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EOFY seminar - streaming issues and tips and traps for the new small business rollover

7 June 2016



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embodies the passion
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Introduction

By Rob Jeremiah

7 June 2016



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Trusts and streaming

Presented by Daniel Smedley

7 June 2016





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Selective streaming and deemed market value gains

Streaming: TLAM No 5 2011

- Div 6E modifies:
 - Division 6E present entitlement.
 - Division 6E income of the trust estate.
 - Division 6E net income of the trust estate.
- Beneficiary taxed on 'specifically entitled' capital gain/franked distribution.
- Beneficiaries presently entitled to income taxed on proportion of capital gains/franked distribution to which no beneficiary 'specifically entitled'.
- Trustee taxed if neither of the above apply.

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Selective streaming and deemed market value gains

- Present entitlement
 - vested and indefeasible interest (Harmer)
 - pay - apply - set aside
 - trust resolutions or default distribution
- Specific entitlement
 - created in accordance with trust deed (i.e. present entitlement)
 - requires net financial benefit
 - alignment of financial benefit
 - notional amounts exclusion
- Timing of trust entitlements
 - before 30 June or earlier if trust deed requires
 - 31 August concession ceased (IT 329W)
 - subsequent recording of resolutions
 - formulas permitted (TD 2012/22EC)
 - default distribution or accumulation

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Selective streaming and deemed market value gains

Division 6

Division 6E

Section 97

- taxes beneficiary no disability
- beneficiary pays the tax
- marginal rates or corporate rate

Section 97 (modified)

- taxes beneficiary no disability
- beneficiary pays the tax
- marginal rates or corporate rate

Section 98

- taxes beneficiary under disability
- trustee pays the tax
- marginal rates

Section 98 (modified)

- taxes beneficiary under disability
- trustee pays the tax
- marginal rates

Section 99A

- taxes trustee where no presently entitled beneficiary
- trustee pays the tax @ 49% (TRBL)

Section 99A

- taxes trustee where no presently entitled beneficiary
- trustee pays the tax @ 49% (TRBL)

- Div 115-C - Capital gains**
- Div 207-B - Franked distributions**
- taxes specific entitlement beneficiary

Capital gains & Franked distributions

- taxes other income beneficiaries

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Selective streaming and deemed market value gains

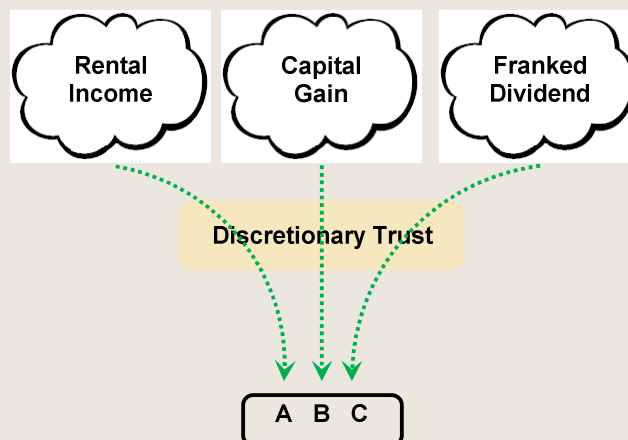
Distributable income: Issues

- Bamford
 - ATO interpreting Bamford to prevent differential streaming
- “Interim” modifications - Division 6E interpretation
 - Disregards capital gains/franked distributions from Division 6
 - Disregards so equalisation or reclassification clauses inoperative
- Administrative modification -TR 2012/D1
 - Distinct tax years
 - Product of the trust estate
 - Notional income exclusion
- Trust Instrument modification
 - Ordinary income
 - Equalisation clauses
 - Receipt re-characterisation clauses

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Selective streaming and deemed market value gains



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Selective streaming and deemed market value gains

Streaming: Division 115-C

- Share of net financial benefit

$$\text{Capital gain} \quad \times \quad \frac{\text{share of net financial benefit}}{\text{net financial benefit}}$$

- Terms of trust determines financial benefit.
- Trust and tax allocation must be consistent or no financial benefit.
- Received or expected to receive.
 - Future receipt example.
 - Asset revaluation reserve example.

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Selective streaming and deemed market value gains

Streaming: Division 115-C

- Trust deed streaming power helpful but alternatives can be workable.
- Recorded in its character in the accounts.
 - Effect on resolutions.
 - Balance resolutions.
- Recorded by 31 August.
- Notional capital gains.
 - taxable proportionately to beneficiaries that receive income.

