KEY TAXATION ISSUES FOR BUSINESS OWNERS

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OUTLINE

This paper will deal with some current tax issues facing businesses of relevance to professional advisers of family businesses. The paper will cover the following:

1. Unpaid present entitlements and trusts;

2. Reasons for moving from a trust to a company structure;

3. Strategies when moving from a trust to a company;

4. Dividend access shares;

5. Low interest loans to super funds

6. Stamp duty issues for superannuation funds

7. Control of Trusts – Asset Protection and Estate Planning

1. UNPAID PRESENT ENTITLEMENTS AND TRUSTS

Trusts have been and remain a legitimate structure to adopt for business and investment purposes. In fact, I have been a keen advocate of trusts in my professional career for the principal reason of their ability to remain flexible for tax planning opportunities.

Generally, the tax rate applicable to the net income of a trust estate will be that of the beneficiary to whom the trust income is applied, or who otherwise has a fixed interest.

Accordingly, access to the corporate tax rate is obtained at the beneficiary level, through the use of a corporate beneficiary. The opportunity to distribute the net income of a discretionary trust, in particular, to a corporate beneficiary with a retention of the cash in the trust for reinvestment has been a 'standard' applied by practitioners for many years.

This was thought to avoid issues under the deemed dividend rules pursuant to Division 7A of the Income Tax Assessment Act, 1936 ('ITAA 1936'). This was on the basis that an unpaid present entitlement (or UPE) was not a loan so that the deemed dividend rules did not apply. The UPE shown on the balance sheet as a beneficiary liability was thought not to cause concern.

However, the Commissioner of Tax in Taxation Ruling TR 2010/3 has put an end to this matter.

For the purposes of Division 7A, a loan (a 'Division 7A loan') includes:

(i) a loan within its ordinary meaning, consisting of a payment and an obligation to repay;
(ii) an advance of money ahead of a due date or with an expectation of repayment;
(iii) the provision of credit or any other form of financial accommodation, in the context in which it appears being the supply or grant of some form of pecuniary assistance or favour, under a consensual agreement where a principal sum or its equivalent is ultimately payable;
(iv) a payment of an amount for, on behalf of, on account of or at the request of an entity, where there is an obligation of repayment; and
(v) transactions that in substance effect such a Division 7A loan of money (as described in any of the above points).

The Commissioner in TR2010/3 then states at paragraphs 17 and 18

> *17. Notwithstanding the extended definition of a 'loan' for the purpose of Division 7A, a subsisting UPE does not amount to a Division 7A loan specifically:*
> - *within the ordinary meaning of a loan;*
> - *under paragraph 109D(3)(a) of the extended definition as there is no advance of money involving a payment in advance of a due date or a payment in expectation of repayment; or*
> - *under paragraph 109D(3)(c) of the extended definition as there is no payment coupled with an obligation to repay.*
>
> *18. However, in some circumstances, a private company beneficiary provides financial accommodation to the trustee of a trust, or enters into a transaction with the trustee of a trust which in substance effects a Division*

7A loan, such that the private company makes a Division 7A loan to the trustee of the trust in respect of its UPE.

Accordingly, if a private company beneficiary has knowledge that funds representing its UPE are being used by the trustee for trust purposes (rather than being held and / or used for that private company's sole benefit), in not calling for payment of its UPE the private company provides the trustee with financial accommodation and, by extension, makes a Division 7A loan to the trustee.

The effect of this Ruling is that any UPE made after the 2008 tax year will be trested as a Division 7A loan in most situations. The Commissioner specifically stated as follows

Section three of this Ruling (contained in paragraphs 16 to 26) provides the Commissioner's view of when a subsisting UPE may be a loan for the purpose of Division 7A. Section three of this Ruling does not apply to UPEs arising before 16 December 2009.

The ATO's change in interpretation of the nature of unpaid present entitlements ('UPE's') has destroyed the comfort zone that we as professionals had fallen into with using trusts in tax structures.. This single move by the ATO means that practitioners in the future will need to consider the selection of new business and investment structures with a great deal of more detail than we have been attuned to in the past. This process will also be required in considering restructuring of existing business and investment structures.

This does not mean that trusts are no longer an appropriate entity to use. On the contrary, trusts have the great advantage of flexibility in tax planning. That advantage alone is principal in significance for the retention of trusts in a business on investment structure.

However, practitioners will I believe need to closely consider the actual position and function that trusts play in the overall business and investment structure of clients.

2 REASONS FOR MOVING FROM A TRUST TO A COMPANY STRUCTURE

There are a number of reasons why a 'trust to company' restructure may be considered.

2.1 Obtaining corporate tax rate for income

Obviously, the choice of a business or investment entity often comes down to the different treatment of capital gains and income for tax purposes. The trust entity has been advanced as the ideal entity to hold capital appreciating assets as the trust can benefit from the 50% discount available under Division 115 of the Income Tax

Assessment Act, 1997 ('ITAA 1997') and pass that benefit through to individuals as beneficiaries of the trust. However, that benefit (advantage) must be weighed against the advantages of a corporate structure in respect of the tax rates applying to income and the ability of the corporate structure to retain after tax profits.

2.2 Paid up capital balance sheet

Whilst unit trusts will have some 'capital', discretionary trusts have none, and it is the beneficiaries' UPE's and loan accounts that fulfil the role of working capital at least, if not pseudo-equity. Many SMEs are comfortable with their effectively self-funded trust operations, and can live with the funding constraints that can be a reality of trust structures. Others, with the ability to provide additional security outside the trust business structure, can also manage without the need to evolve to a company structure.

2.3 Financing reasons

Trusts in the SME business area are inherently controlled by small numbers of equity participants, and this can restrict access to more significant levels of debt funding, and access to a broader range of equity participants. If equity is not the issue, debt management may exert pressure for a corporate restructure, via banks or other external financiers. Unfortunately some banks have a very poor understanding of trusts, both at a conceptual level and at a practical operating level.

2.4 Succession plan

Restructuring a trust business into a company may also be a pre-exit step for an owner as part of a succession plan.

2.5 UPE's and deemed dividends

As already mentioned, Division 7A 'management' has changed with the introduction of Taxation Ruling TR 2010/3 and the ATO's changed approach to UPE's.

2.6 CGT discount not an issue

Family groups with significant real estate portfolios are less concerned with the possibility of obtaining a discounted taxable capital gain rate than a flat corporate rate on income. Namely, some clients view realized capital gains as the 'long term' and even if a gain is realized through the disposal of a property, the likelihood is that the proceeds will be re-invested and not distributed.

