tax Implications of Business Structures

Bruce Collins

Thursday 14 March 2024

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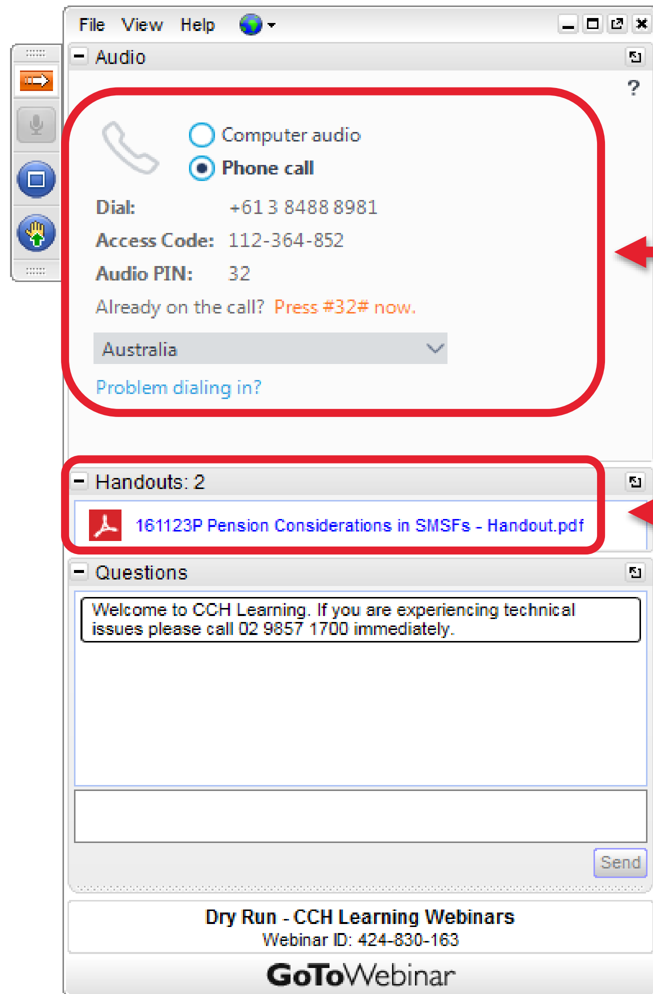

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Susannah Gynther
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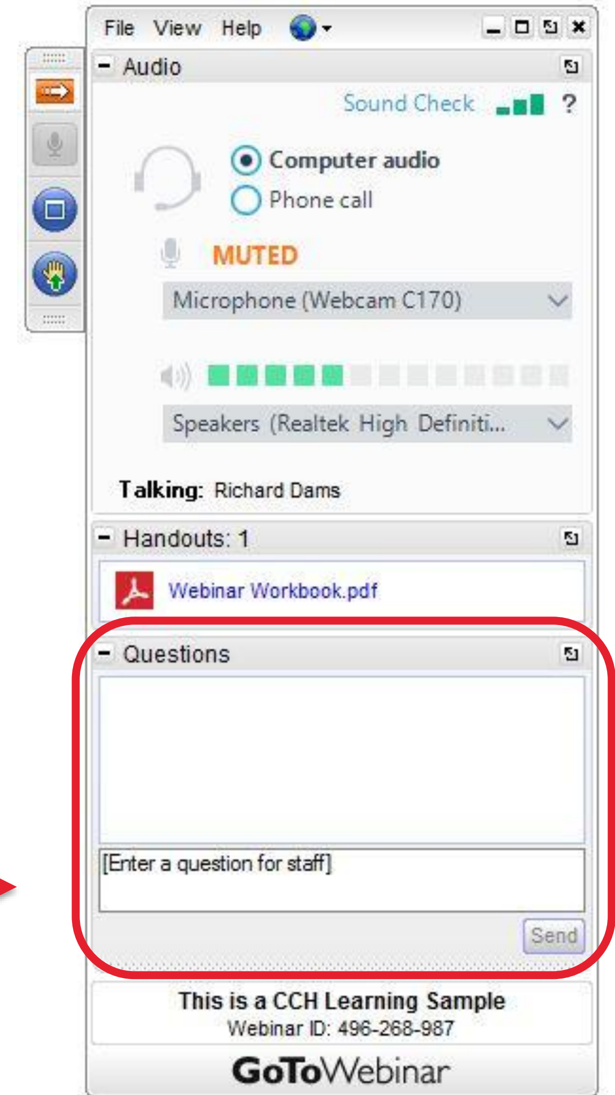

