TAX EFFECTIVE RESTRUCTURING FOR COMPANIES

A paper presented by Michael Bennett for the Television Education Network

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1 Overview

Our clients use structures, including corporate entities and corporate structures, for a myriad of reasons:

- tax planning;
- asset protection;
- to comply with governance and regulation;
- incentivise employees;
- raise capital;
- ease, or not, of administration;
- estate planning; and
- changes in family circumstances (death, divorce, marriage, et cetera),

to name only the obvious reasons. But business and investment structures which may have been appropriate for the business or personal circumstances of our clients when first established, or as they've grown organically, may become less efficient and appropriate as those circumstances change over time. They often require adjustment or restructuring.

This paper sets out some structuring options and techniques that can be used when changes in circumstances occur and the client's structure or structures require modification.

Further, corporate taxation has been topical of late. That rates of tax, and how much companies have been declaring, has never been far from the news.

This paper will consider aspects of corporate restructuring and how it can be done tax effectively. It will be convenient to consider specific issues that arise under this general theme. These include:

1. Getting Value Out of an At Risk Company:
    a. extracting dividends or securing entitlements;
    b. Subdivision 122-A Rollover – single or multiple shareholders;
        i. Stamp duty considerations on restructure;
        ii. Part IVA and dividend stripping;
        iii. tax consolidation issues; and
        iv. impact on future sales;

c. Division 615 Rollover (former Subdivision 124-G Relief) – multiple shareholders;

2. Market valuations and restructures;

3. Selling assets and apply the Small Business Concessions in Division 152;

4. the New Small Business Rollover Relief in Subdivision 328-G;

5. Stamp Duty Issues on Restructuring; and

6. Dividend Washing Arrangements.

7. A discussion of the change to the corporate tax rates.

But it is important to note that as more provisions are being introduced the breadth of consideration increases. Gone are the days of the CGT provisions being a one-stop shop for restructuring. Division 615 has replaced subdivisions 124-G and 124-H (see heading 2.3). Subdivision 328-G has been introduced (see heading 5). There are the stamp duty consideration that have always existed (see heading 6).

Therefore, although the above topics will be dealt with separately and in the order discussed above, it is important to keep a wide lens view when considering restructuring.

2 Growth / Asset Protection Restructuring

It is common for clients to focus on the short term when establishing their structures. This is often because the immediate needs or benefits – such as simplicity, lower accounting fees, et cetera – will be more prominent in the clients mind than longer term needs such as asset protection or succession planning.

As advisors we should be aiming to assist clients accumulate wealth from a business or investment structure whilst keeping that wealth separate from ongoing risks that may exist in the business or structure. This can be difficult where the clients have accumulated significant retained earnings by reinvesting their profits into the business or investment structure. Those retained earnings would be at risk if a claim against the company is made.

There are several strategies available to address this situation, which are discussed separately below.[1]

2.1 Extracting Dividends or Securing Entitlement

The most straightforward way for a company with retained earnings to reduce the level of retained earnings is by declaring a dividend.

Dividends used to be restricted to be declared from profits, but since 28 June 2010 they can now be declared in a broader way.[2]

There is obviously top up tax payable to the extent the shareholder's tax rates exceed the franked amount of the divided or, conversely, tax refunded to the extent the situation is reversed. This strategy is often impractical if the shareholders are individuals as a dividend of any substance will attract significant top up tax.

If the shareholders wish to leave funds in the company, for instance for working capital purposes, the dividend can be declared and paid, and then lent back to the company by the shareholders. If this is adopted the loan should be secured pursuant to the *Personal Properties Securities Act* 2009 (Cth) requirements.

2.2 Subdivision 122-A Rollover – Single or Multiple Shareholders

This provision permits a restructure to enable the dividends to be paid and lent back without incurring the prohibitive top up tax referred to above.

2.2.1 The Roll-Over

In essence, the individual shareholder disposes of their interest in the operating company to a new (usually newly incorporated) wholly-owned company. The shareholders of the operating company become the shareholders of the interposed company.

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[1] This part of this paper extensively draws on an excellent paper by Stephen Holmes of WMS Chartered Accountants.

[2] Though see the new s 254T of the *Corporations Act* 2001 (Cth), inserted by the *Corporations Amendment (Corporate Reporting Reform) Act* 2010 (Cth) and affecting dividends declared on or after 28 June 2010, that broadens the basis on which a

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Almost invariably (and I have assumed) the shareholders would be holding their shares in the operating company on capital account. The transaction would usually result in the happening of a CGT Event because the shareholders are disposing of their shares in the operating company.

The shareholders may use Subdivision 122-A of the *Income Tax Assessment Act* 1997 (Cth) (the '**1997 Act**') to obtain roll-over relief. The relief is also available if the shareholder is a trust.

This roll-over should be the most familiar of the roll-overs discussed in this paper. It allows the tax efficient transfer of an asset. The end result of it is that the shareholder (be it individual or trust) must wholly own the shares in the interposed company immediately after the transfer. That company then owns all the shares in the operating company.

The roll-over also works if assets are to be moved into an interposed company without there having been any company in the structure beforehand. This paper, however, is focusing on interposing a company between an existing company and its shareholders.

The only consideration that is allowed for the transfer is non-redeemable shares in the interposed company. There is actual no requirement for shares to be issued (though it is simpler to do so); all that is requires is that where shares are issued, the market value of the shares must be equal to the market value of the asset transferred.

Certain assets of a business are precluded from the roll-over including trading stock and depreciable assets. The transfer of these assets can still occur as part of the transaction, but the tax consequences of those particular transfers would be considered separately. Where depreciable plant is transferred, no sale occurs for tax purposes by virtue of s 40-30 of the 1997 Act. The company inherits the depreciable profile for assets from the individual / trust.

