TAX TALKS

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Tax effective structuring is not a one-size-fits all. There are at least 13 different criteria to consider.

Tax Effective Structuring

We are all looking for the magic wand when it comes to tax effective structuring. The bad news is there is no magic wand unless you consider overseas tax havens and tax evasion. The good news is that with clever structuring you can improve your position.

In this episode Andrew Henshaw of Velocity Legal in Sydney will walk you through the options you have. Here is what we learned but please listen in as Andrew Henshaw explains all this much better than we ever could.

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Building Blocks

When you look at how to structure your business (or wealth), you have four types of building blocks. Sole trader, partnership, company and trust. That's all. It doesn't look like a huge choice. But it is. For two reasons:

1) Trusts

A trust is only a relationship and there are endless possibilities how to define this relationship.

So a trust is never just a trust. It is either a fixed or a discretionary trust or a hybrid of the two. It is either a discretionary trust with a family trust election or one without. It is either a trust inter vivos or testamentary. It is either an SMSF (a highly regulated form of a trust) or it isn't. And the list goes on.

A quick comment on the side: Superannuation funds are a form of trust but operate quite differently to other trusts. They live in their own world. And so for simplicity let's put super funds aside for this discussion.

2) Stack and Layer

You can stack and layer the four building blocks as needed. There are some limitations, eg. for example don't have a discretionary trust distribute to an SMSF, but apart from those, the sky is your limit.

Partnerships for example don't necessarily just involve individuals. You could also have a partnership of companies or unit trusts.

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So while at the surface there are just 4 types of building blocks, there is a lot more when you look underneath the bonnet.

Criteria To Consider

Each structure has advantages and disadvantages, strengths and weaknesses. Whether a structure will work for you or not depends on your circumstances. The 13 criteria to consider for tax effective structuring are:

1 – Timing of Income Distributions
2 – Allocation of Income Distributions
3 – Allocation of Cash Payments
4 – Preservation of Income Type
5 – 50% CGT discount
6 – State Tax
7 – Small Business CGT Concessions
8 – Government grants
9 – Asset Protection
10 – Complexity
11 – Cost
12 – Issue of Equity
13 – Estate Planning

So let's look at these one by one.

1 – Timing of Income Distributions

Business and wealth generate income, and somebody has to pay income tax on this income, putting tax evasion and tax havens aside. In the end all income – be it from business or wealth – will end up in the hands of individuals, taxed at their marginal individual tax rates. There is no magic wand that changes this.

What does change – depending on the structure you choose – is how much flexibility you have around the timing of these income distributions before they hit an individual tax return.

Without a company in the mix, you have no flexibility. There is no buffer whatsoever – be it a sole trader, partnership or trust without corporate beneficiaries. Every dollar you make in a year will hit marginal tax rates in that year.

But when you throw a company in the mix, you suddenly have time on your side. You can pay a dividend this year, next year, in 20 years. No income hits marginal tax rates until you decide to pay a dividend. So 1 plus point to companies for flexibility around the timing of income distributions.

2 – Allocation of Income Distributions

In the end all income from business and wealth will end up in individual hands.

In a sole trader, partnership, company or fixed trust there is no flexibility of allocation. Whoever is the sole trader, partner, shareholder or unit holder, will receive their share of the income – no more and no less.

In a discretionary trust on the other hand the trustee is free to allocate the income within the terms of the trust deed at their discretion. So 1 plus point to discretionary trusts for flexibility around the allocation of income distributions.

3 – Allocation of Cash

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In a sole trader, partnership or trust without a corporate beneficiary (bucket company) there is no restriction on where the cash goes. You can keep or take as much cash from the business as you see fit. There is no restriction on whether and where the cash goes or stays.

However, the moment you throw a company into the mix that flexibility goes out the window.

In a company, you can keep as much cash in the business as you like, but you can’t pay it out as you like. Any non-dividend cash payment to shareholders will require a s109N loan agreement.

In a trust with a bucket company, the trust can’t keep cash belonging to the bucket company (UPE) in the trust unless they set up a s109N loan agreement. So 1 minus point to companies.

4 – Preservation of Income Type

As a sole trader or partnership any capital gains and CGT discounts as well as franking credits flow through to individuals as such. They stay what they are. In a discretionary trust the same applies as long as the trust deed gives the trustee the power to stream. .

Not in a company. A company can only pay dividends, nothing else. Any capital gains or franking credits derived by the company becomes company income that is then paid out as franked or unfranked dividends. So 1 minus point to companies for zero income type preservation.

5 – 50% CGT Discount

The 50% CGT discount in Div 115 only applies to sole traders, partnerships and trusts (SMSF 33%). Companies don’t get a CGT discount. So that is a big minus point to companies.

6 – State Tax Consideration

If you envisage the business or wealth to change hands over time and land is involved, consider stamp duty.

7 – Small Business CGT Concessions

As a sole trader or partnership the small business CGT concessions are complex, but doable. As a trust or company they become significantly more complex and much harder to qualify. So 1 plus point to sole traders and partnerships.

8 – Government Tax Concessions

Only companies qualify for the R & D tax incentive, the early stage innovation and other government grants. No other structure does. So 1 plus point to companies.

9 – Asset Protection

As a sole trader or partnership, you have no asset protection. You are liable with all your assets – personal as well as business – for any business debts.

A company gives you some asset protection by ring-fencing your business assets from your private assets, but there are many ways creditors can pierce the corporate veil, especially for company directors.

A discretionary trust offers the best asset protection, since the trustee is not the beneficial owner of the assets. That asset protection is not water-tight, but gives you more arguments of defence than any other structure. So 1 plus point to discretionary trusts for asset protection.

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10 – Complexity

A sole trader is the easiest structure. It is just you. In a company you need to look out for Div7A. A partnership can get extremely fiddly, for example when you have partners coming in or leaving.

But by far the most complex structure is anything involving a trust. Trusts are complex creatures. It is easy to make mistakes and those can be very expensive. So a minus point to trusts.

11 – Cost

The more complex the structure, the more it costs. Sole trader is usually the least complex structure. Anything involving trusts usually the most complex.

Trusts are fraud with danger. And that makes it expensive – you either pay now in adviser fees or you pay later through ATO adverse assessments for invalid distributions etc, assessed to the trustee at top marginal rates. So a big minus point to trusts for this one.

12 – Issue of Equity

A company can issue equity and hence the easiest to increase your working capital. Sole trader, partnerships and discretionary trusts make it a lot harder to bring in more equity owners. So a plus point to companies.

13 – Estate Planning

Companies are the easiest to pass on through an estate.

Summary

So for tax effective structuring it all depends on what is important to you. If you want the least complexity and cost the answer will be different than if you want maximum asset protection and flexibility.

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