Law Council
OF AUSTRALIA
Business Law Section

Design Head
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The Treasury
Langton Crescent
Parkes ACT 2600
Via email: taxlawdesign@treasury.gov.au 7 December 2015

Dear Sir or Madam,

Small Business Restructure Taxation Rollovers

The Taxation Committee of the Business Law Section of the Law Council of Australia (**Committee**) is grateful for the opportunity to make a submission to Treasury on the consultation papers released in respect of small business restructure taxation rollover relief announced by the Government in the 2015-16 Budget (**Budget**).

It is noted that those papers comprise exposure draft legislation and an explanatory memorandum (**EM**).

The Committee supports the policy initiative contemplated by the Budget announcement, which will enable greater flexibility in restructures of small business structures without adverse tax consequences.

Subject to its comments below, the Committee agrees with the broad-based application of the rollover relief adopted in the Exposure Draft legislation and commends those concerned for the concise and pragmatic approach taken in the drafting.

Transfers of assets for no consideration

However, as presently drafted, the Committee considers that the legislation is fundamentally flawed as a result of the requirement of paragraph (d) of section 328-440(1).

That paragraph provides:

> "(1) A roll-over under this Subdivision is available in relation to a transaction if:
> …
> (d) no consideration is provided in relation to the transfer, or any of the transfers;…"

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With regard to this requirement, the EM states (at paragraph 1.34):

> "It is a condition of the roll-over that no consideration be provided for the transfer ***[Schedule #, item #, paragraph 328-440(1)(d)]***. As the ultimate economic ownership of any entity to which assets are transferred under the roll-over will not change, there is no need for a small business entity to provide consideration for the transfer. This removes the need for complex cost base and integrity rules in respect of new membership interests issued as part of a restructure."

It is submitted that a regime which is predicated on transfers of assets between entities occurring without consideration will not reflect good policy and should not proceed without amendment.

The small business structures to which the reforms are directed are legal entities engaging in commerce. The ability of any such structure to transfer an asset to a transferee for no consideration will be determined by the commercial context within which that transfer takes place.

Within many, if not most, commercial contexts in which the transfer of an asset takes place between two entities, the fact that the transfer will not affect the "ultimate economic ownership" of the asset in question will have no relevance to the question of whether or not that transfer can be made for inadequate or no consideration as a matter of law.

In particular, the legal requirements which relate to solvency of entities are addressed by reference to the transferor entity alone and without regard to whether there is any commonality of "ultimate economic ownership" between the transferor and transferee.

This is consistent with the fact that the claims of creditors of a business are determined by reference to the entity which owns that business.

In the case of a proprietary company, shareholders are not liable for the debts of the company. To protect the interests of creditors, both the common law and statute impose a strict regime of constraints which protect and preserve the interests of creditors and other third parties dealing with a company.

Those constraints include a broad-based prohibition on any reduction of the capital of the company and specific prohibitions which can impose personal liability on the directors for companies arising out of inappropriate dealings.[1]

In particular, a transfer of assets from a company for less than adequate consideration will expose the directors to action for breach of their obligation of good faith under section 181 of the *Corporations Act 2001* and improper use of position under section 182 of that Act. A breach of either or both of those sections may expose directors to orders against them personally under section 589.[2]

Similar concepts apply in respect of individuals, partnerships and trusts, both in equity, under common law and under the provisions of the *Bankruptcy Act 1966*.[3]

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[1] See *Trevor v Whitworth (1887),* Chapter 2J and s588G *Corporations Act 2001*
[2] See *Australian Combined Financial Services Pty Ltd v Fusion Realty Pty Ltd [2008] NSWSC 1258*.
[3] See in particular sections 120 and 121.

From the perspective of businesses conducted by trustees, in addition to any restraints on dealings with trust property imposed by the relevant trust deed or in equity, the above provisions are particularly relevant from the perspective of the trustee's right of indemnity against the assets of the trust fund.

An adviser who assists a trustee or company director to breach a trust or fiduciary obligation, by advising or implementing transfer of assets without consideration, will be personally liable as being knowingly concerned in a breach of trust or fiduciary obligation. Since that is equitable fraud, the risk is uninsurable.

Realistically, a business will only be restructured on a basis whereby the new owner also assumes liabilities to existing suppliers, such as the landlord, and for employee entitlements. The assumption of liabilities is consideration and it is normal practice for this to occur in transfers of a business in a restructure (this is discussed further below).

In addition to the above legal and equitable constraints affecting transfers of assets for less than their market values, under many credit facility and commercial agreement provisions, the transfer of business assets by a contracting party for inadequate consideration will give rise to a breach by that party of its obligations to the creditor.

It may also be that, well after a restructure to which these provisions apply has occurred, a determination is made that the transaction is an uncommercial transaction under section 588FB of the *Corporations Act 2001* and a Court may declare that the transaction is a voidable transaction. This could have significant consequences in the event that the transferor is no longer a member of the group.

