

7108AFE Tax Planning

Assignment Cover Sheet: Part B: Business Letter of Advice

Semester 2 2010

Due: Monday 11 October 2010 by 5pm

Griffith University

Course Convenor: Brett Freudenberg

Griffith Business School, Logan campus

Department of AFE

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|----------------|---------------------------------|
| Student Name | XXXXXXXXXXXXXXXXXXXX |
| Student Number | XXXXXXXXXXXX |
| Word Count | 1602 |

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(Student signature)

AUTHENTIC FINANCIAL SERVICES
268 Sixth Avenue
Brisbane QLD 4000
Phone +61 3111 3111 Fax +61 3111 3112

4 October 2010

Bill Devine
141 Milli Vanillie Paradise
Burbanke QLD 4156

Re: Business structure advice on the purchase of Karaoke King and Party Supplies.

Dear Mr Devine

We refer to our meeting on Thursday 2nd September 2010 and your request for advice in respect of the purchase of Karaoke King and Party Supplies. In particular, you requested advice regarding:

- What is the best structure to adopt for purchasing the business;
- Whether you have to pay tax on the inheritance from your uncle's; and
- Whether you can get an immediate tax deduction for the restrictive covenant.

Below is detailed our understanding of your relevant circumstances, and the basis of our advice.

Our understanding

Pursuant to the information supplied by you, we understand that:

- You approached Angus Foley, a sole trader, to purchase all of the business assets for \$3,400,000, \$500,000 of which is allocated for the restrictive covenant signed by Angus;
- You are 45, has previously been involved in property development using a corporate form;
- Your wife, Janine, aged 53, holds a Commerce degree and had prior retail experience. Janine would like to be heavily involved in the business. Janine owns the family home worth \$500,000, rental property worth \$750,000 and \$100,000 worth of shares;
- Your son, Jeff, aged 20, attends university. You would like Jeff to be involved in the business;
- The business acquisition is funded by the inheritance of \$4,000,000 from your uncle. The business is expected to make some losses for the first two year and start making profits after that;
- In eight years from now, the business will need to raise \$2,600,000 to expand its operations; and
- Your long term plan is to run the business for 20-30 year and then sell it, make a large profit and retire. However, if things do not go according to plan,

✓ then a "plan B" is to exit the business totally by subdividing the land and selling it off.

If our understanding is incorrect or there are any material omissions, please advise us immediately, as it may affect the conclusions reached in our advice.

Executive Summary

After considering your circumstances we recommend you to adopt the corporation structure for purchasing the business. It is advised that you first incorporate a company limited by share in which Janine and you will be the initial equity investors. Each would hold \$500,000 worth of shares. The corporation appoints you as a director and employs Janine and Jeff. Three million dollars (\$1.5 million each) will be loaned to the company by both Janine and you. The security will be land and building that are going to be purchased from Angus. Then you will sign the contract to buy the business assets on behalf of the company.

You do not need to pay tax on the inheritance. However, you cannot get an immediate tax deduction for the restrictive covenant. ✓

Detailed below is the precise basis for our recommendations.

Detailed advice

Below is a discussion about the business structure, tax treatment of the inheritance and restrictive covenant, and other issues. ✓

Business structure ✓

In determining the business form, we took into account asset protection, ease of understanding, ability to retain profit and control of the business operations, use of losses, tax minimisation and ease of getting out of the business. ✓

With regards to asset ^{proposed to be} protection, a corporation provides limited liability for Janine and you as shareholders. Your liabilities are limited to your contributed share capital which is one million dollars. Therefore, your family's assets are protected. In addition, being secured creditors, Janine and you have the best chance of getting the adequate protection payments for your three million dollar loans in the priority scheme if the company fails. Besides, creditors of members are not able to access the corporation's assets, though they may gain control of the member's interest, as an asset itself, in the corporation. Thus, creditors of outside investors cannot access to the company's assets. However, Janine and you (especially Janine as she holds significant assets) must be careful in providing personal guarantees and securities over personal assets to get a company loan because in the event the company cannot pay the loan you will become liable risking the loss of your assets. ✓

