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Let's chat

Pre-Death Restructures Involving a Business

With:

Darius Hii –Director at Chat Legal

Information provided is general in nature; precise application depends on specific circumstances



Some stats to start

- 2,569,522 registered private businesses (quarter ending September 2022)
 - 41% - companies
 - 31% - sole proprietors
 - 19% - trusts
 - 9% - partnerships
- Australian population of ~26 million (30 June 2022)
- Roughly 1 business per 10 individuals
- Plenty of potential businesses requiring a pre death restructure

*Pre-death restructure means having the business held in a different legal structure than it currently is (even if only at the shareholder level) as part of a transaction before an estate plan is prepared



Theory before the case studies

- Broad overview of various considerations before undertaking a pre-death restructure
- Paper as a compendium rather a detailed analysis of each issue
- Given various tax (both Federal and State), legal and familial considerations – restructures require involvement of a variety of advisors
- Importantly requires the accountant and lawyer to work collaboratively



Overview – the theory

- Business structures and succession planning suitability
- Pre-death tax concessions, rollovers and ‘exemptions’ for a business restructure*
- State tax considerations**
- Additional legal considerations
- Family business considerations

*General anti-avoidance rules should always be a consideration

**Given various rules across Australian States/Territories – big picture considerations only



Case studies to cover

- Restructuring a company with individual shareholders to discretionary trust shareholders
- Amending a discretionary trust to a fixed trust
- Restructuring a discretionary trust to enable fixed ownership
- Restructuring businesses conducted by a sole trader or partnership
- Other potential business restructures



Why restructure 'pre-death'?

- Not waiting for someone to pass away or lose capacity
- Having certainty as to the tax and legal outcome being the rules of today
 - Generally a pathway is available to restructure into the most common of structures
- Ability to include estate planning considerations as part of post-restructure steps
- Ability to have a level of control in determining how to integrate the next generation of ownership
- Ability to gauge family dynamics in relation to a family business



Why not restructure 'pre-death'

- Sometimes the tax (including stamp duty in some States) may not be manageable other than restructuring as part of an estate plan
- Losing control too early
 - Children seizing full control against the wishes of the parents: *Cihan v Cihan* [2022] NSWSC 538
- Potential to bring forward any family dispute:
 - Children arguing over entitlements and management decisions: *Owies v JJE Nominees Pty Ltd* [2022] VSCA 142
- There is no need (depending on the size and type of business)



Business structures – what's best

- What's best to introduce the 'next generation of ownership'
- Considerations are similar to general discussion about appropriate structures for businesses
 - Ability to bring in the next generation
 - Tax
 - Complexity
 - Compliance costs
 - Funding

To (discretionary) Trust or not to Trust (Company)?



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- Weighing on what's more important
 - Retention of funds: Company has a flat tax rate
 - CGT on sale:
 - Trust has access to a general CGT discount
 - Both has potential access to small business CGT concessions
 - Tax compliance issues:
 - Division 7A issues for companies
 - Section 100A issues for trust

To (discretionary) Trust or not to Trust (Company)?



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- Weighing on what's more important (cont.)
 - Ability to introduce the next generation:
 - Clear ability 'transfer' discrete interests in the company and ability to tailor company constitution/shareholders agreement
 - Directorship appointment and share right provisions
 - Pre-emption rights
 - Exit mechanisms
 - Need for significant amendments to terms of a 'standard' discretionary trust but also ability to tailor company constitution if using a company trustee
 - Read the deed
 - Succession powers as part of a trust deed review
 - Succession issues:
 - Shareholding key for companies (potential estate disputes if shares held by individuals but also ability for shares to form part of estate where a testamentary trust exists)
 - Discretionary trusts are more sheltered from estate disputes with an 'appointor' role



Talking about restructures

- Stats don't lie
- Companies significantly used more than trusts (all types of trusts)
- Often a preferred structure to:
 - Enable the introduction of the next generation (whether staggered or all at once)
 - Flat tax rate
 - Reduced Division 7A risk where unrelated parties are shareholders (practically unrelated parties won't treat business asset as their personal assets – due to a greater focus on corporate governance)
 - Ability to continue to access certain small business CGT concessions
- Other structures may still have a niche use (including as a result of other considerations)



Type of trust to note

- Fixed trusts
- Term used in certain tax provisions:
 - Trust loss rules – less tests for a fixed trust to meet
 - Franking credit provisions – easier for the fixed trust to pass franking credits to beneficiaries with fixed interests
 - Small business restructure rollover – in relation to which trusts a certain ‘ultimate economic ownership’ requirement applies to
- Not all unit trusts are fixed trusts and not all fixed trusts are unit trusts
- PCG 2016/16 outlines factors ATO considers in determining whether a trust is a fixed trust (ensuring things cannot defeat beneficiary’s entitlement and removing provisions that can by pass a beneficiary's fixed entitlement – e.g. varying the deed without consent)



