FARM BUSINESS FACT SHEET

GRDC
GRAINS RESEARCH & DEVELOPMENT CORPORATION

TRIGGERS FOR BUSINESS STRUCTURE CHANGE

WESTERN

September 2017

Establishing or transitioning to an appropriate business structure

Farm businesses often 'outgrow' the business structure that was originally chosen and need to transition into another type of entity which better suits its evolving circumstances.

PHOTO: ARTHUR MOSTEAD

There are many reasons for establishing a farm business with a particular trading structure, some of these include:

- inherited entity from the previous generation (owners);
- the number of people involved;
- the business scale and the costs associated with running a particular entity;
- asset protection being more or less important;
- future succession; and
- taxation.

Key triggers that often prompt a change to business structures include:

- farm business growth;
- a need to better manage taxation liabilities;
- the purchase or acquisition of assets;
- farm succession; and
- death or loss of capacity of a farm stakeholder.

Farm businesses often 'outgrow' the business structure that was originally implemented and need to transition into another type of entity that better suits its evolving circumstances. This Fact Sheet will explore the triggers to change business structures, and when and why change may be necessary.

SOLE TRADER

This simple and cost-effective structure is commonly used for 'start-up' growers operating in their own right, where all assets are at risk and taxation is generally not a significant issue.

Maintaining a low-cost entity that is easy to understand is generally important for growers at this early stage of the business cycle.

While being a simple and cheap structure it can become quickly outdated if the grower's circumstances change, such as if they get married, have children or enjoy strong profits and growth in their farming business and choose to protect certain assets and save tax.

PARTNERSHIP

Often the next step would be a transition to a partnership structure to introduce another person into the business, be it a spouse or maybe another relative. A partnership structure has a relatively simple and easily understood entity concept, income-splitting opportunities and potentially some tax-saving measures. Other aspects include:

- **Cheaper compliance administration costs.**
- **Limited succession-planning options.**
- **No asset protection.**

Partnership structures are generally used by smaller-scale family farming businesses, where there are no pressing succession requirements, profits are relatively low and tax is not a significant issue.

A partnership structure offers tax minimisation opportunities over a sole trader by being able to share the business profit among more people and in turn using multiple tax-free thresholds and lower tax rates.

Other partnerships

More advanced partnership structures can also be considered, such as introducing a discretionary trust as an additional partner. Usually in these circumstances a partnership may already exist and the introduction of a trust as an additional partner is to pursue an eventual succession-planning outcome. This structure combines the benefit of both sole trader and partnership entity types.

For example Mum and Dad are in a farming partnership and their son has returned home to commence his career on the farm. In this case introducing a discretionary trust as an additional partner allows the business to share profit to the son via the trust, and if the son gets married the daughter-in-law can also be involved, without the necessity of changing the partnership entity. Eventually Mum and Dad could retire from the partnership. This dissolves the partnership and allows the discretionary trust to take over the farming business, with the son and daughter-in-law at the helm, and their children as potential future beneficiaries.

Farm management deposits for partnerships and sole traders

Farm management deposits (FMDs) are very tax efficient for sole traders and partnerships, especially when it comes to withdrawing the deposit. This is because the farm financial loss incurred in a poor year passes to the individual and can be directly offset against any FMDs withdrawn in the individual's name.

DISCRETIONARY TRUSTS

Discretionary trusts are generally the 'go-to' entity for primary producers of reasonable scale and showing consistent profits. Farming businesses with two or more families/generations will often operate through a trust because the trust structure allows more people to be involved. The discretionary trust structure offers:

- **ease of transitioning family members into and out of the business;**
- **flexible future succession planning opportunities;**
- **improved asset protection if a corporate trustee is involved;**
- **improved tax planning options; and**
- **a separate legal entity.**

Trust structure diagram for a family business

Figure 1 (below) illustrates a typical trust structure with Mum and Dad in control of the business at present, but with an adult son and daughter-in-law also active in the business.

