

Small Business Restructure Roll-Over and Discretionary Trusts

The [Tax Laws Amendment Bill \(Small Business Restructure Roll-Over\) Bill 2016](#) (Cth) (the Bill) was introduced to Parliament on 4 February 2016.

The Bill amends the *Income Tax Assessment Act 1997* (ITAA 97) to allow small businesses to defer the recognition of gains and losses arising from the transfer of active business assets as part of a genuine restructure of their ongoing business that occurs on or after 1 July 2016.

The Bill extends capital gains tax roll-over relief to transfers to and from a range of different entity types, including transfers of assets from a company to a sole trader, partnership or trust. The small business roll-over (the Roll-Over) is in addition to current roll-over relief available for individual sole traders, partnerships and trusts that convert to a company structure (Division 122 and Subdivision 124-N ITAA 97).

We have previously reported on the Exposure Draft Bill when it was released in November 2015. Submissions for comments on the Exposure Draft Bill were closed on 4 December 2015. For more information, [see our earlier Sladen Snippet here](#).

Eligibility for the Roll-Over

Section 328-430 of the Bill requires the transfer of assets to satisfy the following conditions to be eligible for the Roll-Over.

1. Genuine Restructure

Condition 1 requires that the transfer of an asset is, or is a part of a genuine restructure of an ongoing business. Whether a restructure is 'genuine', and not an artificial or inappropriately tax-driven scheme, is a question of fact and will be determined on a case by case basis.

Safe Harbour

To provide certainty to small businesses, the Bill includes a 'safe harbour' rule. The rule provides that a small business is taken to satisfy the genuine restructure requirement where, for three years following the roll over:

- there is no change in the ultimate economic ownership of any of the significant assets of the business (other than trading stock) that were transferred;
- those significant assets continue to be active assets; and
- there is no significant or material use of those significant assets for private purposes.

2. Small Business Entities

Condition 2 is that each party to the transfer of assets must be:

1. a "small business entity" (being a business entity with an annual turnover, which when combined with that of its affiliated and connected entities, is less than \$2 million) in the income year in which the transfer takes place; or

2. an entity that is an affiliate of, or that is connected with a small business entity, or, if the small business entity is a partnership, a partner of that partnership, in the relevant income year.

The Roll-Over does not extend to exempt entities or a complying superannuation entity.

The Bill has removed the requirement in the Exposure Draft for a small business entity to satisfy the maximum net asset value test under section 152-15 at the time of the transfer.

3. Ultimate Economic Ownership

Condition 3 is that the transfer of assets must not materially change the ultimate economic ownership of the transferred assets. Ultimate economic ownership will be a question of fact to be determined on the circumstances of each case. Where there is more than one ultimate economic owner, their proportionate economic ownership of the asset must also remain unchanged.

Ultimate economic ownership is not a defined term in the Bill. The Explanatory Memorandum (EM) accompanying the Bill explains that the ultimate economic owners of an asset are individuals who, directly or indirectly, beneficially own an asset. As ultimate economic owners can only be individuals, a look through approach applies to identify the individuals that will ultimately benefit from the asset where a company, partnership or trust owns the asset.

Application to Discretionary Trusts

Where assets are transferred to or from discretionary trusts, identifying the individuals who are the ultimate economic owners can be difficult as beneficiaries of discretionary trusts generally do not have an interest in any asset or income of the trust until the trustee has exercised its discretion to make an appointment.

The EM at paragraph 1.34 states that in some instances a discretionary trust will meet the requirements for ultimate economic ownership on the facts alone. The EM provides the example where a discretionary trust may be deemed to be non-fixed for tax purposes, but, there is no practical change in the individuals who will economically benefit from the assets before and after the Roll-Over. In these circumstances, the EM provides there will not have been a change in ultimate economic ownership on the facts.

However, there is a lack of clarity as to factors that will prove an individual has ultimate economic ownership of an asset in the discretionary trust context. Does the lack of clarity allow an Australian Taxation Office (ATO) officer to assert that any of the following individuals is the ultimate economic owner of a discretionary trust's assets for the purposes of subsection 328-430(1)(c):

1. an individual if the individual is a trustee;
2. the directors or shareholders of a corporate trustee;
3. the appointor or guardian of the discretionary trust;
4. the primary beneficiaries (and whether they are required to receive distributions); or
5. beneficiaries satisfying some pattern of distribution test?