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found

Just
print ✓

Concerning the ease of understanding, it would be easy for you to understand the legal and tax rules applying to this business form given your prior experience using a corporate structure in property development. Moreover, Janine with her Commerce Degree and retail experience has the necessary skills to meet the legal and tax obligations of the company's operation given the size and nature of your business.

not 100% correct

With respect to the ability to retain profit, profits made by the business can be reinvested in the company as "retained earnings" in order to finance the business growth. Your family as shareholders can also maintain control in the company structure with you as a director. If a new member joins the business as a shareholder, s/he cannot exercise day to day control unless s/he is also a director. Nevertheless, you need to make sure that new members hold similar views in operating the business or your family still attain majority shareholding or voting rights. Alternatively, a new member may join the business by incorporating his/her own company that forms a partnership with your company.

not 100% correct

In relation to the use of losses generated by the business, tax losses stay within the corporation thus cannot be used to offset other incomes of members. Nonetheless, those losses can be a deduction in calculating company's taxable income in later years if the company satisfies either the continuity of ownership or same business test. If there is no significant change to the company ownership, the business is likely to satisfy the ownership test. Otherwise, it is advised that the company should continue to operate the same kind of business in order to carry forward losses. According to the profit and loss projection, the company should be able to utilise all tax losses in 2015.

As to tax minimisation, profits generated by the business can be slitted to Janine and you by way of reasonable loan interests, director fees or salaries and guaranteed superannuation. Jeff can also be paid reasonable wages. Then the company pays tax on its taxable income at a flat rate which is currently 30 percent. After retaining some profits for future expansion, dividends can be distributed to Janine and you. The company may also issue shares to Jeff in a different share class which dividends are not automatically distributed to. Your family members pay tax at your marginal tax rate. Janine can offset her income with the negative gearing from her rental property and BHP Billiton shares. Franking credits and salary packaging are also available for Janine and you.

split?

7A?

good plans

With reference to the ease of getting out of the business, you can sell the business, liquidate and de-register the company. When selling the business, either the corporation could sell the business assets or alternatively the shareholders could sell their shares in the company. The company selling its assets is not able to access the general 50 percent CGT discount; however, shareholders selling shares in a company would be eligible as individuals. You can utilise your carried-forward capital losses from the sale of Qantas shares to offset the capital gains before applying discount. Furthermore, access to the small business CGT concession may be available.

Inheritance and Restrictive covenant

Regarding your concern on the tax treatment of the inheritance and restrictive covenant, it is advised that you don't need to pay tax on the inheritance, however cannot claim an immediate deduction for the restrictive covenant. Cash left to you in your uncle's will is a mere gift or bequest, not an income and therefore not taxed. A restrictive covenant is a contractual right. The lump sum payment for a restrictive covenant is of a capital nature, hence not an allowable deduction for the business. However, the expiration of the contract will trigger capital loss for the business. The losses of \$500,000 will be quarantined in the company and only able to be used to offset capital gains. ✓

Others

For asset protection purpose, land and building might be held by a separate individual or structure from the company that runs the business. The asset owning entity leases land and building to the business. If the company gets into financial difficulty, the business premises are not at risk. Nevertheless, in that case the business will not be purchased as a going concern by one entity; thereby will be subject to GST. Therefore, Angus may charge additional \$340,000 to cover his GST liability. Alternatively, the company might purchase the going concern business, and then sell land and building to a separate entity which in turn will lease them back to the company. Nonetheless, care should be taken to the possible application of the anti-avoidance provisions. Access to the small business CGT concession may still be available on the sale of the business premises if they are held by the entity which is connected to the company.

