TAX TALKS

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Asset protection is an important factor to consider when you structure a business or wealth.

Asset Protection

The more assets, the more asset protection you need. But how do you get asset protection? Where are possible points of attack in various structures? Geoff Stein of Brown Wright Stein Lawyers in Sydney kindly agreed to give you an answer.

Here is what we learned but please listen in as Geoff Stein explains all this much better than we ever could.

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Top Learnings

Let’s start with our big learnings from this episode. We took 6 important insights away from this interview – but please check all this with your lawyer.

1 – Director of Trading Company is At Risk

In a trading company, it is the director who is at risk, but usually not the shareholder, unless you have excessive dividends or personal guarantees etc.

2 – Keep Other Spouse Away From Director Duties

If you have an at-risk spouse and a wealth-accumulating spouse, be careful that the wealth-accumulating spouse does not become a shadow director of the trading company.

3 – Follow the Money from Trust to Bucket Company

When the shares of a trading company are held by a discretionary trust with a corporate trustee, it doesn’t matter so much who the directors and shareholders of that corporate trustee are. Rather focus on where the money went, and that trail will often take you to a bucket company.

4 – Have Trust Hold Shares in Bucket Company

This bucket company is ideally held by a discretionary trust. The trust can just have an individual trustee, which is often the wealth-accumulating spouse. If the bucket company is already established and holds assets, then leave the set up as is. Moving the shares into a trust would trigger CGT E1 and if not E1, then A1.

5 – Register Loan from Bucket Company with PPSR

Any loan from the bucket company back to the trading company should be covered by a general security agreement and this agreement should be registered in the PPSR to make it a secured loan.

6 – Super is Safe

Super is usually the best asset protection there is. You usually can't go any safer than super. Creditors might have one possible point of attack and that is excessive contributions irregular in pattern shortly before filing for bankruptcy, but apart from this the walls around super are pretty bullet proof.

So this is a summary of our learnings, but let's go into the 9 scenarios that Geoff covers in this episode.

Scenario # 1 Sole Trader

A sole trader is fully liable with all assets for any debt. It doesn't matter whether the asset or debt is used for business or private purposes. It is all thrown into one big bucket.

Putting assets into a spouse's name is not a watertight defence against creditors, but it might help. It is all about putting yourself in a position to negotiate with creditors or to negotiate with a trustee in bankruptcy.

Scenario # 2 Partnership

Partners are fully liable for all partnership debt. There is little defence. The best defence is not having any assets in your name.

Scenario # 3 Companies

Company creditors are limited to company assets, unless they manage to pierce the corporate veil. There are a number of laws that impose statutory liabilities on directors. So the director is usually the one at risk and not so much the shareholder, unless there have been excessive dividends irregular in pattern shortly before bankruptcy proceedings.

The most important thing is to ensure that the wealth-accumulating spouse doesn't become a shadow director.

Scenario # 4 Discretionary Trust with Individual Trustees

The trust itself is not an entity, even though it prepares a tax return as a tax entity. The trust doesn't enter a contract. The trustee enters into those contracts on behalf of the trust so the trustee's assets are at risk. Hence the argument for a corporate trustee.

Scenario # 5 Discretionary Trust with Corporate Trustees

The trustee is liable for any debts they incur on behalf of the company. They have recourse against trust assets but these are often not sufficient when the trust hits rough waters. So this is why it is important to have a corporate trustee for any trust incurring debt.

Scenario # 6 Trading Company held by a Discretionary Trust with Corporate Trustees

For asset protection the identity of the director and shareholder of the corporate trustee don't really matter. Because if there is a problem with the company, the shares that are held by the trust will probably be worthless anyway.

But what does matter is where the money went. That is the trail creditors will follow. And this will often lead you to a bucket company.

Scenario # 7 Bucket Company

Bucket companies often function as the financier for the group and lend money to a trading company. Just as with a third-party lender, the trading company should give security to the bucket company for that loan.

Without security the bucket company would be participating with other creditors on a pari par su basis as an unsecured creditor. To avoid this you should create a general security agreement (fixed / floating charge) that you then register with the PPSR.

The shares in the bucket company are usually owned by the wealth-accumulating spouse. And that is a good first step towards asset protection.

But what is even better is having the shares held by another discretionary trust. This gives you flexibility around the distribution of income from the bucket company. And it gives you even more asset protection since the wealth-accumulating spouse has a lower risk of being attacked but nobody is immune.

You don’t necessarily need a corporate trustee for the discretionary trust. The bucket company is not trading and so is not incurring any liabilities, so individual trustees are ok.

But for the discretionary trust don’t forget estate planning. Discretionary trusts don’t go into the estate.

Scenario # 8 SMSF

Irrelevant who holds the shares in the SMSF corporate trustee. All SMSF members must be directors of the corporate trustee.

There is little possible point of attack from creditors in an SMSF. Interests in superannuation funds are not divisible property in a bankruptcy.

So the only way that creditors can attack super funds is if there are excessive contributions or contributions irregular in pattern. The main issue is excessive contributions made just before the sequestration order for bankruptcy. Those are in trouble.

But the assets and the growth in these assets in a super fund are protected from creditors. Super is the best form of asset protection available in Australia.

Scenario # 9 LRBA with Bare Trust

In a limited recourse borrowing arrangements (LRBA) with a bare trust (corporate trustee) the identity of the shareholder and director of the corporate trustee is irrelevant.

The bare trust’s corporate trustee is like a second trustee to the SMSF. It is just holding the assets on behalf of the fund. So all of the protections mechanisms available to the fund are available to the trustee under the LRBA.

Under the LRBA the directors don’t even need to be members of the fund. It could be third parties, but of course it is best if the SMSF members are the directors and shareholders of the bare trust corporate trustee.

Conclusions

So looking at all this, here are five final tips in parting:

1) Nothing is 100% water-tight. But getting the right structure and documentation in place will give you more arguments in defence.

2) Don't just focus on the structure itself. Focus on documentation as well. Make sure that transactions are properly documented. The structure is only the first part of the game. The second one is proper documentation of transactions – think of Div 7A loans as an example.

3) Don't forget that the wealth-accumulation spouse might die or lose capacity. Make sure that all those assets then don't go back to the at-risk spouse. Have proper estate planning and consider moving the assets to a testamentary trust upon death.

4) Discretionary trusts don't become part of the estate. So plan ahead what is to happen to bucket company shares held in a discretionary trust with an individual trustee upon death of that individual trustee.

5) A discretionary trust distributing to an SMSF is likely to give rise to non-arm's length income. So don't do it – unless you have good reasons and know what you are doing.

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