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Structured for Success

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Table of Contents

Structured for Success

Introduction

There are many situations and circumstances where it becomes important to consider the relevant ongoing effectiveness of a client's structure(s), and whether there are changes required to facilitate the client's objectives. These objectives may include:

1. Improved tax outcomes;
2. Asset protection;
3. Succession planning;
4. Business growth;
5. Debt management (including Division 7A issues); and
6. Exit strategies.

In consideration of these objectives, the challenge for advisers is facilitating any change in structure which might involve the transfer of business assets.

Since the introduction of the new small business restructuring provisions (subdivision 328-G ITAA 1997), a new restructuring strategy is potentially available for small business entities.

That is, for most restructuring situations, an adviser has the option of choosing to:

1. **For a trust, partnership and individual:**
   (a) Rollover asset(s) pursuant to subdivision 122-A ITAA 1997 for an individual or a trust, and subdivision 122-B ITAA 1997 for partners of a partnership;
   (b) Sell assets and apply Division 115 ITAA 1997 and Division 152 ITAA 1997 (where applicable); or
   (c) Rollover asset(s) pursuant to subdivision 328-G ITAA 1997 (for a small business entity).
2. **For a company:**
   (a) Sell assets and apply Division 152 ITAA 1997 (where applicable);
   (b) Rollover asset(s) pursuant to subdivision 328-G ITAA 1997 (for a small business entity); or
   (c) Use the tax consolidation regime.

As it would be understood and accepted, there might be circumstances where use of multiple restructuring strategies is preferred. There is not one simple and singular solution to most clients' situations and objectives.

In addition to the introduction of new legislation, there have been some interesting other rulings and case law developments that may influence the strategies available.

Statutory Provisions

Before analysing a case study which illustrates the practical application of the various restructuring arrangements that might be applied, a brief discussion of the relevant statutory regimes is a useful starting point.

1. Subdivision 122-A ITAA 1997

Subdivision 122-A (subdivision 122-B for partnerships) allows an eligible entity to transfer CGT assets to a company without any CGT implications arising from the transfer of assets or interest in the assets.

1.1 Requirements

In addition to the residency requirement, the transfer of the relevant CGT asset(s), or interest therein, must comply with the following statutory requirements (sections 122-15, 122-20 & 122-25):

(a) CGT event related to CGT asset (CGT Event A1 (disposal case) & CGT Event D1 (creation case) & CGT Event F1 (granting of a lease));

(b) If consideration is provided, the consideration must consist of shares (not redeemable shares) in a company;

(c) The company can assume "liabilities" that are in respect of the assets transferred (also refer to the restrictions on the amount of liability (section 122-35));

(d) The market value of the shares must be substantially the same as the value of the assets transferred (net of liabilities where relevant);

(e) Immediately after the asset transfer, the transferor must own all the shares in the company; and

(f) There are certain assets that are excluded. (Note that in relation to depreciable assets (Division 40 ITAA 1997), the balancing adjustment is disregarded if the assets are transferred pursuant to subdivision 122-A – refer to section 40-340).

1.2 Consequences

(a) No CGT consequences arising from the relevant CGT event;

(b) The CGT status of the shares received and the assets held by the company is preserved (that is, pre-CGT assets retain their pre-CGT status in the company and the shares are also deemed to be pre-CGT);

(c) No cost base uplift of assets on their transfer to the company; and

(d) The shares received have a cost base equal to the net cost base of the assets transferred. If all of the assets are transferred, the cost base of the shares will equal:

  (i) The cost base of CGT assets transferred; plus

  (ii) The market value of precluded assets (includes depreciable assets); less

  (iii) Any liabilities assumed.

1.3 Benefits

(a) CGT status retained which is particularly important for pre-CGT assets;

(b) Company is the ongoing asset holding entity. A SBE company has a lower rate of company tax;

(c) Can restructure the asset ownership by creating a tax consolidated group and further transfer assets to subsidiary entities to effect asset separation and asset protection; and

(d) Shares held by the transferor entity can be subsequently transferred/disposed of and access the various CGT concessions (Division 115 & Division 152) to facilitate estate planning and exit strategies.

1.4 Disadvantages

(a) No cost base uplifts;

(b) Restarts the "time" period for subdivision 152-B ITAA 1997 (15-year exemption subdivision); and

(c) In Queensland – stamp duty applies.

1.5 Other matters – the treatment of Unpaid Present Entitlements

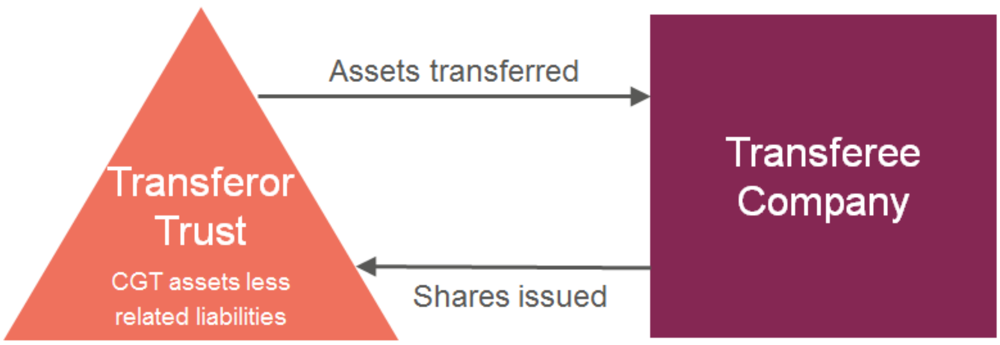
It is relevant to note that where a trust has an amount of unpaid present entitlement (**UPE**) to beneficiaries, the UPE is not generally a "liability" – refer inter alia to TR 2010/3, TR 2015/4 & TD 2015/D5.

The question then arises that if the restructure transferor entity is a trust with UPEs, given the fact that the UPE is not a liability, the UPE cannot be assumed by the transferee company. Further, as a consequence of the decision in Bell v FCT [2013] FCFCA 32, it is doubtful that converting the UPE into a liability before the restructure would satisfy the "in respect" test in section 122-20.

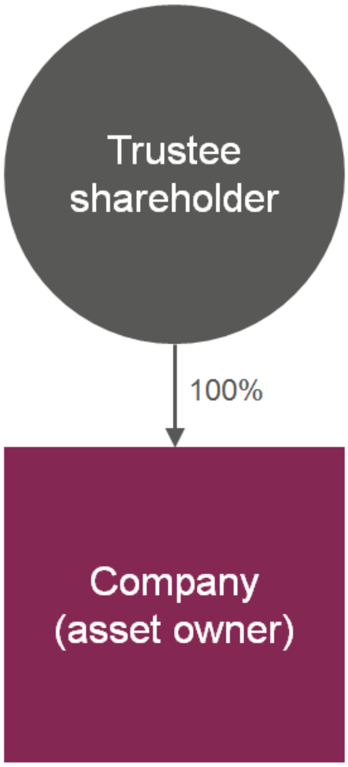
Interestingly, in TR 2015/4 (the treatment of UPEs in relation to section 152-20) and in accordance with the standard Acis trust deed, a UPE is held on sub-trust, that is a separate trust to the main trust. That being the case, it would seem that the UPE (asset) held by the sub-trust could be transferred to a company by applying subdivision 122-A.

1.6 Diagram of the arrangement

Step 1: Transfer of assets



Step 2: Post transfer structure



2. Division 152 ITAA 1997

Whereas the rollover provisions (subdivision 122-A or 328-G) ensure that there are no CGT consequences, there is no change to the cost base of the assets transferred nor any change in CGT status.