Further issues relevant to the "no consideration" requirement

If the draft legislation were to proceed as currently contemplated (and the Committee considers that it should not), consideration would also need to be given to a number of taxation consequences which are not presently dealt with, including the following:

- Where the transferor is a company, Division 7A may apply to the transfer of an asset to a shareholder or the associate of a shareholder if the *roll-over cost* is less than the market value of that asset.[4]
- Where the transferee is a company and the asset transferred to that company is a transfer on capital account from the transferor for no consideration (i.e. a gift), provisions to address the share capital account of that company may be required. Otherwise, amounts that would not have been treated as assessable income to the ultimate economic owners will be treated as unfranked dividends upon return to shareholders.
- In a transfer of a business between related entities on a restructure, the ability to effectively assume and discharge that business's liabilities (and the taxation consequences which flow from doing so) is a normal and necessary incident to any such transfer. The assumption of those liabilities is usually achieved by the transferee providing to the transferor indemnities in respect of those liabilities.[5]

[4] Section 109C(4) *Income Tax Assessment Act 1936*

[5] A common mechanism for providing market value consideration between related entities on a business transfer is for that consideration to comprise an indemnity from the transferee to the transferor for the value of the liabilities of that business, with the balance of the consideration to market value comprising a debt (either "at call", at interest or both) owing by the transferee to the transferor.

> Tax proposed legislative prohibition on this occurring will be disruptive to normal commercial documentation and practice adopted in relation to restructures and to the taxation and accounting treatments that flow from that practice.

The Committee understands and appreciates the concern expressed in paragraph 1.34 of the draft explanatory memorandum concerning possible complexity in respect of cost base and integrity rules for new membership interests.

However, it would appear that the drafting approach adopted in the draft legislation (i.e. based on modifying the application of the tax law in relation to profits and gains of the entities concerned and addressing tax concepts of cost) would appear to lend itself equally to the task of dealing with integrity issues for the membership interests of old and new owners in those entities.

Requirements for roll over

It is noted that paragraph (g) of subsection 328-440(1) imposes a condition precedent to roll-over as follows:

> "(g) in relation to each of the assets referred to in paragraph (a)—every individual who, just after the transfer takes effect, has the ultimate economic ownership of the asset is an Australian resident;"

For discretionary trusts, the breadth of the definitions of classes of beneficiaries is likely to mean that many such trusts will not satisfy that condition. It is commonplace nowadays for a family member to be living and working in New Zealand or Asia, for example.

The Committee is of the view that this unnecessarily limits the potential application of the concession as contemplated in the Budget announcement.

It is further noted that a similar problem affects paragraph (f) of that subsection, which deals with the transfer of an asset not effecting a change in the *ultimate economic ownership* of that asset.

In the case of paragraph (f), the concern is dealt with effectively by subsection 328-440(3). That subsection adopts the concepts of *family group* members of a *family trust* from Schedule 2F of the Income Tax Assessment Act 1936.

Subject to its comments below, the Committee suggests that a similar approach to identifying "underlying ownership" may be taken for paragraph (g). In this regard, consideration may be given to deeming a *family trust* to satisfy paragraph (g) if the *primary individual* specified in the family trust election is an Australian resident in the relevant tax year (or, if deceased, was an Australian resident at the time of that individual's death). Of course, if the Committee has misread the present draft in this regard, perhaps the true meaning could be made plainer in the next draft.

"Ultimate economic ownership"

Although the use of the undefined term "ultimate economic ownership" has the merits of simplicity, the Committee is concerned that the lack of a definition may pose problems of certainty.

- Although subsection 328-440(3) seeks to use the *family trust* concept, that concept operates by exception – that concept does not effect any change to the beneficiaries of a trust but instead imposes a higher rate of tax if a distribution is made outside the *family group.* Because paragraphs (b) and (c) of that subsection refer to "every individual", it would appear arguable that beneficiaries who fall outside the *family group* many still have an "ultimate economic ownership interest".
- Issues may also arise in respect of other entities – for example, in relation to the holders of "dividend access" shares in the case of a company.
- Because the concept of "ultimate economic ownership" seems to be intended to be determined on an individual basis rather than a group basis (see subsection 328-440(1)(f)), it reinforces the need for clarity across different types of entities.

Further submissions

Because of the time limits imposed for lodgment of submissions, the Committee's comments have been limited to those which it was immediately apparent may have a serious adverse impact on the application of the draft legislation. The Committee would be happy to provide further comment if further time is made available.

If you have any questions, in the first instance please contact the Committee Chair, Adrian Varrasso, on 03-8608 2483 or via email: adrian.varrasso@minterellison.com

Yours faithfully,

Teresa Dyson, Chairman
Business Law Section