# SME Structuring (Part 1)

Carlo Di Loreto

Tuesday 6 June 2023

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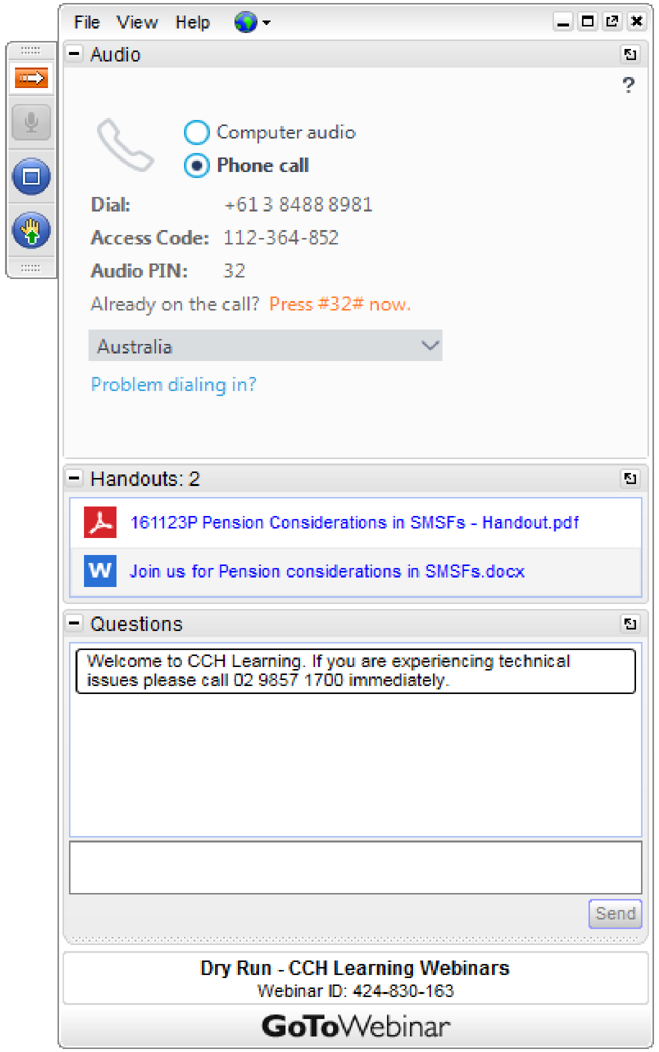


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# Questions?

Alison Wood
Moderator

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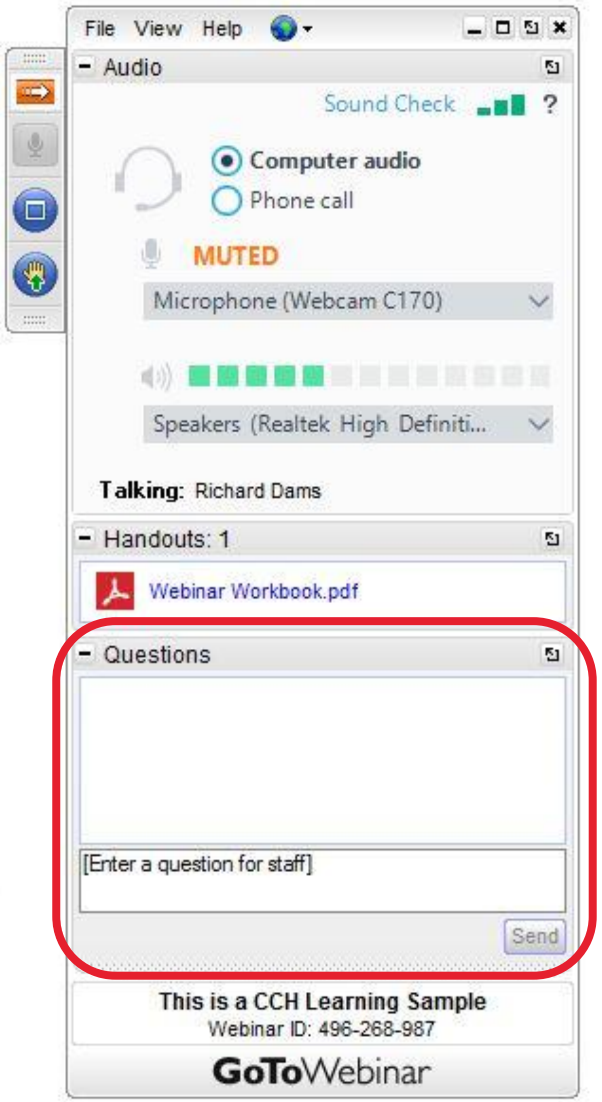

