Pre-Death Restructures Involving a Business

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Pre-Death Restructures Involving a Business.

1 Overview

1.1 Data released by the Australian Bureau of Statistics showed 2,569,522 private registered business' in the quarter ending September 2022.[1]

1.2 With a population of approximately 26 million as of 30 June 2022, there existed a business for every 10 individuals.

1.3 With such prevalence of businesses in the Australian population, professional advisors must no doubt be aware of the various considerations in whether the business is suitable for the 'next generation of ownership'.

1.4 This paper seeks to provide lawyers and accountants (and other advisors) with the foundations to consider the various legal, tax and practical issues in determining how best to transition a client's business for the 'next generation of ownership'.

1.5 In doing so, the paper will be separated into two parts:

(a) Part 1 – Which provides a broad overview of the various considerations and lesser considered traps such as:

(i) Business structures and succession planning suitability.

(ii) Pre-death tax concessions, rollovers and 'exemptions' for a business restructure.

(iii) State tax considerations.

(iv) Additional legal considerations.

(v) Family business considerations.

(b) Part 2 – Which provides examples and case studies of various pre-death restructures involving a business, such as:

(i) Restructuring a company with individual shareholders to discretionary trust shareholders.

(ii) Amending a discretionary trust to a fixed trust.

(iii) Restructuring a discretionary trust to enable fixed ownership.

(iv) Restructuring businesses conducted by a sole trader or partnership.

(v) Other potential business restructures.

1.6 Given the wide range of issues that should be considered as part of a pre-death restructure of a business, this paper does not seek to consider each issue in depth. Rather, this paper seeks to act as a compendium of the issues relevant to professional advisors when assisting a client transition their business for the 'next generation of ownership'.

1.7 It is noted that it is rare for a single advisor to be fully across all the issues and that it is often the case that various advisors (whether it be a combination of one or more accountants, consultants and/or lawyers) work together to determine the most suitable end structure.

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[1] ABS Citation - Australian Bureau of Statistics (June 2020 - Sept 2022) 'Table 4. Quarterly Counts of Australian Businesses, Entries and Exits, Experimental estimates, June 2020 - Sept 2022 [time series spreadsheet], https://www.abs.gov.au/statistics/economy/business-indicators/counts-australian-businesses-including-entries-and-exits/latest-release#data-downloads, accessed 06 February 2023.

1.8 Finally, this paper (and accompanying presentation) has been prepared on the premise that the topic refers to circumstances where a business owner is required to undertake any form of restructure pre-death to ensure the business is owned in a suitable entity for the 'next generation of ownership'. Whether the restructure also requires additional steps as part of an estate plan will also be considered as it is not uncommon for pre-death restructures to be a preliminary step as part of a broader estate plan or business succession plan to introduce the 'next generation of ownership'.

1.9 Please note that this paper will make references to the following legislation:

(a) *Income Tax Assessment Act 1997* (Cth) (**ITAA 1997**).

(b) *Income Tax Assessment Act 1936* (Cth) (**ITAA 1936**).

(c) *Duties Act 2001* (Qld) *(***QLD Duties Act***).*

1.10 It is noted that this paper covers certain tax provisions of ITAA 1936 and ITAA 1997. Any restructure being undertaken should consider the potential application of the general anti-avoidance provisions of Part IVA ITAA 1936. This paper will not consider such provisions.

Part 1 - Considerations

2 Business structures and succession planning suitability

2.1 In determining the most suitable type of entity to hold the business for the 'next generation of ownership', care and consideration is required in relation to the advantages and disadvantages of the various business structures, as well as an understanding of the succession planning issues related to 'transferring' the business structure as part of an estate plan.

Business entities and succession planning

2.2 How to pass a business to the 'next generation of ownership' will ultimately depend on the type of trading entity which it operates from.

2.3 Based on recent data from the Australian Bureau of Statistics, close to a third of registered private businesses in Australia are operated by sole proprietors.[2]

2.4 As ownership of a business through a sole proprietor does not offer scope to introduce new owners, save for forming a partnership; pre-death restructures are commonly considered to transfer the business into a more suitable entity for transitioning to the next generation of ownership.

2.5 Later sections of this paper will consider the available mechanisms in ensuring there are no adverse capital gains tax (**CGT**) consequences in undertaking such a restructure.

2.6 Of relevance, however, is the need to understand the trading structure of the business to ensure steps are taken to restructure the business accordingly.

2.7 Two of the more common non-sole proprietor trading structures are as follows:

(a) company structures (whether with individual or trust shareholders) – of which approximately 40% of registered private businesses operate from; and

(b) discretionary trust structures (whether with individual trustees, company trustee and/or an appointor role).

2.8 It is also useful to acknowledge the distinction in the above structures between ownership (who the underlying owners are), and control (those who will manage the business).

Company considerations

2.9 The use of a company as a trading entity is generally seen as preferable, as reflected by the significant proportion of private registered businesses operating from a company structure.

2.10 The benefits of having a flat reduced tax rate and the ability to retain earnings within the business environment are often stated as reasons for establishing a company to operate a business.

2.11 Often these benefits will outweigh the disadvantages of losing the 50% general CGT discount and the complexity of navigating Division 7A issues in the tax legislation.

2.12 The two key roles involved with a company are the:

(a) members (or shareholders who are the legal entities that own the shares and have an ownership interest in the company equal to the proportion of shares they own); and

[2] Ibid

(b) directors (being the persons who are responsible for making the legal decisions for the company).

2.13 Steps can be taken pre-death to transfer shares to the next generation either during the lifetime of the original business owner or as part of the original business owner's estate plan.

2.14 From a succession planning perspective, the:

(a) management of the company can be dealt with by putting in place appropriate processes and documents governing the succession of the director – for instance, pursuant to a shareholders agreement or a tailored company constitution; and

(b) ownership of the company is managed through ensuring the shares in the company pass to the right people – for instance, through the use of call option agreements or transfers before or after the death of existing key persons (who could be the ultimate owners of shares).

2.15 Where the shares are held by individuals, that individual will require an appropriate Will to specifically ensure the shares are gifted to the relevant recipient. Where the intended recipient is a family member chosen to succeed the business, the Will could be prepared to specifically gift the shares directly to the recipient or indirectly to the recipient via a testamentary trust. As will be considered below, depending on the timing in which ownership is intended to pass to the next generation, it may be preferable for shares to be held by an individual to enable the gifting of such shares into a testamentary trust structure.

2.16 That said, complications can arise with shares held by individuals in a family business where it is likely that an individual's Will could be challenged. Potential arguments in having an individual's Will challenge can arise:

(a) where a disgruntled family member believes they have not received their fair share under a Will (which is common in blended family situations between children from a prior relationship and a current spouse);

(b) where certain promises were made to family members that the family business would pass to them, and such promises were not followed through in the documentation; or

(c) where it can be argued that a deceased failed to have adequate mental capacity in making their Will.

2.17 In situations where there is a chance of a Will challenge, steps should be taken to mitigate the likelihood of disruption to the business transition. Some available solutions can include restructuring the shareholding during the lifetime of the individual such that the shares do not pass pursuant an individual's Will (i.e. by transferring the shares into a trust), or implementing alternative arrangements.[3]

2.18 Where the shares are held by trustees for a trust, the terms of the trust will then need to be reviewed and documents prepared to ensure control of that trust passes to the relevant recipient/s.

[3] Note the case of *Re Permewan No. 2* [2022] QSC 114 in which a 'gift and loan back arrangement' failed for reason of the documentation being improperly completed. Further, had the documentation been properly completed, additional commentary suggested that the 'gift and loan back arrangement' would fail on the basis that the arrangement was a 'sham' and to enable such arrangement to be effective would be against public policy.

2.19 In contrast, if the shares are to be sold to a non-family member for value, then steps could be taken to put in place appropriate option agreements to enable an intended successor to purchase the shares from the deceased's estate or shareholding trust at a prior agreed value or valuation mechanism.

2.20 If the shares are held by other companies, then the succession planning considerations above will need to be made in relation to that holding company.

2.21 Where there are multiple owners of a company, then steps should be taken to ensure an appropriate shareholders agreement or company constitution is drafted containing:

(a) directorship appointment and share right provisions – which if drafted appropriately, can enable an incoming owner to integrate seamlessly into the business;

(b) pre-emption right provisions – which would enable continuing owners to have a first right to acquire an existing owner's interest in the business (to ensure existing owners are not forced into business with an unwanted third party who bought an existing owner's interest);

(c) exit mechanisms due to involuntary events (such as retirement, death, total permanent disablement or breach of agreement).

2.22 Additional issues that should be addressed as part of a comprehensive shareholders agreement may include:

(a) What type of business is to be carried on?

(b) Will all of the parties be actively involved in the day-to-day operations of the business?

(c) How will day-to-day decisions of the company be made (for instance, by simple majority decision of the directors?)

(d) How will decisions in relation to dividends being paid by the company be made?

(e) How will decisions in relation to changes to the company's capital structure (such as the issue of new shares or changes to share rights) be decided? Is a unanimous resolution of the directors and/or shareholders appropriate?

(f) How will the company be funded? If shareholder loans are to be provided, what terms will apply to those loans?

(g) Should a restraint of trade apply to the shareholders/directors and if so, for what duration and geographic area?

(h) Will the parties be required to keep company information, such as financial records and business plans, confidential?

(i) How should any disputes between the shareholders or directors be resolved? Is referral to mediation and then arbitration appropriate?

2.23 In addition to succession planning considerations, the tax and asset protection objectives of the incoming owner may also be of importance. Specifically having a discretionary family trust hold shares in a trading company:

(a) offers flexibility in distributing franked dividends within a family group; and/or

(b) reduces the accessibility for the trustee in bankruptcy to cease title of the shares in the event a key individual is sued in their personal name.

Discretionary trust considerations

2.24 Although not typically considered as the 'go-to' structure for operating businesses (largely due to the fact that all profits made in a year must be distributed out of the trust to beneficiaries as accumulation of such profits results in the top marginal tax rate applying), discretionary trusts are also commonly found in family businesses.

2.25 Often dubbed 'family trusts', the flexible nature in being able to distribute profits between a group of family member beneficiaries and changing such distribution pattern each year can be seen as advantages in themselves for those family businesses. This is possible due to the nature of what a trust is, and the mechanisms of a discretionary trust.

2.26 Broadly, a trust is a legal relationship where there is:

(a) a legal owner of property (the '**Trustee**'), who;

(b) holds the property ('trust property');

(c) for the benefit of others (the '**Beneficiaries**'); and

pursuant to certain terms or rules ('trust deed').

2.27 Unlike companies and sole traders, a trust is not a separate legal entity. Instead, the Trustee looks after the property and manages the trust (i.e. the management position). Any benefits generated from the Trustee's management can then be given to the Beneficiaries (i.e. the owners).

2.28 The complexity that a discretionary trust adds to ownership is the fact that there is a broad ***discretion*** of the Trustee to decide who can benefit from the trust.

2.29 Whilst other trusts may fix who can benefit (and thereby there can be a clear ownership percentage), a discretionary trust blurs this ownership percentage by allowing the Trustee to decide (at the Trustee's discretion) who can benefit from the trust, whilst being able to change this discretion on a yearly basis.

2.30 The 'owners' (i.e. the Beneficiaries) of a discretionary trust are therefore more reliant on the decision-making of the Trustee and absent any other role, are often named or involved at the Trustee level.

2.31 That other role referred to relates to a person/s who can have the ability to change the Trustee. This role is often called the 'appointor' or 'principal' role (**Appointor**) and can even go by other terms.

2.32 A benefit of such a role is that the underlying owners of a discretionary trust can exert a form of influence over the Trustee to make decisions in the best interest of the owners, else they be replaced with someone more complying.

2.33 It is noted, however, that not all discretionary trusts hold an Appointor role.

2.34 Although it is common for family businesses to align all the roles (Trustee, main Beneficiaries and Appointor role) together, the flexibility of having these separate roles become more apparent when undertaking a succession plan for the trust.

2.35 Practically, from a succession planning perspective for a discretionary trust, it is crucial to understand who takes over the Trustee and/or Appointor role.

2.36 Generally, the trust deed will outline a default position on who takes control of the relevant role on the passing of individuals, as well as provide general powers allowing for successors to be nominated. However, each trust deed must be reviewed to confirm this position as each trust deed provider drafts their documents differently.

2.37 Issues that must be considered in the trust deed relating to the succession of the trust include, whether the trust deed:

(a) states who takes control of the relevant role in default of any specified nomination;

(b) provides a power to the Trustee or Appointor in nominating a successor (and if the power can be made by Will);

(c) imposes restrictions on who can be a successor (including if there are limits on the number of nominations);

(d) can be amended to include broad powers if the terms are considered too limited.

2.38 Where companies are involved in these roles, then relevant company documents (such as constitutions) must be considered in addition to the terms of the trust deed.

2.39 More curious questions include:

(a) whether an individual or company should be appointed into the Trustee and/or Appointor role as part of the transition strategy today rather than in the future; and

(b) whether steps can be taken to maximise the trust's vesting date (being 80 years), or potentially extending it indefinitely under South Australian trust law.

2.40 Due to the nature of a discretionary trust, it is not common to see multiple owners operate a business from a single discretionary trust. Rare exceptions, however, can include:

(a) parents passing control of the family business to multiple children, who continue to work in tandem in the short term; and

(b) separate family groups who have tailored made beneficiary classes in the discretionary trust 'splitting' the income and capital of the trust between multiple beneficiary classes.

2.41 Despite these exceptions, discretionary trusts are not generally recommended as trading vehicles where there are multiple potential independent owners. Restructuring the business into a corporate entity, unit trust or partnership of discretionary trusts would be preferred; so that each owner will be entitled to a fixed interest in the business.

Unit trusts and partnerships

2.42 Unit trusts and partnerships (whether a partnership of individuals, companies or discretionary trusts) may also be used as a trading entity.

2.43 These structures are commonly used when there are multiple owners, due to the ability to enable business owners to have a fixed interest in the above entities, and when a corporate structure is not wanted.

2.44 The succession planning considerations of a company will therefore also be applicable for such trading structures in the context that:

(a) the issue in relation to the shareholding of a company would apply for units in a unit trust or partnership interest in the partnership;

(b) the issue in relation to the directorship of a company would apply at the Trustee level for a unit trust.

2.45 Unitholders and partnership agreements would also be recommended to ensure clarity is sought as to the rights of a business owner.

Fixed trusts

2.46 Whilst a unit trust can be drafted to provide business owners with an interest in the business, such unit trusts can also be drafted to contain wide ranging discretionary powers.

2.47 As such, the term 'fixed trust' is used in circumstances where a trust has been drafted to provide certain beneficiaries with a fixed vested and indefeasible interest in the trust property.

2.48 Practical Compliance Guidance PCG 2016/16 outlines the factors the ATO will consider in determining whether to classify a trust as a fixed trust and whether the terms of such trust satisfies the concept of 'fixed entitlement' that certain provisions of the tax legislation require.

2.49 Benefits that are available to a unit trust that is deemed to be a fixed trust includes the ability:

(a) to pass franking credits to unitholders; and

(b) ease for the unit trust to satisfy the trust loss rules.

2.50 Consideration should therefore be had whether any unit trust is required to be a fixed trust or not prior to a restructure depending on the business needs (i.e. if the business is likely to make any losses following the restructure which may require recouping).

The importance of the right structure

2.51 To highlight the importance of having an appropriate business structure as part of a succession plan, consider the following example:

(a) John operates a real estate agency business through a family trust with a company trustee.

(b) The trust was established in the early 1980s and included the usual beneficiary class being John, his spouse, their lineal descendants and parents.

(c) Now in his 70s, John wishes to pass the business equally to his daughter, Jane, and a key employee, David.

(d) Due to the nature of the family trust, even if John passed control of the company trustee and any 'appointor' role to Jane and David jointly, issues would be present including (but not limited to):

(i) David (and his family) are not beneficiaries of the trust;

(ii) If a shareholders agreement is not prepared for the company trustee, then there is no dispute resolution mechanism given that Jane and David would likely need to unanimously agree on decisions;

(iii) Where decisions are not made as to the income or capital of the trust, such income and capital are likely to be distributed to John and his family (such as Jane).

(e) In such circumstances, utilising a discretionary trust would not be suitable and steps would need to be taken to transfer the business into a more appropriate entity.

(f) Although restructuring considerations will be considered below, potential solutions could include:

(i) having David establish his own family trust, and acquiring a 50% interest in the business to be held as a partnership of trusts;

(ii) transferring the business to a company with the shares held equally between David and Jane (or through a discretionary trust);

(iii) transferring the business to a company wholly owned by John's family trust and then selling 50% of the shares to David atmarket value.

