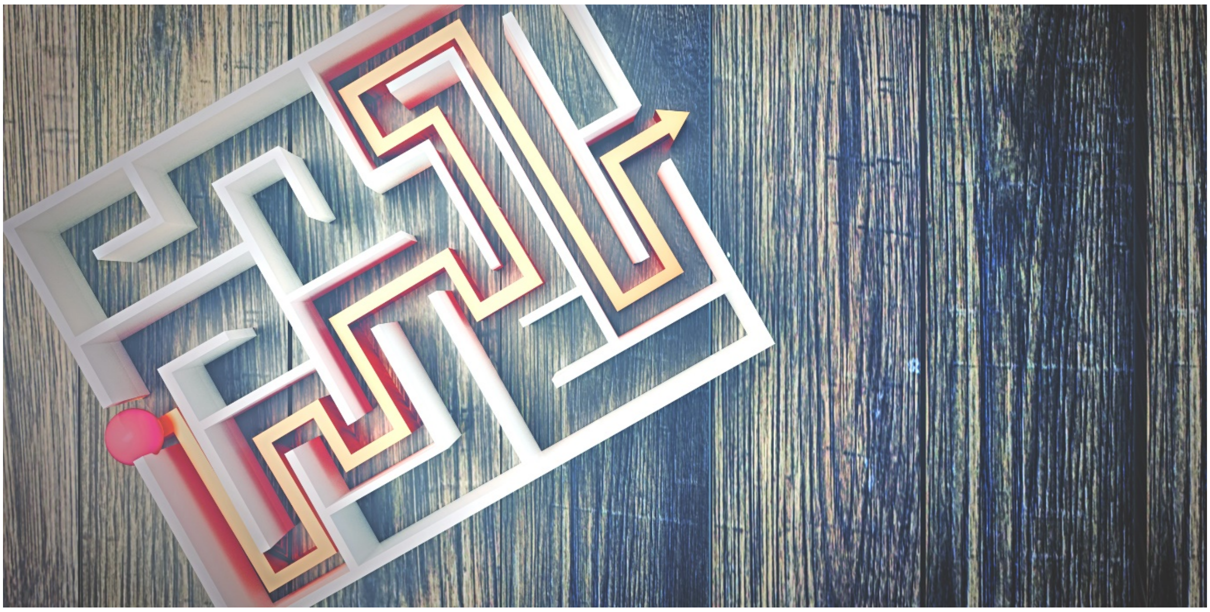
Tax Events

From business start-up to exit
Key decisions and the tax implications

March 2018



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From business start-up to exit

1. Introduction

The issue of what is the "right" structure to use for a business activity (vis-à-vis a passive investment purpose) has been a perennial issue for business advisers. The simple reality is that there is no single answer applicable to all situations.

There are many factors that influence the choice of entity and, as has been previously stated in previous forums, the choice that must be made is a matter of balancing various factors:

(a) The **commercial factors** affecting a business:

- (i) Business risk;
- (ii) Nature and value of assets;
- (iii) Type of economic benefits to be generated by the business i.e. income or asset value;
- (iv) Growth and funding;
- (v) Globalisation of the business; and
- (vi) Succession and estate plans.

(b) The **taxation issues**:

- (i) Ongoing uncertainty about taxation laws, especially as regards the taxation of trusts;
- (ii) The nature of the business;
- (iii) The size of the business (what is a small business?);
- (iv) Integrity measures e.g., Division 7A;
- (v) Special incentives offered to different types of taxpayers;
- (vi) Treatment of losses;
- (vii) Tax liability of net income (i.e., the rate of tax, tax offsets); and
- (viii) Tax treatment of distributions.

(c) The **CGT Issues**:

- (i) Availability of CGT and other taxation concessions – Division 328, Division 152 and Division 115;
- (ii) Treatment of the distribution of a capital gain;
- (iii) Small business CGT concessions; and
- (iv) Availability and application of CGT rollovers for restructures.

These factors will be discussed in greater detail during the course of this presentation.

2. Business structuring – company v trust

There continues to be changing influences on the choice of entity, from amendment to taxation laws relating to different types of entities, to the manner by which the law is administered by the Australian Taxation Office (**ATO**).

Consider the following changes that have occurred recently that affect the choice of entity and/or the taxation of entities, albeit directly or indirectly.

2.1 What is a small business entity (SBE)?

Whether an entity is a SBE is an important factor to be considered in relation to:

(a) Rate of taxation, including SBE income tax offset (Subdivision 328-F);

(b) Division 328 concessions, including inter alia the restructuring concession (subdivision 328-G); and

(c) Division 152.

Having regard to the importance of the concept, the following changes to what constitutes a SBE is important.