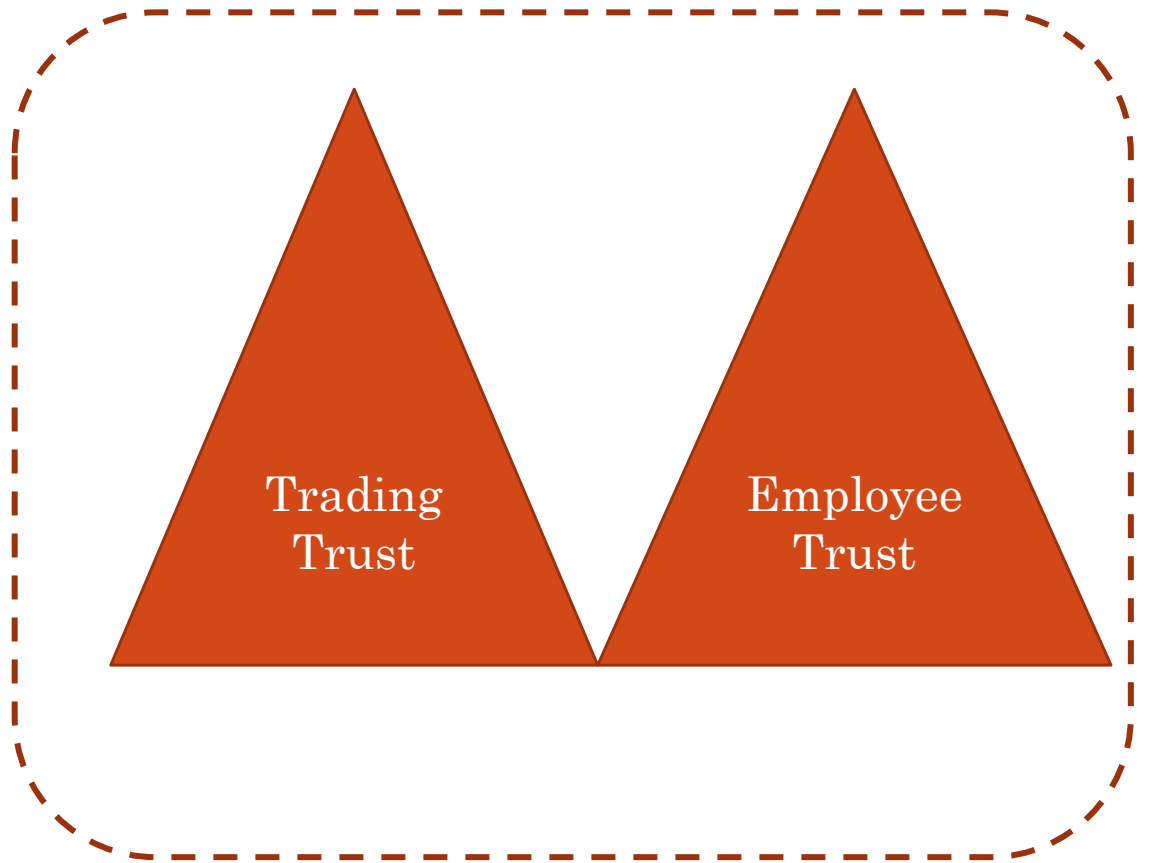
Importance of the structure



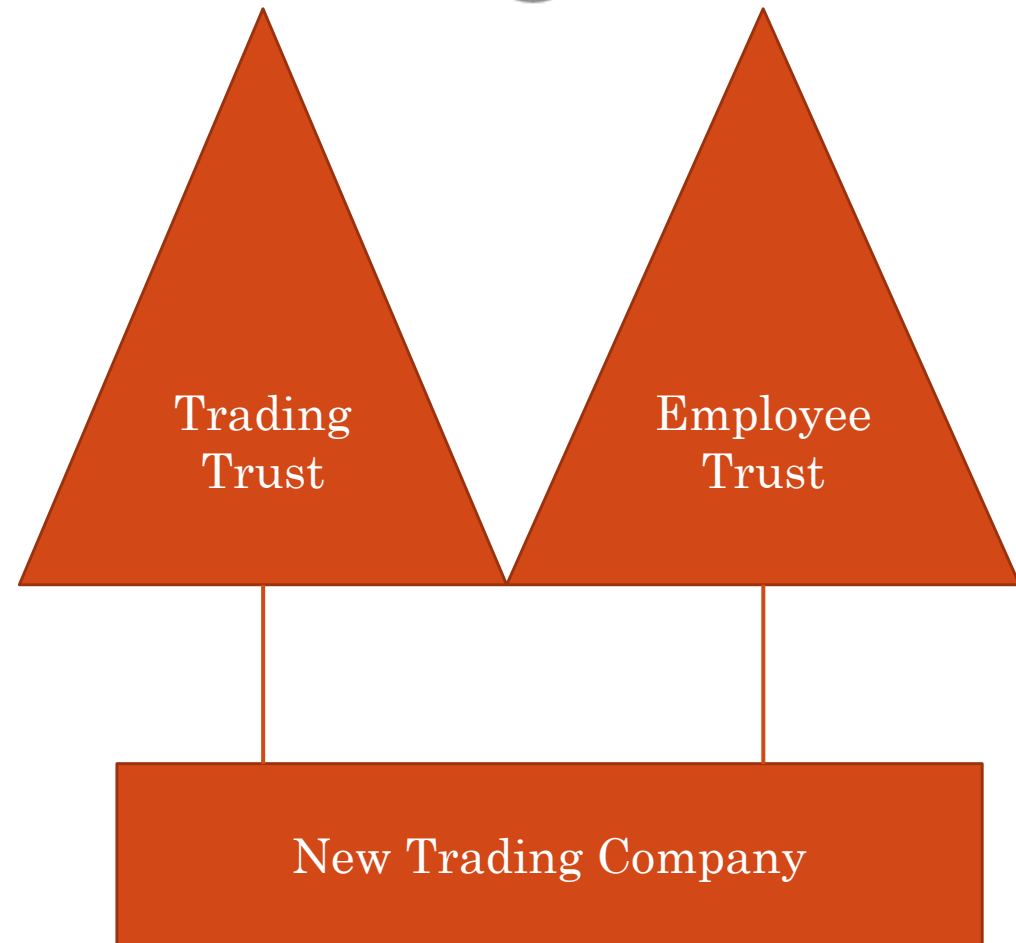
- Real estate business
- Established in 1980's
- Company trustee
- Beneficiary class includes business owner and lineal descendants
- Intention to pass business to daughter and key employee equally during his lifetime



Options



Partnership of trusts





Pre-death tax considerations

- Can the restructure occur in a tax effective manner:
 - Small business CGT concessions
 - Small business restructure rollover
 - Subdivision 122-A rollover (individual/trustee to company)
 - Subdivision 122-B rollover (partnership to company)
 - Amending the trust deed
- Difference between the concession/rollovers:
 - Market value cost base v original cost base rollover*
 - Can concession be funded v restructure requires no cash
 - Rollover applies to revenue assets and trading stock v doesn't apply to revenue assets and trading stock*
 - Need to have flexible consideration v share issue in company as consideration



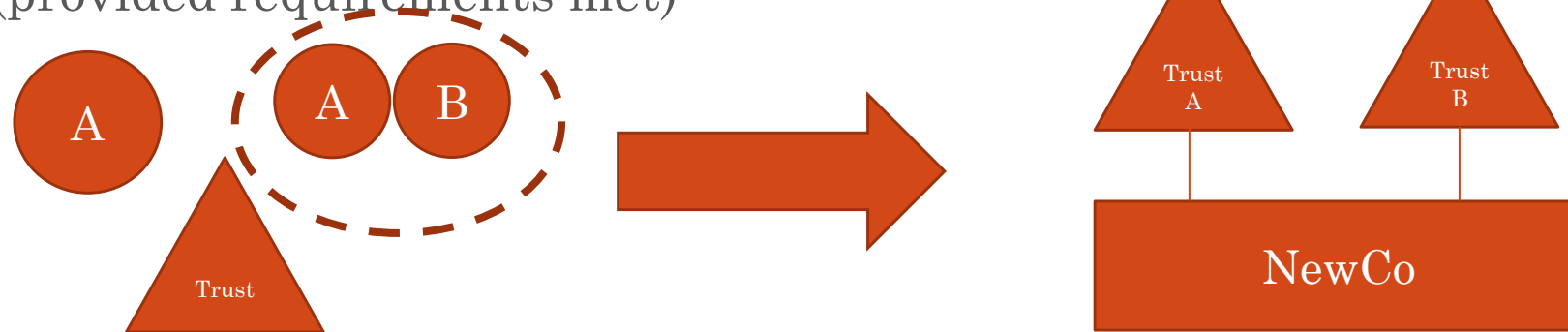
SBCGT concessions

- Reduces capital gain
 - 15 Year Exemption
 - Capital gain fully disregarded if related to business asset for at least 15 years
 - Key person must be over 55 and in connection with person's retirement
 - 50% Active Asset Reduction
 - Reduction of capital gain by 50%
 - Can be used with 50% CGT discount if able
 - Retirement Exemption
 - Disregard up to \$500,000 in capital gains for a 'key person'
 - If key person under age 55, then payment of such amount must be made to a complying superannuation fund
 - Small business rollover*
 - Delay the capital gain for 2 years
- Practically enables capital gains of \$1million (for a company selling) or \$2 million (for a discretionary trust selling) to be reduced