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# Your Presenter

**Carlo Di Loreto**

Partner - Tax Advisory
*Crowe Australasia, an affiliate of Findex*

# Part 1 of 2 Part series

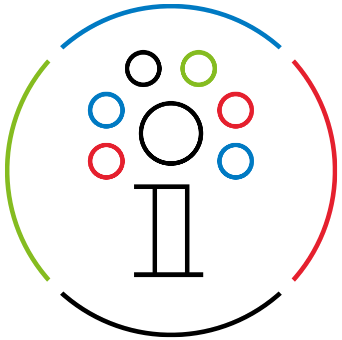
- Part 1 will deal with corporate structures
- Part 2 will cover partnerships

Note:

These sessions will be presented on the basis that a certain degree of assumed knowledge already exists.

To assist, a ‘high-level’ table of comparatives that sets out a summary of key issues that influence decision making for choosing business structures.

# Today's session will cover



## Overview

- structuring objectives
- the cost of getting it wrong
- structuring for proprietary companies
  - set-up
  - introduction of outside investors
  - exit

# Structuring objectives

# Structuring Objectives

- asset protection
- optimising after tax returns
- future exit strategy
- effective financing

# Structuring Objectives

- flexibility for outside investors
- extracting cash
- administrative simplicity
- succession planning

# The cost of getting it wrong

- too difficult for client to administer
- ‘trapped’ losses
- CGT concessions unavailable on exit
- other tax concessions may also be unavailable

# The cost of getting it wrong

- may forgo deductions – incorrect positioning of business and/or assets
- high (ineffective) tax rates
- significant cost to ‘unwind’ or restructure
- may come under ATO and/or OSR scrutiny

# Proprietary company

# Overview

- There are two broad categories of company:
  - proprietary companies
  - public companies (unlisted or listed)

- The type of company  chosen will depend on:
  - the type of business contemplated
  - the finance available; and
  - need for control or restrict membership