The cost base for the shares issued as part of the roll-over transaction is the sum of the cost base of the assets transferred as part of the roll-over.

Where the shares in the holding company are sold within twelve months of issue, the CGT discount remains available by virtue of ss 115-30 and 115-34 of the 1997 Act. However, the sale of the assets constitutes a break in the 15-year ownership period as required by Subdivision 152-B of the 1997 Act for the 15-year exemption.

2.2.2 The Strategy to Reduce Retained Earnings

If the roll-over is used, such that a holding company (or companies if there was more than one original shareholder) and operating company are in the structure, the opportunity to tax efficiently remove retained earnings from risk has been created. The operating company declares a divided to the holding company or companies. No further tax is payable (though going forward the tax rate differentials discussed at heading 8 may affect this statement). If needs be the money can be lent back to the operating co with appropriate security.

As future profits are derived this process would be repeated. Under this strategy, the net worth of the trading company should be able to be kept to a minimum other than the unrealised growth of assets such as goodwill.

2.2.3 Multiple Shareholders

As hinted at above, this roll-over can also work well when the operating company has more than one shareholder. Each shareholder can use the roll-over to dispose of their initial shares in the operating company to their own wholly-owned interposed company. That is, there will be as many interposed companies as there were each original shareholders, where the new companies step into the shareholding of the former shareholder.

To effect the strategy above the operating company would declare dividends to all shareholders, who then take the appropriate security on the amounts they separately lend back to the operating company.

2.2.4 Concerns and Complexities with this Approach

The following concerns and complexities with the above strategy are now discussed.

2.2.4.1 Stamp Duty Considerations on Restructures

As the Subdivision 122-A roll-over involves the disposition of shares in private companies, the main area of concern for stamp duty is where the company is regarded as land rich. To be caught by these landholder provisions a "relevant acquisition" must be made in a "landholder". A company is only a landholder if its NSW land holdings equal or exceed $2 million.

This is because duty has been abolished on share transfers, other than if they are land rich, since 1 July 2016: the note to s 11 of the *Duties Act* 1997 (NSW).

Where a company is conducting a trading business and holds no freehold interest in land, it is highly unlikely that duty should be a major concern.

2.2.4.2 Part IVA and Dividend Stripping

Although the dividend stripping provisions in s 177E of the *Income Tax Assessment Act* 1936 (Cth) (the '**1936 Act**') were originally designed to counteract the classical dividend stripping arrangements of the early 1980's, the provisions are wide. They are sufficiently wide to consider our attention in light of the strategy above.

On the surface, a payment of a dividend from the operating company to the new shareholder company or companies would not appear to be a dividend strip per se. However, the Commissioner of Taxation (the '**Commissioner**') has a controversial view, set out in draft *Taxation Ruling* 2013/D5 regarding dividend access shares. This view has confirmed that some of the more traditional elements of the classical dividend strip do not need to be present in order for s 177E of the 1936 Act to apply.

The Commissioner has issued a number of private binding rulings to taxpayers who were seeking to utilise Subdivision 122-A of the 1997 Act to interpose a corporate shareholder and pay a dividend as discussed above. A point of note, however, is that in both private binding rulings the operating company was to be liquidated after the use of the roll-over. Those private binding rulings were:

- PBR 37296 where the shareholder, using the Subdivision 122-A rollover, was seeking to do so to receive a liquidator's distribution from an operating company. The operating company was to be liquidated and this particular shareholder wanted to continue holding his interests through a company. In the ruling the Commissioner made the following statement:

> "Is the arrangement a scheme having substantially the effect of a scheme by way of or in the nature of a dividend stripping for the purposes of subparagraph 177E(1)(a)(ii) of the ITAA 1936?
>
> 3. Your dominant purpose in entering the arrangement is to continue to operate using a company structure. Therefore the scheme does not have substantially the effect of a scheme by way of or in the nature of a dividend stripping."

- PBR 1011948219931 where a company had three shareholders. The trading company had ceased trading and was to be liquated. Two of the shareholders did not want to extract the dividends from a corporate structure whereas the other shareholder was keen to access the funds. The two shareholders utilised the Subdivision 122-A roll-over to interpose a company to own their shares in the trading company. The trading company was then liquidated and dividends paid to the threes shareholders. The shareholders who utilised the roll-over paid a portion of that dividend to themselves and retained the balance in the interposed companies. The Commissioner ruled that this process did not attract Part IVA (general anti-avoidance) or s 177E (dividend stripping) of the 1936 Act.

Given that such a strategy does contain this risk of s 177E of the 1936 Act applying, seeking a private binding ruling is to be advised before undertaking the strategy. Business administration, efficiency and asset protection would be the argued dominant purposes of the strategy.

Unlike the dividend access schemes of draft *Taxation Ruling* 2013/D5, the profits in this strategy remain in the corporate structure owned by the same original economic owners. It would be a common sense outcome that the above strategies would not attract Part IVA (general anti-avoidance) or s 177E (dividend stripping) of the 1936 Act.

2.2.4.3 Tax Consolidation Issues

The interaction of a roll-over under Subdivision 122-A of the 1936 Act and the tax consolidations regime in Part 3-90 of the 1997 Act results, in most cases, in an anomalous outcome. It most instances, forming a tax consolidated group will result in a capital gain being derived by the hew holding company.

This outcome can be seen by way of example.

> *Operation Co is a successful trading business. It is owned by a single individual shareholder. There is only one share on issue with a cost base of $1.*
>
> *The balance sheet is:*

Item	***$$***

Cash	*500,000*
Stock	*500,000*
Debtors	*500,000*
Plant (written down value)	*250,000*
Total Assets	*1,750,000*
Creditors	*300,000*
Chattel mortgage loan	*100,000*
Total Liabilities	*400,000*
Retained Profits	***1,350,000***

The sole shareholder is concerned that the retained profits are exposed should someone sue Operating Co. But he does not want to pay top up tax on any dividend at his marginal tax rates.

