IDENTIFYING AND DEALING WITH TAXATION ISSUES 10

SECTION 10(A): TAX AND FAMILY DEALINGS

10 This section looks at the taxation issues that typically arise in succession planning, how these issues can be dealt with, and traps that should be avoided.

Often in cases of family succession, the current owners may wish to transfer the business – or equity in the business – to family members for less than its real value, or even gift it, during their lifetimes. If this is done, a taxable capital gain may arise based on the market value of the assets at the time of the transfer, irrespective of the amount of the consideration that has been paid.

This is due to the operation of the ‘‘market value substitution rule’’ contained in Section 116.30 of ITAA97, which applies if:

- the current owners receive no proceeds from the transfer of the asset – e.g., they gift the asset to the successors; or
- the proceeds are more or less than the market value of the asset, and the current owners and the successors did not deal with each other at arm’s length in connection with the transfer. (A transfer of assets between family members would, prima facie, be regarded as a non-arm’s-length transaction.)

Therefore the current owners may be subject to capital gains tax on the transfer of assets such as goodwill or real estate, even if they transferred the assets to the successors as a gift or at a discounted value.

However, where the assets were acquired prior to 20 September 1985, or where the capital gain is able to be sheltered from tax under the small business CGT concessions (see Section 10(b)) this market-value substitution rule may be used to the successors’ advantage. By determining a market value for the assets, the acquiring successor may be able to establish a cost base for capital gains tax purposes considerably higher than the amount he/she has paid for the assets, or even if there was no payment at all. The result may be that the current owners pay no tax but the successors establish a cost base that will save CGT on any future sale of the asset.

In any event, it is vital that valuations are obtained as at the day of transfer in respect of all assets subject to CGT that are transferred between family members, in order to support the amount of capital proceeds used in calculating the taxable capital gain of the transferor, and establishing the cost base for the transferee.

Similarly, the transfer of depreciable assets under a non-arm’s length dealing, or under a private or domestic arrangement (e.g., a gift) will be deemed to have taken place

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at market value under the provisions contained in s 40-300 of ITAA97. Special provisions also apply to the transfer of trading stock. (See **[10 420]**.)

EXAMPLE 10(a)

Marco and Yalda own 100% of the shares in May Engineering Pty Ltd. They have accumulated sufficient assets outside the business to fund their retirement, and decide that they will transfer their shares in the company equally to their son and daughter. Marco and Yalda sell their shares to their children for $100. They appoint an experienced valuer who values the shares at $4 million.

Under the market value substitution rule in Section 116.30 of ITAA 1997, Marco and Yalda will be deemed to have received $4 million for the shares. However, they qualify for all the small business CGT concessions (see Section 10(b)) and, as a result, will pay no tax on the deemed consideration. On the other hand, their son and daughter will have a cost base for the shares in the company of $2 million each.

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SECTION 10(B): SMALL BUSINESS CGT CONCESSIONS

[10 200] What are the small business CGT concessions?

One of the most valuable mechanisms for reducing the tax transaction costs of a succession plan is to be able to access the small business CGT concessions contained in Division 152 of ITAA97. A combination of these concessions with the general 50% CGT discount may operate to completely eliminate a taxable capital gain.

There are 4 small business CGT concessions in addition to the general 50% CGT discount:

- small business 50% reduction referred to as the ‘‘active asset reduction’’);
- retirement exemption;
- 15-year exemption; and
- small business CGT rollover.

These are briefly described below.

Active asset reduction

The active asset reduction effectively reduces a taxable capital gain by 50%. It applies after the 50% general CGT discount and, generally, before the retirement exemption, although a taxpayer may choose for the active asset reduction not to apply.

For example, a company may wish to choose for the active asset reduction not to apply on the basis that the active asset reduction would be partly ‘‘clawed back’’ on distribution to shareholders as an unfranked dividend, and the retirement concession is sufficient to absorb the entire taxable gain.

Retirement concession

The retirement concession provides an exemption from CGT if the proceeds on sale of the relevant assets are used in connection with retirement. However, there is no need for the taxpayer to have retired, or to retire, at the time of the CGT event. The exemption has a lifetime limit of $500,000 for any individual. If the taxpayer is under age 55, an amount equal to the CGT-exempt amount must be contributed to a complying superannuation fund.

15-year exemption

This is the most valuable CGT relief and the most difficult to qualify for. The 15-year concession provides total exemption from CGT for capital gains arising from the sale of an active asset that was owned for at least 15 years, and the sale relates to the retirement of an individual. The asset need only have been an active asset for $7^1/_2$ years of that 15-year period.

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Rollover relief

The small business CGT rollover relief allows tax on a capital gain on sale of a business asset to be deferred where a replacement asset is acquired. The amount of the capital gain ‘‘rolled-over’’ effectively reduces the cost base of the replacement asset so that the taxable capital gain on the eventual sale of the replacement asset will be higher than the actual gain to the extent of the capital gain rolled-over from the original asset. The replacement asset may be basically any ‘‘active asset’’ (see **[10 210]**) acquired within the period of one year before the capital gain is derived, and 2 years after.

The rollover relief is only a deferral mechanism, but is valuable where a taxable capital gain remains after applying all other applicable concessions.

You can also apply the small business retirement exemption, subject to other conditions being met, to the capital gain on the sale of the rollover asset. This may be attractive where it is not desirable for proceeds of the original sale to be invested in superannuation, as required for taxpayers under the age of 55, and allows the funds to continue to be invested in business assets while retaining the option to access the retirement concession on the sale of the replacement asset.