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Deemed market value capital gain

- SECTION 115-228 Specifically entitled to an amount of a capital gain
 - 115-228(3) For the purposes of this section, in calculating the amount of the *capital gain, **disregard sections 112-20 and 116-30 (Market value substitution rule)** to the extent that those sections have the effect of increasing the amount of the capital gain.
- EM to Tax Laws Amendment (2011 Measures No. 5) Bill 2011
 - **Exception for capital gains and the market value substitution rule**
 - 2.52 **No beneficiary can be specifically entitled to the part of a (tax) capital gain that arises because of the market value substitution rules** in sections 112-20 and 116-30. In these cases, the amount of specific entitlement is limited to what the (tax) capital gain would have been if the market value substitution rules did not apply. [Schedule 2, item 11, subsection 115-228(3)]

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Management of market value gains

- Consider ability to pass income out to beneficiaries.
 - “Adjusted Division 6 percentage”.
- Consider whether there is a “net capital gain”.
 - Application of the concessions to reduce the capital gain (steps 3 and 4 of section 102-5 ITAA 97).
- Application of subdivision 152-E small business CGT roll-over and operation of section 115-222 to the 2011 and later years.
 - Section 115-225 in relation to the 2010 and earlier years.
 - NTLG Losses and CGT minutes, June 2012 - where amount assessable to trustee is nil and no s 99A assessment no doubling / quadrupling from s 115-222(5).

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CGT event E5

- Capital gain is calculated by reference to the market value of the asset as per section 104-75(3).
 - 104-75(3) The **trustee makes a capital gain** if the *market value of the asset (at the time of the event) is more than its *cost base. The trustee makes a capital loss if that market value is less than the asset's *reduced cost base.
- EM to Tax Laws Amendment (2011 Measures No. 5) Bill 2011
 - **No one can be specifically entitled to a 'deemed gain'**
 - 2.58 Generally, no beneficiary can be specifically entitled to a purely notional gain — that is, a deemed gain for tax purposes such as deemed capital gains from a trust ceasing to be a resident trust. This is because there is no net economic benefit referable to the notional gain that beneficiaries can receive.
 - 2.59 However, whether a beneficiary can be specifically entitled to a capital gain or franked distribution is a question of fact. **For example, when a beneficiary becomes absolutely entitled to a trust asset, it may be reasonable to expect the beneficiary will receive the net financial benefit referable to the deemed (trust) capital gain from CGT event E5.**

Selective streaming and deemed market value gains

ATO ID 2013/33

- Comments made in ATO Interpretative Decision ATO ID 2013/33 along a similar line. The issue and decision are as follows:

Issue

- Can a beneficiary be specifically entitled to a capital gain made by the trustee of a trust by reason of the happening of CGT event E5 in section 104-75 of the Income Tax Assessment Act 1997 (ITAA 1997)?

Decision

- Yes. If a trustee of a trust makes a capital gain by reason of CGT event E5 **when a beneficiary becomes absolutely entitled to an asset of the trust, the beneficiary can be specifically entitled to the gain.**

Ability to vary deeds to assist with streaming

TD 2012/21

Four examples provided

- Example 1: addition of new entities to class of objects.
 - Does not give rise to the happening of a CGT event.
- Example 2: expansion of power to invest.
 - Does not give rise to the happening of a CGT event.
- **Example 3: addition of definition of income, power to stream, and extension of vesting date.**
 - Does not give rise to the happening of a CGT event.
- Example 4: settling of trust asset on new trust.
 - CGT event 1 happens.

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Ability to vary deeds to assist with streaming

FCT v Clark

- Full Federal Court applied the indicia of continuity developed in *Commercial Nominees*.
 - Although there had been changes to the trustee, trust property and beneficiaries, the majority held that there had been **continuity of the original trust**.
- Importantly, the court in *Clark* held that the indicia **did not** require a strict continuity in property or objects, but rather a **continuum of the essential indicia**.
 - Therefore, the identity of the trust property and objects could change from time to time, however there had been no severance in their continuum.
- The Commissioner of Taxation sought leave to appeal the decision to the High Court. He was unsuccessful.

