**Draft Treasury Submission – Small Business Restructure Rollovers**

I am a member of the Taxation Committee of the Law Council of Australia and was involved in it's submission. What follows though, is my version of that submission (you will recognize similarities).

These submissions relate to Government's 2015 Budget announcement to enable greater flexibility in restructures of small business structures without adverse tax consequences, which has found form, so far, as an exposure draft of the *Tax and Superannuation Laws (2015 Measures No. 6) Bill 2015* – Small Business Restructure Rollovers.

Subject to what follows, I agree that is good to see that the relief is to be available to a suitably wide group of taxpayers, the limits are not too restrictive and the rollover aims to achieve comprehensive tax neutrality, so that the measure has the maximum capacity to achieve its objectives.

I also commend those concerned, for drawing these provisions the concise and pragmatic way.

## Transfers of assets for no consideration

However, the I am of the opinion that this draft of the proposed legislation is fundamentally flawed as a result of the requirement in s328-440(1)(d) that <u>no consideration</u> be given for the transactions for which rollover relief is sought .

This 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;…"*

With regard to this requirement, the Explanatory Memorandum (**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."*

I submit that this requirement will not achieve the policy objectives, of the rollover, for the reasons, which follow.

a) Assuming responsibility for relevant liabilities, of the transferor, will amount to 'consideration'.
b) It will usually be impossible to transfer (acquire) a going concern, if the transferee can't acquire the transferor's liabilities.
c) As a result, these provisions will be robbed of most of their intended operation (as most intended transfers would be of 'going concerns').
d) Further, many, if not most, transferors would be insolvent, if the transferee did not assume responsibility for paying its creditors.
e) Those responsible for such insolvencies would face a range of civil, quasi-criminal and actual criminal offences.
f) Even if the transferor remained solvent (after getting nothing for the transferred assets), it may not have legal power to transfer its assets for nothing.

g) Directors would usually be in breach of their duties for giving away their assets. It may be that the company's constitution can be amended to exonerate this, but query whether the member(s) can lawfully do this (is there a requirement for the change to the constitution to be in the best interests of the company as a whole?).
h) Most (if not all) trustee's would be in breach of their trust duties, if they were to give away their assets for free. The transferee might be a 'beneficiary' and the trust deed may permit the distribution of the assets of the trust (or some of them) to a beneficiary, without consideration. But if this was not the nature of the transfer without consideration, the trustee would need the express approval of all the beneficiaries of the trust (who would all have to be of full age and capacity to give such approval).
i) Discretionary trusts, of course, have a vast array of 'beneficiaries' many of whom are minors or unborn, or have not yet fallen into the class of beneficiaries. If their approval were required, for what would otherwise be a breach of trust, it would be impossible to get the approval of all relevant beneficiaries, without an order of a Supreme Court to approve the gift of the Trust's assets (and the Court may decline to make such an order on the basis that it was not in the interests of the trust as a whole).

There is a further range of problems that relate to the real world task of characterising the transfers of assets for 'nil consideration' (that is outside the effect of the proposed s328-430, which deems the transfers to happen at certain 'rollover cost' values).

a) For instance, the receipt of a gift constitutes a 'profit' for a company, even though the bulk of the assets gifted typically be on capital account, and if purchased, would not constitute an addition to profits. The value of the assets transferred could not be credited to the 'Share Capital Account' with the obvious implications for payments to shareholders being 'dividends' (and ultimately an 'unfranked' dividends, given that the gift is unlikely to be income and unlikely to create a tax liability). This problem is not cured by the s328-430 deemed tax values for the transfers.
b) This problem gift/profits problem, alone, might be enough to preclude rollovers to companies. And I would have thought that the Government expected that rollovers to companies would be common and important not to exclude by the drafting of the provisions.

## Further tax relief required (even allowing for the "no consideration" design feature )

The draft attempts to create a tax neutral result from a rollover (by deeming all transactions to be undertaken at the 'rollover cost' defined in proposed s328-430(2)). However, this is not sufficient to achieve tax neutrality.

a) The effect of s328-430(2)(a) is probably to deem the named CGT assets to be transacted at 'market value', as this is the value that would be required to avoid there being neither a capital gain, nor loss, for the transferor (because the 'market value substitution rules would be activated, either because there was no consideration, or because the parties were not dealing with each other on an on an arm's length basis). This may not be what was intended, however, as the transferee would get a market value cost base, for the same reasons. The intended policy was probably for the transferee to inherit the transfer's cost base, and with it any latent capital gain.

b) However, relief is missing for these transfers of assets being deemed a dividend (under Division 7A of Part III of the *Income Tax Assessment Act 1936*). Under these provisions, there are many assets deemed to be transferred at values less than their market value (under s328-430). This gives rise to a Div 7A 'deemed dividend' exposure for the following reasons. The transfer of the asset will be a relevant 'payment' (given that transfers of property are deemed to be 'payments' under s109C(3)(c)). This 'payment' will be deemed to be dividend to the extent to which the amount the 'amount paid for the transfer' is less than the market value of the property transferred (under s109C(4)). There is obvious exposure here, given that the transferee will pay nothing for the asset (if it wants rollover relief). But even if we assume that deemed 'rollover cost' value applies for Div 7A purposes, the 'rollover cost' value can often be less than the asset's market value – making it likely that may transfers are deemed dividends. The transferee will then be assessable on the dividend value (without franking credits) if it is a shareholder of the transferring company or an associate of such a shareholder – which usually it would be given the requirement for common 'underlying economic ownership' (in s328-440(1)(d)). Also, the extended operation of Div 7A (via subdiv E and EA), means that the transferee can often be deemed to have received a dividend, even if the transferor is not a company - if there is a private company anywhere in the structure. This Div 7A exposure, alone, could prevent a large proportion of the intended restructures from proceeding (because not all of the transactions are 'tax neutral').

