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Dear Sir

Exposure draft legislation - Small business restructure rollover

Chartered Accountants Australia and New Zealand (**Chartered Accountants ANZ**) welcomes the opportunity to comment on the Exposure Draft legislation (**ED**) and Explanatory Materials (**EM**) to amend the law to make it easier for small businesses to change their legal structure without incurring a capital gains tax (**CGT**) liability.

We are made up of over 100,000 diverse, talented and financially astute professionals who utilise their skills every day to make a difference for businesses the world over. Our members are known for professional integrity, principled judgment and financial discipline, and a forward-looking approach to business. We focus on the education and lifelong learning of members, and engage in advocacy and thought leadership in areas that impact the economy and domestic and international capital markets.

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Our comments on the ED and EM are set out below.

Context of the amendments

The ED proposes amendments to make it easier for small business owners to restructure their business by allowing them to defer gains or losses that would otherwise be made when business assets are transferred from one entity to another by electing for roll-over relief.

The proposed amendments are a response to concerns that the most appropriate structure for a small business may change over time, or a new small business may choose an initial legal structure that it later finds to be unnecessarily complex. Restructuring into a more appropriate legal structure is seen as a way to help a business continue to develop and grow, to avoid unnecessary compliance costs resulting from using overly complex structures, or to adapt to current conditions.

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The purpose of the amendments is to remove the income tax liabilities, and consequent cash flow consequences, when a restructure requires business assets to be transferred from one entity to another, such as from a company to a trust.

The ED differs from the Government's Budget announcement in that:

- It seeks to remove all income tax liabilities arising from the transfer of business assets and not simply CGT liabilities as originally announced; and
- Each party to the transfer must be a small business entity (**SBE**) as defined (aggregated turnover of less than $2 million) which satisfies the $6 million maximum net asset value or an affiliate or an entity connected with such a SBE (and not simply an SBE as originally announced).

We understand that the concept of providing roll-over relief for small business restructures stems from one of the longer term options for reform raised by the Board of Taxation in its report on *Taxation impediments facing small business.* It mooted that, subject to integrity concerns, consideration be given to providing roll-over relief to business restructures that occur early on in the business life cycle with a view of a putting such a business in the position it would have been in had it been structured appropriately at its commencement.

The Board acknowledged that allowing transfers to family trusts would have revenue consequences which would need to be considered and also that allowing the transfer of assets other than from individuals would require complex rules which ultimately may make the concept undesirable.

The ED goes further than the Board's suggestion in that it proposes that roll-over relief be available for small business restructures at any time during its life cycle. The ED seeks to avoid the need for complex rules when assets are transferred other than from individuals by requiring such transfers be done for no consideration and for the cost base of equity interests to be reduced by the market value of the assets transferred.

Our comments on the proposed amendments are set out below.

General observations

1. Draft legislation does not cover all tax liabilities

As drafted, the ED only defers any income tax liability arising in respect of gains or losses arising from the transfer of assets as part of the restructure of a small business.

This is because proposed section 328-430 only appears to apply for the purposes of applying the capital gains, trading stock and revenue asset rules. It does not prevent value of the assets transferred by a company to a shareholder or an associate of a shareholder, e.g. a family trust, from being taxed under section 44 of the *Income Tax Assessment Act 1936* (ITAA 1936) because it is a 'dividend', as defined in section 6, or a deemed dividend pursuant to Division 7A of that Act.

If, as per paragraph 1.11 of the EM, it is intended that small business restructures not result in any immediate tax liabilities, then to achieve this outcome the ED would need to switch off not only section 44 of the ITAA 1936 in respect of ordinary or deemed dividends which arise as a consequence of the transfer of assets for no consideration[1] but all other provisions that can give rise to either an amount of assessable income being derived in these

[1] We note that this may reactivate calls that section 44 be switched off in respect of transfers of assets which qualify for roll-over relief under Subdivision 126-A – marriage or relationship breakdowns. Currently the fact that a transfer qualifies for roll-over relief does not preclude the transfer of assets being treated as an ordinary dividend or a deemed dividend which is assessable under section 44 of the ITAA 1936 (see TR 2014/5).

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circumstances or a tax liability arising under another Commonwealth taxing statute, e.g. FBT, GST and possibly sections 45A, 45B and 45C and the value shifting rules. The situation may be different in the event that the proposed amendments required or permitted the transfer of assets for market value, albeit we acknowledge this may give rise to other tax issues.