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Ability to vary deeds to assist with streaming

Cases

- *FCT v Commercial Nominees of Australia Ltd* [2001] HCA 33
- *FCT v Clark* [2011] FCAFC 5

- *Kearns v Hill* (1990) 21 NSWLR 107
- *Jenkins v Ellett* [2007] QSC 154
- *Oswal v FCT* [2013] FCA 745
 - *Oswal v FCT* [2014] FCA 812
- *Mercanti v Mercanti* [2015] WASC 297
- *Andtrust v Andreatta* [2015] NSWSC 38

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The new small business rollover rules – the rules and traps

Presented by Carlos Barros

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Key requirements

1. Big Picture – Accessing the Rollover
2. Noteworthy Exceptions/Issues
3. What is a genuine restructure?
4. The safe harbour rule
5. Ultimate economic ownership
6. Residency requirements
7. Consequences of rollover
 - 7.1. Income Tax Implications
 - 7.2. Effect on cost base
 - 7.3. Effect on pre-CGT assets
 - 7.4. Effect on asset acquisition dates
 - 7.5. Where new membership interests form part of consideration
 - 7.6. New membership interests affected by transfers of assets
 - 7.7. Assets already subject to small business rollover

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Big Picture – Accessing the Rollover

The key requirements to access the rollover include:

1. The relevant entities involved are small business entities, or connected to or affiliates of an entity that satisfies the small business entity (SBE) test (\$2 million aggregated turnover) [*i.e. the maximum net asset test is not relevant - also unclear whether the budgeted announcement to increase the SBE threshold to \$10 million will apply*]
2. The transaction is **or is a part of** a genuine restructure [*i.e. more than 2 entities may be involved*];
3. In the transfer year, each party to the transfer must be any of: - an SBE, an affiliate of an SBE, connected with an SBE, a partner in an SBE partnership [*Note: affiliates can only be individuals or companies*];
4. The transaction does not have the effect of **materially** changing which individual has (or the share held by multiple individuals) the economic ownership of the assets transferred;

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Big Picture – Accessing the Rollover

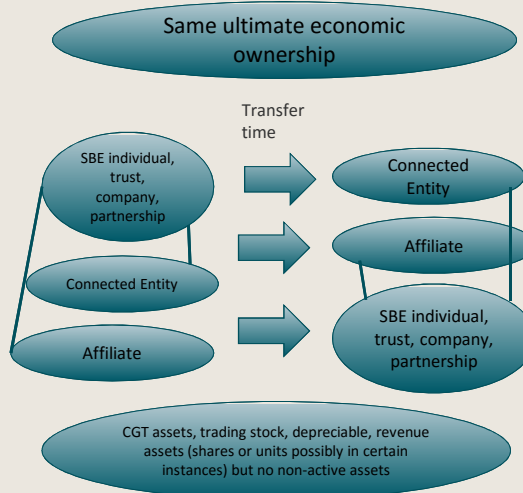
The key requirements to access the rollover include:

5. The transferred asset is an active asset used by:
 - a) a small business entity in carrying on its business
 - b) a connected entity or affiliate of an SBE
 - c) a partnership that is a SBE where the owner is connected or affiliated to the partnership or the active asset is owned by the partner/s;
6. The transaction parties are tax residents;
7. The transaction parties choose to apply the rollover;



Noteworthy Exceptions/Issues

1. Superannuation funds and exempt entities cannot access the rollover
2. Transfers between fixed ownership to non-fixed structure or non-fixed structure to fixed ownership (query whether ultimate economic ownership test is satisfied)
3. Shares and units: rollover may not apply – this is supported by the EM.
4. Exclusion of non-partnership asset where owner is involved in partnership (rather than connected or affiliated to the partnership).



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Genuine Restructure

Genuine restructures (LCG 2016/D3):

- Objective fact based test;

Supporting Factors:

1. Facilitates growth, innovation and diversification (i.e. R&D);
2. Adapt to changed conditions (business risk segmentation);
3. Reduce administrative burdens, compliance costs and/or cash flow impediments;
4. Maintains economic ownership of business assets including continuity of use of transferred assets, key personnel, production, supplies, sales or services;
5. In line with appropriate professional advice to enter that structure;
6. Transfer of business assets to different entities that together conduct the business;
7. Transferring assets from a trust to a company to eliminate UPEs;
8. Asset protection to limit business risk exposure is acceptable;
9. Introducing employee shareholders or capital investment.

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Genuine Restructure

Factors not supporting:

1. Unduly tax motivated (i.e. creating artificial losses, permanent deferral of gain recognition or timing advantages or other tax advantages not reflecting economic reality);
2. Not designed for succession planning (but query);
3. Not winding down or realising business assets or extraction of wealth;
4. Not a divestment strategy.