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Your Presenter

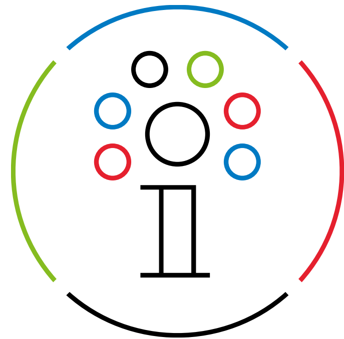
Bruce Collins is the founder and principal solicitor at Tax Controversy Partners, currently helping clients to resolve all types of tax issues with the ATO and SROs. Before moving into private practice in 2017, Bruce worked for over 35 years in the Tax Office, a third of this time as a Senior Executive in what is now Client Engagement Group, covering most ATO functions. Bruce was the leader of the Technical & Case Leadership area in Aggressive Tax Planning and then Private Wealth for several years prior to leaving the ATO, as well as having previously been the strategic and technical leader for many of the ATO's compliance programs. 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.

Bruce Collins

Founder and Principal Solicitor

Tax Controversy Partners

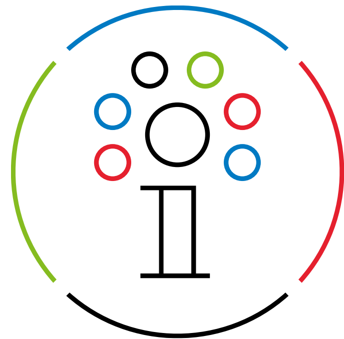
Today's session will cover



This session is intended to give tax practitioners, accountants and lawyers an improved understanding of the impacts of some of these options, covering:

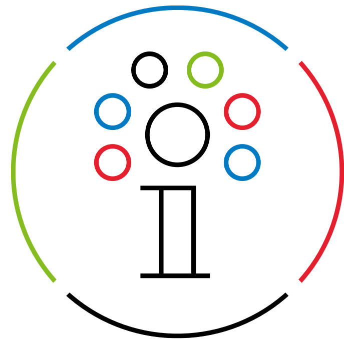
- General Law Partnerships
- Tax Law Partnerships
- Limited Partnerships
- Discretionary Trusts
- Unit Trusts
- Private Companies (Limited by Shares)
- Companies Limited by Guarantee
- Personal Services Income rules
- Debt vs Equity Investments
- Professional firm allocations guidance from the ATO
- Offshore and Non-Common-Law Entity Types

Who are you?



a) Accountant or tax agent
b) Lawyer
c) Financial planner
d) Student
e) Other

Who are you?



a) In private practice, with experience setting up structures
b) In private practice, with <u>no</u> experience setting up structures
c) In public practice
d) Other

Choosing the right structure

- Understanding the available structures is the first steps to choosing the right structure
- After understanding the structures that are available, the next step is to choose the right structure for your business/venture/passive investments/estate planning, which is important – to ensure you achieve the client's desired goals
- In addition, it is important to understand what structural changes might be appropriate as a business grows and evolves, or where family succession planning is necessary for the next phase for the private group's existence

General Law Partnership

- Relationship between persons – natural persons or legal entities
- Carrying on a business *with a view of making a profit*
- Not a separate legal entity
- Each partner jointly and severally liable for *all* liabilities of partnership (risk to partners personal assets)
- Advantages:
  - Easy and cost efficient to set up, vary and dissolve
  - Not a tax paying entity, so losses and tax preferences flow-through to each partners in their proportionate share
- Disadvantages:
  - Limitations on size
  - New partnership where parts exit/enter (noting some ATO administrative concessions)
  - Unlimited liability (cf company structures)
  - Some tax issues dealt with at partnership level, while others at the partner level = complexity

