COOPER GRACE WARD
LAWYERS

Effective Structuring – Protecting Your Assets

Presented to GPS Wealth

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1. INTRODUCTION

The topic of this paper is 'effective structuring – protecting your assets'. As I understand my brief, the purpose of the session is to consider tax-effective structuring options and the implications that commonly used tax planning strategies and structures have in an asset protection context.

There are a number of factors advisers need to consider when advising clients on appropriate structures they should use for operating businesses and holding assets and there is often a degree of tension between competing objectives.

In my experience, the main facets that have to be considered are as follows:

- Most clients express a preference for simplicity but unfortunately simple structures often do not provide the best tax or asset protection outcomes.
- All clients are interested in establishing a structure that provides reasonable tax minimisation benefits.
- It is also important to be conscious of protecting non-business assets and accumulated profits from claims against the business entity and directors.
- While it is not often 'front of mind' when establishing new structures, it is important to have an eye on the problems that can arise if the clients or family members, die or are involved in family law disputes.

The issues and objectives will also often be different depending upon whether clients are establishing structures to undertake active trading activities or merely want a 'safe' investment structure.

In the paper I will endeavour to initially provide an overview of advantages and disadvantages of alternative structures that are typically used and some high level asset protection issues.

For the balance of the paper, I will look at a number of specific tax and asset protection strategies and issues which have come up in our practice.

2. BALANCING TAX AND RISK ISSUES

Importance of identifying relevant risk and getting it right from the start

A challenge facing advisers is that, when establishing a business, clients anticipate that their business will be successful and they tend not to focus on the risk and asset protection problems that may arise in the future.

Problems also arise where a business has been successful but the clients have allowed assets to build up in the business entity and then need to restructure in order to quarantine some of those accrued assets from the ongoing risk of the business.

The cost of restructuring a mature business can be substantial and there is also a risk that a restructure designed to provide asset protection may be ineffective if the claw back provisions in the *Bankruptcy Act* or *Corporations Act* apply.

It is also important to appreciate what risk we are talking about. Most clients will need external finance to fund their business. Except for very substantial clients, external financiers will generally require collateral securities and guarantees so that all assets connected with the business (and generally private assets as well) are held as security.

Therefore, the choice of a business structure will not have a lot of impact on the extent to which the clients' assets are exposed to claims by their financiers.

However, an appropriate structure can reduce the risk of the key business assets and private assets from being exposed to claims by unsecured creditors and contingent claims – for example large damages claims arising from contractual disputes or negligence actions.

Use of multiple entities

As a general statement, clients should, wherever possible, avoid holding personal or passive investment assets in the same entity that carries on their business.

This does not necessarily have to involve overly complex structures or major costs – particularly if the asset protection issues are considered at the outset.

For example, a husband and wife who operate a business with some risk potential might choose to:

- acquire their home in the name of the wife or husband – but not jointly;
- hold investment assets in a discretionary trust;
- operate the business through a trading company and have a single director who is not the spouse who owns the family home.

Where possible it is also desirable to separate valuable business assets from the risks associated with the trading operations.

For example, where there are intellectual property assets that contribute substantially to the value of the business, it is common to hold the intellectual property in one entity and for that entity to grant a licence to the operating entity to use the intellectual property.

Utilising separate business structures can be particularly important for clients involved in property development.

A common strategy for these clients is to establish a holding company in which shares are held by individual clients (or a family trust) and then to establish a separate wholly owned subsidiary to carry out each project. As each project is completed, the project subsidiary is wound up and surplus profits are paid down as dividends to the holding company.

This protects against latent risk issues with prior projects impacting on the value of future projects and the holding company.

3. COMMON STRUCTURES

It is a little trite to say, but the structures commonly used for holding investment assets and operating businesses are generally:

- sole trader;
- partnership (of individuals or possibly a mix of individuals and trusts);
- trust (unit, discretionary or hybrid);
- company;
- limited partnerships.

When considering the implications of trust structures in this paper I will largely confine the discussion to issues with discretionary trusts rather than unit trusts.

Companies

Since the introduction of the capital gains provisions in 1985, it is generally accepted that a company is not the best entity to acquire capital assets which are likely to appreciate in value because companies cannot claim the 50% general discount under division 115 of the 1997 Tax Act.

However, notwithstanding that goodwill owned by a company cannot attract the 50% general discount, more and more clients are electing to carry on business operations in a trading company rather than a trust or partnership structure because of the increasing complexity of compliance issues in relation to Division 7A.

A company can still provide reasonably attractive CGT outcomes for clients who are able to access the small business CGT concessions when selling the business assets or shares.

The main advantages of using a corporate structure as opposed to trusts and partnerships are as follows:

- A company can retain and reinvest profits in the business without any undistributed profits issues and without having to deal with Division 7A.

- Capping the initial tax on business profits at the company tax rate generally is an attractive outcome for most clients (who often forget that the build-up of retained profits will require payment of top-up tax at some time in the future).

- A company obviously offers limited liability but similar outcomes can be achieved utilising a trust structure with a corporate trustee.

- For professional practices and similar businesses, operating through a company structure better facilitates entries and exits of stakeholders as some CGT concessions will generally apply on sales of shares in the entity and share transfers are not subject to duty (assuming the company is not land rich).

Trusts

Contrary to articles that regularly appear in the financial press, the main advantages of utilising a trust structure have little to do with tax outcomes. All of the net income of a trust in each year has to be distributed to beneficiaries or the trustee will pay tax at the top marginal rate.

Generally speaking, the beneficiaries who receive trust distributions will pay a reasonable amount of tax (often capped at 30% by utilising a corporate beneficiary).

The main advantage of a trust structure (either in a business or investment context) is the flexibility that it provides. The controllers of the trust have total flexibility in relation to how they distribute income and capital on a year to year basis and on termination of the trust. This allows clients to deal with changing circumstances and fluctuating marginal tax rates within the family group over time.

Also, a trading trust will generally allow clients to access all available CGT concessions if a capital gain is generated on sale of assets (subject to ensuring there is a CGT concession stakeholder in the year of disposal).

Provided there is a corporate trustee, the parties have much the same limited liability as if they used a trading company structure.

A substantial advantage of holding assets in a discretionary trust in particular is that none of the beneficiaries have a specific interest in the trust assets which provides substantial protection in the event of a claim against beneficiaries.

The main disadvantages of a trust structure are the need to distribute all income on an annual basis to avoid the trustee being assessed under section 99A of the 1936 Tax Act. This means that unpaid present entitlements (UPEs) can build up over time which can be problematic if the beneficiaries happen to be children of the controllers or the beneficiary who has a large UPE owing to them is an 'at risk' person who is subject to claims from external creditors etc.

Part of an effective ongoing asset protection strategy is to carefully monitor the level of UPEs owing to beneficiaries of a trust and to take steps on a regular basis to reduce or eliminate these.

A major issue for clients whose trust distributes excess income to a corporate beneficiary is to deal with the requirements of Division 7A in terms of unpaid UPEs or loans from the corporate beneficiary back to the trust. The complexity of these compliance requirements and the risk of inadvertently triggering a deemed unfranked dividend has resulted in many clients moving from a trust to a corporate structure.

Partnership

Most partnerships of individuals generally tend to be arrangements between couples who operate a small business or own investment properties, or 'legacy partnerships' of professional practices which were originally established when the law required that all of the partners must be individuals and which have elected not to restructure (primarily for tax and duty reasons).

