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SHOULD I RESTRUCTURE MY BUSINESS ENTITY TO A COMPANY?

There is no shame or blame in needing to restructure your business entity.

It doesn't mean that someone has gotten it wrong, be that you, a former advisor or your current one. Your circumstances change, the ATO's view change, sometimes, though rarely these days, even tax laws change!

For a business entity there are many moving parts to what they do and how they do it, and these days, even who does it. As these things change, so will the need to reconsider your structure.

In our view, the most effective legal structure for a business is a company. That is, a company owned by a discretionary trust, or trusts if there are multiple unrelated shareholders.

That is not a controversial view, however it is likely a view borne out of experience gained over the last 10 to 15 years where other legal structures have, for various reasons, become less attractive as a vehicle from which to conduct a business.

Choosing the most appropriate structure(s) often requires the following competing factors to be taken into account:

- Risk issues;
- Growth and/or succession requirements; and
- Tax management.

Ordinarily when considering your choice of structure, all of the above factors will need to be considered. Importantly, you will need to ensure that the structure has the maximum flexibility to facilitate your changing requirements.

Why Restructure?

Once you have established your structure, it doesn't mean the job is done. You need to regularly review and consider your structure and whether it still works for you.

Regard still needs to be had to whether your current structure still achieves the following broad objectives:

1. Limiting the risk associated with the conduct of your activities;
2. Facilitate any potential change in ownership requirements; and
3. Take account of both the immediate and future taxation implications of the generation of your profits as well as the exit strategy from your business.

When considering your current state of the affairs, it is always worthwhile going back to these core objectives to question whether your current structure is still fit for purpose.

The Mechanics of Restructuring to a Company

Simply put, a restructure is effectively the sale or transfer of an asset/s (including a business) from an existing entity to a company.

Therefore, once the decision has been made to restructure into a company, the first step is to identify all of the assets that exist within the current structure and which of these assets will be moved to the corporate structure.

A decision will then need to be made on what specific mechanisms and concessions are going to be utilised on the sale or transfer of that asset to the company.

The first option is a straight sale of the assets to the company and utilising any CGT concessions available.

The second option is to utilise one of the various CGT rollovers available in legislation.

The benefit of the straight sale and utilisation of a CGT concession is that overall, the taxpayer will be paying the least amount of tax and will reset the CGT cost base of the transferred business assets to their current market value. Whereas the benefit of utilising a CGT rollover is that it will defer (but not reduce), the taxpayer's tax liability to the time an actual sale occurs.

Careful consideration of the facts will ultimately dictate what option is best for your individual circumstances.

If you would like to discuss this matter further, please contact Andrew Lowry or Leonard Tebbutt on 08 9444 9711.

SUBDIVISION AS SCALE STILL ON CAPITAL ACCOUNT

There is a large amount of case law that surrounds property subdivisions and whether they are on capital or revenue account.

Often the desire is to have the subdivision income assessed on capital account, as this could mean the 50% general CGT discount may be available, or could mean that sale proceeds of pre-CGT assets remain tax free.

Where the landowner is merely maximising the value of the realisation of a capital asset it is generally found that the subdivision income is on capital account.

Each case is determined on its own merits with consideration given to various factors, including but not limited to:

- How long the land has been held
- What was the primary use of the land before subdivision
- What was the intent of the landowner at the time the property was acquired
- How involved was the landowner in the subdivision
- Was the subdivision carried out in a businesslike manner

A recent decision by the Federal Court has provided some guidance in the capital vs revenue debate.

The case involved Morton, a retired farmer, who held pre-CGT land sold to him by his father, known as "Dave's block". Dave's block sat surrounded by other blocks of land held by various Morton family members and entities. Dave's block had been used for farming by his father, and then solely by Morton from 1996 until 2015.

In 2010 Dave's block was rezoned which resulted in higher rates and charges being levied on the block and Morton's decision that farming it would become unviable in the future. After approaches from and discussions with property developers Morton signed a development agreement in 2012. The same developer entered into agreements for the other family blocks.

The development of Dave's block was stage 15 of the developer's 31 stage development of the properties into 1,632 lots, which started in 2016. Dave's block was subdivided into 48 lots with sales starting in 2016.

The developer would finance the development, was responsible for all operations, marketing, setting sale prices and dealing with regulatory requirements. Upon the sale of each subdivided lots the developer would charge a development fee to Morton based on a percentage of sale proceeds.

Morton did have some contractual obligations, such as authorising the stage budget. The developer was also required to provide Morton with monthly progress reports, but it appears Morton never read them.

The ATO issued Morton with amended assessments to include $3,813,938 of assessable income in relation to the sale of subdivided lots. In court the ATO tried to argue that Morton carried out the development in a business-like manner or was undertaking a profit-making scheme, giving weight to the scale of the development.

The Federal Court found that Morton was not conducting the development in a business-like manner, was not involved in the decision and development activity of the development, and that all commercial risks lied with the developer. It was the developer acting in a business-like manner in its own capacity, not on Morton's behalf. Morton played an inactive role in the development.

In addition, Morton acquired the land for farming, used it as such and continued to do so well after the rezoning. The decision to sell the land was made as a result of the rezoning – a rezoning that Morton did not seek.

The court found that the fact the total development was of a massive scale did not mean that the development should be considered as being a business activity. The scale of the development was merely commensurate with the size of the blocks being developed.

As a result of the above the Federal Court found that the sales were on capital account and the amended assessments were reversed.

Where you are looking to develop long-held land it would be prudent to seek early advice. There are various pathways to subdivision and Morton's case has provided good guidance in how it may be treated on capital account.

If you would like to discuss this matter further, please contact Andrew Lowry or Leonard Tebbutt on 08 9444 9711.

