Small Business Restructure Roll-overs

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This Paper provides an analysis of the legislation tabled by the Government that makes changes to the ITAA 1997 that were announced by the Government on 12 May 2015 as part of its "Growing Jobs and Small Business" package in the 2015-16 Budget. The changes are designed to "provide greater flexibility for small businesses to change their legal structure".

The Explanatory Memorandum that accompanies the legislation states that "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 as part of a genuine restructure".

Although, at the time of writing, the legislation remains to be debated by the Parliament and passed into law, the author is of the view that, as there is little or no controversy about the proposed measures, the Bill can be expected to be enacted in its current iteration in the near future.

Preamble

The new small business restructure roll-over applies in addition to roll-overs currently available where an individual, trustee or partner transfers assets to, or creates assets in, a company in the course of incorporating their business. It will apply where the relevant restructure occurs on or after 1 July 2016 and is designed to make such restructures "tax neutral" by removing any tax liability that would otherwise arise upon changing the legal structure that operates the business.

1. Why restructure?

There are many factors that a small business will take into account when determining the most appropriate structure for their business including tax issues, personal liability for debts, access to capital to expand as well as the various compliance costs for the chosen structure.

A restructure of that business into a more appropriate legal structure may assist the business in a number of ways including to:

- adapt to contemporary conditions in its markets or to align with competitors;
- develop and grow the business with or without further equity;
- avoid unnecessary compliance costs;
- have a more efficient and tax effective structure; or
- generally enhance business efficiency.

However, under the current rules for a restructure, roll-over relief is only available in limited circumstances and these rules have proved to be an impediment to restructures of a small business.

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2. Greater flexibility

Currently, if a restructure requires business assets to be transferred from one entity to another, such a transfer can create significant tax liabilities that impact on the business's cash flow without an increase in the overall economic position.

The legislation aims to remove these negative impacts by allowing access to an optional roll-over for gains and losses arising from the transfer of CGT assets, trading stock, revenue assets and depreciating assets as part of a small business restructure. The effect of this new roll-over is to allow small businesses to move to a more suitable legal structure without realising an income tax liability on the transfer of those assets.

Thus, the transfer will be "tax neutral" at the time of the transfer and the new legal structure will inherit the tax attributes of the old structure/owner of the said assets going forward.

As it would be expected in legislation of this nature, there are a number of integrity rules written into the provisions. Such integrity rules are said, in the EM, to be aimed at "a minority of taxpayers and advisers (who) may try to manipulate the operation of a 'black letter' provision of the tax law to achieve an inappropriate or uneconomic tax outcome".

3. Integrity rules

The major integrity rule for eligibility to access the roll-over is that the transfer of the assets must be, or be part of, a "genuine restructure of an ongoing business". This is said to be a principle to distinguish artificial or inappropriately tax-driven schemes.

The concept of "genuine" is not defined in the legislation and will be assessed as a question of fact having regard to all of the facts and circumstances surrounding the restructure. Having said that, the EM sets out the following factors that would indicate a genuine restructure:

- it is a bona fide commercial arrangement undertaken to enhance business efficiency;
- the business continues to operate following the transfer, through a different entity structure but under the same ultimate economic ownership;
- the transferred assets continue to be used in the business;
- the restructure results in a structure likely to have been adopted had the business obtained appropriate advice when setting up the business;
- the restructure is not artificial or unduly tax-driven; and
- it is not a divestment or preliminary step to facilitate the economic realisation of assets.

In order to give a degree of certainty about these integrity rules, the legislation provides for a "safe harbour" so that a small business will be taken to satisfy the "genuine restructure test". The rule will be satisfied where, for three (3) years following the roll-over:

- there is no significant 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" (see later herein); and
- there is no significant or material use of those significant assets for private purposes.

This rule will not limit the circumstances in which a transaction is, or is part of, a genuine restructure of an ongoing business. If the parties to the transaction can satisfy the genuine restructure principle, then they will still be able to access the roll-over.

The roll-over provisions in the legislation will only apply to a "small business entity" as that term is defined in the provisions already in the ITAA 1997 that provide for concessions to small business owners disposing of their business to third parties.

4. Entities that can access the roll-over

Each party to the transfer of the asset(s) must be a *small business entity* or where the assets are held and used by another entity that other entity must be an *affiliate* or be *connected with* the entity or a partner in a partnership that is a *small business entity*.

(The terms italicized above are defined in Subdivision 328-C of the ITAA 1997 and are too lengthy to be dealt with herein)

Broadly speaking, this rule 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 per annum.

Also, to be eligible for the roll-over, the transaction must not have the effect of changing the ultimate economic ownership of the transferred asset(s) in a material way. The ultimate economic owners of an asset are the individuals who, directly or indirectly, beneficially own an asset. Thus, this test "looks through" entities to the natural person owners of the interests in any interposed entities.

In the event there is more than one individual who is an economic owner of the asset(s), there is an additional requirement that each of those individuals' share of the ultimate economic ownership be materially unchanged, maintaining the same proportionate ownership in the asset(s).

