COOPER GRACE WARD
LAWYERS

Related Party Loan Structuring for Asset Protection

Presentation to Television Education Network

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1. INTRODUCTION

1.1 In most closely held groups there will be amounts owing between entities within the group or to and from family members.

1.2 It is important that the client's structure is regularly reviewed to identify loans that may be at risk from the perspective of:

(a) asset protection; and

(b) estate planning.

1.3 It will be important to ensure that:

(a) any loans to 'at risk' entities are appropriately protected, for example by securing the obligations to pay the loan against the assets of the entity; and

(b) ensuring that assets (including loans) do not build up in the entities and individuals that are at risk.

1.4 This paper will outline a number of strategies to protect loans from claims from an asset protection and estate planning perspective.

1.5 Where asset protection strategies are implemented, the potential application of the Bankruptcy Act (in particular sections 120 and 121 and possible defences to a claim by a trustee in bankruptcy) and the requirements of the PPSA legislation (in relation to perfecting security interests) must be considered.

1.6 Overview of bankruptcy "clawback" provisions in the *Bankruptcy Act 1966*.

The major provisions are sections 120 and 121.

(a) Section 120

Section 120 allows a trustee in bankruptcy to overturn transfers of property at less than market value (undervalued transactions) by a person who subsequently becomes bankrupt where the transaction occurs up to five years prior to the bankruptcy, subject to some exemptions.

One of the exceptions relates to transfers to a related entity where the transfer took place more than four years before the commencement of the bankruptcy provided that the transferee proves that at the time of the transfer, the transferor was solvent.

(b) Section 121

(i) Section 121 applies if:

(A) property is transferred by a person who becomes bankrupt;

(B) the property would probably have formed part of the transferor's estate or would probably have been available to creditors if the property had not been transferred; and

(C) the transferor's **main purpose** was to prevent the property becoming divisible among creditors or to defeat or delay the process of making property available to creditors.

(ii) Section 121(2) provides that the 'main purpose' requirement will be satisfied if it can be reasonably inferred from all of the circumstances that, at the time of the transfer, the transferor was, or was about to become, insolvent.

However this is not the only way that the 'main purpose' requirement can be satisfied.

(iii) Section 121 is not subject to any time limits[1] (unlike section 120).

However, in practice, the longer the period between the transaction and date of bankruptcy the more difficult it may be for a trustee in bankruptcy to establish the requisite purpose, bearing in mind that it is the trustee in bankruptcy who has the onus of proof under section 121.

It might appear that section 121 would defeat any asset protection strategy that involves the transfer of funds or property to a related party if one of the motives of clients in implementing this strategy is to protect assets in the event of bankruptcy.

However, the trustee in bankruptcy has the onus of establishing that the main purpose of the transaction was to delay or defeat creditors. If the client's objectives involve a range of issues including tax and estate planning as well as asset protection and there is no particular or imminent financial risk it may be difficult for a trustee in bankruptcy to successfully discharge the onus of proof.

1.7 Overview of *Personal Properties Securities Act 2009* (PPSA)

(a) The PPSA commenced on 30 January 2012 and fundamentally changed how clients protect their interests in transactions relating to personal property.

(b) The PPSA applies to most types of property (both tangible and intangible) other than land and some rights declared by law not to be personal property.

Basically, the PPSA will apply to any type of property other than land, fixtures, water rights or rights, entitlements or authorities granted by a Commonwealth, State or Territory law.

(c) The concept of a 'security interest' is central to the PPSA.

(i) Basically there are two types of security interest. The first is an 'in substance' security interest. It is an interest in relation to personal property arising from a transaction that, in substance, secures the payment or performance of an obligation.

(ii) The second is a 'deemed security interest'. The most common of these types of security interest is a PPSA lease. It is a lease or bailment of goods for a term of more than one year or for an indefinite term.

(iii) The legislation uses the concept of perfection of a security interest in order to rank an entity's interest in the property underlying a transaction against other interests in the property. The most common way of perfecting a security interest is by way of registration on the PPSA register.

(iv) Examples of security interests arising under common transactions include:

(A) a provision in standard terms of trade whereby the client retains ownership of the property until the property is paid in full by the customer;

(B) any hire purchase agreement;

[1] Section 127(4)

(C) a lease/hire of property;

(D) a consignment of goods;

(E) bailment of goods;

(F) a charge over all present and after acquired property to secure a loan or debt (this is generally done through a general security agreement).

(d) How to protect a ‘security interest’?

(i) Clients will need to ‘perfect’ their interest in the property in order to protect their interest otherwise they may lose the property if the other party to the transaction becomes insolvent.

The PPSA ignores the concept of ownership of property.

(ii) Perfecting under the PPSA involves registration, taking possession of the property or control of the property. For most businesses and in most transactions, the relevant act of perfection will be to register on the Personal Property Securities Register (PPRS). This is an online register.

(iii) To obtain the protection from registration of a security interest, there are timeframes within which registration must occur. These include:

(A) for goods that are inventory of the entity giving the security interest **- registration must occur prior to delivery of** possession of the goods;

(B) for goods that are not inventory – registration must occur within 15 business days of the giving of possession;

(C) in the case of all other goods – registration must occur within 20 business days of the creation of the security interest.

