



THE TAX INSTITUTE

THE MARK OF EXPERTISE

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By email: taxlawdesign@treasury.gov.au

Dear Mr Reid,

Small Business Restructure Roll-over

The Tax Institute welcomes the opportunity to make a submission to the Treasury in relation to the *Small Business Restructure Roll-over Exposure Draft (Exposure Draft)* and associated Explanatory Memorandum (EM).

Summary

Our submission below addresses our main concerns in relation to the Exposure Draft. In particular:

- The requirements to satisfy the '\$2 million aggregated turnover test' and the 'maximum net asset value' should be alternative tests;
- The Australian residency requirement for the 'ultimate economic owners' of the transferee entity may inadvertently disqualify many taxpayers from qualifying for the roll-over contrary to the intention of the roll-over and therefore should be addressed; and
- There are a number of carve-outs required from this roll-over to address potential inappropriate consequences that may arise from interactions of these provisions with other parts of the income tax law.

Discussion

While it is encouraging that the Government has sought to offer small businesses a roll-over to allow small businesses to select the most relevant legal structure at various stages in the life of the business without being inhibited by tax costs, The Tax Institute has a number of significant concerns with the proposed small business restructure roll-over as currently drafted in the Exposure Draft. We set these out below.

Exposure Draft

1. Requirement to satisfy the '\$2 million turnover' and '\$6 million maximum net asset value' tests – tests should be alternatives

Draft section 328-430(1)(a)(i) operates such that an entity may only be able to access the small business restructure roll-over if it both:

- a) satisfies the definition of being a 'small business entity' as contained in section 328-110 of the *Income Tax Assessment Act 1997* (Cth) (**1997 Act**) (that is, it meets the \$2 million aggregated turnover test); and
- b) satisfies the 'maximum net asset value' (**MNAV**) in section 152-15 of the 1997 Act (the \$6 million maximum net value of CGT assets).

These two tests operate as alternatives to determine whether the rollovers in Division 152 could apply to a small business. Making them cumulative tests severely limits the cohort of taxpayers who will qualify for the roll-over and runs against the policy intent of having the two alternative tests in the first place in the context of Division 152. This will disadvantage high volume, low margin businesses and asset rich, turnover poor businesses.

Further, making the two tests cumulative instead of alternative effectively introduces yet another definition of 'small business' into the 1997 Act, increasing the complexity of tax matters for such taxpayers and unnecessarily amplifying the potential for confusion and error.

In our view, these two tests should also operate as alternative tests in determining which taxpayers are eligible for the roll-over. As such, we recommend draft section 328-430(1)(a)(i) be amended accordingly.

2. Residency requirement for individuals who are ultimate economic owners

Section 328-440(2) contains the 'residency requirement' that applies to the ultimate economic owners¹ of the assets subject to the roll-over. In our view, this requirement will inadvertently disqualify many taxpayers from accessing the roll-over which we believe is contrary to the policy intention behind the roll-over.

For example, a taxpayer may nominate their parent as the test individual of the family trust resulting in cousins also being included in the 'family group'. Where a cousin (who is not likely to receive a distribution from the trust and may not even know of its existence) moves overseas to live and work and becomes a non-resident of Australia, they will no longer be an Australian resident. In turn, the requirement that all ultimate economic owners be Australian residents cannot be satisfied and the trust will be unable to access the roll-over.

¹ Section 328-440(1)(g)

The restrictive nature of this requirement should be addressed. Perhaps Treasury could consider whether this requirement may only need to apply to “fixed” interests in the transferee, such as shares or units.

It is also unclear how the residency requirement deals with a ‘temporary resident’ of Australia.