Where arm's length parties operate in a partnership structure, this will often be a partnership of corporate or trustee entities rather than individuals and the primary driver for utilising a partnership structure (rather than a single trust or company) is often to ensure that the individual stakeholders can retain access to small business CGT concessions on disposal of their interest.

A partnership of individuals does not provide any particular tax benefits or flexibility and is problematic from an asset protection perspective. For clients in those situations, the focus from an asset protection strategy is to ensure that, as far as possible, all non-business assets (and even hard assets used in the business) should be held in other entities to quarantine those assets from risks associated with the business.

It is now quite common to have partnerships where all or some of the partners are trustee entities. These structures do provide some ability to secure asset protection via limited liability if corporate trustees are used. However, there are some special issues with partnerships of trusts – particularly with professional practices as highlighted by the recent Tax Alert TA 2013/3 and ongoing audit activities of the ATO in relation to professional practices.

Limited partnership

Since limited partnerships are now taxed as companies they have tended to be used in only special circumstances as there is no material difference in tax outcomes between a company and a limited partnership and financiers and third parties are generally more comfortable in dealing with a company rather than a limited partnership.

4. USE OF TRUSTS FOR ASSET PROTECTION

Advantage of discretionary trusts

Accumulating assets in a discretionary trust is an effective asset protection strategy.

The attraction of a discretionary trust is that no beneficiary has a defined interest in the trust assets but merely a right to have the trust administered in accordance with its terms[1]. Therefore, if a beneficiary becomes bankrupt, the assets in the trust will be protected from claims by a trustee in bankruptcy.

[1] *Gartside v Inland Revenue Commissioners* [1968] AC 553, *Kennon v Spry* [2008] HCA 56 (paragraph 77)

The level of protection afforded by a discretionary trust is substantially less in matrimonial property claims if the client has real control over the trustee. There are numerous cases where the Family Court has made orders in respect of assets in trusts or treated those assets as a financial resource of a party to the marriage[2].

There was a lot of conjecture after the decisions in *ASIC: In the matter of Richstar Enterprises Pty Ltd v Carey No 6*[3] and *Kennon v Spry*[4] as to whether these decisions significantly eroded the extent to which assets held in discretionary trusts are protected against claims in the event of insolvency or in matrimonial property disputes.

In my view, the potential negative impact of the decisions has been overstated.

Richstar

The case involved an application by the ASIC to freeze assets held by trustees of discretionary trusts which the ASIC alleged were controlled by officers of the failed Westpoint group.

Section 1323 of the *Corporations Act* provides that the court can make orders effectively freezing assets of a person under investigation by the ASIC and 'money, financial products and other property' held by a third party 'on behalf of' the person under investigation.

The term 'property' is defined in section 9 of the *Corporations Act* as meaning 'any legal or equitable estate or interest (whether present or future and whether vested or contingent) in real or personal property of any description …'.

The Court referred to the decision in *FCT v Vegners*[5] in which Gummow said:

> … a power exercisable in favour of an person including the donee of the power would be a general power and thus would be tantamount to ownership of the property concerned, whilst the objects of a special power would be limited to some class, and the objects of a hybrid power would be such that the donee might appoint to anyone except designated classes or groups.[6]

The Court went on to say that:

> At least by analogy it may be observed that a beneficiary who effectively controls the trustee of a discretionary trust may have what approaches a general power and thus a proprietary interest in the income and corpus of the trust.[7]

French J went on to grant the freeze orders over assets of several discretionary trusts.

Initially there was concern that this decision might mean that assets in discretionary trusts would be susceptible to claims against beneficiaries who were declared bankrupt. However, as a result of subsequent developments, those concerns have largely abated and, in my view, the *Richstar* decision will be seen as something of an aberration. There are several reasons for this view.

Firstly, the concept of 'divisible property' under the *Bankruptcy Act* is substantially different to the definition of 'property' in section 9 of the *Corporations Act*.

There have also been several cases decided since *Richstar*, where the courts have 'watered down' the notion that a beneficiary of a discretionary trust has an interest that should be characterised as 'property'.

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[2] *Ashton and Ashton* (1986) 11 Fam LR 457; *Goodwin and Goodwin* (1991) FLC 92-192; *Kelly and Kelly* (No. 2) (1981) FLC 91-108
[3] [2006] FCA 814
[4] [2008] HCA 56
[5] (1990) ALR 547
[6] Ibid at 552
[7] Richstar at 10

In *Lygon Nominees Pty Ltd v Commissioner of Stamp Duties (Vic)*[8], Redlich JA held that:

> The nature of a discretionary beneficiary's interest under a discretionary trust as a consequence of the object's rights to have the trust properly administered, does not confer the required proprietary interest. [9]

In *Kawaski (Australia) Pty Ltd v ARC Strang Pty Ltd*[10], the Federal Court made the following comment in relation to the *Richstar* decision:

> Neither the right to due administration of the trust nor the fiduciary obligations owed by the trustee is capable of making the object of a power of appointment into a 'beneficial owner' of the subject matter of the trust.
>
> There is nothing in the reasoning of French J (in Richstar)… which doubts these principles …[11]

In *Public Trustee v Smith*[12] the Court had to consider the assets held in a trust had been effectively gifted by virtue of provisions in a Will of a person who was a beneficiary of the trust. In considering that application White J made a number of observations in relation to the *Richstar* decision. In particular he noted that[13]:

> *Richstar* did not 'establish that because a beneficiary of a discretionary trust controls the appointment or removal of the trustee, or controls the exercise of the trustees' powers and can appoint trust property to himself or herself, that the holder of such a power is the beneficial owner of the trust property irrespective of the terms of the trust deed.

Kennon v Spry

The first point which should be made in relation to the this decision is that it related to a family law dispute with somewhat unusual facts. The facts can be summarised as follows.

Dr Spry had settled property on a trust of which he was the settler and the initial trustee. Beneficiaries of the trust included Dr Spry, his children and his spouse.

In 1983 Dr Spry varied the trust by removing himself as a beneficiary. He and his wife separated in October 2001 and in January 2002 he established trusts in favour of his four children and purported to apply the capital and income of the original trust in favour of the four trusts established for his children.

Mrs Spry obtained an order from the Family Court requiring Dr Spry to pay her approximately $2 million. In determining that quantum the Court considered that the assets in the trust should be regarded as property of the parties of the marriage.

This decision was appealed ultimately to the High Court which handed down its decision in December 2008. The Court dismissed the appeal of Dr Spry against the Family Court order by 4-1 majority.

The reasoning of the majority differed in some respects but a careful analysis of the decisions of the majority does not, in my opinion, warrant the level of concern that has been expressed since this decision was handed down – at least in relation to the implications of the decision in non-family law cases. There are a number of reasons for this.

Firstly, the original order of the Family Court did not direct the trustee of the trust to deal in any way with the assets in that trust. The Court ordered that Dr Spry had to pay a certain amount to his wife and the assets in the trust were taken into account in determining the appropriate amount he should pay.

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8 2007 ATC 4,643
9 Ibid at 4,644
10 [2008] FCA 461
11 Ibid at paragraphs 74 and 75
12 [2008] NSWSC 397
13 Ibid at paragraph 138

In fact one of the grounds that the Family Court relied on (in the alternative) was that the assets in the trust constituted a 'financial resource' for the benefit of Dr Spry and therefore that those assets should be taken into account in determining the amount payable under the property order.