You suggest he implement a Subdivision 122-A rollover and, once effected, declare a dividend of $1.35 million. However, as previous R & D Credits have caused the franking credits to be limited to a dividend of $1.2 million only, an election is made to form a consolidated group between new Holding Co and Operating Co.

*To undertake the Allocable Cost Amount ('**ACA**') for Operating Co you do the following:*

Step 1 – Cost base of members interests ($1)

The roll-over under Subdivision 122-A effectively transfers the cost base of the original shares in Co to Holding Co. The original cost base of the shares is $1. That amount becomes the cost base of the shares in Operating Co now owned by Holding Co.

Step 2 – Liabilities of Operating Co ($400,000)

These are plainly $400,000.

Step 3 – Undistributed franked profits that have accrued to the group ($nil)

Only profits have been earned by Operating Co since it was owned by Holding Co are included. As the consolidation occurred immediately there are no profits to include here.

Steps 4 to 6 are not relevant

The formation ACA is therefore $400,001.

The next step is to allocate that ACA against the retained cost base assets being, in this case:

Cash	*$500,000*
Debtors	*$500,000*
<u>Total</u>	*<u>$1,000,000</u>*

As the value of the retained cost base assets (being $1 million) exceeds the ACA of $400,001, then the head company will derive a capital gain of $599,999 as a result of CGT Event L3.

Additionally, as the ACA has been exhausted on the retained cost base assets, there is no ACA left to allocate towards the tax value of the stock and plant.

Therefore, after consolidation, the written down plant for tax purposes is no $nil and the opening stock value for the consolidated group is now also $nil. A loss of $750,000 in future tax deductions.

The harsh lesson here is that a Subdivision 122-A roll-over is likely to render the formation of a tax consolidated group prohibitively expensive.

It also means the client's history should be checked for any Subdivision 122-A rollovers before undertaking a consolidation.

2.2.4.4 Future Sales of the Group

Before proceeding with a Subdivision 122-A roll-over it is critical to understand the impact it will have on any future sale of the group.

For an asset sale by the company the availability of the small business concessions (discussed at heading 5 below) should not be affected. For example, where the retirement concession is utilised by the operating company, the ultimate shareholder can still qualify as a significant individual due the (now) indirect small business participation percentage within s 152-75 of the 1997 Act.

Nevertheless, the a discussion with the client of the issue should occur.

2.3 Division 615 – Multiple Shareholders

This roll-over is particularly helpful where the purpose of the restructure is asset protection. In the author's view it is also under utilised. It was formerly in Subdivision 124-G. But the roll-over available for the reorganising of a company's affairs contained in Subdivision 124-G of the 1997 Act was replaced, with effect from 10 May 2011, with an expanded business restructure roll-over in Division 615 of that Act.

It is an expanded roll-over because it has replaced and expanded the former separate roll-overs for:

- shares pursuant to Subdivision 124-G; and

- units in a unit trust pursuant to Subdivision 124-H.

In short, it permits the interposition of a new company where the existing company has multiple shareholders. That is, it is akin to the Subdivision 122-A roll-over, but this has a more specific focus.

It operates on a disposal of shares, or a redemption / cancellation of shares, basis.

2.3.1 Disposal of Interests for Shares in Company

A taxpayer is able to choose to apply the roll-over in the disposal case where (s 615-5(1) of the 1997 Act):

a. the taxpayer is a member of a company (or a unit trust) (the *original entity*);

b. the taxpayer and least one other entity (the *exchanging members*) own all the shares (or units) in the original entity;

c. under a scheme for reorganising its affairs, the exchanging members dispose of all their shares (or units) in it to a company (the *interposed company*) in exchange for shares in the interposed company and for nothing else but those shares;

d. the conditions for the roll-over, detailed below, are satisfied.

The roll-over applies automatically where the original company was the head company of a consolidated group immediately before the disposal: s 615-5(2) of the 1997 Act.

2.3.2 Redeeming or cancelling interests for shares in interposed entity

A taxpayer can choose the roll-over in the redemption or cancellation case where the taxpayer is a member of a company (or a unit trust) (the *original entity*), and under a scheme for reorganising its affairs (s 615-10(1) of the 1997 Act):

a. a company (the *interposed entity*) acquires no more than five shares (or units) in the original entity;

b. these are the first shares (or units) that the interposed company acquires in the original entity;

c. the taxpayer and at least one other entity (the *exchanging members*) own all the remaining shares or units in the original entity;

d. those remaining shares or units are redeemed or cancelled;

e. each exchanging member receives shares (and nothing else) in the interposed company in return for their shares (or units) in the original entity being redeemed or cancelled; and

f. the conditions for the roll-over , as detailed below, are satisfied.

The original entity, or its trustee if it is a trust, can issue shares or units to the interposed entity as part of the scheme: s 615-10(3) of the 1997 Act.

The roll-over automatically applies where the original company was the head company of a consolidated group immediately before the cancellation or redemption of the shares under the scheme: s 615-10(2) of the 1997 Act.