Accordingly, a tax rate of 30% on a gain is not greatly different to a discounted rate of 23.25%. The wealth accumulation is seen then to be more desirable in a corporate entity than a trust entity.

2.7 Estate planning issues

Clients have a concern in respect of the passing of their asset wealth to the next generation through existing family trust structures as compared to alternate entity structures. Namely, the trust set up during the lifetime of a family may not be appropriate to pass to the next generation when issues such as control of the trust and distributions of income and capital are determined. The desire for family groups to set into operation a family agreement as part of an estate plan is increasingly popular. In such cases the management and control of a trust structure is less regimented than a straight corporate structure and therefore the corporate alternative is often preferred.

3 STRATEGIES WHEN MOVING FROM A TRUST TO A COMPANY

There are various strategies that can be examined in a restructure. These include

(a) Utilize a capital gains tax ('CGT') roll-over to defer immediate tax consequences of an alteration in the structure;

(b) In appropriate cases, with a mixture of pre-CGT assets, discount capital gains treatment and Division 152 small business CGT concessions, the restructure may be undertaken without using roll-over relief;

(c) Adopt alternative restructuring options.

3.1 CGT roll-over to a company – Subdivision 122-A

There are three rollover relief provisions that defer the immediate tax consequences of a restructure for a trust.

- subdivision 122-A
- subdivision 124-H
- subdivision 124-N

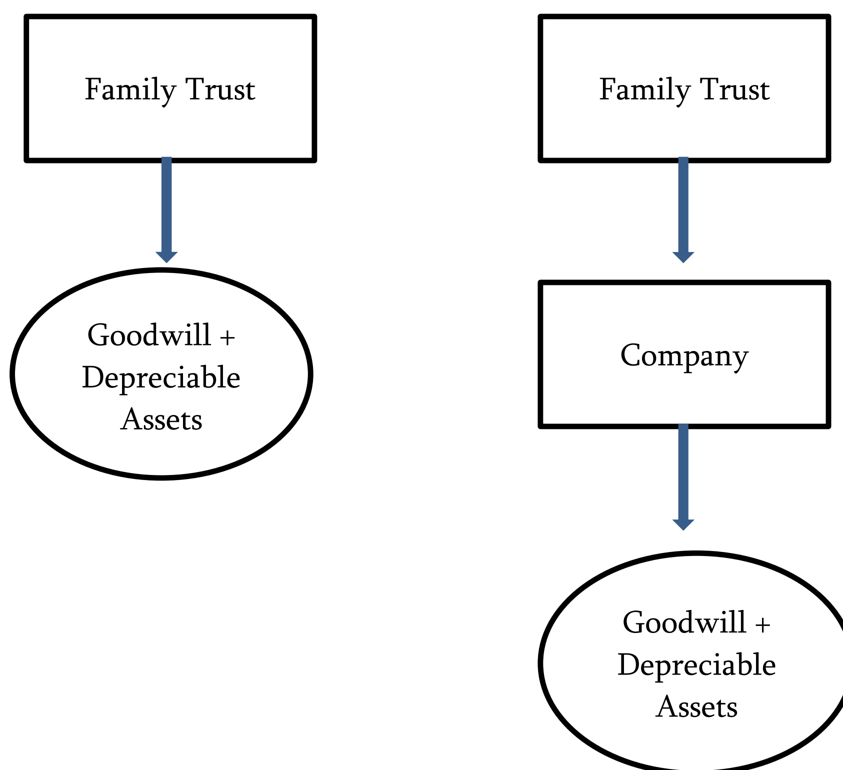
It is noted that subdivision 122-B is also applicable in the 'trust to company' situation. This subdivision can apply where, for example, a partnership of trusts restructures into a company. However, this provision is not considered in this paper. Further, it is not the purpose of this paper to examine the detail of the various CGT roll-over provisions. For such an analysis I recommend the reader to a paper by

Craig Cooper, "*Restructuring Trusts to Companies: What You Need to Know*", Taxation Institute, 50th Victorian State Conference, 6 October 2011.

Subdivisions 124-H and 124-N only apply to a roll-over from a unit trust whereas subdivision 122-A applies to any type of trust.

Subdivision 122-A is the first provision often considered in respect of a CGT roll-over from a trust to a company. In this roll-over the company becomes the new operating entity, or asset holder and the trust becomes the shareholder.

The structural consequence of an application of subdivision 122-A is to leave the trust (and the trust beneficiaries) unaffected, but with the assets 'pushed down' a level into a company which is wholly owned by the trust. The income produced from the asset will be subject to corporate tax at the company level after the restructure, with franked dividends being available for distribution up through the structure.



After the restructure, a family trust election will need to be made in respect of the trust in order to satisfy the "qualifying person" requirement, and allow the passage of the franking credits attaching the subsequent dividends through the trust to beneficiaries. The trust will still fulfil its role as 'distributor' amongst the beneficiaries; but now the net trust income will consist largely or wholly of

franked dividend income, rather than untaxed trust income as was the case pre-restructure.

Cash can now remain as working capital in the business – now conducted by a company.

For asset protection reasons it would be desirable for the family to consider a dividend policy for the trading company. Namely, it would be preferable if annual profits after tax are paid as a fully franked dividend and then distributed to a corporate beneficiary. Those funds can then be lent back to the trading company and if felt necessary appropriate security taken for the loans. In this way, the corporate beneficiary not only becomes a creditor but could become a secured creditor. Accordingly, if the trading company is exposed to liabilities through its trading activities then the corporate beneficiary will stand in a superior position to unsecured claimants/creditors of the company.

Subdivision 122-A does not apply to the disposal or creation of rights in respect of the following assets for both the single asset and business disposal cases:

(i) Collectable or personal use asset;
(ii) Bravery decorations (unless purchased);
(iii) Assets that become trading stock in the company just after the time of the trigger event.

In addition, in the single asset case (either disposal or creation) the following assets ('precluded assets') are excluded from the roll-over protection of subdivision 122-A:

(i) A depreciating asset;
(ii) Trading stock;
(iii) Certain film copyright (subsection 122-25 (2))

Under section 122-50, the first element of each share's cost base is the sum of the market values of the precluded assets and the cost base of the other assets.

Namely, in a roll-over as described above, the cost base for the shares will take on the market value of the depreciating assets and the cost base of the other assets being the goodwill in the business (generally this will be a nil cost base).