Adequate business and personal insurance covers may help to mitigate risk to your business and family. Janine and you may also consider contributing more into superannuation to take advantage of this tax concessional environment and provide for your life after retirement. Finally, the structure should be built over time to take into account your financial circumstances and the actual growth in your business. We can help you with these matters. ✓

Should you have any queries in relation to this advice or wish to proceed with the advised business structure, please do not hesitate to contact Ms Anh Thu CHAU on (07) 3111 3111.

Yours sincerely



Dinkum Smith
Director
Authentic Financial Services



Disclaimers

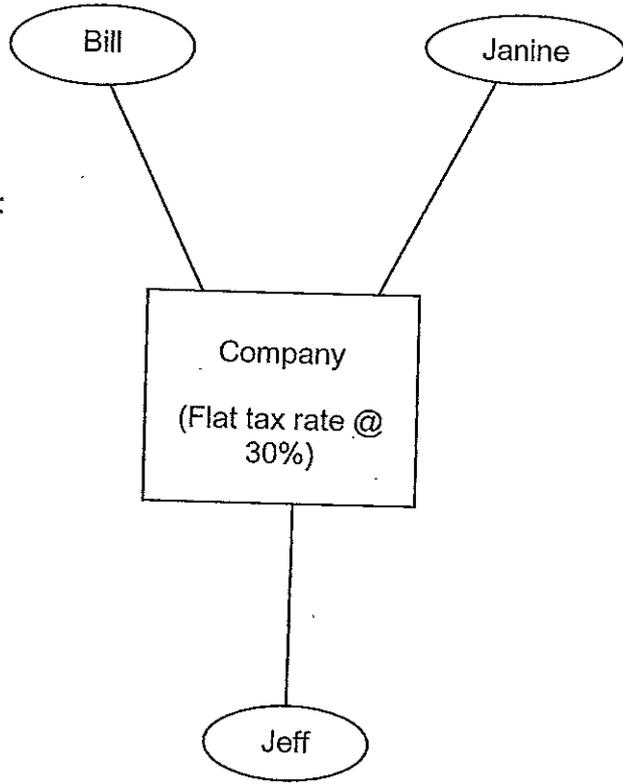
The advice given in this letter is for the recipient only and may not be suitable for other applications. The firm takes no responsibility for liability as a result of incorrect use of the above information. This advice is made on certain assumptions and using a particular case, if these circumstances change then any advice in this letter becomes void.

Appendix 1: Company's structure

You did not refer to this in body of letter.

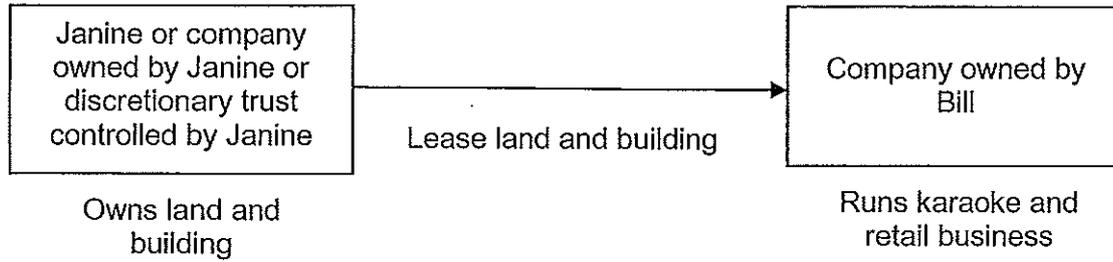
- Shareholder (\$500,000 worth of share): dividends, franking credits
 - Director: director fees, guaranteed supers, salary packaging
 - Secured creditor (loan of 1.5 million): loan interest
- (Marginal tax rate)

- Shareholder (\$500,000 worth of share): dividends, franking credits
 - Employee: salaries, guaranteed supers, salary packaging
 - Secured creditor (loan of 1.5 million): loan interest
- (Marginal tax rate)



Employee: Wages
 (May also be shareholder in different share class: dividends not automatically distributed to)
 (Marginal tax rate)

