





ALTERNATIVE INVESTMENT VEHICLES

Daniel Smedley, Principal, Sladen Legal

#NC2020




Daniel Smedley

Principal, Sladen Legal



Daniel Smedley, CTA, enjoys solving complex taxation and trust law issues for private enterprise clients. He is also a trusted confidant in planning the succession of his client's personal and business affairs. Daniel is a Chartered Tax Advisor with The Tax Institute, accredited as a specialist in Taxation Law with the Law Institute of Victoria, and the principal author of the Trust Structures Guide published by The Tax Institute. Since 2016, Daniel has appeared in the list of one of Australia's "Best Lawyers of the Year" in the practice of tax law. The list is compiled by Best Lawyers and published in the Australian Financial Review. Daniel has also been recognised in Doyles Guide as a recommended tax lawyer since 2016. Daniel is a regular presenter at state and national industry conventions, conferences and workshops.



Introduction

Synopsis

As we know, SMSFs are common tools for accumulating wealth during working years and distributing those funds post retirement. However with recent changes to contribution caps, increased complexity as to the management of SMSFs and restrictions on access to those funds pre-retirement, are there more suitable investment opportunities individuals should consider?

In this session we will compare the **advantages** and **disadvantages** of structures which may provide an alternative to superannuation funds. Consideration will be given to the **asset protection, taxation** and **flexibility** elements of structures.

Choosing an alternative investment structure



A non-exhaustive checklist

- the ability to isolate assets from risks such as:
 - claims of creditors of a business;
 - insolvent trading risks of directors and group companies;
 - directors' liabilities in respect of both insolvent trading and tax;
 - exposure to claims in relation to environmental issues, industrial matters, product liability or negligence;
 - claims that are not sufficiently protected by insurance or where insurance liability is not admitted — for example, claims involving public risk and professional indemnity issues;
 - exposure of assets to claims by spouses (including de facto spouses) following the failure of relationships and risks relating to court jurisdiction over disputed assets;
 - cross liabilities through the provision of loans and guarantees;
- the ability to distribute the income of the structure amongst a wide range of beneficiaries;
- the establishment costs of the structure;
- the management and control of the structure;
- the administrative simplicity and cost efficiency of the structure;
- the regulatory requirements of operating a business through the structure; the ability to transfer interests between participants in the structure;
- the ability to introduce additional investors into the structure in the future;
- the ability to offer investment opportunities to the public at large (including how general Corporations Act 2001 (Cth) issues and more specific managed investment scheme issues may be relevant);

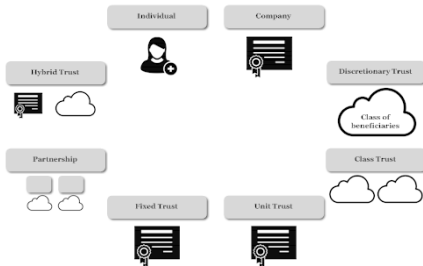
Choosing an alternative investment structure



A non-exhaustive checklist (cont'd)

- the implications in respect of both stamp duty and the goods and services tax (GST) relating to transactions both within and external to the structure, and any restructuring that may be necessary in the future;
- the ability to prepare the structure and costs, and implications of reorganising the structure to enable it to be listed on the Australian Stock Exchange;
- the CGT issues relevant to the structure, including issues relating to the disposal of assets by the structure and the disposal of interests in the structure;
- the applicable rate of tax payable by the entities involved in the structure;
- the payroll tax and WorkCover liabilities associated with a particular structure;
- the application of specific taxation rules such as the alienation of personal services income measures, the provisions of Div 7A Income Tax Assessment Act 1936 which treat certain loans and payments as unfranked dividends and provisions dealing with the ability to offset income against losses (i.e. negative gearing);
- the ability to access various concessions available under the income tax legislation in addition to those relating to CGT, such as research and development concessions;
- the ability to pay superannuation contributions from the structure;
- the GST issues in respect of both registration for the tax system and also the timing of tax periods for the entities involved in the structure, their ability to group and their requirement to comply with the PAVG measures.