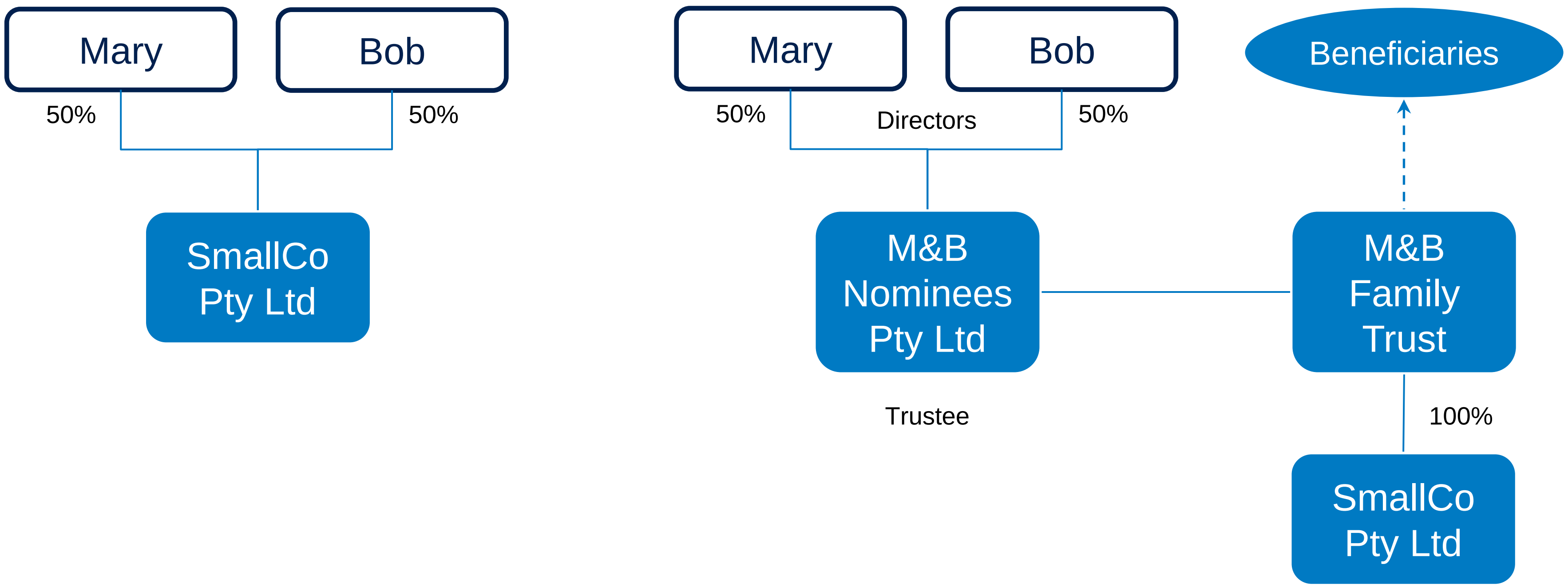
# Proprietary Company

- proprietary companies classified as ‘large’ or ‘small’ - classification depends upon the company’s financial year results & can change from year to year
- a proprietary company is defined as 'large' for a financial year if it satisfies at least two of the criteria below, at the end of the financial year:

| ‘Large’ Proprietary Company | Financial Years to 30 June 2019 | Financial Years from 1 July 2019 |
|---|---|---|
| Consolidated revenue | $25m or more | $50m or more |
| Gross assets | $12.5m or more | $25m or more |
| Number of employees | 50 or more | 100 or more |

Note:
Most large proprietary companies have to lodge audited financial statements. It is also important to note that small proprietary companies that are *controlled* by a foreign company generally require a statutory audit.

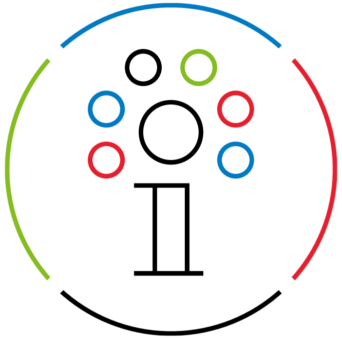
# Common Structures for 'Small' Pty Companies



# Structuring Stages

- set-up or establishment
- introduction of outside parties
- exit or sale

# Poll Question 1



The consolidated revenue of LoSCo Pty Ltd for the year ended 30 June 2022 was $51.7m.  The company's gross assets at the year end totalled $18.8m and it employed 100 people, meaning that it will be classified as:

a. A 'small' proprietary company

b. A 'large' proprietary company

# Proprietary company: Set-up

# Key issues on set-up

- asset protection
- streaming of income & optimising effective tax rate
- accessing tax losses
- retaining the benefit of franking credits
- effective funding arrangements
- exit strategy & ability to access small business relief CGT concessions

# Set-up: asset protection

- a measure of asset protection can be achieved by using family trust, a corporate trustee & appropriate asset ownership

- depending on nature of business & individuals involved, serious consideration should be given 'upfront' to the key asset protections guidelines of:
  - ensuring family assets controlled by person not financially exposed (usually spouse)
  - observing the clawback/avoidance aspects of Bankruptcy Act 1966

# Set-up: asset protection

- generating income in business entities quarantined from the financial risk
- secure funding extended to the risk exposed person or entity
- use ‘layers’ of protection:
  - ensure risk minimised by seeking & implementing expert advice
  - take adequate insurance cover
  - own little or no assets

# Set-up: asset protection

## Limited Liability

- one of the most important benefits of a corporate structure is limited liability

- important to note that courts or Corporations Act 2001 [s 588G] will 'pierce' the corporate veil of limited liability & 'look through' company to members or controllers, where it trades whilst insolvent

- the Directors will be held personally liable for debts incurred by the company whilst insolvent trading taking place

# Set-up: streaming income

- ownership of proprietary company shares by the family trust can be effective from the perspective of ‘streaming’ income

- rules allowing the ‘streaming’ of capital gains & franked distributions need to be considered:
  - allows (where permitted by the Trust Deed) capital gains & franked distributions to be streamed for tax purposes to beneficiaries
  - entitles beneficiaries to primary production averaging & farm management deposits where no trust law income to which beneficiary presently entitled

# Set-up: streaming income

- structure still retains benefits of family trusts & ability to distribute all or part of annual profits to wide range of beneficiaries, subject to constraints of FTE
- in family trust structure - possible in any year to achieve an effective tax rate on profits for that year equal to or less than 25%/30%
- is done by paying limited dividends to family trust which are ‘flowed through’ to lower taxed beneficiaries

# Set-up: accessing tax losses

- if company wishes to carry forward tax losses – must satisfy continuity of ownership test (COT), same business test (SBT) or similar business test (SiBT)
- to satisfy COT > 50% of company's shares must be beneficially owned by same persons in year loss incurred, year claimed & intervening years
- where all shares held by discretionary trust, shares not beneficially owned by anyone
- where 50% or more shares held by discretionary trust, COT can not be satisfied

