



28 June 2011

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Dear Paul

**May 2011 Proposals Paper – Greater Certainty in the Scrip for Scrip Roll-over and the Small Business Entity Provisions**

The Institute of Chartered Accountants in Australia welcomes the opportunity to comment on the abovementioned Proposals Paper (the **Paper**). That Paper sets out, in broad terms, how to implement the 2011-12 Budget measures to:

- Ensure the effective operation of the rules in section 328-125 of the ITAA 1997 so that trusts are not able to avoid being treated as 'connected with' another entity for the purposes of the small business concessions on the basis that trusts do not own assets for their own benefit. This change will also ensure that some small businesses will be able to access the small business CGT concessions because the changes will make their business assets 'active' assets and
- Ensure that the integrity rules in sections 124-782 and 124-783 of the scrip for scrip roll-over rules Income Tax Assessment Act 1997 (the **ITAA 1997**) that apply to individuals and companies also apply appropriately to trusts, superannuation funds and life insurance companies.

Although not specifically mentioned in the Paper, we understand from the Budget announcement that the amendments are intended to apply to CGT events happening after 7.30pm on 10 May 2011.

At the outset we note that the issue which the proposed amendments seek to address is not peculiar to the small business entity and scrip roll-over rules. So for example, in a consolidation context, unless the context otherwise requires, a trust or entities held through a trust will not form part of a consolidated group. This is because section 703-30 requires the membership interests to be "beneficially owned" by the holding entity or its subsidiary entities. We have not sought to identify all other provisions where this issue manifests itself.

**Small business entity/small business CGT concessions**

Whether an entity is 'connected with' another entity is relevant to determining its aggregated turnover, being the combined turnover of the entity and entities connected or affiliated with it, and hence whether it qualifies as a small business entity for the purposes of the small business CGT concessions.

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It is also relevant to determining whether an asset is an active asset for the purpose of the small business CGT concessions as active assets include assets owned by a small business entity and used in the course of carrying on a business by an entity connected with the owner.

Currently, under section 328-125, an entity is connected with another entity if either entity controls the other entity or both entities are controlled by the same third entity.

In so far as is relevant, an entity controls another entity if the entity or its associates, alone or combined:

- where the other entity is a company, *beneficially own*, or have the right to acquire *beneficial ownership* of, equity interests that carry the right to receive at least 40% of any distribution of income
- except where the other entity is a discretionary trust, *beneficially own*, or have the right to acquire *beneficial ownership* of, interests in the other entity that carry the right to receive at least 40% of any distribution of income (net income in the case of a partnership) or capital.

#### *General comments*

The Paper states at paragraph 12 that it:

*... has been argued that the beneficial interest requirements prevent the tests from applying to trusts, life insurance companies and superannuation funds because they do not own the interest for their own benefit, but rather for the benefit of their beneficiaries, policy holders or members*

However, based on feedback from some of our members who work extensively with the CGT small business concessions, we are not aware of any 'abuse' of these concessions in the manner set out in the Paper. On the contrary, our members stated that both they and, as we understand it, the Australian Taxation Office (**ATO**) were currently applying the provisions on the basis that trusts (other than trusts which are generally regarded as bare trusts, e.g. nominees or custodians, or trusts holding interests as security only) were the beneficial owners of the relevant assets for the purposes of those rules.

#### *Specific concerns*

Paragraph 13 of the Paper proposes that:

*... the connected entity test in the small business entity provisions will be amended so that ... [it] is based on 'legal ownership or the right to acquire legal ownership', regardless of who benefits from that right or ownership.*

We have a number of concerns with this proposal and do not believe that it will make the CGT small business concessions work in the manner in which they are intended to apply in the case of bare trusts.

In particular, it is not clear to us why a shareholder in a private company who is a nominee for one (or more) of the other shareholders in that company should be treated as a controller of that company for the purposes of the "connected with" test in section 328-125 of the ITAA 1997.

For example, it was quite common for private companies that were formed in the 1960s, 1970s and early 1980s to have two equal shareholders - with one of those shareholders holding their share(s) as nominee for the other shareholder. Under the current provisions, the shareholder holding their share(s) as nominee for the other shareholder will not be treated as a controller of the company for the purposes of the CGT small business concessions - which we believe is an entirely appropriate result.

