Changes to support the measure to provide greater consistency in the scrip for scrip roll-over and the small business entity provisions

Proposals Paper
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CONSULTATION PROCESS

Request for feedback and comments

The Government seeks your feedback and comments on the issues outlined in this consultation paper. The information obtained through this process will inform the Government's approach on the way forward and also assist in meeting the requirements of the Office of Best Practice Regulation.

All information (including name and address details) contained in submissions will be made available to the public on the Treasury website, unless you indicate that you would like all or part of your submission to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain in confidence should provide this information marked as such in a separate attachment. A request made under the *Freedom of Information Act 1982* (Commonwealth) for a submission marked 'confidential' to be made available will be determined in accordance with that Act.

While submissions may be lodged electronically or by post, electronic lodgement is preferred. For accessibility reasons, please email responses in a Word or RTF format. An additional PDF version may also be submitted.

Closing date for submissions: 18 July 2012

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1. INTRODUCTION

1.1 THE 2011-12 BUDGET MEASURE

The 2011-12 Budget included a measure to provide a more consistent application of particular provisions in the capital gains tax (CGT) scrip for scrip roll-over and the small business concessions to trusts, superannuation funds and life insurance companies.

That Budget measure aims to ensure the effective operation of the integrity rules in sections 124-782 and 124-783 of the scrip for scrip roll-over provisions of the *Income Tax Assessment Act 1997* (ITAA 1997). In particular, that measure seeks to ensure that the concepts of 'significant stake' and 'common stake' apply effectively, and as originally intended, to trusts and other entities that hold interests for the benefit of other entities.

The 2011-12 Budget measure similarly seeks to ensure the effective operation of the rules in section 328-125 of the ITAA 1997 for testing whether one entity is 'connected with' another entity for the purposes of the small business concessions.

These policy outcomes are to be achieved by removing references to 'for their own benefit' and 'beneficial' from the relevant parts of the scrip for scrip roll-over and the small business entity provisions, so that the provisions are based on 'the right to receive', 'ownership' or 'the right to acquire ownership' as they respectively relate to the significant stake and common stake concepts, and the connected entity test.

In designing and consulting on the 2011-12 Budget measure, it became apparent that there were interaction issues with the CGT provisions dealing with absolutely entitled beneficiaries, security arrangements, liquidators and bankruptcy.

1.2 THE 2012-13 BUDGET MEASURE

As a result of these interaction issues, the 2012-13 Budget included a measure to make several changes to support the effective operation of the 2011-12 Budget measure providing greater consistency in the application of the scrip for scrip roll-over and small business concessions.

In particular the 2012-13 Budget measure will ensure that the provisions concerning absolutely entitled beneficiaries, security providers and companies in liquidation interact appropriately with the CGT provisions generally and with the connected entity test in the small business entity provisions. This measure will also ensure that the bankruptcy rule in section 106-30 of the ITAA 1997 applies to the connected entity test.

The 2012-13 Budget measure also ensures that consequential impacts on the *A New Tax System (Wine Equalisation Tax) Act 1999* through the operation of the changes to the connected entity test apply to wine producers from the first financial year after the amending legislation receives Royal Assent.

2. OPERATION OF EXISTING LAW

2.1 SCRIP FOR SCRIP ROLL-OVER PROVISIONS

Subdivision 124-M of the ITAA 1997 (the scrip for scrip roll-over) provides a CGT roll-over where original equity interests in one entity are exchanged for replacement equity interests in another entity, because of a takeover or merger. The roll-over defers recognition of any capital gain on the scrip for scrip transaction until a CGT event happens to the replacement interests.

The integrity rules in sections 124-782 and 124-783 of the ITAA 1997 ensure an appropriate cost base in scrip for scrip transactions where the same stakeholders in the target and replacement entities have the potential to influence both entities.

2.2 SMALL BUSINESS CONCESSIONS

The connected entity test in section 328-125 of the ITAA 1997 seeks to establish whether one entity controls another entity for the purposes of accessing the small business CGT concessions, the small business non-CGT concessions and the wine equalisation tax rebate.

The connected entity test is used to regulate the availability of the small business concessions to genuine small business structures based on the size of the turnover or net assets of the entity and its related entities (that is, its connected entities and affiliates).