[10 210] Conditions for small business CGT relief

Basic conditions

In order for any of the small business concessions to apply, the 4 basic conditions for small business CGT relief set out in Subdiv 152 of ITAA 1997 must be satisfied. These are as follows:

1. A CGT event happens in relation to an asset owned by the taxpayer. This will include the sale or gifting of business assets or equity to successors.
2. The event would have resulted in a capital gain.
3. The maximum **net asset value** threshold is not exceeded.

   This means that the net value of assets owned by the taxpayer, ‘‘connected entities’’ and ‘‘affiliates’’ must not exceed $6m. Importantly, the taxpayer’s home, superannuation, life insurance and assets used solely for personal use are not counted towards the $6m net asset value test.

   ‘‘Small business entities’’, (basically, businesses with a turnover of less than $2m) do not have to satisfy this net asset value test.

   ‘‘Net value’’ of assets means the market value of the assets less the liabilities that are related to those assets. Other liabilities of an entity that may be deducted are limited to provisions for annual leave and long service leave, provisions for unearned income, and provisions for tax liabilities.

   One of the problems with determining whether the $6m net asset value threshold is met, is understanding what entities will be treated as ‘‘connected’’ with, or ‘‘affiliates’’ of, the taxpayer.

   In very basic terms, an entity will be **connected** with a taxpayer if either entity controls the other. ‘‘Control’’ in this context means having 40% or more of rights to capital and income and, in the case of a company, 40% or more of the

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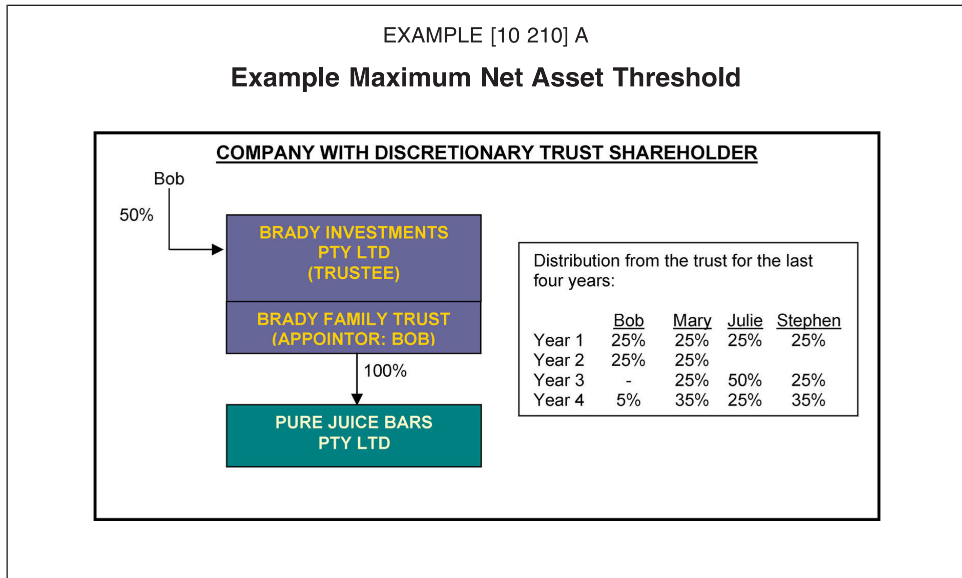
voting shares in the company. In determining whether the required 40% interest is held, the interests of the entity or the entity's affiliates, or the entity together with affiliates, are taken into account.

In relation to a discretionary trust, an entity will be taken to control a discretionary trust if the trustee acts, or could reasonably be expected to act, in accordance with the wishes of the entity, its affiliates, or the entity and its affiliates acting together. In addition, a beneficiary of a discretionary trust will be taken to control the trust if, for any of the 4 years before the year in which the CGT event occurred, the entity or any of the entity's affiliates, or the entity together with its affiliates, received at least 40% of the total distribution of income or capital made in that year.

An "**affiliate**" of an entity may be an individual or a company if that party acts, or could reasonably be expected to act, in accordance with the entity's directions or wishes; or in concert with the entity, in relation to the affairs of the business of the individual or company. This means that an individual or a company cannot be an affiliate of an entity unless they are carrying on a business in their own right. Therefore the spouse of an individual will not be an affiliate unless the spouse is carrying on a business.

Further, an individual or a company is not an affiliate of an entity merely because of the nature of the business relationship the entity shares with the individual or company. Therefore the entity's business partner is not an affiliate merely because that person acts in accordance with the entity's wishes, or in concert with the entity, in relation to the affairs of the partnership. Similarly, directors of the same company and trustees of the same trust, or the company and a director of that company, are not affiliates merely because of these associations.



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EXAMPLE [10 210] B

As part of the Brady family's succession plan 50% of the shares in Pure Juice Bars Pty Ltd are to be transferred from the Brady Family Trust to a new trust controlled by Julie, the daughter of Bob and Mary. The transfer of the shares would result in a capital gain to the Brady Family Trust.

In determining whether the trust would pass the maximum net asset value test of $6m, the net value of the assets of

- the trust;
- any entities "connected" with the trust; and
- affiliates of the trust, or of entities connected with the trust's affiliates

have to be taken into account.