Structure options



Trust structures



Bare trust

- Trustee has no discretion in relation to dealings with the trust property.
- Duty to convey the trust property on demand to a specified party.

Fixed trust

- Each beneficiary has a fixed interest in income and/or capital of the trust.
- The trustee does not have any discretion as to the identity of income/capital beneficiaries, or the amount distributed.

Discretionary trust

- Trustee has a broad discretion in relation to dealing with trust property, and distributing income and/or capital to one beneficiary or class of beneficiary.

Unit trust

- Beneficial ownership is divided into units held by unit holders. Each unit holder is entitled to set proportion of income and/or capital distributions.

Trust structures



Hybrid trust

- Combines features of both a discretionary and fixed trust (e.g. may have classes of units with different rights and entitlements).

Testamentary trust

- The trust does not commence until after the executor has finalised the administration of the deceased estate.

Child maintenance trust

- The trust can be used to distribute income to a child under 18 without attracting the penalty tax rates that usually apply to the unearned income of minors.

Special disability trusts

- Unexpended income is taxed at the principal beneficiary's personal income tax rate.

Charitable trusts

- Charity tax concessions include an exemption from income tax and a range of GST and fringe benefit tax concessions.

Partnership of discretionary trusts



Alienation of income through discretionary trust partners

Taxpayer Alert TA 2013/3 "Purported alienation of income through discretionary trust partners".

Release of guidelines via website

ATO's statement releasing the guidelines on 1 September 2014 was titled "ATO provides guidance on discretionary trust partnerships for professionals".

- "Professional practices may **legitimately operate** as a **partnership of discretionary trusts** or through similar structures."

Guidance later titled "Assessing the risk: allocation of profits within professional firms."

- "a **structurally neutral approach applies**, in that the **ATO isn't going to concern ourselves too much with the form of the arrangement**".

Partnerships and joint ventures



Partnership

- Where parties are in receipt of income jointly.
- Partnership terms may be expressly agreed in writing or by State based partnership law.
- Partnership assets are owned by the partners.
- Partners are jointly and severally responsible for the liabilities or debts of partnership.

Joint venture

- Parties make contributions different in type, amount or timing.
- Venture usually has a defined end and is formed for a particular project or outcome.
- Parties are only responsible for the liabilities or debts of the venture in the proportion determined in the joint venture agreement.

What is a trust?



Importance of the terms of the deed vs the nature of the structure itself

Key elements of a trust:

- Trust **property**
- **Trustee** holds the legal title to the trust property
- Trustee manages and applies the trust property on behalf of **beneficiaries**

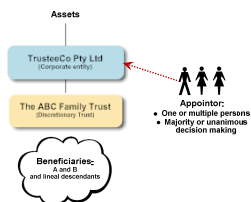
The trust deed is a legal document that defines the trust relationship

- Identifies the beneficiaries
- Outlines the trustee's obligations and duties
- Role of appointor / guardian

Key elements of a trust



Asset protection, taxation and flexibility

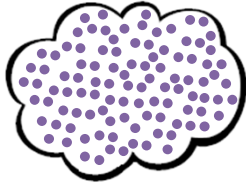


Interest in a discretionary trust vs mere object

Asset protection and flexibility



Discretionary Trust



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Role of the appointor/guardian

Asset protection and succession



Varies from deed to deed.

Look for limitations in the deed:

- Appointor/guardian must consent to distributions of capital;
- Appointor/guardian must consent to variation of trust deed;
- Appointor/guardian must consent to bringing forward the vesting date; and
- Appointor/guardian must consent to appointment of new trustee.

Also look for provisions concerning:

- changing the appointor provisions;
- including an independent appointor;
- requiring unanimous decision making;
- providing a mechanism for resolving disputes; and
- providing for the succession of the appointors.