This means that in relation to entering into a general security agreement relating to a loan, the client will have 20 business days to register its security interest on the PPSR from the date of the general security agreement.

(iv) Once ‘perfected’ the interest in the property will be enforceable against both the entity and any creditors of the entity.

(v) However, it does not automatically mean that the client’s interest in the property will defeat another interest. The PPSA works on a priority ranking system under which the party with the highest ranking security interest will defeat a lower ranking security interest.

The type of transaction will determine the ranking of a security interest. For example, if a financier provides an entity with the funds to acquire an asset, then provided that the financier registers their interest in that asset on the Register correctly, they will enjoy the benefit of a super priority that will defeat other parties including earlier security interests in the property. This type of interest is known as a ‘purchase money security interest’ or a ‘PMSI’.

2. USE OF ENTITIES TO PROTECT RETAINED PROFITS

2.1 Holding Company

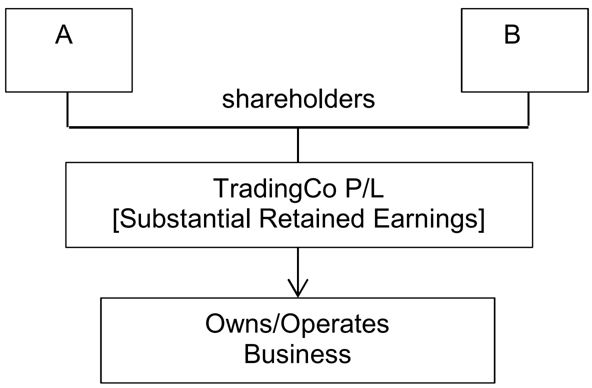
A common problem where clients operate their business through a company is that they build up significant assets in the entity that carries on the business, which means the retained earnings and assets will be continually exposed to that business risk.

There are a number of strategies that can be used to address this problem.

(a) A common strategy is to interpose a holding company between the existing shareholders and the operating company utilising the capital gains tax rollover relief available under subdivision 122-A, subdivision 122-B or subdivision 615-C of the 1997 Tax Act.

This strategy is illustrated in the following diagrams.

Before



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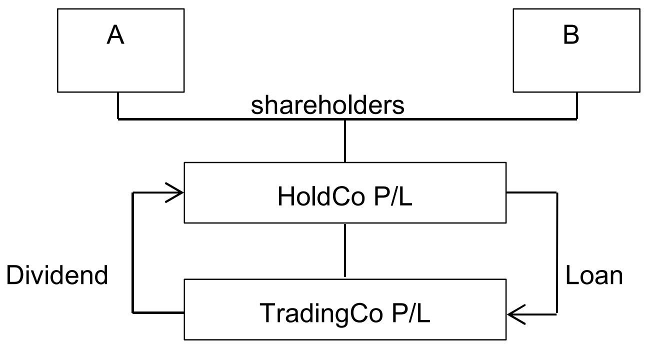

(b) The strategy of interposing HoldCo and declaring dividends from TradingCo to HoldCo provides asset protection benefits for the group as assets (including cash) can build up in HoldCo and then HoldCo can lend funds back to TradingCo or to members in the group.

It will be important that HoldCo enters into a loan facility and general security agreement with TradingCo whereby HoldCo takes security over all of the assets of TradingCo to secure the obligations under the terms of the loan facility.

To perfect its security interest, HoldCo must register its security interest on the Personal Property Security Register within 20 business days of signing the general security agreement.

If an external financier has a prior security interest registered over the assets of TradingCo, HoldCo and the external financier may need to enter into a deed of priority prior to HoldCo registering its interest.

2.2 Issues with HoldCo

(a) Interposing HoldCo may however result in significant adverse consequences for clients who would otherwise be able to access the small business CGT concessions.

(b) If the structure in the second diagram is adopted each of A and B would be able to claim the small business CGT concessions if they sell the shares in HoldCo provided that at least 80% of the market value of HoldCo's assets are 'active assets'[2].

(c) There is a potential problem if the loans that HoldCo makes back to TradingCo or to other entities exceed 20% of the market value of all assets in HoldCo. The only assets that HoldCo may actually have may be its shares in TradingCo and the loans advanced to TradingCo and other entities. Therefore over time it would be relatively easy for this 20% threshold to be tripped.

(d) The issue if that occurs is whether those loans will be 'active assets' and this could be problematical. The loans from HoldCo to TradingCo will be 'financial instruments'. In order for these to qualify as active assets it is necessary that they are 'inherently connected with a business' carried on by HoldCo[3].

(e) There are arguments that HoldCo is carrying on a business and that loans made by HoldCo to TradingCo (being its subsidiary) will be assets inherently connected with that business and therefore active assets.

