

Optimal structuring

the discretionary family trust is absolutely (still) king!

There are four fundamental objectives required to achieve the optimal trading structure for any small-medium business, namely;

1. "Limited Liability" Protection

The ability to utilise the Corporations Law statutory safety net and "walk away" from unsecured creditors in the event the business becomes insolvent.

2. "Asset Protection"

Protection of all private family wealth, including the family home and all other investments, in the event of litigation or personal bankruptcy.

3. Tax Minimisation

Maximum flexibility in determining and distributing the taxable profits to family members, and related entities so that ultimately the minimum amount of tax is paid.

4. Succession Flexibility

Maximum options and minimal capital gains tax / stamp duty when the business is ultimately sold, listed or transitioned to the next generation.

Achieving all of these objectives is critical to good business structuring. The consequences of missing any of these elements can be fatal to both the business and the fundamental financial security of the family (as highlighted in the case study over the page).

Incredibly, none of the last three objectives (i.e. 2 – 4) are possible unless a trust is an integral part of the structure! ☺

hk comment:

While the best structure will be slightly different depending on individual family circumstances, **fundamentally all of the above objectives can be achieved with appropriate advice and utilising at least one company AND one discretionary trust.**

What is the best trading structure?

Depending on circumstances and the type of business, the two most common trading structures that achieve ALL the objectives, will be:

1. **A Company (assuming the shares owned by a discretionary family trust) or;**
2. **A Discretionary family trust (assuming a company is the 'trustee')**

Importantly, the 'at risk' individual (who in both structures above is the 'Director' of the company) should not beneficially own either the company shares, the family home, or any other investment assets.

In some circumstances a variation, such as a 'Limited Partnership', 'Managed Partnership' or 'Public Trading Trust' may be more appropriate however **all of these structures are essentially derivatives of the two listed above and all, structured correctly, involve at least one company and one trust.**

If unrelated parties own the business (i.e. two or more families) the optimal structure will allow each family to separately deal with their respective share of business profits and will also involve a combination of companies AND trusts. The most appropriate structure for unrelated parties trading together will be either:

1. A Company (with respective shareholding owned by separate discretionary (family) trusts), or
2. A Partnership of discretionary trusts (each trust having a company as trustee), or
3. A Unit Trust (with corporate Trustee and with respective unit holdings owned by respective discretionary (family) trusts). ☺

What if not structured this way?

If the trading structure does not contain a trust (either as the direct trading entity, or as the shareholder of a company that is trading) three of the four objectives cannot possibly be achieved. **Accordingly, the private wealth of the family will be at risk, the business will pay much more tax than it should, and the options in terms of business succession will be limited. ☹**

hk comment:

The most common example of a poor structure that we see in practice is a Company with 'Mum & Dad' as directors and shareholders (rather than, as outlined above, a Company with Dad or Mum as sole director and the shares held by them 'As Trustees For' (ATF) their discretionary family trust).

Case Study - the Smiths and the Jones's

Let's compare two families, the Smiths and the Jones's. Both families run businesses in the construction industry. Their respective accountants have set them up with standard Company as the trading entity, the only differences being that Mr and Mrs Smith are both directors and shareholders of 'Smith Builders Pty Ltd', whereas Mr Jones is the sole director of 'Jones Builders Pty Ltd' and he and Mrs Jones hold the ordinary shares ATF the 'Jones Family Trust' (refer diagram below).

The Smith's home is held as 'joint tenants' on title while the Jones's home is held by Mrs Jones only on title.

Otherwise we assume their business and other family circumstances are identical, as follows:

- All four parents are retired, two of whom are self funded (\$50k pensions from their superannuation) the other two receive the government age pension.
- Each family has three children, the eldest of whom is at Uni and has just turned 18 years.
- Each family has a home now worth \$800k with a mortgage of \$350k.
- Both companies have completed their first year of trading and after all expenses (including wages to themselves of \$80k each) are left with a net profit of \$100k. Each company has since lodged the company tax return and paid company tax (30%) leaving \$70K in their respective company bank accounts.