Appendix 2: Assets held by separate individual/structure



File note

| Issue | Sole Trader | General Partnership | Discretionary Trust | Corporation |
|--------------------------------|---|---|---|--|
| <p>Asset protection</p> | <p>Liability for debts is carried fully by the sole trader.</p> <p>The business assets cannot be protected if Bill is a sole trader.</p> <p>If Janine owns land and building and lease to Bill, business premises might be protected.</p> | <p>A partner is jointly and severally liable for the partnership's liabilities, which means a partner could singularly be responsible for all of a partnership's liabilities alone.</p> <p>S9 <i>Partnership Act 1892 (NSW)</i>, section 13 <i>Partnership Act 1958 (Vic)</i>, section 9 <i>Partnership Act 1891 (SA)</i>, section 12 <i>Partnership Act 1891 (Qld)</i>, section 16 <i>Partnership Act 1895 (WA)</i>, section 14 <i>Partnership Act 1891 (Tas)</i>, section 13 <i>Partnership Act 1963 (ACT)</i>, section 13 <i>Partnership Act 1997 (NT)</i>.</p> <p>The partnership between Bill and Janine cannot provide protection for the business and family assets.</p> <p>If land, building and Janine's assets are held in a trust and the trustee lease land and building to the partnership, asset protection can be achieved.</p> | <p>Generally, trustees are personally liable for debts incurred on behalf of the trust.</p> <p>The beneficiaries generally are not liable for the debts incurred by the trustee.</p> <p>Additionally, creditors of a discretionary beneficiary will not have any rights against the trust assets.</p> <p>If trustee is a corporate, it creates another layer of protection.</p> | <p><i>Corporation Act</i>: S516: Shareholders of a company are not liable (in their capacity as shareholders) for the company's debts. As shareholders, their only obligation is to pay the company any amount unpaid on their shares if they are called upon to do so.</p> <p>S124: A company has a separate legal existence that is distinct from that of its owners, managers, operators, employees and agents. <i>Salomon v A Salomon & Co Ltd [1897] AC 22</i></p> <p>S443F creates a statutory lien on the company's property. This statutory lien secures the administrator's right of indemnity under s4443D. Subject to s556, the right of indemnity has priority over all of the company's unsecured debts and debts of the company secured by a floating</p> |

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| <p>Ease of understanding</p> | <p>Although this business form seems to be simple, clients sometimes may find it difficult as regards to GST, depreciation or treatment of private uses, etc.</p> | <p>This business structure seems to be easy to understand. However, few people are truly aware of the complexity of partners' obligations to one another and to third parties.</p> | <p>Even though it may be the best way to protect asset, this business form is not recommended to Bill due to his ability to understand what a trust is. A trust is a complicated legal structure with lots of paperwork, regulations and laws to adhere to. It is only effective if it is operated properly. If Bill does not understand it, he may not operate it properly, and therefore the benefits will not be obtained. Further, the significant tax problems due to the incorrect operation of a trust from his friend's experience concerned Bill.</p> | <p>charge on the property of the company. S588G, 588J, 588M, and 1317H: A director of a company may be liable for debts incurred by the company at a time when the company itself is unable to pay those debts as they fall due.</p> <p>Bill has prior experience using a corporate structure in property development, it would be easy for him to understand the legal and tax rules applying to this business form.</p> <p>Janine with her Commerce Degree and retail experience has the necessary skills to meet the legal and tax obligations of the company's operation given the size and nature of the business.</p> |
| <p>Ability to retain profit</p> | <p>All profits flow to Bill as a sole trader. Bill needs to include the business profits in his individual tax</p> | <p>Individual partners must include their share of the partnership net income or loss in their individual tax</p> | <p>Retention of earning within a trust is restricted. All net income of the trust to which no beneficiary is</p> | <p>After being taxed at a flat rate of 30%, profits made by the business can be reinvested in the</p> |