The ability of the Court to take into account financial resources that do not actually comprise property of the parties to the marriage has been in the *Family Law Act* since its inception[14] and to that extent is not controversial.

Also, a careful reading of the judgment does not disclose any statement by any of the majority to the effect that the assets in the trust were the 'property' of Dr Spry for general trust law or other legal purposes.

The position of the Court can best be summarised by the conclusion of French CJ where he said that 'the assets of the Trust, coupled with Dr Spry's power to appoint them to his wife and her right to due consideration, were,…the property of the parties to the marriage for the purposes of S 79'.[15]

The 'right to due consideration' that French CJ referred to was the 'equitable right to due administration of the Trust fund' of Mrs Spry which French CJ considered 'could be taken into account as part of the property of Mrs Spry as a party to the marriage.

Importantly in that passage French CJ acknowledged that 'it is difficult to put a value on…these rights though a valuation might not be beyond the actuarial arts in relation to the right to due consideration'.

Insofar as the Court considered that the right of a contingent beneficiary to due administration of the trust was 'property' within the context of that expression when used in section 79 of the *Family Law Act*, there is nothing particularly controversial about the outcome.

In their joint judgment Gummow and Hayne specifically noted that the order of the Family Court did not earmark any particular asset of the husband or the trust nor require the trustee to deal with the assets in a particular way. As a consequence the order did not directly impact on the rights or obligations of any third party.[16]

Post *Kennon v Spry*

There have been a number of cases since *Kennon v Spry* which have held that, assets in a discretionary trust should not be included in the pool of matrimonial assets unless a spouse has effective control of the trust.[17]

In *Leader & Martin* the court considered that the principles in *Kennon v Spry* would not be applicable where a wife was merely an eligible beneficiary of a trust established by her parents and the trust was controlled by other family members.[18]

In *Harris & Harris* the court similarly found that a husband did not control a trust of which he was a beneficiary and therefore, the assets of the trust were not included in the matrimonial pool. The following extract from the judgement is relevant.

> 64. In seeking to uphold his Honour's decision to include the assets of the Trust in the assets of the husband, Counsel for the wife has sought to rely on the observations of French CJ in *Kennon v Spry* [2008] HCA 56; (2008) 238 CLR 366 at 387-389 [52]- [57] that the term 'property' when used in s 79 of the Act should be given a wide meaning. However in that decision French CJ also said:
>
> > 77. The beneficiary of a non-exhaustive discretionary trust who does not control the trustee directly or indirectly has a right to due consideration and to due administration of the trust but it is difficult to value those rights when the beneficiary has no present entitlement and may never have any entitlement to any part of the income or capital of the trust.

[14] Section 75(2)
[15] paragraph 81
[16] paragraph 136
[17] *Leader & Martin Leader (No 2)* [2009] FAMCA 979, *Harris & Harris* [2011] FamCAFC 245, *Morton & Morton* [2012] FamCA 30
[18] *Leader v Martin Leader (No 2)* [2009] FAMCA 979

> 65. In the present case and on the basis of the material before us the husband appears to be no more than such a beneficiary of such a trust. He is not the appointor of the Trust nor does he hold any position in the current trustee company. On the assumption that by the use of the word 'directly', the Chief Justice was referring to the strict legal position, it therefore cannot be said that the husband 'directly' controls the current trustee. Nor could it be said that he 'directly' controlled the previous trustee.
> 66. On the assumption that the reference by the Chief Justice to 'indirect' control of a discretionary trust by a beneficiary was a reference to a 'puppet' situation, in the sense that the person with legal control of the trust is a puppet of the beneficiary, that could be the situation in the present case. In the sense, that is, of the mother (who is the appointor of the Trust, and one of the three directors of the trustee company holding two shares in that company with each of the other two directors holding one share each) being the puppet of the husband. This, as was made clear by Counsel's oral submissions to us, has always been the wife's case.
> 67. The difficulty, however, for the wife on this appeal is to be able to point to any evidence which would support a finding that the husband's mother is his puppet, and that it is through her, or perhaps otherwise, that he exercises de facto control of the trustee company and of the Trust.

In *Morton & Morton*, the husband and his brother jointly controlled a discretionary trust but the wife argued that the husband had de facto control of the trust and that the trust assets should be regarded as assets of the husband. Bell J determined that:

> …. there is not sufficient evidence before me to convince me that the Husband has that sufficient control over the entities to which I have referred, to make me believe that they are in fact his property.[19]

However, in such circumstances, the assets in the trust might still be taken into account as a financial resource of the wife.

Some practical measures

While, these court decisions have not seriously eroded the asset protection benefits of discretionary trusts, they do highlight some practical steps that could be considered to strengthen the level of protection for assets held in discretionary trusts.

For example, it may be prudent to exclude the trustee from being a beneficiary. Quite apart from asset protection issues, including the trustee as an eligible beneficiary can trigger stamp duty risks in some situations.[20]

If the at risk client does not have any effective control of a trust and is not a beneficiary, there are very strong arguments that the assets in the trust will not be treated as the property of that person, even in the family law context. Therefore, you need to ask the question whether 'at risk' clients should have any role in relation to the trust (for example, as director, trustee or appointor).

Also, individual clients should not act as trustees of a trading trust.

What many clients overlook is that the trustees are personally liable for debts incurred in their capacity as trustee[21]. Therefore, personal assets of individual trustees are exposed to all risks associated with the business activities of the trust.

Therefore, our view is that it is almost always preferable to have a corporate trustee when establishing a trading trust.

[19] Paragraph 38
[20] Section 167(3) – *Duties Act 2001 (Qld);* Section 54, *Duties Act 1997 (NSW)*
[21] *Halsbury's Laws of Australia*, para 430 –3720.

5. SECTION 100A RESURRECTED

Section 100A of the 1936 Tax Act is something of a 'sleeper provision'. It was introduced as an anti-avoidance measure in 1983 to counter trust stripping schemes that were common at the time but is capable of having much wider application.

The section has rarely been used by the ATO and has been considered in only a small number of cases[22].

However, the ATO is looking more closely at the potential for section 100A to apply to some trust distribution arrangements where the amount distributed is not actually paid out by the trustee or is made in favour of a corporate beneficiary in which the trustee has an interest..

The provisions may apply if a beneficiary of a trust becomes presently entitled to trust income as a result of a 'reimbursement agreement' and the arrangement is not consistent with 'ordinary family or commercial dealing'.

If section 100A applies, the distribution is disregarded and the trustee will be assessed on the amount covered by the reimbursement agreement at the top marginal rate.

A reimbursement agreement is essentially one where, at the time the distribution is made, there is an agreement or understanding in place that someone other than the beneficiary will effectively receive the benefit of the distribution.

In order for the section to apply, parties involved in the arrangement have a tax avoidance purpose and there is an exemption where the arrangement involves ordinary family or commercial dealings.

On 2 July 2014, the ATO issued a fact sheet in relation to some circumstances where section 100A may be applied. This can be accessed on the ATO website.

As is often the case with ATO fact sheets and guidelines, the document actually provides little practical guidance but the following points should be noted:

- If a trustee distributes to one beneficiary and does not 'cash flow' the distribution but instead, lends the amount to another party, this may attract section 100A because a person other than the beneficiary benefits from the distribution.

