
Glossary

The following abbreviations and acronyms are used throughout this explanatory memorandum.

| <i>Abbreviation</i> | <i>Definition</i> |
|---------------------|---------------------------------------|
| CGT | capital gains tax |
| ITAA 1997 | <i>Income Tax Assessment Act 1997</i> |

EXPOSURE DRAFT

General outline and financial impact

Roll-over relief for changes to small business structure

Schedule # to this Exposure Draft Bill amends the *Income Tax Assessment Act 1997* to provide greater flexibility for small businesses to change their legal structure.

The amendments make it easier for small business owners to restructure by allowing them to defer gains or losses that would otherwise be made from transferring business assets from one entity to another.

The new small business roll-over is in addition to roll-overs currently available where a sole trader or partner in a partnership transfers assets to, or creates assets in, a company in the course of a business restructure.

Date of effect: The amendments apply to transfers of assets occurring on or after 1 July 2016.

Proposal announced: This measure was announced on 12 May 2015 in the 2015-16 Budget.

EXPOSURE DRAFT

Chapter 1

Roll-over relief for changes to small business structure

Outline of chapter

1.1 Schedule # to this Exposure Draft Bill amends the *Income Tax Assessment Act 1997* (ITAA 1997) to provide greater flexibility for small businesses owners to change the legal structure of their business.

1.2 The amendments make it easier for small business owners to restructure by allowing them to defer gains or losses that would otherwise be realised when business assets are transferred from one entity to another.

1.3 The new small business roll-over is in addition to roll-overs currently available where a sole trader or partner in a partnership transfers assets to, or creates assets in, a company in the course of a business restructure.

1.4 All references to legislative provisions in this chapter are references to the ITAA 1997 unless otherwise stated.

Context of amendments

1.5 In Australia, small businesses may operate as sole traders, partnerships, trusts, companies or any combination of these. A small business owner may take a number of factors into account in determining which structure is the most appropriate for their business, including tax issues, personal liability, access to equity capital and compliance costs.

1.6 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 may help a business to continue to develop and grow, to avoid unnecessary compliance costs resulting from using overly complex structures, or to adapt to current conditions.

1.7 However, where a restructure requires business assets to be transferred from one entity to another, such as from a company to a trust, significant income tax liabilities may arise. The impact of these liabilities

on cash flow and available capital may create an impediment to restructuring.

1.8 Currently, roll-over relief is available in limited circumstances for business restructures. For example, roll-overs are available for restructures involving the transfer of a capital gains tax (CGT) asset, or all the assets of a business, from an individual sole trader or partnership to a wholly owned company (Subdivisions 122-A and 122-B). However, no roll-over is available, for example, for a restructure that transfers business assets from a company to a sole trader, partnership, or trust.

1.9 As part of its Growing Jobs and Small Business package in the 2015-16 Budget, the Government announced that it would introduce a roll-over to allow small businesses to change legal structure without attracting CGT liability at that point.

1.10 The Budget announcement referred to CGT roll-over, however, this Exposure Draft extends the relief to transfer of trading stock, revenue assets and depreciating assets, to provide greater flexibility for small business restructures.

Summary of new law

1.11 Schedule # of this Exposure Draft Bill provides small businesses with a new roll-over for gains and losses arising from the transfer of business assets that are CGT assets, depreciating assets, trading stock or revenue assets as part of the restructure of a small business. This provides small businesses with the flexibility to change their legal structure without realising an income tax liability on the transfer of those assets.

1.12 The tax cost/s of the transferred asset or assets is rolled over from the entity that transferred the asset or assets (the transferor) to the entity to which the asset or assets are transferred (the transferee). This is achieved by providing that:

- the transferor is taken to have received an amount which would result in them making neither a gain or loss under the transfer, and
- the transferee is taken to have acquired each asset for the amount that equals the transferor's tax cost for the asset just before the transfer.