This means that the net assets of the following entities would need to be included:

- the Brady Family Trust;
- Pure Juice Bars Pty Ltd (connected with the trust because more than 40% of the shares are owned by the trust);
- Bob (connected with the trust because, as appointor, the trustee could reasonably be expected to act in accordance with his wishes (ATO ID 2008/139)); and
- Julie (connected with the trust because she received more than 40% of the total distributions in year 3).

Mary is a 50% shareholder of the trustee and one of two directors. As such, it is not possible to state that the trustee company would be expected to follow her wishes, and therefore she would not be connected with the trust on this basis. If Bob was her affiliate, then she and Bob would control the trustee, however Bob would only be Mary's affiliate if he could be expected to follow Mary's directions.

As Mary has received less than 40% of the trust distribution in each of the last 4 years, she is not connected with the trust under the distribution test.

Stephen is not connected with the trust because he received less than 40% of the distributions in each of the last 4 years.

The company is worth $5m. The trust has other assets of $500,000. Bob has personal investments of $200,000 and Julie has personal investments of $50,000. (The homes and superannuation benefits of Bob and Julie are not counted towards the threshold.) Therefore, the total assets to be counted under the net asset value test amount to $575,000, which means the net asset threshold has not been exceeded.

4. The asset to which the capital gain relates must pass the "**active asset**" test. Basically, an active asset is one that is used in the taxpayer's business, or else is an intangible asset, such as goodwill, which is connected with the business. An active asset may also be one which is used in a business conducted by the taxpayer's affiliate or connected entity. Where the asset is owned by an individual, an asset used in the course of carrying on a business by that individual's spouse will be deemed to be an asset used in the course of carrying on a business by an affiliate.

   Active assets will therefore include goodwill, trademarks, and real estate used by a business, and the benefit of a restrictive covenant granted to a purchaser of a business.

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In order to pass the active asset test, the asset must generally have been active for at least half of the period of ownership. Where the asset was owned for more than 15 years it must have been an active asset for at least $7^1/_2$ years during the period of ownership.

Special conditions for shares in companies and interests in trusts

If a business owner sells shares in a company or units in a unit trust, rather than the actual assets of the business, these may also qualify for CGT relief if certain additional conditions are met:

(i) The taxpayer must be a ''CGT concession stakeholder'' in the company or trust. This means the taxpayer must be either:

- a ''significant individual'', i.e., the person must have ''a small business participation percentage'' of 20% or more; or
- the spouse of the significant individual, provided that the spouse has a ''small business participation percentage'' in the company or trust.

A ''participation percentage'' is, broadly, a shareholding in the case of a company, units in a unit trust, or a distribution from a discretionary trust.

An additional condition exists if the taxpayer-owner is not an individual. In circumstances where the small business owner is a discretionary trust, at least 90% of the income and capital of the trust needs to be distributed to an individual in the year of the CGT event.

(ii) The active asset test is modified to look at the underlying assets of the company or trust. In order for the shares or units to qualify as active assets, the company or trust must itself have active assets which account for at least 80% of the market value of the total assets of the entity. In addition, this 80% test must have been passed for at least 50% of the time the shares or units have been owned or, if the shares or units have been owned for more than 15 years, the test must have been passed for least $7^1/_2$ years.

Apart from active assets, other assets that may be counted towards the 80% test are:

- financial instruments of the entity that are inherently connected with a business conducted by the entity; and
- any cash of the entity that is inherently connected with such a business.

This 80% ''look through'' test is not failed if the breach of the threshold is only temporary.

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EXAMPLE [10 210] C

Active Asset Test

Under the Brady family's succession plan, Bob and Mary are considering transferring 50% of the shares held by the Brady Family Trust to a new trust controlled by their daughter, Julie. During that period, the composition of the assets of the company was as follows, including goodwill at market value.

	Years 1-6	*Years 7-12*	*Years 13-15*
	000's		
Active Assets			
Stock, Debtors, Goodwill, Plant & Equipment	90%	70%	60%
Non-Active Assets			
Cash on deposit (surplus to business needs)	-	10%	10%
Loan to shareholder	10%	20%	30%
Total Assets	100%	100%	100%

The 80% active asset test is passed in only the first 6 of the 15 years the shares have been owned. In order to qualify for the small business CGT concessions, the test must be passed for at least 7.5 years. In order to do this, the company may have to declare dividends to reduce the shareholder loan and cash so they are no more than 20% of the total assets of the company. There may be additional tax on these dividends in the hands of members of the family when they are distributed by the trust, but this cost may be outweighed by the benefits of accessing the small business CGT concessions. If such dividends were declared at the beginning of year 16, Bob and Mary would need to wait at least another 1.5 years before the trust is able to transfer the shares to Julie.

Legal structure of vendor affects CGT liability

The tax treatment of capital gains derived on the sale of business assets differs depending on who the vendor is:

(i) A **sole trader**, or partners in a **partnership**, may be able to access the general 50% discount and the small business CGT concessions, assuming the relevant requirements are met.

(ii) A **company** is not eligible for the general 50% discount but can index the cost base of assets acquired before 21 September 1999 up to 30 September 1999 (the indexation option is also available to other taxpayers but generally the 50% discount provides the most concessional tax position).

Companies are able to access some, or all, of the small business CGT concessions if they meet the conditions set out in Div 152 of ITAA97 (see **[10 210]**). Therefore, assuming the conditions for small business relief are met, a company may be entitled to:

- the small business 50% reduction; and

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- small business rollover relief.

If the company has at least one ''significant individual'', it may also be able to access:

- the small business retirement exemption; or
- the 15-year exemption.