Director: Mr Smith
Mrs Smith

Smith Builders Pty Ltd

Shareholding

50% 50%

Mr Smith

Mrs Smith

Potential Dividend Recipients

Director: Mr Jones

Jones Builders Pty Ltd

Shareholding 100%

Jones Family Trust

Mr J Mrs J Child (18) Child x2 (Minor) Parents (Self Funded)

Potential Dividend Recipients

Both families obviously want to access the \$70k (to further pay down the private mortgage) but understand that to access retained profits (cash) from a company they must ultimately pay this out as a 'Dividend' to Shareholders.

The dividend will be taxable to the ultimate individual beneficiary, however will be 'fully franked' which simply means the company tax already paid (30%) flows with the dividend to the individual as a tax credit.

Accordingly where the dividend is assessable to someone who is in a high marginal tax Bracket (greater than 30%) they will have 'top up' tax to pay on the dividend when they lodge their personal tax return, however where the dividend is assessed to someone in a low marginal tax bracket (less than 30%), they will receive a tax refund when they lodge their tax return.

Remember, Mr and Mrs Smith directly own the shares in Smith Builders Pty Ltd (50/50), whereas the shares in Jones Builders Pty Ltd are held by the Jones Family Trust which provides Mr and Mrs Jones full discretion to allocate the dividend to trust beneficiaries (i.e. across all family members).

The table below compares the tax consequences of drawing the \$70k out of their respective companies:

Allocation of \$70k 'Fully Franked' Dividend (grossed for tax to \$100k with \$30k tax credit)

| Smith Family Tax | Mr Smith | Mrs Smith |
|--------------------------------|------------|------------|
| Dividend (Gross) | \$50,000 | \$50,000 |
| Tax on Dividend (based on MTR) | \$19,750 | \$19,750 |
| Less: Tax Credit | (\$15,000) | (\$15,000) |
| Personal Tax Payable/(Refund) | \$4,750 | \$4,750 |

| Jones Family Tax | Mr Jones | Mrs Jones | Parent 1 (65 yrs) | Parent 2 (65 yrs) | Child 1 (18 yrs) | Child x 2 (Minor) |
|--------------------------------|----------|-----------|-------------------|-------------------|------------------|-------------------|
| Dividend (Gross) | Nil | Nil | \$20,000 | \$20,000 | \$54,000 | \$6,000 |
| Tax on Dividend (based on MTR) | Nil | Nil | Nil | Nil | \$10,860 | Nil |
| Less: Tax Credit | Nil | Nil | (\$6,000) | (\$6,000) | (\$16,200) | (\$1,800) |
| Personal Tax Payable/(Refund) | Nil | Nil | (\$6,000) | (\$6,000) | (\$5,340) | (\$1,800) |

The table highlights that the Dividend to Mr and Mrs Smith has resulted in an **additional tax liability of \$9,500**. Whereas the Jones family have received an **overall tax refund of \$19,140** resulting from the dividend. 🎉

comment:

The Smith family has ultimately paid \$39,500 (\$30,000 + \$9,500) or nearly **40%** tax on the \$100k profit.

The Jones family has ultimately paid \$10,860 (\$30,000 - \$19,140) or just over **10%** tax on the \$100k profit.

It gets much worse for the Smiths...

At the end of the second year of trading a similar profit was made by both companies and therefore, again due to the inflexible nature of the shareholding, the Smiths have ultimately paid considerably more tax on profits than the Jones's. This will be the case year after year.

A few years later, both companies have been involved in litigation resulting from separate, but (incredibly) identical situations whereby an employee lost the use of an arm due to it being crushed when (rusty) scaffolding collapsed. In both cases the lawyers are seeking damages of \$500k but are aware that in suing the company they are 'limited' to the net equity of the company. In both cases as the retained profits have been paid out of the company (dividends) and the value of tools and equipment is negligible, the company value is essentially limited to its share capital (\$2).