Role of the appointor/guardian

Asset protection and succession planning



Review existence and scope of power

- For example, ability to remove existing trustee and appoint a new trustee

Decision making where multiple persons are in the role of appointor / guardian

Appropriately drafted, the appointor provisions may be used to effectively pass control over the discretionary trust to the next generation

Appointor/guardian

An example clause



The Appointors of this Trust are successively the following persons if and for so long as they are willing to act:

- First, PERSON1 (PERSON1) and PERSON2 (PERSON2) both of [ADDRESS] and INDEPENDENT1 of [ADDRESS] (INDEPENDENT1).
- Upon both PERSON1 and PERSON2 ceasing to be appointors, the Appointor will be all of the children of PERSON1 and PERSON2 namely CHILD1 (CHILD1) and CHILD2 (CHILD2).
- Note 1: If any of CHILD1 or CHILD2 die before having become an appointor, or having become an appointor cease to be an appointor leaving children, the survivor of CHILD1 and CHILD2 together with a representative of the deceased's children appointed by the deceased in their will or by inter vivos deed (Deceased Appointor Representative) shall be the Appointor until the last surviving child of the deceased has reached the age of [AGE] years whereupon all of the deceased's children together will be entitled to appoint one person to become the Deceased Appointor Representative.
- Note 2: If the deceased fails to appoint a Deceased Appointor Representative then the deceased's legal personal representatives shall be the Deceased Appointor Representative.
- Note 3: If INDEPENDENT1 is unwilling or incapable of acting in the role described above INDEPENDENT2 of [ADDRESS] shall perform the role otherwise to be performed by INDEPENDENT1.

Who are the beneficiaries?

Importance of the terms of the deed vs the nature of the structure itself



Does the intended beneficiary qualify as a beneficiary?

- Determine the beneficiaries of a trust to establish who may benefit from the trust and to what extent.
- Consider description of the class of beneficiaries.
- Consider additional definitions such as "Eligible Trust" and "Eligible Corporation".
- Any distributions from a trust to a person who is not a beneficiary would be ineffective and could result in adverse and unintended tax consequences.



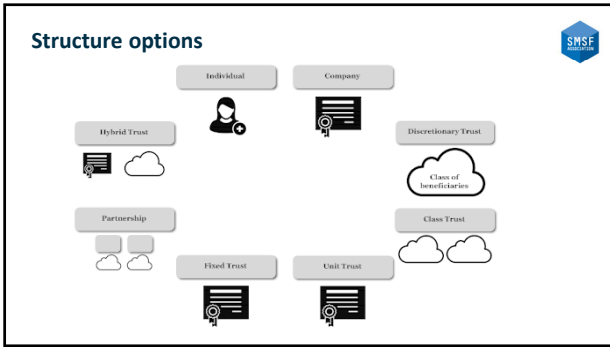
Who are the beneficiaries?

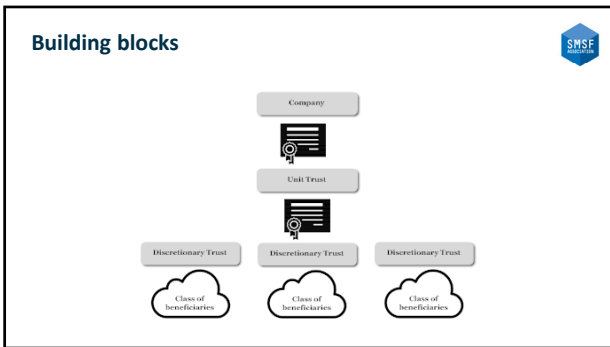
Importance of the terms of the deed vs the nature of the structure itself



Issues to consider:

- Settlor and notional settlor
 - Often trust deeds will exclude the settlor of the trust and any "notional settlor" from being a beneficiary of the trust.
 - For example, "notional settlor" may be defined in the deed as "... someone who has made any disposition of property in favour of the trustee other than for full consideration in money or moneys' worth".
- Trustee
 - A trust deed may exclude the trustee from the class of beneficiaries, unless the trustee is specifically named as a beneficiary.
- Other related beneficiaries
 - Trust deeds may include a provision, for example, which excludes any company in which specific persons (e.g. the guardian) have any interest.
- Traps with multiple trusts
 - Commonly controlled trusts are not automatically included within the class of beneficiaries of one another.