(g) The most suitable option will ultimately depend on:

(i) various tax and stamp duty costs in implementing the restructure;

(ii) whether the transfer will occur before or after the death of John; and

(iii) the commercial terms of the succession plan.

2.52 Unfortunately, the vast majority of businesses are not established with succession planning in mind (often due to owners' primary goal being the initial success for the business), and the need to undertake a pre-succession plan restructure is not uncommon.

3 Pre-death tax concessions, rollovers and 'exemptions' for a business restructure

3.1 As part of analysing the viability of any pre-death restructure, thought must be taken in relation to the income tax/CGT consequences.

3.1 In deciding what strategy should be used, the preferred structure for the business to operate should be settled.

3.2 Potential CGT rollovers, concessions and exemptions available for use include (but are not limited to):

(a) transferring an asset from an individual or trustee of a trust to a company (with the shares held by the transferor) (discussed below)[4] – this can be useful when it is determined that a business is better suited to being operated from a company rather than a sole trader or a trust;

(b) transferring an asset held by partners in a partnership to a company (with the shares held by the partners accordingly) (discussed below)[5] – this could be relevant when the business is conducted by multiple family members in a partnership, and it is determined that it would be better suited to be operated from a company;

(c) transferring an asset held by a 'unit' trust to a company (with the shares in the company held by the unitholders of the 'unit' trust)[6] – again, this can be useful when it is determined that a business is better suited to being operated from a company rather than an unit trust;

(d) utilising the small business restructure rollover to move a business from one structure to another (discussed below)[7] – this option is available when there are no existing rollovers available to move the business into the desired structure (for example transferring the business from a company to a discretionary trust);

(e) utilising the small business CGT concessions to move business assets from one structure to another (discussed further below)[8] – this option is available regardless of the structure but is only limited to 'small businesses';

[4] Subdivision 122-A ITAA 1997
[5] Subdivision 122-B ITAA 1997
[6] Subdivision 124-N ITAA 1997
[7] Subdivision 328-G ITAA 1997
[8] Division 152 ITAA 1997

(f) splitting a business under the demerger rules;[9] and

(g) forming a tax consolidated group and transferring assets within the group.[10]

3.3 When employing a strategy, specialist tax advice must be sought to ensure all the appropriate requirements are met. Such advice will also 'marry' the various tax considerations that intertwine when undertaking a restructure, including stamp duty and GST factors.

3.4 This paper will consider the most common of the above available concessions/rollovers used as part of a pre-death restructure involving a business.

3.5 One factor in determining the most suitable concession/rollover includes the effect the concession/rollover has on the cost base of the business.

3.6 Specifically, the consideration may include whether the concession/rollover:

(a) has the effect of setting the cost base of the business equal to the market value of the business at the time of the restructure; or

(b) has the effect of 'rolling' the existing cost base of the business to the new structure.

3.7 Depending on who the 'next generation of ownership' is and the future circumstances in which they are introduced, an original business owner may be more inclined to rollover the existing cost base rather than realising the increase in the cost base of the business.

3.8 Given the nature in which the small business CGT concessions affect the cost base of the business, this concession will be considered initially and in detail given its flexibility in being relied upon related party restructures and sales to third parties.

3.9 Following the consideration of the small business CGT concessions, thought will be had regarding various CGT rollovers that enable related party restructures.

Small business CGT concessions

3.10 In addition to allowing for business restructures to be undertaken without incurring significant CGT consequences, the small business CGT concessions are also used to reduce the amount of CGT payable by an exiting business owner.

3.11 This applies in both circumstances where an existing business owner sells the business:

(a) for consideration (creating a capital gain); or

(b) for no consideration or under market value when the parties were not dealing with each other on arm's length terms.[11]

3.12 If available for a business owner, the small business CGT concessions can reduce capital gains made by an entity as follows:

(a) if the entity held the sale asset for at least 15 years – the entire capital gains is disregarded – the **15-Year Exemption**;[12]

(b) otherwise:

[9] Division 125 ITAA 1997
[10] Part 3-90 ITAA 1997
[11] Section 116-30 ITAA 1997 substitutes the market value of the asset transferred and CGT still be payable where the market value of the asset exceeds the cost base
[12] Subdivision 152-B ITAA 1997

(i) 50% of the capital gain can be reduced – the **50% Active Asset Reduction**;[13]

(ii) up to $500,000 of the remaining capital gain can be contributed directly into superannuation – the **Retirement Exemption**;[14] or

(iii) any capital gains be delayed by up to 2 years if no replacement asset is acquired – the **Small Business Roll-over**.[15]

3.13 Practically, in the circumstance where the 15-Year Exemption is not available, the small business CGT concessions allows a single business owner to reduce:

(a) in the case of a capital gain made by a company – a $1 million capital gain to zero;[16] and

(b) in the case of a capital gain made by an individual or discretionary trust holding the sale asset for at least 12 months – a $2 million capital gain to zero.[17]

3.14 Given the potential savings (including no CGT payable on a capital gain made by an entity eligible for the 15-Year Exemption), the small business CGT concessions are often seen as the payout for business owners who often focused solely on their business during their working career (potentially at the detriment of investing on passive investments and superannuation).

3.15 The concessions also enable the cost base of the underlying business transferred to be set at the market value of the business at the time of transfer. Depending on circumstances for the original business owner, this may be preferred as it reduces any future on-sale of the business post-restructure.

3.16 As the small business CGT concessions operate on the basis that a CGT event has occurred, the concessions (subject to anti-avoidance provisions) are available for use in restructuring the business to be held in any type of legal structure.

Accessing the concessions – basic conditions

3.17 Section 152-10(1) *ITAA 1997* requires the following basic conditions to be satisfied before an entity (referred to as the **taxpayer** for this section) is eligible to access the SBCGT Concessions:

(a) *a CGT event happens in relation to a CGT asset of yours in an income year;*

(b) *the event would (apart from the SBCGT Concessions) have resulted in the gain;*

(c) ***at least one** of the following applies:*

(i) *the taxpayer is a small business entity for the income year;* (the **Turnover Test**)

(ii) *the taxpayer satisfies the maximum net asset value test;* (the **MNAV Test**)

(iii) *the taxpayer is a partnership that is a small business entity for the income year and the CGT asset is an interest in an asset of the partnership; or*

[13] Subdivision 152-C ITAA 1997

[14] Subdivision 152-D ITAA 1997

[15] Subdivision 152-E ITAA 1997

[16] $1 million capital gain reduced by 50% (due to the 50% Active Asset Reduction). The remaining $500,000 can be directly contributed into superannuation (due to the Retirement Exemption).

[17] $2 million capital gain reduced by the 50% general CGT discount in Subdivision 115-A ITAA 1997. The remaining $1 million capital gain reduced using the 50% Active Asset Reduction and Retirement Exemption.

(iv) *the conditions mentioned in subsection (1A) or (1B) (of 152-10 Income Tax Assessment Act 1997) are satisfied in relation to the CGT asset in the income year; and*

(d) *the CGT asset satisfies the active asset test.* (the **Active Asset Test**)

3.18 In addition to the above conditions, if the asset being sold is a share in a company or an interest in a trust, then section 152-10(2) ITAA 1997 requires the following tests to be satisfied in relation to that company or trust (**object entity**):

(a) *the CGT asset would still satisfy the active asset test (see section 152-35) the assumptions in subsection (2A) were made;*

(b) *if you do not satisfy the maximum net asset value test (see section 152-15) – you are carrying on a business just before the CGT event;*

(c) *either:*

(i) *the object entity would be a CGT small business entity for the income year; or*

(ii) *the object entity would satisfy the maximum net asset value test (see section 152-15);*

If the following assumptions were made:

(iii) *the only CGT assets or annual turnovers considered were those of the object entity, each affiliate of the object entity, and each entity controlled by the object entity in a way described in section 328-125;*

(iv) *each reference in section 328-125 to 40% were a reference to 20%;*

(v) *a determination under subsection 328-125(6) were in force;*

(d) *just before the CGT event, either:*

(i) *you are a CGT concession stakeholder in the object entity; or*

(ii) *CGT concession stakeholders in the object entity together have a small business participation percentage in you of at least 90%.*

3.19 Much of the additional requirements in section 152-10(2) ITAA 1997 were inserted as part of the 2017-2018 Federal Budget as some taxpayers were able to access the small business CGT concessions for assets which were unrelated to small businesses (for example, through arranging their affairs so that ownership interests in larger businesses did not count towards the tests for determining eligibility for the concessions). This was largely possible due to the 40% threshold for grouping related entities as part of the Turnover Test and MNAV Test as too high a threshold. As such, if an MNAV Test was required to be undertaken as part of the additional requirements, a 20% threshold was applied for affiliates and entities connected with the taxpayer under the requirements.

<u>*Accessing the concessions – Turnover Test and MNAV Test*</u>

3.20 Provided a capital gain arose in relation to a relevant CGT asset,[18] either the Turnover Test **or** MNAV Test must be met to potentially be eligible for the concessions.

3.21 Both tests effectively ensure the concessions can only be applied to 'small businesses', being:

[18] For example, the small business CGT concessions would not apply to depreciating assets or trading stock due to sections 118-24 and 118-25 ITAA 1997 respectively.

(a) businesses with a total yearly aggregated turnover of $2 million (the Turnover Test); or

(b) businesses with total aggregated assets of $6 million (the MNAV Test).

Turnover Test

3.22 In order to satisfy the Turnover Test, the taxpayer must:[19]

(a) carry on a business in the relevant income year; and

(b) one or both of the following applies:

(i) the taxpayer carries on a business in the previous income year and its aggregated turnover was less than $2 million; or

(ii) the taxpayer's aggregated turnover for the current income year is likely to be less than $2 million.

3.23 Please note that although section 328-110 ITAA 1997 refers to a $10 million limit for the turnover, section 152-10(1AA)(b) ITAA 1997 states that references to $10 million in section 328-110 should be read as $2 million for the purposes of small business CGT concessions.

3.24 The taxpayer's aggregated turnover is calculated on the annual turnover of the taxpayer and any entity that is an 'affiliate' or 'connected with' the taxpayer.

3.25 Section 328-120 *ITAA 1997* provides the meaning for 'annual turnover' which is the total ordinary income that an entity derives in an income year in the ordinary course of carrying on a business. Please note that non-assessable non-exempt income is excluded from such calculation. There are also rules that relate to amounts derived from dealing with associates that will need to be considered.

3.26 An overview on what it means to be an 'affiliate' or 'connected with' will be provided below.

MNAV Test

3.27 The taxpayer satisfies the MNAV Test,[20] if just before the CGT event, the following does not exceed $6 million:

(a) net value of the CGT asset of the taxpayer;

(b) net value of the CGT assets of any entities connected with the taxpayer; and

(c) the net value of the CGT assets of any affiliates of the taxpayer or entities connected with the taxpayer's affiliates (not double counting assets already counted under paragraph (b) above).

3.28 Net value of the CGT assets is defined to be the amount obtained by subtracting the sum of the market values of the assets of the following:

(a) liabilities of the entity that are related to the assets; and

(b) the following provisions made by the entity:

(i) annual leave;

(ii) long service leave;

(iii) unearned income; and

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[19] Section 328-110 ITAA 1997
[20] Section 152-15 ITAA 1997

(c) tax liabilities;[21] and

(d) other assets (such as the main residence and superannuation).[22]

Meaning of 'affiliate' and 'connected with'

3.29 Section 328-130 *ITAA 1997* states that an entity can only be an *affiliate* of a taxpayer if:

(a) the entity is either an individual or a company; and

(b) that individual or company carries on a business in their own right; and

(c) in carrying on that business, the individual or company does so either:

(i) at the direction of the taxpayer; or

(ii) in concert with the taxpayer.

3.30 Section 328-125 *ITAA 1997* provides that an entity is connected with another entity if:

(a) either entity is controlled by the other; or

(b) each entity shares a common controller.

3.31 The meaning of control is specifically set out in the legislation and includes different tests for determining control of different types of entities. Broadly, however, having a 40% share of the decision making or equity is sufficient to be deemed as control for the purposes of this section. In the case of a discretionary trust, historical distributions of income and capital are considered in determining the 40% control threshold.

3.32 Including 'affiliates' and entities 'connected with' the taxpayer in the Turnover Test and MNAV Test is intended to ensure the concessions are available only to 'small businesses' and those taxpayers with both substantive assets and significant turnovers are denied the concessions.

Accessing the concessions – Active Asset Test

3.33 The Active Asset Test is satisfied under section 152-35(1) *ITAA 1997* if:

(a) the taxpayer has owned the asset for 15 years or less and the asset was an active asset of the taxpayer for a total of at least half of the period which it was owned; or

(b) the taxpayer has owned the asset for more than 15 years, and the asset was an active asset for at least 7.5 years of the period.

3.34 Section 152-40 *ITAA 1997* states that a CGT asset will be an active asset if:

(a) it is used in the course of carrying on a business; or

(b) if the asset is an intangible asset – it was owned by the taxpayer and it is inherently connected with a business that is carried on by the taxpayer, or an entity connected with the taxpayer. This includes goodwill.

3.35 Shares in a company will be considered an active asset if:

(a) the share is in a company that is an Australian resident; and

(b) the total of:

(i) the market values of the active assets of the company; and

[21] Section 152-20 ITAA 1997
[22] Section 152-20(2) ITAA 1997

(ii) the market value of any financial instruments of the company that are inherently connected with the business that the company carries on; and

(iii) any cash of the company that is inherently connected with the business,

is 80% or more of the market value of all of the assets of the company.[23]

3.36 Where the asset being sold are shares or units, then the additional requirements of 152-10(2) *ITAA 1997* must also be satisfied. These additional requirements can be summarised as:

(a) testing that the object entity is in fact a small business – which is made possible due to the broadening of the affiliate and connected with rules by reducing the control threshold from 40% to 20%;

(b) requiring an MNAV Test to be satisfied – that is, satisfying the Turnover Test is not sufficient if you are selling shares in a company or units in a unit trust;

(c) ensuring the person selling the shares or units is a 'key person' in the business.

Benefitting from the concessions

3.37 Once the above tests have been satisfied, the small business CGT concessions may be available.

3.38 Certain exemptions, such as the 15-Year Exemption and Retirement Exemption, requires additional tests to be met that may differ depending on if shares in a company or the underlying business assets are sold.

3.39 At a minimum, the 50% Active Asset Reduction will be available to reduce any capital gains by 50% (provided the 15-Year Exemption is not applied).[24]

15-Year Exemption

3.40 The 15-Year Exemption allows a taxpayer meeting the basic conditions and certain additional conditions to disregard 100% of a capital gain arising from the sale of a CGT asset where that asset has been owned by the disposing taxpayer for at least 15 years.

3.41 Additional conditions such as requiring the taxpayer to have held the CGT asset for at least 15-years and for there to be a 'key person' will also need to be met.[25]

3.42 Crucially, however, in order to apply this exemption, the 'key person' must be over 55 and show that the transaction will occur in connection with that person's retirement.

3.43 Please note that whether an event occurs 'in connection with that individual's retirement' will depend on the particular circumstances of each case. Commentary from the Tax Office indicates that there should be a significant reduction in the number of hours the individual works, or for there to be a significant change in the nature of their present activities.

3.44 Where possible, this exemption should be sought as it allows for the entire capital gain to be distributed tax-free from the business entity to the 'key-person' as 'non-assessable non-exempt income'.[26]

[23] Section 152-40(3) ITAA 1997
[24] Section 152-205 ITAA 1997
[25] Section 152-10 ITAA 1997
[26] Section 152-125 ITAA 1997

Retirement exemption

3.45 Under the Retirement Exemption,[27] a taxpayer can disregard up to $500,000 in capital gains for a 'key person'.

3.46 Section 152-325 *ITAA 1997* requires a taxpayer to make the disregarded amount to the 'key person'. If the 'key person' is under the age of 55 years, then such payment must be made to a complying superannuation fund.[28]

Trap for companies applying the concessions

3.47 Where companies are able to apply the above concessions, there can be circumstances where there is difficulty in extracting the proceeds.

3.48 This is because, where there are tax-sheltered proceeds received by the company that are not extracted due to the operation of any other provision,[29] no franking credits would be made available to such amounts (as no company tax was paid). Relevant proceeds can include such capital gain reduced by the 50% Active Asset Reduction.

3.49 Extracting such amounts would generally result in an unfranked dividend being triggered.

3.50 The general strategy to extract the sheltered amount, therefore, requires a liquidator's distributions.

3.51 Generally, payments to shareholders by liquidators can generally be treated as follows:

(a) taxed as a dividend (with franking credits attaching if available);

(b) taxed as a capital payment (and subject to capital gains tax); or

(c) received tax free.