The connected entity test is also used to define an 'associated producer' for the purposes of the *A New Tax System (Wine Equalisation Tax) Act 1999*. The associated producer rules are integrity rules that ensure that a wine producer cannot access an additional amount of wine equalisation tax rebate by dividing their business into separate entities.

2.3 ABSOLUTELY ENTITLED BENEFICIARIES

Subdivision 106-C of the ITAA 1997 provides that if a beneficiary is absolutely entitled to a CGT asset as against the trustee of a trust (disregarding any legal disability), the CGT provisions apply to an act done by the trustee in relation to the asset as if the beneficiary had done it. This means that the beneficiary, and not the trustee, is liable for any capital gain or loss on the asset.

An absolutely entitled beneficiary is entitled to direct the trustee as to how to deal with the asset and may call for the trustee to transfer ownership of the asset to the beneficiary at any time. As such, the trustee merely acts as a nominee or agent for the beneficiary and it is the beneficiary that controls the asset.

Subdivision 106-C may not operate effectively in relation in certain circumstances (such as where there is no act done by the trustee) and therefore would not treat the absolutely entitled beneficiary as the owner of the asset where that is appropriate for the purposes of applying the CGT law (such as the stakeholder tests). This may result in some anomalous outcomes. For example, the sale of an asset by the trustee is attributed to the beneficiary, but the disposal of an asset through a loss or destruction may technically be attributed to the trustee because a loss or destruction is not an act done by the trustee.

2.4 Security holders

Subdivision 106-D of the ITAA 1997 treats certain acts done by a security holder as being done by the security provider for the purposes of the CGT provisions. This means that the person who provided the security, and not the security holder, is liable for any capital gain or loss on the asset. For example, if a lender sells property under a power of sale after the owner of the property fails to make payments on the loan, any capital gain or loss is made by the owner of the property, and not the lender.

As with Subdivision 106-C, Subdivision 106-D may not operate effectively in relation to certain events or transactions that may affect the security and therefore would not treat the security provider as the owner of the asset for the purposes of the stakeholder tests or other aspects of the CGT law.

In addition, Subdivision 106-D applies to acts done only 'for the purpose of enforcing or giving effect to a security, charge or encumbrance the entity holds over the asset'. This purpose test is restrictive as a security holder may also act on behalf of a security provider in transactions or matters that are not for the purpose of enforcing or giving effect to a security, charge or encumbrance held over the asset.

2.5 Bankruptcy and Liquidation

Bankruptcy

Section 106-30 of the ITAA 1997 states that, for CGT purposes, the vesting of an individual's CGT assets in a trustee under the *Bankruptcy Act 1966* or under a similar foreign law is ignored. By ignoring the vesting of assets in a trustee, section 106-30 operates effectively to treat the bankrupt individual as the owner of the asset for the purposes of the stakeholder tests, and for other aspects of the CGT law.

Section 106-30 also ensures that the CGT provisions apply to an act done by a trustee in relation to an individual's CGT assets as if it had been done by the bankrupt individual. This means that any capital gain or loss which arises is attributed to the individual, not the trustee.

Liquidation

Section 106-35 of the ITAA 1997 states that, for CGT purposes, an act done by a liquidator of a company, or the holder of a similar office under a foreign law, is treated as if the act had been done instead by the company. This means that any capital gain or loss which arises is attributed to the company, not the liquidator.

For the same reasons as set out for absolutely entitled beneficiary and security holders, section 106-35 is arguably not effective where the assets have vested in a liquidator in relation to certain events or transactions that are not acts done by the liquidator.

3. Policy Design of proposal

3.1 Amendment to the absolute entitlement provision

The absolute entitlement rule in Subdivision 106-C will be amended to treat the asset vested in the trustee as being vested in the absolutely entitled beneficiary where the beneficiary is immediately entitled to the asset on either the creation of a trust over the asset or on transfer of the asset to an existing trust.

If a beneficiary subsequently becomes absolutely entitled to an asset of the trust, Subdivision 106-C will treat the CGT asset as having vested in the absolutely entitled beneficiary from when the beneficiary becomes absolutely entitled. This ensures that the absolutely entitled beneficiary is treated as the owner of the asset for CGT purposes.