In respect of the depreciating assets, Subdivision 40 provides a similar relief to Subdivision 122-A. In particular, under section 40-340 there is roll-over relief if there is a balancing adjustment because an entity (the transferor) disposes of the depreciating assets in the income year to another entity (the transferee) and the disposal involves a CGT event under which Subdivision 122A applies. The end result is that despite a

depreciating asset being excluded from Subdivision 122A roll-over relief there is a roll-over relief that applies under Subdivision 40 in respect of any balancing adjustments.

The advantages of this situation is that even though the cost base of the assets held by the trading company are exactly the same as what they were in the trust there is now an uplift in the cost base of the shares held by the family trust in the trading company. This uplift may have an advantage if ultimately the trust sells the shares in the new company.

It is in my opinion worth considering the accounting issues when using the CGT roll-over. This is at both the trust level and the company level.

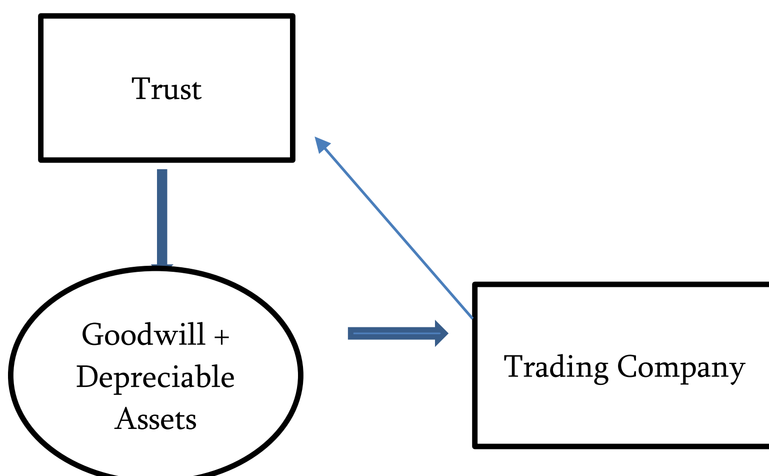
(a) It is my view preferable to have the value (current market value) of the assets transferred on the restructure represented on the balance sheet of the trading company and reflected in equity as share capital.

(b) For accounting purposes the trust would have triggered a capital profit in consequence of the roll-over. That capital profit is an accounting profit and not subject to tax. The capital profit could be retained in the trust as a reserve account or could be distributed to the family members in their capacity as discretionary beneficiaries. As there is no cash available to make such a distribution, the beneficiary entitlements could be lent back to the t rust.

3.2 Utilizing Licensing Arrangement

Under this approach the trustee company continues to operate as the trading entity but now in its own right rather than as trustee of the trust.

In this case, the assets constituting the business could be retained by the trust and simply licensed or made available to the trustee company for the purposes of conducting its business. You would expect that in such a reorganization the employees and contractors would move from the trust to be employed now directly by the trustee company in its own right.



In this way the trustee company continues to trade but with a different ABN on the basis that it is trading in its own right rather than trading as a trustee entity. In turn, the assets are not transferred but rather retained within the trust structure allowing for the opportunity to take advantage of the more favorable CGT treatment for trusts as opposed to corporate entities. It should be noted that it may be necessary to change the trustee of the trust to a different entity so that the trading entity is now no longer acting as the trustee of the trust. In addition, the shareholder in the trustee company would need also be considered before undertaking the new trading operations. It may be necessary in most cases for the shares to be transferred to a further trust allowing for better flexibility in distributing retained profits as dividends to the family group.

The licensing of goodwill is used to avoid stamp duty and CGT on the restructuring of businesses. Instead of transferring the goodwill to a more tax effective structure, that goodwill is licensed and some agreement is reached to where further goodwill will attach. Licensing of goodwill may also be used to maximize the tax effectiveness of a structure or for asset protection reasons. A purchaser may buy goodwill through a discretionary trust or partnership of individuals to maximize the tax free return. This then raises the issue as to whether or not it is possible from a tax perspective to license goodwill.

It would first appear necessary that it be the business that must be licensed as the goodwill is inherently attached to the business. Does this, however, permit the goodwill to remain with the licensor? Can it be said that the licensor has ceased to operate the business itself to which the goodwill related and commenced a new business of leasing assets? What happens to the old goodwill? Is there a disposal of that goodwill by the licensor which results in a capital gain? Presumably, the licensee has not acquired goodwill as it is running a different business than that of the licensor.

Alternatively, does the licensor retain the business and the goodwill attached to it even though somebody else runs the business for a period.

Kirby J in FC of T v Murry 98 ATC 4584 (at para 91) realises the difficulty raised with a licensor not being able to license goodwill.

"The fact that the taxi licence was leased to another person (Mr Gower) does not preclude its being a source of goodwill. One can readily imagine instances in which an asset which is leased out accrues in value through an increase in goodwill. A franchisor, having leased premises to a franchisee for a number of years, could reasonably expect his or her business to have gained value, as a result of an increase in goodwill. Once it is accepted that goodwill can be gained whilst the asset is in the hands of the lessee, it seems absurd to conclude that such an increase would not accrue to the benefit of the lessor in the event that the lease was terminated."

3.3 Using Limited Partnership Structures

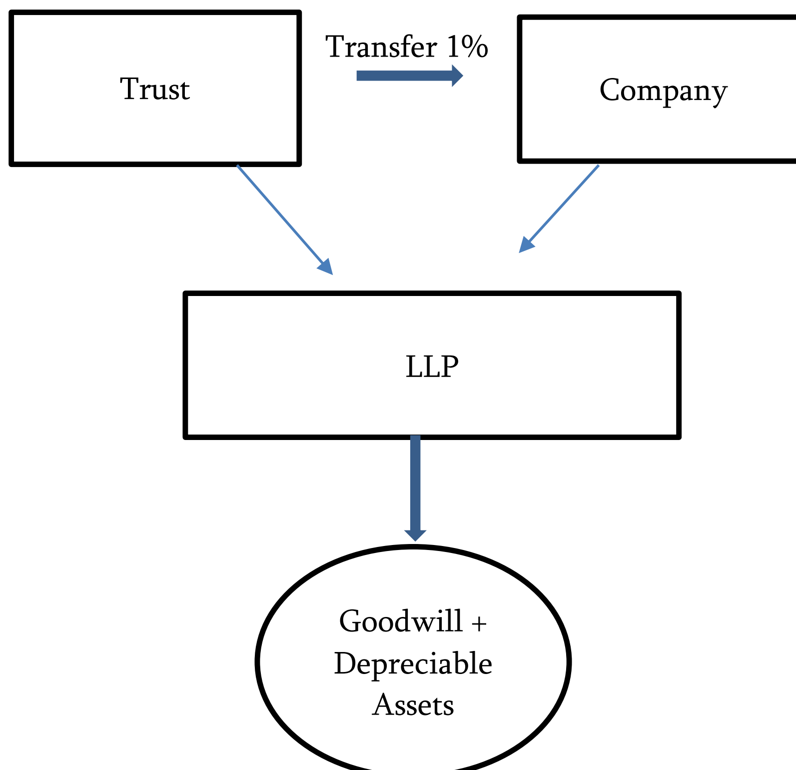
Where stamp duty is a concern the use of a limited liability partnership (LLP) could be considered. Namely, as LLP's are treated as companies for tax purposes it is possible to use an LLP rather than an incorporated company for CGT roll-over purposes. As an LLP is treated as a partnership for all purposes other than income tax (that is for stamp duty purposes) a reduced exposure to transfer taxes can result for certain restructures.