3.52 For a company having benefited from the 50% Active Asset Reduction, the distribution of such amount will not be considered as having been received tax free – it is non-assessable income.

3.53 Whether such non-assessable amount will be taxed as a dividend or as a capital payment will depend on whether it falls within section 47 ITAA 1936.

3.54 Importantly, income derived by a company will include net capital gains assessable to the company.

3.55 In this regard, TD 2001/14 confirms that a distribution by a liquidator of an amount subject to the 50% Active Asset Reduction under 152-205 ITAA 1997 is not deemed to be a dividend under section 47 ITAA 1936 – paragraph 1 TD 2001/14.

3.56 It would therefore be required to consider the tax consequences as such payment will be:

(a) treated as a capital payment;

(b) subject to CGT; and

able to have the small business CGT concessions applied again to reduce capital gains.

[27] Section 152-315 ITAA 1997
[28] Section 152-325(7) ITAA 1997
[29] For example, the 15-Year Exemption provides for the extraction of the proceeds as non-assessable non-exempt income.

Small business restructure rollover

3.57 Introduced by the *Tax Laws Amendment (Small Business Restructure Roll-Over) Act 2016* as Subdivision 328-G ITAA 1997, the small business rollover restructure provisions were intended to '*facilitate flexibility for owners of small business entities to restructure their businesses, and the way their business assets are held, while disregarding tax gains and losses that would otherwise arise*'.[30]

3.58 As such, in contrast with the small business CGT concessions, the small business restructure rollover was only intended to take effect as part of a restructure by a business owner rather than a sale of the business to another person.

3.59 Given the effect of the small business restructure rollover on a business as a whole, the rollover also provides tax relief for the transfer of trading stock and revenue assets as part of the restructure.[31] In effect, the small business restructure rollover provides a cost base transfer of the post-CGT assets, trading stock and revenue assets held by transfer to the transferee. In contrast, the small business CGT concessions do not apply to such assets. Law Companion Ruling LCR 2016/2 provides practical guidance on the effect of the rollover.

3.60 In addition to the above tax relief, the small business restructure rollover also has the effect on the following timing rules in the tax legislation:

(a) the length of time in which the transferor held the transferring CGT assets are reset – that is, the transferee will need to wait 12 months after the application of the small business restructure rollover until it is able to access the general 50% CGT discount (if able);

(b) the transferee is deemed to have held the CGT assets for the length of time in which the transferor held such assets for the purposes of the small business CGT concession 15 Year Exemption;[32] and

(c) where the transferred asset is a replacement asset acquired by the transferor under the small business rollover, then the transferee is deemed to have chosen the small business rollover as well and will be subject to the same CGT consequences under those rules.[33]

3.61 As the small business restructure rollover was intended to allow for the restructuring of a business into the desired structure, provided the conditions are satisfied, there is no restriction in relation to the transferee entity receiving the business.

<u>Accessing the rollover</u>

3.62 Section 328-430 ITAA 1997 requires the following conditions to be satisfied before an entity (the taxpayer) is eligible to access the small business restructure rollover:

(a) the transaction is, or is a part of, a genuine restructure of an ongoing business (**Genuine Restructure Requirement**); and

(b) each party to the transfer is an entity to which any one or more of the following applies:

(i) it is a small business entity for the income year during which the transfer occurred;

[30] Section 328-425 ITAA 1997
[31] Section 328-455 ITAA 1997
[32] Section 152-115(3) ITAA 1997
[33] Section 328-475(3) ITAA 1997

(ii) it has an affiliate that is a small business entity for that income year;

(iii) it is connected with an entity that is a small business entity for that income year;

(iv) it is a partner in a partnership that is a small business entity for that income year; and

(c) the transaction does not have the effect of materially changing (**Ultimate Economic Ownership Requirement**):

(i) which individual has, or which individuals have, the ultimate economic ownership of the asset; and

(ii) if there is more than one such individual--each such individual's share of that ultimate economic ownership; and

(d) the asset is a CGT asset (other than a depreciating asset) that is, at the time the transfer takes effect (**Active Asset Requirement**):

(i) if subparagraph (b)(i) applies--an active asset; or

(ii) if subparagraph (b)(ii) or (iii) applies--an active asset in relation to which subsection 152-10(1A) is satisfied in that income year, or would be satisfied in that income year if paragraph 152-10(1AA)(b) were disregarded; or

(iii) if subparagraph (b)(iv) applies--an active asset and an interest in an asset of the partnership referred to in that subparagraph; and

(e) the transferor and each transferee meet the residency requirement (per section 328-445 ITAA 1997); and

(f) the transferor and each transferee choose to apply the small business restructure rollover in relation to the assets transferred under the transaction.

3.63 The terms 'affiliate', 'connected with' and 'small business entity' refers to the same provisions of ITAA 1997 as with the small business CGT concessions. Unlike the small business CGT concessions, there is no $2 million replacement for the turnover (see section 152-10(1AA)(b) ITAA); and therefore the small business restructure rollover is available to small business entities with a turnover of less than $10 million.

3.64 While certain conditions for the small business restructure rollover is an analysis on an entity's turnover and residency, complications can arise in ensuring the remaining requirements are met.

3.65 Issues to consider in relation to each requirement are mentioned below.

Genuine Restructure Requirement

3.66 There is no definition on what constitutes a 'genuine restructure of an ongoing business' in Subdivision 328-G ITAA 1997.

3.67 Law Companion Ruling LCR 2016/3, however, outlines the ATO's position in circumstances where a restructure will fall within this requirement.

3.68 LCR 2016/3 states that a "*genuine restructure of an ongoing business' is one that could be reasonably expected to deliver benefits to small business owners in respect of their efficient conduct of the business. It can encompass a restructure of the way in which business assets are held where that structure is likely to have been adopted had the business owners obtained appropriate professional advice when setting up the business.* ***However, it is a***

composite phrase emphasising that the SBRR is not available to small business owners who are restructuring in the course of winding down or realising their ownership interests [emphasis added].*"*[34]

3.69 It is accepted that a genuine restructure of an ongoing business may include the following features:

(a) "*It is a bona fide commercial arrangement undertaken in a real and honest sense to*

(i) *facilitate growth, innovation and diversification*

(ii) *adapt to changed conditions, or*

(iii) *reduce administrative burdens, compliance costs and/or cash flow impediments.*

(b) *It is authentically restructuring the way in which the business is conducted as opposed to a 'divestment' or preliminary step to facilitate the economic realisation of assets.*

(c) *The economic ownership of the business and its restructured assets is maintained.*

(d) *The small business owners continue to operate the business through a different legal structure. For example, there is:*

(i) *continued use of the transferred assets as active assets of the business*

(ii) *continuity of employment of key personnel, and*

(iii) *continuity of production, supplies, sales or services.*

(e) *It results in a structure likely to have been adopted had the small business owners obtained appropriate professional advice when setting up the business."*[35]

3.70 In line with the commentary noting that the small business restructure rollover is not intended for those small business owners seeking to wind down or realise their ownership interest, paragraph 10 LCR 2016/3 notes that the following are circumstances that do not reflect a 'genuine restructure of an ongoing business':

(a) "*where the restructure is a preliminary step to facilitate the economic realisation of assets, or takes place in the course of a winding down to transfer wealth between generations*

(b) *where the restructure effects an extraction of wealth from the assets of the business (including accumulated profits) for personal investment or consumption or otherwise designed for use outside of the business*

(c) *where artificial losses are created or there is a bringing forward of their recognition*

(d) *the restructure effects a permanent non-recognition of gain or the creation of artificial timing advantages, and/or*

(e) *there are other tax outcomes that do not reflect economic reality.*"

3.71 While the above may suggest that the small business restructure rollover is not available for 'succession planning' or 'intergenerational wealth transferring' purposes, LCR 2016/3 provides examples where the rollover is available for genuine restructures. For example:

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[34] LCR 2016/3 at paragraph 6

[35] LCR 2016/3 at paragraph 7

(a) Example 2 accepts the use of the rollover as a way to introduce employee equity participants into a business originally operating through a family trust (the rollover applies to transfer the business into a company) provided the original owners remain.[36]

(b) Example 3 accepts the use of the rollover as a way to obtain additional investment into a business originally operating through a partnership (the rollover applies to transfer the business into a company) provided the original owners remain.[37]

3.72 It is noted, however, that a safe harbour rule is available where there is no change in the ultimate economic ownership of any of the significant assets of the business (other than trading stock) transferred as part of the restructure for at least the 3 years following the restructure.[38] If circumstances exists where the examples of a genuine ongoing business in LCR 2016/3 cannot be met and a private ruling is not practical to obtain, such safe harbour rule may provide a level of certainty (although it is accepted that whether the requirement is met may not be known until after the 3 year period).

<u>*Ultimate Economic Ownership Requirement*</u>

3.73 The Ultimate Economic Ownership Requirement requires the same person/s before and after the restructure to ultimately benefit from the assets.

3.74 Where a discretionary trust ultimately benefits from the assets at either point in time of the restructure, a special rule is required to be met.

3.75 Specifically, a transaction involving a discretionary trust will not change the ultimate economic ownership of an asset if:

(a) "*either or both of the following applies:*

(i) *just before the transaction took effect, the asset was included in the property of a non-fixed trust that was a family trust;*

(ii) *just after the transaction takes effect, the asset is included in the property of a non-fixed trust that is a family trust; and*

(b) *every individual who, just before the transfer took effect, had the ultimate economic ownership of the asset was a member of the family group (within the meaning of Schedule 2F to the Income Tax Assessment Act 1936) relating to the trust or trusts referred to in paragraph (a); and*

(c) *every individual who, just after the transfer takes effect, has the ultimate economic ownership of the asset is a member of that family group.*[39]"

3.76 It is noted that a non-fixed trust is a trust that is not a fixed trust (being a trust referred to earlier in this paper at paragraph 2.49).

3.77 For a non-fixed trust to be considered a family trust, a family trust election is required to be made.

3.78 Steps are also required to be taken to ensure that individuals who had ultimate economic ownership in the asset both before and after the transaction are part of a family group.

[36] LCR 2016/3 at paragraphs 24 to 29
[37] LCR 2016/3 at paragraphs 30 to 36
[38] Section 328-435 ITAA 1997
[39] Section 328-440 ITAA 1997

3.79 A family group is defined to be a member of a test individual's (being a person nominated in the family trust election) family, which includes:[40]

(a) *'any parent, grandparent, brother or sister of the test individual or the test individual's spouse;*

(b) *any nephew, niece or child of the test individual or the test individual's spouse;*

(c) *any lineal descendant of a nephew, niece or child of the test individual or the test individual's spouse;*

(d) *the spouse of the test individual or of anyone who is a member of the test individual's family because of the above paragraphs.'*

3.80 This means that if persons who are not part of the 'family group' are potential beneficiaries of the non-fixed trust, then the trust will not satisfy the requirements (as persons who are not a member of the 'family group' may still potentially benefit from the non-fixed trust). Given the wide breadth of the class of discretionary beneficiaries that a 'standard' discretionary trust includes, this is an issue that may commonly appear. A simple solution may be the need to amend or draft the terms of the trust to have a reduced discretionary beneficiary class.

Active Asset Requirement

3.81 Where the rollover applies to the transfer of assets used in the business, this requirement may be easily met.

3.82 An issue, however, arises when seeking to apply the rollover held by an entity holding shares in a company.

3.83 In contrast with the small business CGT concessions that may allow for the concessions to apply to the sale of shares in a trading business where those shares are 'active', the small business restructure rollover does not apply to shares that are considered active assets. This is because the shares are not used by the small business entity.

3.84 LCG 2016/3 provides an example where an individual holding shares in a small business company seeks to transfer her shares to a newly established discretionary trust. As the individual herself does not operate the small business (rather, it is the company which she holds her shares) and the shares are not used, or held ready or use by the small business company in the course of carrying on its business, the shares themselves are not active for the purposes of the small business restructure rollover.[41]

Other available rollovers

3.85 Where neither the small business CGT concessions nor small business restructure rollover are available, alternative CGT rollovers may be available.

3.86 Unlike the above concession and rollover, these rollovers are transaction specific and have additional requirements that must be satisfied in order to be met. Specifically, the rollover available under:

(a) Subdivision 122-A ITAA 1997 enables the transfer of a business from an individual/trust to a company (with the individual/trust as the sole shareholder of the company); and

[40] Section 272-95(1) of Schedule 24 ITAA 1936
[41] LCR 2016/3 at paragraphs 97 to 102

(b) Subdivision 122-B ITAA 1997 enables the transfer of a business from a partnership to a company (with each partner of the partnership as shareholder of the company in the same proportions as their original partnership interest).

3.87 Additional rollovers for other certain transactions are available, and a review of the applicable tax legislation may provide alternative restructuring opportunities.

3.88 This paper does not seek to go into the above rollovers in detail but will rather provide an overview of the conditions required to be met to be eligible and the consequence of such rollovers being relied upon.

3.89 In order to be able to rely on the rollovers of Subdivision 122-A and Subdivision 122-B ITAA 1997, broadly, the following are required to be met:[42]

(a) the transferor (being the individual/trustee/partnership) may transfer the business to a company;

(b) the transferor receives consideration consisting of shares in the transferee company and (if applicable) the transferee agreeing to take over the obligations to pay liabilities in relation to the business;

(c) the shares must not be redeemable;

(d) the transferor must:

(i) if an individual or trustee – own all of the shares in the transferee company following the transfer;[43]

(ii) if a partnership – all partners must own all of the shares in the transferee company, and in the same capacity that they owned their interest in the business in the partnership;

(e) the market value of the shares which are received as part of the transaction must be substantially the same as the market value of the assets transferred less any liabilities assumed by the transferee (this means in relation to the case of a partnership, that each partner's interest remains in the same proportion); and

(f) the transferor and transferee must be Australian tax-residents.

3.90 In contrast with the small business restructure rollover, it is noted that consideration in the form of shares in the transferee company is required to satisfy the Subdivision 122-A and 122-B rollover.

3.91 Certain rules also apply to ensure the rollover does not apply to certain other assets such as assets of personal use as well as a depreciating asset, trading stock and copyright.[44]

3.92 The consequence of such rollovers applying are summarised as follows:

(a) for the transferor:

(i) any capital gain is disregarded;

(ii) where all transferred assets acquired are pre-CGT, then the shares acquired as consideration is taken to be pre-CGT; and

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[42] See Subdivision 122-A ITAA 1997 and Subdivision 122-B ITAA 1997 in detail.

[43] It is noted that where a restructure results in a company being interposed between a trading company and multiple shareholders, then Division 615 ITAA 1997 may be of use.

[44] Sections 122-25(2) to 122-25(4) ITAA 1997 and sections 122-135(3) to (4) ITAA 1997

(iii) where all transferred assets acquired are post-CGT, then the shares acquired as consideration will have the cost base equal to the market value of the assets transferred less any liabilities the transferee company undertakes to discharge;

(iv) where assets transferred are both pre-CGT and post-CGT then an adjustment is made to the calculation of the cost base in the shares provided as consideration;

(b) for the transferee company:

(i) if the asset transferred is pre-CGT, the company acquires the asset as pre-CGT;

(ii) if the asset transferred is post-CGT, the company acquires the asset post-CGT with the transferor's cost base.

Amending a trust deed

3.93 The above concessions and rollovers considers the circumstances where a transfer of a business from one legal entity to another is required to ensure that the business is available for the 'next generation of ownership'.

3.94 Where a business is already held in a discretionary trust, there is an ability to vary the terms of the discretionary trust to ensure the terms of the trust are appropriate for the 'next generation of ownership' rather than have the business transferred into a new legal entity.

3.95 While it may not be intuitive to consider that a CGT event occurs when the business is continued to be held by the same trust, it has been accepted that a variation to a discretionary trust *could* result in:

(a) CGT event E1 – where assets have been settled on a new trust; and

(b) CGT event E2 – where assets are taken to be transferred to a new trust.

3.96 The risk of varying the terms of a trust deed is that if the variation is too broad, there may be an argument that a new trust has been established – this is colloquially called a 'resettlement' of a trust. The consequences of a resettlement include:

(a) all assets are treated as having been disposed of by the original trust and settled on the new trust (i.e. CGT event E1 occurs); and

(b) any losses in the trust are trapped and cannot be carried forward to offset income in the 'new' trust.

3.97 Historically, the ATO in its Statement of Principles (**SOP**) provided an outline of what may give rise to a resettlement of a trust. The guidance provided by the SOP indicates that a resettlement will arise where there has been an alteration to a trust sufficient to constitute a new trust relationship.

3.98 However, the ATO withdrew its SOP following the decision of the Full Court of the Federal Court of Australia in *Commissioner of Taxation v Clark (Clark)* [2011] FCAFC 5. In that case, the trust in question was a unit trust which had been substantially changed over several years by changing the trustee, the beneficiaries and the trust property.