Therefore the respective lawyers have successfully pursued the company directors personally on the basis that they were negligent in executing a sufficient 'duty of care' to adequately maintain equipment. The directors were horrified to find that their respective indemnity insurers have a 'carve out' for such "negligent" situations and wiped their hands of the claims!

Lawyers chasing Mr Jones (sole director) conduct searches that confirm he does not directly own any assets in his name (house held by Mrs Jones and Shares held by him but only ATF the family trust). Accordingly they have no avenue to pursue him personally or bankrupt him. The company is wound up and they commence trading through an identical structure the following week. Accordingly Mr and Mrs Jones are completely unaffected financially by this incident.

As Mrs and Mrs Smith are personally liable (both directors) and have joint equity in their home, they are pursued by the lawyers and ultimately forced into personal bankruptcy. The trustee in bankruptcy sells their home to extract \$450k equity (after paying back the bank) and the balance of the claim (and bankruptcy trustee's fees) will be pursued via a garnishee over future wages for the next 3 years. Further as bankrupts they cannot be directors of a company. ☹



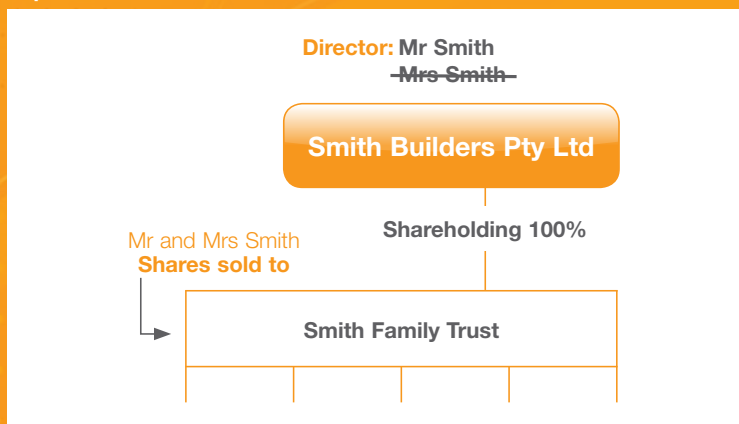
comment:

Mr and Mrs Smith have been absolutely decimated! They are bankrupt, have lost everything including their home, and are unable to commence a new company for at least 3 years.

Rewind!!... What if...

What if just prior to the end of the first year of trading the Smiths got a second professional opinion about the appropriateness of their trading structure, and as a result it was identified that the structure provided very poor 'asset protection' and tax effectiveness.

What if the following (simple) restructure was recommend and implemented at that time...



This restructure involves:

1. The Smith Family Trust is established with Mr and Mrs Smith as the Trustees (cost approx \$700)
2. The business is valued (in this example at \$500k) and the shares sold for this value from Mr and Mrs Smith (held directly) to themselves 'As Trustee For' (ATF) the Smith Family Trust.
 - The trust takes a \$500k tax deductible loan to purchase the shares from Mr and Mrs Smith
 - If Mr and Mrs Smith put 25% of the proceeds (\$125k) into superannuation there will be zero capital gains tax on the share sale. The balance \$375k should be used to pay out their (non deductible) mortgage.
 - The effective result of this step (Share sale to the family trust) is **they have greatly enhanced their 'Asset Protection', replaced a non deductible debt (mortgage) with a tax deductible debt in the trust** and given their super a \$125k tax free injection! The cost is negligible (less than \$1000 as no CGT or Stamp Duty applicable).
3. Mrs Smith resigns as a Director and Mr Smith is removed from title on their family home. The cost in relation to the property transfer will be Stamp Duty based on half value of the property however (subject to passing the statutory 'relation back' timeframe and Mrs Smith having minimal involvement with day to day operations of the business) they now have excellent 'Asset Protection'.

Based on this 'timely' advice and a quite straightforward and cost effective restructure the Smiths have 'kept up with' and in fact are now better structured overall than the Jones's.

Not only will the dividends be able to be paid in the same way to exactly the same class of beneficiaries as the Jones's they will pay even less tax than the Jones's due to the tax deductible interest in their trust resulting in approx \$10,500 less tax than the Jones (assuming interest rate of 7%).