- Arrangements where a trustee distributes to a corporate beneficiary in which the trustee is a significant (or the sole) shareholder will be at risk.

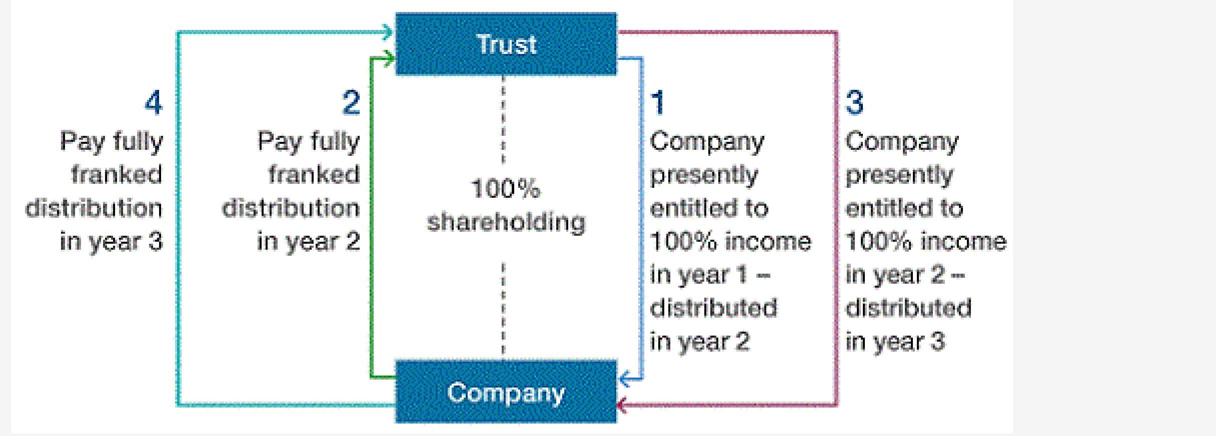
- Distributions to corporate (or other) beneficiaries which are reinvested in the trust under a UPE agreement will not attract the application of section 100A.

- Arrangements where trust distributions are made to some beneficiaries who forgive the UPE or assign the benefit of the UPE to another related party within a short time of the distribution being made might be at risk.

Our view is that arrangements where a trust is distributing to a corporate beneficiary in which the trustee holds all or some of the shares is a very high risk strategy, particularly if the corporate beneficiary recycles the distribution by declaring a dividend back to the trust (e.g. to satisfy the minimum repayment requirements under Division 7A).

This 'income recycling' strategy is illustrated in the following diagram that appears on the Fact Sheet.

[22] *East Finchley Pty Ltd v FCT* 89 ATC 5280 and *FCT v Prestige Motors Pty Ltd* 98 ATC 4241



All that needs to be done to avoid the section 100A risk is for the shares in the corporate beneficiary to be held by a different trust from the one which is making the distribution.

Clients who have been distributing to a corporate beneficiary which is effectively a 'subsidiary' of the distributing trust in the past should not make further distributions but rather establish a new corporate beneficiary with a different trust holding the shares[23].

6. PARTNERSHIPS AND TRUSTS

The ATO has flagged that it has concerns about arrangements involving partnerships of trusts – mainly when used by professional practices.

The main areas of concern appear to be whether:

- it is possible to have a partnership of trusts;
- a person can be a partner in their own right and also hold an interest in a partnership as a trustee;
- it is possible to have a partnership of trusts where all of the trusts have the same trustee.

In March 2009, Mark Konza (ATO deputy commissioner) indicated that 'it might be questionable whether a trust is capable or actually involved in, the 'carrying on a business in common with a view to profit' as required under the various state partnership acts.

I am aware of audits where the ATO has questioned whether an arrangement where a party is a partner in a partnership in different capacities (e.g. in their own right and as trustee for a trust) is effective.

However, it is difficult to see any substantive basis for the ATO concerns in this area and their arguments are confusing to say the least and are inconsistent with the decision in *Everett*[24] where the High Court had no difficulty in accepting a situation where a partner retained some of their interest in the partnership in their own right and held the assigned portion on trust for the assignee under the Everett assignment.

The area where there is considerable uncertainty is where a business is carried on by an entity (usually a company) as trustee of several different trusts and the clients treat this as a 'partnership of trusts'.

[23] *Idlecroft Pty Ltd v FCT* (2005) ATC 4647
[24] [1980] HCA 6

What is clear is that this structure does not actually qualify as a 'partnership' as the definition of partnership in the tax legislation requires that there must be 'an association of **persons**'.[25] If there is only one legal entity (a company) then there is not an association of 'persons'.

While each trust estate is a separate entity for the purposes of the tax legislation[26], the requirement in the act is that there is an association of persons, not an association of entities.

In *Fagenblat v Feingold Partners Pty Ltd* [27] the court was prepared to allow litigation to proceed on the basis that a legal practice was carried on by a partnership or trusts where each trust had the same trustee.

There are also instances where the ATO has accepted an arrangement involving a 'partnership' of trusts with the same trustee in the past[28] but it appears likely that they will challenge such arrangements – particularly where the structure involves professional practices.

Irrespective of whether a grouping of trust estates with a single trustee qualifies as a partnership, it is difficult to see that this will result in any materially different outcome from an income tax or capital gains perspective. Even if there is not a partnership, the operation of the tax acts will still result in each trust estate deriving a share of practice income and any capital gain as each trust estate is a tax 'entity'.

The problem for businesses structured in this way if they are audited is that, if the company that acts as trustee of several trusts has registered as a 'partnership', the ATO may argue that the incorrect entity has been registered and GST has not been properly accounted for.

7. NOMINEE ENTITY HOLDING ASSETS

It is quite common for a partnership or investment syndicate to have the legal title held by an entity as nominee.

This structure is commonly used with property syndicates to avoid the inconvenience of having to get individual partners or owners signing documentation, etc. It is mandatory for managed investment schemes.

The objective of partnerships that appoint a nominee to hold partnership property is usually so that there is a single legal entity that deals with third parties.

In most cases the parties consider they are operating as a partnership for tax purposes.

In the past, the ATO appeared to accept in these situations that there was a partnership between joint owners of investment property notwithstanding that the legal title was registered in the name of a nominee. For example, are a number of authorities where the courts (and the ATO) appear to have accepted that there can be a partnership for tax law purposes even though the investment property is held in the name of a nominee entity [29].

However, the current view of the ATO (as set out in in *TD 2005/28)* is that where the real estate is held by the responsible entity, and not by the investors or syndicate members directly, it is held on trust…. The assessable income and allowable deductions of the… syndicate compose the net income of the trust estate for the purposes of division 6'[30].

[25] 995-1(1)
[26] Section 960-100
[27] [2001] VSC 479.
[28] ATO *ID 2005/43* (since withdrawn).
[29] *A.R.M. Constructions Pty Ltd -v- FCT*, 87 ATC 4790 and *Ryvitch -v- FCT* 2001 ATC 4403
[30] para 6

The ATO's response to the recent case of *Colonial First State Investments Ltd v C of T*[31] is also a strong indication that in most cases the ATO will consider that nominee companies hold their assets on a separate trust estate.

Also, PS LA 2000/2 has recently been amended to make it clear that any exemption from furnishing an income tax return does not mean that the trust estate is ignored implying that where there are losses these will be trapped in the trust estate.