A suggested proposal is as follows:

1. A new company is incorporated ("New co") with the trust as the sole shareholder.

2. The trust transfers to New co a 1% interest in all of the assets of the business and a partnership agreement between New co and the trust is entered into. Namely, the trust would hold a 99% interest in the partnership and New co would hold a 1% interest.

3. The Partnership is then converted to a limited liability partnership ("LLP") with New co as general partner (operates the business for the LLP) and the trust as the limited partner. Under this step the trust and New co as partners can elect to roll-over the assets under subdivision 122-B (see comment in point 3.1 above) as for tax purposes the assets will then be owned by a company (the LLP) and the only shareholders will be the trust and New co (which in turn is also owned by the trust).



In summary, the LLP will enable the Business to continue operating without the need to incur the costs of assigning the assets of the Business to a new corporate entity. The stamp duty exposure is restricted to the transfer of a 1% interest in the assets under step 2 above. There is no transfer of assets under step 3 since for general law purposes the trust continues to own a 99% share in the assets despite the fact that for tax purposes the assets are 'owned' by the corporate entity (the LLP).

The LLP is also a more attractive structure as the profits are taxed at a flat rate of 30% as LLP is considered a "company" for tax purposes.

The core taxation provisions concerning limited partnerships are contained in Division 5A of the Income Tax Assessment Act, 1936. The key provisions are:

(a) Section 94J which provides that a reference in income tax law to a company includes a reference to a corporate limited partnership. Because of this provision a limited partnership is treated in the same way as a company for tax purposes which means that the tax rate of a limited partnership is the corporate rate.
(b) Section 94K prevents references in income tax law to a "partnership" from applying to a limited partnership. This effectively excludes from Division 5, which deals with the taxation of partnerships, applying to a limited partnership.
(c) Section 94L provides that references in income tax law to "dividends" includes a distribution by limited partnership to its partners.
(d) Section 94M provides that amounts paid or credited to a partner by the partnership out of existing or anticipated profits are deemed to be dividends paid by the partnership out of profits derived by the partnership.
(e) A limited partnership is a corporate tax entity under the imputation provisions (section 960-115 of the ITAA 1997). This means that the imputation system applies to a limited partnership in the same way that it applies to a company. In particular, a limited partnership is able to maintain a franking account (section 205-5) and pass on franking credits to its partners as members (section 207-5).

There is no CGT event in the ITAA 1997 that applies directly to the change in status of a partnership to a limited liability partnership. Namely, there is no disposal or deemed disposal when a partnership ceases to be taxed as a general law partnership and commences to be taxed as a company on conversion to a limited liability partnership. Accordingly, it is debatable whether step 3 above requires the election of a CGT roll-over. If no roll-over is required (as there is no CGT event to seek exemption) then the question is what cost base the trust has in the 'shares' it holds in the LLP. Arguably the cost base is the market value of the trust's interest in the assets.

However, if the above interpretation is found not to be correct then clearly in the current situation the roll-over provisions of Division 122-B of the ITAA 1997 would apply.

The roll-over consequences for the trust will be

1. Any capital gain or loss made on the disposal of the Business assets to the LLP is disregarded: sections 122-150 and 122-170
2. The “shares” received in LLP by the trust will be deemed to be post-CGT assets with a cost for tax purposes equal to the current market value of the depreciable assets (section 122-185).

The roll-over consequences for LLP will be that the assets will be taken to have been acquired by LLP for its cost base and/or reduced cost at the time of its disposal (section 122-70(2)).

Because the goodwill of the Business is a business asset under the various Duties Acts in Queensland, New South Wales and Western Australia, a transfer of goodwill is a dutiable transaction in each of those States. The liability for stamp duty, however, will be limited by the fact that the dutiable transaction is limited to a 1% interest in the Business assets.

4. DIVIDEND ACCESS SHARES

The ATO has recently targeted the use of dividend access shares in a corporate structure.

Essentially a dividend access share entitles the holder to dividends on a discretionary basis but the shares have no voting rights or rights to surpluses on a winding-up (equity rights).

The ATO issued Taxpayer Alert TA 2012/4 outlining one type of arrangement causing them concern:

(a) a private company has accumulated profits;
(b) the ordinary shares in the company are held by one or more individuals;
(c) a new class of dividend-only shares are created, and issued to an entity closely related to the individual shareholder, for little or no consideration;
(d) significant profits are distributed as dividends to the holders of the new class of shares; and
(e) the funds are dealt with in some way by the dividend-only shareholder so that the benefit of the funds ultimately goes to the individual shareholder, in a way that minimises the tax payable. For example, the funds may be distributed to a discretionary trust with significant carry-forward losses.

The ATO has started sending section 264 notices to practitioners in order to identify clients making some use of dividend access shares. These notices also seek to determine to what extent the practitioner may have been involved in “promoting: these arrangements”. The ATO have raised various provisions in the tax legislation that they consider could apply in respect of such arrangements however their focus is

the arrangement may be a scheme by way of or in the nature of, or have substantially the effect of, dividend stripping under section 177E of the ITAA 1936;

The actions of the ATO in sending section 264 notices to practitioners may well stop practitioners making any use of dividend access shares in the future, but this matter should be seen within the context of general structuring measures.

4.1 Long-standing dividend access shares

The Taxpayer Alert refers specifically to arrangements where the company has accumulated profits; creates a new class of share; and, issues new shares to an entity.

There would therefore seem no obvious issue where dividend access shares are issued at an early stage in the company's existence. In particular, the issue of such shares at the time of incorporation should not give rise to any concern at that time nor at any future time when discretionary dividends are paid on such shares. This merely highlights the importance of taking care when setting up structures. The creation of various shares with differing rights and issuing those shares to various persons and entities in the family group is important.