The benefit of the application of Division 152 (and Division 115) is that, to the extent that the taxpayer chooses to apply the concessions, the CGT gain is reduced but the asset's cost base is reset. The acquisition date for the assets is also reset.

Below is a brief summary of the requirements to access Division 152 (refer to section 152-10):

(a) The CGT event must be such as to generate a capital gain (as distinct to a revenue gain);

(b) The taxpayer must satisfy one of the eligibility tests:

(i) Entity is a small business entity (**SBE**);

(ii) Entity satisfies the maximum net asset value test (**MNAV**); or

(iii) Entity satisfies the passive asset test used by SBE (section 152-10(1A)); and

(c) The CGT asset satisfies the eligibility tests:

(i) The asset satisfies the active asset test; and

(ii) If the CGT asset is a share in a company or an interest in a trust, the additional basic conditions required by subsection 152-10(2) are satisfied.

All of the above basic conditions are generally well understood, however there are certain factors that need to be accounted for in any restructuring strategy. These include:

(a) Asset protection; and

(b) Flexibility of distribution of income and/or capital.

2.1 Asset Protection

With regard to this factor, the most usual strategy includes inter alia isolating the "valuable" asset(s) from the risk associated with the trading activities; however the following needs to be considered:

(a) There is the real risk that at a later point of time, if the "valuable" asset is disposed of, whether the asset holding entity can access the Division 152 concession unless the isolated asset can satisfy the "active" asset test;

(b) It is critical that the entity holding the "valuable" asset is connected to the entity carrying on the business activity that uses the asset.

2.2 Example

(a) **Facts**

(i) The valuable passively held asset is held by a discretionary trust;

(ii) The business is conducted by a company;

(iii) The company uses the valuable asset for the purpose of its business;

(iv) The company shareholders are Mr and Mrs; and

(v) The discretionary trust disposes of the asset.

(b) **Issue**

Can the trust access Division 152 on the disposal of the asset?

(c) **Discussion**

Whether the company is a small business entity or otherwise, the essential issue is whether the discretionary trust is "connected" to the business company.

Passive asset eligibility criteria (section 152-10(1A)) provides:

> *Passively held assets--affiliates and entities connected with you*
>
> *(1A) The conditions in this subsection are satisfied in relation to the * CGT asset in the income year if:*
>
> *(a) your * affiliate, or an entity that is * connected with you, is a * small business entity for the income year; and*
>
> *(b) you do not carry on a * business in the income year (other than in partnership); and*
>
> *(c) if you carry on a business in partnership--the CGT asset is not an interest in an asset of the partnership; and*
>
> *(d) in any case--the small business entity referred to in paragraph (a) is the entity that, at a time in the income year, carries on the business (as referred to in subparagraph 152-40(1)(a)(ii) or (iii) or paragraph 152-40(1)(b)) in relation to the CGT asset.*

The **active asset test** provides:

Section 152-40(1) *A * CGT asset is an active asset at a time if, at that time:*

*(a) you own the asset (whether the asset is tangible or intangible) and it is used, or held ready for use, in the course of carrying on a * business that is carried on (whether alone or in partnership) by:*

(i) you; or

*(ii) your * affiliate; or*

*(iii) another entity that is ** ***connected with*** *you; or*

(b) if the asset is an intangible asset--you own it and it is inherently connected with a business that is carried on (whether alone or in partnership) by you, your affiliate, or another entity that is connected with you.

That being the case, if the asset holding entity wishes to access the Division 152 concessions at a later time, it is essential to ensure that the asset holding entity is "connected" to the entity carrying on the business.

The tests for "connection" are provided by section 328-125. There are 4 types of connection:

(i) Where entities are controlled by the same party;

(ii) An entity has a 40% interest in another entity;

(iii) In the case of a trust, an entity can sufficiently influence the trustee; and

(iv) Indirect connection via control of an interposed entity.

The statutory details are as follows:

Section 328-125 Meaning of connected with an entity

(1) An entity is connected with another entity if:

(a) either entity controls the other entity in a way described in this section; or

(b) both entities are controlled in a way described in this section by the same third entity.

Direct control of an entity other than a discretionary trust

*(2) An entity (the first entity) controls another entity if the first entity, its *affiliates, or the first entity together with its affiliates:*

(a) except if the other entity is a discretionary trust--own, or have the right to acquire the ownership of, interests in the other entity that carry between them the right to receive a percentage (the control percentage) that is at least 40% of:

(i) any distribution of income by the other entity; or

(ii) if the other entity is a partnership--the net income of the partnership; or

(iii) any distribution of capital by the other entity; or

*(b) if the other entity is a company--own, or have the right to acquire the ownership of, * equity interests in the company that carry between them the right to exercise, or control the exercise of, a percentage (the control percentage) that is at least 40% of the voting power in the company.*

Direct control of a discretionary trust

*(3) An entity (the first entity) controls a discretionary trust if a trustee of the trust acts, or could reasonably be expected to act, in accordance with the directions or wishes of the first entity, its * affiliates, or the first entity together with its affiliates.*

(4) An entity (the first entity) controls a discretionary trust for an income year if, for any of the 4 income years before that year:

(a) the trustee of the trust paid to, or applied for the benefit of:

(i) the first entity; or

*(ii) any of the first entity's * affiliates; or*

(iii) the first entity and any of its affiliates;

any of the income or capital of the trust; and

(b) the percentage (the control percentage) of the income or capital paid or applied is at least 40% of the total amount of income or capital paid or applied by the trustee for that year.

Applying the above legislation to a practical set of circumstances, assume that it is decided to hold the valuable asset in a discretionary trust and conduct the business in a company:

(i) If the trust holds the shares in the company, the connection test is satisfied (subsection 328-125(2)); and

(ii) If shares in the company are held by individuals (subject to the percentage of shares held), the trust will be connected to the company if either:

(A) A shareholder with at least a 40% interest in the company has received trust distributions during the 4 year prior to the year of the CGT event of at least 40%; or

(B) A shareholder with at least a 40% interest in the company can sufficiently influence the trustee in the manner prescribed by subsection 328-125(3).

In regard to this latter point, I refer you to Gutteridge v FCT [2013] AATA 947 and the Commissioner's subsequent decision impact statement on the case, where the Commissioner stated:

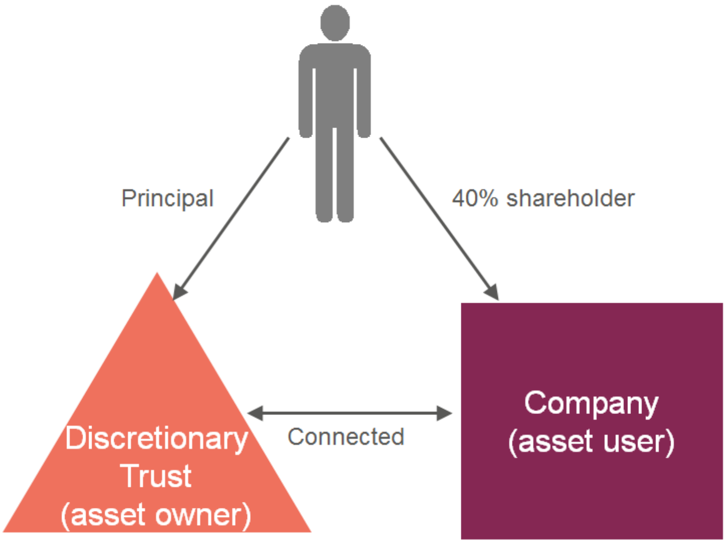
"The Commissioner accepts that the decision was open to the AAT in view of the findings of fact made by the Tribunal.