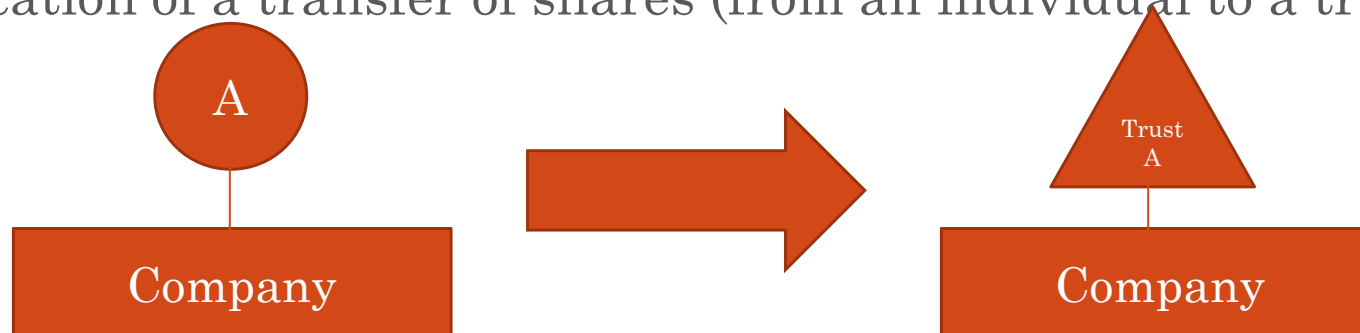
SBCGT concessions – when of use



- As CGT event triggered, can be utilised in any restructure scenario (provided requirements met)



- Not limited to the transfer of a business, and even has potential application of a transfer of shares (from an individual to a trust)





SBCGT concessions

- Key requirements/considerations:
 - Seller needs to meet Turnover Test (turnover less than \$2 million) or MNAV Test (net assets less than \$6 million)
 - Asset being sold is an 'active asset' being an asset actively used in the business for at least half the time asset held in the business (or 7.5 years if held for 15 year or more)
 - Turnover Test and MNAV Test requires aggregating Seller with entities 'affiliated' and 'connected with' the Seller
 - Affiliates include entities which are deemed to act in accordance with the Seller.
 - Entities are connected with the Seller if they are controlled, are controlling the Seller or are with the Seller mutually controlled by another (control being defined as a 40% or greater interest)
 - Where the asset sold is a share, additional tests are required to be met



SBCGT concession traps

- Section 152-47 – Spouse is an affiliate
 - Control – *An entity controls another entity if ... the first entity together with its affiliates* – section 328-125(2) ITAA 1997
- Tax law partnership able to be an ‘entity connected with’
 - Arguments that tax law partnership not conducting a business (as it would otherwise be considered a general law partnership)
 - Common risk with assets jointly owned by husband/wife
- Turnover – ordinary income...in the ordinary course of carrying on a business – possible to disregard passive income and capital gains?
 - What does ‘carrying on a business’ mean?
- MNAV excludes main residence, superannuation and liabilities
- Care when transferring share in company as active asset:
 - additional requirements
 - Need for liquidator distribution (?)



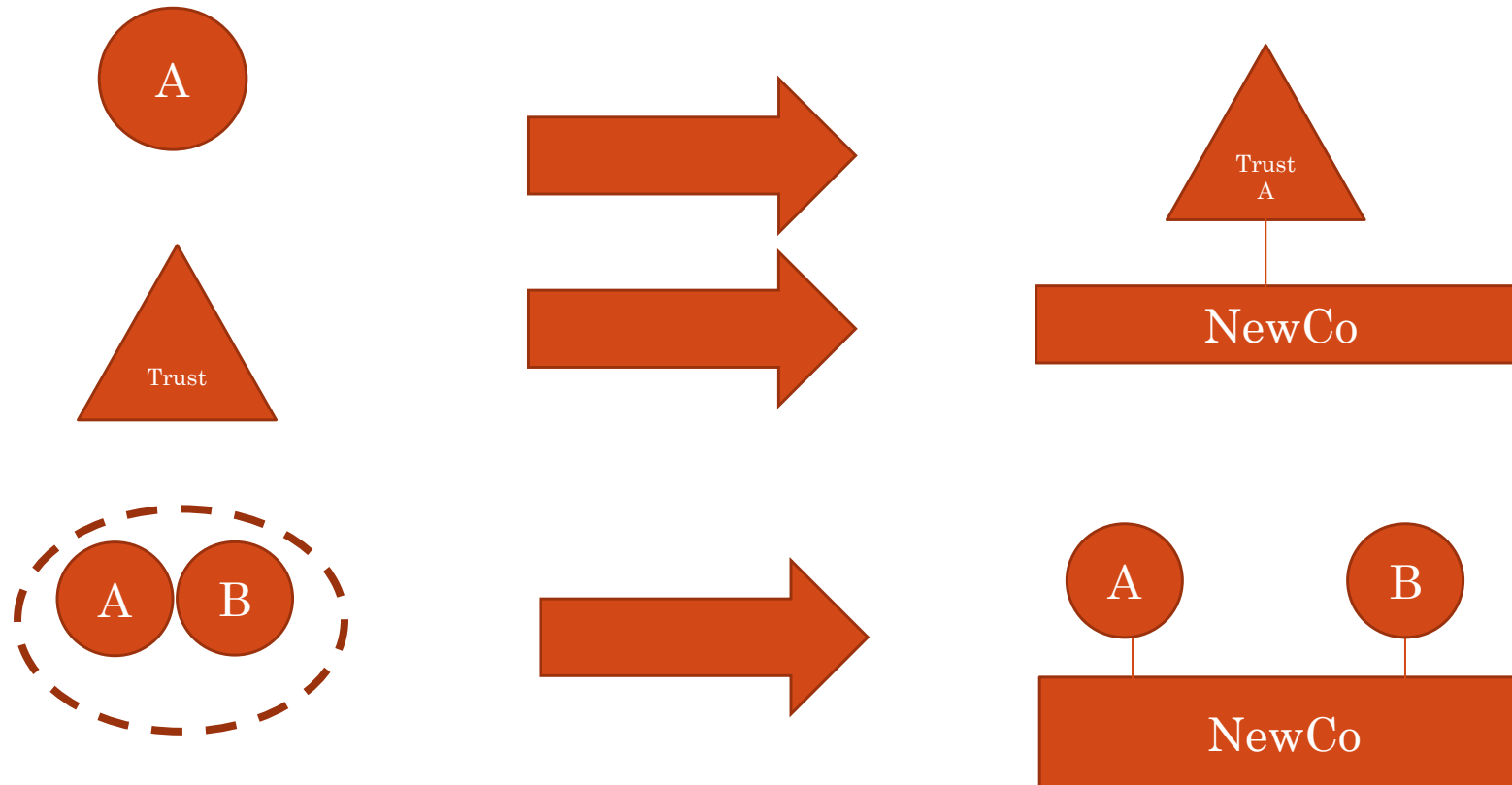
SBRR

- Introduced 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'*
- Rollover of business as a whole (including trading stock and revenue assets)
- Original cost base of CGT asset 'rolled over'
- Disregards CGT consequences
- Resets 50% CGT discount (for new entity)
- SBCGT concession timings not affected



SBRR – when of use

- Due to 'Ultimate Economic Ownership Requirements' and 'Active Asset Test' – certain limitations