In this example farm income can be split between the four adults, grandchildren and other siblings at the trustee's complete discretion. This flexibility offers significant tax-saving opportunities by way of accessing tax-free thresholds and low tax rates where appropriate. The beneficiaries would also be eligible for the primary production averaging provisions to save additional tax.

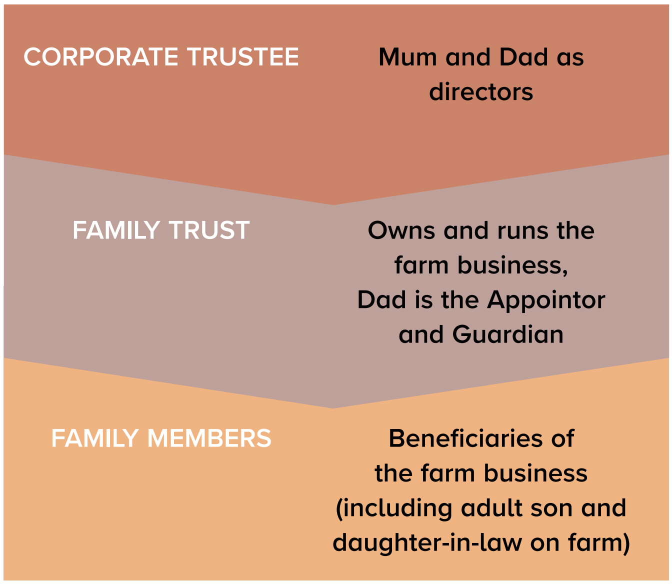

FIGURE 1: Typical trust structure for a family business

Succession of events

When Mum and Dad want to retire from a business with a discretionary trust structure, they can pass the business to a son and daughter (and their partner(s)) by way of the son or daughter (and partner) taking controlling positions in the Corporate Trustee and Family Trust. This change effectively transfers control to the next generation without interrupting the ownership of the trust's business or assets.

There is no need to close and open new bank accounts, change tax registrations, rewrite finance contracts and there is generally no capital gains tax or stamp duties activated.

A trust structure also enables more advanced tax planning techniques to fully utilise the benefits of the primary production income averaging system. If we revisit our example and now look down the track a few years, the farm business could still have Mum and Dad as beneficiaries (but without any control of the farm business), the son and daughter and their partners in control and running the farm, and their children being trust beneficiaries.

You can start to see that this structure offers longevity, flexibility and other ongoing benefits.

These advantages and this flexibility is why discretionary trusts are the most popular business structure of family farms.

Farm management deposits and discretionary trusts

FMDs present an issue when being withdrawn within a discretionary trust structure because the farm financial losses are quarantined within the trust and cannot be passed to the individual. Therefore the farm loss is not able to be offset against the FMD withdrawal, which would be declared as income in the individual's name.

LANDHOLDING TRUSTS

Sometimes additional trusts are introduced to hold farm assets, especially land. This may be done for various reasons, such as:

- **separating land holdings for a future succession event;**
- **asset protection – separating key business assets (e.g. land) from operating activities to reduce exposure to legal risk;**
- **future estate planning pathways; and**
- **savings on future duty and capital gains tax.**

An example of when a landholding trust could be used is when adult children on the farm have future plans to separate the farming business into two separate entities. To achieve this when the farming enterprise is acquiring additional land, it would be useful to strategically buy land through separate trusts. In the future the children could take control for a landholding trust each and commence their own separate farming operations.

This process negates the need to transfer land and deal with potential stamp duty and capital gains tax liabilities. The controlling positions of each land holding trust are allocated separately and the next generation can commence farming independently. Other important matters would need to be dealt with, including livestock, plant, bank borrowings etc., but at least the land is dealt with simply and with minimal cost.

COMPANIES

Companies are commonly used to act as the trustee of a family (discretionary) trust. This is done primarily as a means of providing an extra 'layer' of protection for personal assets (e.g. of family members) against the farming business' trading activities.