The case of *Wynnum Holdings No 1 Pty Ltd & Anor V FC of T* [32] illustrates the problems that can arise where a nominee entity holds assets on behalf of a partnership or syndicate of investors. It involved a situation where a group of investors formed a syndicate to develop a retirement village and established a company to hold the real estate as a nominee for the syndicate members.

The nominee entity made a claim for input tax credits in relation to the acquisition and development costs of the retirement village but the AAT held that the nominee was not carrying on an enterprise and therefore was not entitled to claim input tax credits. It was the syndicate that was carrying on the enterprise and the parties had failed to register the correct entity for GST purposes.

There are some practical steps that clients can take to try to ensure that arrangements where a nominee holds property for a partnership or syndicate are not treated as a separate trust estate.

- The agreement should expressly state that the individual partners or investors are beneficially entitled to the assets as tenants in common and that the assets are held in the name of the nominee for convenience only.
- The documents should provide that the nominee is required to act in accordance with the directions of the partners/syndicate.
- All decisions should be made by the partners/investors, as opposed to the directors of the nominee company.
- The terms of the nominee agreement should make it clear that the nominee can issue tax invoices and make creditable acquisitions as agent for the partnership/syndicate in accordance with sub-division 152-B of the GST Act.
- All income should be deposited to a bank account in the name of the partnership/syndicate and similarly all expenses should be paid from that account.

8. PROTECTING RETAINED EARNINGS IN COMPANIES

A common problem where clients operate their business through a company is that they build up significant assets in the entity which carries on the business, which means the retained earnings and assets will be continually exposed to that business risk.

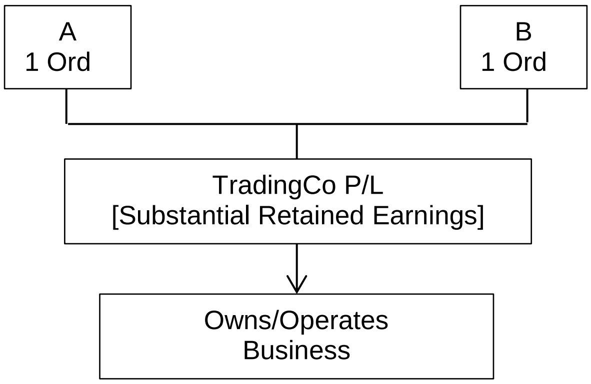
There are a number of strategies that can be used to address this problem.

A common strategy is to interpose a holding company between the existing shareholders and the operating company utilising the capital gains tax rollover relief available under subdivision 122-A or subdivision 124-G of the 1997 Tax Act.

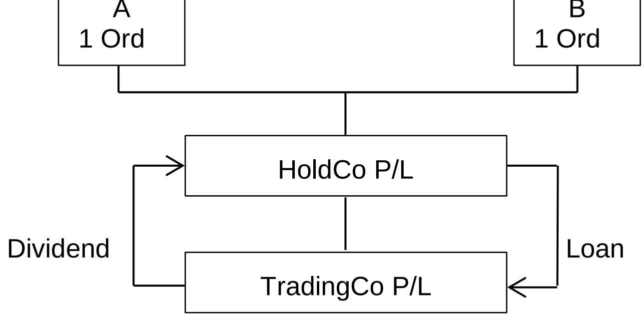
[31] [2011] FCA 16
[32] [2012]AATA 616

This strategy is illustrated in the following diagrams.

Before



After



While the strategy of interposing HoldCo and declaring dividends from TradingCo to HoldCo which ends the funds back to TradingCo may be provide asset protection benefits, this strategy may also result in significant adverse consequences for clients who would otherwise be able to access the small business CGT concessions.

If the structure in the second diagram is adopted each of A and B would be able to claim the small business CGT concessions if they sell the shares in HoldCo provided that at least 80% of the market value of HoldCo's assets are 'active assets'[33].

There is a potential problem if the loans that HoldCo makes back to TradingCo exceed 20% of the market value of all assets in HoldCo. In the example the only assets that HoldCo will actually have will be its shares in TradingCo and the loans advanced to TradingCo. Therefore over time it would be relatively easy for this 20% threshold to be tripped.

The issue if that occurs is whether those loans will be 'active assets' and this could be problematical. The loans from HoldCo to TradingCo will be 'financial instruments'. In order for these to qualify as active assets it is necessary that they are 'inherently connected with a business' carried on by HoldCo[34].

There are arguments that HoldCo is carrying on a business and that loans made by HoldCo to TradingCo (being its subsidiary) will be assets inherently connected with that business and therefore active assets.

[33] Section 152-40(3)
[34] Section 152-40(3)(b)(ii)

- In *American Leaf Blending Co Sdn Bhd v Director-General of Inland Revenue*[35], Lord Diplock stated that

  > in the case of a company incorporated for the purpose of making profits for its shareholders any gainful use to which it puts any of assets prima facie amounts to the carrying on of a business…. The carrying on of 'business' no doubt, usually calls for some activity on the part of whoever carries it on, though, depending on the nature of the business, the activity may be intermittent with long intervals of quiescence in between[36]

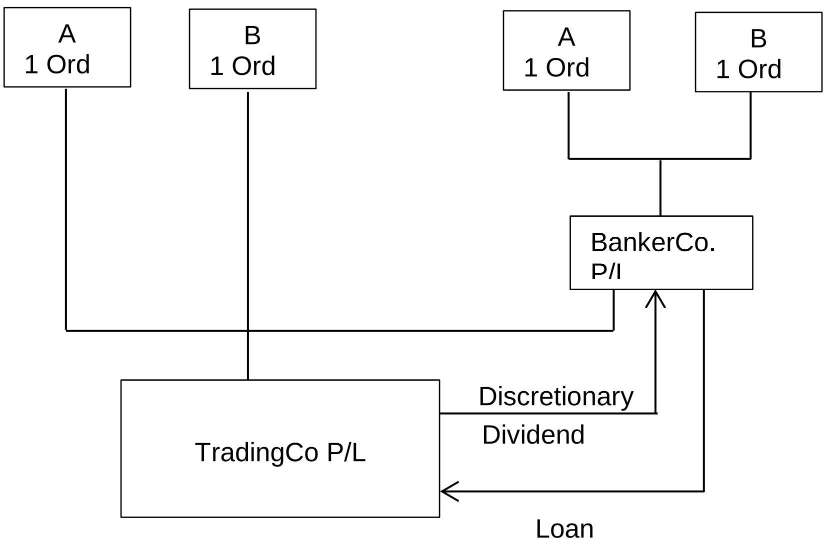
- The ATO accepted in Taxation Ruling *TR 2002/*11 (about STS average turnover), that 'the use by a company of its assets to produce profits for its shareholders pima facie amounts to the carrying on a business by the company'.

- A company can carry on the business of a holding company, even if the holding company is not involved in the active management[37].

- In Private Binding Ruling Authorisation Number 80022, the ATO accepted that a loan was inherently connected with a business that a holding company carried on as it was lent by the parent to fund stock and debtors of the subsidiary company.

While these arguments support the contention that the loans from HoldCo to TradingCo will qualify as active assets there is still some degree of uncertainty about what approach the ATO would take in particular circumstances.

We therefore generally recommend an alternative strategy which provides substantially the same asset protection advantages but removes this small business CGT risk. This alternative is to incorporate a separate company which acts as a 'banker' and for TradingCo to issue dividend access shares to BankerCo. This alternative structure is outlined in the following diagram.