3.99 In rejecting the Commissioner's argument that these amendments had amounted to a resettlement of the trust, the Court held that the three factors to consider in determining whether there has been a continuum of the trust are:

(a) the terms of the trust deed;

(b) the trust property; and

(c) the membership of the trust.

3.100 Further, the Court confirmed that where the changes are within the scope of the variation power in the relevant trust deed, changes over time to the trust property and beneficiaries should not trigger a resettlement, if they can be identified at all times and there has not been a severance which would lead to the termination of the trust.[45]

3.101 Following the withdrawal of its SOP, the ATO released Tax Determination 2012/21. This determination states the ATO's position formerly set out in its SOP was largely unsustainable following the Court's decision in Clark and that neither CGT event E1 nor CGT event E2 happens unless:

(a) the change causes the existing trust to terminate and a new trust to arise for trust law purposes; or

(b) the effect of the change is such as to lead to a particular asset being subject to a separate charter of rights and obligations such as to give rise to the conclusion that that asset has been settled on the terms of a different trust.

3.102 Paragraph 24 of TD 2012/21 specifically states that:

"Relevantly, the principles established by those cases are also relevant to the question of the circumstances in which CGT event E1 or E2 may happen as a result of changes being made to the terms of an existing trust pursuant to a valid exercise of a power in the deed (including a power to amend). In light of those principles, the ATO accepts that a change in the terms of the trust pursuant to exercise of an existing power (including an amendment to the deed of a trust), or court approved variation, will not result in a termination of the trust and, therefore, subject to the observation in paragraph 27 [which relates to when trust property are held under a new charter of obligations] will not result in CGT event E1 happening."[46]

3.103 Therefore, provided the terms of the respective trust provides sufficient power to allow for a certain amendment to be made in relation to the trust, there will be no adverse income tax consequences for such an amendment being made.

3.104 Whether a discretionary trust has a valid power or if a valid power is used to vary the deed, however, is an entirely different question that requires a detailed analysis of the specific wording of the trust deed's variation power. This is particularly important when dealing with variation powers that:

(a) only refers to one of the following two words, being '*trust*' or '*power*'; or

(b) imposes certain restrictions on what clauses in the trust deed can be varied.[47]

3.105 It should be noted the difference between the two powers was described in *Farwell on Powers*[48] by referencing Lord Eldon's judgment in *Brown v Higgs*[49]:

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[45] *Commissioner of Taxation v Clark (Clark)* [2011] FCAFC 5 at [87]

[46] Tax Determination 2012/21 at paragraph 24

[47] Cases such as *Jenkins v Ellett* [2007] QSC 154 and *Mercanti v Mercanti* [2016] WASCA 206 provides practical examples of variation powers containing restrictions on what can be varied with the later case considering two discretionary trust deeds with differing terms where, notwithstanding the same variation was made to the trust, one discretionary trust's deed had sufficient power to effect the change while the other did not

[48] 3rd edition (1916)

[49] 8 Ves.Jr. 561

'Where there is a mere power of disposing and it is not executed, the court cannot execute it; but wherever a trust is created and the execution of that trust fails by the death of the trustee or by accident, the court will execute the trust. But there are not only a mere trust and a mere power, but there is also known to the court a power which the party to whom it is given is intrusted and required to execute; and with regard to that species of power, the court considers it as partaking so much of the nature and qualities of a trust, that if the person who has that duty imposed on him does not discharge it, the court will to a certain extent discharge the duty in his room and place.'

3.106 The above judgment can be summarised in that 'mere powers' may or may not be exercised, whilst 'trust power' must be exercised if not by the trustee then by the court, or a trustee appointed by the court.

3.107 Consider difference in the variation power wording of the following two examples:

Example 1

An example of a variation power restricting the power to vary a trust and power is as follows:

18 *The Trustee for the time being may at any time and from time to time by deeds* ***revoke add to or vary all or any of the trusts hereinbefore provided or the trusts provided by any variation or alteration or addition made thereto*** *from time to time and may be the same or any other deed or deeds declare any new or other trusts or powers concerning the Trust Fund or any part or parts hereof the trusts whereof shall have been so revoked added to or varied…*

3.108 In the above Example 1, the variation power seems to limit any revoking, adding to or varying of a trust in a trust deed to the trusts listed before clause 18.

3.109 The variation power is then explicit in flagging that the powers of the trust fund can only be added to and not varied.

3.110 This may troublesome if any of the powers in the trust deed require amending or deleting, however, it can equally be suggested that the trustee then choose not to exercise the particular power in question or merely insert an 'amended' power.

Example 2

A slight variation to Example 1 is as follows:

9.2 *The Trustee may by Deed* ***revoke add or release or vary all or any of the trusts or powers hereinbefore declared*** *or any trusts or powers declared by variation, alteration or addition made hereto from time to time and may by the same or any other Deed declare any new or other trusts or powers concerning the Trust Fund or part or parts thereof provided…*

3.111 Regarding Example 2, while the trust and power may be amended, revoked or added to, any variation to the trust deed can only be made to the trusts and powers before clause 9.2.

3.112 Note the slight expansion of the ability to vary the terms of the trust deed through the addition of the word 'powers'.

3.113 Whilst not as much of a problem in more recent trust deeds, this issue will commonly arise when reviewing older trust deeds. Therefore, thought should be had in considering whether appropriate provisions should be included in 'trust variation' documents to safeguard against any invalid exercise of power under a trust deed.

Amending trust deeds – the Mercanti v Mercanti case (Mercanti Case)

3.114 While the case will be considered in the context of an analysis of the variation powers of two trust deeds, the case also serves as a reminder of the various issues that should be considered when passing the business to 'the next generation of ownership'.

<u>Background</u>

3.115 The Mercanti Case involved a relationship breakdown between a father (Michael Mercanti) and son (Tyrone Mercanti) and the validity of deeds of variation of two trusts changing the appointor role and the subsequent change of trustee effected by the new appointor.

3.116 Michael commenced a shoe repair business in the 1960s which grew into a successful business, resulting in the establishment of two discretionary trusts to be utilised as part of the trading business:

(a) the Michael Mercanti Family Trust (**MMF Trust**), which Slondia Nominees Pty Ltd (**Slondia**) acted as corporate trustee; and

(b) the Footwear Wholesale Trust (**FW Trust**), in which Citycourt Pty Ltd acted as corporate trustee.

3.117 The directors and shareholders of the corporate trustees were Michael and his wife, Yvonne; with Michael being named as the Appointor of the MMF Trust and FW Trust.

3.118 Over time, Michael's youngest son, Tyrone became involved in the business (upon leaving school at the age of 18), ultimately being made a director of the corporate trustees in 2001.

3.119 Steps were subsequently taken in 2004 (as part of effecting Michael and Yvonne's estate planning intentions) to pass the appointor role to Tyrone and deeds of variations were subsequently executed.

3.120 By late 2012, the relationship between Tyrone and his parents broke down. Disputes arose as Michael wished to receive more income from the businesses and have certain expenses paid by the business; in which Tyrone disagreed.

3.121 Additional disputes and disagreements continued to arise until July 2013, whilst Tyrone was away on holiday; Michael and Yvonne (as shareholders of the corporate trustees) removed Tyrone as a director.

3.122 Tyrone subsequently, as appointor, executed documentation changing the corporate trustees of the MMF Trust and FW Trust.

3.123 Michael subsequently disputed the original 2004 deeds of variations appointing Tyrone as an Appointor of the MMF Trust and FW Trust.

<u>First instance</u>

3.124 The relevant variation powers for the MMF Trust and FW Trust are set out below.

Variation power for MMF Trust
28 Subject to clause 10 hereof the Trustees for the time being may at any time and from time to time by deeds revocable or irrevocable revoke add to or vary all or any of the trusts terms and conditions hereinbefore contained or the trusts terms and conditions contained in any variation or alteration or addition made thereto from time to time and may in like manner declare any new or other trusts terms and conditions concerning the Trust Fund or any part or parts thereof the trusts whereof shall have been so revoked added to or varied

provided that the rule known as the Rule against Perpetuities is not thereby infringed and provided that such new or other trust powers discretion alterations or variations -

(1) insofar as the beneficial interests created by this Deed are revoked added to or varied shall be for the benefit of all or any one or more of the General Beneficiaries or any one or more persons born or unborn being lineal descendants of whatever degree (or the spouse of any lineal descendant) of any grandparent of any General Beneficiary; but

(2) shall not be in favour of or result in any benefit to any member of the excluded class;

(3) shall not affect the beneficial entitlement to any amount set aside for any beneficiary prior to the date of the variation alteration or addition; and

(4) shall not (save as provided in paragraph (1) of this clause) enlarge the number of persons capable of falling within the description 'beneficiary' hereinbefore contained.

Save as provided in this clause these presents shall not be capable of being revoked added to or varied.

Variation power for FW Trust

14.1 The Trustee may at any time and from time to time (but whilst there shall be an Appointor only after having given not less than 30 days written notice to the Appointor of his intention so to do) by deeds revoke add to or vary all or any of the trusts hereinbefore provided or the trusts provided by any variation alteration or addition made thereto from time to time and may by the same or any other deed declare any new or other trusts or powers concerning the Trust Fund or any part thereof the trusts whereof shall have been so revoked added to or varied.

14.2 The powers specified in clause 13.1 shall not be exercised so that:

14.2.1 any interest under the trusts as so revoked added to or varied may vest after the expiry of the perpetuity period;

14.2.2 any member of the Excluded Class is becomes or may become entitled to any interest or benefit under the trusts as so revoked added to or varied; or

14.2.3 the beneficial entitlement to any amount set aside for any Beneficiary prior to the date of the variation alteration or addition is affected.

14.3 Save as provided in clauses 14.1 and 14.2 these presents shall not be capable of being revoked added to or varied.

3.125 In determining whether the above variation powers were broad enough to enable a variation to the appointor role, the Le Miere J considered the following:

(a) that it is the '*court's primary task in construction is to discover the intention of, relevantly, the settlor from the words used in the instrument read as a whole. Where an instrument is capable of more than one meaning the interpretation which avoids consequences which are, in the circumstances, capricious or unreasonable will be preferred. That meaning may not necessarily be the most obvious or most grammatically correct: Scaffidi v Montevento Holdings Pty Ltd [2011] WASCA 146 [65], [66], [154]*';[50]

[50] *Mercanti v Mercanti* [2015] WASC 297 at 74

(b) that a *'power of amendment in a trust deed will be construed according to its natural meaning. In Kearns v Hill (1990) 21 NSWLR 107 the New South Wales Court of Appeal rejected any narrow or strict construction of a power of amendment in a trust deed';*[51]

(c) that '*a power of amendment is not likely to be held to extend to varying the trust in a way which would destroy its 'substratum': Re Dyer [1935] VLR 273';*[52]and

(d) in '*Jenkins v Ellett [2007] QSC 154 Douglas J held that a power to vary 'all or any of the trusts' of a trust deed did not include a power to discharge the principal of the trust deed, who had power to remove and appoint trustees. Douglas J reached that view after considering the text of the provision conferring the power of amendment. Douglas J also had regard to the nature of the proposed amendment:*

The power to appoint a new trustee available to the Principal under clause 12 does not seem to me to be one that requires easy amendment to add to any desirable flexibility in managing the fund: cf Meagher JA in Kearns v Hill (1990) 21 NSWLR 107 107 - 109. Clause 12's purpose of allowing the removal of a trustee is also inconsistent with the possibility that the trustee could negate the operation of the power by amending the schedule to the deed to change the identity of the Principal …

The Principal's ability to remove and replace a trustee seems to me to be one of the fundamental features of the structure of this deed, one setting up the family discretionary trust. The maintenance of that power is obviously designed to ensure that the control of the trust will remain with the significant intended beneficiary, here George Jenkins, and after him his spouse or his executor, as follows from the definition of 'The Principal' in the schedule. To allow the power in clause 12 to be subverted by the trustee it was designed to supervise purporting to use clause 11's powers to amend the deed rather than the trusts declared by the deed is not, in my view, permissible. It is akin to destroying the substratum of the deed [18] - [19].'[53]

3.126 Le Miere J held that the variation to the MMF Trust was valid and that '*the natural and ordinary meaning of the words of cl 28 are that the trustees may amend the provisions of the trust deed, including the items in the Schedule naming or describing the Appointor and the Guardian. In my opinion there is nothing in the remaining provisions of the trust deed that necessarily imply that the trustees cannot amend the deed by removing the Appointor or Guardian and replacing them'.*[54]

3.127 In contrast, his Honour determined that the variation to the FW Trust was invalid as:

(a) the wording of the variation only allowed variations to clauses prior to the variation power (in which the appointor powers were not present):

'*The crucial words of cl 14.1 are 'the Trustee may … vary … the trusts hereinbefore provided'. In my opinion the 'trusts hereinbefore provided are the trusts provided for in the earlier provisions of the trust deed. Clause 2 (Declaration of Trust) declares that the trustee shall stand possessed of the Trust Fund and the income thereof upon the trusts and with and subject to the powers and provisions hereinafter expressed. The trusts and powers expressed are found in cl 2 (Declaration of Trust), 4 (Profits of*

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[51] Ibid at 75

[52] Ibid at 76

[53] Ibid at 77

[54] Ibid at 91

the Trust), 5 (Vesting of Trust), 6 (Benefits in Addition), 7 (Trustee Powers), 8 (Trustee's General Powers). The identity of the Appointor is not 'any of the trusts hereinbefore provided …'.';[55] and

(b) regardless, the variation of an appointor's role did not relate to the underlying trusts of the FW Trust:

'*In my opinion the natural and ordinary meaning of the words 'the Trustee may … vary … the trusts hereinbefore provided' does not extend to varying the terms and conditions of the trust deed dealing with the office of Appointor as distinct from the trusts created by the trust deed.* '[56]

<u>On appeal</u>

3.128 Michael appealed the decision in relation to the findings for the MMF Trust (in which the change of Appointor was held to be valid) to the Court of Appeal[57] on the following grounds:

(a) **Ground 1**: The MMF Trust Deed does not empower the Trustee to do so on construction of the variation power.

(b) **Ground 2**: Alternatively, the variation power did not allow the Schedule the MMF Trust Deed to be varied so as to remove the appointor and appoint a new appointor in his place.

(c) **Ground 3**: The MMF Trust Deed of Variation is not binding upon Slondia (the corporate trustee) because the instrument was not executed by Slondia pursuant to the lawful authority of Slondia's directors or shareholders.

(d) **Ground 4**: The MMF Trust Deed of Variation constituted a fraud on the power to amend the MMF Trust Deed and thus a breach of Slondia's fiduciary duty as Trustee of the MMF Trust.

(e) **Ground 5**: Michael's agreement to and execution of the MMF Trust Deed of Variation was as a result of the equitable fraud by, further or alternatively the undue influence of, Tyrone.

(f) **Ground 6**: The appointment of a new trustee by Tyrone for the MMF Trust amounted to a fraud on the power of the appointor and was a breach of duty.

(g) **Ground 7**: That the appointment of Tyrone as appointor was void but in the alternative, that Tyrone held such powers on constructive trust for Michael.

3.129 In rejecting Michael's arguments relating to **Grounds 1 and 2**, the Court accepted that notwithstanding the variation power related to variations '*hereinbefore*' declared and the MMF Trust deed of variation varied the Schedule (being situated after the variation power), on construction:

(a) *'the attachment of the Schedule as a convenient drafting technique in the context of a trust deed that was obviously intended for use as a standard form document;*

(b) *the status of the definition of 'the Appointor' as, in part, a definition in the strict sense and, in part, an operative provision; and*

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[55] Ibid at 100
[56] Ibid at 101
[57] *Mercanti v Mercanti* [2016] WASCA 206

(c) *the express references in the definition of 'the Appointor' to the relevant provision of the Schedule,*

(d) *require, in combination, that the relevant provision of the Schedule be read and construed as if it were, in substance, embodied in and part of the definition.*

Also, in my opinion, the definition of 'the Appointor', with the relevant provision of the Schedule read and construed as if it were, in substance, embodied in and part of the definition, must be read and construed with the operative provision with respect to the Appointor in cl 21.'[58]

3.130 The Court also made note to distinguish between the words 'the trusts' (in which the Schedule would not be apart of) and the 'terms and conditions' (of which the Schedule relates to).

3.131 In rejecting **Ground 3**, reference was made to the file note of lawyers present at a meeting between Tyrone, Michael and Yvonne, in which they were instructed to change the Appointor of the trust to Tyrone.

3.132 This, along with other contemporaneous evidence, was sufficient in documenting that there 'was a meeting of minds' as to the execution of the deed of variation, notwithstanding the lack of formal procedures being met.