The amendment to the absolute entitlement rule in Subdivision 106-C will apply at the option of taxpayers from the 2008-09 income year and automatically from Royal Assent so that the measure does not disadvantage taxpayers retrospectively.

3.2 Amendment to the Security Holder provision

The security holder rule in Subdivision 106-D will be amended to ensure that the vesting of the asset in the security holder does not prevent the security provider from being treated as the relevant owner of the asset for CGT purposes.

The security holder rule in Subdivision 106-D will be further amended to remove the limitation that acts be done only for the purpose of enforcing a security, charge or encumbrance. This will allow the Subdivision to apply to all the acts done by a security holder in relation to the security asset as having been done by the security provider for the purposes of the CGT provisions.

The amendment to the security holder rule in Subdivision 106-D will apply at the option of taxpayers from the 2008-09 income year and automatically from Royal Assent.

3.3 Amendment to the liquidation provision

Generally, liquidators control the assets of a company in liquidation by gaining control of the company. However, the Court may order that the assets of the company vest in the liquidator. One example is where a special purpose liquidator is appointed.

The liquidation provision in section 106-35 of the ITAA 1997 will be amended to ignore the vesting of assets in a liquidator. This will ensure that the company under liquidation is treated as the relevant owner of the assets for CGT purposes.

This amendment to the liquidation provision in section 106-35 will apply at the option of taxpayers from the 2008-09 income year and automatically from Royal Assent.

3.4 Amendment to the connected entity test to clarify interactions with Subdivisions 106-B, 106-C and 106-D

The connected entity test is used to determine eligibility for the small business CGT concessions, the small business non-CGT concessions and the wine equalisation tax rebate.

The connected entity test will be amended to clarify that assets that are actually owned by a trustee on behalf of an absolutely entitled beneficiary, a security holder, a bankruptcy trustee or a liquidator are treated as being owned respectively by the absolutely entitled beneficiary, security provider, bankrupt or company in liquidation for the purposes of the connected entity test.

This change will apply in relation to the:

- small business CGT concessions for CGT events happening from the beginning of the 2008-09 income year until Royal Assent at the option of the taxpayer and automatically from Royal Assent onwards; and
- small business non-CGT concessions for assessments from the 2008-09 income year at the option of the taxpayer and automatically from the beginning of the income year after Royal Assent.

3.5 Impact on *A New Tax System (Wine Equalisation Tax) 1999* (WETA 1999)

The connected entity test is also used to define an 'associated producer' for the purposes of the WETA 1999. The associated producer rules are integrity rules that ensure that a wine producer cannot access an additional amount of wine equalisation tax rebate by dividing their business into separate entities.

The 2011-12 Budget measure provided for changes relating to the CGT aspects (that is, the changes relating to the stakeholder tests in relation to the scrip for scrip roll-over and the changes relating to the connected entity test in relation to the small business CGT concessions) to commence from 7:30 pm (AEST) on 10 May 2011 and for the non-CGT aspects to commence from the 2011-12 income year.

The proposed 2012-13 Budget changes, in so far as they affect the connected entity test in the small business entity provisions, also apply for the purposes of the WETA 1999.

To the extent that the changes proposed in the 2011-12 Budget measure and 2012-13 Budget measure impact on the WETA 1999, the amendments will apply from the first financial year after Royal Assent.

4. Amended assessments

A provision will be inserted in these amendments to the effect that the mere fact that there has been a change in the wording of the law in respect of the 2011-12 Budget changes to the stakeholder and connected entity tests cannot be used as the basis for seeking an amended assessment.

5. Issues for discussion

We invite interested parties to lodge written submissions on the design of this proposal. In particular:

- Do the suggested amendments to Subdivisions 106-C (absolute entitlement) and 106-D (security holders), and section 106-35 (liquidators) in the ITAA 1997 achieve the intended policy outcome to ensure that the significant and common stakeholder tests in the scrip for scrip roll-over provisions and the connected entity test in the small business entity provisions apply to the appropriate entity?

- Are there any problems with the suggested amendments that could adversely affect taxpayers aside from the effects of the relevant provisions applying appropriately to the relevant taxpayer?