For the period up to 1 July 2017, a SBE was defined in the following manner:

> ***Section 328-110: Meaning of a small business entity***
>
> ***General rule: based on aggregated turnover worked out as at the beginning of the current income year***
>
> *(1) You are a **small business entity** for an income year (the **current year**) if:*
>
> *(a) you carry on a *business in the current year; and*
>
> *(b) one or both of the following applies:*
>
> *(i) you carried on a business in the income year (the **previous year**) before the current year and your *aggregated turnover for the previous year was less than $10 million;*
>
> *(ii) your aggregated turnover for the current year is likely to be less than $10 million.*

The relevant elements of the above definition are:

(a) that the entity carries on a business; and

(b) aggregated turnover does not exceed the threshold amount.

The matter of conjecture concerns the concept of carrying on a business. Relevant to that, the ATO issued taxation ruling **TR 2017/D7; Income tax: when does a company carry on a business within the meaning of section 23AA of the *Income Tax Rates Act 1986*?**

The ruling, interestingly, provides commentary as to when activities of what would ordinarily be regarded as a "passive investment" constitute the carrying on of a business. The ruling further provides that there is a difference between the treatment of company vis-à-vis a trust (and individual) with regard to similar activities/investments.

The ruling provides, inter alia:

> *13. Where a company's activities have a significant commercial nature or purpose and are conducted in a commercially viable manner, they are likely to amount to the carrying on of a business.*
>
> *14. Limited and NL companies are typically formed for the purpose of carrying on a business and are unlike individuals, who may have multiple purposes for undertaking an activity.[18] Unlike individuals, a company's profitable activities are unlikely to be in the nature of a hobby or be undertaken to meet a domestic need. Thus its profit making activities are unlikely to have a domestic or personal nature.*
>
> *15. For these reasons, the profit-making activities of a company will normally have a fundamentally different character to those of **an individual**. This difference has led the courts to observe that profit-making activities, such as receiving rent from property, will not give rise to the presumption that an individual is carrying on a business, whereas it would if those same activities are undertaken by a company.[19]*
>
> *16. This is **also true for trusts** whose nature[20], and the variety of purposes for which they are established[21] place them in a materially different position to limited and NL companies.[22] These differences mean that the same activity undertaken by a trustee is similarly less likely to amount to the carrying of a business, than if it were to be carried on by a company.*

One of the interesting examples provided in the ruling asserts that a company which has an UPE owing by a trustee will in **most instances** be treated as carrying on a business:

> ***Possibility B - FamCo reinvests its UPE***
>
> *58. After being made presently entitled to the $50,000 of trust income, FamCo enters a written loan agreement on commercial terms with the trustee of the Pail Family Trust. Under this agreement, FamCo loans the money back to the trust in return for a commercial rate of interest secured against the assets of the trust. The interest income received is then either distributed to FamCo's shareholders by way of annual dividends, or reinvested back in the trust by way of further loans made on the same terms under written loan agreements. FamCo's activities consist of investing its assets in a business like way with both a purpose and prospect of profit. FamCo carries on a business.*

2.2 Treasury Laws Amendment (Enterprise Tax Plan Base Rate Entities) Bill 2017

In addition to the draft ruling, the *Income Tax Rates Act* (1986) was further amended by the **Treasury Laws Amendment (Enterprise Tax Plan Base Rate Entities) Bill 2017** (the **Bill**). The Bill was introduced into the House of Representatives on 18 October 2017 and will amend the current tax law to ensure that from 1 July 2017 the definition of a small business entity is no longer dependent on the concept of carrying on a business.

Under subsection 23(2) of the *Income Tax Rates Act* (1986), from the 2017-18 income year, a corporate tax entity will qualify for the 27.5 % corporate tax rate for an income year if it is a "base rate entity" for that income year.

The Bill amends section 23AA in the following manner:

> ***Section 23AA Meaning of base rate entity***
>
> *An entity is a base rate entity for a year of income if:*

(a) no more than 80% of its assessable income for the year of income is base rate entity passive income; and

(b) its aggregated turnover (within the meaning of the Income Tax Assessment Act 1997) for the year of income, worked out as at the end of that year, is less than $25 million.

As is noted, a base rate entity (lower taxed – 27.5%) will now include two threshold conditions:

(a) aggregated turnover threshold; and

(b) no more than 80% of the assessable income must be "base rate entity passive income".