However, while the circumstances in this case allow for a finding that a person could reasonably be expected to act in a certain way because they were 'accustomed to act' in that way, the Commissioner does not accept that the 'reasonable expectation' test in subsection 328-125(3) of the ITAA 1997 can be substituted with an 'accustomed to act' test in all cases. It depends, as the AAT said at paragraph 21, on an examination of all the circumstances of a case. For example, if there is no history at all of a trustee having acted on the directions of another, there may nonetheless be an expectation (reasonably founded) that they would act on the directions of a particular person, were such directions to be given."

The issue raised by Gutteridge concerned inter alia whether the "principal" of the trust was connected to the trust.

Relevantly, with a standard discretionary trust used in a family business structure arrangement, it would be highly reasonable to conclude that the principal of the trust would be connected to the trust by the application of subsection 328-125(3).

Accordingly, where there are such circumstances, the principal of the trust would be connected to the trust and if that principal has a 40% interest in the company, the trust and the company are connected as a consequence of the application of subsection 328-125(1). (That is there is no requirement that the shareholder receive any trust distributions to be connected):



Indirect control

One further situation around connection that needs to be considered concerns the application of the indirect connection test provided by subsection 328-125(7):

> ***Indirect control of an entity***
>
> *Section 328-125(7) This section applies to an entity (the first entity) that directly controls another entity (the second entity) as if the first entity also controlled any other entity that is directly, or indirectly by any other application or applications of this section, controlled by the second entity.*

This test is particularly relevant where there is an interposed entity situation. The subsection would apply where, for example, an entity A controls entity B and entity B controls entity C. In that situation, entity A is deemed to be connected to entity C.

This is particularly important for the active asset test but also relevant where the SBE aggregated turnover test is of concern.

2.3 Flexible income/capital distribution

A discretionary trust is the usual choice of structure if there is a need, immediate or in the future, for flexibility concerning the distribution of income or capital.

The disadvantage with a discretionary trust, however, is that the beneficiaries have no interest in the capital of the trust (IRC v Gartside [1968] AC 553). This presents a significant disadvantage if estate planning is a feature of the restructuring arrangement.

Using a company structure is preferred for estate planning, as:

(a) It has the ability to deal with shares via the testator's will;

(b) Shares can be issued with different rights and entitlements; and

(c) Most states have no duty on the transfer of shares.

The perceived notion is that, if Division 152 is a factor in the future plans of the client, having variable share interests causes an issue. The additional basic condition where the CGT asset is a share in a company requires compliance with the stipulations in subsection 152-10(2):

*(2) If the * CGT asset is a * share in a company or an interest in a trust (the object company or trust), one of these additional basic conditions must be satisfied just before the * CGT event:*

*(a) you are a * CGT concession stakeholder in the object company or trust; or*

*(b) CGT concession stakeholders in the object company or trust together have a * small business participation percentage in you of at least 90%.*

What this requires is that the shareholders, directly or indirectly, are CGT concession stakeholders.

An individual will be a CGT concession stakeholder (section 152-60) if:

(a) The entity has a small business participation percentage of at least 20%; or

(b) The entity is a spouse of significant individual and that entity has a small business participation percentage of greater than zero.

In the instance of a company, an entity's small business participation percentage is determined by the application of section 152-70, namely that:

Item 1 A company

*This percentage that the entity has because of holding the legal and equitable interests in * shares in the company:*

(a) the percentage of the voting power in the company; or

*(b) the percentage of any * dividend that the company may pay; or*

(c) the percentage of any distribution of capital that the company may make;

or, if they are different, the smaller or smallest.

Whereas subsection 152-70(2) states that redeemable shares are to be ignored with regard to determining the item 1 percentages, the question is: What is the position if the shares merely have different, albeit discretionary, rights?

The ATO's Advanced Guide to Small Business CGT concessions provides the following example:

A company has two different classes of shares, A and B, which have equal voting and distribution rights. Isaac holds 20% of the shares of each class. The directors can decide to make a distribution of income or capital to either class of shares to the exclusion of the other class of shares.

In this situation, the company does have a significant individual. Isaac holds 20% of the voting power and, regardless of how the directors' discretion is exercised, Isaac will always receive 20% of any distribution made by the company.

However, if Isaac only held the class A shares and no class B shares, he would not be a significant individual. His right to receive the distribution is only notional, and dependent on how the directors exercise their discretion to make distributions.

Accordingly, the perceived difficulty is that the use of discretionary shares can create a small business participation percentage problem if all shares have discretionary rights.

Of interest in relation to this topic is the recent case of Devuba Pty Ltd v Commissioner of Taxation [2015] AATA 255 (**Devuba**). In Devuba, the AAT considered whether the taxpayer could satisfy the small business participation percentage where the company had issued dividend access shares (**DAS**). The share status of the company was as follows:

(a) One ordinary share held by John Van der Vegt (**Mr Van der Vegt**);

(b) One ordinary share held by VDV Nominees Pty Ltd (**VDV Nominees**) as trustee of the Van der Vegt Family Trust (**Trust**);

(c) One DAS held by Sloane Van der Vegt (**Mrs Van der Vegt**).

The AAT noted that "of particular significance in this context is Article 129 which confers power on the directors of the company to declare dividends as follows:

Where at any time there shall be more than one class of shares on issue, any dividend or distribution of capitalised profits may be declared by the Company in general meeting, and as the Directors from time to time recommend, and all dividends with interim or otherwise may be paid, and distribution of capitalised profits made on the shares or on any one or more class or classes of shares to the exclusion of the shares of any other class or classes the and if it any meeting dividends are declared or distributions made on more than one class the dividend declared or distribution made on the shares of any such class may be at a higher or lower rate than or at the same rate as dividend declared or distribution made on the shares of the other or others of such classes provided that the shares in each class shall inter se participate pari passu in any dividend declared or any distribution of capitalised profits made in respect of that class…"

The AAT focused the issue for the taxpayer to be as such:

58. In the view of the Respondent (ATO), the directors of the Applicant had discretion to pay a dividend on the DAS and could use their powers to pay a dividend on the DAS to the exclusion of all and any of the other classes of shares. Accordingly, the holders of the ordinary shares might obtain a zero distribution. As a result, for the purposes of the test contained in item 1 of the s 152-70, the "percentage of any dividend that the company (namely the Applicant) may pay" on the ordinary shares is nil. The consequence of such a finding would be that the SBPPs held by Mr Van der Vegt and the Trust in the Applicant would be zero and the Applicant would not be entitled to any relief under div 152.

59. The issue comes down to this – what is the effect of the words "the percentage of any dividend the company may pay" as those words are used in the Table in s 152-70(1) of the Act when read in the context of the DAS.

The following AAT analysis is informative:

61.When one looks at the terms of s 152 – 10 (2) it is readily apparent that the CGT stakeholder test that is the subject of that subsection needs to be satisfied "just before the CGT event". Similarly, in s 152 – 70 the direct SBPP is to be worked out "at the relevant time" which again is just before the CGT event. It would seem to follow from this that the rights of shareholders in the Applicant and for that *matter in Primacy are to be assessed at the same time namely just before the CGT event.*

62.At that time being the moment just before 19 May 2010 logic would suggest that the only shares that carried any rights to dividends that may be paid in the Applicant were the ordinary shares. Those ordinary shares and no other shares at that time carried all the rights not only in respect of dividends but also in respect of voting and in respect of rights to distribution of surpluses on a winding up.

63.The consequence is that it cannot be said that at the relevant time (i.e. just before 19 May 2010), the DAS holder may be paid a dividend.

64. In reaching this conclusion the Applicant relies heavily on the decision of the High Court in Federal Commissioner of Taxation v Casuarina Pty Limited (1971) 127 CLR 62.