In certain circumstances a company can also be introduced as an additional beneficiary of a trust, or as a business partner with the trust, to limit the overall business tax rate to a maximum of 30 per cent. The corporate tax rate is currently 27.5 per cent for a company directly involved in the farming business or 30 per cent if it acts as a beneficiary.

Where a company acts as a beneficiary of a trust, special consideration should be given to the rules under the 'Division 7A' anti-avoidance legislation, which can attract severe penalties if breached. Professional advice should be sort on

PHOTO: STEVE COWLEY

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the implications of Division 7A and/or on the introduction of a company as part of an overall business structure.

Corporate growers

Larger 'Corporate Growers' often operate as a trading company, the main reasons being that there are usually several unrelated parties involved, definitive ownership interests are important and segregation of business activities is mandatory. Also, the business is not attempting to support normal family private expenditure or benefit from the primary production averaging system.

Farming companies are typically owned by investors or other corporates and after-tax profits can be effectively paid to the company shareholders (owners) by way of a franked dividend. This can help minimise the tax impost to shareholders, although the level of dividends paid is important to avoid tax-bracket creep.

With current corporate tax rates on a downward trend these structures are likely to become more popular among larger family farms.

Companies are used mainly for trading entities and have tax disadvantages for asset ownership and so are not commonly used to hold land.

CHANGE NECESSITATES CHANGE

Owners' individual circumstances generally dictate business structure changes. A 'single' grower who marries and has children could start out as a sole trader, change to a partnership when married then restructure to a trust when the business or family grows.

Another typical example is where two siblings farm with their partners in a family trust structure but want to divide their operations to farm separately. This may necessitate another trust structure being established to ultimately allow each sibling and their immediate family to farm in their own right.

A third example is where the parents are farming in a family trust (with their two adult children) and the parents wish to retire and set each child up with their own farming operation. It is more than likely a second trust structure will be required, so each son/daughter ultimately ends up in a suitable structure to conduct their future business.

Sweeping changes to a business structure for purely tax purposes should not be considered unless the potential savings can justify the cost.

BANK'S VIEW

All financial institutions have the appropriate processes and protocols in place to accommodate the different financial structures. Banks will ensure their position is secured and will carry out the normal assessments to satisfy themselves that the business has the capacity to repay the borrowings over time. Dealing with different business structures is part of the banks' normal business operations.

FREQUENTLY ASKED QUESTIONS

I currently have individual trustees for my family trust. Do I really need a corporate trustee?

Individual trustees will be personally liable for any shortfall in the trust's assets should the trust become insolvent. By introducing a $2 company to act as trustee, the personal assets of the main farming family members can be significantly protected from the activities of the trust's business.

I am currently operating my farming enterprise through a partnership with my wife, should I swap to a discretionary trust?

There are many factors to take into account.

- Do you have significant off-farm assets at risk?
- Is your business making significant profits and therefore paying large amounts of tax?
- Are there other people you could share farm profits with?
- Is there a generational change looming?

Once you navigate these questions the answer will be apparent. For example, if you do not have any off-farm assets, there is no-one coming home to take over the farm and profits are modest, then it seems unlikely there is any need to convert to a trust.

Transitioning to a partnership structure allows for the introduction of another person into the business.

SUMMARY

The changing of, and transition to, different business structures is a natural evolution for most farming businesses. It can be a particularly involved process, with the risk of unforeseen taxes and costs. Paramount to any change is detailed planning, healthy discussion between the entities and ensuring the appropriate advice is obtained. Every family farm circumstance is different – appropriate planning helps to ensure all possible benefits are achieved.

Useful resources

Small Business Development Corporation:
https://www.smallbusiness.wa.gov.au

Department of Industry Innovation and Science:
https://www.business.gov.au

Australian Securities and Investment Commission:
http://asic.gov.au/for-business/yourbusiness/your-business-structure

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Project code

ORM00015 ORM00017

Content prepared and edited by ORM on behalf of the GRDC – western region.
Acknowledgements: Simon Northey, Director of Byfields Business Advisers

Produced by **www.coretext.com.au**