The Bill further amends section 23AB as follows:

Section 23AB Meaning of base rate entity passive income

Base rate entity passive income is assessable income that is any of the following:

(a) a distribution (within the meaning of the Income Tax Assessment Act 1997) by a corporate tax entity (within the meaning of that Act), other than a non-portfolio dividend (within the meaning of section 317 of the Assessment Act);

(b) an amount of a franking credit (within the meaning of the Income Tax Assessment Act 1997) on such a distribution;

(c) a non-share dividend (within the meaning of the Income Tax Assessment Act 1997) by a company;

(d) interest income (within the meaning of the Assessment Act), royalties and rent;

(e) a gain on a qualifying security (within the meaning of Division 16E of Part III of the Assessment Act);

(f) a net capital gain (within the meaning of the Income Tax Assessment Act 1997);

(g) an amount included in the assessable income of a partner in a partnership or of a beneficiary of a trust estate under Division 5 or 6 of Part III of the Assessment Act, to the extent that the amount is referable (either directly or indirectly through one or more interposed partnerships or trust estates) to another amount that is base rate entity passive income under a preceding paragraph of this definition.

The Bill provides that a company will not qualify for the lower company tax rate of 27.5% if more than 80% of its assessable income is passive income (such as interest, dividends or royalties).

This is a "bright line" test that will replace the previous requirement that a company be "carrying on a business".

Some commentary from the Explanatory Memorandum that perhaps clarifies the above "bright line" test:

*1.11 ...A **non-portfolio dividend** is, broadly, a dividend paid to a company where that company has a voting interest amounting to at least 10 per cent of the voting power in the company paying that dividend. Consequently, dividends derived, for example, by a holding company which are made by a wholly-owned subsidiary company will not be base rate entity passive income of the holding company.*

1.12 *In relation to paragraph 23AB(g), an* ***amount that flows through a trust to a corporate tax entity*** *(that is, directly from the trust to the corporate tax entity)* ***will retain its character*** *for the purposes of determining whether or not the amount is base rate entity passive income of the corporate tax entity. That is:*

- *if an amount derived by a trust is, for example, a dividend (other than a non-portfolio dividend) which passes directly from the trust to a beneficiary that is a corporate tax entity, then the amount will be base rate entity passive income of the corporate tax entity because the trust distribution is directly referable to the dividend of the trust;*

- *if an amount derived by a trust is, for example, trading income which passes directly from the trust to a beneficiary that is a corporate tax entity, then the amount will not be base rate entity passive income of the corporate tax entity because the trust distribution is directly referable to the trading income of the trust.*

2.3 Imputation implications of changing tax rates for SBEs

One of the other "unsung" implications of the lower base rate has been the practical changes to the imputation provisions. There are two aspects about this:

(a) Previously, the franking credits attributable to a dividend were based on the tax paid but the system is slightly different now; and

(b) The lower tax rate is irrelevant if the company intends to repatriate after-taxed profits to its shareholders.

Franking a dividend

The amount of franking credits that can be attached to a distribution cannot exceed the maximum franking credit for the distribution (**section 202-60 ITAA 1997** – see section below). The maximum franking credit is worked out by reference to the **corporate tax gross-up rate**, which is defined in **subsection 995-1(1)** by reference to the **corporate tax rate for imputation purposes** (definitions below).

Corporate tax entities usually pay distributions to members for an income year during that income year. However, a corporate tax entity will not know its aggregated turnover, the amount of its base rate entity passive income, or the amount of its assessable income for an income year until after the end of that income year.

Therefore, generally, for the purposes of working out its corporate tax rate for imputation purposes for an income year, a corporate tax entity must assume that the previous year is the indicator. That is:

(a) Its **aggregated turnover** for the income year is equal to its aggregated turnover for the previous income year;

(b) Its **base rate entity passive income** for the income year is equal to its base rate entity passive income for the previous income year; and

(c) Its **assessable income** for the income year is equal to its assessable income for the previous income year.

Section 202-60 Amount of the franking credit on a distribution

*(1) The amount of the * franking credit on a * distribution is that stated in the * distribution statement for the distribution, unless that amount exceeds the * maximum franking credit for the distribution.*

(2) The ***maximum franking credit*** *for a * distribution is worked out using the formula:*

$$\text{Amount of the *frankable distribution} \quad X \quad \frac{1}{\text{Applicable gross-up rate}}$$

Where:
"applicable gross-up rate" *means the * corporate tax gross-up rate of the entity making the distribution for the income year in which the distribution is made.*

Section 995

corporate tax gross-up rate

of an entity for an income year, means the amount worked out using the following formula:

$$\frac{\text{100\% - *Corporate tax rate for imputation purposes of the entity for the income year}}{\text{Corporate tax rate for imputation purposes of the entity for the income year}}$$

corporate tax rate for imputation purposes

of an entity for an income year, means:

*(a) unless paragraph (b) applies—the entity's *corporate tax rate for the income year, worked out on the assumption that the entity's *aggregated turnover for the income year is equal to its aggregated turnover for the previous income year; or*

(b) if the entity did not exist in the previous income year—the rate of tax in respect of the taxable income of a company covered by paragraph 23(2)(a) of the Income Tax Rates Act 1986.