(i) In *American Leaf Blending Co Sdn Bhd v Director-General of Inland Revenue*[4], Lord Diplock stated that:

> in the case of a company incorporated for the purpose of making profits for its shareholders any gainful use to which it puts any of assets prima facie amounts to the carrying on of a business…. The carrying on of 'business' no doubt, usually calls for some activity on the part of whoever carries it on, though, depending on the nature of the business, the activity may be intermittent with long intervals of quiescence in between[5]

(ii) The ATO accepted in Taxation Ruling *TR 2002/*11 (about STS average turnover), that 'the use by a company of its assets to produce profits for its shareholders prima facie amounts to the carrying on a business by the company'.

(iii) A company can carry on the business of a holding company, even if the holding company is not involved in the active management[6].

(iv) In Private Binding Ruling Authorisation Number 80022, the ATO accepted that a loan was inherently connected with a business that a holding company carried on as it was lent by the parent to fund stock and debtors of the subsidiary company.

While these arguments support the contention that the loans from HoldCo to TradingCo will qualify as active assets there is still some degree of uncertainty about what approach the ATO would take in particular circumstances.

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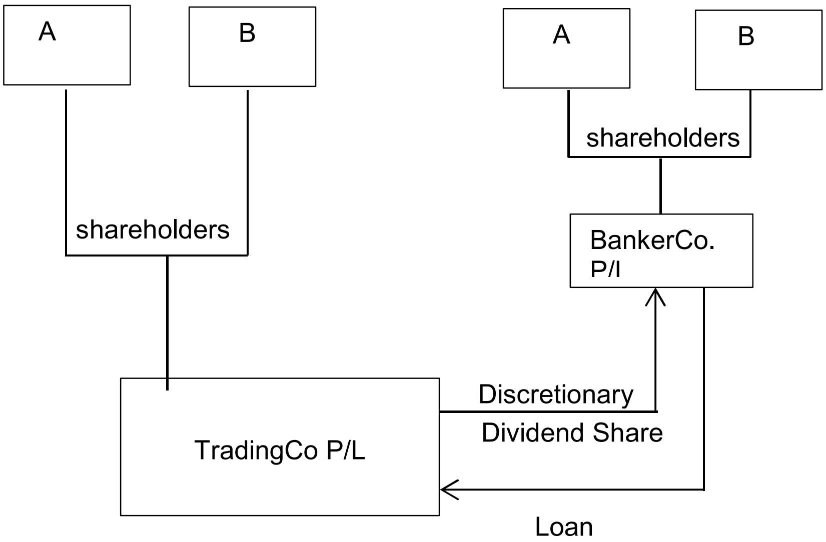
[2] Section 152-40(3) of the *Income Tax Assessment Act 1997* (Cth)
[3] Section 152-40(3)(b)(ii) of the *Income Tax Assessment Act 1997* (Cth)
[4] [1978] 3 All ER 1185
[5] Page 1188
[6] *Spassked Pty Limited v Commissioner of Taxation [*2003] FCAFC 282*, Federal Commissioner of Taxation v Total Holdings (Australia) Pty Ltd* [1979] FCA 30

(f) In any case, the loans to other entities will unlikely to be 'active assets'.

(g) We therefore generally recommend an alternative strategy that provides substantially the same asset protection advantages but removes this small business CGT risk, especially where loans are made to entities other than TradingCo. This alternative is to incorporate a separate company that acts as a 'banker' and for TradingCo to issue dividend access shares to BankerCo. This alternative structure is outlined in the following diagram.



(h) Under this alternative the retained profits of TradingCo are reduced and BankerCo (which has the same shareholders as TradingCo) becomes a creditor.

Like the HoldCo option, BankerCo can lend funds to TradingCo and other entities as a secured creditor.

(i) The issue of dividend access shares to BankerCo should not trigger any adverse value shifting or dividend stripping consequences.

(i) The value shifting rules will apply to arrangements that reduce the value of some shares and increase the value of others irrespective of whether there is a tax avoidance purpose.

(ii) If there is a value shift this may result in a deemed capital gain (or cost base reduction) in respect of existing shares held by the clients.

(iii) Although the value shifting rules will apply, it is unlikely that the issue of the discretionary dividend shares or declaration of dividends on those shares would have any consequences under the provisions, because of the application of the 'reversal rule' in section 725-90.

(iv) Some time ago we obtained a private ruling from the ATO in which they indicated that, the declaration of a dividend on discretionary dividend shares might trigger a value shift; but this would have no consequence under the value shifting rules because, once the dividend was actually paid, any value shift was reversed.

The edited version of this private ruling can be accessed on the ATO register of private binding rulings. The authorisation number is 66948.

(j) If ordinary or dividend access shares are issued to a new holding company or banker company for the group, TradingCo should not pay dividends on those shares within 45 days of the issue date (or 90 days if the shares are redeemable preference shares).

If dividends are paid within the relevant holding period, the recipient may not get the benefit of the franking credits attaching to those dividends because this payment will breach the 'holding period' requirements that must be satisfied in order for a shareholder to claim franking credits on shares.