In conclusion, because at the relevant CGT event date, the directors had not declared any dividends on the DAS shares, the residual interests were that of the shareholders who held the ordinary shares, and those ordinary shares had defined and distinct interests in the three factors stipulated in section 152-70 item 1. Accordingly, the relevant small business participation percentage was satisfied.

Based on the above, it is possible to satisfy the CGT concession stakeholder test where the share capital of the company has "fixed" entitlement shares (ordinary shares) and a DAS is used for the flexibility to distribute income to different discretionary shareholders.

3. Subdivision 328-G ITAA 1997

The recently introduced small business restructuring provisions (subdivision 328-G), legislated by Tax Laws Amendment (Small Business Restructure Roll-over) Act 2016, are intended to facilitate flexibility for owners of small business entities to restructure their businesses, and the way their business assets are held, while disregarding tax gains and losses that would otherwise arise.

The provisions only apply to entities that can satisfy the SBE test ($10 million turnover, as a consequence of the most recent legislative change) and are not more generally available to a broader category of small business owners.

It is interesting to consider where the subdivision might apply because it will have a limited application. In this regard, the Bill's Explanatory Memorandum (**EM**) provides the following circumstances which would prompt a small business entity to consider restructuring and potentially use the rollover concession:

(a) Continue to develop and grow;

(b) Avoid unnecessary compliance costs;

(c) Enhance business efficiency;

(d) Move to a more efficient structure for tax purposes; or

(e) Adapt to current conditions.

Importantly, all taxation implications arising from the transfer of the assets are ignored, including inter alia Division 7A issues that might otherwise occur with the transfer of the company's property (section 328-450):

Section 328-450 Small business transfers not to affect income tax positions

*(1) Except as provided by this Subdivision, a transfer of an asset has no direct consequences under the *income tax law if:*

(a) the transfer occurs under a transaction in relation to which section 328-430 applies; and

(b) a roll-over under this Subdivision is available under that section in relation to the asset.

Example:

If the transfer were a transfer of the asset from a company to a shareholder, it would not be treated as a payment of a dividend under Division 7A of Part III of the Income Tax Assessment Act 1936.

*(2) To avoid doubt, this section does not affect the application of the *income tax law in relation to:*

(a) anything that happens in relation to the asset that does not directly relate to the transfer; or

(b) the ownership of the asset at any time.

Operative provision:

Section 328-430(1) *A **roll-over** under this Subdivision is **available** in relation to an asset that, under a transaction, an entity (the transferor) transfers to one or more other entities (transferees) if:*

*(a) the transaction is, or is a part of, a **genuine restructure** of an ongoing *business; and*

*(b) **each party** to the transfer is an entity to which any one or more of the following applies:*

*(i) it is a ***small business entity** for the income year during which the transfer occurred;*

*(ii) it has an ***affiliate** that is a small business entity for that income year;*

*(iii) it is ***connected** with an entity that is a small business entity for that income year;*

(iv) it is a partner in a partnership that is a small business entity for that income year; and

*(c) the transaction does **not have the effect of materially changing**:*

*(i) which individual has, or which individuals have, the **ultimate economic ownership** of the asset; and*

(ii) if there is more than one such individual — each such individual's share of that ultimate economic ownership; and

*(d) the asset is a *CGT asset (other than a *depreciating asset) that is, at the time the transfer takes effect:*

*(i) if subparagraph (b)(i) applies — an ***active asset**; or*

(ii) if subparagraph (b)(ii) or (iii) applies — an active asset in relation to which subsection 152-10(1A) is satisfied in that income year; or

(iii) if subparagraph (b)(iv) applies — an active asset and an interest in an asset of the partnership referred to in that subparagraph; and

(e) the transferor and each transferee meet the residency requirement in section 328-445 for an entity; and

(f) the transferor and each transferee choose to apply a roll-over under this Subdivision in relation to the assets transferred under the transaction.

3.2 Features of the new subdivision

(a) Subdivision 328-G is only available for restructure arrangements applicable on or after 1st July 2016;

(b) The rollover provision is available (section 328-425) where the following transfers of "active assets" are involved:

(i) The transfer of a depreciating asset if the balancing adjustment event arising from the transfer occurs on or after 1 July 2016;

(ii) The transfer of trading stock or a revenue asset if the transfer occurs on or after 1 July 2016; or

(iii) The transfer of a CGT asset (other than a depreciating asset, trading stock or a revenue asset) if the CGT event arising from the transfer occurs on or after 1 July 2016;

(c) Negates all tax consequences – CGT, Division 40 & Division 70;

(d) No cost uplift. Transferee inherits the transferor's asset cost base;

(e) No change in CGT status as a consequence of the rollover;

(f) No change in underlying economic ownership of assets;

(g) The rollover is optional – that is, the taxpayer can consider other modes of restructuring and the tax implications of the consequences of those alternative methods;

(h) The rollover does not require that market value consideration, or any consideration, be given in exchange for the transferred assets;

(i) Choice of structure – unlike the company requirement in subdivision 122-A/122-B, there is no type of entity restriction; and

(j) The pre-empting requirement is that the arrangement must be to implement a genuine restructure.

3.3 Genuine restructure

The threshold issue is whether the proposed restructure is a "genuine restructure" of a business and it is unfortunate that such a subjective term is critical to the application of the subdivision. The term "genuine" has some equivalent impact on the demerger provisions, much to the chagrin of SMEs.

At least with this piece of legislation, there is a statutory safe harbour provision as a fall back, albeit it has the complication of being a three year problem in waiting. That is, as regards the requirement for the restructure to be a "genuine restructure" is treated in alternative methods:

(a) In accordance with the general reference provided by section 328-430(1)(a); and

(b) The safe harbour provision which requires examination of a 3 year period post the restructuring transaction - section 328-435:

> ***Section 328-435*** *For the purposes of paragraph 328-430(1)(a) (but without limiting that paragraph), a transaction is, or is a part of, a genuine restructure of an ongoing *business if, in the* ***3 year period after*** *the transaction takes effect:*
>
> *(a) there* ***is no change in ultimate economic ownership*** *of any of the significant assets of the business (other than *trading stock) that were transferred under the transaction; and*
>
> *(b) those significant* ***assets continue to be *active assets****; and*
>
> *(c) there is* ***no significant*** *or material* ***use of*** *those significant* ***assets for private purposes****.*

The EM provides the following examples of factors that would indicate a "genuine" restructure include:

(a) It is a bona fide commercial arrangement undertaken to enhance business efficiency;

(b) The business continues to operate following the transfer, through a different entity structure but under the same ultimate economic ownership;

(c) The transferred assets continue to be used in the business;

(d) The restructure results in a structure likely to have been adopted had the business owners obtained appropriate professional advice when setting up the business;

(e) The restructure is not artificial or unduly tax driven; and

(f) It is not a divestment or preliminary step to facilitate the economic realisation of assets.

To assist with the application of the subdivision, the ATO have issued Law Companion Guidelines (LCG 2016/D3) which outline the ATO's intended application of the new provisions. (Note that the LCGs are to be treated as public rulings).

The guidelines state, inter alia:

6. A 'genuine restructure of an ongoing business' is one that could be reasonably expected to deliver benefits to small business owners in respect of their efficient conduct of the business going forward. It is a composite phrase emphasising that the SBRR is not available to small business owners who are restructuring in the course of winding down or realising their ownership interests.

7. The following features indicate that a transaction is, or is part of, a 'genuine restructure of an ongoing business':

- It is a bona fide commercial arrangement undertaken in a real and honest sense to
  - o facilitate growth, innovation and diversification
  - o adapt to changed conditions, or
  - o reduce administrative burdens, compliance costs and/or cash flow impediments.
- It is authentically restructuring the way in which the business is conducted as opposed to a 'divestment' or preliminary step to facilitate the economic realisation of assets.
- The economic ownership of the business and its restructured assets is maintained.
- The small business owners continue to operate the business through a different legal structure. For example, there is
  - o continued use of the transferred assets as active assets of the business
  - o continuity of employment of key personnel
  - o continuity of production, supplies, sales, or services.
- It results in a structure likely to have been adopted had the small business owners obtained appropriate professional advice when setting up the business.