From the 2017-18 income year, the 27.5% corporate tax will apply to a base rate entity.

A corporate tax entity will be a base rate entity if it satisfies the new section 23AA definition of base rate entity and, which has for the 2017-18 income year, an aggregated turnover of less than $25 million. The aggregated turnover threshold, which applies to determine whether a corporate tax entity is a base rate entity that qualifies for the lower corporate tax rate, will be raised annually.

The aggregated turnover threshold which applies to determine whether a corporate tax entity is a base rate entity that qualifies for the lower corporate tax rate will then be (possibly) raised annually to:

(a) $50 million for the 2018-19 income year;

(b) $100 million for the 2019-20 income year;

(c) $250 million for the 2020-21 income year;

(d) $500 million for the 2021-22 income year; and

(e) $1 billion for the 2022-23 income year.

Treasury Laws Amendment (Enterprise Tax Plan Base Rate Entities) Bill 2016 Explanatory Memorandum

Example 1.1

In the 2015-16 income year, Company A has an aggregated turnover of $18 million. In the 2016-17 income year, its aggregated turnover increased to $20 million.

Therefore, for the 2016-17 income year, Company A will have:

(a) a corporate tax rate of 30 per cent (having regard to its aggregated turnover of $20 million in the 2016-17 income year), since the base rate turnover threshold was $10m;

(b) a corporate tax rate for imputation purposes of 30 per cent (based on aggregated turnover of $18 million in the 2015-16 income year); and

(c) a corporate tax gross-up rate of 2.33 — that is (100% — 30%)/30%.

As a result, if Company A makes a distribution of $100 in the 2016-17 income year, the maximum franking credit that can be attached to the distribution is $42.86 — that is, $100/2.33.

In the 2017-18 income year, Company A will work out its corporate tax rate for imputation purposes based on its aggregated turnover for the 2016-17 income year — that is, $20 million. Therefore, for the 2017-18 income year, Company A will have:

(a) a corporate tax rate for imputation purposes of 27.5 per cent; and

(b) a corporate tax gross-up rate of 2.64 — that is, (100% — 27.5%)/27.5%.

As a result, if Company A makes a distribution of $100 in the 2017-18 income year, the maximum franking credit that can be attached to the distribution is $37.88 — that is, $100/2.64, notwithstanding the fact that in the 2016/17 year the company would have paid tax at 30%.

2.4 Ongoing decisions in relation to the use of trusts

Lewski v FCT [2017] FCAFC 145 dealt with a range of trust matters including the trustee's attempt to provide for a different pathway for trust income if there was any variation to any variation of net income caused by any ATO amendment.

The issue turned on whether the relevant beneficiary was presently entitled to the trust income pursuant to an ATO amendment.

With regard to the effectiveness of the variation resolutions, the Court referred to Harmer's case and noted:

The High Court held in **Harmer v Commissioner of Taxation (Cth) (1991) 173 CLR 264** at 271, that:

> *the beneficiary has an interest in the income which is both vested in interest and vested in possession; and*
>
> *the beneficiary has a present legal right to demand and receive payment of the income, whether or not the precise entitlement can be ascertained before the end of the relevant year of income and whether or not the trustee has the funds available for immediate payment.*

In **Walsh Bay Developments Pty Ltd v Commissioner of Taxation [1995] FCA 428; 130 ALR 415**, Beaumont and Sackville JJ explained (at 427-428):

> *A vested interest is one where the holder has an "immediate fixed right of present or future enjoyment":* ***Glenn v Federal Commissioner of Land Tax [1915] HCA 57****; (1915) 20 CLR 490 at 496, per Griffith CJ. In relation to land, an estate is vested in possession where there*

is a right of present enjoyment, as where A has a life estate or fee simple estate in the land. An estate is vested in interest where there is a present right of future enjoyment. Thus where T holds in trust for A for life and then in trust for B in fee simple, B's equitable fee simple estate is vested in interest during A's lifetime. The estate will vest in possession on A's death: Glenn v Commissioner, at 496; Dwight v FCT, at FCR 192.

An estate is contingent if the title of the holder depends upon the occurrence of an event which may or may not take place: E H Barr, Cheshire's Modern Law of Real Property (11th ed, 1972), p 241. However, the mere fact that an estate will not fall into possession until the regular determination of a prior estate does not make the first estate contingent. As stated in C Fearne, Contingent Remainders and Executory Devises (10th ed, 1844), vol 1, p 216:

> *It is not the uncertainty of ever taking effect in possession that makes a remainder contingent; for to that, every remainder for life … is and must be liable; as the remainder-man may die … before the death of the tenant for life. The present capacity of taking effect in possession, if the possession were to become vacant, and not the certainty that the possession will become vacant before the estate limited in remainder determines, universally distinguishes a vested remainder from one that is contingent.*