These holding period provisions were contained in former sections 160 APHC to 160 APHU of the *1936 Tax Act*. The provisions were repealed when the dividend imputation measures were moved to Part 3–6 of the *1997 Tax Act.*

While new holding rule provisions have not yet been legislated, the government announced at the time that legislation would be inserted into the *1997 Tax Act* to confirm the holding rule requirements and that this legislation will have effect from 1 July 2002[7].

2.3 What happens if the shares in TradingCo are to be sold to a third party?

(a) It will be easier to satisfy the 80% test, as all (if not the majority) of assets in TradingCo should be active assets.

(b) The shareholders will keep BankerCo Pty Ltd which means that they do not have to deal with any retained profits before the sale of the shares.

(c) Before the shareholders sell their shares in TradingCo, the dividend access share should be dealt with.

(i) The benefit of having a redeemable preference share is that the company does not have to go through the share-buy provisions in the Corporations Act (which require ASIC to have a two week notice period before the buy-back can occur).

(ii) Also, although TD 2006/77 provides that for the purpose of determining whether an individual is a significant individual or CGT concession stakeholder you ignore redeemable preference shares, we would recommend that the shares are redeemed prior to the sale of the shares.

2.4 Ownership of BankerCo

(a) BankerCo could be owned by the same shareholders of TradingCo or by a trust controlled by the shareholders.

(b) If the shares in BankerCo are owned by the same shareholders as TradingCo, there should be minimal risk that the ATO would attempt to attack this arrangement as:

(i) there are commercial reasons for wanting to warehouse profits in a separate entity to the operating entity which can easily be carved off; and

(ii) the shareholders of BankerCo are the same as the shareholders of the operating company (which is similar to that which would have been achieved by applying the Division 615-C roll-over).

However, this means that there would still be exposure for them in relation to any dividends paid to the existing shareholders. If the shareholders receive dividends they could gift these amounts to trusts, however this may leave them exposed to sections 120 and 121 of the Bankruptcy Act.

[7] Treasurer's press release No. 53, 13 May 2008

(c) If BankerCo is owned by a trust, there will also be an added level of asset protection for the individuals.

(i) However, there is a real risk that the ATO may attempt to attack the BankerCo strategy due to their perceived misconception that the only reason discretionary dividend shares are issued is to enable taxpayers to obtain a tax benefit.

(ii) To obtain a greater level of asset protection for the individual but with a much reduced risk that the ATO could attempt to attack the strategy, BankerCo could be owned by a trust, but a clause could be inserted into the deed for the trust (which could not be varied) that has the following effect:

Any dividends received by the trust from TradingCo are to be either accumulated by the trustee or paid to individuals who are in the highest marginal tax bracket.

(iii) There are further asset protection benefits to accumulating the income.

As there will not be any beneficiaries entitled to the income, the trustee will pay tax at the top marginal tax rate (assume 46.5%).

The benefit of accumulating the income is that, the income does not flow out to individuals but remains protected in the trust. The trustee can then make capital distributions of the 'taxed income' in later years. As this has already been taxed in the hands of the trustee, it will not be taxed again in the hands of the beneficiaries.

3. TRUSTS

3.1 Trustee holds passive assets (low risk entity)

(a) Clients who have built up assets in a discretionary trust as part of their asset protection strategy should ensure that they are not owed any material amounts by the trustee as these amounts will be assets that will vest in a trustee in bankruptcy.

(b) This means that any capital contributed to the trust should be injected as a gift and not a loan if the clients are concerned about asset protection.

The trustee could pay an interim capital distribution or make a loan if the individuals require funds.

(c) If for some reason, it is necessary for funds to be injected into the trust as a loan, then the loan should preferably be made by a family member who is not "at risk".

(d) There should also be regular checks to ensure that there are no unpaid present entitlements (UPEs) that have built as these are also amounts that will be assets that will vest in a trustee in bankruptcy.

The trustee should pay these amounts to the beneficiary and then the beneficiary could 'gift' the amount back to the trust.

(e) If all beneficiaries are in the highest marginal tax rates, the trustee may resolve to accumulate the income in the trust rather than it being distributed.

This will result in the income becoming part of the trust capital rather than an asset of the beneficiary.

The 'after tax' consequences for the clients are the same and, if beneficiaries do need to access the cash, it can then be advanced to them so that the trust is a creditor of the 'at risk' person, not the reverse.

3.2 Trustee operates a business

(a) Where the assets of the trust are at risk, amounts owing to and from the trust by related parties should be regularly monitored.

(b) In relation to the amounts owing by related parties and amounts owed to related parties the following should be considered.

(i) A receiver can call for payment of the amounts owing to the trust, whereas the amount owing to related parties may be unsecured.

Therefore loans should be made under secured loan arrangements.

(ii) If the trust does not have sufficient funds to pay the amounts owing to related parties, it could make a payment of the loans by assigning the amounts that are owed to it by related parties.

For example, if the trust is owed $300,000 by the husband but the trust owes $400,000 to the wife, the trust could pay the wife $300,000 of the total amount to the wife by way of assigning the amount owed to it by the husband.

This would result in the following:

(A) Trust would not be owed any amount by the husband (therefore it does not have an amount owing to it that could be called on).