3. No consideration provided

Section 328-440(1)(d) positively requires that no consideration be provided for the transfer of assets subject to the roll-over

a) Interaction with other provisions

This provision creates a number of potential interaction issues (with inappropriate consequences for taxpayers) with a number of other parts of the tax law including (but not limited to):

- Division 7A of the *Income Tax Assessment Act 1936* (Cth) (**1936 Act**) – whether the ‘roll-over’ could amount to a ‘deemed dividend’ for the purposes of these rules (section 109C would likely be triggered). For example, in Example 1.2 in the EM, Division 7A could apply to potentially create a deemed dividend to the value of \$600,000.
- The definition of ‘dividend’ in section 6 of the 1936 Act could be engaged where the transferee was a shareholder in the transferor.
- The capital benefit provisions in sections 45A, 45B and 45C of the 1936 Act could be engaged where the requisite more than incidental purpose was considered to be present.
- The application of the FBT provisions in the *Fringe Benefits Tax Assessment Act 1986* (Cth) – where the recipient of the roll-over is an employee or associate of an employee, a question will arise whether the transfer of an asset for less than market value to that recipient could be taxed as a property fringe benefit.
- Trust distribution rules – whether the transfer of an asset in specie for no consideration involves making a beneficiary presently entitled to some of the income of the trust for the purposes of section 97 of the 1936 Act and therefore will cause the recipient to be assessed on a proportion of the net income of the trust for tax purposes. In addition, that the roll-over should not amount to a distribution from a trust for the purposes of Division 6 and Division 6E of the 1936 Act.
- Indirect value shifting rules – when the conditions for an indirect value shift are met, these rules will, it would appear, apply to the taxpayers involved despite the existence of the rollover.

To ensure these consequences do not arise, appropriate carve-outs should be included in the provisions.

b) Employee obligations

This requirement will also be difficult to satisfy in practice where there is a transfer of a business which has employees. As a general rule, employee obligations are usually transferred to the transferee (because the employees usually take up employment with the new employer). As this will amount to the assumption of liabilities, and therefore 'consideration', the roll-over will not be available.

c) Transfer of liabilities generally

Where no consideration is provided for a transfer of a business, no transfers which involve the transferee assuming the liabilities of the business transferred will be eligible for the roll-over, therefore preventing a number of ordinary business transactions from being able to access the roll-over.

There are also a number of likely flow-on effects from this. For example, where the liabilities of a business cannot be transferred, the parties to the transaction may be prevented from accessing the 'going concern' provisions² in the *A New Tax System (Goods and Services Tax) Act 1999* (Cth) (**GST Act**) (that require all things necessary for the continued operation of the business to be transferred to be eligible for GST-free treatment).

An acquiring entity commercially may need to inherit a liability secured against the asset. We query whether the rollover could be extended to cover the assumption of liabilities in respect of the assets acquired similar to Div 122-A.

Another issue is whether interest remains deductible on a loan in the entity used to purchase the transferred business assets where the loan is not transferred with the business assets.

This requirement is also commercially unrealistic. Even if sufficient assets can be left in the transferor entity to satisfy expected liabilities, to avoid breaches of director duties, 'phoenix' issues, etc, in practice, there will need to be some sort of indemnity provided to the transferor for pre-transfer liabilities which would also be 'consideration'.

4. Roll-over cost of an asset

Draft section 328-430(2)(a) creates uncertainty in that it permits a range of possible values to be determined as the 'roll-over cost' of an asset. Any cost in the range between 'cost base' and 'reduced cost base' (as defined in the CGT provisions contained in the 1997 Act) could apply. We query whether this outcome is intended.

² Subdivision 38-J of the GST Act

To resolve this, a prioritising rule similar to the rule in Step 1 of the consolidation rules contained in section 705-65 of the 1997 Act³ should be inserted into the law to assist taxpayers to be able to determine the most appropriate amount to be the 'roll-over cost' of an asset.

5. Ultimate economic ownership

The term 'ultimate economic ownership' should be defined for the purposes of these provisions. The concept is central to these provisions. However, it has only been defined in relation to discretionary trusts that have made a family trust election. We query, for example, how this concept of ultimate economic ownership would be applied to certain entities such as unit trusts, hybrid trusts and companies with different classes of shares.

For example, does it extend to shareholders of a company, particularly where there are different income and capital rights. The loss rules include specific tracing rules - can these be replicated? If a company has a discretionary or preference share on issue, will this mean no-one is the ultimate economic owner? Does it extend to a family trust shareholder of a company which has made an election in respect of the same test individual as another trust?

6. Cost base of membership interests in the transferor entity

Draft section 328-445 contains the rules for determining the cost base of membership interests in the transferor entity. This provision operates to reduce the cost base of the membership interests in the transferor entity. In our view, the value of this 'downwards adjustment' should be the 'cost' of the asset(s) transferred rather than the market value as currently drafted in the provision.