3.133 **Ground 4** was rejected on the basis that it was accepted that the trustee's duties conferred in exercising the variation power were:

(a) *'to act honestly and in good faith; and*

(b) *to exercise the power for the purpose for which it was conferred and not for any extraneous or ulterior purpose.,*[59]

and that '*the power of variation in cl 28 of the MMF Trust Deed may be exercised to achieve or promote, relevantly, any of the purposes for which the MMF Trust was created'.*[60]

3.134 Such purpose could be inferred to include:

(a) '*conferring benefits from time to time on one or more of the Beneficiaries for the time being of the MMF Trust, as determined from time to time by the Trustee for the time being (at all material times, Slondia), subject to the provisions of the MMF Trust Deed, including any consent required from the Guardian for the time being (at all material times, Michael Mercanti) pursuant to cl 10 of the MMF Trust Deed; and*

(b) *ensuring, in the context of a trust which may not vest until the Vesting Day (namely, 30 June 2055) and the existing provisions with respect to the effective control of the MMF Trust, that the provisions of the MMF Trust Deed with respect to the offices of Guardian and Appointor remain appropriate.'*[61]

3.135 Therefore, the exercising of the variation power to 'advance Tyrone's inheritance' would not render the deed of variation '*improper or liable to be set aside in equity'.*[62]

3.136 The Court also accepted that the substratum of the trust was not varied by the changing of the appointor under the deed of variation. Relevantly '*the substratum of the MMF Trust was the conferral of benefits from time to time on one or more of the Beneficiaries for the time*

[58] Ibid at 140 and 141
[59] Ibid at 250
[60] Ibid at 261
[61] Ibid at 262
[62] Ibid at 264

being of the MMF Trust, as determined from time to time by the Trustee for the time being, subject to the provisions of the MMF Trust Deed, including any consent required from the Guardian for the time being pursuant to cl 10 of the MMF Trust Deed. The substratum was not, in my view, to be ascertained or defined by reference to the identity of the persons or entities who, at the date of execution of the MMF Trust Deed, held the offices of Trustee, Guardian or Appointor'.[63]

3.137 The Court also separately noted the independent legal advice obtained by Michael and Yvonne from Brett Davies Lawyers.[64]

3.138 In rejecting **Ground 5** regarding Michael's execution of the deed of variation for the MMF Trust being due to equitable fraud, the Court did not accept Michael's evidence that he did not give instructions to make Tyrone the appointor of the MMF Trust.[65]

3.139 Rather, weight was placed on evidence from advisors at the time claiming that Michael was properly advised of the effect of the change and that the change of appointor was being made to allow Michael to 'step back' from the business.[66]

3.140 **Ground 6** was rejected on the basis that not all roles in a trust deed attached fiduciary duties on them.

3.141 Where the role:

(a) prevents the exercise of a power in favour of the yielder, then fiduciary duties may arise;

(b) otherwise, if the yielder of a power is entitled to exercise the power for his or her own benefit, then the power will be person as distinct from a fiduciary. [67]

3.142 The Court held that the '*effect of Tyrone Mercanti exercising his power as Appointor to remove Slondia and appoint Parradele as Trustee was consistent with the purpose of the MMF Trust, as revealed by the MMF Trust Deed of Variation. The effect of executing the MMF Trust Deed of Variation in 2004 was to transfer effective control of the MMF Trust and its business to Tyrone Mercanti immediately. Tyrone Mercanti's action in preserving the status quo was not improper. He was not acting dishonestly or in bad faith or for any extraneous or ulterior purpose'*.[68]

3.143 **Ground 7** was dismissed without consideration.

<u>*Takeaways*</u>

3.144 Whilst the Mercanti Case considers various avenues in challenging a discretionary trust's succession plan, from a 'resettlement' perspective, the case emphasises the importance of the wording in a trust's variation power in determining the extent of which variations can be made in relation to certain trusts.

3.145 From a succession planning perspective, one wonders whether the case would have made it this far if Michael had prepared a nomination appointing Tyrone as the successor appointor following the death and loss of capacity of Michael and Yvonne, rather than making the change to the appointor role during Michael and Yvonne's lifetime.

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[63] Ibid at 265
[64] Ibid at 267
[65] Ibid at 295 and 296
[66] Ibid at 298 and 299
[67] Ibid at 320
[68] Ibid at 326

4 State tax considerations

Payroll tax grouping

4.1 Where a business is currently operating from a legal structure which **does not** include the use of a discretionary trust, the restructuring of a business to a legal entity that incorporates a discretionary trust (whether directly or indirectly) may have unintentional payroll tax implications.

4.2 Specifically, the use of a discretionary trust may cause the restructured business to be grouped with other businesses conducted by family members who are beneficiaries of the discretionary trust.

4.3 This is due to a deemed control provision of the payroll tax legislation which considers any person who **may benefit** from a discretionary trust (whether by way of the trustee exercising their discretionary power or through a default provision) as being a beneficiary of the trust who has more than 50% of the value of the interests of a trust.[69]

4.4 Given the broad drafting of beneficiary classes in discretionary trusts, this may potentially deem family members operating unrelated businesses as controllers of the new business, and therefore be grouped under common control provisions.

4.5 Such provisions are clearly not practical, and steps may be available to argue that such technical grouping should be severed; however, thought should be had as to whether any beneficiary class of a discretionary trust should be limited to reduce the application of such provisions.

4.6 Further, it is noted that '*the carrying on of a trust (including a dormant trust)*'[70] is defined as a business under payroll tax legislation for general grouping purposes as well.

Transfer duty

4.7 Although transfer duty has been abolished on business transfers for the majority of Australian States/Territories, it may still apply for some States/Territories.

4.8 For those States/Territories, the ability to manage the transfer duty cost will be a relevant consideration in determining whether to undertake a restructure or not.

4.9 Potential exemptions that are mutually available (albeit with potentially differing requirements) for transfer duty on business restructures can include those related to a farming family as well as corporate restructures.

4.10 Specific to Queensland is also the availability of a small business restructure exemption for businesses with an annual turnover of less than $5 million. Whilst there are specific requirements to be met, broadly this exemption enables a restructure of a small business in Queensland to a company in the following circumstances:

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[69] Section 71(7) *Payroll Tax Act 1971* (Qld), section 72(6) *Payroll Tax Act 2007* (NSW), section 72(6) *Payroll Tax Act 2007* (VIC), section 72(6) *Payroll Tax Act 2009* (SA), section 72(6) *Payroll Tax Act 2008* (TAS), section 72(6) *Payroll Tax Act 2009* (NT), section 72(6) *Payroll Tax Act 2011* (ACT), section 34 *Pay-roll Tax Assessment Act 2002* (WA)

[70] See section 66 *Payroll Tax Act 1971* (Qld) and noting that the Commissioners of all States revenue authorities committed in 2007 and again in 2010 to harmonise the practice of payroll tax to reduce discrepancies in how legislation is applied across the States – and therefore other Australian States/Territories will have similar provisions included in their payroll tax legislation (consider the fact that all payroll tax legislation contained similar provisions regarding the deeming of control in a discretionary trust).

(a) transfer of a business from an individual to a company which the individual is the sole shareholder;[71]

(b) transfer of a business from a partnership to a company which the partners are shareholders in the same proportions as their original interest;[72]

(c) transfer of a business from a trust to a company which the 'default beneficiaries' of the trust are the shareholders in the same proportions as their trust interest;[73]

(d) transfer of a business from a trust to a company which the trust is the sole shareholder.[74]

4.11 It is curious to note that the Queensland transfer duty small business restructure exemption mimics the availability of the Subdivision 122-A and Subdivision 122-B ITAA 1997 rollovers for certain circumstances.

5 Additional legal and tax considerations

5.1 In addition to the above factors, there are a range of other legal and timing considerations. Given the breadth of such issues, this section will consider such factors in no specific order.

Additional business to company issues

5.2 In addition to the succession planning issues identified above in relation to companies, the following commercial considerations should also be factored in when transferring a business to the 'next generation of ownership'.

5.3 Where the shares in a company are held by a single owner, then it is prudent for the parties to consider whether the business itself or the shares in the company should be sold.

5.4 Key factors that can impact the parties' decisions include:

(a) historical trading liability considerations – a buyer will generally prefer to buy the business assets rather than acquiring an existing entity. This is to ensure that the buyer does not have liability for any historic claims that may lie in waiting against the business entity for past conduct, either known or unknown by the seller;

(b) stamp duty consequences – in some jurisdictions there is no material difference in the duty cost between buying business assets compared to equity in a business structure, whereas in other jurisdictions (such as Queensland unless an exemption applies), the transfer of business assets will still create a duty liability for the buyer based on the unencumbered market value of the assets being acquired; and

(c) whether a partial or full sell-down is occurring – it will typically be more appropriate for the buyer to acquire equity in the existing entity so tax and stamp duty (as applicable) costs are only imposed in respect of the proportionate interest being acquired, rather than on 100% of the assets being transferred to a new vehicle. That said, in some instances tax and stamp duty concessions may be available to allow the seller to transfer the business assets to a clean skin vehicle, prior to selling equity in that new vehicle to the buyer. Further, the dynamics of a gradual sell-down may be preferable for the incoming generation as the original business owner remains to enable the transition and retention of key business contacts.

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[71] Section 413F QLD Duties Act
[72] Section 413G QLD Duties Act
[73] Section 413H QLD Duties Act
[74] Section 413I QLD Duties Act

Additional discretionary trust considerations

5.5 Where a business is to be held in a discretionary trust or in a company wholly owned by a discretionary trust, care needs to be taken regarding the rise of disputes arising from beneficiaries of a discretionary trust.

5.6 The general law in relation to discretionary trusts is on the basis that beneficiaries of such a discretionary trust:

(a) only have a 'mere expectancy' to receive any of the trust fund and cannot force a trustee to distribute trust funds in their favour[75] (subject to the rule of equity in *Saunders v Vautier*[76]); and

(b) can only compel the trustee to properly administer the trust.[77] Specifically:

'[N]o object of a discretionary trust has, as such, any legal right to or in the capital. His sole interest, if it be an "interest" within the scope of these provisions is with regard to the income: he can require the trustees to exercise, in bona fide, their discretion as to how it shall be distributed, and he can take and enjoy whatever part of the income the trustee choose to give him. I cannot see any ground for holding that he can have any "interest" in the capital if he has no interest in the income.'[78]

5.7 This has been referenced in Australian law cases (not an exhaustive list):

(a) Per Owen J in *R and I Bank of Western Australia Ltd v Anchorage Investments Pty Ltd* [1992] 10 WAR 59 at 79:

The trustee has a duty to administer the trust bona fide having regard to the purpose for which it was established. This is a duty which the court will enforce at the behest of the beneficiary. In this way, the remedy defines the nature of the interest of an individual beneficiary.

(b) Per French J in Richstar Enterprises Pty Ltd and Others; Australian Securities and Investments Commission v Carey (No 6) (2006) 153 FCR 509 at 29:

… in my opinion, in the ordinary case the beneficiary of a discretionary trust, other than perhaps the sole beneficiary of an exhaustive trust, does not have an equitable interest in the trust income or property which would fall within even the most generous definition of "property"….

(c) More recently in *Kestenberg v Kestenberg* [2020] VSC 84 at 7:

[A] discretionary beneficiary has no proprietary interest, vested or contingent, in the assets of a trust but only an expectation…a discretionary beneficiary, is not entitled as of right to disclosure of that which could be properly described as 'trust document'

5.8 There is, however, a rise of disputes where one or more particular family members are placed in a decision-making capacity of the trust and such decisions are disputed by other potential beneficiaries of the trust.

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[75] *Pearson v Inland Revenue Commissioner* (1981) AC 753

[76] The rule in *Saunders v Vautier* (1841) EWHC Ch J82 states that all beneficiaries of a trust can force the trustee to dissolve the trust and pay the trust fund. For a discretionary trust, this will need to include all Discretionary Beneficiaries including eligible trusts and companies

[77] *Gartside v Inland Revenue Commissioners* (1986) AC 553

[78] *Gartside v Inland Revenue Commissioners* (1986) AC 553 at 606

5.9 The Victorian case of *Callus v KB Investments* [2020] VCC 135 is example where by a disgruntled beneficiary could not establish the fact that the trustee '*was not in a position to give real and genuine consideration to the interests of the beneficiaries, or that it did not give real and genuine consideration of those interests*'.

5.10 This was notwithstanding that the trustee of the trust in that case transferred a property to one of the beneficiaries over another, and left no written reasons or record for making such a decision.

5.11 In that case, a disgruntled family member challenged the trustee's discretion to transfer trust property to one of four named beneficiaries in a discretionary trust deed.

5.12 The Court undertook to consider, not whether the final outcome was fair, but rather whether the trustee at the time had proper consideration as part of the process of making a decision.

5.13 The Court in *Callus v KB Investments* [2020] VCC 135 provided a detailed summary of the relevant legal principles by referencing McMillan J in Re Marsella; Marsella v Wareham (No. 2) [2019] VSC 65.

5.14 The key principles can be summarised as follows:

(a) In accepting to be a trustee, the trustee is bound by duties to exercise their power in the best interest of beneficiaries.

(b) Where a trustee is provided 'unfettered discretion', such discretion must be exercised in good faith, upon real and genuine consideration and in accordance with the purposes for which the discretion was conferred.

(c) In determining whether such discretion was exercised appropriately, a Court may look at the inquiries the trustee made, the information they had, and their reasons for, and manner of, exercising their discretion.

(d) It is not the Court's role to determine the weight of such matters in the trustee exercising its discretion.

(e) A lack of good faith can include the taking account of irrelevant considerations and a refusal to take into account relevant considerations.

(f) The trustees must inform themselves of the relevant matters to exercise the discretion. Where the consideration is not properly informed, then it is not genuine.

(g) Finally, the purpose for which a power is conferred on the trustee must be inferred from the trust deed.

(h) Whether a trustee exercised a power for a proper purpose is a question of fact to be decided on the evidence. A trustee is not bound to disclose her or his reasons in reaching a particular decision, and a negative inference cannot be drawn from the non-disclosure by a trustee of the reasons for his or her decision.

5.15 In this case, the Court held that there was no proof that the trustee did not act honestly and in good faith. The Court considered the following:

(a) the trustee exercised their discretion pursuant to the terms of the discretionary trust (including not being required to retain records of the decision or not being required to seek the guidance of the Guardians);

(b) the trustee exercised their discretion per an oral recollection from the prior decision-maker of the trust (being the father of those managing the trustee);

(c) there was no hostility between the trustee and disgruntled beneficiary at the time of the transfer (such hostility arising at a later point in time); and

(d) there was sufficient evidence that on the balance of probabilities, the trustee obtained appropriate legal advice regarding the deed prior to exercising its discretion.

5.16 In contrast, the decision of *Ying Mui & Ors v Frank Kiang Ngan Hoh & Ors* (No 6) [2017] VSC 730 was an example where the Court examined the distribution determinations by the trustee of a discretionary trust and found that they had been made in bad faith and for an improper purpose and ordered that the funds were held on constructive trust for a particular beneficiary who did not receive discretionary distributions.

5.17 More recently, the case of *Owies v JJE Nominees Pty Ltd* [2022] VSCA 142 outlines when a Trustee has exercised their discretion in good faith and with real and genuine consideration.

5.18 This can include, '*In considering the nature of the power to distribute annual income, the starting point must be the nature and purpose of the trust having regard to the terms of the trust deed'*[79].

5.19 It can also include the '*premise on which the trustee would be expected to discharge its duties is that it would generally be informed about the differing circumstances, needs and desires of each beneficiary as an incident of the familial bonds that underpin the trust and explain its purpose'*[80] .