2.3.3 Additional Conditions for Roll-Over

There are additional conditions that apply to both the disposal case and the cancellation / redemption case. They are (s 615-30 of the 1997 Act):

1. the interposed entity must own all the shares (or units) in the original entity immediately after the time the exchanging members' shares are transferred, cancelled or redeemed under the scheme (the *completion time*): s 615-15;

2. immediately after the completion time, each exchanging member must own a whole number of shares in the interposed company and those shares as a percentage of the total shares issued to exchanging members is equal to the percentage of shares (or units) that the member held in the original entity before the completion time: s 615-20(1);

3. the following ratios are equal:

   a. the ratio of the market value of each exchanging member's shares in the interposed company to the market value of the share in the interposed company issued to all the exchanging members (worked out immediately after the completion time); and

   b. the ratio of the market value of that member's shares (or units) in the original entity that were disposed of, redeemed or cancelled under the scheme to the market value of all the shares (or units) in the original entity that were disposed of, redeemed or cancelled under the scheme (worked out immediately before the first disposal, redemption or cancellation): s 615-20(2);

4. either:

   a. the taxpayer is an Australian resident at the time of the disposal, redemption or cancellation; or

   b. the taxpayer's shares or units in the original entity are taxable Australian property immediately before that time and their shares in the interposed entity are taxable Australian property immediately after the completion time: s 615-20(3);

5. the shares in the interposed company are not redeemable shares: s 615-25(1);

6. each exchanging member who is issued shares in the interposed company must own the shares from the time they are issued until at least the completion time: s 615-25(2);

7. immediately after the completion time either:

a. the exchanging members must own all the shares in the interposed company; or

b. entities other than the exchanging members must own no more than five shares in the interposed company, and the market value of those shares expressed as a percentage of the market value of all the shares in the interposed company must be such that it is reasonable to treat the exchanging members as owning all the shares: s 615-20(3); and

8. either:

a. where immediately before the completion time, a consolidated group consisted of the original entity as head company and one or more other members (the *other group members*) and immediately after the completion time, the interposed company is the head company of a consolidated group consisting only of itself and the other group members – the interposed company must choose within 28 days of the completion time (or such further time as the Commissioner allows) that a consolidated group continues in existence as and after the completion time with the interposed company as its head company; or

b. in any other case, the interposed entity must choose within two month of the completion time (or such further time as the Commissioner allows) to apply the consequences of the roll-over detailed in s 615-15.

Importantly, for condition 3, where a taxpayer holds any shares in the interposed company before the reorganisation and, after the reorganisation, continues to hold those shares together with other replacement shares, the proportionality requirement won't be present: *Taxation Ruling* 97/18.

If the conditions are all satisfied the roll-over relief will apply regardless of the character of the asset.

2.3.4 CGT Consequences of Applying this Roll-Over

For CGT purposes, where the conditions of this roll-over are satisfied, the general rules for replacement asset roll-overs in Subdivision 124-A of the 1997 Act apply: s 615-40 of the 1997 Act. Accordingly, the first element of the cost base and reduced cost base of the shares in the interposed company are worked out under those rules.

2.3.5 Consequences for the Interposed Entity

Where the interposed entity chooses to apply the roll-over pursuant to s 615-30(1) (i.e. condition 8 above) and any of the original entity's assets at the completion time are pre-CGT assets, the interposed entity is taken to have pre-CGT shares (or units) in the original entity: s 615-65(2). The number of pre-CGT shares (or units) in the original entity is the greatest possible whole number that (when expressed as a percentage of all the shares (or units)) does not exceed the market value of the original entity's pre-CGT assets less its liabilities (if any) in respect of those assets expressed as a percentage of the market value of all the original entity's assets less all of its liabilities: s 615-65(3). The remainder of the shares (or units) in the original entity are taken to be post-CGT units.

The first element of the cost base of the interposed company's post-CGT shares (or units) in the original entity is the total of the cost bases (at the completion time) of the original entity's post-CGT assets less its liabilities (if any) in respect of those assets. The first element of the reduced cost base of the interposed company's shares (or units) in the original entity is worked out in a similar way: s 615-65(4).

A liability of the original entity that is not a liability in respect of a specific asset or assets of the entity is taken to be a liability in respect of all the assets of the original entity, e.g. a bank overdraft: s 615-65(5). If a liability is in respect of two or more assets, the proportion of the liability that is in respect of any of those assets, under s 615-65(6), is:

$$\frac{\text{the market value of the asset}}{\text{total market value of all assets that liability is in respect of}}$$

3 Market Valuations & Restructures

As the discussion above shows, and the discussions that follow will show, determining market value is important in any restructuring exercise.

3.1 What is Market Value

Market value is not defined in any general provisions of the income tax legislation. The Commissioner has, however, given guidelines on the issue. They are discussed below.

Given the absence of a statutory definition, it takes its ordinary meaning. This is the estimated amount for which an asset should exchange in an open market between a knowledgeable and willing, but not anxious, buyer and seller. The market value should also be based on the highest and best use of the asset as recognised in the relevant market.

In *Spencer v The Commonwealth* (1907) 5 CLR 418 at 432 Griffiths CJ said:

> In my judgment the test of value of land is to be determined, not by inquiring what price a man desiring to sell could actually have obtained for it on a given day, i.e., whether there was in fact on that day a willing buyer, but by inquiring 'what would a man desiring to buy the land have had to pay for it on that day to a vendor willing to sell it for a fair price but not desirous to sell?

It brings in issues of dealings at arms' length. There is also no definition of "arm's length" in the 1936 Act or the 1997 Act. It is the dealing itself, not whether the parties are in fact at arms length or not, that is relevant. Justice Hill said in *Trustee for the Estate of the Late A W Furse No 5 Will Trust v FCT* (1990) 21 ATR 1123 at 1132:

> What is required in determining whether parties dealt with each other in respect of a particular dealing at arm's length is an assessment whether in respect of that dealing they dealt with each other as arm's length parties would normally do, so that the outcome of their dealing is a matter of real bargaining.

Although it cannot be put as highly as a presumption in favour of an arm's length dealing, the starting point is that parties at arm's length usually deal at arm's length. This point, and the qualification to it, was expressed by Lee J in *Granby Pty Ltd v FCT* (1995) 30 ATR 400 at 403-4:

> If the parties to the transaction are at arm's length it will follow, usually, that the parties will have dealt with each other at arm's length. That is, the separate minds and wills of the parties will be applied to the bargaining process whatever the outcome of the bargain may be.
>
> That is not to say, however, that parties at arm's length will be dealing with each other at arm's length in a transaction in which they collude to achieve a particular result, or in which

> one of the parties submits the exercise of its will to the dictation of the other, perhaps, to promote the interests of the other.

