Protecting assets without triggering tax liabilities

By John Ioannou, Hayden Bentley, Mark Lowis and Georgia MacGinley

Overview

Risk is a critical consideration for all modern business owners. In many ways, the level of risk associated with operating a successful and compliant business in Australia has never been higher – particularly if we consider the relative weakness of the underlying Australian economy, fledgling consumer confidence and the increasing complexity and regulation of the business environment.

It makes sense, therefore, that every individual appreciates how their involvement in business impacts their personal lives. While it may be possible to restructure one's affairs to reduce their overall exposure to risk, it is equally important to understand that there may be adverse tax implications that arise alongside any risk restructure.

The aim of this article is to provide insight into some of the planning options which may be available to address both concerns.

What is asset protection?

"Asset protection" is a general term for any planning carried out to reduce a potential creditor's ability to access assets or value.

This planning might involve:

1 isolating assets or value from risk (e.g. housing passive income-producing assets in separate structures to a business structure);

2 segregating multiple sources of risk, such that liability or exposure from one activity does not contaminate or put at risk assets in unrelated activities (e.g. carrying on separate businesses in separate structures); or

3 limiting the number and value of assets held by 'at risk' individuals (e.g. transferring the legal ownership of valuable assets from at risk individuals to lower risk entities).

A successful outcome of asset protection planning might include the ability for at risk individuals and their families to control or benefit from assets without legally owning them. The implication is that if the at risk individual becomes subject to liabilities or claims from creditors, those assets would not be available to satisfy them – even if a creditor is a successful litigant.

This might be achieved by restructuring to have a discretionary trust hold assets, where:

(a) there are a range of discretionary beneficiaries (e.g. family members);

(b) control is wielded by a trustee which itself has limited assets (e.g. a company); and

(c) the controlling individuals have an ability to change the trustee (i.e. an 'appointor' or 'principal' role).

If appropriately structured, the assets of the trust should be protected from claims made by creditors against the controlling individuals.

Similarly, a segregation strategy might include utilising multiple companies or trust structures for different 'at risk' activities.

As a general principle, 'passive' assets should be segregated from operating activities.

Costs of implementing asset protection planning

The cost of implementing asset protection strategies can be significant and may discourage clients from pursuing an optimal strategy. Often, the most substantial cost in restructuring is income tax (including capital gains tax) and stamp duty.

Understandably, many business owners are unwilling to incur substantive upfront cash costs in order to create what may seem to be, in effect, a very large 'insurance premium'.

Gift and loan back strategies

An excellent example of a tax-effective asset protection strategy is a 'gift and loan back'.

The strategy involves transferring the **value** of an asset or entity from a high risk to low risk structure without a transfer of the underlying legal interest in the asset itself. Without a transfer, there is no income tax or stamp duty impact that arises. Broadly, this method involves:

(a) the owner of a valuable asset gifting the **value**, or net value, of the asset to a low risk passive entity (often a special-purpose protective trust);

(b) the passive entity agreeing to loan that value back to the owner; and

(c) the passive entity taking security for repayment of the loan over the owner's asset (e.g. mortgage, security interest).

By registering security over the loan, it means that the passive entity should be entitled to enforce a priority right over other creditors, thus achieving the asset protection goals.

No requirement for cash

Given that this strategy is an internal arrangement, sufficient cash may not be available to fund the gift and loan back. In these cases, it is possible to arrange for the parties to use a form of non-cash consideration (e.g. a promissory note).

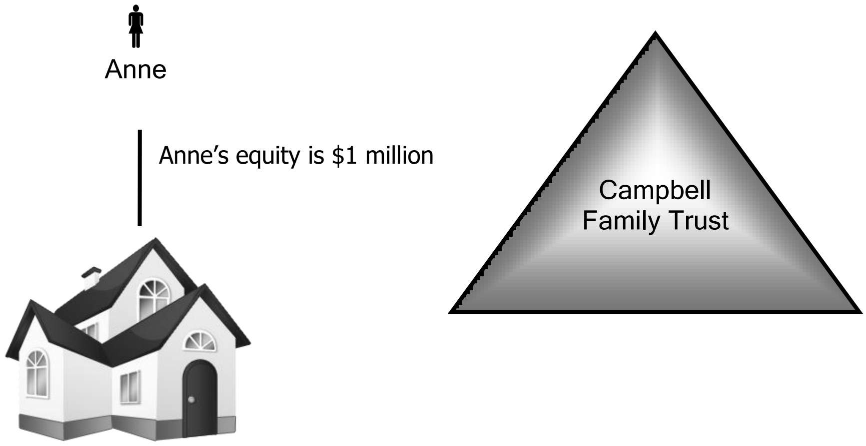
Worked example

Assume that Anne holds 100% of an investment property.