# Setup: accessing tax losses

- SBT only applies where change takes place in beneficial ownership of shares in company
- where discretionary trust holds 50% or more of shares – there can be no change in beneficial ownership – SBT can not apply
- 2 special tracing rules allow companies whose shares owned by discretionary trusts, to be able to satisfy requirements of COT & SBT:
  - the family trust concession; and
  - the alternative test

# Set-up: accessing tax losses

## Family Trust Concession

- where FTE is made - trustee taken to own shares beneficially - means can satisfy COT or if there has been a change of ownership, SBT can be applied

## Alternative Test - requires that:

- at least 50% of shares are held by non-fixed trusts either directly or indirectly;
- there has been no change to any of shareholders' interests in company; and
- non-fixed trust can satisfy trust loss tests – 50% stake, control & POD tests

# Set-up: benefit of franking credits

- ‘45 day holding period rule’ - cannot claim imputation credits in relation to franked dividends unless held shares for at least 45 days

- only applies to shares acquired after 31 December 1997 - modified version of 45 day holding period applies to beneficiaries of a trust

- beneficiary needs to be exposed to 30% of risks & opportunities of trust's shareholding before they can
  - satisfy 45-day rule &
  - claim imputation credits on dividends distributed to them by trustee of trust

# Set-up: benefit of franking credits

- for beneficiary to be able to claim imputation credits, beneficiary must have fixed interest in corpus of trust before they can satisfy 45-day rule
- *but*, beneficiaries of a discretionary trust do not have a fixed entitlement to corpus of a trust
- means they cannot be exposed to at least 30% of risks & opportunities of trust's shareholding – means 45-day holding rule cannot be satisfied
- a separate exception applies where shares are owned by a discretionary trust that has made a FTE
- means beneficiary of family trust entitled to claim imputation credits on dividends received by trust provided trustee (not beneficiary) satisfies 45 day holding rule

# Set-up: benefit of franking credits

- 2 exceptions to the rule:
  - 45-day rule must only be satisfied to shares acquired on or after 31 December 1997
  - beneficiary entitled to claim imputation credits where small shareholder exemption satisfied i.e., beneficiary's total imputation credits from all sources do not exceed $5,000

Note:

The above limit applies to dividends on all shares held by taxpayer – not just those acquired after 31 December 1997.

# Set-up: company loans

- significant disadvantages of companies  - inability for shareholders to obtain, in a tax effective manner, income from the company

- *Division 7A ITAA 1936* prevents a company from lending the amount interest-free to the shareholders

- the alternative is for the company to lend the funds to the shareholders on terms that comply with *s 109N ITAA 1936*

- *Division 7A* loans have to be carefully managed to ensure that adverse tax consequences are not triggered

# Set-up: effective funding arrangements

- two basic finance methods:
  - equity financing involves selling or allotting shares in the company
  - debt financing

- debt funding often easier for companies than other forms of organisation because a company can make use of floating charge

- commercial advantage over other entities as a borrower because of:
  - the familiarity of the company as a commercial structure
  - the capacity of a company to grant a floating charge over its assets

# Set-up: effective funding arrangements

## Debt: Equity Provisions

- the debt: equity rules [*Division 974 ITAA 1997*] contain specific rules relating to ‘at call loans’ made to a company by a ‘connected entity’
- a connected entity is basically an associate of the company in terms of *s 318 ITAA 1936*
- an ‘at call loan’ is a loan that does not have a fixed term & is repayable on demand

# Set-up: effective funding arrangements

## Debt: Equity Provisions

- issue is whether loan treated as debt & therefore interest deductible or treated as equity & hence not deductible

- this concession allows companies with GST turnover of less than $20 million to treat at call loans as debts

## Note:

The concession only applies to at call loans from connected entities.

# Set-up: effective funding arrangements

## Debt: Equity Provisions

- if GST turnover is $20 million or more, then the loan needs to have term of < 10 years to be classified as debt

- An 'at call' loan can also be a debt interest if interest is charged on the loan and the interest rate is at least 75% of the benchmark rate of return for the loan

- if the debt test is not passed & treated as equity, a non-share capital account must be maintained

CAUTION: The ATO may apply section 45B of the ITAA 1936 to deem a repayment of a loan that is a non-share equity interest – the effect of this is to treat the repayment as being made in substitution of a dividend.