Discretionary Trust

Key elements of the structure

	Discretionary Trust
Asset protection	<p>The structure is protected from claims by creditors of beneficiaries.</p> <p>Beneficiaries are protected from claims by creditors of the structure.</p> <p>Assets are protected from claims by future spouses of principals and children.</p> <p>Note: the indication of the availability of asset protection is based on the structure itself. Care should always be taken to review loans, entitlements and any personal guarantees that may exist between the various parties.</p>
Income taxation	<p>Income accumulated by the structure will be taxed at the highest marginal income tax rate plus the Medicare levy.</p> <p>Flow-through taxation applies, so that income distributed by the structure will be taxed in the hands of the recipient at their income tax rate.</p> <p>There is flexibility to distribute income (including income with special characteristics, eg franked dividends) to any one or more beneficiaries (subject to personal services income and Pt IVA issues).</p>

Discretionary Trust (cont'd)

Key elements of the structure



	Discretionary Trust
Capital gains tax concessions	50% CGT Discount – available to structure. Small business CGT concessions – available to structure. CGT concessions only relate to the availability to the structure. Consideration must be given to the requirements for accessing the concessions outlined in the ITAA97 and the requirement to distribute amounts of net capital gains in some circumstances to avoid the benefit of the concession being eroded by the gross-up rules in Subdiv 115-C ITAA97.
Succession planning	The assets of the structure are not owned by any one beneficiary and do not form part of a beneficiary's estate on their death. Ultimate control of the trust resides with the appointor. Ultimate control of the structure may be planned by appropriate drafting of the appointor provision.
New Investors	Beneficiaries may be added to the structure. Adding beneficiaries may cause a resettlement that incurs CGT and stamp duty liabilities. The structure is not capitalised by beneficiaries.
Other issues	The trustee on behalf of the trust may need to make a family trust election if: <ul style="list-style-type: none"> a beneficiary is to receive the benefit of franking credits attaching to dividends paid in respect of shares acquired after 31 December 1997; and the beneficiary will have greater than \$5,000 in franking credits (in total and from all sources) in the applicable financial year.

Comparing options

Advantages and disadvantages



Company		Discretionary Trust		Unit Trust		Partnership/Joint venture	
Advantages	Disadvantages	Advantages	Disadvantages	Advantages	Disadvantages	Advantages	Disadvantages
<ul style="list-style-type: none"> Limited liability asset protection for shareholders. Access to some advantages of DT with DT shareholder. Can retain profits. 	<ul style="list-style-type: none"> Division 7A tax risks in relation to non-commercial transactions with related parties. No 50% CGT discount at company level. Limited flexibility of distribution as compared to other structures (share rights). No flow through taxation. Regulatory compliance obligations. 	<ul style="list-style-type: none"> Asset protection to structure. Asset protection to beneficiaries. Flexibility of distribution. Ability to access losses. Succession planning without triggering tax event. Extraction of capital without triggering tax liability. 	<ul style="list-style-type: none"> Critical to read the deed to understand how structure operates. Traps with beneficiaries. Traps with multiple family groups. Need to exclude foreign beneficiaries for residential land investments. 	<ul style="list-style-type: none"> Access to advantages of DT with DT unit holder. Ability to add new investors without triggering a CGT liability. Flow through taxation for income. 	<ul style="list-style-type: none"> CCT event E4 trap Franking credit flow through trap. Challenges in accessing losses. Danger of reliance on unit trust deed to manage third party investor disputes. 	<ul style="list-style-type: none"> Access to advantages of DT with DT partner. Each partner may make their own Family Trust Election for purpose of access to losses and income injection Availability to small business CGT concessions (incl passive land used in business of connected entity) 	<ul style="list-style-type: none"> Joint and several liability CGT liability triggered on partnership changes Challenges on partnership vs joint venture distinction. Complex administration and management of structure.