For these reasons, it is said that before a beneficiary is entitled to a vested interest two things must occur:

(i) *his identity must be established;*

(ii) *his right to the interest (as distinguished from his right to possession) must not depend upon the occurrence of some event.*

Then, whether the variation resolutions resulted in the beneficiary being presently entitled, the Court observed that:

> *In concluding, at [154]-[157] of the Reasons, that the applicant was presently entitled, the Tribunal treated the 'distribution of trust income' and the 'variation of income' resolutions as distinct and sequential. However, we do not consider it correct to treat the resolutions in this way. In the case of the ACPS resolutions, the two resolutions were made at the same time: they were set out in a single document signed by the sole director of the company. In the case of the Drewvale resolutions, the two resolutions were made at about the same time, at a meeting of the Board of Directors. In both cases, the resolutions were interdependent in that both resolutions dealt with the same subject matter – the distribution of the income of the trust for a particular year of income – with the latter resolution varying, in certain circumstances, the distribution made by the former resolution. In light of these matters, it is artificial to treat the two resolutions (namely, the 'distribution of trust income' resolution and the 'variation of income' resolution) as separate and sequential for the purposes of deciding whether the applicant was "presently entitled". Rather, the two resolutions should be read together for the purposes of deciding this question. There does not appear to be any issue between the parties that, **if the two resolutions are read together, the distribution to the applicant was contingent**: it depended on the occurrence of an event that may or may not take place (namely, the Commissioner disallowing a deduction or including an additional amount in assessable income). It follows that, assuming that each 'variation of income' resolution was authorised by the relevant trust deed, the applicant was not "presently entitled" to a share of the net income of the trust estate of the ACE Trust for the 2006 year or the Arjod Trust for the 2007 year.*

The issue of the effectiveness of "contingent" resolutions is further noted in **TD 2012/22**.

2.5 Use of a trust to hold personal assets

Taxation Determination TD 2017/20, issued by the ATO (November 2017), contains guidance on when **family trust distribution tax** is payable by the trustee of a trust that has made a family trust election.

As is well understood, if a trust elects to be a family trust (useful for trust loss and franking distribution purposes), one of the consequences is that the trustee is not able to make a distribution to an entity that is not "family" without the consequence of the penalty rate of tax applying to the distribution.

Specifically, TD 2017/20 provides that a "distribution" can be made by a family trust to a non-beneficiary for the purposes of **Section 272-60 of Schedule 2F ITAA 1936** (the trust loss rules). This is a change from the previous ATO view that, in relation a trust, s 272-60 only covers benefits received by a person in the person's capacity as a beneficiary of the trust.

The ATO separately advised that TD 2017/20 "*will have no adverse impact on those trusts being used appropriately to benefit members of the relevant family group*".

Background

Under the trust loss rules, the trustee of a family trust is subject to family trust distribution tax if the trustee confers a present entitlement, or distributes income or capital of the trust, to a person outside the family group. The term "distributes" is given an extended meaning in s 272-60 to include any form of benefit that exceeds the consideration given in return.

Section 272-60(1) of Schedule 2F provides that a trust distributes income or capital to a person if the trustee:

(a) pays (including lends) or credits money of the trust to the person, or reinvests such money for the person;

(b) transfers property of the trust to, or allows the use of the property by, the person;

(c) deals with money or property of the trust for or on behalf of the person;

(d) applies money or property of the trust for the benefit of the person; or

(e) extinguishes, forgives, releases or waives a debt or other liability owned by the person to the trust.

Although the focus of TD 2017/20 is on trustee distributions, s 272-60 also deals with distributions by partnerships and companies. The ATO says that its views in TD 2017/20 apply equally to companies and shareholders, and to partnerships and partners.

Commissioner's view

TD 2017/20 provides that where a non-beneficiary receives a benefit from a transaction of the kind described in s 272-60(1), that benefit is a distribution, but only to the extent the amount or value of the benefit exceeds the amount or value of any consideration given in return (s 272-60(2)).

The ATO notes that the s 272-60(2) limitation on the extended definition of "distributes" is designed to ensure that genuine commercial dealings do not inappropriately give rise to a liability to pay family trust distribution tax.

Accordingly, where the relevant transaction occurs on arm's length terms and is "an ordinary incident of a business being carried on by the trust", the Commissioner will infer that the amount or value of a benefit provided to a person does not exceed the amount or value of consideration given in return.

The Determination also states that the term "consideration" in s 272-60(2) has a broad meaning, extending beyond contractual consideration to include any value passing to the trustee which "moves" the relevant transaction.

TD 2017/20 includes six examples concerning business-related transactions:

(a) the use of a holiday home for non-business purposes;

(b) an interest-free loan;

(c) entertainment for arm's length clients;

(d) a discounted fee for services; and

(e) the writing off of bad trade debts.