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| | <p>returns (s 6-1, 6-5(1)), and might be taxed at the highest marginal tax rate.</p> | <p>returns (s92), and might be taxed at the highest marginal tax rate.</p> | <p>presently entitled is taxed at the highest personal marginal tax rate plus Medicare levy, with the trustee liable for tax (s99A). An unpaid present entitlement (UPE) may be an arrangement to maintain money within the trust to aid with the funding of the business operation, especially when the unpaid beneficiary is a corporation (taxed at flat rate of 30%). However, TR 2010/3 indicated that the UPE may be indeed a loan from the corporation back to the trust. If the trust is an associate of a shareholder of the corporation, Division 7A could apply to deem this loan as an unfranked dividend form the corporation to the trust.</p> | <p>company as "retailer" in order to finance the business growth.</p> |
| <p>Control of the business operations</p> | <p>Complete control over all operations. However, Bill must raise capital himself. Otherwise, structure must change if a new member is to be introduced.</p> | <p>More people involved in the partnership, less control each partner has (harder to manage). Technically partnership ends when a new partner joins, hence change in partners can be costly.</p> | <p>Control can be exercised by trustee and differentiated from beneficial ownership, thereby maintained if there is no change to trustee. Just a pure change in trustees will not normally result in a disposal of a</p> | <p>Bill and Janine as shareholders can also maintain control in the company structure with Bill as a director. If a new member joins the business as a shareholder, s/he cannot</p> |

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| <p>exercise day to day control unless s/he is also a director. Nevertheless, Bill needs to make sure that new members hold similar views in operating the business or his family still attain majority shareholding or voting rights.</p> <p>Alternatively, a new member may join the business by incorporating his/her own company that forms a partnership with Bill's company.</p> | <p>CGT asset (s104-10(2)).</p> <p>If only discretionary beneficiary is added to a trust deed, this will not normally result in a resettlement of the trust. If the default beneficiaries are altered then this can result in a resettlement of the trust causing CGT and stamp duty liability on the deemed disposal of assets (ATO Statement of Principles: <i>Trust Resettlements - AIFRS related amendments to trust deeds</i>).</p> <p>A new member may also join the business by forming his/her own trust that becomes a partner with the original trust.</p> | <p>Losses stay within the corporation thus cannot be used to offset other incomes of members. <i>Division 35</i> Non-commercial rules do not apply to companies. Losses are subject to carry-forward rules, which are currently the continuity of ownership test (s165-12) or same business test (s165-13).</p> |
| <p>CGT asset (s104-10(2)).</p> <p>If only discretionary beneficiary is added to a trust deed, this will not normally result in a resettlement of the trust. If the default beneficiaries are altered then this can result in a resettlement of the trust causing CGT and stamp duty liability on the deemed disposal of assets (ATO Statement of Principles: <i>Trust Resettlements - AIFRS related amendments to trust deeds</i>).</p> <p>A new member may also join the business by forming his/her own trust that becomes a partner with the original trust.</p> | <p>Losses are trapped in the trust (<i>Weyers & Ors v FC of T</i>), hence cannot be used to offset other incomes of members. <i>Division 35</i> Non-commercial rules do not apply to trusts. Losses are subject to carry-forward rules. That is four tests for discretionary trust: 50% stake test, income injection test, pattern of distribution test</p> | <p>Losses are trapped in the trust (<i>Weyers & Ors v FC of T</i>), hence cannot be used to offset other incomes of members. <i>Division 35</i> Non-commercial rules do not apply to trusts. Losses are subject to carry-forward rules. That is four tests for discretionary trust: 50% stake test, income injection test, pattern of distribution test</p> |
| <p>Use of losses</p> | <p>Tax losses flow to Bill (s8-1) but <i>Division 35</i> Non-commercial loss rules may apply.</p> <p>No restriction on carry forward losses.</p> | <p>Tax losses are available for use by individual partners (s8-1) but <i>Division 35</i> Non-commercial loss rules could apply to partners that are individuals.</p> <p>No restriction on carry forward losses.</p> |
| <p>Use of losses</p> | <p>Tax losses flow to Bill (s8-1) but <i>Division 35</i> Non-commercial loss rules may apply.</p> <p>No restriction on carry forward losses.</p> | <p>Tax losses are available for use by individual partners (s8-1) but <i>Division 35</i> Non-commercial loss rules could apply to partners that are individuals.</p> <p>No restriction on carry forward losses.</p> |