Safe Harbour Test

Safe harbour rule may apply (but Part IVA can still apply)

1. Where for **3 years** following the restructure:
 - a) there is **no change in the ultimate economic ownership** of any significant assets transferred (other than trading stock); and
 - b) the significant assets continue to be active assets; and
 - c) there is no significant or material use of those assets for private purposes.
2. See Part IVA (see s 177C(2)(a)(i),(ii))



Ultimate economic ownership (safe harbour rule for discretionary trusts)

There is no legislative test.

The safe harbour rule for retaining ultimate economic ownership for transfers from or to or between **discretionary trusts** is as outlined below:

1. Where the asset is transferred between two discretionary family trusts both with valid family trust elections (FTE) nominating the same specified test individual;
2. Or the recipient trust has made an interposed entity election that connects it to the family group of the transferor trust;
3. Each discretionary trust is in the family group of the other, and each non-discretionary trust entity is in the family group of the discretionary trust.

Residency requirements

1. Individual or company – Australian resident;
2. Trust – a resident for CGT purposes;
3. Partnership – at least one partner is an Australian tax resident;
4. Corporate Limited Partnership – under s.94T is a resident.

There is no specific time at which the residency requirement must be satisfied but presumably this needs to be satisfied at the transfer time.

Consequences of a Rollover

- No **direct** consequences under the income tax laws from rollover.

Cost Base

- The cost base in a CGT asset transferred to the transferee;
- Trading stock may be passed on at value (if held at 1 July) and at cost if acquired during the transaction year;
- Revenue assets may be passed on at no-profit value (i.e. market value at venture in time or cost if acquired as a revenue asset);
- Pre-CGT assets retain their pre-CGT status (s.328-460);
- Any capital losses arising from the disposal of shares/units in a transferee or transferor is disregarded;
- SBCGT rollover elections in respect of rollover assets transferred are deemed to have been made by the transferee.

Consequences of a Rollover – cost base (membership interests)

- Where membership interests are issued as part of the consideration for the transferred assets, then the cost base is the sum of the cost bases of the transferred CGT assets, the adjustable value of depreciable assets, **less any liabilities the transferee undertakes to discharge in relation to the transferred assets** and calculated in proportion to the value of all consideration provided (where the membership interests only comprised part of the consideration).

Example:

Assets Transferred

Goodwill (internally generated) : \$300,000

Building: \$1,000,000*

Pre-CGT Land: \$200,000

P&E WDV : \$200,000*

Trading Stock (cost): \$500,000

Liabilities Transferred

- Finance on P&E : (\$60,000)*

- Mortgage on Land: (\$540,000)*

-New membership interests: 1,000 shares

-Cost Base = (\$1,000,000 + \$200,000 - \$600,000) = \$600,000 /1,000 = \$600 cost base/share

Consequences of a rollover (Division 7A)

Division 7A issues:

- a) A transfer from a company to a shareholder will not be treated as a payment for Division 7A purposes;
- b) May be triggered in relation to loans or unpaid present entitlements in the transferor;
- c) May be triggered upon forgiveness of consideration payable on a transfer.

Indirect tax issues

State duty, GST, payroll tax, land tax and Fringe Benefits Tax issues are not addressed.

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Outline

- Small business tax concessions v small business rollover
- Restructuring to qualify for the rollover
- Starting with a cheap structure
- Rolling into a discretionary trust
- Can the rollover be used for – asset protection, succession or to clean up Div 7A issues

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Small business tax concessions (SBTC) v small business rollover (SBR)

- Advantages of SBTC:
 - Access to SBTC contribution caps under the 15 year exemption and the retirement exemption
 - Uplift in cost base
 - No need for genuine restructure or safe harbour
 - Can facilitate the “double rollover”

Small business tax concessions (SBTC) v small business rollover (SBR)

- Advantages of SBR:
 - Rollover also applies to depreciating assets, revenue assets and trading stock
 - Doesn't use up the SBTC contribution cap
 - Don't have to make contributions unlike the retirement exemption
 - Is a full tax exemption
 - 50% discount is irrelevant so companies are not penalised
 - More flexibility than the SBTC rollover exemption

Restructuring to qualify for the rollover

- Can a double SBR rollover be used?
 - Can the first rollover be a genuine restructure?
 - Under the safe harbour
 - must wait 3 years for the second rollover if there is a change in economic ownership
 - What if no change in economic ownership
- Using another rollover first or second?
 - SBTC
 - Subdiv 122 rollovers
 - Scrip for scrip

Starting with a cheap structure

- For startup businesses –
 - starting with a company with shares held by individuals
 - having business real property and business in the same entity
 - having assets in an individual's name (eg business premises)
- Once the business is successful restructure using the SBR
 - move assets into discretionary trusts
 - separate assets into separate entities