Generally speaking, it is relatively straight forward to trace ultimate economic ownership through entities where the interests are fixed by the nature of the entity e.g. a company, a fixed trust or a partnership.

It is not so straight forward in the case of a discretionary trust and these amending provisions allow for such a trust to be a party to the roll-over transaction.

5. Discretionary Trusts

In some cases, a non-fixed (i.e. discretionary) trust may be so for the purposes of the income tax law but, because there is no practical change in which individuals economically benefit from the assets before and after the roll-over, there will not have been a change in ultimate economic ownership on those facts.

However, in other cases, it may not be possible to determine proportionate ultimate economic ownership of the assets of the trust. The new roll-over provisions will allow a discretionary trust to access the roll-over if it is a "family trust" (as defined) and instead meet an alternative ultimate economic ownership test.

A "family trust" is one in which the beneficiaries of the trust are only those who are related to a person who is nominated and called the "test individual" for those purposes. To meet the alternative test, it will be necessary for every individual who had ultimate economic ownership of the transferred asset(s) before the transfer and every individual who has ultimate economic ownership of the transferred asset(s) after the transfer to be members of the family group relating to the family trust.

This measure is intended to provide additional flexibility to small family businesses carried on through such a discretionary trust by allowing them to meet the requirement to maintain ultimate economic ownership of the asset(s) if the ultimate economic ownership of those assets remains within the family.

The rules concerning the nature of the asset(s) that can be subject to this new roll-over ensure that the criteria only apply to asset(s) of a small business entity.

6.	Asset(s) eligible for roll-over

Where a party to the transfer of the asset(s) is itself a small business entity, the asset(s) being transferred must be CGT asset(s) that are/is an *active asset* as defined and, broadly, includes assets that are used in a business.

Where a party to the transaction is not a small business entity but is an *affiliate* or is *connected with* the small business entity (see 4 above) then the asset must be an active asset that, among other things, requires that the relevant small business entity carries on business in relation to the asset.

Where a party to the transaction is not a small business entity but is a partner in a partnership that is a small business entity, the asset must be a) an active asset and b) an interest in the asset of the partnership.

There are various machinery provisions that restrict the roll-over to tax residents, ensure both parties must choose the roll-over and that the roll-over cannot apply to exempt entities and complying superannuation entities.

As with other roll-overs already existing, these new provisions will give a certain flexibility to taxpayers contemplating restructures to allow them to be done without the impediment to cash flow that would otherwise be caused by realising a tax liability on the restructure into a new entity. It achieves this outcome by "switching off" the existing income tax law that would otherwise apply to the subject transactions.

However, that "switching off" does not apply to prevent the Commissioner from invoking the general anti-avoidance provisions contained in Part IVA of the ITAA 1936 nor does it affect any liability for stamp duty under State legislation.

The amending Bill also deals with the effect of a restructure on the transferred cost of assets and the income and capital gains consequences for the transfer in relation to "timing rules" that will apply going forward.

7. Effect on transferred cost of assets

The income tax law will apply to the transferor as if the transfer takes place at the asset's *roll-over cost* i.e. essentially, the transferor's cost 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 relevant asset for that same amount.

For "pre-CGT assets" transferred under the roll-over, those assets retain their "pre-CGT" status in the hands of the transferee.

For CGT assets, the *roll-over cost* will be the cost base of the asset in the hand's of the transferor. For the purposes of determining eligibility for a discount capital gain i.e. ownership of the CGT asset for at least 12 months, the time period will recommence from the time of the transfer.

Assets that are trading stock in the hands of the transferor will retain that status in the hands of the transferee and the transferee will inherit the transferor's cost.

Revenue assets (i.e. those held with a purpose of resale at a profit) will have a *roll-over cost* such that the transferor makes no profit or loss on the transfer and the transferee will inherit the same cost attributes as the transferor just before the transfer.

For depreciating assets, the *roll-over cost* will be an amount that does not give rise to a balancing adjustment so that there is no assessable or deductible amount arising for the transferor. The transferee can deduct the decline in value 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. Roll-over relief is also available for pooled assets.

The roll-over does not require that market value consideration or, indeed, any consideration be given in exchange for the transferred assets. The parties can, for instance, agree that the assets are to be transferred for cost to eliminate any future unrealised gains on membership interests held in the transferor entity.

The Bill also contains an integrity rule (the loss denial rule) that will ensure that any capital loss arising on any direct or indirect membership interest in the transferee or transferor arising subsequent to the roll-over is disregarded. However, this rule will not apply to the extent that the taxpayer can demonstrate that the loss is reasonably attributable to something other than the roll-over transaction.. Thus an "artificial loss" arising on membership interests in a transferor entity following a transfer for no consideration would be subject to this integrity rule. That same rule would not apply where no such membership interest exists i.e. in the case of a sole trader or a discretionary trust.

This loss denial rule operates in addition to the "genuine restructure" requirement but the EM acknowledges that, given that most small businesses are expected to be owned and operated by their initial owners, the rule will have little or no practical operation.

Finally, the legislation provides that, for the purpose of determining eligibility for the 15 year CGT exemption for the small business concessions, the transferee will be taken as having acquired the asset when the transferor acquired it.

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