Tax Law Partnership

- Broader definition than general law partnership – common eg. jointly held property
- Partnership is defined in s995-1(1) *ITAA97* as:
  - *(a) an association of persons (other than a limited partnership or company) carrying on business as partners or in receipt of ordinary income or statutory income joint,*
  - *(b) a limited partnership*
- If tax law only partnership, net income is allocated in accordance with each partnership interest, and the interest cannot be changed by an agreement, without formal documentation to establish a general law partnership

Taxation of partnership income and loss

- Div 5 *ITAA36* – assessing provision
- s90 *ITAA36* - Net income or loss
- s92 *ITAA36* – Partnership share of net income
- Assessable income calculated using normal principles
- Capital gains assessed to partners
- Partnership receives grossed up franked dividend – imputation is shared proportionately to each partnership share
- Deductions which are not allowable:
    - Prior year losses are not carried forward – distributed to partners
    - Salaries paid to partners assessable in hands of partners
    - Interest paid on capital assessable in hands of partners
    - Drawings by partners
    - Personal superannuation contributions

Capital Gains in Partnership

- Capital gains (or losses) amounts are determined by the partnership agreement or by partnership law (as each partner has a separate cost base for their interest) – s106-5
- Capital gains will be assessed in the partner's tax return, and if an individual taxpayer, may be eligible to use the 50% general discount
- Small business CGT concessions and other roll-over relief is available for CGT events of partnership assets
- Exit from partnership - results in the remaining partners 'acquiring' that interest in each of the partnership assets – s106-5(4)
- New partner joins – original partner will dispose of their share of the new interest, and be liable for CGT on any capital gain made, existing partners will then 'acquire' a new share in all of the partnership assets at the new cost base

Trading Stock and Depreciable Assets

Trading Stock

- Changes in partnership will result in notional disposal of trading stock (at market value) - s70-90 and s70-100
- If at least 25% is retained by the previous partners, can elect to use book value for disposal

Depreciable assets

- Change in partnership will result in deemed disposal of depreciable assets (at market value) – s40-295 and s40-300
- Balancing adjustment required
- Election available for disposal to be at current written down value

Corporate Limited Partnerships

- Liability of partnership debts of one or more partners is limited but at least one partner must bear unlimited liability for partnership debts – and is exclusively responsible for operating the business of the partners
- Not subject to regulatory rules that govern companies
- Flexibility for admission and retirement of partners
- s995-1 *ITAA97* definition of “limited partnership”:
    - (a) an association of persons (other than a company) carrying on business as partners or in receipt of ordinary income or statutory income jointly, where the liability of at least one of those persons is limited; or
    - (b) an association of persons (other than one referred to in para (a)) with legal personality separate from those persons that was formed solely for the purpose of becoming a venture capital limited partnership (VCLP), an early-stage venture capital limited partnership (ESVCLP), an Australian venture capital fund of funds (AFOF) or a venture capital management partnership (VCMP) and to carry on activities that are carried on by a body of that kind.

Corporate Limited Partnerships

- Generally meet the definition of a corporate limited partnership in s94D and be taxed as a company (s94A).
- Unlike a general law or tax partnership:
  - Tax losses cannot be deducted directly by partners – instead carried forward in partnership
  - Distributions attributable to profits/gains will be treated as dividends to partners (s94L)
  - Drawings are deemed to be dividends (s94M)
  - Change in partners does not change the continuity of partnership for tax purposes (s94S) – not CGT consequences for individual partners
- Div 7A regime applied to corporate limited partnerships (s109BB) – considered closely held if one of the following conditions are met:
  - Has less than 50 members, or
  - Entity directly or indirectly has a beneficial entitlement to at least 75% of the income or capital of the corporate limited partnership