Under this alternative the retained profits of TradingCo are reduced and BankerCo (which has the same equity holders as TradingCo becomes a creditor. Depending upon arrangements with bankers

[35] [1978] 3 All ER 1185
[36] Page 1188
[37] *Spassked Pty Limited v Commissioner of Taxation [*2003] FCAFC 282*, Federal Commissioner of Taxation v Total Holdings (Australia) Pty Ltd* [1979] FCA 30

and other financiers it may be possible for BankerCo to register a general security interest under the PPSA legislation so that it is a secured creditor.

The issue of dividend access shares to BankerCo should not trigger any adverse value shifting or dividend stripping consequences.

If ordinary or dividend access shares are issued to a new holding company or banker for the group, TradingCo should not pay dividends on those shares within 45 days of the issue date (or 90 days if the shares are redeemable preference shares).

If dividends are paid within the relevant holding period, the recipient may not get the benefit of the franking credits attaching to those dividends because this payment will breach the '45-day holding period' requirements which must be satisfied in order for a shareholder to claim franking credits on shares.

These holding period provisions were contained in former sections 160 APHC to 160 APHU of the *1936 Tax Act*. The provisions were repealed when the dividend imputation measures were moved to Part 3–6 of the *1997 Tax Act.*

While new holding rule provisions have not yet been legislated but the government announced at the time that legislation would be inserted into the *1997 Tax Act* to confirm the holding rule requirements and that this legislation will have effect from 1 July 2002[38].

9. BUSINESS LICENSING – MOVING THE RISK AWAY FROM THE ASSETS

Is it possible to grant a licence to use goodwill?

A problem faced by many clients who have built up a successful business is that their current structure may no longer suitable but the cost of transferring business assets to a more appropriate structure is prohibitive.

This is common with clients who have a partnership or discretionary trust structure but would prefer to trade through a company for various reasons (including the lower corporate tax rate and difficulties in dealing with Division 7A issues).

These structures also have risk issues because the goodwill and other valuable assets in the business remain exposed to operational risk.

One strategy that can allow clients to move the business operations into a related company without triggering any material duty or CGT consequences and to achieve significant asset protection benefits is for the entity that owns the assets to grant a licence to a related company to operate the business.

Under a typical business license arrangement:

- the existing entity grants a licence to a related company to operate the business;
- the existing entity retains ownership of the goodwill and other tangible assets; and
- the licence can be terminated on short notice.

CGT and duty implications of a business licence

The grant of a licence to operate a business will not trigger any material stamp duty implications provided the licence can be terminated at short notice[39].

The ATO accepts that it is possible to licence goodwill[40].

[38] Treasurer's press release No. 53, 13 May 2008
[39] *Roussos v. Commissioner of Stamp Duties (Tas)* 92 ATC 4370
[40] *Interpretative Decision ID 2003/517* and *Interpretative Decision ID 2004/7*

The grant of a licence to operate the business will involve the creation of contractual rights and, if a premium is paid, this would constitute capital proceeds from CGT event D1. However if no premium is payable, there should be no CGT consequences arising from the grant of the licence, as the market value substitution rule will not apply[41].

Under the *Duties Act 2001* (Qld), the grant of the licence will constitute the grant of a 'new right'[42] and transfer duty will be payable. How

The Office of State Revenue (OSR) will require a valuation of the licence.If the licence fee is commercial and the licence agreement can be terminated at short notice, the inherent value in the licence should not be great and no material duty will be payable

Asset protection implications

The asset protection consequences of licensing a business were considered in *Harrington v. Harrington Services Pty Ltd (In Liquidation)*[43].

Mr and Mrs Harrington had entered into a 'lease' of their nursing home business to their family company.

The company was subsequently placed in liquidation and the liquidator sold the bed licenses attaching to the nursing home.

Mr and Mrs Harrington argued that the company was merely the lessee of the business and that the ownership of the goodwill and the bed licenses remained with them at all times. They were successful in the action and the liquidator was required to pay the proceeds of the sale to them.

In the course of his judgement, Palmer J. indicated that he could see no reason why the owner of a business could not lease the business to another party to operate. A crucial finding was that the bed places were 'simply part of the leased goodwill of the business'.

PPSA issues

To protect the licensed assets from claims against the operating entity, the owner of the assets will need to register their security interest in respect of the licenced assets, on the Personal Property Securities Register.

If there is any intellectual property included in the licenced assets, (e.g. trademarks or designs) these will need to be registered separately by reference to their registered IP Australia Numbers

10. FAMILY TRUST ELECTIONS

Some advisers seem to recommend that clients who establish a trust should make a family trust election (FTE) as a matter of course. However, our view is that FTEs should only be made when absolutely necessary as they impose a substantial fetter on the options available to the clients to deal with changing circumstances.

The requirements to make an FTE and most of the implications of doing so are set out in the 'loss trust provisions' in Schedule 2F of the 1936 Tax Act.

The main consequence of making a FTE is that the class of beneficiaries to whom distributions can be made (without paying penalty tax) is limited and there are many circumstances where the existence of an FTE can create significant problems.

There are actually not many circumstances where it is necessary to make an FTE and our view is that the FTE should only be lodged if absolutely necessary.

[41] section 116-30(3)
[42] section 9(1)(g)
[43] [2002] NSW SC 859

The main circumstances where an FTE needs to be lodged are if:

- the trust incurs losses and there is a change of control[44] or the trustee wants to adopt variable patterns of distribution[45]; or
- the trust owns shares which will generate significant franked dividends.

In many cases where clients have a discretionary trust which incurs losses there is little danger of not being able to carry forward the losses because generally there will be no change in control of the trust because the same family members will be involved and, until the trust trades out of its losses, it is almost impossible to fail the 'pattern of distribution test'.

Therefore we find that many FTEs are lodged when there is absolutely no need to do so. However once the FTE is made it is very difficult to revoke or vary it (unless this is done within the first four years and even this is subject to some restrictions).

Our firm is currently advising a couple who have separated and are in the process of implementing a matrimonial property settlement. The parties have a trust which has lodged an FTE and which holds valuable shares in a private trading company. Their preference is to retain joint control of the trust and to continue to work together in the business.

The problem is that the test individual under the FTE is the husband. If the shares are left in the trust after the divorce is finalised, the wife's share of trust income will have to be distributed to her (or her children with the current husband). She will have no flexibility to distribute to other relatives or to a corporate beneficiary or related trust.

The prudent strategy when providing structuring advice to clients who have trusts is to caution against making an FTE unless there is a specific reason why this is necessary. In our view blanket recommendations to make FTEs whenever a client has a trust is a recipe for disaster which could result in the adviser being sued for negligence.

11. WHO WANTS TO MAKE A CAPITAL GAIN?

Usually taxpayers are reluctant to trigger capital gains (or any other tax liabilities) before this is absolutely necessary.

However for some clients who have built up a successful business and are in danger of not being able to satisfy the $6 million net asset test or $2 million turnover test, disposing of the goodwill and possibly other business assets to a related entity and triggering the unrealised gain may be very tax effective in the long term.

If clients undertake a restructure which involves a transfer of business assets to a related entity while they are still able to access the CGT small business concessions, they may be able to substantially reduce or if not eliminate any tax on the capital gain generated by the realisation of the capital gain and will get an uplift in the cost base of those assets to current market value.