1.13 Generally, the roll-over applies to transfers of business assets that do not result in a change in the ultimate economic ownership of the

assets. Discretionary trusts may be able to access the roll-over if the assets continue to be held for the benefit of the same family group.

Comparison of key features of new law and current law

| <i>New law</i> | <i>Current law</i> |
|---|--|
| <p>In addition to the existing roll-overs, a roll-over is available for small businesses to transfer assets to or from different legal entities as part of a restructure.</p> | <p>Roll-overs are available for businesses to transfer assets as part of a restructure:</p> <ul style="list-style-type: none"> • from a sole trader or partnership to a wholly owned company (Division 122); or • from a trust to a company (Subdivision 124-N). <p>A roll-over is also available where a business restructures by changing shares in a company or units in a unit trust for shares in another company (Division 615).</p> |

Detailed explanation of new law

1.14 Schedule # to this Exposure Draft Bill amends the ITAA 1997 to allow small businesses to roll-over gains or losses that may arise from a transfer of business assets under a restructure of their business.

1.15 This will facilitate flexibility by reducing tax impediments that might arise for small business owners wishing to change the legal entity or entities running the business to a more suitable structure.

1.16 Subdivision 328-G will provide an optional roll-over where a small business entity transfers a business asset to another small business entity without changing the ultimate economic ownership of the asset. The roll-over can also apply to affiliates or entities connected with the small business entity for assets they hold that are used by the small business entity.

1.17 The roll-over will apply to gains and losses arising from the transfer of CGT assets, depreciating assets, trading stock or revenue assets between entities as part of a small business restructure.

Eligibility for the roll-over

1.18 There are two types of entities that may be eligible for the roll-over. The first is entities that are small business entities in the income year in which the transfer takes place, and that satisfy the maximum net asset value test. *[Schedule #, item #, subparagraph 328-430(1)(a)(i)]*

1.19 An entity will be a small business entity if it meets the requirements under Subdivision 328-C. Broadly, this requires that the entity carry on a business and that the combined annual turnover of the entity, and other entities that are affiliated or connected with it, is less than \$2 million.

1.20 An entity will satisfy the maximum net asset value test if it meets the requirements in section 152-15. Broadly, this requires the sum of the net values of the entity's CGT assets, together with the net values of CGT assets of other entities that are affiliated or connected with it, to be less than \$6 million.

1.21 This first kind of entity may access the roll-over in relation to CGT assets that are assets of the business carried on by the small business entity. *[Schedule #, item #, subparagraph 328-430(1)(c)(i)]*

1.22 The second kind of entity that may be eligible for the roll-over is an affiliate of, or connected with, a small business entity for the income year that satisfies the maximum net asset value test at the time of the transfer. These entities may access the roll-over in relation to CGT assets that satisfy subsection 152-10(1A) or (1B), relating to passively held assets that are used by the small business entity in their business. *[Schedule #, item #, subparagraphs 328-430(1)(a)(ii) and 328-430(1)(c)(ii)]*

Effect of the roll-over

1.23 The income tax law will apply to the transferor as if the transfer takes place for the asset's 'roll-over cost'. The roll-over cost is essentially the transferor's cost of the asset for income tax purposes, such that the transfer would result in no gain or loss for the transferor. The transferee will be taken to have acquired each asset for an amount that equals the transferor's cost just before the transfer. *[Schedule #, item #, section 328-430]*

1.24 The income tax law may apply different costs to an asset depending on which rules apply to that asset, and this affects the roll-over cost. The roll-over cost for CGT assets, trading stock and revenue assets is discussed below. Depreciating assets receive different treatment, discussed at paragraph 1.31.