Key taxation challenges



	Company	Discretionary Trust	Unit Trust	Partnership
Taxation at entity level	✓	-	✗	✗
Flow-through taxation	-	✓	✓	✓
Extraction of capital from structure	✗	✓	✓	✓
Division 7A implications	✗ (applies)	-	-	-
Family Trust Elections	N/A	✓	✗	✓
50% capital gains tax concession	✗	✓	✓	✓
Accessing franking credits	✓	✓ (Make FTE)	✗ (PBR req'd)	✓ (Make FTE)

Influence on structure choice - Division 7A



Recap of Division 7A

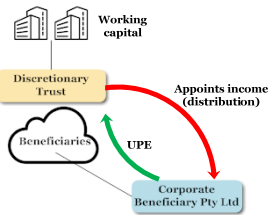
- Division 7A of Income Tax Assessment Act 1936 operates to prevent amounts being extracted from companies (through payments, loans or forgiven debts) in a non-taxable manner where income may have benefited from the **lower corporate tax rate** rather than the potentially higher individual marginal income tax rate.
- The liability triggered pursuant to the provisions is an **unfranked deemed dividend** - a significant penalty for tax purposes.
 - Amounts will only be deemed to be unfranked dividends to the extent of the company's distributable surplus (s. 109Y).
- Unless:
 - exempt (ss. 109G and 109R);
 - **complying commercial loan agreement** in accordance with legislation (s.109N);
 - fully repaid within the required time (s. 109RD); or
 - the Commissioner exercises discretion (s. 109RB).

Unpaid present entitlements (UPEs)



Trusts interaction with Division 7A

- A UPE is created when the trustee of a trust **makes a determination to appoint income or capital to a beneficiary of the trust**. Generally, at this time the beneficiary will have an immediate right to call on the trustee of trust to pay the UPE in part or full – CGT Event D1.
- TR 2010/3: "Economically the practice **replicates a trustee accumulation** and the policy of the law is thereby being compromised when the trustee uses the income, for effectively no cost, for trust purposes and not for the benefit of its real owner, the corporate beneficiary."



Trusts and Division 7A



Complex interaction creates traps

- **Subdivision EA of Division 7A of ITAA 36** extends the potential operation of Division 7A to arrangements where a trust makes a payment or loan to a beneficiary who is the shareholder or associate of the shareholder in a company and that **company has a UPE in the trust**.
- **Interposed entities - section 109XI** deems there to be a relationship between the trust making the payment or loan to the beneficiary (who happens to be the shareholder or an associate of the shareholder in a company) and the relevant company even though **there may not be a direct UPE relationship** between those two entities.
- **Taxation Ruling TR 2010/3 and Practice Statement Law Administration (PSLA) 2010/4**, post **16 December 2009** UPEs that have not been called for by their entitled beneficiaries (**subsisting UPEs**) that are not held for the sole benefit of the beneficiary will be treated as loans for the purposes of Division 7A of ITAA 36.

Future of Trusts and Division 7A Reforms



Division 7A reforms likely to have significant impact on the future of trusts. Need to await exposure draft legislation.

Notable issues arising from Treasury Discussion Paper (October 2018) include

- Codifying "financial accommodation" to include UPEs
- Treatment of quarantined UPEs pre December 2009....

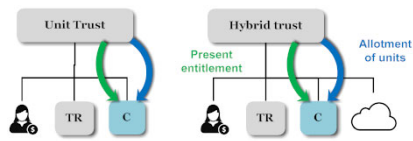
Subdivision EA of Division 7A of ITAA 36 will continue to require careful analysis – Trusts with outstanding UPEs should not lend to another related entity.

S.109T (tracing through entities/transactions related rules) risks and the ATO's Taxation Determination TD 2018/13 (technical/outside of scope but care required).