Private Company

- A company for income tax purposes is defined in s995-1 as:
  - A body corporate, or
  - Any other unincorporated association or body of persons but does not include a partnership or non-entity joint venture
- Separate legal entity
- Company will pay tax on its taxable income at the company tax rate
- Distribute profits to shareholders as dividends, may be franked
- Has flexibility to raise fund, including through issue of shares
- Company is a "resident of Australia" (and therefore assessed on Australian and world-wide sourced income) where:
  - It is incorporated in Australia, OR
  - Not incorporated in Australia, and carried on business in Australia AND has
    - Central management and control in Australia OR
    - Voting power is controlled by shareholders who are Australian residents

Private Company

- Liability of company is limited to equity in company
- However, directors may be liable for certain liabilities – PAYGw, GST, WET, LCT, SGC – under the Director Penalty regime
- Higher set up costs and ongoing costs to meet regulatory requirements
- Allowed to consolidate for tax purposes where there is a wholly-owned group
- Company is a private company *for income tax purposes* unless it is a public company – s103A(1) *ITAA36*
- Tests for being a public company are contained in s103A(2), any one of which can be met:
  - Listed shares
  - Cooperative company (s.117)
  - Not-for-profit
  - Mutual companies/friendly societies
  - Government owned company, or
  - Subsidiary of public company

Company Losses

- Cannot distribute losses to shareholder – retained in company
- Losses may be offset against income in future, where on the following tests are met:
  - Same business test, <u>or</u>
  - Similar business test
- Tests also apply for claiming a deduction for writing-off bad debts that arose in a prior year must also satisfy the continuity of ownership or continuity of business test

Division 7A for companies

- Any payment by a private company to a shareholder or associate as dividend – s109C(1)
- Payments includes amounts paid, credit and/or transfers of property - s109C(3)
- Treat a loan by a company to a shareholder or associate as a dividend if the company makes a loan during the current income year AND the loan is not repaid in full by the lodgement day of the company for that year – s109D
- Where a company forgives a debt owed to a shareholder or associate the amount forgiven will be treated as a dividend – s109F
- Circumstances where a forgiven debt will not be treat as a dividend are in s109G
- Must have a complying loan agreement in place
- Must make minimum repayments which includes interest and the benchmark Div 7A interest rate

Company Limited by Guarantee

- Is a public company where a member’s liability is limited to the amount they contributed
- Often used by charities, NFP organisations and recreational/sporting clubs
- Cannot issue shares or pay dividends
- Otherwise, directors are subject to the same regulatory requirements as companies with shares
- Three primary types:
  - Small companies limited by guarantee
  - Companies limited by guarantee with an annual revenue <$1m
  - Companies limited by guarantee with an annual revenue >$1m
- Taxed as a public company – but access to exemptions and concessions if a registered charity

Trusts

"… A trust is an equitable obligation binding a person (who is called a trustee) to deal with property over which he [/she] has control (which is called the trust property), for the benefit of persons (who are called beneficiaries …) of whom he[/she] may himself be one, and any one of whom may enforce the obligation." A Underhill et all, *Law of trusts and trustees* (London: Butterworths, 13th ed. 1979)

- Therefore, needs to have several elements:
  - Trustee
  - Beneficiary/ies
  - Trust property
  - Equitable/fiduciary obligations on trustee for trust property to beneficit beneficiary/ies
- Not a separate legal entity – it's a relationship between trustee and beneficiaries
- Types of trusts:
  - Fixed trusts
  - Unit trusts
  - Discretionary trusts
  - Service trusts

Fixed Trusts

- Beneficiaries have a fixed interest in the assets of the trust, and fixed entitlement to income (not always the same beneficiaries)
- Beneficiaries are entitled to the 50% general discount on disposal of capital assets (if held for 12 months)
- Trust is unable to accumulate income of the trust – must be distributed per the fixed interests
- Asset protection advantages
- Land tax advantages
- Fixed trusts are unable to distribute capital or income losses to beneficiaries – the losses have to be carried forward by the trustee
- No discretion for the trustee on distributions – as beneficiaries have a fixed interest
- Fixed trusts CAN be consolidated, cf discretionary trusts which cannot