Even if the shares are created at a later time then there may not be any reason to hold off using these shares to distribute dividends if the accumulated profits are not significant.

4.2 No distribution of accumulated profits

The Taxpayer Alert refers specifically to arrangements where the relevant company has significant accumulated profits. The issue of dividend access share in such a case should not give rise to any concern provided the distribution of profits on such shares is not to the extent that the accumulated profits are 'stripped' from the company.

For example, where a company has been distributing profits each year out of current year profits (even to dividend-only shareholders) there is no reason to believe that the ATO will be concerned with the arrangement, based on the Taxpayer Alert.

4.3 Family arrangements

Dividend access shares have often been used by family-owned companies to distribute dividends to family members that are not directly involved in the running of the business. The Taxpayer Alert does not make any mention either way about whether the ATO is concerned about ordinary family arrangements.

However, in considering whether the general avoidance provisions is applicable to any transaction, one of the factors that the Commissioner is required to consider is *the nature of any connection (whether of a business, family or other nature)* between the parties to a transaction. Further, when introducing the Part IVA legislation, the then treasurer, John Howard, stated that Part IVA was not intended to apply to *arrangements of a normal business or family kind*.

Accordingly, where there is a family relationship that explains why dividend access shares have been issued then Part IVA should not apply and the ATO should not have any particular concern.

5. LOW INTEREST LOANS TO SUPER FUNDS

There remains some controversy as to whether a low or nil rate of interest can apply to a borrowing by a self-managed superannuation funds ('SMSF').

There are two relatively recent private rulings given by the ATO on nil interest loans to SMSF which at first appear to give conflicting views.

5.1 Private Ruling No. 1012414213139

In the first ruling given in 2013 (this ruling is published as No. 1012414213139) the Commissioner states that there is no adverse tax consequence in respect of a nil interest loan entered into by a SMSF. In particular, it states that the effect of the transaction is not to trigger the non-arm's length income provisions of section 295-550 of the Income Tax Assessment Act, 1997 ('ITAA 1997').

Note that this ruling related to a situation where the super fund concerned acquired a real estate property and borrowed from a related party at nil rate.

The basis of this ruling was that section 295-550(1) applies and that subsection looks at gross income rather than net income. As the gross income is the same whether interest applies or not, the provision does not operate. In that ruling the ATO states

> *Subsection 295-550(1) of the ITAA 1997 lists the types of ordinary income or statutory income that are non-arm's length income of a complying superannuation fund and, as far as relevant, states:*
> *An amount of ordinary income or statutory income is non-arm's length income of a complying superannuation fund, a complying approved deposit fund or a pooled superannuation trust (other than an amount to which subsection (2) applies or an amount derived by the entity in the capacity of beneficiary of a trust) if:*
>
> > *(a) it is derived from a scheme the parties to which were not dealing with each other at arm's length in relation to the scheme; and*

> (b) *that amount is more than the amount that the entity might have been expected to derive if those parties had been dealing with each other at arm's length in relation to the scheme…*
>
> *Subsection 295-550(1) of the ITAA 1997 applies only to amounts of ordinary income (section 6-5 of the ITAA 1997) or statutory income (section 6-10 of the ITAA 1997). It does not capture taxable income (section 4-15 of the ITAA 1997), that is, the subsection does not require the consideration of the overall economic benefit obtained from the scheme.*
>
> *Therefore, for subsection 295-550(1) of the ITAA 1997 to apply, the scheme must inflate the level of ordinary or statutory income derived as a result of the non-arm's length dealings. Whether or not the level of taxable income derived by the entity is inflated as a result of a lower level of deduction amounts than would normally be incurred had the parties been dealing at arm's length is not to be taken into account in applying subsection 295-550(1) of the ITAA 1997.*
>
> *In this case, the Fund will derive a greater level of taxable income because the rate of interest payable by the fund is reduced to 0%. That is, the level of taxable income derived by the Fund will be inflated as a result of a lower level of deduction amounts than would normally be incurred if the parties were dealing at arm's length. However, subsection 295-550(1) of the ITAA 1997 does not apply in these circumstances as this subsection applies strictly to amounts of ordinary or statutory income, not taxable income.*
>
> *Therefore, the income derived by the Fund in these circumstances is not non-arm's length income of the Fund as defined in subsection 295-550(1) of the ITAA 1997.*

That ruling makes perfect sense at least to the writer of this paper.

5.2 Private Ruling No. 1012582301006

In a later ruling (No. 1012582301006) the ATO give what on first appearance is the complete opposite answer to what would appear the same question.

In the second ruling the facts were a little more complex. Namely, the related entity provided two interest free loans. One so that the custodian acquired listed shares and the second loan was to enable the custodian to acquire units in a related unit trust which in turn deposited cash on bank deposits etc.

The ATO took a view that the custodian held the assets (shares and the units) under a trust estate which was a fixed trust. On that basis the relevant provision is subsection 295-550(5) (and not subsection 295-550(1) as considered in the first Ruling) and the ATO stated

> *Section 295-545 of the ITAA 1997 provides that the taxable income of a complying superannuation fund is split into a non-arm's length component and a*

low tax rate component. The note to subsection 295-545(1) explains that a concessional rate of tax applies to the low tax component, while the non-arm's length component is taxed at the highest marginal rate. These rates are set out in the Income Tax Rates Act 1986.
Subsection 295-545(2) of the ITAA 1997 provides that the non-arm's length component for an income year is the entity's non-arm's length income for that year less any deductions to the extent that they are attributable to that income. The phrase 'non-arm's length income' has the meaning given by section 295-550. Subsection 295-550(5) provides that:

> *Other income derived by the entity as a beneficiary of a trust through holding a fixed entitlement to the income of the trust is non-arm's length income of the entity if:*
>
> *(a) the entity acquired the entitlement under a *scheme, or the income was derived under a scheme, the parties to which were not dealing with each other at *arm's length; and*
>
> *(b) the amount of the income is more than the amount that the entity might have been expected to derive if those parties had been dealing with each other at arm's length.*

Having stated the above the ATO then consider various preliminary matters and then state in conclusion

> *The final requirement of subsection 295-550(5) of the ITAA 1997, which is set out in paragraph 295-550(5)(b), is that the amount of the income (derived by the entity as a beneficiary of a trust through holding a fixed entitlement to the income of the trust) is more than the amount that the entity might have been expected to derive if the parties had been dealing with each other at arm's length.*
> *If the parties in this case were dealing with each other at arm's length, the amount of income the Fund might be expected to derive through the Custody Trust is either:*
> *Ÿ nil - on the basis that no lending on the proposed terms by the Family Trust might be expected and therefore no income might be expected to be derived by the Fund through the Custody Trust; or*
> *Ÿ is less than under the proposed arrangement - on the basis that the Family Trust might be expected to lend on commercial terms that involve lower than 100% loan to value ratios given the nature of the assets to be acquired with the borrowed money and the limited recourse nature of the loans. Therefore, the substantially lower borrowed amounts available to be invested might be expected to generate less income to be derived by the Fund through the Custody Trust than under the proposed arrangement.*
> *Either way, the final requirement of subsection 295-550(5) of the ITAA 1997 is satisfied.*

5.3 Comparing the Two Rulings

The question is then whether the two rulings are inconsistent?