Examples provided in the Companion Guide which endorse the application of subdivision 328-G include:

(a) **Genuine restructure**:

(i) Bona fide asset protection;

(ii) Maintaining essential employees;

(iii) Raising new capital; and

(iv) Simplifying the taxpayer's affairs.

(b) **Not genuine restructures**:

(i) Succession planning; and

(ii) Extraction of wealth from the business assets (example cites transfer of assets to satisfy UPE as not a genuine restructure).

Example 7: Extraction of wealth from the business assets

Facts

60. Peterson Pauper is a successful business that has been operating through a trust (the Peterson Trust) since its commencement.

61. Each year, the trustee of the Peterson Trust has made its corporate beneficiary, Peterson Pty Ltd, presently entitled to the income of the Peterson Trust.

62. However, none of Peterson Pty Ltd's entitlements have been paid. Instead, the associated funds relating to the unpaid present entitlements (UPEs) have been retained for use in the Peterson Trust.

63. Patricia, the controller of the group, causes the Peterson Trust to satisfy Peterson Pty Ltd's UPEs with the transfer of its active assets to Peterson Pty Ltd. It is assumed that the ultimate economic ownership requirement is satisfied. In effect, the business is transferred to Peterson Pty Ltd, and the SBRR is claimed.

64. Peterson Pty Ltd in turn transfers those active assets to a newly established trust, the Patricia Family Trust, and the SBRR is claimed again. The Patricia Family Trust subsequently seeks to dispose of those assets, and transfer any related proceeds to Patricia as a capital distribution.

Relevant considerations

65. The restructure of the business is undertaken as 'back-to-back' transfers. There is no real business benefit from undertaking the arrangement in this way.

66. There is no reasonable expectation that Patricia will continue to run the small business in the different legal structure.

67. The arrangement results in a legal structure that largely replicates the original structure, but has the effect of extinguishing the UPEs on foot. This assists Patricia to divest the business in a manner that involves the extraction of accumulated profits accrued in the corporate tax environment without 'top up' tax ever being paid (that is, the difference between Patricia's marginal tax rate and the corporate rate).

Conclusion

68. There is no bona fide commercial arrangement undertaken with respect to the efficient operation of the business going forward. The series of transactions involving the transfer of assets effectively from the Peterson Trust to the Patricia Family Trust replicates the original structure and eliminates existing and impending tax liabilities. Furthermore, the Patricia Family Trust has divested the business. The arrangement is not undertaken to authentically restructure the way in which the business is conducted, but rather as a preliminary step to facilitate the economic realisation of assets. There are no commercial advantages outside of the undue tax considerations of this restructure.

69. In these circumstances, the application of the SBRR will be denied.

70. Where the safe harbour rule is met, the application of Part IVA would still need to be considered.

Where the safe harbour rule is satisfied, it is not necessary to consider whether the arrangement would otherwise be a "genuine restructure of an ongoing business" under paragraph 328-430(1)(a).

3.4 Maintenance of "underlying economic ownership" – section 328-430(1)(c)

To be eligible for the rollover, the transaction must not have the effect of changing the ultimate economic ownership of the transferred assets in a material way. The ultimate economic owners of an asset are the individuals who, directly or indirectly, beneficially own an asset.

Ultimate economic ownership of an asset can only be held by natural persons. Therefore, where a company, partnership or trust owns an asset, it will ultimately be the natural person whom owns the interests in these interposed entities that will benefit economically from that asset.

There is a specific provision to deal with discretionary trusts – section 328-440. As will be noted, it is important that the discretionary trust has made a family trust election.

Section 328-440 Ultimate economic ownership—discretionary trusts

For the purposes of paragraph 328-430(1)(c), a transaction does not have the effect of changing the ultimate economic ownership of an asset, or any individual's share of that ultimate economic ownership, if:

(a) either or both of the following applies:

*(i) just before the transaction took effect, the asset was included in the property of a *non-fixed trust that was a ****family trust**;*

(ii) just after the transaction takes effect, the asset is included in the property of a non-fixed trust that is a family trust; and

*(b) **every individual** who, just before the transfer took effect, **had the ultimate economic ownership** of the asset was **a member of the family group** (within the meaning of Schedule 2F to the Income Tax Assessment Act 1936) relating to the trust or trusts referred to in paragraph (a); and*

*(c) **every individual who**, just after the transfer takes effect, **has the ultimate economic ownership** of the asset is a **member of that family group**.*

Example 1.3 (EM) – Use of discretionary trust

Chris and Victoria are husband and wife and are the only shareholders in Puppy Co, with each owning one share with a cost base of $2 per share.

Puppy Co has successfully carried on a puppy training school and has acquired significant assets including puppy boarding facilities, a vehicle, and goodwill.

Victoria and Chris wish to transfer the puppy boarding premises from Puppy Co to a recently settled discretionary trust, the Fluffy Trust, which will lease the premises to Puppy Co. The family trust election is made nominating Victoria as the primary individual controlling the trust. Victoria and Chris are members of Victoria's family group.

For the purpose of the roll-over, there will not be a change in the ultimate economic ownership of the premises as a result of the transfer of the asset from Puppy Co to the Fluffy Trust. Therefore, assuming that the other requirements are also met, the roll-over would be available in respect of the transfer.

3.5 Active asset

The provisions require that the assets transferred pursuant to the rollover are "active assets" (section 328-430(1)(d)).

This requirement will be satisfied if:

(a) The asset satisfies the requirement in section 152-40; or

(b) The entity, not being a SBE, is either an entity:

(i) that has an affiliate that is a small business entity; or

(ii) that is connected with a small business entity,

then the asset must be an active asset that satisfies subsection 152-10(1A).

3.6 Consequences of choosing the rollover

In addition to the following points, refer to Law Companion Guidelines LCG 2016/D2 which provides examples and explanation of the consequences of a rollover.

(a) **Example 1 - Restructure from company to discretionary trust**

Facts

Pep and Sally, a married couple, are the directors and shareholders in Vitamin Pty Ltd, which has issued two shares for total contributed capital of $100. Each share has a cost base of $50. Vitamin Pty Ltd carries on a naturopathy business.

As at 1 January 2017, the active assets of the company are:

- *a small consulting room, which was acquired by Vitamin Pty Ltd for $200,000 in 2010*
    - o *No other additional capital expenditure has been outlaid in relation to the room.*
    - o *The market value is $230,000.*
- *a pill press, with an adjustable value of $14,000*
- *goodwill, which is self-generated, and*
- *50 bottles of homeopathic pills, which were made and processed by Pep and Sally, and became Vitamin Pty Ltd's trading stock during the income year at a cost of $250.*

The liabilities of the company, arising from a debt for unpaid income tax and trade creditors, total $24,000.

A new discretionary trust, the P&S Trust, is settled and family trust election is made with Pep as the primary individual.

On 1 January 2017, Pep and Sally cause Vitamin Pty Ltd to transfer all [4] of its assets (except petty cash) to the trustee of the P&S Trust (the trustee) in consideration for the trustee undertaking to discharge Vitamin Pty Ltd's liabilities. The company and the trustee choose to apply the SBRR.