The EM also fails to acknowledge a situation where there is no ultimate economic owner of an asset in a discretionary trust. The consequences for that business electing to use the Roll-Over to change to a structure where the ultimate economic ownership of the asset is easily determined, for example the position of shareholders in a company, would automatically make the business ineligible for the Roll-Over.



Alternative Test for Discretionary Trusts

The Bill provides an alternative means for discretionary trusts to satisfy the requirement not to materially change the ultimate economic ownership as required by in subsection 328-430(1) (c). Section 328-440 states ultimate economic ownership of an asset will not change where:

1. the asset is transferred to, from or between discretionary trusts;
2. the transferor or transferee trust is a family trust with a family trust election (FTE) in place; and
3. every individual who had ultimate economic ownership of the asset before the transfer and every individual who has the ultimate economic ownership of the asset after the transfer are members of the family group of the discretionary trust.

While the family group requirement of the alternative test provides a level of protection for discretionary trusts with a FTE in place, the Bill fails to address the key issue of what constitutes ultimate economic ownership of assets in a discretionary trust as discussed above.

Whilst making a FTE provides a potential means of confirming access to the Roll-Over, it is important to carefully consider the implications of making an FTE before proceeding. A FTE limits the beneficiaries of the trust eligible to receive tax effective distributions to those within the family trust's family group. This may prove to be restrictive and result in significant tax implications for distributions made outside of the family trust's family group.

4. Eligible Assets

Condition 4 is that where the transferor is a small business entity, the asset being transferred must be a CGT asset that is an active asset pursuant to section 152-40 of the ITAA 97. In general, a CGT asset is an active asset where it is used or held ready for use in the course of carrying on a business and includes trading stock and revenue assets.

Passively held assets (including those held by an affiliate or connected entity transferor) that are used by the small business entity in its business may also be eligible assets for this purpose.

5. Residency

Condition 5 is that the transferor and transferee of the assets must be Australian residents in accordance with the relevant income tax residency test for that type of entity.

6. Choice to Apply the Roll-Over

Condition 6 is that the transferor and transferee must both choose to apply the Roll-Over.

Consideration for the Transfer

The Exposure Draft Bill had required that the Roll-Over was only available where no consideration was provided for the transfer. It is likely in response to industry consultation regarding the commercial reality of many circumstances where the Roll-Over would apply; the Bill has removed the requirement for no consideration.

The Bill does include an integrity rule where membership interests are affected by transfers. The rule operates to ensure that a capital loss from a CGT event that arises in relation to a membership interest is disregarded, except where the entity can prove the loss is attributable to matters other than the transaction.

Effect of the Roll-Over

Provided the above conditions are satisfied, the Roll-Over will allow small businesses to change their legal structure without income tax consequences arising from the transfer of the asset.



In summary, this purpose is achieved by providing that:

1. the transferor is taken to have received an amount equal to the roll-over cost of the asset to them; and
2. the transferee is taken to have acquired the asset for an amount equal to the transferor's roll-over cost for the asset just prior to the transfer.

The roll over cost differs depending on the type of asset transferred, and is:

1. for CGT assets, the transferor's cost base of the asset immediately prior to the transfer;
2. for trading stock, either the cost of the item for the transferor at the time of the transfer, or the cost at the start of the income year if the item is held as trading stock at that time; and
3. for revenue assets, the amount that would result in the transferor not making a profit or a loss on the transfer.

Interaction with other tax laws

1. Any pre-CGT assets will retain their pre-CGT status;
2. The Roll-Over **does not** provide the transferee with the transferor's existing acquisition date for the purposes of obtaining a discount capital gain under Subdivision 115-A. This is to ensure the Roll-over is not used to transfer assets to an entity entitled to the CGT discount prior to the sale of the asset.
3. The Roll-Over **does** provide the transferee with the transferor's existing purchase date for the purposes of eligibility for the 15 year exemption provided under the Small Business CGT concessions.
4. Where an entity has already chosen to apply a small business roll-over under the Small Business CGT concessions and the replacement asset is transferred under the Roll-Over, CGT events J2, J5 or J6 are deemed to apply to the transferee.

The Bill is expected to be enacted into legislation in the coming months and we will continue to update you on its progress through Parliament.

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