Example 2 of the determination is particularly interesting and is set out below.

> **Tax Determination TD 2017/20**
>
> **Example 2**
>
> The Wonder Family Trust has made an FTE [family trust election] and Diana Prince is the specified individual. The trust owns a holiday home. The holiday home is used by Diana's friends, for no consideration, for four weeks in the year.
>
> This transaction is not on arm's length terms nor an ordinary incident of a business being carried on by the trust.
>
> As no consideration is given in return for the use of the property, the full value of that use is a distribution within the extended meaning of "distributes".

2.6 Practical Compliance Guidelines PCG 2016/16: Fixed entitlements and fixed trusts

The issue of the application of **Section 272-5 of Schedule 2F ITAA 1936** to determine whether a trust is a fixed trust is relevant in many situations, especially where the trust incurs losses.

As a consequence of the decision in **Colonial First State Investments Ltd v. Commissioner of Taxation [2011] FCA 16**, nearly all trusts fail the indefeasibility test proposed by that case.

Accordingly, the discretion of the Commissioner (section 272-5(3)) is particularly relevant. The PCG now provides some useful guidance as to when a trust might self-assess as a fixed trust. The following extracts from the PCG are applicable:

> *29. When examining the circumstances in which a beneficiary's interest is capable of not vesting or being defeated, the Commissioner will have regard to any factor that may affect the defeasance of any beneficiary's interest, including:*
>
> - *the number of circumstances of potential defeasance, and*
> - *the significance of those circumstances.*
>
> *30. This includes having regard to:*
>
> - *any person who is capable of altering the beneficiary's interest*
> - *the nature of their relationship to the beneficiary, and*

- *any limitation on their capability to so alter that interest.*

The PCG includes Appendix C that details the factors that the Commissioner will consider in making his determination:

> ***Factors favourable to the exercise of the Commissioner's discretion***
>
> *55. The Commissioner regards the following factors favourably when deciding whether to exercise the discretion:*
>
> - *a trustee or manager has never exercised a power capable of defeating a beneficiary's interest to defeat a beneficiary's interest in the income or capital of the trust*
> - *commitments are made in unit holder agreements, Product Disclosure Statements or other documents with legal consequences that the trustee or manager will not exercise a power capable of defeating a beneficiary's interest at all, or in a way that is adverse to the rights of beneficiaries to receive the income and capital of the trust*
> - *all beneficiaries have the same rights to receive the income and capital of the trust*
> - *the trust instrument can only be amended with the unanimous (100%) approval of all the beneficiaries*
> - *although the trust instrument can be amended without the unanimous approval of beneficiaries, the approval percentage calculated on the current interest or unit holdings of beneficiaries effectively means that all beneficiaries must approve any amendment (for example, where the approval of 75% of unit holders is required to make the amendment and the smallest unit holding is more than 25% of the units)*
> - *the trust instrument has been amended in accordance with section 601GC of the Corporations Act 2001 (so as to assist with the efficient administration of the trust) but no beneficial interests in the income and capital of the trust are adversely affected*
> - *the beneficiaries whose rights to receive the income and capital of the trust have been adversely affected by the exercise of a power capable of defeating a beneficiary's interest have explicitly consented to that specific act (such as upon the redemption of the interests of an employee not covered by the savings rule upon the cessation of employment)*
> - *the trustee or manager deals with the beneficiaries of the trust on an arm's length basis*
> - *the trust is governed by a foreign law that is similar to Chapter 5C of the Corporations Act 2001, and*
> - *the trust would satisfy the basic and specific conditions (as applicable to the type of trust) for access to a safe harbour.*
>
> ***Factors adverse to the exercise of the Commissioner's discretion***
>
> *56. The Commissioner regards the following factors unfavourably when deciding whether to exercise the discretion:*
>
> - *a trustee or manager exercises a power to defeat beneficiaries' interests in the income or capital of the trust, however:*
>   - *the nature of the power that is exercised will be important, for example, compulsorily redeeming units where a unit holder's stake is less than a minimum specified in the trust instrument, and the unit holder receives the redemption price of those units, is unlikely to preclude the exercise of the discretion*

- *where external factors (such as those in the Global Financial Crisis) temporarily affect the ability of the trustee or manager to fund distributions or redemptions, this is unlikely to preclude the exercise of the discretion (for example, a temporary wholesale freezing or deferral of interests)*

- *there are significantly different beneficiaries of the trust in an income year for which an entity seeks to have a fixed entitlement, than the beneficiaries of the trust in the income year(s) in which the trust made a tax loss, or incurred a bad debt deduction or debt/equity swap deduction*
- *an arrangement has been entered into which would result in:*
  - *(a) section 272-35 having application*
  - *(b) the trafficking of the tax benefit of a tax loss, bad debt deduction or debt/equity swap deduction, or*
  - *(c) fraud or evasion.*

There are now some sensible guidelines that allow trusts with different parties interested to have some potential to determine that the trust is a fixed trust for the purposes of Schedule 2F ITAA 1936.