(B) Trust owes wife $100,000 (which the wife may choose to secure against the assets of the trust).

(C) Husband would then owe wife $300,000.

(iii) Related parties should consider taking security over the assets of the trust for amounts owing to them, otherwise they will be an unsecured creditor.

As a UPE is an obligation by the trustee to pay an amount to a beneficiary, there should be no reason why the UPE could not be secured. However, as there is contrary views as to whether or not a UPE can be secured, it may be prudent to convert the UPE to a loan under a secured loan arrangement.

(iv) Cash should be paid out to reduce amounts owing to related parties and lent back under secured loan arrangements as the funds are required by the trust.

(c) Clients who have allowed significant assets to build up in a trading discretionary trust may be able to make interim capital distributions to beneficiaries who are not in a high risk category to reduce its exposure.

(i) Distributions of capital from a discretionary trust will not generally be subject to tax under Division 6 on the 1936 Tax Act[8] nor will they trigger any immediate capital gains implications. Although there may be some capital gain implications under the streaming provisions when the trust does incur a capital gain.

(ii) There are potential problems if an interim distribution of capital is made to a beneficiary where the trustee has previously distributed income to a corporate beneficiary and those income distributions have not been paid in cash because of the potential application of subdivision EA of Division 7 of the 1936 Tax Act.

[8] ss99B and 99C – 1936 Tax Act

If contemplating this strategy it will be important to confirm that the trust deed for the client's trust allows the trustee to make a distribution of capital from a revaluation reserve.

(iii) Under this strategy, the trustee can make an interim distribution to the low risk beneficiary who could then lend the amount back to the trust (and take security) as a further measure of asset protection.

4. GIFT AND LOAN BACKS

4.1 A strategy sometimes recommended to clients who own valuable assets in their own name and who have asset protection issues is to:

(a) gift the equity in those assets to a related trust;

(b) have the trust lend back an amount equivalent to the gift; and

(c) secure that loan (by way of a mortgage of land or on the PPSR) to protect the asset against claims by future creditors.

4.2 Clients who employ this or similar strategies might have difficulties in contesting a claim by a trustee in bankruptcy under section 121 if there is no other apparent reason for the gift and loan back transaction. However, the strategy may be quite useful for clients who have valuable assets in their own name who want to transfer the value in those assets to a related trust so as to effectively remove the assets from their estate (and therefore from the risk of a challenge to their Will).

An example of how this strategy could be employed is as follows.

(a) Assume that a client owns all of the shares in a company with substantial assets and which operates a business. The client wants to leave those shares to a particular beneficiary who has been actively involved in the business but is concerned that a gift of the shares under the Will might be challenged by other beneficiaries.

(b) In those circumstances the client could borrow funds from the bank approximately equal to the value of their shares and gift the amount of that loan to a related trust ("Newtrust").

(c) Newtrust could then lend the funds back to the client, which would allow them to repay the bank loan.

(d) Newtrust takes security over the shares and registers its security interest on the PPSR.

(e) If the client dies while the loan is still in place, the shares may form part of the estate but there will be substantially less risk of a challenge to the Will if the shares are left to the designated beneficiary subject to them assuming liability for the debt owed to Newtrust.

(f) In addition to leaving the shares to the designated beneficiary, the client should make sure that the designated beneficiary acquired full control of Newtrust on their death. That is, the designated beneficiary becomes the appointor of the trust on the death of the client.

4.3 Important

Under the New South Wales succession legislation, the court can overturn asset transfers within the three years prior to death.

There is no similar legislation in the other jurisdictions at this stage, however there is always a risk that the Governments in other States could introduce a similar clawback provision. Therefore it may be prudent for clients considering a strategy along these lines to move sooner rather than later.

5. GIFTING LOANS TO TRUSTS

5.1 Clients sometimes look to transfer assets to their children (or entities controlled by their children) during their lifetime rather than leave the assets to them under their Will.

5.2 If this is to occur, the following issues should be considered:

(a) Are the children (or their entities) to pay for the assets or are they to be 'gifted'?

(b) If the children are to pay for the assets and a loan is created between the clients and the children:

(i) What are the terms of the loan repayments?

(ii) On the death of the clients, what happens to the loan?

5.3 Examples of strategies we have implemented for clients are as follows:

(a) Where the client wants the ability to call on the loan during their lifetime, but do not want the loan to form part of the estate:

(i) The client assigns the loan (by way of gift) to a new trust (Loan Trust).

(ii) Clients control the trustee and are the appointors of the Loan Trust, but on their death, the child becomes the appointor.

(iii) The Loan Trust could take security of the asset transfers to secure the obligation to repay the loan.

(b) Where the clients want the loan to form part of the estate.

(i) The clients enter into a loan agreement with the child's entity and take security of the assets of the entity.

(ii) Careful consideration is required in relation to the repayment terms.

For example, on the death of the clients, should the outstanding balance become payable immediately (which may cause cashflow issues) or is it to be paid over a particular period commencing on the death of the clients.