There should also be a corresponding 'upwards adjustment' to the cost base of the membership interests in the transferee entity included in the rules for the 'cost' of the asset(s) transferred pursuant to the roll-over (to compensate for the 'downwards adjustment' discussed above). Accordingly, relevant provisions should be included in the Exposure Draft.

7. Other matters

- a) We query whether section 328-430(1)(a)(i) should also be extended to assets inherently connected with a business being carried on (eg goodwill/intellectual property held by an entity associated with the entity the subject of the roll-over which may not necessarily carry on the business).

³ Which is about determining the allocable cost amount for membership interests of a joining entity

- b) What does the expression 'asset of a business' (used for example in draft section 328-430(1)(c)(i)) mean? It seems similar to the wording used in Division 122-A of the 1997 Act. Is the same meaning intended to apply?
- c) Is an asset that is leased to other parties (eg a building) an 'asset of the business' for the purposes of the roll-over provisions?
- d) Section 328-430(2)(b) makes a clear statement regarding what the expected consequences are under Division 70 of the 1997 Act. However, we are not certain this will satisfactorily prevent the 'deemed disposal' provisions (section 70-100) from applying. Therefore, we suggest a consequential amendment is required to be made to Division 70 to ensure no deemed disposal arises when a roll-over subject to the small business restructure roll-over provisions occurs.
- e) There may also be a possible conflict with the Division 70 trading stock rules that apply when there is a disposal of trading stock outside the ordinary course of business (section 70-90).
- f) Where a small business entity that is eligible for the CGT discount has held an asset for more than 12 months and rolls that asset into a new company pursuant to these roll-over provisions and the shares in the new company are subsequently disposed (within 12 months) can the CGT discount apply to the disposal of the shares? (Refer to section 115-34 of the 1997 Act.)
- g) We raise a general suggestion that the \$2 million aggregated turnover test in the definition of 'small business entity' be indexed (by increments of \$100,000).

Recommendation to relocate the roll-over provisions to another part of the 1997 Act

It is currently proposed that the small business restructure roll-over provisions be inserted into Division 328, the 'small business entity' provisions of the 1997 Act.

Small business taxpayers have a number of provisions to contend with to determine whether certain roll-overs are available to them, including in Divisions 122, 124, 152, 328 and 615 of the 1997 Act. In the interests of ensuring there is a streamlined design for these provisions consistent with the 1997 Act and to minimise compliance costs (and accordingly 'red tape'), we recommend Treasury insert a clear cross-reference to the new roll-over provisions in other relevant parts of the Act (such as Division 152) if it is not inclined to consider inserting these roll-over provisions in another location, such as Division 152, rather than in Division 328.

Explanatory Memorandum

1. Example 1.2

It is unclear how Treasury has arrived at the conclusion it has in this example. We query whether there is some factual information missing from the example.

It would be useful if Treasury could state in the example the original and final values of the cost base of all the shares on issue (as well as the amount by which the cost base changes. It is a little confusing to have referred to the value of the assets throughout the example and then only refer to the change to the cost base for each share on an individual basis (rather than on an aggregate basis) in the final paragraph of the example. It is also not clear what happens if the cost base falls below zero as is likely in this example.

2. Similarity of the two examples

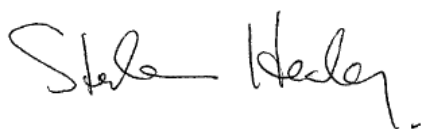
We observe that the two examples that have been included in the EM are very similar in nature and recommend Treasury insert an example that is different.

We suggest Treasury consider including the following examples:

- a) There is a transfer of a manufacturing business from a company to a discretionary trust paired with the transfer of the factory from which the business operated to a separate discretionary trust; and/or
- b) A business is operated from a company in which passive investment assets are also accumulated. There are shares in the hands of the company's shareholders with a cost base of \$12. There is \$100,000 of plant and equipment (written down value) and \$500,000 of goodwill (market value where cost is nil) to be transferred to a new discretionary trust along with employee leave entitlements. The example should illustrate how the cost base adjustments apply in this situation.

If you would like to discuss any of the above, please contact either me or Tax Counsel, Stephanie Caredes, on 02 8223 0059.

Yours sincerely



Stephen Healey
President