5.20 Case law exists which has accepted that a trustee may take into account a 'memorandum of wishes' in relation to a trust controlled by the deceased with the Courts accepting that the '*Trustee is entitled to take into account this memorandum of wishes in exercising its discretions conferred under the Trust Deed, just as the Trustee is entitled to take into account the views of beneficiaries'*.[81]

5.21 The Court noted, referencing *Hartigan Nominees Pty Ltd v Rydge* (1992) 29 NSWLR 405, that the trustee is entitled to take into account the memorandum of wishes in determining how to deal with the assets of a discretionary trust:

*"[62] But as Campbell JA said speaking extra-judicially**, established principles of trust law would appear not to require the application of rules of natural justice to the decisions of discretionary trustees**: see JC Campbell "Exercise by Superannuation Trustees of Discretionary Powers" [2009] 83 ALJ 159, at 175. As Campbell JA said, the private law context in which trustees make their decisions usually does not give rise to an obligation to adhere to the rules of natural justice but this is really as a matter of construction of the constitutive documents of the trust. **But his Honour also pointed out that the well-known obligation of trustees to give "genuine consideration" to the exercise of a discretion will sometimes mean the trustee will be required to gather information the trustee does not then hold and that such a procedure**, though not identical to affording rights of natural justice or procedural fairness, covers at least some of the same ground. But Campbell JA also observed in the common case of a family discretionary trust the trustee will frequently already know enough about the circumstances in life of the various potential objects of the power of appointment to be able to make an appointment without gathering extra information."*[82]

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[79] *Owies v JJE Nominees Pty Ltd* [2022[VSCA 142 at [110]
[80] *Owies v JJE Nominees Pty Ltd* [2022[VSCA 142 at [111]
[81] Monaghan v Monaghan [2016] NSWSC 1316 at [49]
[82] Ibid at [62]

5.22 In this regard, the Court reiterated that "*the Trustee's obligations in this area are well established: Karger v Paul [1984] VR 161 at 164, 166 and 178. It can be assumed that the Trustee will follow established law in respect of the degree of inquiries the Trustee has to make in order to give "genuine consideration" to the exercise of its discretion to reach the decision that the Trustee contemplates*".[83]

Commerciality of succession plan

5.23 The commerciality of the transition to the 'next generation of ownership' should also be considered.

5.24 Will the transition occur for no consideration or under-market value? This can be common:

(a) when dealing with family businesses and parents exiting the business by gifting it to their children to operate;

(b) as part of post-death transitions for family businesses where children can receive their inheritance through the business; and

(c) occasionally, between unrelated parties and from the business owner to a key or ear-marked employee.

5.25 Alternatively, will the transition occur on arm's length terms (regardless of it being between family members or unrelated parties)? Relevant issues to consider for such transactions include:

(a) the purchase price and the timing for it to be paid (i.e. whether there will be any retention amounts or earnouts);

(b) whether any assets are being excluded from the sale, including the proposed treatment of working capital, work-in-progress, debtors and retained profits;

(c) whether the buyer will take on the existing liabilities, including assuming responsibility for employee annual leave, sick leave and long service leave entitlements;

(d) what level of due diligence will be undertaken by the buyer;

(e) whether the seller will be subject to any restraint of trade and if so, the scope of the restraint; and

(f) what types of warranties and indemnities will be provided by the seller and whether any of those warranties and indemnities will be backed by personal guarantees (if the seller is a trust or company).

5.26 Financing of a business transition for value should also be considered, and in circumstances where the transition is vendor-financed, the impact of having a loan owing to an existing business owner should be considered as part of the business owners' personal estate plan. This is of particular importance where a business owner sells the business to a particular child as part of that child's inheritance; whilst other family members benefit through an estate plan.

[83] Ibid at [63]

5.27 Where a discretionary trust is to be utilised, then thought should be had in relation to unpaid present entitlements owed by the trust to beneficiaries of a family group.[84]

Transitioning today or tomorrow

5.28 An often-difficult task for business owners is to know when to pass the decision-making to the next generation. Business owners may feel that they can keep running the business through themselves or may just not be comfortable relinquishing control at this stage.

5.29 Risks can exist, however, when business owners pass control before they are ready. Cases such as the Mercanti Case (referred above at paragraph 3.114) and *Cihan v Cihan* [2022] NSWSC 538 provides public examples of when the next generation (in this case, the child of the original business owner) chooses to freeze the original business owner out.

5.30 It is imperative that steps be considered on how to integrate key future decision-makers into the business today, rather than tomorrow, to ensure a smooth transition.

5.31 Doing so allows such persons to learn and understand the operations of the business, whilst having the 'safety net' of the knowledge and experience of the current business owner.

5.32 Integrating the next generation now also allows them to contribute with potential improvements to the business process and system, based on their education and experiences.

5.33 Where it is not possible to integrate the future decision-makers into the business today, thought has to be given to implementing a transition plan that can allow an as smooth as possible hand-down at a later date.

5.34 For example, whereas an integrated decision-maker would have an opportunity to understand the business through liaising with staff and key employees, a decision-maker thrown into the deep end would be left without any operational experience or understanding on how the business operates.

5.35 A potential strategy to manage this 'void' of understanding in the business could be to establish a board (whether formally or informally) in the business with key senior employees or business advisors (with an understanding of the business) to assist and advise the incoming successor/s.

Putting in place a framework

5.36 Whilst establishing the board informally may include nothing more than just verbally informing of the intention to the persons to be involved, setting out such intentions formally can include:

(a) having documents (such as family constitutions, company constitutions and/or shareholders agreements) drafted outlining:

(i) any named successor decision-makers;

(ii) the process to appoint successor decisions-makers;

(iii) any key persons to be involved in advising successor decision-makers, including:

[84] Consider the case of *Fischer v Nemeske Pty Ltd* [2016] HCA 11, which although related to whether a power in a trust deed was validly exercised, arose due to a debt owed by a trust to the estate of a deceased which remained unpaid. Specifically, the beneficiaries of the estate of the deceased sought to have such debt repaid by the trust which was controlled by other individuals.

(A) key employees involved in the business – who can assist with advising on the operational aspects of the family business;

(B) independent advisors – who can provide unbiased recommendations in the interest of the family business;

(iv) the process on how decisions must be made including:

(A) the voting power of decision-makers;

(B) any threshold percentage for decisions to be made;

(C) requiring certain persons to be in the majority for decisions or holding casting votes;

(D) limiting the ability for owners to override the decisions of the decision-makers;

(b) implementing additional documents to ensure the above framework cannot be overridden – for example, by ensuring any Appointor role in a trust is structured in a manner consistent with any trustee role which can include:

(i) amending the terms of the trust deed by replacing the Appointor terms; and/or

(ii) changing the Appointor role to align with the Trustee role including through the use of a company appointor (whether the company is the same company acting as Trustee or a new company with the same constitution terms).

5.37 It is noted that such an informal document is more commonly seen with family businesses given the casual manner in which they operate. Formal and binding documents are utilised where non-related parties are involved in the transition given the need to protect each person's (and their respective family's) interests.

Extracting retained earnings prior to exit

5.38 It is not uncommon for business owners to consider the transition to the next generation as they reach retirement age.

5.39 By that point in time, their business would have accumulated significant retained earnings.

5.40 Where a company is the legal structure of choice, due to the nature of companies (being trading entities that allow for the retention of profits at a corporate tax rate), businesses trading through such structures will often hold large retained amounts.

5.41 This is in contrast to businesses that trade through discretionary trusts who are required to distribute profits each financial year to avoid paying the top marginal tax rate on accumulated profits.[85]

5.42 A key question, therefore, relates to how business owners are able to deal with retained earnings. In particular:

(a) What options are available to extract retained earnings from a company?

(b) How to deal with franking credits for a departing shareholder?

5.43 Prior to extracting retained earnings, a company must ensure its assets exceed its liabilities immediately before a dividend is declared. Further, the payment of the dividend must be fair

[85] Section 99A ITAA 1936

and reasonable to the company's shareholders as a whole and not materially prejudice the company's ability to pay its creditors.[86]

5.44 Various issues can arise for business owners in relation to extracting multiple years' worth of retained earnings. These issues include where an exiting shareholder:

(a) holds their share in the company in their personal name – as the shareholder will lose the flexibility of distributing such retained earnings to other family members and flattening the tax rate of historical profits between multiple individuals or a company;

(b) holds their share in the company with a discretionary trust – as the shareholder will be forced to either:

(i) distribute all retained earnings to family members; or

(ii) distribute retained earnings to a 'bucket company' and potentially paying top-up tax due to the difference in company tax rate between a 'base rate entity' and ordinary company.

5.45 The above issues arise as it is standard tax planning for retained earnings to be stored in a company environment and dividends slowly distributed to assist business owners to self-fund their retirement. Therefore, for a business owner to be forced to receive the entirety of the retained earnings in a single income year (due to being the individual shareholder and the need to exit the business structure), they will lose the ability to 'pick and choose' the timing of extracting retained earnings.

5.46 This particular issue can be managed either through:

(a) the interposition of a new holding company between the exiting individual and trading company (which the individual is exiting); or

(b) the issuing of 'dividend access shares' in favour of a company or discretionary trust controlled by the exiting individual.

New holding company

5.47 The interposition of a holding company between the exiting individual and trading company allows for dividends to be declared and distributed to the holding company for retention.

5.48 In addition to allowing the exiting business owner to retain earnings in a corporate environment after exiting the trading company, the interposition of the holding company reduces the need to pay any 'top-up' tax on dividends which may have franking credits based on the lower company tax rate.

5.49 Section 23 *Income Tax Rates Act 1986* (Cth) sets out the rate of tax payable by companies. As of the date of this paper, the rates of tax for a company are as follows:

(a) if the company is a 'base rate entity' for an income year – 25%; or

(b) otherwise – 30%.

5.50 A base rate entity is defined to be an entity:[87]

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

[86] Section 254T *Corporations Act 2001* (Cth)
[87] Section 23AA *Income Tax Rates Act 1986* (Cth)

(b) its aggregated turnover[88] for the income year is less than $50 million.

5.51 Base rate entity passive income is defined to be income that is any of the following:[89]

(a) a distribution by a corporate tax entity **other** than a non-portfolio dividend[90] (within the meaning of section 317 *Income Tax Assessment Act 1936* (Cth));

(b) an amount of a franking credit on such a distribution;

(c) a non-share dividend by a company;

(d) interest, royalties and rent;

(e) net capital gain;

(f) an amount included in the assessable income of a partner in a partnership or of a beneficiary of a trust estate to the extent that the amount referable (either directly or indirectly through one or more interposed partnerships or trust estates) to another amount that is base rate entity passive income.

5.52 Therefore, a company:

(a) where at least 20% of its income **does not** constitute 'passive income'; and

(b) together with its related entities, has a turnover of less than $50 million,

will be taxed at the 25% company tax rate.

5.53 For trading companies, a substantial amount of their income will be generated from trading activities. Further, to be considered a base rate entity (thereby receiving the lower company tax rate), at least 20% of the company's income need be from trading activities.

5.54 For holding companies that hold at least a 10% share in a trading company, the distribution of retained earnings to that holding company will not amount to base rate entity passive income as the dividend relates to a non-portfolio dividend; provided such retained earnings equates to at least 20% of the holding company's income for that particular income year.

5.55 In contrast, a 'bucket company' receiving retained earnings through a trust distribution will be receiving such amount as 'base rate entity passive income'. Provided the bucket company does not receive trading income or non-portfolio dividends, the bucket company will not satisfy the definition of base rate entity, and will be required to pay the differential (if any) in company tax rate of 5% (as of the financial year ending 30 June 2021).

Dividend access shares

5.56 Dividend access shares (also known as 'dividend only shares') are a special class of shares which can be introduced into a company's constitution and allotted to a new shareholder, which carry the right to receive a dividend as determined by the company's directors in their absolute discretion from time to time.

5.57 Dividend access shares are typically structured such that:

(a) the holder does not have any right to attend or cast votes at shareholder meetings and does not have any rights to the repayment of capital from the company;

[88] See section 328-115 *Income Tax Assessment Act 1997* (Cth) for the meaning of aggregated turnover
[89] Section 23AB *Income Tax Rates Act 1986* (Cth)
[90] Section 317 *Income Tax Assessment Act 1936* defines a non-portfolio dividend to mean '*a dividend…paid to a company where that company has a voting interest…amounting to at least 10% of the voting power…in the company paying the dividend.*'

(b) the holder is only entitled to dividends at the sole discretion of the directors of the company from time to time and is not entitled to the dividends until they are actually paid; and

(c) the shares can be redeemed for a nominal amount (or at a pre-defined redemption price in the constitution) at the discretion of the company. In some instances, the shares may be automatically redeemed after a specified period of time, typically less than four years.

5.58 Historically, the argument adopted by many taxpayers and their advisers has been that in light of the limited rights outlined above, the market value of the shares at the time of their issue (and at the time of any subsequent redemption) is nominal and as a result, no adverse tax consequences arise from their allotment.

5.59 That said, the Tax Office has expressed significant concern regarding the use of dividend access shares. Those concerns are articulated in Taxpayer Alert TA 2012/4 (**Taxpayer Alert**) and the specific issue of dividend stripping is further explored in Taxation Determination TD 2014/1.

5.60 TA 2012/4 states:

'The ATO considers that arrangements of this type give rise to the following issues relevant to taxation law, being whether:

(a) an amount should be included in the assessment of any entity as an ordinary dividend or as a deemed dividend under Division 7A of the Income Tax Assessment Act 1936 (ITAA 1936);

(b) an amount should be deductible for the target company or its shareholders in respect of any fees paid to an entity recommending the arrangement under section 8-1 of the Income Tax Assessment Act 1997 (ITAA 1997) or another provision;

(c) the new shares may be debt interests under Division 974 of the ITAA 1997;

(d) a taxing event may generate a capital gain under CGT event K8 for the original shareholders of the target company by virtue of the direct value shifting rules in Division 725 of the ITAA 1997;

(e) an amount should be allowable as a franking credit/offset under Part 3-6 of the ITAA 1997;

(f) 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;

(g) the arrangement may be a scheme to which sections 177A to 177D of Part IVA of the ITAA 1936 (the general anti-avoidance rules) may apply;

(h) the general anti-avoidance rule for franking credit benefits on section 177EA of the ITAA 1936 may apply to the arrangement;

(i) any amounts received by an entity recommending the arrangement are assessable income of that entity;

(j) any entity involved in the arrangement may be a promoter of a tax avoidance scheme for the purposes of Division 290 of Schedule 1 of the Taxation Administration Act 1953 (TAA 1953); and

(k) any entity involved with the arrangement that is a tax practitioner may be referred to the Tax Practitioner Board under the Tax Agent Services Act 2009 regarding matters relevant to the Code of Professional Conduct.'

5.61 The Tax Office's invocation of the promoter penalty rules in the Taxpayer Alert has understandably created significant concern amongst advisers and resulted in a material reduction in the use of these arrangements, since 2012.

5.62 That said, the widely held view amongst the tax community is that subject to the over-arching operation of the Part IVA anti-avoidance rules to the arrangement, each of the other areas of concern mentioned by the Tax Office can be satisfactorily addressed in an appropriately structured arrangement, such that no adverse tax consequences should arise.

5.63 Where a client is advised of the risks and wishes to proceed, the dividend access arrangement would typically be implemented as follows:

(a) the company's constitution would be updated to create the new class of dividend access share (if that share class does not already exist);

(b) a dividend access share would be allotted to a family trust for nominal consideration of $1. The family trust will likely need to make a family trust election;

(c) a dividend equal to the retained profits would be declared as a dividend to the family trust and subsequently distributed to either individual family members or a corporate beneficiary;

(d) at some point either before or after the sale transaction, the dividend access share would be redeemed by the company. Key considerations in this regard include:

(i) ensuring the holding period rules for franking credits are satisfied in respect of the dividend;

(ii) considering the impact on the small business CGT concessions (and in particular, the ability to satisfy the CGT concession stakeholder test) if the share remains on issue; and

(iii) addressing the wider commercial implications for the transaction, such as the buyer's willingness to acquire a vehicle which has a dividend access share on issue.

5.64 Naturally, the tax avoidance risk is materially higher if a dividend access share arrangement is implemented within a short period of time before a share sale occurs.

Franking credits for a departing shareholder

5.65 Where a shareholder of a company is a discretionary trust, care must be taken to ensure franking credits are able to be claimed.

5.66 Specifically, Division 1A of Part IIIAA of *Income Tax Assessment Act 1936* (Cth) (repealed effective from 1 July 2002) applies to the ability for franked dividends to flow through a trust to its beneficiaries.

5.67 Despite the repeal of such legislation, Taxation Determination TD 2007/11 confirmed the Tax Office's acceptance of the old law:

The very wording of sections 207-145 and 207-150 makes it clear that regard is to be had to the rules in Division 1A in determining whether a person is a qualified person for the purposes of these provisions in respect of a franked distribution, irrespective of whether the

distribution is made after 30 June 2002. There is nothing in the relevant extrinsic material to indicate the contrary.[91]

5.68 Broadly, the Tax Office has accepted that to be entitled to a franking credit tax offset, a taxpayer is required to be a 'qualified person' in relation to a franked dividend. The qualified person test ensures only the true economic owners of shares benefit from franking credits attached to distributions made from the shares.

5.69 A shareholder generally meets the qualified person test if they satisfy either the:

(a) holding period rule

(b) where applicable, the related payments rule.

5.70 The related payments rule only applies to a distribution on shares where there is an obligation to pass on the benefit or value of the distribution to another. Given that the extraction of retained earnings are intended to remain with the exiting business owner, the related payments rule will generally not be applicable.

5.71 Therefore, in order for a shareholding trust to satisfy the qualified person test, they will need to comply with the holding period rule.