# Set-up: exit strategy

Reminder:

- The small business CGT concessions can often provide planning opportunities for:
  - new business operating structures : consider your client's 'exit strategy' when establishing the structure
  - existing business operating structures: potentially access reliefs in future (care required when altering existing structure)

# Set-up: exit strategy

Reminder:

- The significant individual & CGT concession stakeholder tests apply.

- Three situations where a significant individual is required:
  - for small business relief on sale of shares or units;
  - 15-year exemption through an entity or by selling shares/units;
  - retirement exemption on a capital gain made by a company/trust

# Set-up: exit strategy

Reminder:

- An individual is CGT concession stakeholder of a company or trust at a particular time if, at that time, the individual is:
  - a significant individual (i.e., 20% or more SBPP) of the company or trust; or
  - a spouse of a significant individual in the company or trust, provided the spouse has a SBPP in the company or trust at the time, that is greater than zero

# Set-up: exit strategy

Reminder:

- Where interposed entity such as a company or a trust is vendor of  shares or units, additional '90% test' test applies.

- To pass the 90% test, in relation to a share or unit in the object company or trust (owned by the interposed entity):
  - the CGT concession stakeholders in object company or trust
  - must together have a SBPP in interposed entity of at least 90%

# Poll Question 2

Under the debt: equity rules, an 'at call' loan has a fixed repayment term and is repayable under the terms of a written loan agreement.

a. True

b. False

# Proprietary company: Introduction of outside parties

# Key issues – introduction of outside parties

- Typically, the introduction of outside parties can be done in the following ways:
  - the allotment of ordinary shares
  - the sale of existing ordinary shares
  - the allotment of dividend access shares

# Allotment of Ordinary Shares: Value Shifting

- general value shifting (GVS) rules apply to both companies & trusts

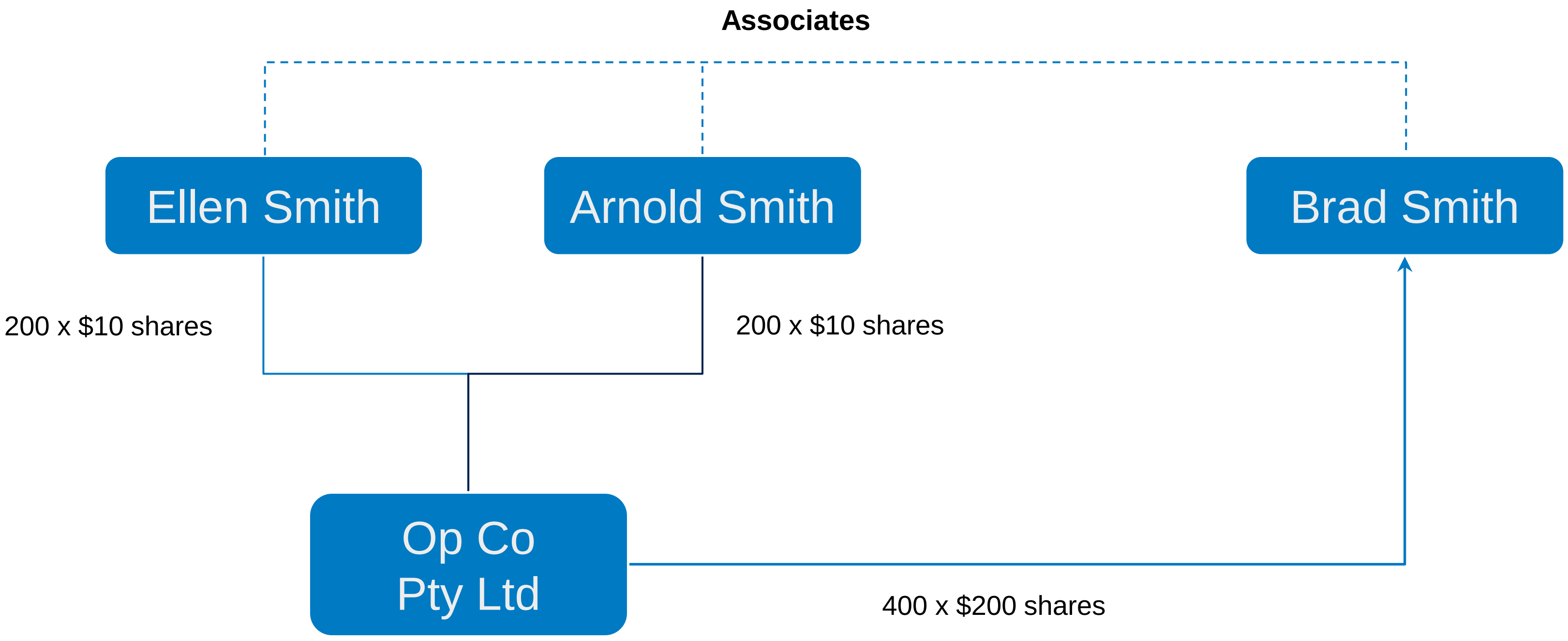
- 3 types of value shift can arise:
  - direct value shift
  - indirect value shift
  - direct value shift by creation of rights