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| <p>Minimising the tax implications</p> | | | <p>Schedule 2F). If the trust make a family trust election, only one test need to be satisfied – income injection test (s 272-100, 272-75, 272-10).</p> | <p>Profits generated by the business can be slitted to Bill and Janine by way of reasonable loan interests, director fees or salaries, guaranteed super. Jeff can also be paid reasonable wages for his work. The company pays tax on its taxable income at a flat rate which is currently 30 percent. After retaining some profits for future expansion, dividends can be distributed to Janine and Bill. The company may also issue shares to Jeff in a different share class which dividends are not automatically distributed to. Bill family members pay tax at their marginal tax rate. Janine can offset her income with the negative gearing from her rental property and BHP Billiton shares (s8-1). Franking credits (s207-</p> |
| | <p>Bill need to include the business profits in his individual tax returns (s 6-1, 6-5(1)), and might be taxed at the highest marginal tax rate.</p> | <p>Individual partners must include their share of the partnership net income or loss in their individual tax returns (s92 ITAA36), and might be taxed at the highest marginal tax rate.</p> | <p>Profits generated by the business can be slitted to by way of reasonable salaries or wages, guaranteed super, present entitlement. Where a beneficiary is presently entitled and not under a legal disability then beneficiary gets assessed at normal tax rates (s97 ITAA36). It is flexible to vary income distributions to members each year. It is also possible to stream income to different members. Trust income retains its same character in the hands of the beneficiaries (<i>conduit theory</i>). If the capital gain is distributed to Bill, he can use his carried forward losses from the sale of Qantas shares to offset his present entitlement of the capital gain (s115-215 ITAA97).</p> | <p>Profits generated by the business can be slitted to Bill and Janine by way of reasonable loan interests, director fees or salaries, guaranteed super. Jeff can also be paid reasonable wages for his work. The company pays tax on its taxable income at a flat rate which is currently 30 percent. After retaining some profits for future expansion, dividends can be distributed to Janine and Bill. The company may also issue shares to Jeff in a different share class which dividends are not automatically distributed to. Bill family members pay tax at their marginal tax rate. Janine can offset her income with the negative gearing from her rental property and BHP Billiton shares (s8-1). Franking credits (s207-</p> |