We also observe that businesses of the size to which the proposed amendments apply are not generally required to comply with accounting standards. Accordingly, there may be a variety of ways in which such entities may account for the transfer of assets to shareholders or associated entities for no consideration. These include debiting retained earnings for the book value of the assets transferred or treating the book or market value of those assets as a distribution. There are probably also a variety of ways in which the transferee may account for the acquisition of assets for no consideration.

We suggest that Treasury consider whether different accounting treatments which might be adopted impact on the tax treatment of future distributions of profits/share capital of a company or corpus of a trust. The interactions between the income tax outcomes, trust law and corporations law also requires more detailed consideration (see below).

2. Role of the anti-avoidance rules in Part IVA

Treasury has indicated that the proposed amendments are intended to allow a small business restructure for commercial reasons (or at least reasons which are not predominantly motivated by tax), i.e. to develop and grow, to avoid unnecessary compliance costs resulting from using overly complex structures, or to adapt to current conditions. This presumably would include, as in Example 1.2, the transfer of land from a trading entity for asset protection purposes.

We do not believe that this is clearly reflected in the EM or indeed in the ED itself in either proposed section 328-420 (What this Subdivision is about), proposed section 328-425 (Object of this Subdivision) or paragraph (c) of proposed subsection 328-440(1) which requires transactions to be part of a restructure designed to effect certain changes.

Even when a small business is restructured for commercial purposes, the nature of the restructures permitted by the ED is such that the restructure may facilitate income splitting or other tax advantageous outcomes, e.g. the transfer of assets from a company to an entity which qualifies for the CGT discount or which has capital losses.

It is also conceivable that the proposed amendments will be perceived as a green light for small business to restructure solely or mainly for tax purposes, particularly in the light of the subsection 177C(2) which precludes a tax benefit from arising in certain circumstances, including where at taxpayer has opted for roll-over relief.

We recommend that Treasury liaise with the ATO to determine if the proposed amendments are likely to cause the ATO concern in relation to Part IVA in certain circumstances. If so, the ATO needs to signal its concerns at the same time as the changes are made (or incorporated into the EM). This is particularly important given the level of the market to which the changes are directed.

3. Income tax liabilities are not the only impediment to restructuring

Income tax liabilities are not the only impediment to the restructuring of small businesses. So, the success of the proposed legislation will, to some extent, depend on the significance of the following additional imposts/consequences in particular cases:

- *Stamp duty* - depending on the assets transferred and the state(s) in which the assets are located, the transfer of assets may also attract stamp duty. Where there

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is no consideration for the transfer, stamp duty will generally be imposed on the market value of the assets transferred. Stamp duty can be a significant impost.

- *GST* – to qualify for the going concern exemption all things necessary for the continued operation of the business must be transferred. If the requirement that there be no consideration for the transfer means that liabilities cannot be transferred then it may not be possible to satisfy this requirement (see comments below).
- *Market valuations* – small businesses wishing to restructure may be required to obtain market valuations in order to:
  - Show that they are eligible for the proposed roll-over relief. This is because to qualify it is a requirement that each party to the transfer be a SBE which satisfies the maximum net asset value test or an 'affiliate' or entity 'connected with' such a small business entity.

    The need to obtain market valuations of SBE groups will be felt most by small businesses the value of which is likely to be close to the $6 million threshold.
  - Reduce the cost base of interests in the transferor entity, i.e. shares in a company or units in a trust, by the market value of the assets transferred.
  - Quantify any stamp duty obligation.

  We note that there have been numerous disputes between the ATO and taxpayers as to the market value of assets for the purposes of applying the $6 million threshold and that by making this test a pre-requisite for being able to access this new roll-over the number of such disputes will undoubtedly increase.
- *Other transaction costs* - the above costs are in addition to normal legal, tax and accounting fees for advice in relation to the transaction.
- *Access to roll-over where assets are debt funded and/or other liabilities cannot be transferred* – one of the practical consequences of the requirement that there be no consideration is that the entities which would otherwise be able to take advantage of the proposed roll-over may not be able to do so because:
  - Their assets are funded by debt which, in the absence of consideration for the sale of business assets, cannot be serviced or repaid; and/or
  - They have liabilities associated with the business, e.g. creditors and employee leave provisions, which would normally be assumed by the transferee for an amount which is set off against the consideration for the sale of the assets. Absent such consideration, the transferor may not be able to pay the transferee for assuming such liabilities. Should the transferee simply assume the liabilities of the business for no consideration we suspect that this would amount to consideration for the transfer of the assets with the result that the transfer would not qualify for roll-over relief.