It can be seen, therefore, that there is no exact science in determining the market value.

3.2 Commissioner's Guidance

The Commissioner has released general guidelines on *Market Valuation for Tax Purposes*. This can be found on the ATO website at: https://www.ato.gov.au/General/Capital-gains-tax/In-detail/Market-valuations/Market-valuation-for-tax-purposes/

the guidelines are intended to provide practitioners, valuers and their business clients with broad guidance on how to establish a market valuation for tax purposes, including for tax consolidation.

3.3 Market Value Substitution

Practitioners should also be aware of the market value substitution rule in s 116-30 of the 1997 Act. This is relevant in case any element of a corporate restructure involved no consideration or, if the parties are no dealing at arms' length (see above), the consideration is less than it would have been if they were dealing at arms' length.

Under the rule the capital proceeds from a CGT event are replaced with the market value of the relevant CGT asset at the time of the CGT event. The market value is worked out as at the time of the relevant CGT Event. However, this rules does not apply if the expiry of a CGT asset or a cancellation of a statutory licence happens under CGT Event C2 or if CGT Event D1 happens.

The rule does not apply merely because it is difficult, costly or inconvenient to obtain a valuation: *Taxation Determination* TD 1999/84.

The Commissioner has accepted that shares in a "no goodwill" incorporated practice have a nil market value for the purposes of applying the market value substitution rule to an individual practitioner shareholder's admission to or exit from the practice for no consideration in specified circumstances: *Taxation Determination* TD 2011/26.

4 Selling Assets and the Small Business Concessions

Division 152 of the 1997 Act contains the small business capital gains tax concessions. They are relevant to any transactions that give rise to a CGT Event. They will not be dealt with in detail in this paper, as Division 152 is a well covered area of the 1997 Act so far as commentary and presentations go.

The broad points are:

- there are basic conditions to be satisfied in Subdivision 152-A of the 1997 Act;
- the entity, with associated entities connected to it, must be a small business entity, which can arise from have net assets that don't exceed \$6 million and annual turnover of \$2 million;
- that there are four exemptions available if the requirements are met:
  - the 15 year exemption in Subdivision 152-B, which entirely disregards any gain;
  - the active asset 50% discount (in addition to the general 50% discount) in Subdivision 152-C, which provides a further 50% discount on the gain;
  - the retirement exemption in Subdivision 152-D, which allows up to \$500,000 to be rolled-over if used for retirement; and
  - small business roll-over in Subdivision 152-E, which allows gains to be rolled-over to replacement assets.

Consideration should given to these provisions whenever a gain is otherwise brought to tax by Parts 3-1 and 3-3 of the 1997 Act.

5 Small Business Rollover Relief

A new small business tax rollover makes make it easier for small business owners to restructure their businesses without having to face CGT consequences.

The new small business rollover is contained in Subdivision 328-G of the 1997 Act. The rollover is effective from 1 July 2016. It is an effective tool in restructuring small businesses and, when combined with existing rollovers and concessions, certainly provides a wide range of tools to restructure clients' affairs.

The purpose of the new rollover is to make it easier for small business owners to restructure their businesses without having to face CGT consequences in restructuring their affairs.

For example, assets can be transferred from one trust to another trust and, by utilising the rollover, CGT consequences will not arise. This means that trust cloning techniques used prior to legislative amendments effective from 2008 can now be used again.

The rollover will allow for the transfer of assets from:

- Individual(s) to trusts or companies;
- Partnership assets by partners to trusts or companies;
- A company to a trust;
- A company to individuals and partnerships;
- A trust to beneficiaries of that trust; and
- From one trust to another trust.

As with all taxation concessions, stringent conditions need to be satisfied to access the Rollover.

5.1 The Conditions

These are the main conditions which must be satisfied in order to access the rollover:

- There must be a transaction – The transaction may be for consideration (eg, a sale of assets) or for no consideration (eg, a gift of assets). Given the word transaction is not defined, it takes its wide ordinary meaning.
- The entities involved in the rollover must be small business entities – This means that the entities must satisfy the $2 million turnover test. The rollover can be applied to entities holding passive assets, provided those assets are used by a connected small business entity. The connected entity and affiliate rules that apply for the purposes of the small business CGT Concessions apply for the rollover.

- There must be a genuine restructure of an ongoing business – The fact that taxation considerations are taken into account in a restructure is not a bar to a genuine restructure. A genuine restructure is one where the restructure is driven by business efficiency gains, the business continues to operate and the structure would have been adopted at the establishment of the business if advice had been obtained at that time.

- Genuine restructure safe harbour – Where a restructured business continues for at least three years the restructure is deemed to be genuine, provided the assets rolled over continue to be used in the business.

- There must be no change in ultimate economic ownership of the asset subject to rollover – For example if an asset is transferred by partners to a company and they want to use the rollover, they must hold all the shares in the company in the same proportion as they held the partnership assets.

- There is an alternate ultimate economic ownership for trusts – Although two trusts with identical beneficiaries may satisfy the ultimate economic ownership test, where a trust has made a family trust election and the asset transfers are within the members of a family group, the alternate test will be satisfied. For example, an asset transferred from trust A to trust B where both trusts have the same test individual will not give rise to a change of ultimate economic ownership even if the beneficiaries are different.

- The asset subject to rollover must be an active asset – This requirement is consistent with the rollover being used for business and not investment assets. Because of amendments to Division 40 of the 1997 Act*,* the rollover also extends to depreciating assets.

5.2 The Effect of the Roll Over

The roll-over allows what would have been a CGT liability to be postponed. But there are also five opportunities afforded by the roll-over that may not be so obvious.