Unit Trusts

- Beneficiaries are unitholders of the trust – they have a fixed interest in income and assets of the trust
- Trustee retains discretion on how and when to distribute
- Beneficiaries and trust have access to the 50% general discount on disposal of capital assets
- Losses are trapped at trust level and can't be distributed to beneficiaries
- Less asset protection advantages compared to a discretionary trust – as unit-holders have traceable interest in the assets of the trust
- Entity types that is used to hold assets with other unrelated parties – as everyone has a fixed entitlement, as opposed to flexible/uncertain 'mere expectancies' in discretionary trusts
- Commonly used by SMSFs for joint investments, and purchase of business real property
- More units can be issued by the trustee – BUT need to consider general value-shifting rules

Discretionary Trusts

- VERY popular in private/family groups
- Trustee has flexibility over distributions, after deciding which objects of the trust are made beneficiaries and presently entitled to income/capital for the income year
- Beneficiaries don’t have an equitable or proprietary legal interest over trust property – only a ‘mere expectancy’ or right to be considered for potential distributions each year
- Access to 50% general discount on disposal of capital assets, flowing through to individuals/trusts
- There are regulatory burdens in running a discretionary trust
- Access to franking credits and loss carry forward through the Family Trust Election process
- Asset protection can be achieved, as there is no traceable interest in trust property for objects
- Income can be accumulated – trustee will have to pay tax on income retained by the trust at 47%
- Common estate planning tool
- Trust property is usually exempt from creditors in individual bankruptcy or liquidation of company
- Vesting date is set by Trust Deed or States (depending on the Deed) – usually no more than 80 years
- Discretionary trusts CANNOT be consolidated for income tax purposes, unlike fixed or unit trusts

Service Trusts

- Any type of trust that is used to provide services or other business activity support for a professional services business
- TR 2006/2
- Everest assignments and professional firm allocations guidance require careful navigation
- Not easily understood by many taxpayers (and even some advisors)
- Costs can outweigh benefits – but can be powerful adjunct to other distribution structures for private groups, especially in professional services industries
- Arrangement needs to be well-documented and the actual legal form followed closely
- Pricing of the service charges needs to be based on defensible market values, not being excessive

Taxation of Trust Income

- Division 6 (ss95-102) applies to the trust estate which means the trust property or trust fund over which the trustee has control
- If a trust exists in general law, it will be a trust estate for tax purposes
- Net income and taxable income are calculated as if the trustee is an Australian resident (s95(1)), however the trustee is only liable to pay tax on that income if conditions in s96 are met
- s97 provides that the assessable beneficiary, who is not under a legal disability, will include the share of net income of the trust to which they are presently entitled
- Trustee will be liable where:
    - Beneficiary who is presently entitled I under a legal disability (S96)
    - No beneficiary presently entitled (s99a and s99A)
- Trust income can be different to taxable income due to accounting treatment vs tax laws
- If net income (tax law income) exceeds trust law income – excess assessable under Div 6 *ITAA36*
- If distributable income (trust law income) exceeds tax law income – beneficiary assessed on net income only
- BUT, note risks of getting it wrong – like s.100A

Streaming of Trust income

- Div 6E provides streaming rules, allowing beneficiaries to be distributed capital gains and franked dividends
- Amounts are excluded from net income of the trust for s95 purposes
- Assessable to the beneficiary (based on their proportion that they are presently entitled to)
- Normal assessing rules apply – individual beneficiaries are eligible for the 50% general discount on capital gains, and have access to imputation credit attached to the franked dividends

Trust Losses

- Trustee cannot distribute a trust loss to a beneficiary – s97 and s98
- Trust loss must be carried forward and offset against future trust income
- Offsetting of prior year trust losses against trust income is subject to the Trust Loss measures in Schedule F *ITAA36*
- Measures are designed to restrict the recoupment of prior and current year losses and debt deductions of trusts and to prevent the transfer of the tax benefit of those losses or deductions
- Intended to restrict the claiming of carry-forward losses and bad debt deductions where there has been a change in the ownership or control of the trust
- Where s265-5 operates, trust may:
  - Be prevented from deducting its tax losses of earlier income years
  - Have to work out in a special way its net income and tax loss
  - Be prevented from deducting certain amounts in respect of debts incurred in the income year or earlier income years