6. CASE STUDY ONE: PROTECTING RETAINED PROFITS

Background facts

6.1 The Braveheart Group is made up of the following entities:

(a) Braveheart Pty Ltd, which:

(i) is the main operating entity and has retained profits of approximately $30 million the majority of which is tied up in working capital;

(ii) is owned equally by two individuals, Tom and Jack;

(b) Braveheart Equipment Pty Ltd, which:

(i) owns equipment worth approximately $20 million that is used by Braveheart;

(ii) is owned equally by two family trusts (controlled respectively by Tom and Jack).

6.2 The following risks associated with the activities of the Braveheart Group have been identified:

(a) Braveheart may be vulnerable to claims of breach of contract, particularly due to the size of both its contracts and customers.

(b) Claims from employees including, workplace health and safety issues.

Directors can be held personally liable if Braveheart is found to be in breach of workplace health and safety requirements.

(c) A substantial portion of Braveheart's working capital is tied up in trade debtors.

(d) There are substantial loans owing by the shareholder's entities to Braveheart.

This means that the assets of Braveheart and the personal assets of the individuals (including shares in Braveheart) will be vulnerable to the risks identified above.

Recommendations

6.3 Retained Profits

(a) A substantial portion of the retained profits of Braveheart should be paid out as dividends.

There is approximately $30 million in retained profits that are exposed to the business risk associated with Braveheart's operations.

(i) Also, the directors may be exposed personally to negligence claims, workplace health and safety breaches and creditors where they have provided personal guarantees.

(ii) This means that Tom's and Jack's shares in Braveheart together with any personal assets are at risk.

(b) There are commercial and risk issues with paying out the dividends to the existing shareholders.

(i) Braveheart requires working capital to continue its activities.

(ii) Tom and Jack own their shares personally.

This means that there would still be exposure for them in relation to any dividends paid to the existing shareholders.

Tom and Jack could gift any amounts received to trusts, however this may leave them exposed to sections 120 and 121 of the Bankruptcy Act.

(c) There are two main strategies that can be used to pay out the retained profits of Braveheart to overcome the above issues.

(i) Interpose a holding company between the existing shareholders and Braveheart.

(ii) Issue a dividend access share to a company that is owned by entities controlled by the existing shareholders.

(d) Interposing a holding company

(i) Under this option, all of the shareholders of Braveheart would transfer their shares to Holdco.

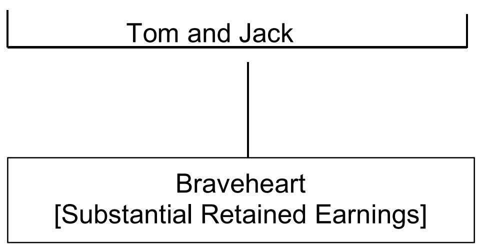
(ii) Each of the shareholders would incur a capital gain on the transfer of their shares (at market value). However, they can choose to disregard the capital gain under subdivision 615-C of the 1997 Tax Act provided that each of the shareholders receive non-redeemable shares in Holdco in the same proportion and with the same value and rights as the shares they held in Braveheart.

(b) Each of the shareholders will have a cost base for the Holdco shares equal to the cost base of their Braveheart shares and will be taken to have acquired the Holdco shares when they had acquired their Braveheart shares for the purpose of the general 50% discount under Division 115.

(c) Holdco will be taken to have a cost base for its Braveheart shares equal to the total cost base of Braveheart's assets less any liabilities in respect of those assets.

This strategy is illustrated in the following diagrams

Before



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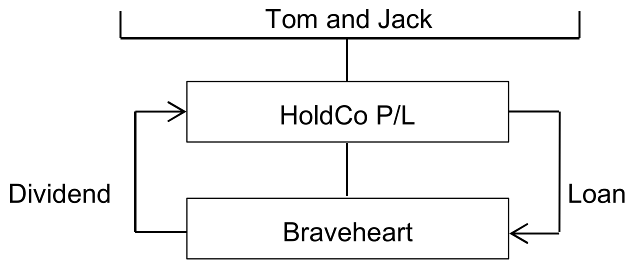
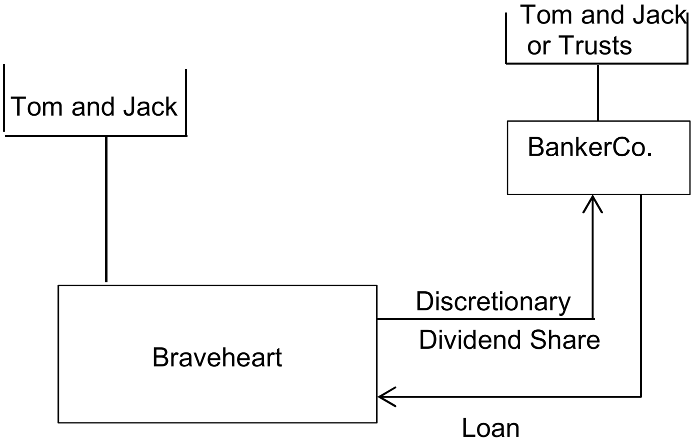


(e) While the strategy of interposing HoldCo and declaring dividends from Braveheart to HoldCo that lends the funds back to Braveheart (under a secured loan agreement) may provide asset protection benefits against the exposure to Braveheart, this strategy does not provide protection against the personal risks that Tom and Jack are exposed to. This is because Tom and Jack will continue to hold shares in HoldCo (which will be building up value).