(b) **General consequences**

(i) Transfer of the cost base of assets (section 328-455);

(ii) Pre CGT status of capital assets is preserved (section 328-460);

(iii) The Division 115 acquisition date is the transfer date (that is, the date is not grandfathered);

(iv) For the purposes of subdivision 152-B, the transferee will be taken as having acquired the asset whether the transferor acquired it (subsection 152-115(3)); and

(v) The cost base of membership interests received pursuant to the rollover will be based on the cost base of CGT assets and the adjustable value of revenue assets transferred (section 328-465).

(c) **Example 1.7 cost base of membership interests**

Edamame Pty Ltd transfers three assets that it owns to the Soy Trust in circumstances that qualify for rollover:

- *a CGT asset having a cost base of $100,000;*
- *a second CGT asset having a cost base of $1 million; and*
- *a depreciating asset having an adjustable value of $400,000.*

The Soy Trust issues 10 units to Edamame Pty Ltd in exchange for the transfer.

The cost base and reduced cost base of each unit is $150,000 [($100,000 + $1 m + $ 400,000)/10].

Case study: Keeping up with the Joneses

Having reviewed the alternative restructuring options, it is intended to consider the following facts and provide commentary on which transfer arrangement might be preferred.

4. Case analysis

4.1 Facts

A small business (operating through a trust) has a turnover of less than $2m and is estimated to be presently worth $600k ($200k EBITA x3 profit multiple) at 30 June year 1.

The value is primarily attributable to the goodwill and intellectual property (patents) of the business, although the trust does hold depreciable assets and trading stock. The trust has in the past regularly made trust distributions to a corporate beneficiary. A UPE of $150k is "owing" to a corporate beneficiary as at the present date. This is anticipated to grow as the trust continues to generate profits which are required to fund the business's growth including increasing working capital and investment in plant and research matters.

The goodwill and intellectual property have no cost base as the business and the intellectual property were initiated and developed by the trust's primary beneficiaries, that is Mr and Mrs Jones.

Interest costs in relation to the UPE has been paid in accordance with PS LA 2010/4 (the present rate of payment in relation to the UPE is 5.4%). On 15 May year 8, the $150k principal of the UPE is due. The client is aware of the future implications of the financial obligations.

4.2 Future issues

(a) **Financing repayment of the UPE**

If the business steadily grows, as is anticipated at a rate of 10% per annum cumulative over 7 years, then the enterprise value of the business goodwill will be valued at approximately $1m ($340k EBITA x 3 profit multiple).

To satisfy the repayment of that first UPE, at that time:

(i) $340k of profits must be used to repay the year 1 UPE, leaving only $190k of working capital. This would cause disruption or pressure on the capacity to finance the business growth; or

(ii) The funds must be borrowed from an independent financial institution. This is always problematical for a small business entity without any "hard" assets to offer as security.

This becomes a recurring issue if the trust continues to make distributions to its corporate beneficiary.

(b) **Asset protection**

As the business grows there is a further risk that the trading activities could have a detrimental impact on these assets.

There has been some discussion with the client as to whether there is any advantage in transferring or quarantining the valuable assets (that is the goodwill and IP) out of the operating entity to a safe harbour entity.

(c) **Future family members**

Mr and Mrs Jones have a son that presently works in the business as a research assistant. The son provides a significant skill factor that augments the innovation process, which has been identified as the driver of the business growth.

Ultimately, Mr and Mrs Jones would like to pass the business to their son, albeit for value, in about 5 years. They have indicated that they would provide financial support to their son to pay for the business, albeit on their death they would be willing to forgive any amount outstanding.

4.3 Accountant's issues

(a) The accountant is concerned with how to restructure the business to deal with the above issues. The accountant considers that:

(i) A restructure would be useful, the earlier the better, to free up working capital so that the future UPE issues are better managed;

(ii) The movement of the goodwill (if possible) and the intellectual property have immediate taxation consequences; and

(iii) If the business is to be transferred to the son for value, the transferor must have something to assign and it is important to ensure that, at that time, the transferor has access to all of the CGT concessions (Division 115 and Division 152).

(b) If the operating entity was a company then Division 7A would be a lesser problem, to the extent that the profits can be used to generate and fund business growth.

The company, as a small business entity, has a company tax rate of 28.5% (potentially 27%).

There is also an accumulation of undistributed profits being held by the company (with franking credits attached) which could ultimately be used as a retirement annuity with tax benefits.

Despite this, asset protection is still an issue and any restructure arrangement to move goodwill and IP away from the operating entity needs careful thought with regards to tax and duty. Further thought needs to be given as to how this could be achieved.

For example, the accountant considers whether there is any virtue in forming a tax consolidated group, with some concern around the apparent complexity of the consolidation regime.

(c) There is also some angst about the personal assets of Mr and Mrs Jones. Although modest, their personal assets are relevant to their conservative risk assumptions. The accountant considers whether a vendor financing arrangement could be implemented in relation to the transfer of the business (even if a restructure is done, or if a restructure is not possible or feasible) to protect personal assets e.g. home, investment properties and public shares.

Such an arrangement is made using a company as the transferee. In addition to having the effect of creating a cost base of the assets transferred, this also provides a mechanism to "draw down" profits against the vendor loan without any Division 7A implications.

(d) Other matters the accountant has some concerns around include:

(i) Lack of reform measures dealing with the taxation of trusts which causes ongoing uncertainty;

(ii) The ATO's persistence with the legal distinction between equity and common law;

(iii) The succession planning issues and whether the son is capable of running the business; and

(iv) The personal and business asset protection issues.

4.4 Restructure objectives

Having regard to the various issues outlined, it is pertinent to consider that the current business and its relevant assets be transferred to a company structure of some sort:

(a) Small business companies attract a lower rate of tax (subject to the 2016 budget ratification);

(b) Working capital is freed up so that the year 8 and onward UPE implications do not adversely affect the business;

(c) Valuable assets (e.g. goodwill, IP and valuable depreciating assets) moved out of the operating entity and into new separate entities provides asset protection;

(d) As the trust is a small business entity there are a number of options available, including subdivision 122-A and sale and application of Division 115 & Division 152 (to the extent that the gain is subject to CGT). The question then is how to deal with the intellectual property (as it is a depreciating asset);

(e) Consider moving the IP into a separate company applying stamp duty IP exemption; and

(f) A vendor financing strategy could be implemented to protect personal assets and provide a "draw down" facility.

5. How to achieve the above objectives

5.1 Application of subdivision 122-A

(a) **Step 1:**

(i) Transfer all assets to a company in exchange for shares in the company:

(A) CGT rollover relief on all CGT assets;

(B) Depreciating assets including IP, no tax implications – section 40-340; and

(C) UPE cannot be assumed by company – not a liability.

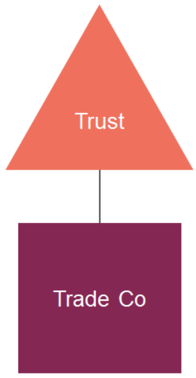
(ii) Consequences:

(A) No tax;

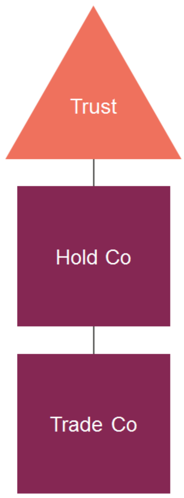
(B) No cost uplift;

(C) Trust owns all shares in company (Trade Co); and

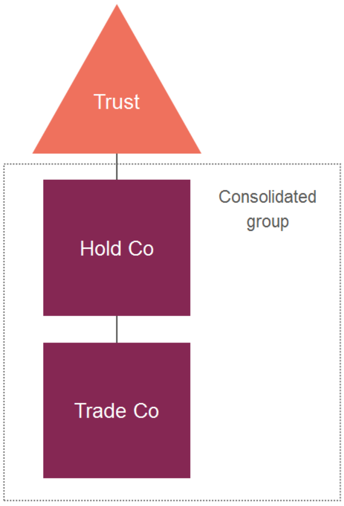
(D) In Queensland – stamp duty applies.