Also, there is always a 'legislative risk' which could result in the concessions being repealed or wound back.

One issue which is often an impediment to a restructure which involves the disposal of business assets is the potential duty cost. However, if clients operate their business through a trust structure it is possible to trigger a disposal for CGT purposes without triggering any duty – in Queensland at least[46].

[44] Section 267-45 and Subdivision 269-E
[45] Section 267-30 and Subdivision 269-D
[46] Section 53(2) – *Duties Act 2001*(Qld)

12. DIVIDEND ACCESS SHARES

Many clients with private companies have utilised dividend access shares but, as with many strategies which provide flexibility and reasonable tax outcomes, the ATO has hardened its position in relation to the use of dividend access shares.

Dividend stripping and Part IVA

The ATO issued Taxation Alert TA 2012/4 followed by Tax Determination TD 2013/D5 in which they indicate that many arrangements involving the use of dividend access shares will be caught as dividend stripping arrangements under Part IVA[47].

The ATO also issued numerous section 264 notices requiring accounting practices to provide the ATO with particulars of clients who have utilised dividend access shares in their private companies and the ATO are now following up taxpayers identified in the responses to those section 264 notices.

I do not intend to go into detail in this paper about the circumstances when use of dividend access shares might or might not attract the operation of Part IVA. However, one point that should be noted is that, if dividends are paid on dividend access shares and this results in a reduced rate of tax on the dividends, the onus will be on the clients to demonstrate that the 'dominant purpose' was not to obtain that tax benefit.

Many clients/advisers will argue that the use of the dividend access shares is part of an asset protection strategy to move value away from the shares held by individuals who might be at risk of external claims.

The ATO does accept that asset protection is a legitimate alternative purpose when considering the dominant purpose of an arrangement[48]. However, what is clear from dealings that Cooper Grace Ward have had with the ATO in connection with various section 264 notices is that, merely asserting that there the dividend access shares are used as part of an asset protection strategy will not be sufficient.

The taxpayer/adviser must be able to demonstrate that:

- the party who held the shares from which value has been shifted did in fact have a material risk exposure;
- paying dividends via dividend access shares actually reduced the client's risk exposure; and
- the outcome could not have been achieved in some other way.

Impact on ability to access small business CGT concessions

Another significant problem with dividend access shares that is often overlooked is that the existence of dividend access shares will often mean that it is not possible for any individual to be a 'CGT concession stakeholder' in the company which means that the clients will not be able to fully access the small business CGT concessions if active assets of or shares in the company are sold.

It is often necessary for the company to have a CGT concession stakeholder in order to claim the small business concessions in various circumstances (e.g. if the shareholder is a company or trust or the company wants to apply the small business retirement or 15 year exemption).

A company will only have a CGT concession stakeholder if there is an individual who has al direct or indirect 'small business participation percentage' in the company of at least 20%[49]. In order to have a small business participation percentage of at least 20%, there must be a shareholder who has the right to receive at least 20% of any dividends or capital distributions and who can exercise at least 20% of votes.

[47] Section 177E
[48] Taxation ruling TR 2006/2
[49] Section 152-55

The problem where there are dividend access shares is that, because these generally give the directors an absolute discretion as to what dividends can be declared, none of the shareholders actually has a fixed entitlement to receive any dividend. Their interest is more akin to that of a beneficiary in a discretionary trust.

This means that all shareholders in a company will have a small business participation percentage of zero and there will be no CGT concession stakeholder or significant individual.

Cooper Grace Ward is currently acting for a client whose company operated a small business for 25 years. The only shareholders during that period were the client and his former wife who, between them, had received 100% of all dividends declares.

However, dividend access shares had been issued when the company was established.

The company sold the business for a substantial gain in anticipation that the client would be able to apply the 15 year exemption and eliminate all tax on that gain. It was only after the event that the client's adviser realised he was not eligible for the 15 year exemption because the company had not had a significant individual for the required period because of the discretionary nature of the dividend access shares.

The client is now suing their former accountant.

However, clients who have a legitimate purpose for dividend access shares can still get some flexibility while ensuring that the company continues to have a significant individual at all times.

For example, if there are two equal shareholders in a company it is possible to issue dividend access shares to related parties or trusts but stipulate that the dividends that can be paid on the dividend access shares cannot exceed 60% of all distributions. This means that the two ordinary shareholders will still be significant individuals because they have a fixed entitlement to at least 20% of all dividends. This assumes that they also have at least 20% of voting and capital rights.

Another strategy is to draft the constitution so that the directors are only allowed to declare dividends on the dividend access shares during a set period each year – for example between 1 July and 31 August. Any dividends declared outside that period must be paid on the ordinary shares.

Assuming that one or more individuals hold at least 20% of the ordinary shares, this means that for 80% of the time, the company will have a significant individual and, provided any contract for sale of shares or company assets is signed outside of that 'discretionary dividend period' the company and shareholders will be able to access the small business concessions.

Another option is to ensure that all dividend access shares are redeemed or converted before any contract for sale of company assets or shares is signed. This would mean that generally the company would be able to satisfy the requirement to have a CGT concessions stakeholder or significant individual at the time of the CGT event.

However this will not assist the clients in accessing the 15 year exemption because one of the requirements to claim that exemption is that the company had a significant individual for at least half the period of ownership or 7.5 years whichever is less.

Also, if the dividend access shares are redeemed just before a CGT event occurs there is always the risk that the ATO will argue that the redemption is a scheme to which part IVA applies and deny the access to the small business concessions.