(f) Banker Company option

An alternative is to incorporate a separate company that holds a redeemable share in Braveheart and acts as a 'banker' for the entities in the Braveheart Group. This alternative structure is outlined in the following diagram.



(i) Under this alternative Braveheart would issue a redeemable preference share to BankerCo. The share would be redeemable at the option of the company and only have dividend rights.

(ii) The retained profits of Braveheart would then be paid to BankerCo, which means that its profits would be accumulated outside of the operating entity.

(iii) BankerCo could lend funds back to Braveheart as they are needed to fund working capital. The terms of the loan should be included in a written loan agreement between BankerCo and Braveheart. Also, before lending the funds, BankerCo should register a general security interest under the PPSA legislation so that it is a secured creditor.

Before paying any dividends, Braveheart will need to check with any external financier to ensure that this will not result in a breach of any covenants relating to the payment of dividends. Also, there will need to be discussions with external financiers before a security interest is registered over Braveheart's assets as the financier will most likely require BankerCo to enter into a deed of priority with it under which the financier has first right over the assets.

(iv) BankerCo could also lend funds to other entities within the Braveheart Group. For example, to Braveheart Equipment to purchase additional equipment. Again any loans should be covered by a written loan agreement and security should be taken over the assets of the borrowing entity and registered on the PPSR.

(v) If BankerCo lends to an entity that is not a company, then there may be adverse Division 7A implications.

(vi) Any excess cash in BankerCo could be paid out to the shareholders as dividends.

(g) Ownership of BankerCo

(i) BankerCo could be owned by two trusts, which would be controlled by Tom and Jack respectively.

This means that profits can be built up outside of Braveheart in an entity that is not owned by the individuals.

This means that Tom's and Jack's exposure is reduced.

(ii) An alternative could be to have the same shareholding in BankerCo as is currently the shareholding in Braveheart.

However, this does not achieve the objective of reducing Tom's and Jack's exposure as they will have ownership interests in BankerCo.

As outlined above, to obtain a level of asset protection, BankerCo would need to pay out all of its dividends to Tom and Jack who would then need to 'gift' the amounts that they receive to trusts in order to get the funds out of their own names.

The concern with this alternative is that the funds have flowed outside the Braveheart Group rather than being retained by BankerCo to fund working capital of Braveheart and other members of the group.

Also, there is a real risk that if Tom and Jack 'gift' amounts to trusts to defeat creditors, a trustee in bankruptcy may claw back the transaction under the Bankruptcy Act.

(iii) If, however the shares in BankerCo are held by trusts, the trustees could exercise its discretion to accumulate the dividend income rather than distribute it to beneficiaries.

As there will not be any beneficiaries entitled to the income, the trustee will pay tax at the top marginal tax rate (assume 46.5%). However, this is likely to be the same rate as the individual beneficiaries in any case.

The benefit of accumulating the income is that, the income does not flow out to individuals but remains protected in the trust. The trustee can then make capital distributions of the 'taxed income' in later years. As this has already been taxed in the hands of the trustee, it will not be taxed again in the hands of the beneficiaries.

(iv) Part IVA risk

There is a real risk that the ATO may attempt to attack the BankerCo strategy due to their perceived misconception that the only reason discretionary dividend shares are issued is to enable taxpayers to obtain a tax benefit.

To achieve the commercial objective with a much reduced risk that the ATO could attempt to attack the strategy, a term of the trust deed (which could not be varied) could be inserted which has the following effect:

> Any dividends received by the trusts from Braveheart are to be either accumulated by the trustee or paid to individuals who are in the highest marginal tax bracket.

(h) What happens if the shares in Braveheart are to be sold to a third party?

(i) The shareholders can keep BankerCo, which means that they do not have to deal with any retained profits before the sale of the shares.

(ii) Before the shareholders sell their shares in Braveheart, the dividend access share will need to be dealt with.

The benefit of having a redeemable preference share is that Braveheart may redeem the share rather than comply with the share buy-back provisions in the Corporations Act (which require ASIC to have a two week notice period before the buy-back can occur).

(i) The issue of dividend access shares to BankerCo should not trigger any adverse value shifting or dividend stripping consequences.

(j) Passing on the benefit of franking credits

AS THE SHARE WILL BE A REDEEMABLE PREFERENCE SHARE, BRAVEHEART CANNOT PAY DIVIDENDS ON THE SHARES HELD BY BANKERCO WITHIN 90 DAYS OF BANKERCO BEING ISSUED THE SHARES.