It should be noted that, for companies, not all these concessions are permanent benefits. In particular, the small business 50% reduction is only totally concessional while the sale proceeds remain in the company; when the company subsequently pays dividends (including the capital gain), the portion which is represented by the small business 50% reduction will not be franked. Accordingly, unless the company already has compensating excess franking credits, part of the dividends will be unfranked and will therefore be fully taxed at the shareholder's marginal tax rate. However, if the small business 50% reduction amount is only distributed to shareholders during the course of the liquidation of the company, it will not be treated as a dividend on liquidation but will form part of the proceeds on disposal of the shares on liquidation and, as such, may be subject to CGT. Of course, the 50% general CGT discount may apply to reduce the taxable capital gain if the shares are held by trusts or individuals. Where there are significant individuals, the small business CGT concessions may also apply.

Therefore, the small business CGT concessions are of limited benefit in the case of a company which does not have a ''significant individual''.

Normally, the small business 50% reduction applies before the retirement concession, but a taxpayer can choose not to apply the small business 50% reduction. Instead, a company with a significant individual may treat the entire capital gain as a retirement exemption, subject to the $500,000 limit per individual. This strategy would enable the entire capital gain (up to this limit) to be permanently exempt because the superannuation contribution or retirement payment is expensed by the company and, although they are not deductible expenses, they reduce the retained profits. The contribution to superannuation of an amount equal to the CGT-exempt amount is not subject to contributions tax in the hands of the superannuation fund, and forms part of the tax-free component when paid from the fund to the member.

As discussed at **[10 310]**, often the sale of shares in the company will provide a lower CGT liability than the sale of business assets by the company.

(iii) **Trusts**. Where **a trust** sells a business, the trust may be eligible for the 50% general CGT discount and the small business CGT concessions, as long as the relevant conditions are met.

50% discount

Where the trust distributes a capital gain which is subject to the 50% general discount, the distributed gain is grossed up and the beneficiary then claims any CGT concessions relevant to the beneficiary. Therefore, a capital gain distributed to a beneficiary company would not have access to the 50% discount. However, if the same gain was distributed to an individual the 50% discount may apply.

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Small business 50% reduction

Trust beneficiaries may also be able to access the CGT small business 50% reduction where the trust qualifies for the concessions and distributes the capital gain to beneficiaries.

Loss of CGT benefits by unit trusts

However, in the case of a unit trust, CGT event E4 will apply to the small business 50% reduction and require that the non-assessable portion of the distributed capital gain be applied to reduce the cost base of the beneficiary's units in the unit trust.

As a result, when the beneficiary disposes of the units, the capital gain on that disposal will effectively be increased by the amount of the non-assessable distribution of the small business 50% reduction. If the small business 50% reduction is an amount greater than the cost base of the beneficiary's units, the beneficiary will derive a taxable capital gain at the time of the distribution. If the beneficiary has held the units for more than 12 months, the 50% CGT discount may then apply to that capital gain.

Where the trust has a significant individual, the small business CGT concessions may apply on disposal of the units in addition to the 50% discount, to further reduce the capital gain from CGT event E4.

The effect of this is that at least half of the small business 50% reduction will effectively be lost where the business is sold by a unit trust and the capital gain is distributed to unit holders who are not significant individuals. The use of a hybrid trust instead of a unit trust may overcome this problem.

Retirement concession

Where a trust has a significant individual, it may also access the small business retirement concession. In the case of a discretionary trust, there will be a significant individual if at least 20% of any distribution that the trust makes in the year the capital gain is derived is made to an individual beneficiary.

In the case of a unit trust, there will be a significant individual where an individual holds units that carry an entitlement to at least 20% of the income and capital just before the trust derived the capital gain.

In the case of the common structure where discretionary trusts own the units in a unit trust, the retirement exemption will be available where the discretionary trust holds at least 20% of the units in the unit trust, *and* the discretionary trust distributes at least 90% of its income and capital to one individual.

15-year exemption

Similarly, the 15-year CGT exemption requires the existence of a significant individual. Further, the person who is the significant individual just before the sale must retire or be permanently incapacitated.

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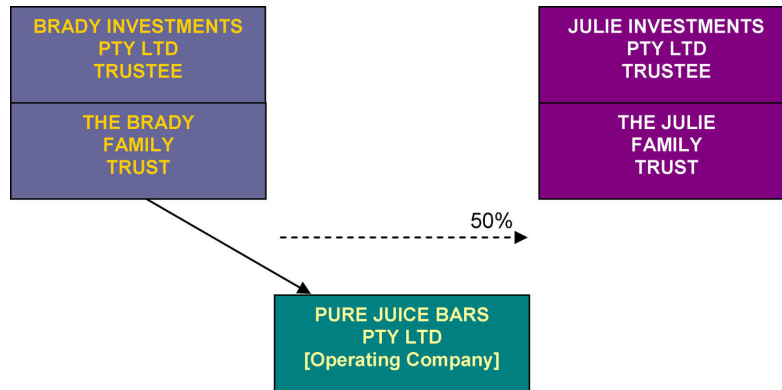
EXAMPLE [10 210] D

Application of small business CGT concessions



Under the Brady family's succession plan 50% of the shares held by The Brady Family Trust in Pure Juice Bars Pty Ltd are transferred to a trust for Julie. (At some point in the future the control of The Brady Family Trust may pass to Stephen.)

The company is valued at $5 million, and therefore a 50% shareholding is worth $2.5 million.