Accordingly, as a result of this additional tax deduction (conversion of non deductible debt to tax deductible debt) and the ability to now distribute the dividend via their family trust, the Smiths will pay just \$360 tax, less than 1%, based on the above trading figures.

Further, any future litigation resulting in the director (Mr Smith) being pursued should not expose the equity in the family home, or any other private funds/investments (provided occurs outside the 'relation back' timeframe). ☺

Optimal Structure for investments

The optimal structure, from both an 'asset protection' and 'tax efficient' perspective in which to hold passive investment assets (e.g. cash/property/shares) is a **Self Managed Superannuation Fund (SMSF)**. The SMSF (a special purpose trust) provides "pure" asset protection and very concessional tax rates on both investment earnings and capital gains. Superannuation however does have some restrictions on investments, limits on amounts that can be contributed and of course benefits are "preserved" until at least age 55.

The optimal structure for Small-Medium (SME) business owners to hold passive investments, outside of superannuation, is the **'vanilla' discretionary family trust** (with 'mum and dad' as the trustees). As outlined previously the discretionary trust provides 'asset protection' and optimal tax efficiency due to the ability to distribute income (e.g. rent, dividends, interest and ultimately capital gains) to family beneficiaries. Again these core objectives (2-4) are best achieved by the discretionary trust and, due to the passive environment, the 'limited liability' protection (objective 1) is not relevant.

Importantly the trust will access the Capital Gains Tax (CGT) 50% discount. **It should be noted that a company is specifically excluded from accessing the 50% CGT discount and accordingly a company should not be used to hold investment assets.**

Critically the trusts that hold these (passive) investment assets should not conduct business, but rather trading activities should be carried out in separate entities (i.e. correctly structured companies or trusts as outlined previously). ☺

hk newsletters

Some particularly relevant articles from previous newsletters include:

Summer 2008

'Hold the Press ... Super Funds can now borrow!' – Self Managed Super Funds (SMSF) can now borrow, subject to guidelines, to purchase assets including residential and commercial properties with very tax effective outcomes (worked examples provided).

Summer 2010

'Mum and Dad land developers can have their cake and eat it too' – HK obtained separate private ATO rulings confirming subdivision of land into 22 and 36 lots respectively was "mere realisation" (ie passive /non business) and accordingly sale of individual lots was ultimately deemed on capital account and completely tax free in both cases.



hk comment:

It is critical that the passive investment objectives and structure are considered in the overall business structure review. Profits must be able to be passed from the trading structure/s to the investment trust in order to fund investments and to offset any (negative gearing) losses. This requires good professional advice and appropriate tax documentation including 'family trust' / 'interposed entity' elections. **Correctly structured however the discretionary trust, combined with superannuation contributions, is hands down the best place for passive family wealth to accumulate!**

Invitation

Free review of your Business Structure

If, after reading our feature article **Optimal Structuring**, you would like a free no obligation* review of your existing structure, then please call 3394 2311 or email mail@hoffmankelly.com.au

*Includes meeting with Troy Kelly or Tony Hoffman including detailed review of existing structure and our recommendations to achieve optimal structure based on specific circumstances (absolutely no cost/no obligation).

COPYRIGHT: This newsletter is the property of Hoffman Kelly Pty Ltd directors, Troy Kelly and Tony Hoffman. Any disclosure, copying, distribution or any action taken or omitted to be taken in reliance on it without express permission is absolutely prohibited and will be unlawful.

DISCLAIMER NOTICE: The content of this newsletter is general in nature and is based on legislation at the time of writing. Hoffman Kelly takes no responsibility for reliance on the content herein without a thorough review of specific individual circumstances. This newsletter is the property of Hoffman Kelly Pty Ltd. The information in this newsletter is confidential and may be legally privileged. It is intended solely for the addressee. Access to this by anyone else is unauthorised.

Liability limited by a scheme approved by Professional Standards Legislation.