    Our understanding is that if employees are transferred the new employer has to recognise an employee's service with the old employer when working out many of their entitlements, particularly where the new employer is an associated entity. In effect, if employees are transferred, the transferee may statutorily be required to assume certain accumulated employee leave obligations.
- *Consequences for trustees and directors* – related to the above point we observe that transferring assets of a company or a trust for no consideration may have

consequences for company directors under the *Corporations Act* and trustees of trusts under trust law and/or the relevant trust deed which should be considered. If nothing else, the EM should at least alert readers to the need for these issues to be considered.

- *Access to roll-over where interests in assets is not fixed* - the ED is drafted on the basis that, other than in the case of discretionary trusts, interests in transferor and transferee entities is fixed so that it is possible to establish the ultimate economic owners of assets before and after they are transferred and make adjustments to the cost base of interests in transferor entities. This will not always be the case so that access to the roll-over relief may be more limited than envisaged.

4. Is the concept of a small business too narrow?

As noted above, the proposed roll-over is limited to small businesses which are SBEs as defined (less than $2 million turnover) and which satisfy the $6 million maximum net asset value test.

This is narrower than the Government's announcement. It is also narrower than the small business CGT concessions which, on the face of it, are available to entities which satisfy either of these tests.

As drafted, we suspect that there will be a number of businesses which qualify for the small business CGT concessions but which will not qualify for the proposed roll-over relief.

Given that the reason the small business CGT concessions have an alternative net asset test is to ensure that high volume (more than $2 million turnover), low profit margin, businesses are not excluded from the concessions we suggest that consideration should be given to making the proposed roll-over available to entities which satisfy either test. This would have the added benefit of consistency within the CGT regime as to what constitutes a small business.

We acknowledge that this would have revenue implications which need to be taken into account.

Specific provisions of the ED

5. Requirements for a roll-over – section 328-440

Transferred assets must be business assets

We understand from subsection 328-430(1) and the EM (paragraphs 1.18-1.22) that roll-over is intended to be available in respect of:

- the transfer of a business asset(s) by a SBE which satisfies net asset value test; and
- the transfer of an asset by an affiliate or an entity connected with such a SBE where the asset is of a type described in subsection 152-10(1A) or (1B), i.e. passively held assets that are used in the business of the SBE.

However, as one of the requirements for roll-over relief is that an entity transfer to one or more other entities 'a CGT asset, or all of the assets, of *its business* (paragraph (a) of subsection 328-440(1) – emphasis added) it is difficult to see how transfers referred to in the second dot point will qualify.

Roll-over cost of a CGT asset

As drafted the roll-over cost of a CGT asset (other than trading stock, depreciating or revenue assets) is such amount as gives rise to neither a capital gain or capital loss to the transferor. Given that any amount between the cost base and reduced cost base of a CGT will fit this description we recommend that the section be reworded to achieve its desired effect.

In this regard we note that the Subdivision 126-A treats the transferee as having the same cost base (or reduced cost base) as the transferor and this may be one way of dealing with this issue.

The transfer must be, or be part of, a restructure

One of the requirements which must be satisfied to qualify for roll-over relief is that (proposed paragraph (c) of subsection 328-440(1)):

The transaction is, or is a part of, a restructure of the business that has either or both of the following effects:

> *(i) Changing the type of any or all of the entities through which all or part of the business is operated;*
>
> *(ii) Changing the number of the entities through which all or part of the business is operated;'*

We question whether the requirement that the transaction be part of a restructure is necessary or if it would be sufficient to simply require that:

The transaction ~~is, or is a part of, a restructure of the business that~~ has either or both of the following effects...

If the reference to a restructure of a business is retained, we think that the EM should elaborate on exactly what transactions may have the desired effect but be out of scope because they cannot be aptly described as 'a restructure' of a business.

In relation to the two requisite effects a restructure must achieve we believe it is the case that:

- Any assets transferred must continue to be used in the business, at least immediately after the transfer.
- There is no actual requirement that any entities be liquidated or wound up. For example, if a business conducted by a company is transferred to its corporate shareholder, there is no change in the type of entity through which all or part of the business is operated. However, there is arguably a change in the number of entities through which the business is operated, notwithstanding that the transferor is not liquidated, because the transferor no longer operates all or part of the business.

If this is correct then it may be worth highlighting these points in the EM.

There must be no consideration for the transfer

Elsewhere in this submission we make a number of comments on the consequences of requiring that the transfer be for no consideration which we do not repeat here. In our view, the requirement that there be no consideration for the transfer should be reconsidered.

Residency requirements

We have not considered the proposed residency requirements in detail but note that given the increasingly 'global' residence of family members we expect this requirement will prove to be problematic.

No change in ultimate economic ownership of transferred assets

The requirement that the ultimate economic ownership of the assets transferred does not change as a result of the restructure is critical to the operation of the proposed roll over.