In the year the shares are transferred to Julie, the trust distributes income and capital gains to:

Bob	90%
Mary	10%

The conditions for the application of the small business CGT concessions are passed as follows:

1. A CGT event (A1) happens when the shares are transferred to The Julie Family Trust;
2. The event would have resulted in a capital gain of $2.5m (the shares have minimal cost base);
3. The maximum net asset value threshold of $6m is not exceeded (see example "Net Asset Threshold");
4. The asset, being the shares, passed the "active asset test" (see example "Active Asset Test");
5. Additional conditions relating to shares.

   As the owner of the shares is a discretionary trust there must be a CGT concession stakeholder in the company and at least 90% of the income and capital of the trust needs to be distributed to an individual in the year the shares are transferred.

   In this case, Bob has received a distribution of 90% of the income and capital gain of the trust in the year the shares are transferred to The Julie Family Trust. Bob is a significant individual because he has an indirect participation percentage in the

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company greater than 20%. His small business participation percentage is 90% (based on the 100% shareholding of The Brady Family Trust in the company and his small business participation percentage of 90% in the trust, i.e., 100% × 90% = 90%); and

6. The trust is able to access the retirement exemption because Bob is a significant individual. The trust can choose to apply the lifetime maximum limit of $500,000 for the retirement exemption for Bob. The retirement exemption can also be accessed for Mary because she is the spouse of the significant individual and has a small business participation percentage because she received 10% of the trust distribution in the year the shares are transferred.

   Bob and Mary are both over 55 years of age and therefore do not have to have the amount of the retirement concession contributed into a superannuation fund.

   Therefore all the conditions for the small business CGT concessions have been met and the concessions may be applied as follows:

Deemed market value consideration on transfer of shares to The Julie Family Trust		2,500,000
Less cost base (insignificant)		-
CGT 50% discount		(1,250,000)
Active asset reduction – 50%		(625,000)
Small business retirement concession	– Bob	(500,000)
	– Mary	(125,000)
Taxable gain		-

As a result of applying the concessions the trust does not have to pay any tax in relation to the transfer of shares to The Julie Family Trust.

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SECTION 10(C): ISSUES RELATING TO SALES

[10 300] Understand what is being sold

Where the succession plan is for a sale from the current owners to the successors, you need to determine what is actually being sold.

In the case of a business conducted by a sole trader or partnership, any transfer of ownership will involve a transfer of assets, or a transfer of a direct interest in the assets.

In the case of a business conducted by a trust or company, there is a choice between:

- selling the business assets out of the trust or company, for example to a new entity owned by the successor; or
- selling shares in the company or units in the unit trust.

In the case of a discretionary trust the ‘‘sale’’ may be simply effected by way of changing the control of the trust from the parents to the children, and making capital payments to the parents.

[10 310] Selling business assets

While the transfer of shares or units may result in a capital gain, the sale of business assets may result in ordinary taxable income and/or capital gains, for example:

- gains in respect of assets such as goodwill, trademarks, and land and buildings are subject to the CGT provisions;
- gains in respect of assets subject to the uniform capital allowances provisions (Division 40 of ITAA97) are taxed as ordinary income. These include assets such as plant, equipment, vehicles, copyright, patents and registered designs; and
- gains in respect of trading stock are taxed as ordinary income.

This may mean that the tax payable on the sale of the business assets will be higher than the tax on the sale of equity interests. This is because capital gains may be subject to concessions such as the general 50% discount and the small business CGT concessions.

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EXAMPLE [10 310] A

Sale of Assets vs Sale of Equity

(i) Jason Electronics Pty Ltd

	Tax and/ Book Value	*Market Value*	*Ordinary Income*	*Capital Gain*	*Tax Rate*	*Tax Payable by Company*
	000's					*000's*
Assets						
Trading Stock	1,000	1,500	500		30%	150
Plant	1,000	2,000	1,000		30%	300
Patent	-	500	500		30%	150
Goodwill	-	2,000		2,000	30%	600
	2,000	6,000	2,000	2,000		1,200
Liabilities						
Creditors	1,000	1,000				
Employee Entitlements	400	400				
Income Tax	200	200				
	1,600	1,600				
Net Assets	*400*	*4,400*	*2,000*	*2,000*		*1,200*

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If the company sold the assets to a new entity, or simply transferred the assets for nominal or book value to an associated party, it would result in a taxable income of $4m, being a combination of ordinary income and capital gain. Because it is a company, it is not entitled to the 50% CGT discount, nor in this example do the patent and goodwill have a cost base that can be indexed to CPI under Section 114-10 of ITAA 97 (up to 30/9/99). As a result, all of the $4m gain would be taxed at the company tax rate of 30%, resulting in tax payable of $1.2m. Further, where market value consideration has been paid, additional tax may be payable when the taxed gain is paid out to shareholders as franked dividends and those shareholders have personal tax rates greater than 30%.

Where all shareholders are on the highest personal tax rates, the overall tax on the sale of assets would be 46.5%; i.e., $1.86m.

(ii) Sale of Shares in Jason Electronics Pty Ltd

If the shareholders transferred their shares in the company instead of transferring the assets, assuming they qualify for the general 50% CGT discount, the maximum tax rate on their gain would effectively be 23.25% (being the highest personal tax rate of 46.5% applied to half the gain). When applied to the $4m capital gain this would result in tax payable of $930,000 which, when compared to the sale of assets, is an immediate saving of $270,000 ($1,200,000 - $930,000), and a potential saving of up to $930,000 ($1.86m - $930,000).