SBRR - requirements

- Key requirements/considerations:
 - Transaction part of a genuine restructure of an ongoing business
 - Small business entities (\$10m limit unlike the SBCGT Concessions)
 - Transaction does not have the effect of materially changing the ultimate ownership of the asset (and the percentages)
 - Asset is actively used in the business (does not include shares unlike the SBCGT Concessions)
 - All parties meet the Australian residency requirements
 - All parties choose to apply restructure rollover (retaining proof of election as evidence)
- Similar terms such as 'affiliate', 'connected with' and 'small business entity' applies (other than \$10m for turnover purposes)



SBRR - traps

- Genuine restructure:
 - No definition so see LCR 2016/3
 - Not available to those restructuring in the course of winding down or realising ownership interests
 - Intended for bona fide commercial arrangement to facilitate growth, innovation, diversification; adapt to changing conditions or reducing administrative burdens/compliance costs
 - Continued use of transferred assets
 - Continuity of employment of key personnel
 - Continuity of production, supplies, sales or services
 - For arrangements which results in a structure likely to have been adopted had the small business owners obtained appropriate professional advice when setting up the business (works simple to complex and vice versa)
 - Specifically not intended to 'take place in the course of a winding down to transfer wealth between generations'



SBRB – traps (cont.)

- Genuine restructure:
 - Example 2 – Genuine restructure – way to introduce employee equity participants into a business originally operating through a family trust
 - Allows family trust to company with ultimate economic ownership owners as same shareholder
 - Example 3 – Genuine restructure – way to obtain additional investment into business originally operating through a partnership
 - Allows partnership to company with original partners in same proportions as shareholders
 - Example 6 – **NOT** genuine restructure – separating two restaurants owned in a single company by transferring one restaurant to another company and then passing control of each company to a respective son
 - Note that transfers within a 3-year period
 - NB Example 4 in simplifying affairs from a trust to an individual
 - Safe harbour rule – no change of ultimate economic ownership for at least 3 years – s328-435 ITAA 1997



SBRR – traps (cont.)

- Ultimate economic ownership requirement
 - Difficulty when dealing with a discretionary trust – who is the ultimate economic owner
 - S328-440 ITAA 1997 special rule for discretionary trusts:
 - Only applies to ‘non-fixed trust’ (consider earlier slide regarding what constitutes a fixed trust)
 - Individuals who had ultimate economic ownership limited to a member of a family group (within meaning of Schedule 2F ITAA 1936)
 - Discretionary trust can be amended to ensure individuals limited to a member of a family group
 - Family trust election made
 - Reduced beneficiary class to limit to only members of family group
 - Smaller than usual discretionary trust beneficiary class
 - Individual, their spouse and:
 - Those persons parent, grandparent, brother, sister, nephew, niece or child;
 - Lineal descendants a nephew, niece or child
 - Spouses of the above



SBRR – traps (cont.)

- Active asset requirement
 - Shares in a trading company will not be active for SBRR purposes
 - LCR 2016/3 provides example of individual seeking to transfer shares in company to discretionary trust:
 - Shares were not used, or held ready or use by the small business company in the course of carrying on it's business
 - Shares not active for such purposes

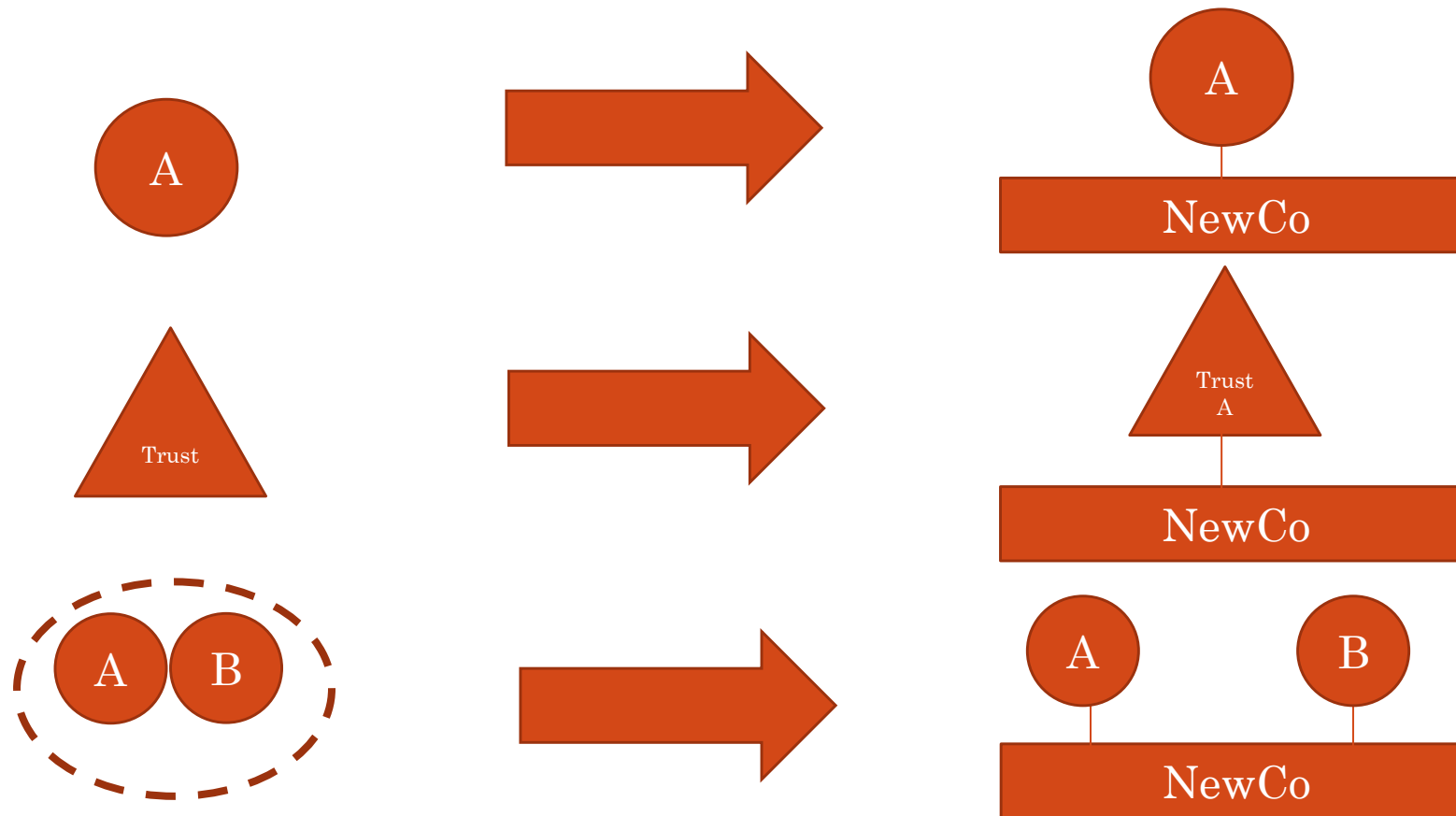


122-A/122-B rollover

- Differs from SBRR:
 - Only applies to capital gains
 - Consideration different (SBRR does not specify consideration requirements) – share issue
 - Only enables transfer to company
- Key requirements to note:
 - Transfer only for capital assets and assumption of liabilities
 - Consideration for transfer must be shares whose market value are substantially the same as the market value of the assets transferred (less any liabilities assumed by the company)
 - Shares must not be redeemable
 - Transferor must own shares in transferee company
 - All parties must be Australian tax-residents