c) There is also the problem that there is no franking credit transfer relief. This might only be relevant for a company-to-company rollover, but again, there could be many eligible companies wanting to separate out one business from another, into a fresh company, but are not able to do this, because of the lack of deemed franking credit transfer.

d) And in a similar vein, there is no transfer of accumulated (carry forward) tax losses. This too could block many would-be transfers, because of this shortcoming.

## 'Residency' rollover requirement is too limited

I note that s328-440(1)(g) imposes a 'residency' requirement for rollover relief. It provides 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;

I am of the view that this unnecessarily limits the potential application of the rollover concession contemplated in the Budget announcement. There is no policy reason (apparent to me, at least) for excluding resident transferors and transferees from this rollover relief, just because there is a foreign resident individual who holds some of the ultimate economic ownership in both the transferor and transferee. There are often foreign interests in Australian small businesses with real growth potential (whether venture capitalist funds or otherwise).

## Residency requirement not specified for discretionary trusts

Discretionary trusts typically have wide classes of potential beneficiaries and the trustee has a discretion as to who will get trust income or capital. These trusts do not fit easily into various tax tests that involve tracing through entities for one purpose or another.

In other tax provisions there are a variety of approaches taken. I note that at least some attempt has been made to provide for this special class of entity (in s328-440(3)) to satisfy the the 'ultimate economic ownership' test to discretionary trusts (in s328-440(1)(f)).

But there is no equivalent provision for the ‘residency’ requirement (in s328-440(1)(g)). Nor should the same approach be taken. There is no warrant for the whole of this trust’s ‘family group’ to be resident. That is too wide.

I suggest that the relevant test for a discretionary trust be that the ‘appointor’ trust be a resident (which might include the existing trustee, who often has the power to appoint a replacement trustee, if that power is not already given to a named office holder). If there were no appointor, then perhaps the requirement ought be that the trust be a Australian Resident Trust.

This whole issue requires some further thought.

## ‘Ultimate economic ownership’ requirement

The requirement that there be no change in the ‘ultimate econonomic ownership’ of the transferred assets (s328-440(1)(f)) might well be the correct policy setting for the parties eligible for the rollover.

But, unless I’m mistaken, this term does not appear to be defined and leaves much to the ‘imagination’ of the reader, the authority responsible for administering these provisions and ultimately the Courts. This will have its difficulties (although it’s a matter of judgement whether clarification is worth the extra ink).

I assume that this is tested by a ‘multiplying through’ interposed entities to relevant individuals (much like the ‘continuity of ownership’ test before a company can carry forward its tax losses). These provisions, however, offer no guidance on how to do this. For instance, is the test based on the percentage individual’s direct and indirect percentage entitlement to income or capital of the interposed entities? And if it is to be based on both, will it be on the higher or the lower of these two interests?

Also, there is a special family discretionary trust provision (in s328-440(3)), for determining whether a transfer to or from a discretionary trust changes the individuals who hold the ultimate economic ownership’, which may not work.

a) It seems to say that a trust has to be a ‘family trust’ (which is to say, it must have made a ‘family trust election’ and thus have a ‘family group’) to avoid a transfer to or from a discretionary trust changing the underlying economic ownership. Without such a trust, these deeming provisions would not be attracted and there would be a change in the individuals with ‘ultimate economic ownership’ as there would be no such individuals who had the relevant ownership.
b) It seems to be saying that individuals who had the ‘ultimate economic ownership’ in a transferor entity’s assets, would not change that ownership (or their respective percentage shares in that ownership), if all those individuals were members of the transferee trust’s ‘family group’ - though it would be clearer if s328-440(3)(b) expressly said that it is referring to the transferee trust.
c) It also seems to be saying that a transfer from a ‘family trust’ to another entity (where individuals with the ‘ultimate economic ownership’ of the transferred assets can be identified) will not effect any change in those individuals with those interests (or their shares in that ownership), if all those individuals are members of the ‘family group’ of the transferor trust. Again, it would be better if s328-440(3)(c) expressly said that it was referring to the ‘family group’ of the transferor trust.

d) It is not clear whether these slightly ‘Delphic’ provisions allow a transfer from a ‘family trust’ to a ‘family trust’, but probably they do, if all the individuals in the transferor trust’s ‘family group’ are the same as all the individual’s in the transferee trust’s family group. This is a stringent requirement, but might be what was intended by the Government’s announcement.
e) It is disappointing to have yet another (tax) reason why a discretionary trust must make a ‘family trust election’ as these elections are irrevocable and come with a lot of baggage (in that distributions outside the ‘family group’ attract tax at a nasty rate). As best I understand it, a discretionary trust already has to make a FTE to carry forward tax losses or to allow franking credits to pass through to beneficiaries.

## Further submissions in due course

I, like the Tax Committee of the Law Council of Australia, have only had limited time to make these submissions, and I have done so on the basis of the defects I can see at this stage.

The passage of time and further drafts might give further opportunity for other comments.

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