# Allotment of Ordinary Shares: Value Shifting

- direct & indirect value shift rules apply to equity & loan interests in an entity
- value shift by creation of rights applies to rights created over non-depreciating assets
- simple example will put these provisions in context

# Allotment of Ordinary Shares: Value Shifting

## Direct Value Shift - Example



# Allotment of Ordinary Shares: Value Shifting

## Direct Value Shift – Example

- OpCo originally had 400 shares, 200 each owned by Mr & Mrs Smith
- these were issued for $10 each & now have a MV of $1,000 each
- OpCo issues 400 new shares to Brad Smith for $200 per share
- 40% of MV of OpCo's shares before new issue shifted from Mr & Mrs Smith to Brad (who now has a 50% interest)

# Allotment of Ordinary Shares: Value Shifting

## Direct Value Shift – Example

- Mr & Mrs Smith taken to have made capital gain of $79,200 each
- calculated as if they had disposed of 40% interest to Brad
- the cost base of Brad's shares are equal to MV ($600 each)
- cost base of Mr & Mrs Smith's shares reduced (to $6 each) on the basis that (effectively) 40% of each of their interests is disposed of

# Direct Value Shifting

- The conditions for a direct value shift are that:
  - the target entity is a company or trust
  - the controlling entity test is passed
  - the cause of value shift test is passed
  - the taxpayer must be an affected owner
  - the direct value shift is not reversed within 4 years

# Allotment of Ordinary Shares: Value Shifting

## When does share value shifting not apply?

- where there is no controller  - if there are 3 or more independent shareholders with equal shares, there will not be a controller
- where value shifted to shares which are not owned by controller or an associate (or associate of that associate) – affected owners
- where value shift is <$150K - if shares are issued at MV share value shifting will not apply
- if it is more than likely it will be reversed within 4 years

# Allotment of Ordinary Shares: Division 149 ITAA 1997

WARNING

- when dealing with (existing) pre-CGT shares, need to check Division 149 ITAA 1997 will not be triggered, whereby a pre-CGT shares becomes a post CGT shares
- Division 149 ITAA 1997 applies where there has been a change of 50% or more on the underlying interests (i.e., shares or units) in the pre-CGT asset
- where it applies, the underlying asset is deemed to have been acquired at market value at the time of the ownership change

# Allotment of Ordinary Shares: Division 149 ITAA 1997

## Exceptions

- for purposes of calculating majority underlying interests, rules are modified if:
  - rollover relief in respect of a marriage breakdown claimed
  - death of shareholder

- if either event occurs, new owner taken to stand in shoes of old owner – new owner deemed to hold shares as if they were former owner

# Sale of Ordinary Shares: CGT Event K6

- CGT only applies to extent the value of the post assets exceed their cost base
- if CGT event K6 triggered, CGT may apply to disposals of pre-CGT shares in company or units in a unit trust
- Taxation Ruling TR 2004/18 deals with application of CGT event K6, including:
  - what is meant by ‘property’
  - application of the 75% test
  - calculation of the capital gain
  - interaction with other provisions of the ITAA 1997

# Sale of existing Ordinary Shares

WARNING

- if you do not receive capital proceeds from a CGT event - generally taken to have received the MV of the CGT asset

- there are a number of exceptions to this rule & situations where MV substitution rule may be disregarded

- rule also applies if capital proceeds are more or less than the MV of asset and:
  - parties to CGT event are not dealing at arm's length; or
  - CGT event is redemption, release, abandonment, surrender, forfeiture or cancellation of the asset (CGT event C2)

# Dividend Access Shares

- dividend access shares:
  - designated class of shares issued by company
  - entitle holder to dividend payment
  - if directors exercise discretion to declare dividend on that class of shares

- dividend access shares are not new  - historically were used in context of tax planning under death duties legislation

# Dividend Access Shares

- use of discretionary trust as shareholder has become preferred structure
- due level of asset protection it provides – decreases  need to have a range of different classes of shares
- for businesses that have not started with a discretionary trust in place as an owner of the business – dividend access shares can still be used

# Dividend Access Shares

WARNING

- A number of related provisions that directly impact dividend access share arrangements must also be considered.