Problematic structures



Unitised structures



Present entitlement satisfied by the allotment of units often by trustee's power in the deed to allot units in satisfaction of entitlement.

Problematic structures



Unitised structures

- ATO website guidance
- Section 109C
 - If the payment of units is not at market value, the exclusion in 109J does not apply
 - Carefully consider terms – market value of unit may be less than face value
- Section 109T - TD 2017/D3 > TD 2018/13.
- Section 100A
- Part IVA

In essence, part or all of the subscription price of the units could be treated as a "payment" for Division 7A purposes with the effect that the amount is treated as a taxable amount without the benefit of any franking credits.

Trust shareholder in company

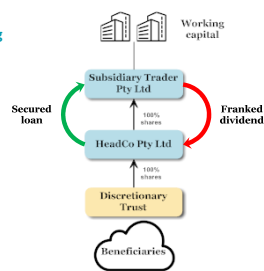
Division 7A - Pros | Cons



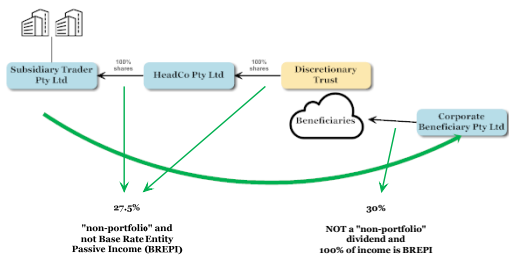
Pros	Cons
Less complex working capital financing: <ul style="list-style-type: none"> Avoid complexity of Subdivision EA Avoid complexity of s.109X! Avoid complexity of TR 2010/3 and PSLA 2010/4 option 1 and option 2 investment agreements to provide a return to the corporate beneficiary 	Capital extraction problematic <ul style="list-style-type: none"> s.109C payment "profits first" rules – franked and unfranked dividends, capital reductions, buy-backs, liquidations and operation of s.45B ITAA 36.
Can extract funds from exposed trading subsidiary to a passive corporate head entity without triggering Div 7A management issues	Use of asset potentially triggers s.109CA payment
Can finance other corporate entities where funds retained within corporate group with s.109K exemption.	Still need to consider s.109T – Refer TD 2018/13
Potential to retain profits at lower corporate rate (not taxed at 30% as a corporate beneficiary)	Need to be mindful of proposed removal of distributable surplus requirement

Division 7A - Pros

Can extract funds from exposed trading subsidiary to a passive corporate head entity without triggering Div 7A management issues



Division 7A - Pros



Division 7A - Cons

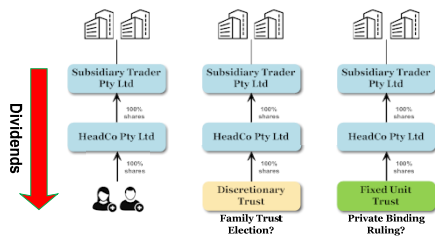


Use of asset potentially triggers s.109CA payment

ATO guidance – 14 examples - example 4 – provision of assets for use by shareholders

- Peter is a shareholder of a private company that owns five cars for company use. Shareholders and their associates have general permission to use the cars on weekends if they are not being used for company business. Peter regularly takes one of the cars home.
- Peter's **use of the car that he takes home will be subject to Division 7A**. This will include **driving** the car (actual use) and the **availability** of the car for his use to the exclusion of the company, such as when it is parked at home, or at a restaurant that Peter is visiting.
- Although Peter may have general permission to use all five of the cars, he does not use all of them for the purposes of Division 7A. The four cars that Peter leaves at the company premises are available for the company to loan to another shareholder, employee, customer, or other party. That is, these cars are **not available to Peter to the exclusion of the company**.

Trusts as a company shareholder



Franking credits through trusts



Shares acquired post 3pm 31/12/1997

Specific rules contained in Division 1A of Part IIIAA of Income Tax Assessment Act 1936 (Division 1A).