CGT assets

1.25 To the extent that a gain or loss on the asset is calculated under the CGT provisions (Parts 3-1 and 3-3), the relevant cost for income tax purposes is the cost base of the asset. For the transfer of a CGT asset, the income tax law will apply under the roll-over as if the asset had been transferred for the amount that would result in the transferor making neither a capital gain or capital loss, that is, as if the asset had been transferred for an amount equal to the cost base of the asset. *[Schedule #, item #, paragraph 328-430(2)(a)]*

Pre-CGT assets

1.26 Pre-CGT assets transferred under the roll-over will retain their pre-CGT status in the hands of the transferee. *[Schedule #, item #, section 328-435]*

Discount capital gains

1.27 Capital gains made from a CGT asset may be discounted where the entity making the capital gain acquired the asset at least 12 months before the CGT event triggering the capital gain happened (Subdivision 115-A). For the purpose of determining whether a capital gain may be discounted under Subdivision 115-A, a transferee receiving an asset under the roll-over is treated as having acquired the CGT asset either:

- when the entity that owned the CGT asset before the roll-over acquired it; or
- if the asset has been involved in an unbroken series of roll-overs – when the entity that owned it before the first roll-over in the series acquired it. *[Schedule #, item #, item 12 in the table in subsection 115-30(1)]*

Trading stock

1.28 To the extent that the asset is trading stock, (as defined in subsection 70-10(1)), the roll-over cost for income tax purposes is:

- the cost of the item for the transferor at the time of the transfer; or
- if the transferor held the item as trading stock at the start of the income year, the value of the item for the transferor at that time. *[Schedule #, item #, paragraph 328-430(2)(b)]*

in order to ensure that the transferor incurs no tax liability as a result of the transfer.

1.29 The transferee will inherit the same cost attributes of the asset as the transferor just before the transfer. This is to ensure that any deductions claimed by the transferor up to the date of the transfer are taken into account.

Revenue assets

1.30 To the extent that an asset is being assessed as a revenue asset, the roll-over cost is the amount that would result in the transferor not making a profit or loss on the transfer. The transferee will inherit the same cost attributes as the transferor just before the transfer.

Depreciating assets

1.31 Where the transferor chooses to apply the small business restructure roll-over in relation to a transfer, roll-over relief will be available for depreciating assets under section 40-340 [*Schedule #, item #, item 8 of the table in subsection 40-340(1)*]. This prevents an amount being included in or deducted from the transferor's assessable income because of a balancing adjustment event (subsection 40-345(1)). Instead, the transferee can deduct the decline in value of the depreciating asset of the depreciating asset using the same method and effective life (or remaining effective life if that method is the prime cost method) as the transferor was using (subsection 40-345(2)).

Requirements for roll over

1.32 The roll-over will be available where:

- the transferor transfers a CGT asset or all of its business assets that are CGT assets, depreciating assets, trading stock and revenue assets;
- the transferor chooses to apply the roll-over;
- the transaction is a restructure that has the effect of changing the type of any or all of the entities and/or the number of entities through which all or part of the business is operated;
- no consideration is provided for the transfer;
- the transferor, transferee and the ultimate owners of the assets transferred are Australian residents;
- the transfer does not have the effect of changing the ultimate economic ownership of the asset or assets transferred; and

- the transferee is not an exempt entity or a complying superannuation entity, or none of the transferees are exempt entities or complying superannuation entities.

Changing the type or number of entities

1.33 The roll-over applies where a small business transfers assets as part of a restructure. The restructure must have either or both of the following effects:

- changing the type of any or all of the entities through which all or part of the business is operated;
- changing the number of the entities through which all or part of the business is operated. [*Schedule #, item #, paragraph 328-440(1)(c)*]

No consideration provided by the transferee

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.

Residency requirements

1.35 Each of the transferor, the transferee and the ultimate economic owners of the assets must be a resident of Australia. The income tax law uses different residency tests for different kinds of entities. Since the ultimate economic owners will be individuals, they must be Australian residents [*Schedule #, item #, paragraph 328-440(1)(g)*].

1.36 The transferor and transferee must meet whichever residency test applies to them:

- If the entity is an individual or a company – the entity is an Australian resident.
- If the entity is a trust – the entity is a resident trust for CGT purposes.
- If the entity is a partnership (other than a corporate limited partnership) – at least one of the partners is an Australian resident.