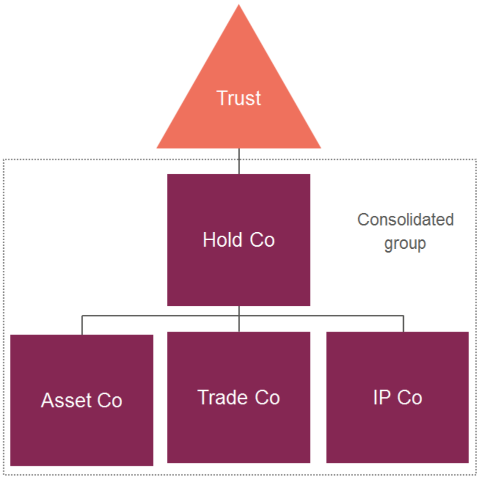
(b) **Step 2:** Interpose a holding company (Hold Co) between trust and Trade Co – must use subdivision 124-M rather than Division 615 – as there is only one shareholder.



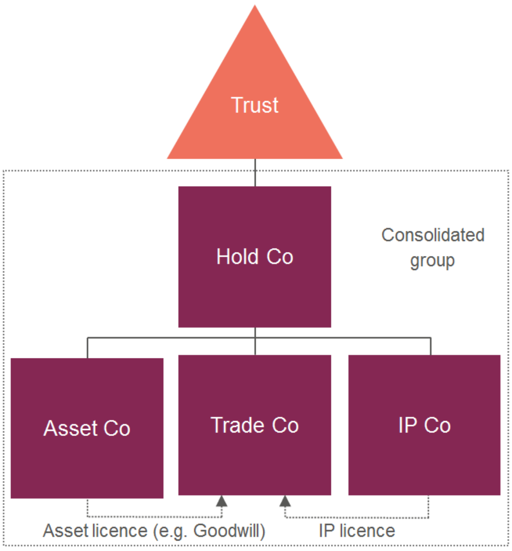
(c) **Step 3:** Form a tax consolidated group.



(d) **Step 4:** Form subsidiary entities with Hold Co as the parent.



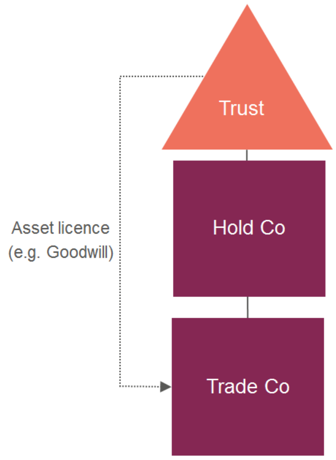
(e) **Step 5:** Licence assets and IP to new Trade Co – Trade Co will carry on future business activities.



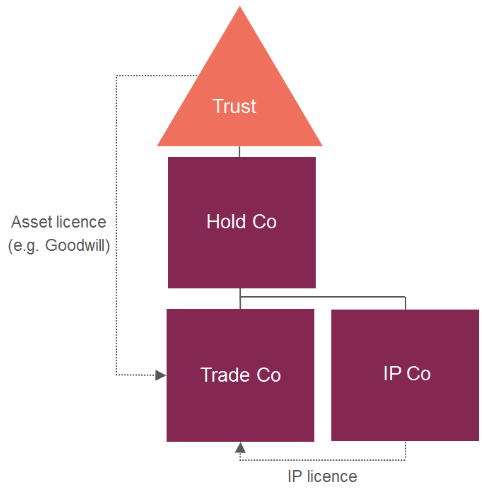
(f) **Step 6:** Trust sells shares in Hold Co to son in the future.

5.2 Alternative application of subdivision 122-A (no Queensland stamp duty applies)

(a) **Step 1:**



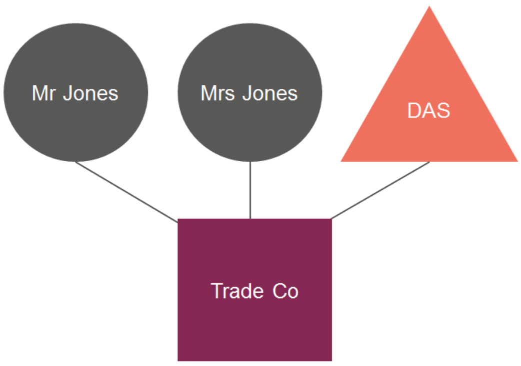
(b) **Step 2:**



5.3 Sale of assets – application of Division 115 & Division 152

(a) **Step 1**: Establish a new company with Mr and Mrs Jones holding ordinary shares (with the full complement of rights) and a trust holding DAS shares - income only rights.

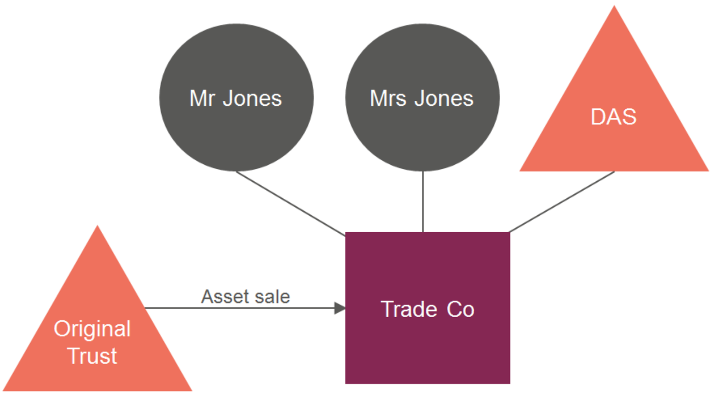
Query whether it is relevant to establish a cost base for the shares.



(b) **Step 2:** Trust sells all of the assets to a company for value.

The IP could be licensed to the company in exchange for the payment of a reasonable licence fee. No division 40 issue, if licence fee is based on a commercial basis.

The sale price to be vendor financed – that is, the trust sells the asset(s) in exchange for a loan to the company (care with Division 7A – section 109XA implications covered by section 109K exclusion). Loan amount should be covered by a commercial loan agreement (albeit not a section 109N loan). It is important to get the documentation right and ensure that the sale price is equivalent to the market value of the assets!



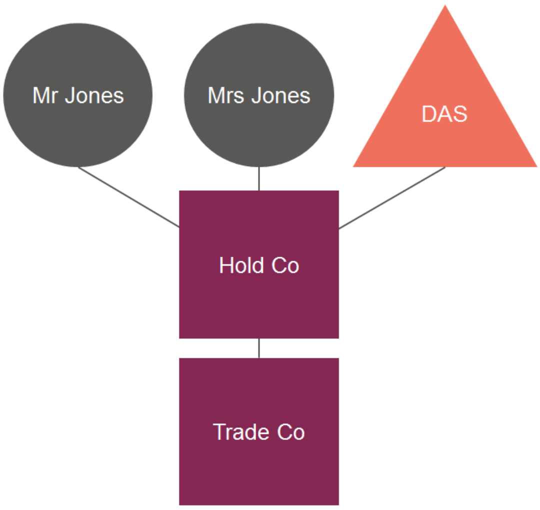
Consequences:

(i) As the trust is a SBE, any capital gain associated with the transfer of the goodwill would be reduced by Division 115 and Division 152. Only a small amount of the capital gain would need to be committed to superannuation – $250,000 (based on $1m capital gain).