Rolling into a discretionary trust

- No change in ultimate economic ownership
 - Make a family trust election
 - Transferor must be in the family group
 - Individual – generally ok
 - Company – interposed entity election must be made
 - Trust – both trusts have the same test individual or the transferor trust has made a interposed entity election
 - The active asset must be included in the property of the family trust

Rolling into a discretionary trust

- Transferor company or individual to trust must have made a family trust election
- Can a trust to trust transfer occur without the transferor trust making a family trust election
 - For example, what about a transfer to a “cloned trust”
 - The EM suggests it could occur

Rolling into a discretionary trust

- Advantages of doing a trust to trust rollover
 - Separation of assets for asset protection
 - Moving to a trust with a longer vesting date
 - Perpetuity period?
 - Moving to a more flexible trust
 - Restricted powers of amendment
 - Lost trust deed?
 - Increase the classes of beneficiaries
 - Move to a South Australian trust?

Can the rollover be used for – asset protection, succession or to clean up Div 7A issues etc

- Asset protection
 - ATO has accepted that using SBR for asset protection reasons can be a genuine restructure
 - But not always
- Succession
 - ATO's view is that using SBR for succession reasons is not a genuine restructure
 - Would have to rely on safe harbour

Can the rollover be used for – asset protection, succession or to clean up Div 7A issues

- Other genuine restructure reasons (LCG 2016/D3)
 - Moving to a structure that allows employee equity
 - Raising new equity (not selling equity)
 - Simplifying affairs
- Non-genuine restructure reasons (LCG 2016/D3)
 - Accessing the 50% discount
- Transactions to deal with a UPE (LCG 2016/D3)
 - Transfer of business from trust to a company is ok
 - Transfer of business from trust to co. to trust is not

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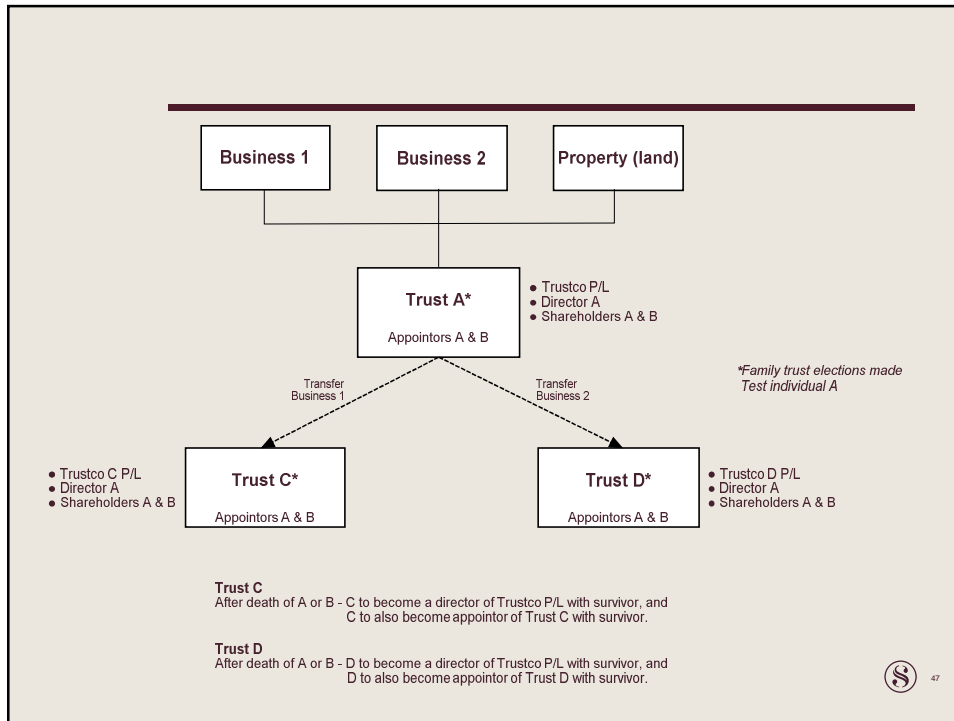


Can the rollover be used for – asset protection, succession or to clean up Div 7A issues

- Div 7A
 - EM states that Div 7A loans are not active assets and cannot be transferred under the SBR
- Part IVA
 - The ATO has confirmed that it is prepared to apply Part IVA for taxpayers who use the SBR


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Thank You

Drinks and canapés are served until 8.00pm, so if you have further questions, please come and chat.

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