The answer in my opinion is no – as the reason lies within the facts of each ruling. The second ruling concerned two loan arrangements. Under the first arrangement there was a loan in order to acquire units in a unit trust. That is the question to be considered relates to income derived under a trust where the SMSF holds a fixed interest (for example, units in a unit trust). In such a case the non-arm's length income is determined under sub-section (5) and that sub-section is not confined to ordinary or statutory income (as sub-section (1) is so confined). To that extent, the second Ruling seems to me to be consistent with the first Ruling and, with respect, logically correct.

The real issue to be resolved is whether the second Ruling is correct to interpret the custodian deed arrangement as a trust estate so that subsection (5) is the relevant test in all limited recourse borrowing arrangements for SMSF's.

On 10 March 2010, the Government announced that it would amend the tax law to clarify that capital gains tax ('CGT') is not payable upon the transfer of an asset to a SMSF from a custodian trust used to undertake the superannuation limited recourse borrowing arrangement. In particular, it was stated that the trustee of the SMSF being a party to the limited recourse borrowing arrangement will be treated as the owner of the asset for income tax purposes.

This measure is designed to ensure that a trustee of a SMSF who enters into a permitted limited recourse borrowing arrangement will not face CGT obligations at the time the last instalment is paid. The income tax amendments are to apply for assessments for the 2007-08 and later income years.

In the article "*Self- managed super: strategies & investment structures for purchasing business real property*", Peter Bobbin comments that

> *in the writer's view such a safeguard to be introduced into the law is only necessary in those circumstances where a bare trust approach to the creation of the relationship does not exist.*

Peter Bobbin argues that where the nature of the Custodian Trust deed is akin to that of a bare trust, reliance on section 106-50 of the ITAA 1997 can be made so as to recognize the CGT events and consequences at the SMSF level. Section 106-50 provides that if a beneficiary is absolutely entitled to a CGT asset as against the trustee of a trust, the CGT provisions apply to an act done by the trustee in relation to the asset as if the beneficiary had done it. A beneficiary would be absolutely entitled if that beneficiary has a vested and indefeasible interest in the entire trust asset to call for the asset to be transferred to

them or as they so direct.

The changes however to the legislation will confirm the practice of treating an investor in a limited recourse borrowing arrangement as the owner of the assets for income tax purposes. See Media releases

- The former Assistant Treasurer, the Honourable Bill Shorten, media release 008/2011
- the former Assistant Treasurer, Senator the Honourable Nick Sherry, media release 37/2010
- the former Minister for Financial Services, Superannuation and Corporate Law, the Honourable Mr Chris Bowen MP, media release 020/2010.

Accordingly, it is my conclusion is that the second Ruling as discussed above fails to recognise these legislative changes and the legal concept of a bare trust (namely, not being a trust estate for tax purposes). So it is my view that the second ruling is incorrect to the extent it relates to the custodian deed and the holding of assets – in such a case the first ruling is correct and the relevant provision is 295-550(1) and not (5).

6. STAMP DUTY ISSUES FOR SMSF's

Section 67 of the Superannuation Industry (Supervision) Act, 1993 ('SIS Act') prohibits a SMSF from borrowing money. The significant exception to this rule is that a SMSF can enter into a "limited recourse borrowing arrangement" as described in section 67A of the SIS Act.

Under section 67A, a SMSF can borrow money if:

1. the money is to be applied to acquire a "single acquirable asset (including related expenses, and including expenses to maintain or repair the asset, but not to improve the asset,

2. the asset is held on trust for the fund by a "custodian" so that the fund is entitled to gain legal title to the asset after paying off the loan,

3. the rights of the lender against the borrower (ie the fund) are limited to the asset acquired, so that the lender has no recourse to any other assets of the fund.

Because of the requirement that the asset is held on trust for the fund by a "custodian" some care needs to be applied to avoid unnecessary stamp duty issues in NSW. This issue becomes even greater when clients wish to take advantage of the stamp duty concession under section 62A to transfer commercial property held in their own name into a SMSF.

6.1 Execution of a Contract for Sale of Land

The problem arises most in this area with clients entering into arm's length contracts and not knowing what name to put onto the contract.

Where a trust is the purchaser then the trust itself obviously will not go on title. Therefore what name should be used for a SMSF even if no borrowing is involved? In my view, the contract should be executed by the trustee and nothing further stated. Evidence to support the fact that the SMSF in fact acquired the property can be provided otherwise – ensuring that the deposit cheque, for example, is paid by the SMSF.

The issue becomes much more complicated when a borrowing arrangement is intended. In this case the purchaser must be the proposed custodian and not the trustee for the SMSF.

If the purchaser in the contract is described as "X Pty Ltd as custodian for Y Pty Ltd as trustee for the Z Super Fund" then issues concerning double stamp duty arise. That is the Contract can be stamped as an agreement to transfer land and, in addition, be stamped as a declaration of trust. The latter arising on the basis that the custodian trust will not have been set up prior to the date of the contract.

See further below re dating the custodian deed.

6.2 Executing the Custodian Deed

There are two alternative provisions under the stamp duty legislation in NSW that provide relief from full ad valorem duty applying to a custodian deed. Namely, relief under section 55(1)(a) and relief under section 65(10).

Section 55(1)(a) of the Duties Act provides that nominal duty of $50 is charged for a declaration of trust made by an "apparent purchaser" in respect of property that is to be held on trust for the "real purchaser". This is the concession that applies to the declaration of trust by the custodian (which is only the "apparent purchaser" of the property because it does not provide any funds for the purchase) in favour of the super fund (which is the "real purchaser" because it provided the funds for the purchase).

Similarly, section 55(1)(b) provides that nominal duty of $50 is charged for any transfer of the title to the property from the "apparent purchaser" to the "real purchaser" (the transfer that is required once the loan is fully repaid by the super fund).