IF DIVIDENDS ARE PAID WITHIN 90 DAYS (THE HOLDING PERIOD) BANKERCO WILL NOT GET THE BENEFIT OF THE FRANKING CREDITS ATTACHING TO THOSE DIVIDENDS BECAUSE THIS PAYMENT WILL BREACH THE ‘HOLDING PERIOD’ REQUIREMENTS THAT MUST BE SATISFIED IN ORDER FOR A SHAREHOLDER TO CLAIM FRANKING CREDITS ON SHARES.

6.4 Non business assets owned by Braveheart

Any assets that are not related to the business operations of Braveheart should be transferred or assigned out of Braveheart (subject to the transactional costs). For example:

(a) The loans owing to Braveheart by the director related entities can be assigned to BankerCo as part payment of the dividends. There will not be any duty or tax implications in relation to the assignments.

(b) The funds in bank accounts should be paid out to BankerCo and re-lent (under a loan that is secured against the assets of Braveheart) as funds are required.

7. CASE STUDY TWO: GIFT AND LOAN BACK

Background Facts

7.1 Steven has:

(a) three children – Jenny, Johnny and Sally; and

(b) a spouse, Julie, who is considerably younger than him.

7.2 Steven's assets consist of 42% of the shareholding in a company that operates a manufacturing business (ManCo).

(a) The other shares are owned by two other non-related entities.

(b) Under the terms of ManCo's shareholders' agreement, on the death of Steven, one of the other shareholders can acquire sufficient shares from Steven's estate to enable that shareholder to obtain 51% of the shareholding in the company.

(c) The shares in ManCo (ManCo Shares) that were acquired post-CGT have a cost base of $42 but are valued at approximately $4 million.

7.3 Steven's wishes are that the shares in ManCo are to go equally to Jenny and Johnny on his death.

No assets are to go to Sally or Julie.

Jenny and Johnny do not get on with either Sally or Julie.

Steven would not satisfy the small business CGT concessions.

Recommendation

7.4 We could establish two separate trusts to transfer the shares:

(a) Jenny's Trust (of which Steven is the appointor but on his death, Jenny becomes the appointor);

(b) Johnny's Trust (of which Steven is the appointor but on his death, Johnny becomes the appointor).

However, Steven will have a capital gain of $2 million if ManCo Shares are transferred to Jenny's Trust and Johnny's Trust.

Issue is that shares are exposed to an estate challenge.

7.5 Option:

(a) Steven borrows $4 million from the bank.

(b) Steven gifts an amount of $4 million to Steven's Trust (a new trust) of which Steven is the appointor, but Jenny and Johnny become the appointors on his death.

(c) Steven borrows the $4 million from Steven's Trust and repays the bank. Steven's Trust takes security over the ManCo Shares to secure Steven's obligation to repay the amount.

This may require consent of the shareholders of ManCo Shares as it is usually a term of a shareholders' agreement that a shareholder cannot use their shares as security.

(d) The ManCo Shares pass to Jenny and Johnny under the terms of Steven's Will.

If the Will is contested – Steven's Trust can call in the loan and therefore the estate will have a debt of $4 million.

One issue is that the value of the ManCo Shares will need to be monitored.

8. CASE STUDY THREE: GIFT OF LOAN TO A TRUST

Background Facts

8.1 Bob is transferring shares in a company that he owns in his own name to his two children's respective trusts (Lisa Trust and Simon Trust).

The shares transferred are worth $1 million ($500,000 to each trust).

8.2 Bob will vendor finance the purchase.

Bob wants the ability to call on these funds during his lifetime, but does not want the loans in his own name.

On the death of Bob, each child will control their respective loans.

Suggestion

8.3 Bob will be owed $500,000 by each of the trusts.

8.4 Bob will assign the amount owed to him by:

(a) Lisa Trust to a new trust by way of gift (Lisa Gift Trust); and

(b) Simon Trust to a new trust by way of gift (Simon Gift Trust).

8.5 Bob will be the 'appointor' of both Lisa Gift Trust and Simon Gift Trust, but on his death:

(a) Lisa will become the appointor of Lisa Gift Trust; and

(b) Simon will become the appointor of Simon Gift Trust.

8.6 The loan amounts will form part of the capital of each of the trusts but will not be in Bob's name.

9. CASE STUDY FOUR: LENDING TO AN ENTITY CONTROLLED BY A CHILD

Background Facts

9.1 Brian and Sarah are looking at transferring their shares in their company to their son, John.

9.2 The company owe Brian and Sarah $2 million.

9.3 Brian and Sarah have three other children.

9.4 What questions should be asked of Brian and Sarah and what suggestions should be made?

Suggestion

9.5 Questions:

(a) Do Brian and Sarah want to be repaid the $2 million?

If no, gift loan amount to a trust that John controls.

(b) If yes, then when both Brian and Sarah die, is it their expectation that the outstanding loan balance should be repaid?

(i) If yes, look at putting in place a written loan agreement that includes repayment terms.

For example, the outstanding balance will be repayable in equal monthly instalments over 5 years commencing at the end of the sixth month following the death of both Brian and Sarah.

(ii) If no, look at gifting the loan to a trust that Brian and Sarah control during their lifetime but control passes to John on the death of both of them.

(c) The lender should be taking security over the assets of the company.