If the small-business CGT concessions applied, the potential saving would be greater because half of the gain on a sale of assets shown in (i) above would be treated as ordinary income which would not be subject to any CGT concession.

Allocating purchase price

While it may be attractive to allocate the purchase price to business assets in a way that maximises capital gains and minimises ordinary income, you should bear in mind that the transfer of depreciable assets under a non-arm's length dealing (which prima facie would include a transaction between family members) will be deemed to have taken place at market value under the provision contained in S 40-300 of ITAA97. (See Section 10(b).)

In addition trading stock which is disposed of outside the ordinary course of business is effectively deemed to have been sold for its market value under s 70-90 of ITAA97. These provisions apply where inventory is sold in its entirety in the course of a sale of business and also where inventory is gifted, or otherwise disposed of outside the normal operation of the business.

Where, however, a sole trader or partner in a partnership sells a partial interest in trading stock on the introduction of a new partner, the old and new owners may agree to treat the inventory as being disposed of at its tax value, not at market value. This option is only available if the old owners retain an interest of at least 25% in the new partnership and therefore in the trading stock. (s 70-100(4) ITAA97).

Unless there are compelling commercial reasons to transfer the business out of its existing structure (such as concerns in regard to unknown liabilities from past transactions) most succession planning for family businesses will deal with the transfer of equity in the existing structure.

Pre CGT assets may be subject to CGT

In transferring business assets such as goodwill and real estate that were acquired by a company or unit trust prior to 20 September 1985, it should be remembered that they will not always be free from CGT.

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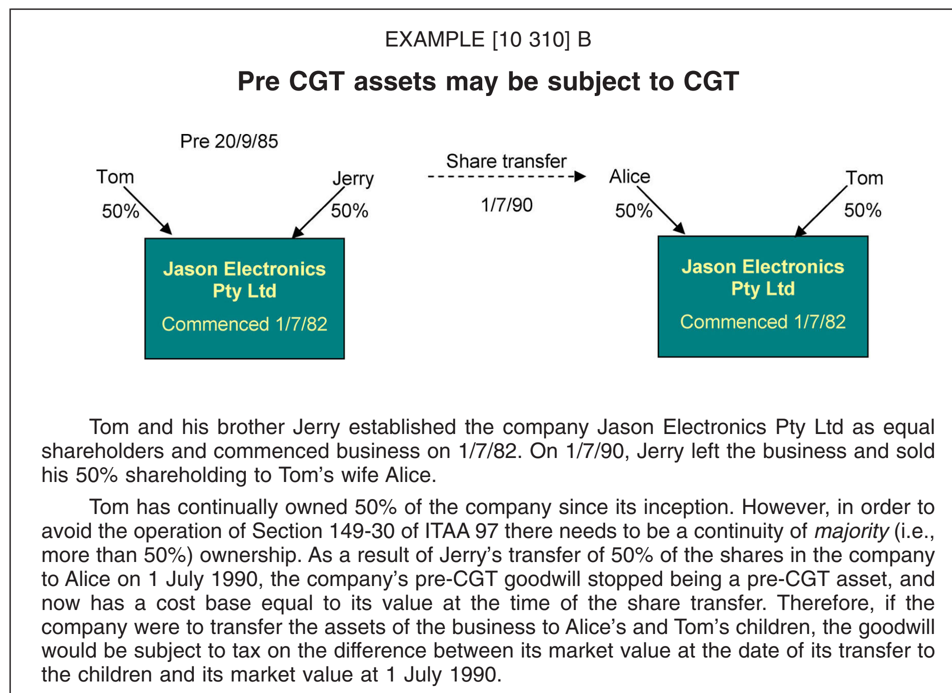
Where the majority underlying interests in an asset changed after 19 September 1985 the asset will be deemed to have been disposed of by the trust or company on the date of the change of the ownership interests and immediately reacquired at its market value on that date. (s 149-30 ITAA97). This means that, if more than 50% of the shares in a company or units in a unit trust changed hands after 19 September 1985, the pre-CGT assets that existed at the time of the change would lose their pre-CGT status and take on a cost base equal to their market value at that time. Therefore any increase in value from that cost base until the transfer of the asset as part of a sale or succession plan would be a taxable capital gain derived by the trust or company (subject to any applicable CGT concessions).



Tom and his brother Jerry established the company Jason Electronics Pty Ltd as equal shareholders and commenced business on 1/7/82. On 1/7/90, Jerry left the business and sold his 50% shareholding to Tom's wife Alice.

Tom has continually owned 50% of the company since its inception. However, in order to avoid the operation of Section 149-30 of ITAA 97 there needs to be a continuity of *majority* (i.e., more than 50%) ownership. As a result of Jerry's transfer of 50% of the shares in the company to Alice on 1 July 1990, the company's pre-CGT goodwill stopped being a pre-CGT asset, and now has a cost base equal to its value at the time of the share transfer. Therefore, if the company were to transfer the assets of the business to Alice's and Tom's children, the goodwill would be subject to tax on the difference between its market value at the date of its transfer to the children and its market value at 1 July 1990.

[10 320] Selling equity

The sale of shares in a company, or units in a unit trust, acquired after 19 September 1985 are subject to the CGT provisions of ITAA97. Where the equity has been held for more than 12 months it will generally be subject to the 50% CGT discount (but see below) and where the relevant conditions are met, the combination of concessions may result in no CGT liability. (See Section 10(b).)