However, contrary to the assertion in paragraph 1.41 of the EM, we do not believe that identifying individuals will always be straight forward in the case of a company, partnership or fixed (unit) trust. Indeed, it is not entirely clear to us what the test is, i.e.

- Which individuals have the ultimate economic ownership of the assets in the sense of, for example, who would be entitled to a distribution of capital/corpus on a winding up of a company, fixed trust or partnership. These entitlements might be different if made when the entity is a going concern; or
- Which individuals will benefit economically from the assets transferred, which suggests that ongoing entitlements to the profits from the asset or business in the form of dividends, trust or partnership distributions may also be relevant; or
- Something else.

The EM suggests that an individual's interest in the asset itself and in the income it generates is relevant. For example, paragraph 1.41 refers to determining who will benefit economically from the asset and paragraph 1.42 states that 'The situation is somewhat more complicated for discretionary trusts as beneficiaries do not have an interest in any asset or income of the trust until the trustee exercises their discretion'.

We highlight the fact that while the constituent documents may set out members' entitlements, they will not necessarily be the same interest in income and capital. Indeed, if an individual's interest in any income from the transferred asset is relevant the reality is that, in the small business arena, it is common for shares in companies to carry discretionary rights, at least to dividends. So, in Example 1, there would be a good chance that shares in Pail Co owned by Jack and Jill carried discretionary entitlements to dividends but share equally in any distribution on winding up. If so, is it the case that:

- the transfer would not qualify for roll-over; or
- the transfer would qualify for roll-over because, as a group, there has been no change in economic ownership.

The ED seeks to address the fact that beneficiaries of a discretionary trust cannot be said to have an economic interest in the underlying assets of a trust. The EM, at paragraph 1.42, says it does this by treating as the ultimate economic owners of the assets of a discretionary trust which has made a family trust election the family group for whom the trust is administered.

However, proposed subsection 328-440(3) does not deem members of a family group to be the ultimate economic owners of the underlying assets of a trust (or specify their percentage interest in those assets). Instead, it simply sets out the circumstances in which the transfer of an asset to or from a family trust, or between family trusts, will not result in a change in economic ownership. The two concepts are different.

For reasons set out in our comments below in relation to Example 1.2, to achieve the outcome sought we think that proposed subsection 328-440(3) should be amended to apply to treat a transaction as not effecting a change in ultimate economic ownership where:

- where paragraph (a)(i) applies because there is a transfer to a family trust from an entity (other than from another family trust) and paragraph (c) is satisfied, e.g. a transfer from an individual, partnership or company to a family trust;
- in the reverse situation where proposed paragraph (a)(ii) applies because there is a transfer to a family trust (other than from another family trust) and paragraph (b) is satisfied, e.g. a transfer from a family trust to an individual, partnership or company;
- where paragraphs (a)(i) and (ii) are satisfied because there is a transfer from one family trust to another family trust and the family group in respect of each trust is the same.

6. Effect of small business restructures on transferred cost of assets

Transfer of revenue assets

As drafted, the ED ensures that the transfer of revenue assets is tax neutral to the transferor and that the transferee inherits the transferor's cost. You may wish to consider whether the character of the asset as a revenue asset should be retained in the hands of the transferee.

Transfer of trading stock

Under Subdivision 328-E of the ITAA 1997), SBEs are not required to value each item of trading stock on hand at the end of the income year, or account for any change in the value of trading stock on hand, if the difference between the value of the trading stock at the start of the income year and the end of that year is less than $5,000.

We have not considered whether the proposed amendments mesh appropriately with these rules.

7. Cost base of membership interests in transferors

Proposed subsection 328-445 reduces the cost/reduced cost base of membership interests in the transferor by the market value of the assets transferred.

We have not road tested whether this produces appropriate outcomes but observe that Subdivision 126-A of the ITAA 1997, which also involves the transfer of assets from an entity for no consideration, seeks to achieve a similar outcome but does so differently – see section 126-15. Treasury may wish to revisit the approach adopted in the ED.

Treasury should also consider whether, where an asset is transferred to a company or fixed trust for no consideration, there needs to be an upward adjustment to the cost/reduced cost base of interests in the transferee entity.

8. Other amendments

We have two comments relating to depreciable assets transferred:

- It is proposed that a new item be added to the table in subsection 40-340(1) of the ITAA 1997 and that the 'Type of CGT roll-over' in column 2 be described as 'Transfer of asset under a transaction for transfer of all of the assets of the transferor's business'.

Given that it is not a requirement that all of the assets of a business be transferred we suggest you reconsider this wording.