- The main concern with issuing a dividend access share to a new shareholder is value shifting. Objectives of the direct value shifting provisions are:
  - to prevent inappropriate losses from arising on realisation of equity or loan interests from which value has been shifted to other equity or loan interests in the same entity; and
  - to prevent inappropriate gains from arising on the realisation of equity or loan interests in the same entity to which the value has been shifted

# Dividend Access Shares: Part IVA ITAA 1936

- for Part IVA ITAA 1936 to be applied to an arrangement - must be shown that sole or dominant purpose was to obtain a tax benefit
- the conclusion on Part IVA must be drawn having regard to the 8 factors listed in s 177D(2) ITAA1936
- issuing of dividend access shares at time company set up would make it more difficult for Part IVA to be applied
- at time structure established - many factors & concerns to be taken into account - income tax minimisation is only one

# Dividend Access Shares: Part IVA ITAA 1936

- where dividend access shares are issued at a later time however, Part IVA may be of concern

- if intention to issue a dividend access share:
    - to provide asset protection, or reduce value of entity, where alternative to simply pay a dividend to the existing shareholders
    - then it can be contended that dominant purpose to provide asset protection, or to allow a sale to proceed

# Dividend Access Shares: Dividend Stripping

- alternative mechanism rendering dividend access share ineffective - disallow franking credit benefit by treating arrangement as a 'dividend stripping operation'

- a distribution is made as part of a 'dividend stripping operation' when it is made in the course of a scheme that:
  - was by way of, or in the nature of, dividend stripping; or
  - had substantially the effect of a scheme by way of, or in the nature of, dividend stripping

# Dividend Access Shares: TD 2014/1

- ATO take the view that Part IVA ITAA 1936 may apply to 'dividend access share arrangements' - highlights arrangements typically involve:
  - issuing a special class of share, then
  - declaration of dividend to shareholders that distributes profits to associates with reduced tax
- ATO take view this is 'dividend stripping' – contention that transaction motivated by non-tax purpose - likely to be challenged
- ATO will consider each case on its merits before applying Part IVA - timing of special share issue & circumstances of shareholders important

# Proprietary Company: Exit or sale

# Exit or Sale

- 2 alternatives for effecting a business sale:
  - Sale of business assets by the business entity (i.e., sale of a business)
  - Sale of the entity (i.e., sale of shares in a company or units in a unit trust)

- in all cases, clients should do a comparison to determine whether it is preferable to sell the business or the entity

- the preferred option will depend on the particular circumstances of the seller and the buyer

- advisers that fail to compare both options can result in the client paying more tax than they need to

# Exit or Sale: Accessing CGT SBR

- 2 basic conditions must be satisfied
  - The first basic condition is that at least one of the following applies:
    - you are a ‘small business entity’ (SBE) for the income year; or
    - you satisfy the NAVT; or
    - you are a partner in a partnership that is a SBE for the income year and the CGT asset is a partnership asset
  - The second basic condition is the CGT asset satisfies the ‘active asset’ test

# Exit or Sale: Accessing CGT SBR

- If the CGT asset is a share in a company, or interest in a trust, you must satisfy either of the following additional conditions:
  - you are a CGT concession stakeholder in the company or trust (i.e., you must be an individual); or
  - CGT concession stakeholders in the company or trust have a combined small business participation percentage (SBPP) in you (i.e., the shareholder/unit holder) of at least 90%
  - ‘CGT concession stakeholder’ is a ‘significant individual’ (SI)

# Exit or Sale: Accessing CGT SBR

- A CGT concession stakeholder in a company or trust is an individual who is:
  - a significant individual in the company or trust; or
  - a spouse of a significant individual in the company or trust, provided spouse has a small business participation percentage (SBPP) in company or trust greater that zero

# Exit or Sale: Accessing CGT SBR

- an individual is a significant individual in a company or trust if the individual has a SBPP in the company or trust of at least 20%

- three situations where a significant individual is required
  - for small business relief on sale of shares or units;
  - 15-year exemption through an entity or by selling shares or units;
  - retirement exemption on a capital gain made by a company or trust

# Exit or Sale: Accessing CGT SBR

Reminder:

- The meaning of ‘control’ determined for three different situations:
  - direct control of an entity other than a discretionary trust
  - direct control of a discretionary trust
  - indirect control (which applies to all entities)

# Exit or Sale: Accessing CGT SBR

Reminder:

- company
  - rights to 40% of dividends, or capital or voting
- unit trust
  - entitlement to 40% of income or capital of the trust
- partnership
  - entitlement to 40% of income or capital of the partnership

# Exit or Sale: Accessing CGT SBR

- different classes of shares (e.g., voting/non-voting shares, redeemable shares, preference/dividend access shares) - impact calculation of SBPP

- for an entity to hold a direct SBPP in a company at a particular time, it must have:
  - voting power in the company; or
  - an entitlement in respect of any dividends payable; or
  - an entitlement in respect of any distribution of capital

- all classes of share except redeemable shares are taken into account for the purpose of applying SBPP

# Exit or Sale: Accessing CGT SBR

Note:

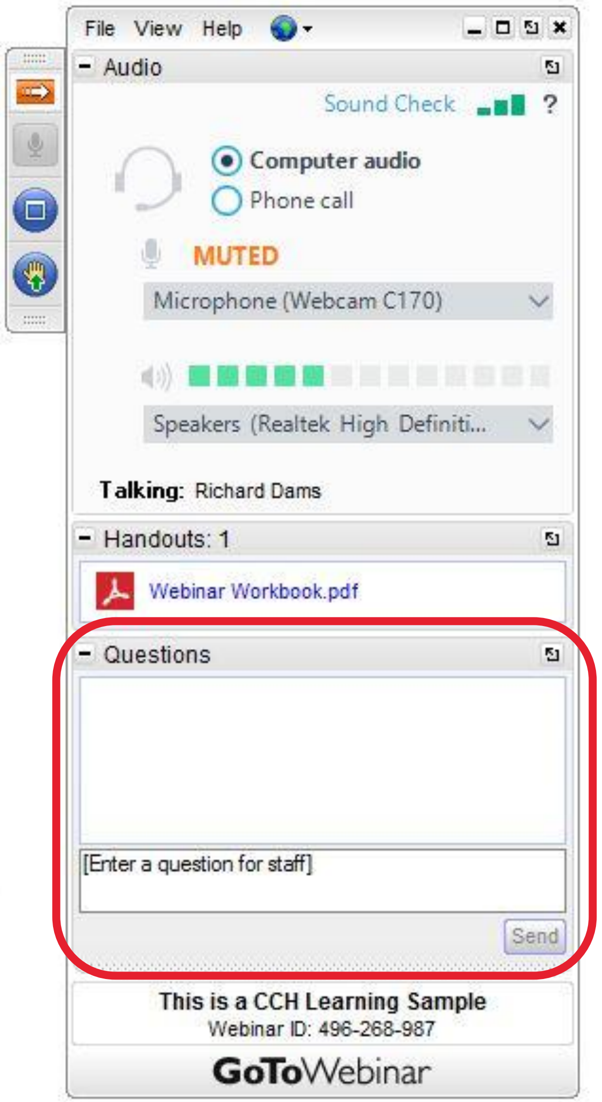
- If the voting, dividend & capital entitlements are different, then you are required to select the 'small or smallest' percentage.

- Where there are dividend access shares on issue – may need to consider the company buying back the shares prior to selling to fall within the SBR concessions.

# Questions?

Alison Wood
Moderator

Type your question and hit Send



# Upcoming Webinars

- 7 June – Thin Cap and Transfer Pricing Reform
- 7 June – The New $3M Super Tax: What we know, and what your clients MUST know!
- 8 June – Aged Care for High-Net-Worth Individuals
- 8 June – For-Profits - Getting ready for 30 June 2023 Reporting Season
- 13 June - Preparing Clients for Mediation Involving Relational Conflict
- 13 June – Late Invoices - How to Encourage your Clients to Pay with Grace and Ease

# Questions

**Carlo Di Loreto**

Partner - Tax Advisory
*Crowe Australasia, an affiliate of Findex*

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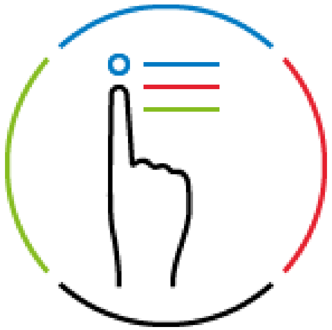

# Thank you for attending

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