- Division 1A was repealed with effect from 1 July 2002 but continues to apply.
- Taxation Determination TD 2007/11
 - 9. The very wording of sections 207-145 and 207-150 makes it clear that regard is to be had to the rules in Division 1A in determining whether a person is a qualified person for the purposes of these provisions in respect of a franked distribution, irrespective of whether the distribution is made after 30 June 2002. There is nothing in the relevant extrinsic material to indicate the contrary.

Broadly, subject to small shareholder exception (\$5,000 of franking credits from all sources) a taxpayer may only claim franking credits if it is a **qualified person** in relation to the franked dividend.

To be a qualified person a taxpayer must satisfy two rules:

- the **holding period rule**; and
- the **related payments rule**.

Significance of Family Trust Election



The making of a family trust election has particular significance to discretionary trusts.

- It facilitates the flow through of franking credits to members or beneficiaries of the family group
- It facilitates the ability for losses to be carried forward in the discretionary trust.
- It is a precondition to satisfying the requirements for the Small Business Restructure Rollover.

A FTE can be made (somewhat) retrospectively.

A FTE also restricts flexibility in the discretionary trust

- Family Trust Distributions Tax on distributions to members who are not part of the Family Group
- Unlimited period of review of Family Trust Distribution Tax
- (Generally) an irrevocable election

The future of discretionary trusts might place further significance on FTEs.

Colonial First State Investments Ltd v. COT [2011] FCA 16



[ATO view] Fixed entitlement issue

- The decision confirms the **ATO view that very few trusts satisfy the definition of 'fixed trust'** in section 272-65 of Schedule 2F in the absence of the exercise of the Commissioner's discretion (essentially because beneficiary entitlements to income or capital are generally **liable to be defeated by the exercise of a power** in the deed or by a statutory power).

[Administrative Treatment] Fixed entitlement issue

- The ATO has previously considered issuing a public ruling about the fixed entitlement test in the trust loss provisions in Schedule 2F. The ATO has previously concluded that, even on a purposive and contextual interpretation of the actual words used in the legislation, an interpretative position could not be reached that aligned with industry expectations. The **indefeasibility requirement was significant in that respect.**

Interest to be vested and indefeasible



160APHL(14) Commissioner may determine an interest to be vested and indefeasible.

if:

- (a) the taxpayer has an interest in so much of the corpus of the trust as is comprised by the trust holding; and
- (b) apart from this subsection, the interest would not be a vested or indefeasible interest; and
- (c) the Commissioner considers that **the interest should be treated as being vested and indefeasible**, having regard to:
 - (i) the circumstances in which the interest is capable of not vesting or the defeasance can happen; and
 - (ii) the likelihood of the interest not vesting or the defeasance happening; and
 - (iii) the nature of the trust; and
 - (iv) any other matter the Commissioner thinks relevant;

the Commissioner may determine that the interest is to be taken to be vested and indefeasible.

Can we self-assess the Commissioner's discretion?



Guidelines (PCG 2016/16) - Guideline outlines the factors the Commissioner will consider when deciding whether to **exercise the discretion** to treat an interest in the income or capital of a trust as being a fixed entitlement – but not for franking credit purposes.

Joint submission on Draft PCG 2016/D16 that it would be efficient if the PCG dealt with subsection 160APHL(14).

Final PCG 2016/D16

- 4. This Guideline **does not apply**:
 - For the purposes of applying former subsection 160APHL(14) of the ITAA 1936 (about the holding period rule for franking credits).

Solution is to seek a private binding ruling from the Federal Commissioner of Taxation regarding subsection 160APHL(14).

Future of structuring decisions



Discretionary trust ideal for single family investment.

Unit Trusts ideal for multiple family investment but care required.

Different considerations apply if conducting a business (direct or with another family).

- In that case increased movement in SME industry to use of trading company with ultimate discretionary trust shareholders.

Division 7A changes (1 July 2020) will have an impact on structure choice.

Flow-through of franking credits presents an often overlooked trap.

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