122-A/122-B – when of use





Amending trust deed

- 'Resettlement':
 - CGT event E1 (assets settled on new trust)/CGT event E2 (assets transferred to new trust) occurring
 - Statement of Principles stating resettlement arises where an alteration to a trust sufficient to constitute a new trust relationship
 - *Commissioner of Taxation v Clark (Clark)* [2011] FCAFC 5
 - Case dealt with question of unit trust amendment changing the trustee, beneficiaries and trust property
 - *Ship of Theseus* – *whether or not a ship that has had all of its components replaced one by one over a period of time is the same ship*
 - Clark considered continuity of three factors – the terms of the trust deed, the trust property and membership of the trust
 - Held ultimately that where changes are within a scope of variation, changes over time to the trust and beneficiaries should not trigger a resettlement provided there has not been a severance that would lead a termination of the trust



Amending trust deed

- ‘Resettlement’:
 - *Commissioner of Taxation v Clark (Clark)* [2011] FCAFC 5 (cont.)
 - Referencing *Federal Commissioner of Taxation v Commercial Nominees of Australia Limited* (2001) 75 ALR 1172:

[56] So long as any amendment of the trust obligations relating to such trust property is made in accordance with any power conferred by the instrument creating the obligations, and continuity of the property that is the subject of trust obligation is established, there will be identity of the “taxpayer” for the purposes of s 278 and ss 79E(3) and 80(2), notwithstanding any amendment of the trust obligation and any change in the property itself.

- Statement of Principles withdrawn and TD 2012/21



Amending trust deed

- Paragraph 24 of TD 2012/21:

“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.”



Amending trust deed

- Question is whether trust deed allows for the variation
- Note distinction between terms used in variation power:
 - Trust power v mere power
 - Terms and conditions
 - Hereinbefore
- Consider restrictions on variation and inability to two-tier variations
- More common in older trust deeds but all deeds should be read and analysed appropriately



Amending trust deed

- Example:

*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 (MMF Trust Example)*

compared

*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. (FW Trust Example)*



Amending trust deed

- Examples taken from trust deeds considered as part of the line of *Mercanti v Mercanti* cases
 - *Mercanti v Mercanti* [2015] WASC 297
 - *Mercanti v Mercanti* [2016] WASCA 206
- Background:
 - Michael operated a shoe repair business (started in the 1960s) from two discretionary trusts (MMF Trust and FW Trust) with company trustees (with Michael and his wife Yvonne as the directors)
 - Michael integrated his youngest son, Tyrone, into the business
 - Steps were taken to vary the terms of the trust deed to enable the passing of the appointor role to Tyrone
 - Relationship between Tyrone and Tyrone's parents broke down in 2012 as Michael wanted to receive more income and have the business pay certain expenses
 - Came to head in 2013 when Michael and Yvonne removed Tyrone as a director of the company trustee whilst Tyrone was away on holiday.
 - Tyrone subsequently exercise his appointor power to change the trustee of the trusts



Amending trust deed

- Case regarding business succession issues (i.e. when to pass control and how – more on that later on)
- Also a case on fraud on power
- Relevant to this topic is a case where the Courts considered the wording of the variation power and went into detail regarding the distinction of certain phrases
- MMF Trust wording broad enough to enable changes to the Appointor power – even to the Schedule of the trust (regardless of the *hereinbefore* wording)



Amending trust deed

- FW Trust:

*'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 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 ...'.'*



Amending trust deed

- Decision regarding MMF Trust upheld on appeal, mentioning *'hereinbefore'* did not affect the amendment of the Appointor role in the Schedule as the express reference in the definition of 'the Appointor' to the Schedule linked the relevant part of the Schedule to the definition of Appointor.
- Note Court reiterated distinction of phrase 'terms and conditions':

In my opinion, the phrase 'the trusts terms and conditions hereinbefore contained' in cl 28 refers:

(a) in the case of 'the trusts', to the trusts created or declared in provisions of the deed appearing before cl 28; and

(b) in the case of 'the ... terms and conditions', to the other provisions of the deed (that is, the provisions apart from those declaring or creating trusts) appearing before cl 28.

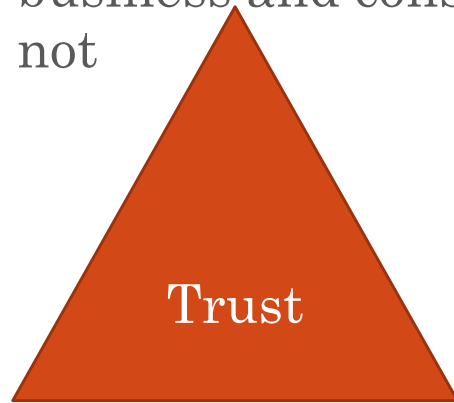
However, I am satisfied that the preferable and correct view is that the power in cl 28 to 'revoke add to or vary all or any of the ... terms and conditions hereinbefore contained' extends to the provisions of the Schedule (relevantly, the provision relating to the Appointor).

Amending trust deeds – when of use



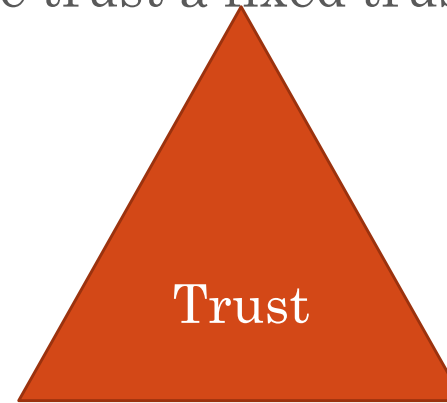
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- Due to limits of using a single discretionary trust to run a business with multiple unrelated parties – only of real use within a family business and consideration whether to make trust a fixed trust or not



Beneficiary class:

- Named person
- Wide family member discretionary class



1/3:

- Child 1
- Direct family of child 1

1/3:

- Child 2
- Direct family of child 2

1/3:

- Child 3
- Direct family of child 3



State tax considerations

- Payroll tax grouping:
 - Care when introducing a discretionary trust as it broadens the potential to capture businesses operated by other beneficiaries of the trust
 - Deemed provisions stating any beneficiary of a discretionary trust controls the discretionary trust – same provision across all States
 - Provisions exist to also state that acting as trustee for a trust constitutes a business for grouping purposes under payroll tax legislation
- Transfer duty (for some States)
 - Consider available exemptions – such as farming exemption or corporate restructure exemptions
 - Queensland has small business restructure exemption for turnover less than \$5million and from individual/trust/partnership to company (similar to 122A/122B rollovers from a CGT perspective in types of transactions that can apply)
 - Extends to sole trader to company with discretionary trust as shareholder if sole trader the 'taker in default' of discretionary trust

Additional legal and tax considerations



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- Where share transfers involved – historical trading liability
- Whether a partial or full sell-down occurring
- Where discretionary trust is the business entity or sole shareholder of company – consider rising trust dispute cases regarding exercise of trustee discretion:
 - *Re Marsella; Marsella v Wareham (No. 2)* [2019] VSC 65
 - *Callus v KB Investments* [2020] VCC 135
 - *Ying Mui & Ors v Frank Kiang Ngan Hoh & Ors (No 6)* [2017] VSC 730
 - *Owies v JJE Nominees Pty Ltd* [2022] VSCA 142
 - Note role that a memorandum of wishes can play - *Hartigan Nominees Pty Ltd v Rydge* (1992) 29 NSWLR 405