6 Stamp Duty Issues on Restructure

As a corporate restructuring involves transactions and the movement of assets or financial assets, stamp duty is relevant. It is convenient to consider the transfer of shares separately to the transfer of land or other business assets.

6.1 Transfer of Shares

As stated at heading 2.2.4.1 above, duty has been abolished on share transfers, other than if they are land rich, since 1 July 2016: the note to s 11 of the *Duties Act* 1997 (NSW). If, however, the share transfer involves a "relevant acquisition" must be made in a "landholder" (who is a company that's NSW land holdings equal or exceed $2 million), landholder duty will also be payable.

Where a company is conducting a trading business and holds no freehold interest in land, it is highly unlikely that duty should be a major concern.

6.2 Transfer of Land or other Business Assets

The position differs if land including mining tenements and exploration tenements) or other business assets are transferred. This paper will look at the issues broadly, but the legislative references for deeper study of the corporate reconstruction exemptions are:

- Part 1 of Chapter 10 of the *Duties Act* 1997 (NSW);
- Part 1 of Chapter 11 of the *Duties Act* 2001 (Qld);
- Part 2 of Chapter 11 of the *Duties Act* 2000 (VIC);
- Chapter 6 of the *Duties Act* 2008 (WA);
- Division 2 of Part 3 of the *Stamp Duty Act* 1978 (NT);
- Section 91A of the *Duties Act* 1999 (ACT);
- Part 4AA of the *Stamp Duty Act* 1923 (SA); and
- Section 226F of the *Duties Act* 001 (TAS).

The relief is between 95% and 100% of the duty otherwise payable.

6.2.1 The Nature and Location of the Assets

A transfer of business assets such as goodwill is not subject to duty in all jurisdictions. On the other hand, a transfer of land will be subject to duty in all jurisdictions (regardless of whether it is being used in a business or not). Accordingly it is important to determine whether the transaction is subject to stamp duty before considering whether the corporate reconstruction provisions need apply.

6.2.2 Corporate Reconstruction Relief

If the transaction is subject to stamp duty in a particular jurisdiction, then the corporate reconstruction provisions for that particular jurisdiction have to be considered (see above for the list of them). While each jurisdiction is different, some general conditions that apply to corporate reconstruction applications in all jurisdictions are discussed below.

Of course, specific advice should be obtained, or specific consideration should be given, in relation to the relevant jurisdiction before any transactions are implemented.

6.2.2.1 The Transaction Must be Solely for the Purpose of a 'Corporate Reconstruction'

The proposed transaction must be *solely* for the purpose of changing a corporate structure to make internal adjustments to corporate arrangements. This means that if the transaction is for a purpose other than an internal corporate reconstruction, the exemption will not be granted even if the conditions to grant the exemption are otherwise met: for instance, see *Orica IC Assets Pty Ltd v Commissioner of State Revenue* [2011] QSC 001.

In South Australia, in addition to the above, at least 90% of the assets of the transferring company must be transferred to the transferee company for the exemption to apply.

6.2.2.2 The Transaction Must be Between Members of a 'Corporate Group'

In order for the exemption to apply, the transfer must be between members of a 'corporate group'. A 'corporate group' is formed between a parent and each subsidiary in which the parent owns 90% or more of the shares. Ownership includes direct ownership and, in most jurisdictions, indirect ownership. The transfer can occur between two such subsidiaries or between a parent and a subsidiary.

In jurisdictions other than Queensland, a corporate entity includes a unit trust where the parent owns 90% or more of the units in the unit trust.

The exemption will *not* apply where property is held as trustee of a discretionary trust.

6.2.2.3 Most Jurisdictions Require a Period of Prior Association

The requirements regarding prior association vary, depending on the jurisdiction, from no period of prior association (WA, Vic and NSW) to up to three years (Qld, SA and NT). There are exemptions where, for example, the transfer is to a new formed subsidiary or the property came into the ownership of the relevant group member after it became a member of the corporate group.

The prior association requirement can be problematic where a corporate group conducts business nationally. For example, if a group company buys all the shares in a competitor and that competitor then becomes part of the corporate group, an immediate transfer of the business assets of that newly acquired competitor to another group member will be exempt in jurisdictions where there is no prior association condition but not in the jurisdictions requiring a three year prior association period. In those cases, you will need to consider the potential liability in the jurisdictions where no relief is granted before deciding on whether to proceed.

6.2.2.4 The Majority of Jurisdictions Require a Period of Post Association

The post association period can vary between no period of post association to three years ((Vic, WA, Qld, SA and NT) depending on the jurisdiction. There are certain exceptions to this requirement. For example if the shares in the group member are to be listed on a stock exchange or where one of the companies is wound up (provided that it is not for the purpose of avoiding stamp duty).

6.2.2.5 There Must be No 'Outside Consideration'

The exemption will not be granted where consideration for the transaction has come from 'outside' the corporate group except under normal financing arrangement. For example, if the selling company then transferred the funds it received from the internal sale to an external party, the exemption would be granted.

6.2.2.6 Corporate Consolidation

Stamp Duty relief is available in most jurisdictions (all except SA and NT) for a corporate consolidation where a new parent company is interposed between the existing parent company and its shareholders.

6.2.3 Conclusion on the Exemption

The rules relating to the corporate reconstruction relief from stamp duty are complex. In order to determine the potential liability and in which jurisdiction to apply a thorough examination of:

- the purpose of the transaction;
- the nature and location of the assets being transferred; and
- the corporate group structure,

must be considered in order to determine whether the stamp duty relief for the transaction is required or available.

The jurisdictions allow the taxpayers to seek a private ruling to confirm the outcome of the transaction prior to effecting it. This is a form of tax planning and gives certainty to what are otherwise inherently tax risky transactions.