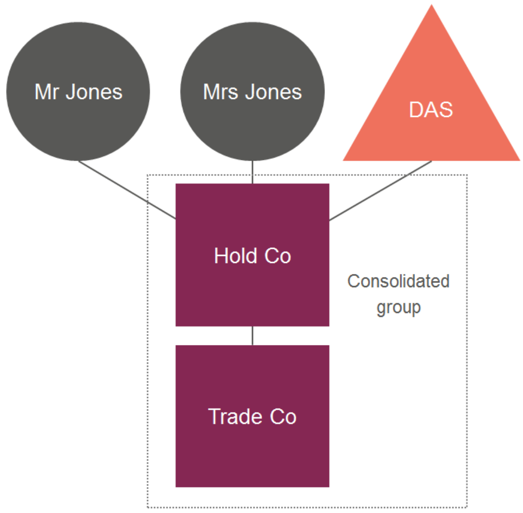
(ii) Consider whether subdivision 152-E could be used on the balance, rather than subdivision 152-D, and apply the active asset replacement exclusion (CGT Event J5) if superannuation is not possible.

(iii) In Queensland – stamp duty applies.

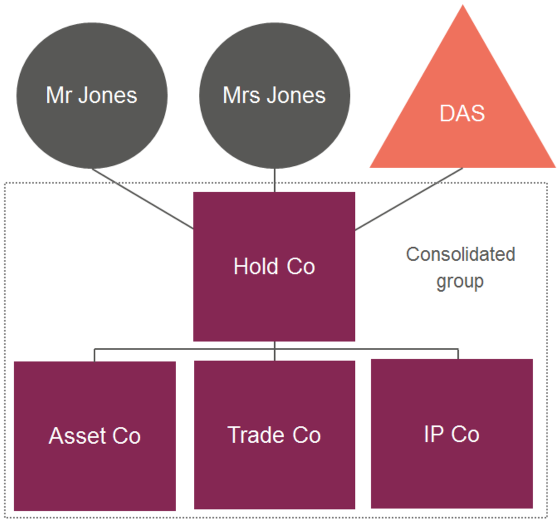
(c) **Step 3:** If considered necessary, interpose a holding company (Hold Co) between company and shareholders using Division 615 rollover.



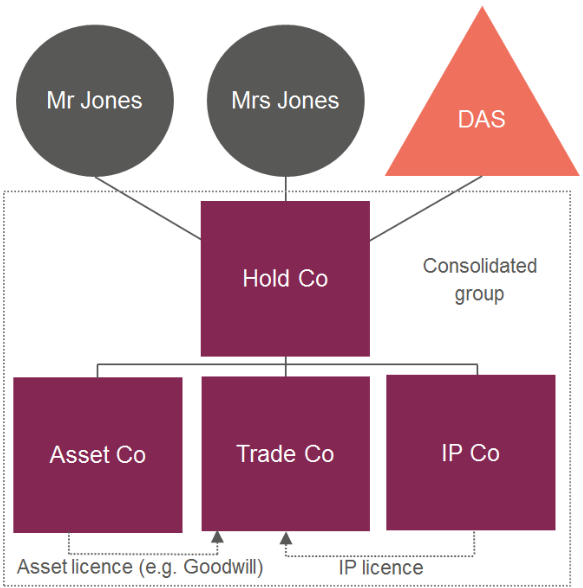
(d) **Step 4:** Form a tax consolidated group.



(e) **Step 5:** Establish subsidiaries under Hold Co to hold any IP and/or assets.



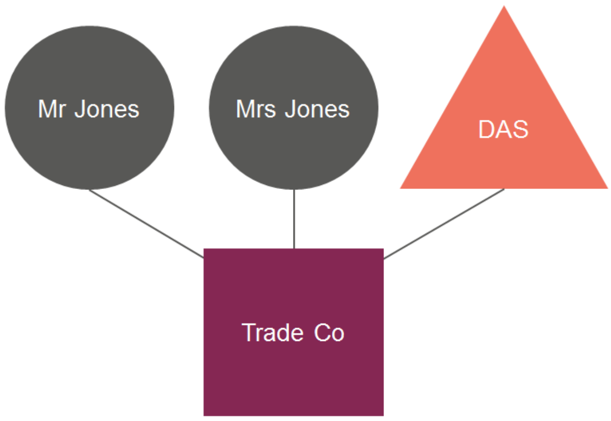
(f) **Step 6:** IP and assets licenced to Trade Co.



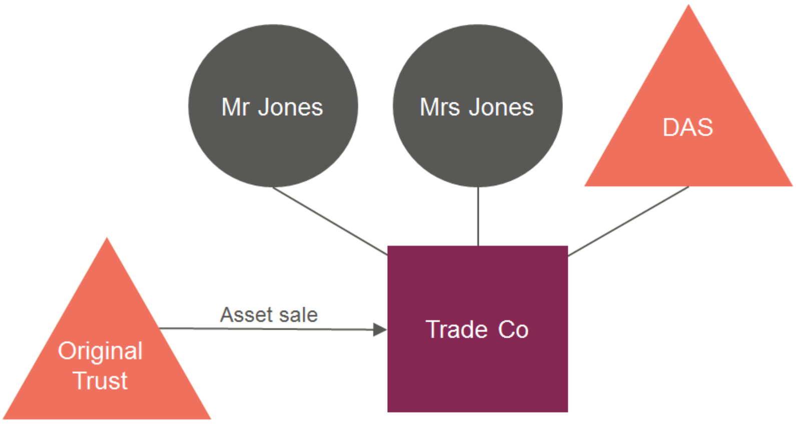
(g) **Step 7:** Mr and Mrs Jones sells shares in Hold Co to their son when applicable – use Division 115 and Division 152 then to reduce their CGT liability.

5.4 Application of Subdivision 328-G (the new small business restructuring provisions)

(a) **Step 1:** Establish a new company with the same shareholders as in the above strategy. The DAS holding trust should have the same test individual as with the transferor trust, or could be the transferor trust.



(b) **Step 2:** On the basis that the restructure is a genuine restructure, all of the assets are transferred to the new company for their market value on a vendor finance basis – asset protection measure. The trust could have some form of security over the assets of the company.



Consequences:

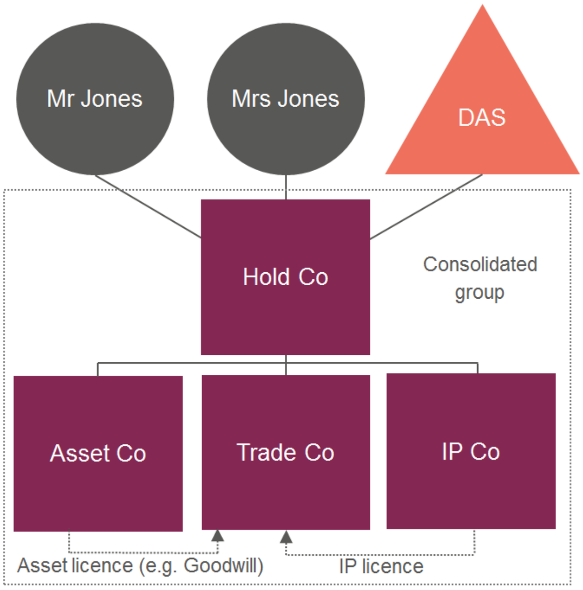
(i) In accordance with subdivision 328-G no CGT or Division 40 implications;

(ii) All assets have been transferred – somewhat simpler process;

(iii) In Queensland – stamp duty applies; and

(iv) Consider the risk issues and whether it is necessary to separate or isolate the asset ownership by using the same additional restructuring measures as with the above sale process in (ii).

(c) **Steps 3-6:** as per above scenario.



(d) **Step 7:** Mr & Mrs Jones sells their shares to the son in future years. Arguably as the son is a beneficiary of the transferor trust, there would be no change in the underlying ownership issue if that transaction occurred within the requisite three year period.