Additional legal and tax considerations



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- Commercial circumstances of selling to the next generation:
 - No consideration/under-market value/market value
 - Dealing with unrelated party or family?
 - Integrate succession as part of estate plan – i.e. transition occurs post-death
 - Financing arrangement – vendor finance?
 - Due diligence
 - More required where full sell-down v more trust where original owner still involved
- Transition today or tomorrow:
 - Mercanti case
 - *Cihan v Cihan* [2022] NSWSC 538 (another case of son in the Appointor role able to change trustee which had the father involved)

Additional legal and tax considerations



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- Tailored company constitutions requiring independent directors/trusted advisors/key employees
- Extracting significant retained earnings (if an issue)
 - Use of holding company (to enable retained earnings to remain in company environment)
 - Dividend access share noting ATO alert!!
- Difficulties of accessing franking credits where discretionary trust is a shareholder unless family trust election made (noting certain thresholds)

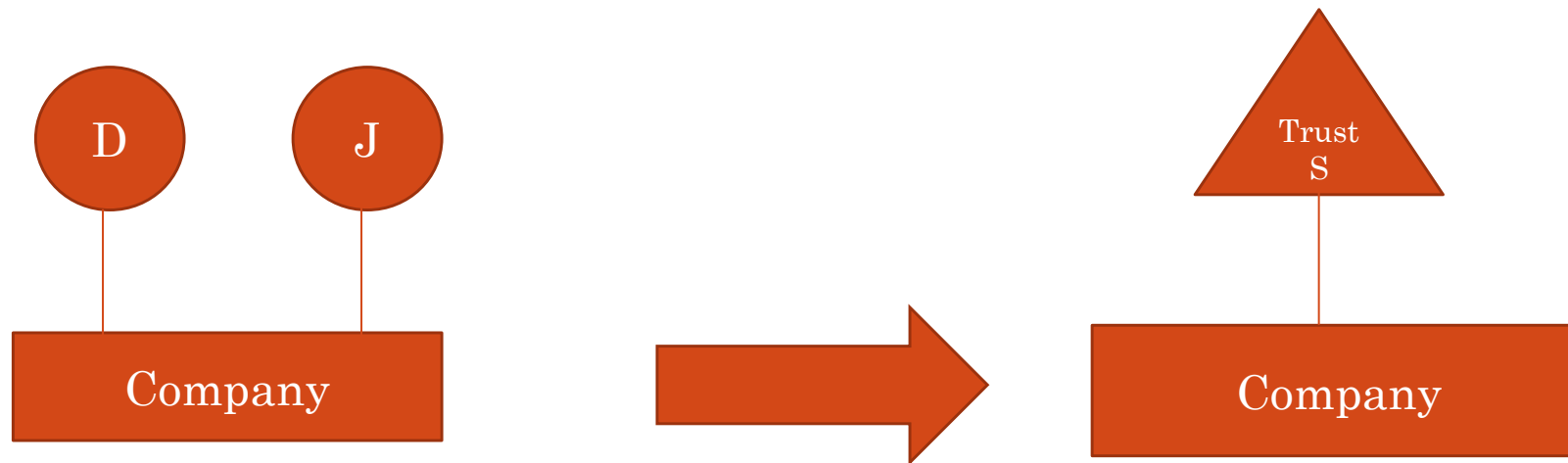


Family business considerations

- See paper
- A lot of references to academic literature on concept of 'socioemotional wealth' in that decisions in family businesses often made to maximise:
 - a family's control and influence in the business;
 - the identification of family members involved in the business;
 - the potential to exert the family's name within social ties and the broader community;
 - emotional attachment of the family in the business; and
 - the prolonging of the 'family dynasty' even to the detriment of the business financially



Bucket company shareholdings



- Not possible if dealing with bucket company as shares not active asset for SBCGT (company itself does not hold active assets) or SBRR purposes (wording of provisions does not allow)
- If company was a trading entity (e.g. dental business operated through the company), then either options may be available



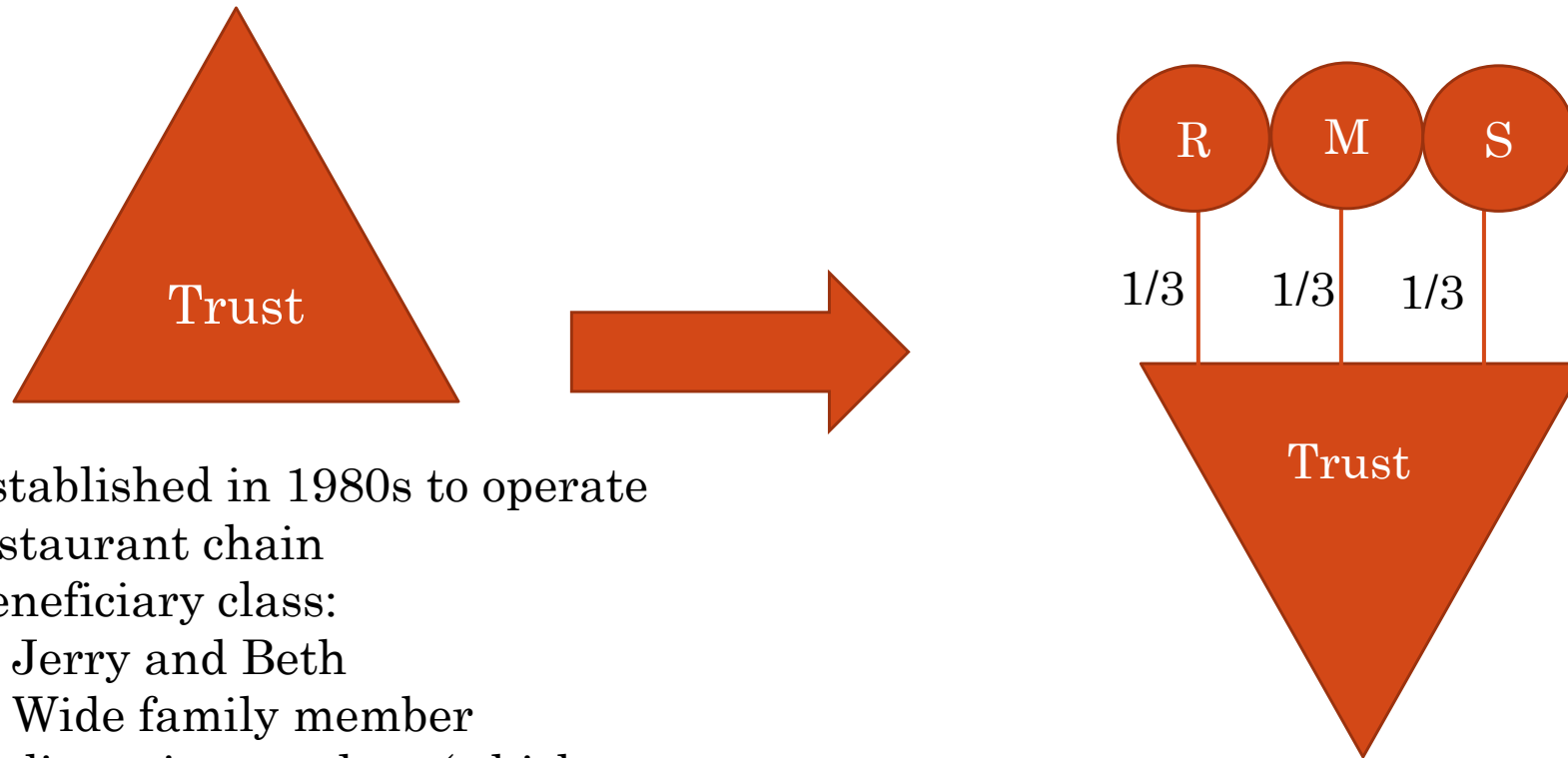
Bucket company shareholdings

- Issues if company has used retained earnings as financial loans or share investments for a significant period of time
- Issues with satisfying genuine restructure of an ongoing business on its face for SBRR
- How to pass interest to children in a fair manner (hard to use one discretionary trust)
 - Funding requirements