5.72 The holding period rule requires shares to be held 'at risk' for a continuous period of at least 45 days (90 days for preference shares).

5.73 Where a discretionary trust holds shares, then steps must be taken to calculate the number of days in which a beneficiary held the interest in the shares to satisfy the holding period rule.

5.74 Former section 160APHL ITAA 1936 outlines the mechanism in how to calculate a beneficiary interest in the underlying shares based on the fixed interest that such beneficiary holds in a trust. Such provisions do not apply if the relevant trust is a family trust within the meaning of Schedule 2F ITAA 1936.[92]

5.75 Further, section 160APHL(11) ITAA 1936 states that only a 'vested and indefeasible interest' will constitute a fixed interest, therefore being impossible for beneficiaries of discretionary trusts to satisfy such holding rule requirements.

5.76 Given the difficulty in calculating the number of days a beneficiary held an interest in the shares, steps will need to be taken to make family trust elections to ensure the discretionary trust is considered a family trust for Schedule 2F purposes.

6 Family business considerations

6.1 Where a family business are to be restructured, it is noted that additional considerations will be required given the unique issues that are not present as part of non-family businesses.

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[91] TD 2007/11 at paragraph 9

[92] Section 160APHL(10) If:

(a) the trust is not a family trust within the meaning of Schedule 2F…

the taxpayer has, in addition to any other long and short positions (including the positions that the taxpayer is taken to have under subsection (8)) in relation to the taxpayer's interest in the relevant share or relevant shares, a short position equal to the taxpayer's long position under subsection (7) and a long position equal to so much of the taxpayer's interest in the trust holding as is a fixed interest.

6.2 In particular, the academic literature[93] relating to a concept of 'socioemotional wealth' (or '**SEW**') and its influence in the decisions made by family businesses provides a level of insight into the issues relevant to a family business.[94]

6.3 SEW has been defined as the *'non-financial aspects of the* [business] *that meet the family's affective needs, such as identity, the ability to exercise family influence, and the perpetuation of the family dynasty'*.[95]

6.4 To put simply, family businesses need to manage the 'family' aspects and issues that come with having family involved in the ownership and management of the business.

6.5 Whilst non-family businesses merely need to balance the relationship between management (those making the day-to-day decisions) and ownership (those who benefit from the growth in the business); family businesses also need to consider the impact decisions at the management and ownership level could have on family standing both internally and to the wider community.

6.6 It has been suggested that '*family* [businesses] *are typically motivated by, and committed to, the preservation of SEW*'.[96] This means that decisions in family businesses are often made to maximise:

(a) a family's control and influence in the business;

(b) the identification of family members involved in the business;

(c) the potential to exert the family's name within social ties and the broader community;

(d) emotional attachment of the family in the business; and

(e) the prolonging of the 'family dynasty',

even (potentially) to the detriment of the business financially.

6.7 Examples of the effect SEW may have on certain business decisions are listed below in comparison to potential decisions that non-family businesses *could* make.

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[93] However, the literature acknowledges the early nature of such research and theories.

[94] The author has specifically considered the following research and papers in relation to this concept of 'SEW' and the contents of this section is largely influenced by the information read: Gavin J Nicholson, "Succession Planning Management (SPM): A Case Study of Vietnamese Family Owned Business in Australia" Submitted in fulfilment of the requirements for the degree of Doctor of Business Administration (DBA) Victoria University Graduate School of Management College of Business; Matias Kalm and Luis R. Gomez-Mejia, "Socioemotional wealth preservation in family firms" Revista de Administracao 51 (2016) 409-411; Qing Lan, "Understanding Socioemotional Wealth – Examining SEW and Its Effect on Internationalization" May, 2015 as part of a Master's thesis within Business Administration of Jonkoping International Business School; David Devins and Brian Jones, "Review of Family Business Research on Succession Planning in the UK" ERASMUS+ KA2 Strategic Partnership 2014-1-HUO1-KA200-002307 ;Helge Mensching, Sascha Kraus, Ricarda B. Bounchken, "Socioemotional Wealth in Family Firm Research – A Literature Review" JIB, Volume 14, Number 4 2014.

[95] P Berrone, C Cruz, L.R Gomez-Meija, "Socioemotional Wealth in Family Firms: Theoretical Dimensions, Assessment Approaches , and Agenda for Future Research" *Family Business Review,* 25(3), 258-279 – It has been proposed that SEW could be broken down into five preferences (**FIBER**), namely (1) **f**amily control and influence; (2) **i**dentification of family members within the firm; (3) **b**inding social ties; (4) **e**motional attachment; and (5) **r**enewal of family bonds to the firm through dynastic succession

[96] Ibid

Family business	***Non-family business***
Picking family members into leadership roles in the business regardless of experience as it maximises the identification of family members in the business and family control	Picking a person (whether family or not) with the most suitable qualifications into leadership roles, whether internally (from the business) or externally
Family member executives deciding to proceed with risk adverse strategies to maintain the family wealth[97]	Directors deciding to proceed with strategies to maximise potential returns
Family businesses choosing to self-finance transactions to ensure control is retained within the family	Non-family businesses may seek financing via debt financing or equity participation from non-family members to undertake any large-scale transactions
Family businesses choosing to 'avoid taxes less aggressively than nonfamily' businesses out of fear of the negative outcomes associated with aggressive tax avoidance[98]	Management seeking strategies that can maximise profits to the owners (to validate the appointment of such persons in management positions)
Family businesses 'sticking by' underperforming family member executives either due to fear of repercussions within the family dynamic or due to the fact that such executive is earning less than what a non-family member executive would have earnt	Non-family member executives more easily criticized and dismissed if underperforming
Lack of written documents and evidence maintained due to the trusting nature of family members	Formal documents and processes implemented to provide a record of decision making

6.8 Additionally, social, economic, political and cultural factors can further impact the decisions and processes in a family business. For example, literature has suggested that Anglo family businesses in Australia tend to excel in business performance and individualism, with moderate business longevity. In contrast, Asian family businesses were found to focus on family and collectivism.[99] It was also acknowledged that the superstition against discussing death and finality found in Asian culture resulted in Asian family businesses having a lack of succession planning or focus.

6.9 As may be identified, decisions made by family businesses can often be driven by emotion rather than rational thinking. Therefore, the input of independent advisors cannot be

[97] Family businesses may alternatively be willing to take large financial risks to mitigate losses on their socioemotional wealth

[98] S. Chen, X. Chen, Q. Cheng and T. Shelvin (2010), "Are family firms more tax aggressive than non-family firms?" *Journal of Financial Economics*, 95(1), 41-61

[99] D. Waddel, M. Parris, J. Ye (2013), "The succession decision in Chinese-Australian family businesses: An exploratory study", *Small Enterprise Research*, vol. 20, p.110-125

underestimated in ensuring family businesses are advised in a balanced and non-biased manner.

Family business specific succession planning issues

6.10 Given that one of the key influences in how decisions are made in family businesses revolves around the want to create a 'family dynasty', it would be expected that succession planning for family businesses should be high on the list of issues to be properly considered.

6.11 Unfortunately, statistics show a different picture, and it is often the case that having a business owner consider a succession plan is the issue, with the vast majority of family businesses lacking an appropriately documented succession plan.

6.12 The role that independent advisors play extends further than just providing advice but also in assisting families to bypass the initial inertia associated about planning for death or loss capacity, and putting arrangements and documents in place to allow for a suitable transition in creating that family dynasty.

6.13 Once traction to consider the succession plan for the family business is in motion, the crucial questions that need to be asked of the family can be summarised as follows:

(a) *What is the long-term vision of the ownership in the family business? Specifically, who should take ownership of the business after the current family head leaves?*

(b) *How should decisions in relation to the family business be made in the future to ensure the longevity of the family business? Specifically, should there be a framework implemented to require certain people to 'approve' or be in the majority of decisions being made in the family business?*

(c) *Are there any family issues or concerns that can affect the implementation of the above intention?*

6.14 Each of these questions will have various sub-questions and issues to consider, but the broadness of the questions will at least be the start of a continuous ever-evolving discussion with the family.

What is the long-term vision of the ownership in the family business?

6.15 The information sought from this question is to effectively understand who should benefit from the operations of the family business:

(a) once a parent exits the business;

(b) once both parents have exited the business; and

(c) for the next generation or two down the line.

6.16 Families should consider if any of the following outcomes are ones that they are looking to achieve for their family business:

(a) the family business to be managed for the benefit of a surviving spouse;

(b) the family business to be managed for the benefit of a child or children involved in the business, whether that be:

(i) equally; or

(ii) disproportionately;

(c) the family business to be managed for the benefit of the broader family (i.e. all children) despite only having some of the children involved, whether that be:

(i) equally;

(ii) disproportionately; or

(iii) in a manner determined by key family members;

(d) the family business be sold to particular family members at market value (as opposed to being passed down under a succession plan);

(e) the family business be sold to key employees or third parties in the business at market value; or

(f) the family business to be wound up on the family head's exit.

6.17 Where the family business is a 'partnership' between siblings or a combination of family members (each considered a separate **Family Branch**), the questions need to be considered holistically by all Family Branches and whether all other Family Branches are in agreement.

6.18 Further, the traditional business succession planning issues may also need to be considered given separate 'partners' (despite the parties being family) such as:

(a) whether an exiting family member will transfer their share in the family business to the remaining family member/s; and

(b) how such a transfer will be funded (e.g. whether the remaining family member/s must fund third party financing to pay out the exiting family member, whether the use of a buy sell deed is appropriate, or whether the transfer occurs for no consideration given the close family relationship).

Example

A family business operates various sea vessels. The business is owned by two brothers (Adam and Ben) as equal owners (through their family trusts in a partnership).

Both brothers will need to consider what happens to their respective share in the business regarding who takes ownership in the event either one or both of them lose capacity or pass away (**Default Event**).

Adam has three sons involved in the operation of the business, while Ben has one son who is not involved in the business.

Scenario 1

Adam and Ben agree that on a Default Event occurring to Ben, Adam (or Adam's sons) will 'buy-out' Ben.

The 'buy-out' can be way of finding bank financing or through a self-funded insurance buy sell deed.

Scenario 2

The two families enjoy a close relationship and it is agreed that it is in the best interest to keep the two Family Branches involved with each other.

Steps are taken to introduce Ben's son in the business and in a position to succeed Ben on the occurrence of a Default Event.

Documents are also implemented to ensure each family member in the second generation receives an equal share in the business and in a manner that reduces a potential abuse of power by Adam's three sons holding a majority interest in the business.

Informal documents are also prepared to ensure Adam and Ben's respective spouses continue to benefit from the family business in the same manner as if Adam and Ben were in control.

6.19 Further complications can arise when the intention is for certain 'subsidiaries' or business branches/assets to pass to specific family members, especially where the family business is not operated through a suitable structure.

Example

A family business operates various businesses selling tyres and autocare services, effectively creating a brand through the State.

The business is operated through a discretionary trust by the father (Carl).

Carl has three sons who are all involved in the family business.

As Carl is too old to continue managing the business, Carl wishes to step down and pass control of the business to his three sons.

Unfortunately, in this case, Carl's three sons do not get along and as a result various stores must be transferred into separate structures controlled by each of the sons at significant stamp duty and capital gains tax costs.

Comments

This example (which is inspired from the facts of a payroll tax case) is an example of a family business not having an appropriate succession plan in place.

If a succession plan was considered and it was found that the sons would be unable to work together, then the question on how to separate various stores in the business and set them aside for the relevant son would be appreciated and appropriate strategies implemented prior to the transition (even if to just manage the adverse tax consequences).

6.20 Understanding a family's intention in relation to the ownership of the family business allows us as independent advisors to consider:

(a) whether the current succession planning arrangements for the family is sufficient to achieve the family's intention;

(b) whether the current structure of the family business is appropriate to achieve the family's intention; and

(c) what is the best structure to achieve the family's intention for the family business?

6.21 We will discuss further below about the importance of having the right structure in place and how 'beneficial' ownership can pass in those structures from a succession planning perspective.

How should decisions in relation to the family business be made in the future to ensure the longevity of the family business?

6.22 Although it is critical to ensure ownership in the family businesses passes for the benefit of the intended family members, studies have shown that businesses in which the CEO (e.g. the family head) has a specific successor in mind tends to be more successful than other businesses.[100]

[100] F. De Visscher (2004), "Balancing capital, liquidity and control", available at http://www.devisscher.com, accessed September 2019

6.23 Therefore, the success of a 'family dynasty' will largely rely on those involved with making decisions in the future for the family business

6.24 While this question looks to draw out the current family head's intention and opinion regarding who should succeed as the family head, there are various ancillary issues that should also be considered at this juncture to ensure the transition to the new family head is appropriate and well managed.

6.25 These ancillary issues can include:

(a) who the successor family head will be;

(b) whether the successor family head/s will be one or more people;

(c) whether other persons should be appointed as a director with the family head;

(d) whether there should be qualifications required prior to a person being appointed as a director;

(e) whether key non-family employees or independent advisors should be involved in the decision-making process and appointed as a director;

(f) whether the knowledge of the existing family head has been transferred to the successor (being the successor family head and/or directors) or how such knowledge can be transferred;

(g) whether the successor has been integrated and respected within the business (by employees) and key third parties (such as suppliers);

(h) whether the successor's values aligns with the family businesses values;

(i) when the transition to the successor should occur; and

(j) if a framework (whether informal or outlined in a legally binding or non-legally binding document) should be implemented in appointing successors that can survive the first transition of the family business.

6.26 As outlined above, family businesses often choose to appoint family members as 'CEO's of the business. This decision can be made regardless of whether such a family member has the appropriate qualifications or experience to fulfil this role.

6.27 While such a decision may be seen (independently) to be inappropriate, the role as advisors to the family business should be focused on ensuring the chosen successor has the appropriate support systems and processes in place to succeed.

6.28 While this may simply be achieved by having the chosen successor 'shadow' and learn from the current CEO by making direct decisions that can impact the business, it can be extended to having key advisors involved with the decision making (whether it be informal or legally embedded in a document) for the successor.

Example

Dad and mum have operated a food stall off the street for over 30 years.

The food stall was once filled with customers but due to changes in lifestyle, technology and food palates, the customer base has diminished.

As a result, non-family staff have been let go and in order to manage the rising costs of employees, they have reached out to their daughter to assist in the family business.

Despite initial concerns in passing the decision making of the business to their daugther, the fresh perspective of the daughter in utilising technology to be more efficient in the preparation of food (rather than making products by hand) and broadening the customer base (through online social media orders) allowed the family business to be modernised to the needs of the customers.[101]

In this example, the passing of experience came down to just allowing the next generation to make some decisions in the business.

6.29 Understanding a family's intention in relation to who should be responsible for directing the family business allows us as independent advisors to consider:

(a) what can be done today to allow for the transition to be as smooth as possible;

(b) whether arrangements or documents need to be prepared to assist with the transition by establishing support systems and processes; and

(c) whether thought has been considered in relation to putting in place a framework for future generations to work with.

6.30 We will discuss further below the various processes and legally binding documents that can be prepared to assist with such a transition.

Are there any family issues or concerns that can affect the implementation of the above intentions?

6.31 Existing studies have already outlined how 'the family factor' can influence the decisions of a family business in unexpected manners. It is therefore crucial to properly understand the 'family factor' relating to each family business as no two families will be the same.

6.32 Given the personal nature of family dealings, questions and issues that are often considered as part of a personal estate plan will also be relevant for the succession plan of a family business.

6.33 These questions and issues can include:

(a) family members having an issue with the business succession plan, which can arise:

(i) when a family member working in the business is left with less than what they expected;

(ii) where a promise was made to a family member to receive more of the family business than was received;

(iii) where certain family members are passed up from leadership or directorship roles in favour of other family members;

(iv) due to 'rivalry' issues between family members; or

(v) due to some family members feeling like they do more in the business than others (and they have accordingly not been appropriately acknowleged or appreciated);

(b) concern of certain 'step-family' or children-in-laws negatively affecting the direction and performance of the business;

(c) whether separate Family Branches are able to work with each other for the family as a whole;

[101] Example has been inspired from the stories told in Netflix's TV series "Street Food" (2019), Season 1, Episodes relating to Chiayi, Taiwan; and Singapore

(d) issues in being direct with failings within key family members;

(e) a lack of clear communication lines (or 'workability') between the family members involved in the family business (those in 'Management') and those reaping the benefit (the 'Owners');

(f) 'buried' family arguments arising once the older generation has left the picture;

(g) the asymmetrical influence, power and views between generations which can result in:

  (i) older generations choosing not to transition day-to-day decision making to younger generations at the right juncture;

  (ii) older generations not valuing or considering opinions from younger generations; or

  (iii) younger generations keeping with the 'status quo'; and

(h) the lack of the family retaining appropriate documentation of key decisions and resolutions; and

(i) failing to enforce an underlying family value that can outlast the generation.

