BRIEFINGS

WATERHOUSE
CHARTERED ACCOUNTANTS

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Why Changing Your Business Structure Just Got Easier

New rules that apply from 1 July 2016 mean that small businesses can restructure their business operations without triggering adverse tax implications.

Before the introduction of the new restructuring rules, if a business restructured from, say, a partnership to a trust there was a possibility that the change in structure could trigger capital gains tax (CGT). That is, the tax law would treat the restructure the same way as a sale and the owners could be liable for CGT on their share of any gain based on the current market value of the assets being moved into the new structure.

While the existing CGT provisions already contain a number of rollovers that can be utilised for business restructures, they generally only provide relief when assets are transferred to a company. Other concessions can potentially apply in a broad range of situations, but will not necessarily provide complete tax relief. This new form of rollover relief can provide complete income tax relief when assets are transferred to a sole trader, partnership or trust if certain conditions can be met.

The conditions for accessing these new rules are fairly strict. Broadly, the key conditions are:

- The transaction is a genuine restructure of an ongoing business so the concessions cannot be used for winding down or selling a business.
- Each of the parties to the transaction is a small business entity (revenue under $2m) or is related to a small business entity in the year the transaction occurs. The turnover test is subject to some grouping rules.
- The business owners (the people who have ultimate economic ownership of the assets) and their share in those assets does not materially change.
- The asset being transferred is currently being used in a business carried on by the current owner or certain related parties.
- Both the original entity and the entity the business is being transferred into need to be Australian residents.
- The parties involved in the transaction must choose jointly to apply the rollover.
- None of the entities involved in the transaction are a superannuation fund or exempt entity.

For many small business owners, the business structure they start with is not always the best structure over time. There are a lot of reasons why a business owner might need to restructure:

- **Risk and asset protection** - separating assets from business activities will generally help protect the assets. Companies and trust structures offer greater protection then operating as a sole trader or partnership of individuals.
- **Tax** - your business structure determines the tax rate you pay and how it is paid. In addition, some structures offer greater tax concessions throughout the life of the business (e.g. for research and development activities) or on the sale of assets.
- **Compliance** - some structures are more expensive to maintain and administer than others and provide less flexibility for succession, sale and the introduction of investors.

If you are looking at changing your business structure, there are a few overarching principles you should think about:

1. **Keep it simple** – your structure should be as simple as possible and each entity should have a clear reason to exist. The more complex your structure the more expensive it becomes and the more likely that the Tax Office will start querying whether the entity exists for commercial or tax reasons. If reducing tax is the primary reason for structuring something in a particular way then the Tax Office can seek to remove the tax benefits the structure might provide.

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2. **Think of the future** - your structure should facilitate future growth and should allow for flexibility.
3. **Start with the end in mind** - you should be aware of your exit strategies from the business. Your structure can make a difference to how you are taxed and what concessions you can access when you eventually exit.
4. **The commercial considerations** – different structures have different implications for how you run and manage your business. You need to be clear about the commercial reasons for adopting one structure over another.
5. **Separate business activities from valuable assets** - where possible, ensure that valuable passive, business or private assets are not subject to the risks associated with your business activities.
6. **Protect retained profits** – in some groups the use of a dormant holding company can help protect retained profits that have been generated by trading entities. The holding company can then operate as the banker for the group of entities, lending funds to operating entities as required (security could be taken over assets of the operating entity).
7. **Separate risk between individuals** - within a family group, consider providing some additional asset protection by ensuring that only one spouse is a director of an operating company.
8. **Corporate trustees for a trust** - the use of a corporate trustee is generally prudent to protect from the risk of being personally liable for the debts of the trust.

The Real Story Behind the Tax Reform Debate

With the Federal Budget on 3 May 2016 and an election later this year, tax and tax reform are on the national agenda … again.

The upcoming budget is likely to contain some of the anticipated structural reforms expected, but shy away from the populist policy decisions touted in the media such as the removal of negative gearing.

Much of the tax and tax reform debate in Australia is focussed on the position of various interest groups and how the national revenue 'pie' should be carved up. When it comes to tax, however, it is important to understand the foundations.

Australia has a working age population of 15.6 million. Of those, 81% paid income tax totalling just over $166 billion. 2.9% of all taxpayers are very high income earners earning over $180,000. This 2.9% contributed almost 30% of the total income tax collected. The largest income tax contribution comes from the 16.6% of taxpayers earning between $80,001 and $180,000. Around 2.6 million of our working age population pay no tax. Another 5.6 million pay on average $1,400. Looking at the statistics you can see how the tax debate can very easily skew. Any policy offering broad based income tax cuts, concessions or incentives is immediately going to benefit higher income earners because they pay more tax. Conversely, the 8.2 million Australians earning no or low incomes do not benefit from income tax cuts as they pay no or negligible amounts of tax. It is not a headline.

An example of how these statistics play out is the negative gearing debate. There is no question that negative gearing benefits high income earners because negative gearing only works as a strategy if you pay enough tax to offset the rental losses. Rental interest deductions claimed cost $21.4 billion in 2013-14. If you include other forms of rental deductions such as capital works deductions for rental properties this figure rises to $42.5 billion. To give some context to this figure, the total Defence budget for this same period was $25.3 billion. But negative gearing is not a concession; it is part of the broader tax system that allows deductions to be claimed against income producing assets and as such is not something that can be easily turned on or off simply for rental properties.

Similarly, superannuation concessions benefit those with the most income and wealth. As numerous Government reports have pointed out superannuation is an attractive savings and wealth management vehicle for middle and higher income earners because of the highly concessional tax treatment of contributions and earnings. The reason why very high superannuation balances in particular are targeted for change is because it is difficult to argue that the account balance is solely for retirement purposes as opposed to wealth management or estate planning purposes.

On the other side of the equation is the social welfare system; an essential part of any strong community. The latest statistics show that 27.5% of Australia's working age population are on some form of welfare – this has reduced from a peak of 31.4% in 2002. Of those on welfare, the age pension makes up 46%. You can see from this statistic the reason for some of the previous policy decisions to tighten assets tests and extend the access age to the pension.