Trust Anti-avoidance provisions

- Section 100A – aimed at trust reimbursement arrangements where a persons (not under a legal disability) is legitimately presently entitled to trust income, but there is a connected reimbursement agreement in place, where a 'true' recipient (or the trustee) actually benefits economically
- Referred to in the law as a reimbursement agreement – provides for the payment of money or the transfer of property to, or the provision of services or other benefits for, a person or person other than the (presently entitled) beneficiary- s100A(7)
- Agreement must have <u>a purpose</u> of securing a reduction or elimination of income tax a person would have been subject to but for the agreement - s100A(8)
- Unlimited period of review – meaning the Commissioner can go back however long the arrangement may have been in place

Division 7A for trusts

- Unlike company-to-company loans (exempt from Div 7A under s.109K), private company to trust loans ARE subject to Div 7A
- Payment or loan made by a private company to a shareholder or associate through an interposed entity may also be treated as a dividend – s109T
- An amount of a UPE can be a loan if the payment is considered to be the provision of financial accommodation by the ultimate beneficiary to which it is owed
- The ATO is concerned with the arrangement where a UPE is declared to a private company beneficiary, but the funds are retained by the trustee to use for the general benefit of the trust – rather than being held on behalf of the private company beneficiary (as a 'sub-trust')
- In February 2022- the ATO changed its approach to UPEs, largely ending the previous approach to sub-trusts, except where the relevant funds are held exclusively on behalf of the relevant private company under a 'real' sub-trust segregated from the trust's other funds or assets
- ATO approach to UPEs currently subject to appeal to Federal Court, after taxpayer success in Tribunal in *Bendel and Commissioner of Taxation* [2023] AATA 3074

Personal Service business/Income Rules

- Need to consider whether any business entity may be carrying on a personal services business, where income is mostly (>50%) earned from the personal skills/efforts of individual
- If so, income from that personal services income will be attributed to the individual providing those personal services
- Various tests apply to see if the rules apply to a business
  - 80% threshold for source of income) and
  - Results test (paid for results, using tools/equipment and reparation payable for defects)
  - Unrelated clients (2 or more) test
  - Employment test (at least 20% of principal work carried out by employees, not controller)
  - Business premises test (solely used for generating PSI, excluding home, etc)
- Note: Special risks for working through an agency on behalf of multiple unrelated clients, as the agency can thus be the single source of income

Debt v Equity

- Variety of ways to invest in companies – some which are debt-like (interest deductible, pre-tax) and some equity-like (profits distributed post-tax)
- Equity interest – defined in s974-70 *ITAA97*
  - Payments made will not be allowed as a deduction even though they may have been deductible under common law – s26-26, and
  - Payments made will constitute a frankable distribution by virtue of s202-40
- Debt interest – defined in s974-15 *ITAA97*
  - Payments made under that interest will qualify as a debt deduction for other provisions of the ITAA, in particular the thin capitalisation provisions
- An interest that would otherwise qualify as both a debt interest and an equity interest is treated only as a debt interest
- Important for several tax purposes including:
  - Thin capitalisation methods
  - Consolidation measures
  - Whether withholding tax is required

Employer obligations

- Across all entities, you need to consider the following (non-exhaustive list) if you intend to employ through the structure:
  - PAYG withholding
  - Superannuation Guarantee
  - Provisions for leave
  - Employee vs contractor
  - FBT – if benefits are being provided
  - Payroll tax
  - DPNs for not paying SG or PAYGw
  - Workers’ compensation
  - Lodging TPAR’s
  - Offering Employees Share Schemes
  - Redundancy and termination

Non Common Law Entities

- There are many legal structures created under foreign laws that don't fit neatly within Australian tax law categories
- These are especially frequent in civil law countries and foreign jurisdictions that were previously known as tax havens or bank or corporate secrecy countries (now labelled 'offshore financial centres'):
- Some of these entity types may have characteristics similar to partnerships, trusts of companies or a combination of more than one
- Care needs to be taken in dealing with such entities, as making assumptions about their Australian tax treatment can lead to conflicts treatment or errors in tax consequences
- Names include stifftungs, stichtings, anstalts, fondations, etablissements, segregated cell companies, protected cell companies, etc – none of which have exact parallels in Australian law

Questions?