There are a number of problems that can be encountered when you try to rely on section 55 relief. These problems include

(a) *Execution of Deed Pre signing the Contract*

(b) *Changing the Apparent or Real Purchaser before settlement*

(c) *Making In Specie Contributions*

Given such problems we use section 65(10) for relief from stamp duty on custodian deeds. This provides as follows

(10) No duty is chargeable under this Chapter on:

(a) an instrument referred to in section 60 (1) (a), (b) or (c) that is first executed on or after 1 July 2001, or

(b) a dutiable transaction effected by such an instrument, if the Chief Commissioner is satisfied that the primary purpose for which the transaction was effected was to comply with legal requirements relating to complying superannuation funds, complying approved deposit funds, pooled superannuation trusts or eligible rollover funds.

Section 60(1)(c) relevantly provides

(c) an instrument that is executed in order to set out …the terms of custodial arrangements concerning a complying superannuation fund,...

6.3 Transfers of property from Members to SMSF

Section 62A(1) of the Duties Act provides that concessional duty of $50 is payable on the contract of sale or transfer of property from a member of an SMSF to the trustee, provided that the transferor is the only member of the fund or that the property is to be held by the fund for the sole benefit of that member.

This concession will apply where the fund is able to make the purchase without borrowing money (ie there is no custodian involved) and the property is transferred directly from the member to the fund. Note also the as the singular applies to the plural and vice versa then a transfer from joint owners (both being the members of the SMSF) will also fall within this concession.

Where borrowing is involved, section 62A(3) of the Duties Act provides that duty of $500 is payable on the contract of sale or transfer of property from the member to the custodian.

The key requirement for these concessions is that the member is the sole member, or that the property will be held for the member's sole benefit. Where the vendor/member is not the sole member, the requirement that the property will be held for the member's sole benefit may be satisfied by the execution of an agreement (an "allocated investment agreement") by the trustee and members that the property to be acquired from the member will be allocated to that member and that any income or proceeds of sale of that property is used for the member's sole benefit.

An option to avoid an allocated asset arrangement is to have the vendor/member make an initial transfer of a minor interest in the property to the other member/s of the SMSF. For example. If member A is the sole owner of the property but the SMSF has two members being A and B, then A could transfer say a 1% interest in the property to B and then A and B transfer the property as co-tenants to the SMSF. The transfer of the 1% interest will be exposed to duty without concession.

7. CONTROL OF TRUSTS – ASSET PROTECTION AND ESTATE PLANNING

Where guarding family assets against the effect of matrimonial disputes is a concern, the estate planner needs to have some understanding of the issues that can arise in respect of trusts in a family law dispute. There are of course significant powers available to the Family Court to treat trust property as the property of the parties (or one of them) and so make orders that take account of such property. See, in particular, the High Court decision in Kennon v Spry [2008] HCA 56.

From a family law perspective, where a spouse is the real controller/appointor of a trust then the assets of the trust are usually treated as property of the parties to the marriage and added to their pool of property to be divided in the event of a financial settlement relating to a matrimonial dispute. This is especially likely where the assets of the trust accrued during the marriage from the efforts of one or both spouses.

On the other hand, where a party to the marriage was not a settlor, trustee, appointor nor beneficiary of a trust then the assets of the trust concerned may not normally be included in the pool of property. (In the Marriage of Kelly (No. 2) (1981) 7 Fam LR 762). The High Court in Spry referred to the decision in Kelly and stated:

> *The Court was concerned, inter alia, with the assets of a family company and family trust which were under the "de facto control" of the husband. The assets could be taken into consideration as a "financial resource" of the husband within the meaning of s 75(2)(b) of the Family Law Act. The trust assets, however, did not fall within the description of the "property" of the husband for the purposes of s 79 because "the husband could not assert any legal or equitable right in respect of them". That was a case in which the husband had neither a legal nor a beneficial interest.* *(footnotes deleted)*

The High Court in Spry characterised Mrs Spry's right with respect to the due administration of the Trust concerned in that case as part of her property for the purposes of the Family Law Act. That was held by their Honours to extend to her equitable entitlement to due consideration in relation to the application of the income and capital of the trust. However, the Court noted, consistently with the observations of the Full Court in In the Marriage of Hauff [1986] FamCA16; (1986) 10 Fam LR 1076 and In the Marriage of Evans (1991) 104 FLR 130, that it is difficult to put a value on either of these

rights "though a valuation might not be beyond the actuarial arts in relation to the right to due consideration".

The important point in Spry though was that their Honours, in reaching the conclusion set out above, found that Dr Spry had total control of the trust. This is set out at paragraph 73 of French CJ's reasons:

> *They are also supported by a consideration of Mrs Spry's equitable right to due consideration as an object of the Trust prior to the 1998 instrument and, for the reasons enunciated by Gummow and Hayne JJ, by consideration of that right in conjunction with Dr Spry's power as trustee to apply the assets or income of the Trust to any of the beneficiaries in his discretion. …*

It is ultimately a question of fact or degree, and the courts will look at factors including:

- whether the spouse is the appointor of the trust,
- the degree of control the spouse can exercise over the trustee (eg if the spouse a director or majority shareholder in a corporate trustee?)
- whether the spouse is a sole beneficiary,
- whether it is evident from the circumstances that the assets of the trust are ultimately intended solely for the spouse,
- whether the one or both spouses has contributed assets to the trust, and
- whether there is a pattern of distributions of income to the spouse.

By way of example, note the recent case of Romano & June [2013] FamCA 344, in which the assets of a discretionary trust were included in the pool of matrimonial assets where the husband was a director of the corporate trustee (but not a shareholder) and a named beneficiary of the trust but not an appointor. On the facts in that case (including the fact that the assets of the trust were largely the result of his efforts) the court found that the husband consistently treated the trust assets as his, to be used for his benefit or at his direction.

One issue that arises when taking into account the possibility of family law disputes is whether to establish in an estate plan one single testamentary trust for the benefit of all adult children or separate testamentary trusts such that each child will have the control and benefit of their own trust. In the case of separate testamentary trusts for each child, a further question is whether the fact that the source of the assets of the testamentary trust is the parent (and not the efforts of the adult child during that adult child's marriage) is sufficient to protect the assets from a disputing spouse of the child concerned?