6.34 Potential family issues in a family business succession plan based on real life examples (which are further considered in the Annexure) can include:

(a) the father who had to protect the succession of the property management business he built for the benefit of his daughter, whilst in the middle of a matrimonial breakdown;

(b) the father and mother who needed to pass down the business to their three children with various issues between each child:

  (i) one child took a lead role in the business and believed he deserved more from the business;

  (ii) one child and her husband was involved in the business, but they were often considered as underperforming; and

  (iii) one child who had nothing to do with the business (and thereby managing the sibling's feelings); and

(c) the father who had concerns that his eldest daughter and son-in-law would cause trouble in the family business until it was sold, and ensuring the right children of his took control of the business to build that 'family dynasty'.

6.35 What needs to be appreciated is that 'the family factors' and issues will continuously evolve as:

(a) family members who may have no involvement in the business may choose to start working in the business;

(b) estranged relationships can reconcile;

(c) existing relationships can sour due to disagreements; and

(d) family values and standings can change,

and as a result, a family business' succession planning must consistently be reviewed (even more than a business operated between non-family members).

Part 2 – Case studies

The below case studies will be considered in further detail during the accompanying presentation and the comments outlined below seek to raise the various potential issues and concerns in relation to each type of transaction.

7 Restructuring a company from individual to discretionary trust shareholders.

Background

7.1 David and Jan control The Smith Family Trust.

7.2 The Smith Family Trust operates a dental clinic.

7.3 Over the years the Smith Family Trust has distributed excess profits to a 'bucket company' (BucketCo).

7.4 The shares in BucketCo are held by David and Jan in equal shares.

7.5 BucketCo holds significant retained earnings.

7.6 David and Jan wish to declare dividends from BucketCo to their adult children.

7.7 They have obtained a recommendation to have the shares in BucketCo held by a newly-settled discretionary trust with a broad range of discretionary beneficiaries.

Can it be done?

7.8 No rollover or concession will be available for the above proposed transaction.

(a) As the shares held by David and Jane are in a company that does not operate a business, the shares will not be considered active for the purposes of the small business CGT concessions.

(b) As noted at paragraph 3.82 above, shares in a company do not satisfy the active asset test for the purposes of the small business restructure rollover.

Changes to original background

7.9 Rather than BucketCo acting as a company receiving trust distributions and holding significant retained earnings, assume that the dental clinic is operated through BucketCo.

7.10 As David and Jan's children are aspiring dentists, David and Jan wish to eventually pass control of the dental clinic to them through the control of the discretionary trust shareholder.

Some issues to consider

7.11 In light of the changes to the facts, the transaction could take effect in a tax effective manner.

7.12 The small business CGT concessions may be available to transfer shares held by David and Jan to a newly-settled discretionary trust provided David and Jan's total net worth is below $6 million, as the shares in BucketCo could be considered an active asset.

7.13 It should be noted that if BucketCo holds significant loans as an asset or share investments for a significant period of time, the active asset may not be met.

7.14 Alternatively, although the shares cannot be transferred by David and Jan, thought may be had as to transferring the business from BucketCo to a newly incorporated company (NewCo) wholly owned by a newly-settled discretionary trust. Under this circumstance, the small business restructure rollover may be considered albeit there are a number of potential issues to address such as satisfying the genuine restructure of an ongoing business requirement and ultimate beneficial ownership requirement. Further, in certain States, stamp duty will be an additional consideration to this option.

7.15 Thought should be had in relation to how control of BucketCo can pass in a manner than enables the children to acquire equity. The use of a single discretionary trust as a sole shareholder may provide difficulties in the event multiple children are intended to control the business.

7.16 Steps could be taken to have each child acquire such interest in market value, or alternative additional steps could be introduced to implement arrangements that can separate control of the sole discretionary trust shareholder so that each child can exercise decisions in relation separate shares in the company.

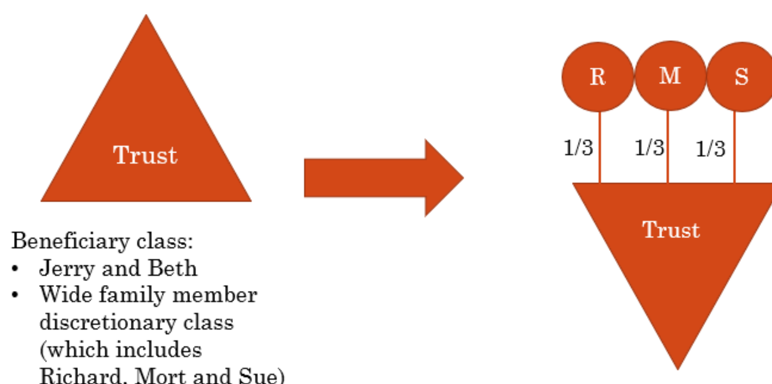
8 Amending a discretionary trust to a fixed trust

8.1 Jerry and Beth successfully operated a chain of restaurants through the Smith Family Trust.

8.2 Being established as a standard discretionary trust in the 1980s, the Smith Family Trust had a discretionary beneficiary class including the 'Primary Beneficiary' (being Jerry and Beth) as well as the children, grandchildren, parents, grandparents, brothers and sisters of the Primary Beneficiary.

8.3 Jerry and Beth now wish to pass control of the Smith Family Trust to their children: Richard, Mort and Sue who are to benefit equally.

8.4 Having received advice that simply changing the trustee of the Smith Family Trust does not guarantee that Richard, Mort and Sue will benefit equally, Jerry and Beth would like to amend the terms of the Smith Family Trust to 'fix' Richard, Mort and Sue's beneficial interest equally.



Some issues to consider

8.5 Given the time since the trust deed was established, steps should be taken to review the deed and confirm:

(a) whether the trust has vested – as it is not uncommon for older trust deeds to contain shortened vesting periods;

(b) the maximum length of time in which the trust has left to exist – if it is possible to lengthen the vesting date, thought should be had whether it is appropriate for the 'next generation of ownership' to take control of an entity that has a limited life span remaining; and

(c) whether the trust deed contains a sufficiently broad variation power to enable the proposed variation.

8.6 Assuming the above trust deed related impediments can be managed, thought should be had as to the range of changes required and whether they are commercial and practical to implement such as:

(a) whether the changes to the terms of the trust deed to satisfy the definition of a fixed trust are appropriate given the changes would:[102]

(i) significantly reduce the ability to amend the trust deed in the future by effectively requiring unanimous approval of all beneficiaries;

(ii) reduce the ability in the future to enable beneficiaries to have different rights to receive income and capital of the trust;

(iii) reduce the trustee's ability to exercise any power that could defeat a beneficiary's interest in the income or capital of the trust; and

(b) whether it is appropriate for each of Richard, Mort and Sue to have a one-third fixed interest each;

(c) the ability to pass the beneficial interest as part of Richard, Mort and Sue's estate planning intentions.

8.7 Where Richard, Mort and Sue each have a one-third fixed interest, a lack of tax planning would be possible as any income or capital of the trust would have to be distributed to each of them as individuals.

8.8 Such a consideration may be addressed through two separate options:

(a) Option 1: the discretionary trust deed is amended into a fixed trust deed enabling the issue of units to a discretionary trust each of Richard, Mort and Sue control; or

(b) Option 2: the discretionary trust deed is amended into a fixed trust deed that contemplates fixed equal entitlements to each of Richard, Mort and Sue's family group (the decisions to distribute within each family group exercisable by the trustee of the trust).

8.9 Option 2 offers more questions as to its appropriateness as it raises concerns as to whether it is a fixed trust and the actual mechanics of how income and capital distributions are determined within each family group.

8.10 Both options may be possible provided the variation power of the trust deed is broad enough. Both options also require consideration as to whether any stamp duty is applicable

[102] Practical Compliance Guidance PCG 2016/16 at paragraphs 55 and 56

(depending on the State/Territory in which the business is conducted)[103] and whether and exemptions are available.[104]

9 Restructuring a discretionary trust to enable fixed ownership

9.1 John has operated his engineering firm from a discretionary trust for the past 20 years.

9.2 During that time, he has built a client base such that he now employs over 10 staff.

9.3 As certain staff have taken a greater involvement in the management of John's business, he is considering the option to grant such staff an opportunity to obtain equity in the business.

9.4 Given that the business is conducted from a discretionary trust, John has been advised that it is difficult to transfer a partial interest in the business to potential employees.

9.5 John has decided that he would like to transition the business into a company structure.

Can it be done?

9.6 There are various options available for John to restructure his business in a discretionary trust to enable fixed ownership via a company in a tax effective manner. These include:

(a) the availability of the Subdivision 122-A rollover to transfer the business to a newly incorporated company (NewCo) with the discretionary trust receiving shares in NewCo;

(b) the availability of the small business restructure rollover to transfer the business as well as associated revenue, depreciating assets and trading stock to NewCo; and

(c) the transfer of the business from the discretionary trust to NewCo and the use of the small business CGT concessions.

9.7 Depending on the intended tax outcome and client circumstances, different options may be preferred.

9.8 For example:

(a) where the business does not have significant revenue assets or trading stock of concern and there are difficulties in satisfying the 'genuine restructure of an ongoing business' requirement for the small business restructure rollover, Subdivision 122-A rollover offers a pathway to undertake the restructure;

(b) in the more likely scenario that John's circumstances will satisfy the genuine restructure of an ongoing business requirement (as his circumstances match

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[103] For example, the changing of the 'taker in default' of the discretionary trust may trigger a dutiable transaction for Queensland stamp duty purposes over dutiable property (as Queensland business assets are dutiable property in Queensland).

[104] For example, a 'family trust exemption' is available for trust dutiable transactions in Queensland. Difficulty may exist to satisfy the exemption if the amendments are too significant.

example 2 of LCR 2016/3), the use of the small business restructure rollover may be preferred as it requires no issuing of shares as consideration in addition to the availability of the rollover to non-capital assets as well; and

(c) where John may have use in obtaining market value cost base in the business or he wishes to make contributions to his superannuation, reliance on the small business CGT concessions offers John the opportunity to restructure accordingly.

9.9 The above options may yet again be impacted on the intended manner to introduce the 'next generation of ownership' and whether John does or does not satisfy the relevant net value or turnover tests of the small business CGT concessions. Where the sell down is not intended for another two years, the small business CGT concessions may be preferred if the trajectory of the business continues to grow.

9.10 Alternatively, the small business CGT concessions may be preferred if there are any historical trading risks associated with the discretionary trust that may jeopardise the new shareholding in NewCo.

Other considerations

9.11 Following the restructure of the business to a company, thought will need to be had in relation to the steps required to integrate the next generation of ownership. Issues to consider can include:

(a) Whether a gradual or total buy-out should occur.

(i) Where a gradual buy-out is preferred, this offers the incoming equity partners an opportunity to liaise with other key parties such as the business' landlord or financier (among other persons). It can often be a requirement that such party's consent is required in the event any lease or financing exists. Under this approach, call options may be preferred for incoming equity partners as it enables such persons to invest their energy into the business without fear of any purchase price for additional future buy-ins increasing as a result of their efforts.

(ii) Where a total buy-out is preferred, additional weight may be placed by incoming equity partners in undertaking proper due diligence as they may not have an opportunity to undertake the underlying finances of the business (unlike a gradual buy-out). Under this approach, thought may be had to retain the exiting business-owner in a consultant role to enable a smooth transition of relationships to the incoming owners.

(b) The method of funding any buy-out which could include the incoming equity partners obtaining independent financing or the exiting business-owner offering a vendor financed loan. Where related parties are involved, thought may be had as to the fact that CGT events may still be triggered even if transactions are undertaken for no market value (as there are deemed market value rules applicable to such under market value transactions).

10 Restructuring businesses conducted by a sole trader or partnership

10.1 As outlined at paragraph 3.86, there are specific tax rollovers available to transfer a business from a sole trader or a partnership to a company (NewCo).

10.2 Although such a restructure can be undertaken without adverse CGT consequences, where the partnership involved is between individuals, there may be deficiencies in the final structure in that the shareholders of NewCo are individuals rather than a trust or company.

10.3 An alternative approach could be the use of the small business restructure rollover or small business CGT concessions. As noted above, the key potential impediments in accessing a tax effective restructure can include:

(a) in relation to the small business restructure rollover – satisfying the genuine restructure of an ongoing business and ultimate economic ownership requirements; and

(b) in relation to the small business CGT concessions – managing any CGT payable or payment into superannuation (if key persons are not of a relevant age).

10.4 Where either of the small business restructure rollover or small business CGT concessions is available, the business will be better held in a more appropriate structure.

11 Other potential business restructures

11.1 This section will seek to provide a broad overview of other potential pre-death business restricting options available not already considered.

Trust splitting

11.2 Where:

(a) a discretionary trust operates multiple businesses or 'shops';

(b) the business owner wishes to pass control of each business to a different related person (usually a child); and

(c) there are no available tax or stamp duty concessions available,

trust splitting offers the ability to create separate sub-trusts over each business, each sub-trust to be assigned to the respective person.

11.3 Trust splitting is also an option where a discretionary trust operates a business and owns investment assets with the business intended for a different related person than the investment assets.

11.4 Following the establishment of a separate sub-trust, steps are then taken to change either the trustee and appointor of the sub-trust, or the successor trustee and appointor of the sub-trust to the appropriate person.

11.5 No transfer of assets out of the original trust occurs. Rather, there may be a change of trustee, in which case, change of trustee exemptions are available for stamp duty and CGT purposes.

11.6 Whilst potentially useful in allowing control over separate assets to pass to different recipients, trust splitting does not solve the issue of having multiple recipients manage a single discretionary trust.

11.7 This is because notwithstanding different people managing separate sub-trusts, persons will still need to be appointed to act as trustee and appointor for the head trust.

11.8 In such circumstances where the control between the sub-trusts and head trust does not align, the controllers at the head trust level may potentially cause concern for those at the sub-trust levels.

11.9 Practitioners have sought to mitigate such arrangement by varying the terms of trust deeds to further 'remove' the sub-trust from head trust interference. This could be achieved by:

(a) varying the terms of the trust deed such that a separate appointor can be appointed for each sub-trust;

(b) ensuring (through variation) that the trustee and appointor of a sub-trust can appoint their own successor);

(c) limiting the beneficiaries of a sub-trust to a family group; and

(d) limiting the ability for trustees of parallel sub-trusts from claiming trustee indemnities against the other sub-trusts.

11.10 Whilst able to solve the practical commercial concerns with having control over a head trust differing from the sub-trusts, such additional steps brought cause for concern from the Australian Taxation Office (**ATO**) via Tax Determination TD 2019/4.

11.11 Where complex trust splitting arrangement as identified in TD 2019/4 are effected, the ATO has adopted a view that adverse CGT consequences could arise.

11.12 Where the trust splitting arrangements are limited to the simpler arrangement of merely changing the trustee over an asset held on sub-trust – no adverse CGT consequences would arise. However, in such a scenario, the trust split would not properly achieve a client's succession planning intention in ensuring multiple recipients would not need to work with each other.

Trust cloning (or transferring trust assets into separate structures – a Queensland unique restructure)

11.13 Trust cloning is a strategy used to transfer Queensland dutiable property from one trust to another.

11.14 It works by effectively 'cloning' a second trust on substantially similar terms as the initial trust to ensure that no dutiable transaction is triggered for Queensland stamp duty purposes.

11.15 If successful, it allows assets to be transferred into separate discretionary trusts, and separate succession plans implemented for each respective trust.

11.16 While historically, there was a CGT exemption applied to trust cloning arrangements under section 104-55(b) and 104-60(b) ITAA 1997; such exemptions have been abolished since 2008.

11.17 It should be noted that although there is no explicit CGT exemption for trust cloning, there are tax legislation provisions available that may assist in managing the CGT consequences of transferring assets as previous considered in this paper.

11.18 The use of the trust cloning arrangement is as a tool to manage adverse Queensland stamp duty consequences of moving dutiable property from one trust to another.

11.19 In dealing with the relevant stamp duty heads of duty under Queensland stamp duty law, trust cloning obtains an exemption by:

(a) ensuring persons with the relevant trust interests in the original and cloned trust are identical and with the same percentages in the trust interests;

(b) ensuring assets are not suddenly held or ceased to be held on trust by the trustee; and

(c) ensuring there is no change in the legal owner of the asset.

12 Disclaimer

12.1 This paper covers legal and technical issues in a general way. It is not designed to express opinions on specific cases. It is intended for information purposes only and should not be regarded as legal advice. Further advice should be obtained before taking action on any issue dealt with in this paper.

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