DIVISION 296- WHAT DO WE DO NOW?

The proposed Division 296 legislation is part of the federal government's policy to reform the taxation of large superannuation accounts. It is scheduled to take effect on 1 July 2025, pending approval from the Labor-Greens-controlled Senate. The results of the election means that the introduction of this measure almost seems inevitable.

The Division 296 legislation is designed to impose an additional tax on individuals with superannuation balances exceeding $3 million. Here's how it will work:

- The tax will be calculated based on the proportionate earnings related to the amount of an individual's total superannuation balance (TSB) that exceeds $3 million on 30 June 2026. The first assessments will be issued in the 2026–27 income year.
- The calculation involves determining the 'superannuation earnings percentage' of the TSB above $3 million, which is then applied to the net movement in the adjusted TSB to arrive at the tax base, referred to as 'taxable superannuation earnings'.

The steps to calculate the tax include:

1. Calculate the percentage of your total superannuation balance above $3 million at the end of the financial year.
2. Multiply this by the earnings in your super, which are calculated differently from other existing taxes.
3. Multiply this by 15% (the Division 296 tax rate). The ATO will calculate this tax automatically and issue a tax bill to individuals to pay.

For example, if your total superannuation balance is $4 million, the amount above $3 million is $1 million. If the earnings on your superannuation balance are $100,000, the taxable earnings would be calculated as follows:

1. Percentage of balance above $3 million: $1 million / $4 million = 25%
2. Earnings on superannuation balance: $100,000
3. Taxable earnings: 25% of $100,000 = $25,000
4. Division 296 tax: 15% of $25,000 = $3,750

The member of the superannuation fund would receive the notice to pay this amount and could elect to pay it personally or release funds from superannuation to pay it.

The difficulty with this tax is that the calculation does not look at real earnings rather it simply focusses on the movement in an individual's superannuation account and deems this movement as earnings, thus creating a tax on unrealised growth within a members superannuation balance. It would therefore be correct to class this as a tax on the member rather than a tax on superannuation itself especially as the liability is created in the name of the member.

This measure has received much criticism from various industry bodies due to the nature of the way the tax is levied however, with the government winning a second term with a larger majority the passage of the law in its current form seems a lot more certain. So how can you plan to deal with this without simply resorting to withdrawing funds out of superannuation prior to the start date of the legislation? In many cases, depending on your situation, withdrawing funds from superannuation may not be the best course of action and work should be done together with ourselves as your trusted tax advisor and your licensed financial adviser to ensure that a holistic solution is applied.

There are strategies all fund members should consider from 1 July 2025 when the measure is slated to commence.

1. <u>Recognise all liabilities of the Superannuation Fund</u>

The measure will apply from 1 July 2025 and so will take the member's superannuation balance at 30 June 2025 and track this against their balance at 30 June 2026 (adjusted for contributions and withdrawals). Many SMSFs only recognise the tax payable at 30 June each year on the balance sheet, noting that the net assets representing the members balance at the end of the year. Many SMSFs don't account for deferred tax on investments.

Deferred tax is recognised by calculating the temporary differences between the carrying amount and the tax base of assets and liabilities. For superannuation funds, this often involves investments that have appreciated in value but have not yet been sold. The deferred tax liability is recorded in the financial statements and represents the future tax payable when the asset is eventually sold.

Recognising this liability in the 2026 financial year will therefore reduce the fund's net assets and therefore reduce or even eliminate a member's 2026 exposure to the Division 296 tax.

For example, a member has a balance of $5 million at 30 June 2025. If the fund trustee determined that from 1 July 2025 they would now recognise deferred tax, and the fund value at 30 June 2026 was $5.5 million of which $4.4 million was unrealised growth in fund investments, then the fund would recognise a deferred tax liability of $440k in 2026. The fund's net asset value would now be $5.06 million rather than $5.5 million. The earnings for the fund would now be $60k instead of $500k thus substantially reducing the impost of the measure in the first year.

This measure does not apply unless the member's balance is $3m at the start of the year. Therefore the recognition of deferred tax liabilities in the 2025 year may bring a member balance under $3m and eliminate exposure to the Division 206 tax in the 2026 year.

2. <u>Look at investment mix</u>

This measure will effectively tax the unrealised growth within a superannuation environment, where this would not occur outside the superannuation environment. The superannuation fund itself would still continue to receive concessional tax treatment on real cash earnings, and under this new measure the member would be taxed on notional and cash earnings. The total of the two taxes combined need to be factored into determining where assets are to be held and whether assets should be removed from the superannuation environment. In many cases the overall tax payable utilising a superannuation fund is still substantially lower than utilising another structure.

If, for example, we look at the first calculated example above to calculate the tax we can see that the member will pay $3,750 for the $100k in "earnings" for the period. If these earnings were all notional (ie unrealised growth) then this is $3,750 more in tax than would have been paid in any other structure. If however the earnings were in fact net cash from a term deposit then the $3,750 plus the $15k income tax the fund pays (15% of $100k) would total $18,750, or 18.75% of the income. This is still less than the 30% rate that could be utilised in the next most tax effective structure being a corporate rate, and would be less that the rate for an individual already earning significant other income.

It is therefore critical that a holistic analysis is done with ourselves as your trusted tax advisor and your financial adviser considering your whole portfolio to determine whether a change in investment mix such that yield generating assets are held within the fund v growth related assets now held outside the fund.

The introduction of this measure therefore means that you need to be more vigilant and holistic in how you plan your affairs and to work with us as your trusted tax advisers and closely with other advisers, specifically financial advisers, to deliver strategies that best suit you given the way this new measure singles out growth in superannuation assets.

If you would like to discuss these matters further, please contact Andrew Lowry or Leonard Tebbutt on 08 9444 9711.