Amending discretionary trust to a fixed trust



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Established in 1980s to operate restaurant chain

Beneficiary class:

- Jerry and Beth
- Wide family member discretionary class (which includes Richard, Mort and Sue)

Amending discretionary trust to a fixed trust



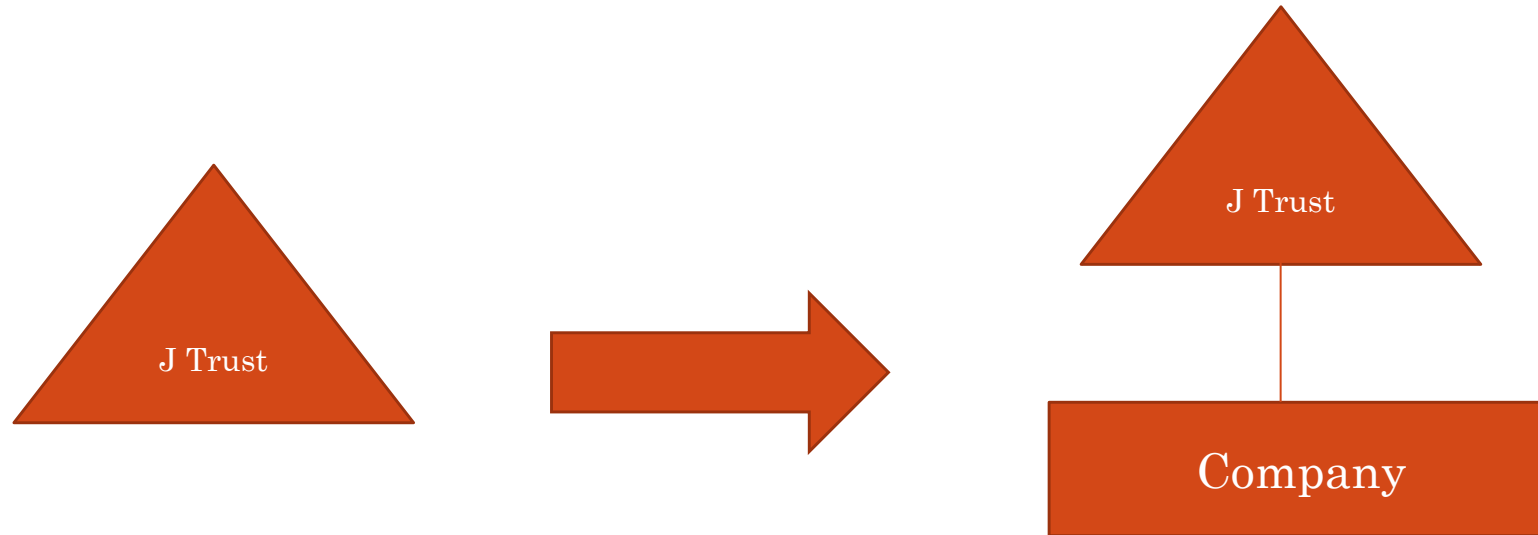
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- Assume variation power includes words 'trust, powers, terms and conditions in this document' – variation power may be broad enough
- Continuity of trust property (the business), certain beneficiaries (Richard, Mort and Sue) and certain terms (trustee powers)
- Potential duty issues for certain States (e.g. Queensland)
- Practical issues can include vesting date (established since 1980s, is there an 80 year
- Fixed trust includes unitholdings or named beneficiaries with fixed interest
 - Need to have fixed trust or possible to have a discretionary class of beneficiaries for each 1/3 interest