3. Choice of entity

Which entity form is best to use is not necessarily a static decision. It is arguable that, subject to the duty issues and perhaps other contractual complications, the form of entity can be altered with the changing requirements of a business.

The usual factors that would influence the choice should be considered at two levels:

(a) The entity's activities and assets; and

(b) The holder of the ownership interest in the entity.

As indicated in the preliminary observations, the choice of entity is dependent on:

(c) Commercial factors;

(d) Taxation issues; and

(e) CGT issues.

3.1 Commercial activities

The principal commercial factors that might influence the choice of entity are:

(a) **Risk**

  (i) What is the nature of the risk?

  (ii) What is the probability that the risk will occur?

  (iii) What are the "true" implications of the risk, if it should occur?

  (iv) Creation of ongoing asset ownership – goodwill vis-à-vis trade marks and separate ownership?

  (v) Who or what will suffer the implications of the risk – entity or owners?

(vi) Will separate entities solve the risk dilemma – use of legal?

(vii) If separate entities are to be used, what will be the nature of the economic transactions between the entities?

(viii) Is it likely that the "at risk" asset might be disposed separately from the risk activities (Division 152 considerations)?

(b) **Economic benefits**

(i) Is it projected that the business will generate "income" or "capital" during the ordinary life cycle of the business?

(ii) Is it expected that revenue losses will be incurred at some stage of the life cycle of the business?

(iii) Will the owners require constant and high percentage of profit distributions?

(iv) Do the owners want to have flexibility as regards profit and/or capital distribution?

(v) What are the taxation implications of profit distributions?

(c) **Taxation characteristics of business assets**

(i) Revenue or capital?

(ii) What is likely to be disposed – entity or assets?

(iii) Is there a taxation consequence of either?

(iv) Can the assets be held by a SMSF?

(d) **Succession and estate planning**

(i) Is it envisaged that the business will evolve to a multiple generational business?

(ii) Will employees or other external parties ever have an interest in the business?

(iii) What are the timelines associated with either the succession plan or estate planning?

(iv) Do the principals of the business wish to continue with the business post death?

3.2 Comments

A **company** is a preferred business structure where:

(a) Losses are to be incurred;

(b) Assets are of a revenue nature;

(c) Profits are required to be grandfathered; or

(d) Succession planning and/or estate planning are features of the principal's business strategy

A **trust** is a preferred business structure where:

(a) Economic benefits are envisaged to be predominantly capital in nature; or

(b) Flexibility is required for any income/capital distributions.

The combination of a company as the "trader" and a trust as the "owner" is preferred.

Ultimately, the decision will be determined by the principal's business strategy.

4. Business growth – company v unit trust v partnership

To the extent that business growth is a relevant factor in the principal's business strategy there are, again, a series of questions to be considered:

(a) Is the business growth generating additional revenue of business capital value?

(b) How will the business growth be financed:

  (i) Internal regeneration of business profits;

  (ii) Debt financing secured by personal assets; or

  (iii) New equity introduced (albeit convertible debt or new equity interests)?

(c) Will the growth create "new and different" assets, eg., new goodwill?

(d) Is there any risk associated with the indicated growth, and do these risks influence the nature of structuring (eg., in this regard the use of the tax consolidation regime for the different business activities is useful)?

(e) Is the business growth generated by innovation – R & D considerations?

(f) Will growth in the business include global expansion?

4.1 Comment

Generally, where growth is a feature of the business strategy, a company is the preferred structure.

Whilst a partnership might be a simple structure, if there is any business risk associated with the business activities, the use of a partnership is problematical even where the partners are limited liability entities.

Other than the application of subdivision 328-G, most rollover provisions of the ITAA favour the transferee entity being a company.

5. Exit planning – share sale v asset sale

In the simple analysis of an exit and the taxation implications (other than circumstances where exit occurs on death of the principal), the main factor that will influence the initial choice of structure are the CGT considerations, in particular the availability of the various CGT concessions:

5.1 Division 115 ITAA 1997

Obviously, the disposal of CGT assets (of a capital nature) by a company does not attract the benefit of the general CGT discount, albeit the company tax rate of 27.5% minimises the tax implications of this concession.

The availability of Division 115 is only useful if the CGT asset is subject to assessment as a capital gain.

Division 115 is available, however, if the subject matter of the disposal is the interests in the entity and not necessarily the business assets such as:

(a) Certain types of intellectual property;

(b) Depreciable assets; or

(c) Concerns about the taxation implications of distribution of the capital gain to the owners of the business.