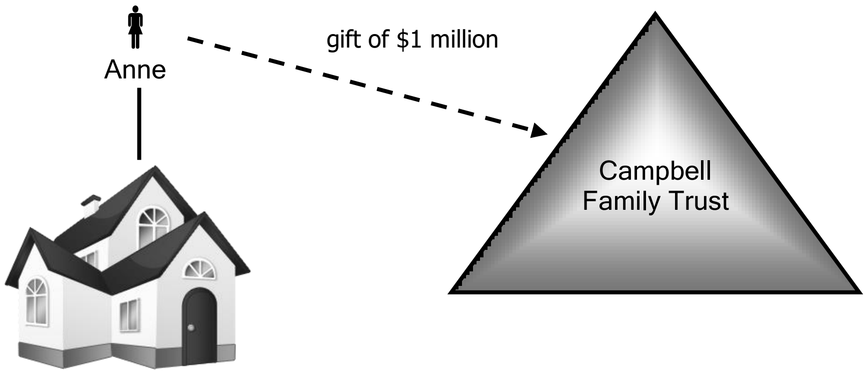
The current value of the home is $1,500,000, although there is an existing mortgage of $500,000.

Anne's equity in the property is $1,000,000.

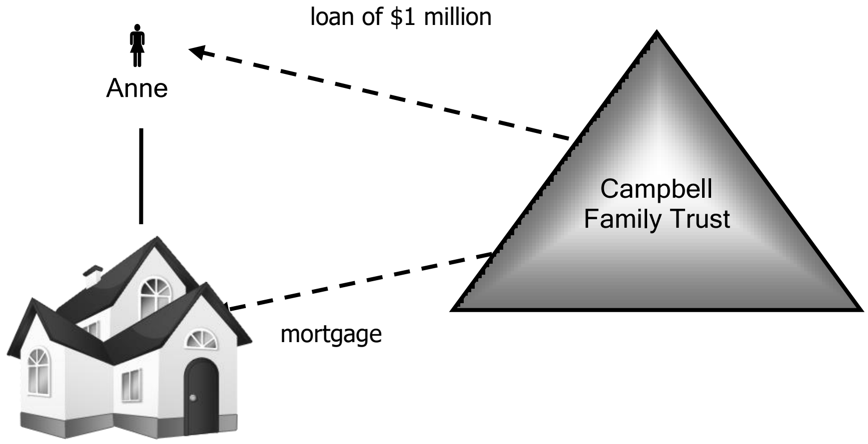
Current structure



Step 1: Anne gifts the amount of her equity in the property to a trust



Step 2: The trust subsequently lends the amount back to Anne and takes security over property



By carrying out the gift and loan back strategy, the Campbell Family Trust has become a secured creditor in respect of the $1,000,000 equity in the property.

Valuation issues

It is important to note that the gift will be a fixed dollar amount representing the owner's equity in the asset. For this reason, it would often be appropriate to review the asset's value periodically and enter into additional gift and loan back transactions if the equity increases and the asset remains owned by the at risk entity.

Depending on the difficulty associated with valuing the asset, it would often be appropriate to have the valuation confirmed by a valuer or independent professional. Alternatively, the parties should ensure there is a sufficient margin between the amount gifted and the net value of the asset.

Loan facility and documentation

It is important to ensure that the entire gift and loan back arrangement is formally documented.

Further, in order to provide the passive entity with the necessary priority, a mortgage should be registered (for real property) or a security interest under the PPSA (for personal property).

Some other things to consider

There are other issues which should be considered when implementing a gift and loan back strategy.

For example, where the asset is a 'private' asset, then the business owner should consider whether eligibility for the small business concessions will be jeopardised. Generally, a family home and assets used solely for personal use and enjoyment are not taken into account in the $6M maximum net asset value test.

However, if a gift and loan back strategy is implemented in respect of the owner's home, and the resulting loan is secured with a mortgage or second mortgage, then:

(a) the passive entity which holds the loan receivable will now have an asset that is not used for personal use and enjoyment; and

(b) the liability of the high risk individual or entity will not relate to a 'business' asset, but rather the family home and therefore will not reduce the net assets for small business purposes of that entity.

There may also be corporations and tax law issues in circumstances where a company intends to make a gift.

Clawback periods under bankruptcy and insolvency

Unsurprisingly, strategies which are implemented in order to transfer assets or value at or immediately prior to insolvency are ineffective. It is too late to undertake asset protection strategies when creditors are 'knocking at the door'.

Specific advice about the impact of the insolvency law may be necessary when seeking to implement a gift and loan back strategy.

Conclusion

Planning for risk remains a critical consideration for anyone involved in business. Whilst the general principles of asset protection may be well known, there can be a number of complicating factors in practice, and some structures which are far too difficult or expensive to re-engineer. The gift and loan back strategy may be particularly useful in circumstances where the costs associated with moving assets are too great. However, advisers will need to assist their clients in considering cost versus benefit.

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