- Under Subdivision 328-D of ITAA 1997 SBEs have access to simplified depreciation rules under which they may choose to deduct amounts for most of their depreciating assets on a diminishing value basis using a pool that is treated as a single depreciating asset. These were intended to be a compliance cost savings measures, relieving the small business entity of the need to calculate depreciation on each asset.

  We have not considered whether the proposed amendments mesh appropriately with these rules.

9. *Specific comments on the EM*

- We think that the EM should make clear that although roll-overs are already available for certain transactions, e.g. the transfer of a CGT asset, or all the assets of a business, from an individual to company under Subdivision 122-A, SBEs which satisfy the maximum net asset value test may now choose whether to restructure in a way which satisfies one of the existing Subdivisions or proposed new Subdivision 328-G.

- Example 1.1 – as previously discussed, in our view the transfer by Pail Co of its assets to its shareholders will result in the market value of those assets being assessed as a dividend in their hands under section 44 of the ITAA 1936 (at least to the extent that no amount is a distribution of share capital which is debited to the share capital account and hence not a 'dividend' as defined).

  We also note that based on the assumed facts in the example, Pail Co's balance sheet probably looks something like this:

Assets and Liabilities	Book value $	Market value $
Truck	13,000[1]	15,000
Goodwill	0	30,000
Liabilities	(12,800)	(12,800)
Net assets	200	32,000
Equity		
Share capital	200	
Retained earnings	0	
Total equity	200	

We have assumed that book value, being 50% of cost, is $13,000.

The transfer of the business assets, valued at $45,000 to Jack and Jill for no consideration will result in Pail Co having no assets to satisfy its liabilities and give rise to other issues under the Corporations Act, e.g. the unlawful payment of a dividend/return or capital.

As an aside, on the face of it we do not find the reason for the restructure compelling if regard is had to commercial considerations. It would be unusual to restructure from a company with limited liability to a partnership with joint and several liability – thereby exposing all of Jack and Jill's assets, including the family home, to creditors – simply to save compliance costs. Whether it makes sense purely from a tax

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perspective would depend on the income generated from the business and other factors.

- Example 1.2 – in this example Victoria and Chris who have an equal interest in Puppy Co transfer the land on which its business is operated to the recently settled Fluffy Trust which has made a family trust election and which will lease the premises to Puppy Co. The objects of the Fluffy Trust are Victoria and Chris and their family members. Assuming all the necessary requirements are met the conclusion is that the transfer will qualify for roll-over as there has not been any change in the ultimate economic ownership of the land.

  This conclusion depends on proposed subsection 328-440(3) being satisfied. That subsection provides that a transaction will not be taken to change the economic ownership of an asset, or an individual's share of that ownership if, among other things,

  - Just after the transaction the asset is included in the property of a non-fixed trust that is a family trust. This requirement would be satisfied as after the transaction the land is included in the property of the Fluffy Trust which has elected to be a family trust; and

  - Every individual who before the transfer had ultimate economic ownership of the asset was a member of the family group relating to the family trust. Again, this requirement would be satisfied because Jack and Jill, who had an equal economic interest in the land before the transfer, are members of the family group relating to the Fluffy Trust; and

  - Every individual who, just after the transfer, has the ultimate economic ownership of the asset is a member of the family group. In our view this requirement cannot be satisfied because, after the transfer, the beneficiaries of the Fluffy Trust do not have ultimate economic ownership of the land. As noted in the EM, for discretionary trusts such as the Fluffy Trust, 'beneficiaries generally do not have an interest in any asset or income of the trust until the trustee exercises their discretion'.

  - We think that proposed subsection 328-440(3) should be amended to apply to treat this transaction as not effecting a change in ultimate economic ownership where:

    - proposed paragraph (a)(ii) applies because there is a transfer to a family trust (other than from another family trust) and paragraph (b) is satisfied. This would mean that the transfer of land from Puppy Co to the Fluffy Trust would not be treated as a change in economic ownership of the land.

    - in the reverse situation, where paragraph (a)(i) applies because there is a transfer to a family trust from an entity (other than a family trust) - paragraph (c) is satisfied.

    - where there is a transfer from one family trust to another family trust and the family group in respect of each trust is the same.

- As for Example 1.1, the example ignores the fact that the transfer of the land to the Fluffy Trust for no consideration is likely to be a deemed dividend under Division 7A which is assessable to the Puppy Trust. We have not considered whether the deemed dividend is frankable.

Should you wish to discuss any of our comments please call me on 02 9290 5609 or Susan Cantamessa on 02 9290 5625.

Yours sincerely

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