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| <p>Ease of getting out of the business</p> | <p>The sale of business will occur through the sale of business assets.</p> <p>Bill can access <i>Division 115</i> discount for capital gains as an individual.</p> <p><i>Division 152</i> Small business CGT concessions may also be available.</p> | <p>The sale of business will occur through the sale of business assets.</p> <p>It is possible for partners that are individuals to access <i>Division 115</i> discount for capital gains.</p> <p><i>Division 152</i> Small business CGT concessions may also be available.</p> | <p>The sale of business can occur through the sale of business assets.</p> <p>If trustee is a corporation, the sale of business can occur through the sale of shares in the corporation and the amendment to beneficiaries in trust deed.</p> <p>Trust is able to access the general 50% discount on CGT assets (<i>Division 115</i>).</p> <p><i>Division 152</i> Small business CGT concessions may also be available. However, rollover relief is not available for trust.</p> | <p>20(2)) and salary packaging are also available for Bill and Janine.</p> <p>When selling the business, either the corporation could sell the business assets or alternatively the shareholders could sell their shares in the company. The company selling its assets is not able to access the general 50 percent CGT discount; however, shareholders selling shares in a company would be eligible as individuals (<i>Division 115</i>). Bill can utilise his carried-forward capital losses from the sale of Qantas shares to offset the capital gains before applying discount. Furthermore, access to the small business CGT concession may be available (<i>s152-10(2)</i>).</p> |
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| <p>Inheritance</p> | <p><i>Subsection 6-5(1): Ordinary income is income according to ordinary concepts. Scott v C of T (NSW) (1935) 35SR (NSW) 215 at p 219: Ordinary income is income according to the "ordinary concepts and usages of mankind"</i></p> <p>The inheritance of money is a one-off receipt. It has no nexus with the income earning activity. Mere gifts, bequests or windfall gains do not have the character of income.</p> |
| <p>Restrictive covenant</p> | <p>A restrictive covenant is a contractual right. The lump sum payment for a restrictive covenant is of a capital nature (<i>Beak v Robson</i> [1943] AC 352; <i>Higgs v Olivier</i> [1951] Ch 899; <i>McLean v FCT</i> (1996) 32 ATR 647). It is not an allowable deduction for the business. Therefore, the company cannot get an immediate tax deduction. The CGT event D1 will occur when the contractual right is created and trigger a capital gain for Angus (s104-35). If the contractual right is a separate asset to the goodwill (TR95/3, <i>Trego v Hunt</i> (1895-9) All ER Rep 804; (1896) AC 7), after five years the CGT event C2 will occur on the expiration of this contract and trigger a capital loss for the business (s104-25). The capital loss is quarantined and only able to be used to offset capital gains. If the covenant is part of business goodwill (TR95/3, <i>The Bacchus Marsh Concentrated Milk Co Ltd (In Liquidation) & Anor v Joseph Nathan & Co Ltd</i> (1919) 26 CLR 410 at p 438), there are no CGT consequences until a CGT event happens to that goodwill (TD95/54). In this case, the restrictive covenant seems to be a separate asset to the goodwill.</p> |
| <p>Assets are held by a separate entity</p> | <p>For asset protection purposes, it is best to have the business held by one entity and the business assets held by a separate entity. Personal assets should be held separately from the business entity as well, for the same reason. If the business fails, then the personal and business assets should be protected.</p> <p>The sale of the business may be GST-free if it satisfies the conditions of a sale of a going concern: s38-325 GST Act. If a separate entity buys the land and building and the company buys other assets, then the sale of the business will not satisfy GST-free conditions. Therefore, it is subject to GST.</p> <p>If the company buys the going concern business, then transfer land and building to another entity, it is likely to give rise to capital gains tax, stamp duty and other tax implications as well as being costly. Further, there are rules that allow in the event of bankruptcy a claw back of assets that have been divested in order to defeat creditors (s588FB Corporation Act).</p> <p>The business premises will need to be held in a connected entity (s328-125) or affiliate (s328-130) of the business entity so that they continue to be active assets (s152-35). If they are not active assets, the small business CGT concessions in <i>Division 152</i> will not be available (s152-40(4), <i>Tingari Village North Pty Ltd v FCT</i> [2010] ACT 233). This is not relevant for depreciable plant and equipment as it will not be subject to CGT on sale (s118-24). However, a drawback is that it may bring in new "affiliates" and more entities "connected" with the business taxpayer in calculating the maximum net asset value test (s152-15).</p> <p>If the business assets are held in a separate entity, that entity can lease the business assets to the business entity. But beware of the possible application of <i>Part IVA (Eastern Nitrogen Ltd v FC of T</i> [2001] FCA 365-N30 of 2001). As a general rule, tax minimization should never be the main priority.</p> <p>While best practice is to have different assets owned by different entities, this can get expensive. Besides, not only must a client understand how each entity in the structure works, but must also have the discipline to run the structure properly and to treat each entity as a separate entity. A more complex structure can be extremely tax effective, however, if it is not run properly, or one mistake is made, significant extra tax can be payable.</p> |