13. NEGATIVE GEARING TRUSTS

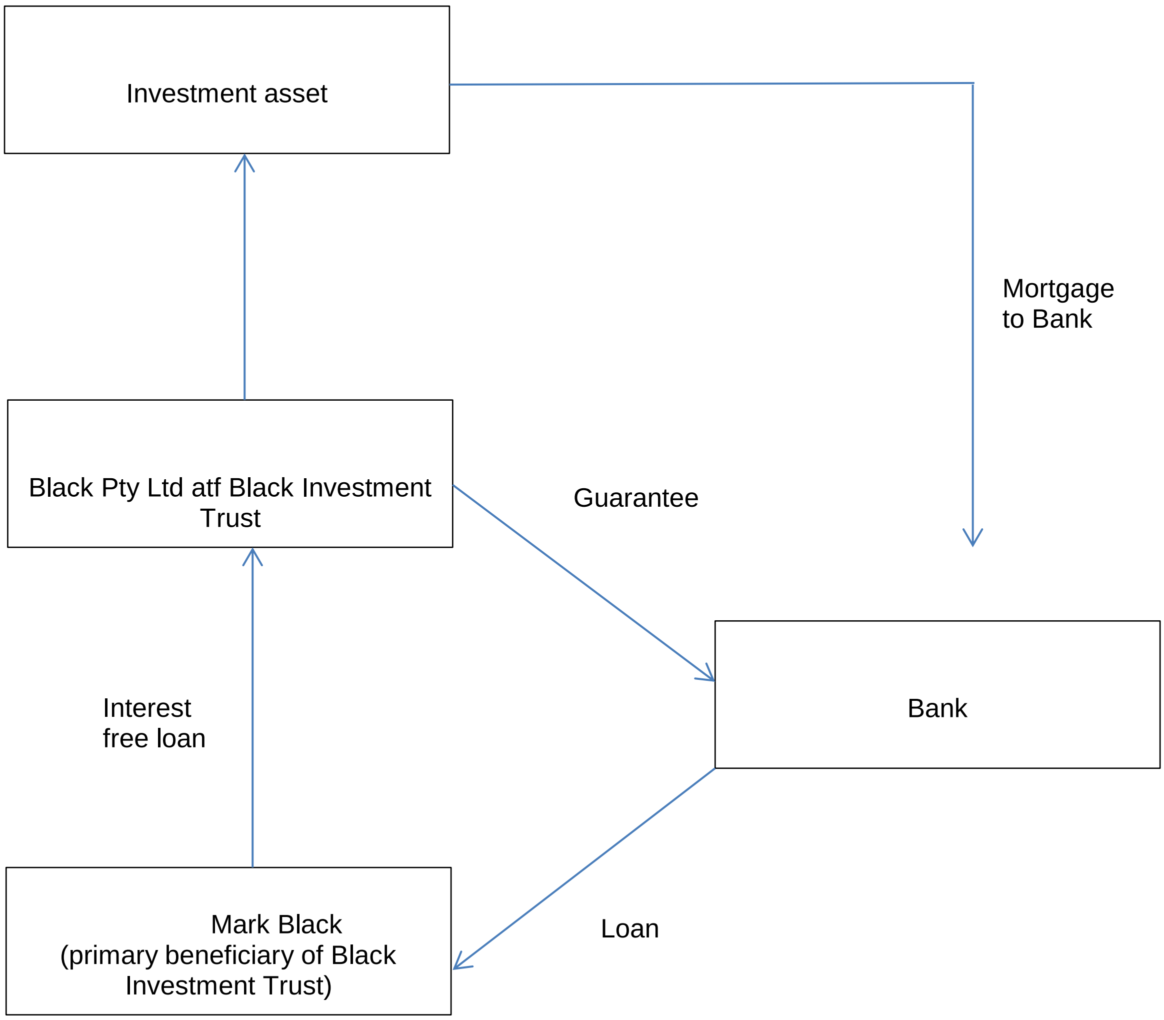
Clients in high risk occupations often want to borrow to access the tax benefits of negatively gearing investment properties but have a dilemma in that, if they acquire an investment in their own name in order to claim the interest deductions, their equity in the property will be exposed to claims against them.

Cooper Grace Ward has developed a strategy under which individual clients can claim a deduction for interest on loans associated with acquisition of investment properties while still holding the asset in a protected discretionary trust environment. This not only allows them to claim the interest as a deduction but may ultimately allow greater flexibility in the allocation of any capital gain that they generate on sale of the asset – which his consistent with the desired asset protection objectives.

The way in which this strategy works is as follows:

- The clients establishes a special purpose trust in which the only beneficiaries are the taxpayer who wants to claim the interest deductions (primary beneficiary) and a related discretionary trust (secondary beneficiary).
- The primary beneficiary borrows from the bank and on lends those funds to the trust – interest free.
- The trust uses the funds to buy an investment asset.
- The trustee does not have to pay interest on this loan but, while any part of that loan remains outstanding, the trustee must distribute to the primary beneficiary an amount equal to trust net income in each year or the interest paid on the bank loan (whichever is less).
- If the net income in any year does not cover the interest (which will be the case in early years) the shortfall is added to the minimum distribution amount required in the subsequent year(s).
- Any additional trust income automatically flows to the discretionary trust that is the secondary beneficiary.
- When the interest free loan is paid out, all income and capital gains can be distributed to any eligible beneficiaries of the trust that is the secondary beneficiary.

The following diagram illustrates how the structure operates:



In those circumstances the interest payable on the bank loan are deductible under section 8-1 as the interest will be incurred for the purpose of producing assessable income.

It is not necessary that the relevant income is derived in the same year as the expenses incurred[50]. If this was not the case, all taxpayers would have difficulty claiming deductions on a negatively geared investment.

In *Fletcher v FCT*, the High Court considered that, even though expenses might exceed the income in the early years of an arrangement, those expenses would be deductible if there was an expectation that positive income would be generated in later years, provided there was no question that the 'arrangement' was not intended to run its course.

The Tax Office issued *Taxation Ruling TR 95/33* to clarify their position subsequent to the decision in *Fletcher*. The following extracts from that ruling indicates that, in most cases where an investment is negatively geared, the Tax Office will accept that the interest incurred on the loan will be fully deductible.

> 46. ….. It is generally not the case in commonly encountered negative gearing arrangements that they are intended to, and are structured on the basis that they have a defined and pre-ordained period to run.

[50] *Steele -v- FCT* 99 ATC 4242 and *Fletcher -v- FCT* 92 ATC 4611

> Whilst certainly a consideration, the **major** advantage of such an arrangement is not usually the tax deductions available for interest outgoings. Accordingly, and in the usual case, a common sense or practical weighing of all the factors could be expected to lead to the conclusion that the relevant interest expense is properly to be characterised as genuinely, and not colourably, incurred in gaining or producing assessable income or in carrying on a business for that purpose, and will fall entirely within either the first or second limbs of subsection 51(1).

There have been cases where individuals who have borrowed funds and on-lent them to related companies or trusts have not been able to claim a deduction for the personal interest[51]. However these generally involved situations where the individual borrower could not demonstrate there was any guarantee they would receive future dividends or trust distributions and therefore there was not a sufficient nexus between the incurring of the interest and possible future receipt of income.

In *Federal Commissioner of Taxation -v- Munro*[52], the High Court held that Mr Munro could not claim a deduction for interest on funds which he borrowed and on-lent to a company of which he was a 10% shareholder.

In *Economedes -v- FCT*[53], a husband and wife borrowed funds from the ANZ Bank and on-lent those proceeds to a company in which they held all the shares under an informal arrangement where the company was to pay them interest at least equivalent to that payable on the Bank loan. The Tax Office argued that the decision in *Munro* should be applied and that the interest was not deductible.

The AAT (member G Hughes) distinguished *Munro* on the basis that the decision in *Munro* clearly 'centred not on the fact that the loan was inherently incapable of being characterised as having been made for the purpose of gaining or producing assessable income of the taxpayer, but rather on the fact that nine-tenths of the money was applied directly or indirectly for the benefit of third parties.'[54].

The principle that a taxpayer can claim a deduction for interest on money borrowed and on-lent to a related entity where there is a genuine and reasonable expectation of deriving future assessable income as a result of the loan was established in *FCT -v- Total Holdings (Aust) Pty Ltd* [55].

The Tax Office accepted that the principles in *Total Holdings* were 'correct in law' in *Taxation Ruling IT 2606*[56].

The taxpayer was allowed a deduction for interest incurred where the external loan funds were on-lent to a related family trust in *Crawford -v- FCT*[57].

The ATO has issued a private ruling to a Cooper Grace Ward client confirming that a taxpayer who incurs interest under this arrangement can claim a deduction for the interest even though the borrowed funds are on lent to a related entity interest free.[58]

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This paper is only intended as a general overview of issues relevant to the topic and is not legal advice. If there are any matters you would like us to advise you on in relation to this paper, please let us know.

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[51] e.g. Case U221 87 ATC 1225, Case 51/97 97 ATC 543
[52] (1926) 38 CLR 153
[53] 2004 ATC 2353
[54] at 2357
[55] 79 ATC 4279
[56] paragraph 8
[57] 93 ATC 5234
[58] Private ruling authorisation number 1012502598156