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Let's chat

Company or family trust – May 2021

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

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Overview

- Company or discretionary trust
- Active business
- Passive property investment

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Simple comparison

- Availability of CGT discount v lower corporate tax rate
- Unpaid present entitlements v division 7A loans
- Investment and funding options
- Debt/equity interests in related parties

Business example

- Lizzy and Tom are looking to set up a new retail business
- They have a number of other assets/passive investments in which they derive income of around $200,000 per year (pre-tax)
- They have two children, one of which has shown interest to be involved in the business
- The business makes a tax loss in the first year ($50,000)
- In the second year, the business makes a profit ($50,000 after losses)
- In the third year, the business makes profit of $525,000

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Case for the company

- Corporate tax rate:
  - 26% in 2020-2021 income year
  - 25% in 2021-2022 income year
  - Available provided no more than 80% of assessable income is base rate entity passive income (BREPI)
- Funding benefits:
  - Interest from loans to fund business deductible regardless if third party or related party
  - If Lizzy and Tom lent money, then such interest received by them from the company is assessable; and if they borrowed such money, then such interest is deductible
  - Argument exists to potentially allow on-loan from Lizzy and Tom to company on interest-free terms; and have bank loan interest deductible on the basis that Lizzy and Tom may earn assessable income via dividends

Case for the company

- Funding benefits (cont):
  - Loans allow for return of funds pre-tax
  - If funded by equity, then returns are post tax (albeit with franking credits potentially available) subject to buy-back/company liquidation arrangements
  - Contemplate long term objectives of company in relation to cost base of shares
- Taxing of profits
  - Company tax rate and ability to defer taxing point
  - Where dividends are paid, consider section 245T *Corporations Act 2001*

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Case for the company

- CGT tax status:
  - Disposal of underlying business does not entitle 50% CGT discount
  - SBCGT Concession protected capital gains not extracted via 15-year exemption/retirement exemption has no franking credits attached to them
  - Disposal of shares in company requires additional tests to be met
- Other issues:
  - Loans from business (tax compliance)
  - Ease of defined ownership
  - Governments consider businesses as running through 'companies' – see COVID 'boosts'
  - Small business test for company losses
  - Share classes

Case for the trust

- Flow through entity:
  - Note, lack of ability to retain
  - Potential to use bucket company, but consider Division 7A issues if requiring working capital
- Funding options
  - Ability to lend
  - Note difficulty for interest-free loans made by beneficiaries to trust (although very narrow cases have allowed interest to be deductible)
  - Difficulty to finance with banks
- 'Trickier' compliance
  - Trust law obligations
  - Minutes
  - Trust deed issues

Case for the trust

- CGT tax status:
  - CGT discount available
  - SBCGT Concessions trickier to meet; but also easier to extract concessional amounts
- Other considerations:
  - Lack of fixed interest
  - Flexibility in distribution without needing additional share classes
  - Family trust election issues
  - Ease to retain losses with family trust election
  - Section 100A and 99B

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Business structure?

- Consider objectives
- Need to reinvest in business/accumulate franked distributions
- Timeframe to hold assets
- Expected time to profitability
- Practical difficulties of trust
- Size of the business
- Persons to ultimately benefit

Passive structure

- Harold and Katherine are looking to acquire a new property investment
- They have other investments which they derive $200,000 per year
- They have children, one of which is interested in property investment
- Acquire a property worth $1.3million
- Rental income of $120,000 is derived, and sufficient to offset interest and principal payments

Case for the company

- Corporate tax rate:
  - 30%
  - Unlikely to access lower tax rate
- Distribution of profits
  - Where rental income, then ability to cap at company tax rate
  - Note where shareholdings are in other entities, then no tax benefit
  - Note where negatively geared, then no franking credits available
- CGT taxing
  - Likely to sell underlying asset in which no CGT discount
  - Note stamp duty if dealing with property and business assets (Qld only)
  - Selling shares to avoid stamp duty, then consider landholder duty
  - Depending on nature of business, no SBCGT concessions available

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Case for the trust

- Flow through entity:
  - Likewise with earlier case study
  - Noting trapping of losses if negatively geared
- Cash flow
  - NB potential issue if mismatch of distributable income and tax income
  - Difficulty to recontribute profits in trust without distributing out and then recontributing
- CGT taxing
  - Only able to sell underlying asset
  - Note stamp duty if dealing with property and business assets (Qld only)
  - No ability to 'sell shares to avoid stamp duty'
  - Corporate trustee duty as an issue for company trustee
  - Depending on nature of business, no SBCGT concessions available

Passive structure

- Company loses CGT discount but allows deferred top up tax
- Trust requires 'top up tax' to be paid (subject to bucket company) and difficulty to reinvest earnings
- Trust has availability of CGT discount
- Perhaps trust preferred if short investment timeframe and high expected capital growth expected

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Take-away factors

- Investment time frame:
  - Benefit of CGT discount available diminishes over time
  - Deferral of upfront tax through company becomes of benefit over time
  - Consider cost of funding
- Expected return on investment
  - Where higher capital growth, then CGT discount potential increase
  - Compare against ability to reinvest profits without need for top up tax
  - Middle groud?
- Complexity of compliance and risk of tax law change
  - Companies easier to understand but Division 7A issues
  - Trust structures are much more complex and should ideally require legal assistance
- Succession planning

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Bonus topic – electronic signing

- Appreciate distinction between agreement and deed
- Commonwealth and each state authorises electronic transactions (with certain exclusions)
- If document requires witnessing – i.e. deeds – then questionable whether can be signed electronically
- Federal Government did not extend COVID-19 legislation allowing corporations to electronically sign deeds
- Constitutions also need to allow electronic execution
- 'Signed sealed and delivered' for deeds
- Paper/parchment
- Qld has allowed electronic signing of deed without witness until September 2021
- DQH preference – 'wet ink'

Contact details

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