However there are some CGT traps that you need to be mindful of.

CGT can apply to pre-CGT equity holdings

In transferring shares or units acquired before 20 September 2005 you first need to consider whether CGT Event K6 applies to make the transaction subject to CGT. This provision, contained in Section 104-230 of ITAA97, applies where the market value of the assets of the company or unit trust, that were acquired after 19 September 1985, is

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75% or more of the net value of the company or unit trust. If this is the case, on the transfer of the shares or units, the transferors would make a taxable capital gain equal to that part of the sale proceeds that is reasonably attributable to the amount by which the market value of the post-CGT assets exceeds the cost bases of these assets. In other words, the relevant proportion of the taxable capital gain inherent in the assets of the company or trust will be attributed to disposal of the shares or units.

The purpose of this provision is to overcome what would otherwise be a loophole whereby pre-CGT equity interests could be transferred tax free instead of a transfer of assets that would be subject to CGT.

Equity held for 12 months or more may not be eligible for the general 50% CGT discount

A capital gain may be eligible for a CGT discount. The discount rate is 50% where the capital gain is made by a trust or an individual, and 33?% if the gain is made by a superannuation fund. Companies are not entitled to a discount. In order to qualify for the 50% CGT discount, an asset must have been owned for 12 months or more. However, there are some instances where assets held for the required period will not qualify for the 50% discount.

Where assets of an entity have been held for less than 12 months, provisions are in place to ensure that the CGT discount cannot be obtained by transferring equity interests in the entity which have been held for at least 12 months, instead of the assets that have been held for less than 12 months.

The relevant provisions are contained in s 115-45 of ITAA97. These apply where:

- the company or trust has less than 300 members;
- the transferor of the equity and their associates owned at least 10% of the shares in a company or 10% of the issued units in the unit trust or 10% of trust voting interests;
- the total of the cost bases of CGT assets owned for less than 12 months is greater than 50% of the cost bases of all the CGT assets owned at the time of the transfer of the equity; and
- the net capital gain that would arise on sale of the entity's assets, that have been held for less than 12 months, is more than 50% of the net capital gain that would arise if all of the assets were sold for their current market value.

[10 330] Gifting equity

Transferring equity for no consideration

We have discussed at Section 10(a) the effect of the CGT market value substitution rule where assets are transferred at less than market value. Therefore where equity is gifted by the current owners to successors, the transferor may still incur a CGT liability unless the operation of the various CGT concessions can apply to eliminate the liability.

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Issuing equity at a nominal price

One alternative that is often considered is to issue new shares in the family company, or units in the unit trust, to the successors. Sometimes this is done as a first step to succession, to give the successor a sense of ownership or to act as a ‘‘golden handcuff’’. Issuing new equity may be aimed at ensuring that the current shareholders do not have to dispose of their equity and incur a CGT liability in respect of that disposal. However, there can be significant tax issues involved in issuing equity for less than its real value.

Employee share plan provisions

Note: This section needs to be revised if, and when, the new employee share scheme legislation is passed.

In the first instance, where the business is operated by a company, the employee share plan provisions contained in Division 13A of ITAA36 may operate to tax successors who are employees on the difference between the market value of the shares and the amount they are required to pay for them. The tax would be payable in respect of the year in which the shares are issued. Deferral of tax on the discount is only available where the shares are ‘‘qualifying shares’’. There are 6 conditions for ‘‘qualifying shares’’, which include that at least 75% of the permanent employees of the employer were, or at some earlier time had been, entitled to acquire shares or rights under the ‘‘employee share scheme’’. Generally, this would mean that shares issued to one, or a few, successors would not be ‘‘qualifying shares’’, and therefore there would be no opportunity to defer the tax on the discount.

It should be noted, however, that options could be issued to successors that may have ‘‘qualifying rights’’ because the requirement for 75% of permanent employees to participate in the scheme does not apply in the case of options. (You should note however, that one of the other conditions for ‘‘qualifying shares or rights’’ is that the person does not hold a beneficial interest of more than 5% in the company or control more than 5% of the voting power.) Options are generally not securities that small and medium businesses are used to dealing with. Nevertheless, they may be useful for a first tranche of equity, especially where performance hurdles for either the individual or the business are desired.

In order for Division 13A to apply to the acquisition of a share or right by a taxpayer, it does have to relate directly or indirectly to employment of the taxpayer, or an associate of the taxpayer, or relate directly or indirectly to services provided by the taxpayer or an associate of the taxpayer. A relative is an associate. In the case of an employee of a family business, or a relative of an employee of a family business, it may be difficult to argue that the issue of the shares at a discount did not relate to employment but instead to the ownership of the business (in the latter case, Division 7A or the value shifting provisions may operate as discussed below). Even if the successor is not currently employed in the business, and does not include the discount in their assessable income in the year of issue, S 139B(2A) of ITAA36 may require the discount to be included in the successor’s assessable income in the year in which they first became an employee, if that employment can be connected with the issue of the shares.

It should be noted that, where Division 13A applies to shares, fringe benefits tax will not apply. However, there is no equivalent to Division 13A to the issue of units in a unit trust, and therefore where the issue of units to an employee or their associate is at a

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discount to market value, and in respect of the employee's employment, then fringe benefits tax would apply. This would impose FBT on the employer at the FBT rate, which is equivalent to the top personal tax rate.