Although this issue is not completely resolved it would appear that the cases so far lend support to the view that the source of the property in a testamentary trust will not protect the property from being included in the pool of matrimonial assets during a

matrimonial dispute involving the adult child. See, for example, Coventry v Coventry & Smith [2004] FamCA 249 and Essex v Essex [2009] FamCAFC 236. In Essex the husband's brother controlled the two trusts that had been established by their mother. The husband had not benefited from the trust. However, the Appeal Court held that one of the trusts had been clearly established with the intention that the capital be distributed on vesting to the husband's children and that the husband could receive income from the trust, so the assets of that trust were included in the pool of matrimonial assets.

In Lovine & Connor and Anor [2011] FamCA 432 the husband was a beneficiary under a testamentary trust established by his father. The father had in his estate provided for the establishment of two testamentary trusts. Moshin J at [122] + [124] held

> *I find the following facts. The will appointed the husband and his two sisters as executors and trustees. It divided the Estate, to the extent that it was not left to the deceased's widow, into the proportions of two thirds and one third. The one third portion was designated for the husband's sister, Ms H and has been applied accordingly. The two thirds portion was designated for the husband but intended for both the husband and his other sister, Ms S. The reason for the difference between the designation and the intention was the breakdown of Ms S's relationship. However, Ms S and/or her children have effectively received approximately half of the two thirds of the estate being one third of the entirety of the trust funds. As a result, there is a remainder of one half of the two thirds being one third of the entirety of a trust fund. They have not been distributed. It is entirely consistent and probable that they are intended by the husband to be distributed to himself and/or the parties' children.*

The Court then went on to discuss the 'control' element in relation to trusts and family law matters.

> *Circumstances in which a party to proceedings for alteration of property interests before the Court might have control of a trust in relevant terms have been the subject of judicial consideration on many occasions. In Ashton and Ashton, 1986 FLC 91-777, the husband had created a trust of which he was appointor and in exercise of that power of appointment, had appointed several different trustees over a period of time. However, the Court found that he had always had control arising out of that power of appointment and determined that the assets of the trust were there for assets of the husband to be included in the pool of assets in the proceedings. (See also Davidson and Davidson (1991) FLC 92-197, Stephens and Stephens and Ors (2007) FLC 93-336).*
> *The circumstances of this matter are distinguishable from those in Ashton's case (supra) but not in any ultimately material sense. While that trust was not a testamentary trust, there were beneficiaries other than the husband. The husband had the sole power of appointment and treated the assets of the trust as effectively*

> *his assets.*
> *In this matter there are other beneficiaries. However in every sense the husband is the only real decision maker and while the will appointed his sisters as trustees with him, they play no active role. The actual distributions in this matter have already benefited the husband's two sisters and/or their children and it is entirely consistent with the facts that the residual benefit should be applied to the husband and/or his children. Accordingly, I find that the residual assets must be included as an asset in these proceedings. I will refer to their quantum in due course.*

The husband in Lovine appealed the decision of Moshin J including that part of the decision discussed above. However, in the Full Court the husband did not ultimately challenge this part of the judgement of Moshin J.

Lovine may be compared with the trust in MacDowell & Williams and ors [2014] FamCA 479. The wife in MacDowell was a primary and default beneficiary of the F G MacDowell Discretionary Trust (her parents being the secondary beneficiaries) and B Pty Ltd was the corporate trustee for the Trust, the directors of which were the wife's parents. The wife's parents had absolute control of the F G MacDowell Discretionary Trust, and, although the wife was the primary and default beneficiary of that Trust, the wife's parents had in the past caused the Trust to make distributions to themselves and to other entities they controlled where the wife might have otherwise received those distributions as the default beneficiary.

Kent J in MacDowell referred to the decision in Spry and, in particular, paragraph 73 of French CJ's reasons as quoted above in this paper under paragraph (a). His Honour then held

> *It is clear, on the evidence before me, that the Wife does not in fact control any of the entities from which documents are sought by the Husband. The Husband concedes that the Wife is neither a director nor a shareholder in any of those companies, and that her interest is restricted to being the primary and default beneficiary of the F G MacDowell Discretionary Trust. … I also find unpersuasive the Husband's submission that the creation of C Pty Ltd in March 2010, near to the date of separation of the parties, of itself implies that this company was to be used as a vehicle for the protection of the Wife's funds from any property dispute between the parties, without further evidence.*

Kent J in MacDowell went on to emphasise the 'control' issue by comparing the current matter with the trust in Keach & Keach [2011] FamCA 192 as follows

> *However, there appear to be significant distinctions between Keach and this case. In Keach, the husband was in fact a director and a minority shareholder in the corporate trustee of the trust and had also advanced loans to the trust. This,*

amongst other factors, indicates that although the husband in Keach did not technically control the relevant trust, he had significant input into its administration. This is a clear point of contrast with this case, where the Husband does not submit that the Wife has any directorship or membership of the corporate trustee of the F G MacDowell Discretionary Trust or any of the other entities subpoenaed by the Husband. There is not, at present, any evidence before this Court to suggest, even prima facie, that the Wife has control over any of the entities referred to in the subpoena or that such control is likely to occur in the future. Nor has there been a pattern of significant and consistent distributions which point to the F G MacDowell Discretionary Trust being a significant source of funds for the Wife into the future. As highlighted by Senior Counsel for the Wife's parents, the Wife has received only $28,000.00 over the ten years of the existence of the Trust, and during that time, distributions have also been made to other beneficiaries of the Trust, indicating that this Trust is truly discretionary not only in form but also in use and effect.

If a single testamentary trust with all of the children as beneficiaries is to be established, careful consideration needs to be given to the control of such a trust.

Where a single testamentary trust is established it is common for all of the children to be named as joint appointors. In such a case, child No. 1 cannot be said to be in control as that child cannot act alone but requires the joint agreement of all of the children. Similarly, none of the other children have control of the trust. Drafting the appropriate mechanism as to how decisions are reached between the joint controllers then becomes the major task for the estate planner, and it is important to ensure that the trust does not become ungovernable if, for example, one child refuses to cooperate with the others.

Another difficulty arises where there is say only one child in the family. Is it appropriate in such a case to have an outside person to be appointed with that child as a joint appointor?

The question remains open, however, whether a single testamentary trust owned and controlled equally by several adult children will protect the property of the trust from a matrimonial dispute involving one of the adult children. There is no case that I am aware of that provides a definitive answer to this question. It is, however, strongly arguable that property in a trust should not be included in the pool of matrimonial assets where the trust is under joint control and is intended for the benefit of multiple families (ie the various families of the siblings). Note, however, the case of Simmons v Simmons [2008] Fam CA 1088 which resulted in the inclusion of the husband's interest in such a trust (namely, a multiple family trust). However, the facts in that case were unusual and, in particular, the husband had made financial contributions to the trust concerned.