- If the entity is a corporate limited partnership – the entity is, under section 94T of the *Income Tax Assessment Act 1936*, a resident for the purposes of the income tax law. [*Schedule #, item #, subsection 328-440(2) and paragraph 328-440(1)(e)*]

Ultimate economic ownership

1.37 The transaction must not have the effect of changing the ultimate economic ownership of the transferred asset or assets. The ultimate economic owners of an asset are the individuals who, directly or indirectly, beneficially own an asset. [*Schedule #, item #, paragraph 328-440(1)(f)*]

1.38 If there is more than one individual who is an ultimate economic owner of an asset, there is an additional requirement that each of those individuals' share of that ultimate economic ownership be unchanged, maintaining proportionate ownership in the asset. [*Schedule #, item #, subparagraph 328-440(1)(f)(ii)*]

1.39 Where the transferor (or transferee) is an individual, such as a sole trader, the transferor (or transferee) will also be the ultimate economic owner of the asset transferred.

Discretionary trusts

1.40 The roll-over is restricted to circumstances where there has been no change in the ultimate economic ownership of assets resulting from the transfer of the assets between small business entities. Ultimate economic ownership of an asset can only be held by natural persons. Therefore, where a company, partnership or trust owns an asset it will be the natural person owners of the interests in these interposed entities that will ultimately benefit economically from that asset.

1.41 Identifying those individuals that will benefit economically from the assets of a company, partnership or fixed (unit) trust is relatively straight forward as the degree to which they will benefit from the asset will be expressly set out in the documents and agreements that support the business.

1.42 The situation is somewhat more complicated for discretionary trusts as beneficiaries generally do not have an interest in any asset or income of the trust until the trustee exercises their discretion. However, discretionary trusts that have made a family trust election are administered for the benefit of a specified family group. For the purposes of the roll-over members of this group will be the ultimate economic owners of the business assets.

1.43 Therefore, a transaction will be taken as not having the effect of changing the ultimate economic ownership of assets where:

- immediately before or after the transaction took effect, the asset was included in the property of a discretionary trust (a ‘non-fixed trust’) that was a family trust; and
- every individual who, just before or just after the transfer took effect, had ultimate economic ownership of the asset was a member of the family group of that family trust.
[Schedule #, item #, subsection 328-440(3)]

Exempt entities and complying superannuation entities

1.44 The roll-over will not apply to a transfer to an exempt entity or complying superannuation entity *[Schedule #, item #, paragraph 328-440(1)(h)]*. ***Exempt entity*** and ***complying superannuation entity*** are defined in subsection 995-1(1).

Consequences for membership interests

1.45 The cost base of membership interests in the transferor, if any, is reduced to the extent of any transfer of value from the transferor (but not below zero). This ensures that an owner of membership interests in a transferor entity cannot realise an artificial loss on disposal of those interests, following the reduction of value of the entity from the assets transferred. *[Schedule #, item #, section 328-445]*

1.46 Membership interests are defined in section 960-135, and include shares in a company, units in a unit trust, a beneficiary’s interest in a trust other than a unit trust, and partnership interests in a partnership.

1.47 The transfer of value is worked out by multiplying the ‘asset value’ by the ‘membership interest percentage’ for each asset transferred. The asset value is the market value of the asset transferred at the time of the transfer. The membership interest percentage is the proportion of the owner’s membership interests in the transferor, expressed as a percentage of all of the membership interests in the transferor. This ensures that the cost base of each owner’s membership interests is reduced in proportion to their membership interests in the company.

1.48 This section has no operation where no membership interests in the transferor exist, including where the transferor is a sole trader.