7 Dividend Washing Arrangements

It is convenient to draw on the Commissioner's description of dividend washing before looking at the provisions and a recent case.

7.1 The Commissioner's Views

The Australian Securities Exchange Ltd ('**ASX**') sometimes operates what is known as a special market independent of the normal ASX market. Shares that are trading on an ex-dividend basis (without the right to a dividend) on the normal ASX market may be traded on a cum-dividend ('**CD**') basis (with the right to a dividend) on the special ASX market.

Dividend washing occurs when a taxpayer tries to take advantage of the special ASX trading market to generate an unintended outcome. They do this by:

- selling shares on the ordinary market on an ex-entitlement basis, thereby retaining the right to receive a franked dividend
- purchasing a substantially identical parcel of shares on the ASX special market on a cum dividend basis, conferring an entitlement to the franked dividend on these shares also
- thus receiving a dividend on the original parcel of shares and a corresponding dividend in relation to the substantially identical parcel of shares.

In these circumstances, the tax offset entitlement for any franking credits attached to the second distribution is denied.

Dividend washing can also occur if a connected entity buys or sells either of the parcels of shares. This is if it can be objectively concluded that either transaction took place only because at least one of the entities expected that the other transaction had occurred or would occur.

7.1.1 Substantially Identical Interest

The dividend washing measure applies where a taxpayer acquires a second parcel of shares (the washed interest) that is very alike to the first parcel of shares disposed of (the substantially identical membership interest). A substantially identical membership interest includes an economically equivalent, or fungible, interest. This means that interests may be considered to be substantially identical where they:

- are held indirectly
- are in different forms or classes of shares
- involve different numbers of shares.

In some circumstances, holding shares in two different companies may be a substantially identical interest. For example, where one company is predominantly owned by the other company, or where shares in one company can be exchanged at a fixed rate for shares in the other company.

Example: Substantially identical interest

Anne sold 100 shares in Z Ltd, and then repurchased shares in Y Ltd. If Z Ltd was predominantly owned by Y Ltd, or shares in Y Ltd could be exchanged at a fixed rate for shares in Z Ltd, then the shares could be considered to be substantially identical.

7.1.1.1 Corresponding Dividend

Two franked dividends received are corresponding if they have ultimately arisen from the same source, or from closely connected sources.

This would occur when both dividends arise from a company declaring various dividends for different types of shares (such as preference or ordinary shares) in connected processes, or in relation to profits that arose over the same period.

7.1.2 The Dividend Washing Integrity Rule

The effect of the dividend washing integrity rule is that if you receive a dividend as a result of dividend washing, you are not entitled to a tax offset for the franking credits associated with the dividend received on the shares purchased on the special ASX trading market.

You are also not required to include the amount of the franking credits on the shares purchased on the special ASX trading market in your assessable income. You must still declare all assessable dividends in your assessable income.

Where you receive a dividend indirectly as a result of dividend washing – for example, as a partner in a partnership, or as a beneficiary of a trust – the integrity rule applies to you in the same way as if you had received the dividend directly.

The rule applies to distributions received on or after 1 July 2013.

Example: Dividend washing integrity rule for an individual

Elizabeth, an Australian resident taxpayer, holds 100 ordinary shares in OT Ltd. On 14 April 2015, OT Ltd declares it will pay a franked dividend of 10 cents to all holders of its ordinary shares.

Elizabeth sells her shares shortly after the shares start trading ex-dividend, retaining the right to receive a franked dividend in relation to the 100 shares that she has sold.

After selling the shares, Elizabeth purchases 175 ordinary shares in OT Ltd on the special ASX trading market, and is entitled to a franked dividend in relation to these shares.

In this case, 100 of the new parcel of shares is economically equivalent to the original 100 shares. Elizabeth will not be entitled to any of the franking credits attached to the dividend she received for these shares. However, as Elizabeth has purchased a parcel of shares that goes beyond her original parcel, her interest in the remaining 75 new shares is not substantially identical to the original parcel.

Elizabeth is only entitled to the benefit of the franking credits she received for :

100 of the original parcel of shares that she sold

75 of the new parcel of 175 shares that she has purchased. This assumes no other integrity rules apply (such as the holding period and related payment rules).

Elizabeth must include all the dividends received in her assessable income, except for the amount of the franking credits that she is not entitled to.

7.1.2.1 Exceptions to this Rule

The dividend washing integrity rule generally applies to all resident taxpayers, but there is an exception.

The rule generally does not apply to individuals who receive $5,000 or less in franking credits in a year. We call this the small holder exemption.

This exception only applies to dividends received by an individual directly. It does not apply to dividends received indirectly from an interest in a trust or partnership.

However, individuals who receive $5,000 or less in franking credits in an income year may still be subject to the general anti-avoidance rules. This will apply if they have entered into a scheme for the purpose of obtaining franking credit benefits

7.1.3 The General Anti-Avoidance Rules

The general anti-avoidance rules do not usually apply where another specific provision prevents the obtaining of a tax or franking credit benefit. Where dividend washing arrangements involve distributions made before the integrity rule commenced application on 1 July 2013, the general anti-avoidance rules will apply to deny franking credits.

The Commissioner's view on this is explained in *Tax Determination* TD 2014/10.

7.2 The Provisions & a Recent Decision

Since 1 July 2013 there has been specific legislation to prevent dividend washing: s 207-157 of the 1997 Act. And since the Administrative Appeals Tribunal's recent decision in *David Lynton as trustee for the David Lynton Superannuation Fund* [2017] AATA 694, those arrangements will also be held to fall foul of s 177EA of the 1936 Act (discussed under the next heading).

Therefore, anyone who engaged in dividend washing arrangements before the introduction of s 207-157 of the 1997 Act, and did not amend their income tax returns before 28 May 2014, should consider amending their relevant returns.