Discretionary trust to enable fixed ownership

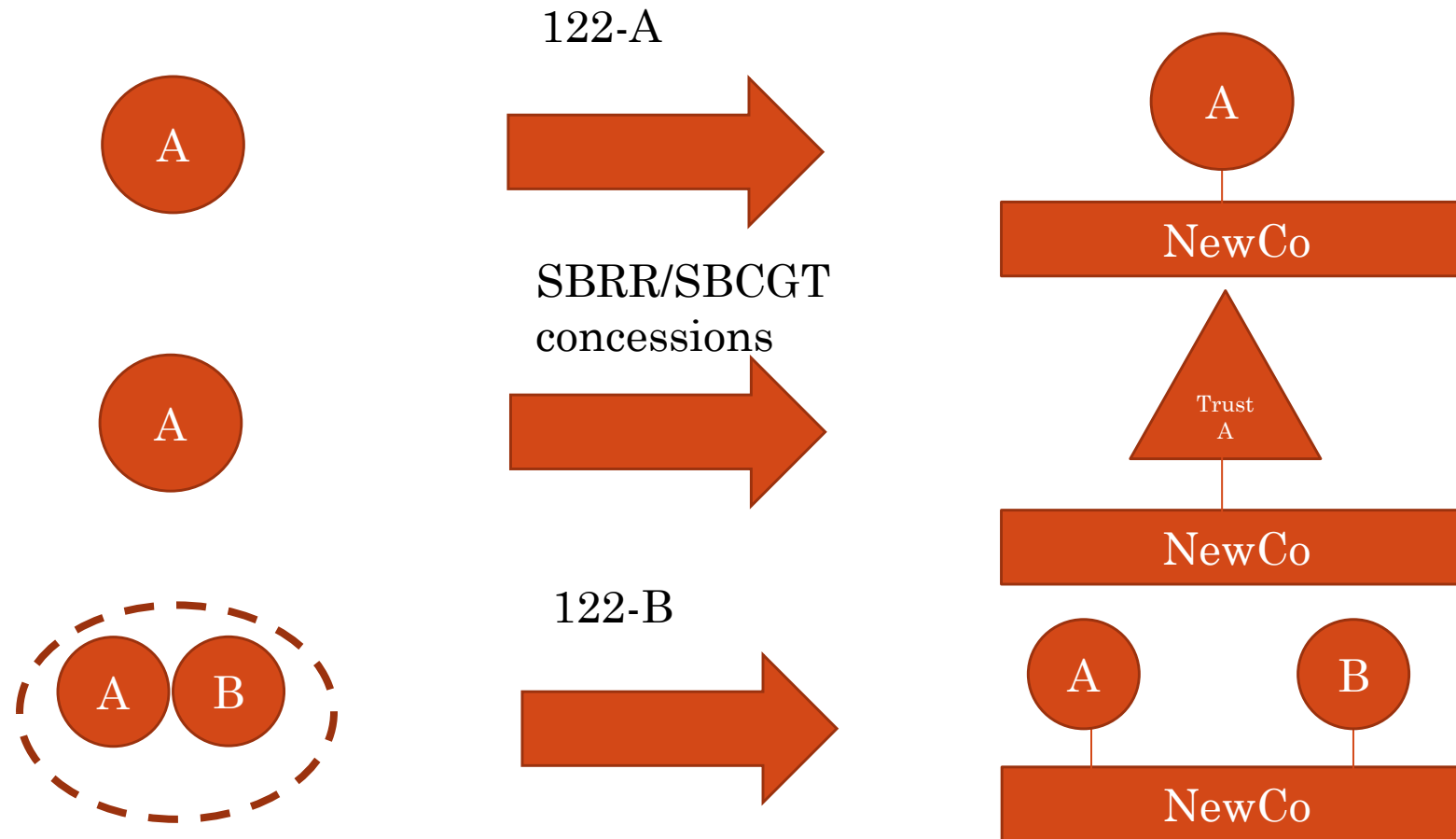


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- Possible with SBCGT concessions, SBRR or 122-A rollover
- Considerations of use is whether market value cost base is wanted and if SBCGT concessions can be obtained
- If SBRR, then noting that restructure may qualify for genuine restructure

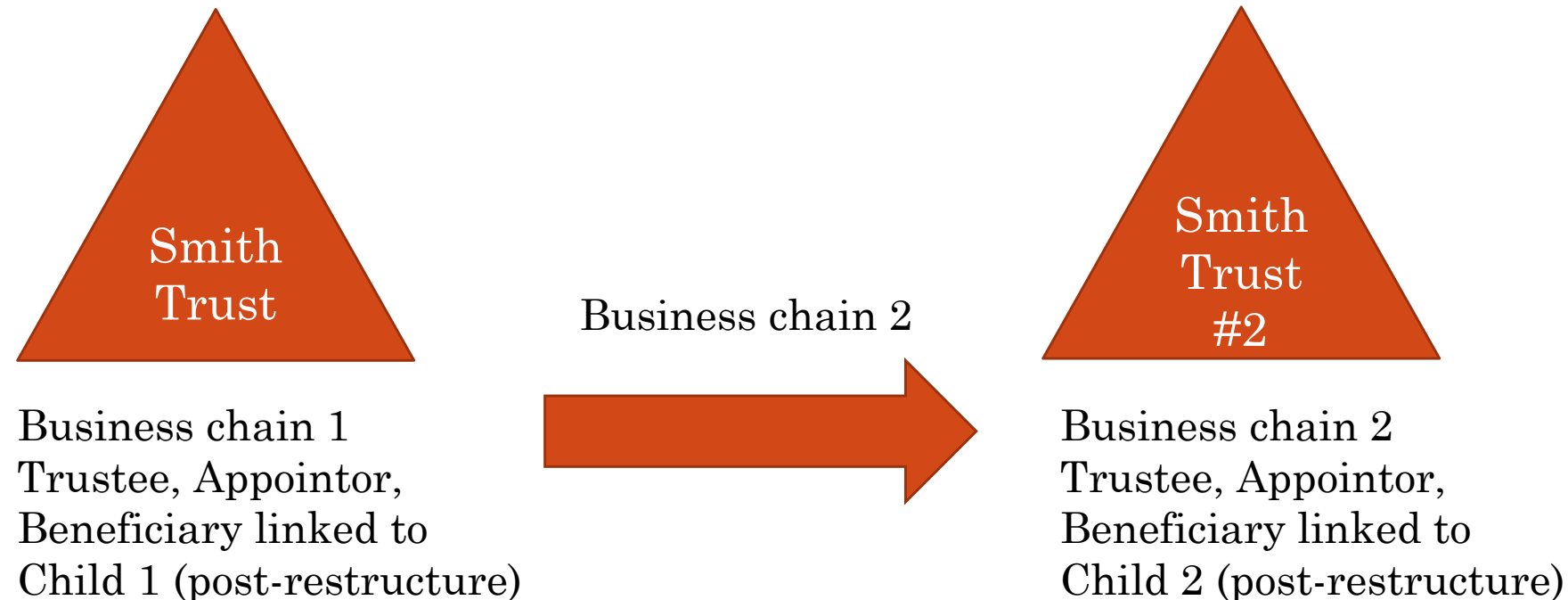
Sole trader or partnership restructures





Other ideas

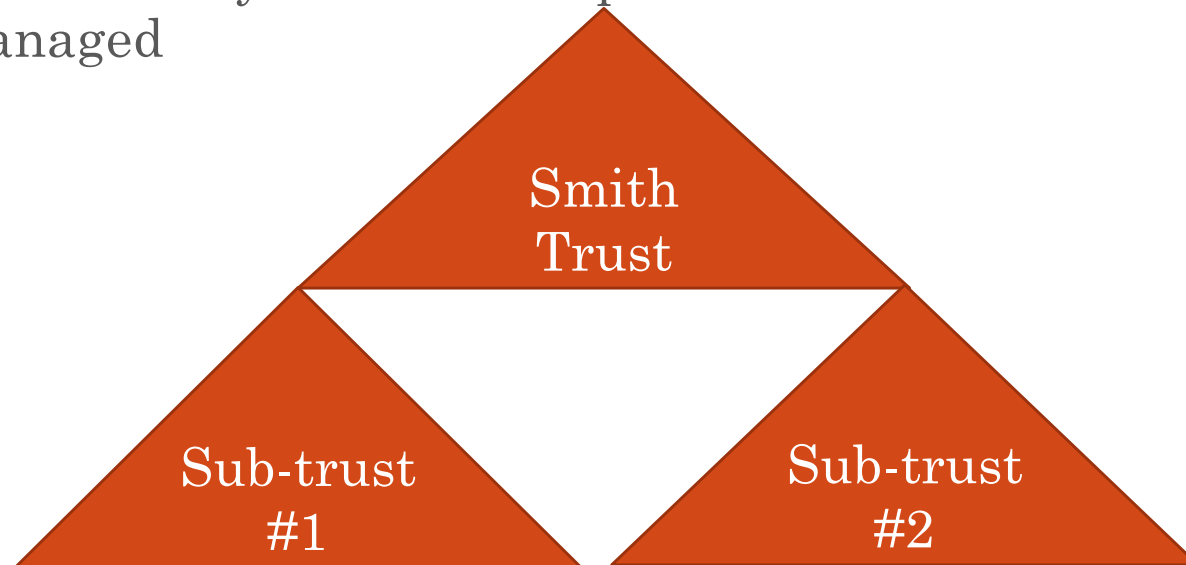
- Trust cloning – A Queensland restructuring tool to manage stamp duty on restructures. CGT is still required to be managed (potentially through SBCGT concessions or losses)





Other ideas

- Trust splitting – Creation of separate sub-trusts within a discretionary trust with separate trustees when CGT cannot be managed



Business chain 1
Trustee and Appointor of
sub-trust #1 – Child 1

Business chain 2
Trustee and Appointor of
sub-trust #2 – Child 2

Contact details

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