Example 1.1

Jack and Jill are husband and wife and are the only shareholders in Pail Co, with each owning 1 share with a cost base of \$100. Since 1995, Pail Co has successfully carried on a water hauling business. The assets of the business are a hauling truck and goodwill. All profits have been distributed. Pail Co is a small business entity for the income year, and satisfies the maximum net asset value test.

However, Jack and Jill have found that the current business structure creates compliance burdens and costs disproportionate to their benefits, and wish to run the hauling operation directly as partners.

Using the small business restructure roll-over, Pail Co can transfer all of the business assets to Jack and Jill as partners of the partnership. The partnership is also a small business entity for the income year, and satisfies the maximum net asset value test.

The goodwill is a CGT asset with a market value of \$30,000. Pail Co's cost base for this asset, and therefore the rollover cost, of the goodwill is zero. Pail Co is taken to have transferred the goodwill to Jack and Jill in equal shares for \$0, and Jack and Jill are taken to have acquired their shares for this amount.

The hauling truck is a depreciating asset with a market value of \$15,000. At the time of the transfer, Pail Co had already claimed depreciation deductions of 50% of the original cost of the truck, and the market value of the truck exceeds its adjustable value. Since the truck receives roll-over relief under section 40-340, no amount will be included in Pail Co's assessable income as a result of a balancing adjustment. Jack and Jill will be able to continue to deduct the decline in value of the depreciating asset using the same method and effective life that Pail Co was using, to the extent of their respective interests in the partnership.

The cost base of Jack and Jill's respective shares in Pail Co is reduced to reflect the transfer of value from the company:

$$\text{Asset value } (\$30,000 + \$15,000) \times \text{membership interest percentage } (0.5) = \$22,500$$

Jack and Jill each reduce the cost base of their shares by \$22,500 (but not below zero). That is, the cost base of each share will be \$0. This is appropriate because there is no value left in the company.

Example 1.2

Victoria and Chris are husband and wife and are the only shareholders in Puppy Co, with each owning 50 shares. Since 2012, Puppy Co has successfully carried on a puppy training school and puppy boarding facilities. The business has been profitable and the company has

acquired premises. The company's assets comprise the premises, a vehicle, cash, accounts receivable, and goodwill.

Victoria and Chris wish to transfer the premises from Puppy Co to a recently settled discretionary trust, the Fluffy Trust, which will lease the premises to Puppy Co. Victoria and Chris, and their family members, are the only objects of the Fluffy Trust, which has made a family trust election.

Puppy Co is a small business entity that satisfies the maximum net asset value test, and the premises are an asset of the business carried on by Puppy Co. The Fluffy Trust is not a small business entity in the income year, but it is connected with Puppy Co, and the premises satisfy the test in subsection 152-10(1A).

For the purpose of the roll-over, there has not been a change in the ultimate economic ownership of the premises by the transfer of the asset from Puppy Co to the Fluffy Trust. Therefore, assuming that the other requirements are also met, the roll-over would be available in respect of the transfer.

The premises are a CGT asset of Puppy Co, which it acquired on 1 July 2002 for \$300,000. The current market value of the premises is \$600,000.

Under the roll-over, Puppy Co is taken to have disposed of the premises for the roll-over cost, and the Fluffy Trust is taken to have acquired the premises for the roll-over cost. This is the amount necessary so that Puppy Co makes neither a capital gain nor a capital loss from the transfer of the premises. Therefore the roll-over cost is \$300,000.

Following the transfer of the premises from Puppy Co to the Fluffy Trust, the value of Puppy Co has been reduced by the market value of the premises, namely \$600,000. The cost base of each of Victoria and Chris's shares in Puppy Co is reduced by \$6,000 to reflect the transfer of value from the trust.

Consequential amendments

1.49 The definition of 'roll-over cost' is inserted into the Dictionary in Division 995 of the ITAA 1997. *[Schedule #, item #, Division 995]*

Application and transitional provisions

1.50 The amendments made by this Bill apply to transfers of assets occurring on or after 1 July 2016. *[Schedule #, item #]*