Similarly, it is not uncommon in situations where shares in a company have been sold or put up as security for a loan/other transaction to find that a custodian will hold legal title to those shares pending the completion of the sale/fulfilment of the relevant contractual obligations. Once again, under the current provisions the shareholder holding the share(s) as custodian will not be treated as a controller of the company for the purposes of the CGT small business concessions - which we also believe is an entirely appropriate result.



There are, in fact, probably a range of commercial circumstances in which one party will hold legal title to assets (such as shares and trust interests) without being the beneficial owner of them - the current "connected with" test in section 328-125 of the 1997 Tax Act deals adequately with these cases and we would be extremely concerned with any change which opens up the possibility of a changed outcome.

#### *Alternative proposal*

We believe that a "for the avoidance of doubt" style amendment should be introduced that deems:

- trusts (other than bare trusts, e.g. nominees or custodians, or trusts holding interests as security<sup>1</sup>) that are, and will continue to be, subject to tax under Division 6 of the *Income Tax Assessment Act 1936* (i.e. those that are not managed investment trusts)
- life insurance companies and
- superannuation funds

to be the beneficial owners of equity interests for the purpose of determining whether an entity is a connected entity under section 328-125 for the purpose of determining . the aggregated turnover (section 328-115) and whether an asset is an active asset (section 152-40) of another entity.

Such an amendment will mean that the provisions can continue to be applied in the manner that our members (i.e. those who work extensively with the CGT small business concessions) have been applying them and will avoid the need to consider extensive 'carve outs' so that the mere legal ownership of an asset, e.g. by a bare trustee, does not give rise to problems in a range of commercial circumstances.

#### **Scrip for scrip roll-over provisions**

In broad terms and using the terminology in Subdivision 124-M of the scrip roll-over provisions, the integrity provisions apply where the original entity obtains a roll-over and neither the original entity nor the replacement entity are widely held before the scrip for scrip arrangement starts.

The integrity provisions ensure that the acquiring entity's cost base for the original interests will be the same as the original interest holder's cost base in those interests where the original interest holder is a 'significant stakeholder' or a 'common stakeholder' for the arrangement.

An original interest holder is a significant stakeholder if it had a significant stake in the original entity just before the arrangement and also in the replacement entity just after the arrangement.

An original interest holder has a significant stake in a company at a time if it and its associates between them have:

- shares carrying 30% or more of the voting rights in the company<sup>2</sup> or
- the right to receive *for their own benefit* 30% or more of any dividends that the company may pay or
- the right to receive *for their own benefit* 30% or more of any distribution of capital.

An entity has a significant stake in a trust where it and its associates between them have the right to receive *for their own benefit* 30% or more of any distribution of income or capital of the trust.

In broad terms a common stakeholder has, together with its associates and third parties, 80% or more of rights described above in the original entity and the replacement entity (after the exchange).

<sup>1</sup> In this regard we note that the ATO takes a broad view of when a trust relationship within the scope of Division 6 is created.

<sup>2</sup> It would appear to us that a trust, a superannuation fund and a life insurance company may be a significant shareholder under this limb as there is no requirement that the shares to which the voting rights attach be beneficially owned.



*General comments*

As indicated above, the Paper states at paragraph 12 that it has been argued that the beneficial interest requirements prevent the tests from applying to trusts, life insurance companies and superannuation funds because they do not own the interest for their own benefit, but rather for the benefit of their beneficiaries, policy holders or members.

Again, as for the small business concessions, feedback from members who we have consulted with is that, to their knowledge, the provisions are not generally being applied by taxpayers in the manner suggested in the Paper.

*Specific concerns and alternative proposal*

To address the concerns raised in the Paper, it is proposed that the significant and common stakeholder tests be amended so that they are based simply on 'the right to receive' regardless of who benefits from that right. As for the proposed amendment to section 328-125 we see merit in specifically targeting the proposed amendments to certain Division 6 trusts,, superannuation funds and life companies to avoid any unintended consequences.

**Start date**

As we are unaware of taxpayers seeking to apply the rules other than as originally intended, we are not aware of any transactions in train on 10 May 2011 which might be adversely impacted by the proposed start date.

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Should you wish to discuss any aspect of our submission would you please call Susan Cantamessa on 02 9290 5635.

Yours sincerely



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