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.

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.

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.

Closing date for submissions: Friday, 24 June 2011

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1. INTRODUCTION

1. The 2011-12 Budget included a measure to provide more consistent application of the Capital Gains Tax (CGT) scrip for scrip roll-over and the small business concessions.

2. This proposal will ensure the effective operation of the integrity rules in sections 124-782 and 124-783 of the *Income Tax Assessment Act 1997* (ITAA 1997) of the scrip for scrip roll-over provisions. In particular, the proposal will 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.

3. This proposal will similarly 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.

4. These policy outcomes can be achieved by removing references to 'for their own benefit' and 'beneficial' from the relevant parts of the scrip for scrip 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.

2. OPERATION OF EXISTING LAW

2.1 SCRIP FOR SCRIP ROLL-OVER PROVISIONS

5. Subdivision 124-M (the scrip for scrip roll-over provisions) allows a CGT roll-over when original equity interests in one entity are exchanged for replacement equity interests in another entity, typically because of a takeover or merger. The roll-over defers recognition of any capital gain (but not a capital loss) on the scrip for scrip transaction until a CGT event happens to the replacement interests.

6. 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 stakeholders in the target and replacement entities have the potential to influence both entities.

2.2 Small business concessions

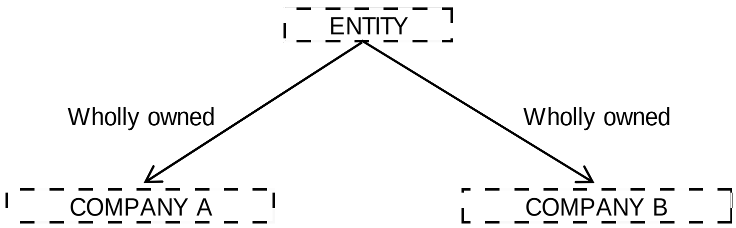
7. The connected entity test seeks to establish whether one entity controls another entity for the purposes of accessing the small business concessions.

8. The connected entity test is used to restrict 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 affiliates and connected entities).

9. The proposed changes will ensure that large businesses cannot access the concessions simply by including a trust (or similar entity) in their business structure and arguing that the trust breaks the link between entities so that certain income and assets are not counted in determining whether the relevant entity in the business structure is a small business.

Example

Assume that an entity owns all of the shares in Company A and Company B.



If that entity is an individual or company, then it is clear that:

- the entity is connected with both Company A and Company B, and
- Company A and Company B are connected with each other.

This measure will ensure that the same treatment will apply where the entity is a trust.

The connected entity test is also used to provide 'active asset' status, which is necessary for accessing the small business CGT concessions, where an asset owned by one entity is used by a small business entity. The small business entity has to be connected with (or an affiliate of) the asset-owning entity.

10. The proposed changes will ensure that an entity that legally owns an asset that is used in a small business can access the small business concessions where a trust or similar entity is included in the entity's business structure and the relevant tests are satisfied.

2.3 Operation of the tests

11. Both the significant and common stakeholder tests and the connected entity test consider whether a taxpayer, along with its associates or affiliates respectively, has a certain percentage interest in the voting rights, income or equity of a particular entity. These tests seek to determine whether one entity has the potential to influence or control the other entity.

11.1. In the case of the stakeholder tests, the taxpayer and their associates must have a right to receive income or capital 'for their own benefit'.

11.2. In the case of the connected entity test, the taxpayer or its affiliates must 'beneficially own or have the right to acquire beneficial ownership of' the interest.

12. It has been argued that the beneficial interest requirements prevent the tests from applying to trusts, life insurance companies and superannuation funds because they do not own the interest for their own benefit, but rather for the benefit of their beneficiaries, policy holders or members.

3. POLICY DESIGN OF PROPOSAL

13. Trusts and similar entities can potentially influence other entities by virtue of their legal rights, regardless of who benefits from that ownership. Therefore, 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 will be amended so that the former is based on 'the right to receive' and the latter is based on 'legal ownership or the right to acquire legal ownership', regardless of who benefits from that right or ownership.

4. ISSUES FOR DISCUSSION

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

14.1. Do the suggested amendments of 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 achieve the intended policy outcome?

14.2. Are there any problems with the suggested amendments that could adversely affect taxpayers aside from the effects of the relevant provisions applying consistently to all types of taxpayers?