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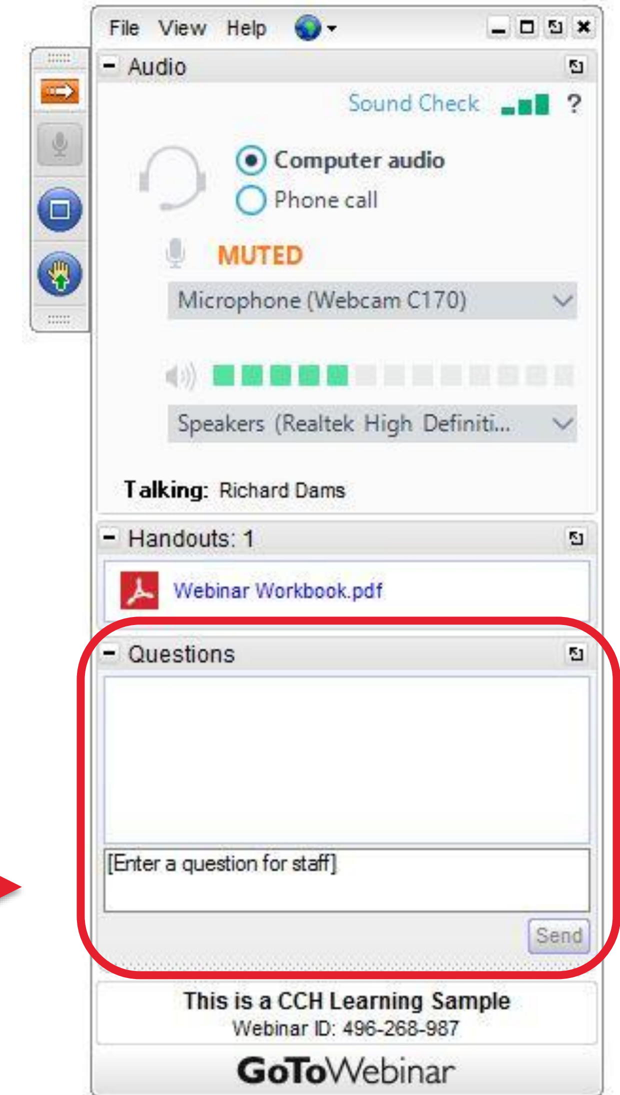

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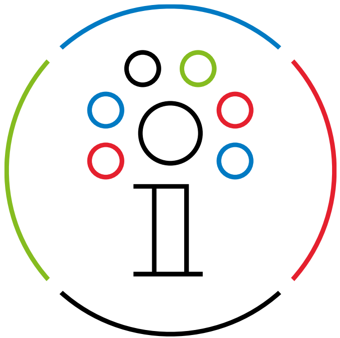

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- 19 March – Turbo-Boost Performance through High-Quality Feedback
- 19 March – Tax Technical Update – March 2024
- 20 March – FBT 2024 – Car Parking Essentials for Success
- 26 March – AML Phase 2: What we've learnt from New Zealand and the International Market and how to Prepare
- 26 March – Initial Meeting to Profitable Client

Questions?

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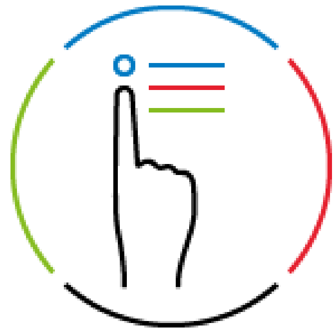

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