7.2.1 Section 177EA

Section 177EA is a general anti-avoidance provision in Part IVA of the 1936 Act that enables the Commissioner to make a determination to cancel the franking credits attached to a franked dividend. If the Commissioner does make such a determination, then the dividend is treated as an unfranked dividend. As such, the taxpayer will not receive the franking credits nor is the taxpayer required to gross up the dividend when calculating income.

For section 177EA to apply, the following conditions need to be satisfied:

- there is a scheme for the disposition of membership interests;
- in a corporate tax entity;
- a frankable distribution is paid or payable to the taxpayer in respect of the membership interest;
- the taxpayer receives an imputation benefit as a result of the distribution; and
- having regard to the relevant circumstances, it would be concluded that the person entered into the scheme of a non incidental purpose of receiving the imputation benefits.

Generally, where the Commissioner asserts that the arrangement is a dividend washing arrangement under s 177EA the first four elements will be present.

There would be a clear disposal of the legal ownership in the ex-dividend shares and purchase of cum-dividend shares in a company. As the purchase price of the cum-dividend shares has been increased for the dividend and franking credits, the distribution will be a frankable distribution and the taxpayer will receive a tax offset equal to the franking credits. Consequently whether a dividend washing arrangement exists will depend on the degree to which the factors in s 177EA(17) are present and demonstrate that the taxpayer had a not incidental purpose of entering into the arrangement in order to receive the franking credits.

The test in s 177EA(17) is an objective test and it lists the relevant circumstances to consider when determining if the taxpayer had a not incidental purpose, including:

- the extent and duration of the risks of loss, and opportunities for profit or gain that accrue to them as a member;
- where the taxpayer derives a greater benefit from receiving the imputation benefits;
- whether any amount was calculated by way of the imputation benefits; and
- the period the taxpayer held the membership interests in the corporate tax entity.

The fact that the test only requires a not incidental purpose is what captures taxpayers in a dividend washing arrangement. When entering into the arrangement to buy and sell the shares in the same company the taxpayer may have other valid commercial reasons. However, provided the purpose to obtain the franking credits is not incidental purpose, as a opposed to a dominant purpose, the taxpayer will be caught under s 177EA.

7.2.2 Lynton's Case

Lynton's case involved David Lynton, or his broker, as Trustee for his superannuation fund entering into transactions on a special ASX market to sell shares on an ex-dividend basis and purchase shares on a cum-dividend basis. The only economic rationale for entering into these transactions was to obtain the benefit of the franking credits – without the double franking credit, there was a net loss on the transactions in question.

As a complying superannuation fund, the Fund is only taxed at a flat 15% rate and, accordingly, derives a greater benefit from the refundable franking credits than an ordinary taxpayer. The franking credits can be used to offset taxable income from other sources of income or to receive a refund of the franking credits.

7.2.3 Dividend Washing and Franking Credits

Lynton's case appears to have been chosen by the Commissioner as being in the nature of a test case, as it is undoubtedly a dividend washing arrangement on all fours with the example set out in *Taxation Determination* TD 2014/10. Unfortunately, the taxpayer was aggressively self-represented, to the extent that his case appeared to be limited to one that the 1936 Act predated the concept of dividend washing, and could not therefore apply to it. He clearly did not have a clear understanding of the administration of the 1936 Act and could not formulate a credible argument for s 177EA not to apply to a dividend washing arrangement.

Regardless, given the context of s 177EA it is likely that it would normally apply to dividend washing arrangements of the type found in Lynton.

One could argue that where the taxpayer intends to hold the shares for the next 12 months that they are bearing the economic risks of being a member of the company. As such, the taxpayer should receive the benefit of the dividends and the franking credits on the shares. However, where the taxpayer is constantly engaging in this these arrangements, the taxpayer is never bearing the economic risk of holding the two parcel of shares. The taxpayer is effectively receiving two lots of dividends and franking credits for the same number of shares but only bearing the economic risks of holding the one parcel of shares. This is contrary to the stated intention of the imputation system.

It is worth noting that the Explanatory Memorandum to *Taxation Laws Amendment Bill (No.3)* 1998 states that the intention for a 177EA is a catch-all provision to target franking credit trading and dividend streaming. Therefore the question is whether dividend washing arrangements are a form of franking credit trading.

Franking credit trading is defined in the Explanatory Memorandum to be:

> "broadly the franked distributions are diverted from the real owners of interests in companies, who have no use or a relatively limited use from franking benefits, to a person who has a relatively greater use for them, but who is not in substance the owner of an interest in the company".

Accordingly, given that dividend washing is the purchase of a share on a cum-dividend basis (presumably) from a taxpayer who cannot fully utilise the franking credits, it is arguable that dividend washing is a type of franking credit trading.

Whatever the correct characterisation of dividend washing, it is now clear that both s 207-157 of the 1997 Act and s 177EA will apply to dividend washing arrangements. Section 177EA is contained in Part IVA, which in theory is a "provision of last resort", so where there is more specific legislation, that legislation will be applied first. Consequently, the Commissioner will seek to apply s 207-157 before s 177EA, which will only apply to dividend washing arrangements where it is not captured under s 207-157.

8 Corporate Tax Rates

A paper at this time considering tax issues for companies and corporate groups must consider the corporate tax rate.

The *Treasury Laws Amendment (Enterprise Tax Plan) Act* 2017 (Cth) was passed on 19 May 2017. The measures introduced come into effect from 1 July 2016, notwithstanding that they were passed into law on 19 May 2017, and they have two main effects:

1. a reduction in the company rate for small businesses to 27.5%; and

2. a reduction in the imputation credit / franking credit allocation.

A company (or indeed a corporate unit trust or public trading trust) is a small business if its turnover is under $10 million.

There remains some uncertainty but it seems the reduction will only apply to companies where 80% or more of their income is from non-passive sources.

This is very much an area to be watched.