Note that where the asset is held by a partnership, it is the interests of the partner that is the CGT focus (refer to section 106-5).

5.2 Division 152 ITAA 1997

The importance of being able to access the various Division 152 concessions is obvious to all advisers. In that regard ensuring that, on the occasion of the disposal (CGT Event) that applies to a CGT asset, that the basic conditions (section 152-10) apply without the need for changes to the structure contemporaneously with the CGT Event.

There are many factors that need to be considered with regard to the basic conditions, some of which do have an influence on the choice of structure where a CGT Event is contemplated:

(a) Will the asset be an **active asset** (refer principally to section 152-40):

> *Meaning of active asset*
>
> *(1) A * CGT asset is an active asset at a time if, at that time:*
>
> *(a) you own the asset (whether the asset is tangible or intangible) and it is used, or held ready for use, in the course of carrying on a * business that is carried on (whether alone or in partnership) by:*
>
> *(i) you; or*
>
> *(ii) your * affiliate; or*
>
> *(iii) another entity that is * connected with you; or*
>
> *(b) if the asset is an intangible asset--you own it and it is inherently connected with a business that is carried on (whether alone or in partnership) by you, your affiliate, or another entity that is connected with you.*

Where it is proposed to separate ownership of assets from the business risk, ensuring that the asset holding entity is a connected entity is critical. The concept of "connected entity" is provided by section 328-125 – a 40% test in most instances other that a discretionary trust where the "control" test is applicable (subsection 328-125(3)).

A share and/or an interest in a trust can be an active asset if 80% of the value of assets of the entity are active assets (refer to section 152-40(3).

(b) If the asset being sold is a share in a company or an interest in a trust (unit trust), the additional basic condition needs to be satisfied (refer to section 152-10(2)):

*152-10(2) If the * CGT asset is a * share in a company or an interest in a trust (the object company or trust), one of these additional basic conditions must be satisfied just before the * CGT event:*

*(a) you are a * CGT concession stakeholder in the object company or trust; or*

*(b) CGT concession stakeholders in the object company or trust together have a * small business participation percentage in you of at least 90%.*

Example: A discretionary trust sells shares in an operating company (the object company). Anna receives 90% of the distributions from the trust, and the trust has a 50% interest in the object company.

This provides scope for an ownership interest in an entity to attract the Division 152 concession where either the share (or trust interest) is:

(i) Disposed by a "CGT concession stakeholder" (defined successively by section 152-60, section 152-55 and section 152-70) by of the entity; or

(ii) Another ownership entity where the CGT concession stakeholders in the principal entity have at least a 90% small business participation percentage in the taxpayer entity.

This latter requirement allows, for example, a share in a company to be disposed where the taxpayer entity is a discretionary trust.

It is to be further noted that in determining the small business participation percentage (**SBPP**):

(i) In the case of a company:

(A) the SBPP is determined by the interests in voting, income or capital (and the lower of any such interests;

(B) redeemable shares in a company are ignored for the purposes of determining the SBPP.

(ii) In the case of a discretionary trust, the determination of the interests is based on the percentage of distributions of either income or capital in the relevant CGT year (again the SBPP is based on the lower of either income or capital if distributions of either is made)

Note the proposed amendments which are intended to restrict the application of Division 152 where the CGT asset is the asset being – refer to Treasury Laws Amendment (2018 Measures No. #) Bill 2018. In summary the proposals will mean that include additional basic conditions that must be satisfied for a taxpayer to apply the CGT small business concessions to a capital gain arising in relation to a share in a company or an interest in a trust (the object entity).

Broadly, the new conditions will require that:

(iii) if the taxpayer does not satisfy the maximum net asset value test, the relevant CGT small business entity must have carried on a business just prior to the CGT event;

(iv) the object entity must have carried on a business just prior to the CGT event;

(v) the object entity must either be a CGT small business entity or satisfy the maximum net asset value test (applying a modified rule about when entities are 'connected with' other entities), **and**

(vi) the share or interest must satisfy a modified active asset test that looks through shares and interests in trusts to the activities and assets of the underlying entities.

(c) One significant disadvantage of using a company (unless subdivision 152-B applies) is that the untaxed component of the gain will have further implications if such amount is intended to be distributed to the shareholders, albeit in the normal course of distributions made by an on-going entity (the distribution is a dividend and generally will be unfranked) or alternatively on liquidation of the company in relation to which section 47 ITAA 1936 applies. (Note that for the purposes of section 47, the untaxed Division 152-C amount is treated as a capital distribution).

(d) One possible advantage of being able to dispose of a share in the company entity is the benefits potentially available to the purchasing entity attributable to the application of the tax consolidation regime – the ACA is allocated over the assets of the entity based on relative market values of all of the assets.