Issuing shares or units at market value funded by loans

In order to avoid the application of Division 13A to the issue of shares, or FBT to the issue of units, the shares or units must be issued for market value. If the whole intention was to gift some equity to the successors, then this would seem to defeat the purpose. One approach to this dilemma would be for the current owners to make a loan to the successors to allow them to pay market value for the equity.

However, a loan to an employee (or an associate of an employee) by the employer or an associate of the employer may also be subject to fringe benefits tax if it is interest free, or if interest is charged at a rate lower than the statutory FBT rate, and the benefit is provided in respect of the employment of the employee. This would include a benefit which is also provided in respect of something else, such as a family relationship. However there must still be a sufficient or material connection between the benefit and employment in order for fringe benefits tax to apply. Arguably, an interest-free loan from parents to a child, to allow the child to purchase shares in the family company, should not be treated as relating to employment unless there are other indications that it does; for example, if it is given in relation to performance as an employee.

One of the problems with this strategy is that the successor pays the company for the allotment of shares (or units in a unit trust) which leaves the family with the dilemma of how to get the cash out of the company or trust without triggering a tax liability. However, where the parents are owed significant amounts by the company or trust, the issue of shares or units may be funded by the repayment of these loans. In doing so, you need to consider that this would reduce the potential for future tax-free drawings by the parents from the business, and take care that the resulting loan between the parents and the children is appropriately dealt with in the parents' estate planning.

If the intention is that the equity be gifted by the parents, or provided at a discount, it is likely that they would want to forgive the loan to the successors. This raises the issue of the tax consequences of commercial debt forgiveness. However, these provisions do not apply where the forgiveness is made for reasons of natural love and affection or if it is effected by a will. Therefore, the release of the debt of a child by a parent for natural love and affection should not result in the tax consequences that can arise to the debtor under the commercial debt forgiveness provisions of Section 2C Division 245 of ITAA 36; i.e., a reduction in carry-forward tax losses, or a reduction in the cost base of any assets of the successor, including the cost base of the shares.

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EXAMPLE [10 330] A

Brad and Natalie own all the shares in Natalie Cosmetics Pty Ltd which operates the business. They wish to gift an interest in the company to each of their daughter Jane, who does not work in the business, and their son Michael who does work in the business. The value of the company is $1,000,000. Michael will soon become CEO on Bob's retirement, and Brad and Natalie intend to leave the balance of their shares in the business in their wills to Michael, resulting in him having a majority shareholding on their deaths.

Brad and Natalie are owed $1m by the company. They do not ever intend to draw down fully on the loan as they have substantial investment assets outside the business, which has meant that they do not qualify for the small business CGT concessions. They are happy to leave $500,000 in the business permanently.

They draw $500,000 from the company against the loan and lend it to Michael and Jane who pay $250,000 each back to the company for the issue of their shares. They each receive an interest of 16.67% in the company. (The company is worth $1.5m after the new issue of shares).

The loans from Brad and Natalie to the children are interest-free but FBT should not apply as there is an insufficient connection to employment. Michael and Jane both receive the benefit of an interest-free loan but Jane does not work in the business at all.

Division 13A will not apply to the issue of the shares because they are issued at market value. If Brad and Natalie later forgive the loans, either during their lifetime for natural love and affection or in their wills, the commercial debt-forgiveness provisions should not apply. Brad and Natalie will not have incurred CGT when Michael and Jane received their shares in the company because they did not dispose of their own shares. Nor would the value shifting provisions apply to tax Brad and Natalie when the shares were issued to the children because the issue was for market value (see following).

Application of value shifting rules

Apart from the possible tax for the successor under Division 13A, the issue of shares at a discount to successors may result in a capital gains tax liability to the current shareholders under the direct value shifting rules contained in Division 725 of ITAA97. These rules apply in relation to trusts and companies where value is shifted between equity (and loan) interests, e.g., from shares owned by the parents to shares owned by the successors, by issuing new shares at a discount, resulting in a reduction in the value of existing interests and an increase in value of the new interests. For the value shifting provisions to apply there is no requirement for the arrangement (scheme) to have a tax-avoidance purpose.

These provisions may also apply where shares or units are subject to a buy-back or redemption for less than market value and where rights attached to shares or units are changed, and where these actions result in the decrease in the value of some shares or units and an increase in the value of others.

In order for Division 725 to apply, the company or trust must have a controlling entity at any time during the period starting when the arrangement (scheme) is entered into, and ending when the arrangement (scheme) has been carried out. A controlling entity of a company for this purpose under Section 727-360 of ITAA 97 is one which:

- the entity together with associates, exercises at least 50% of:
  - the voting power; or
  - the right to receive dividends; or

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  - the right to distributions or capital; or
  - 40% where no other entity controls the company; or
- together with associates, the entity in fact controls the company.

An entity will be a controlling entity of a fixed trust under Section 727-360 of ITAA 97 where:

- together with associates, it has the right to receive, directly or indirectly, at least 40% of trust income or trust capital;
- together with associates, it has the power to obtain beneficial enjoyment of the trust's income or capital;
- it is able to control the distribution of the trust's capital or income;
- the trustee of the trust is accustomed or under an obligation, or might reasonably be expected to act in accordance with the directions, instructions or wish of the entity; or
- it is able to appoint or remove the trustee (e.g., the appointor).

Division 725 may even apply to a non-fixed or discretionary trust which has interests capable of being measured and quantified, but this would exclude discretionary trusts where the only interest of the beneficiaries is the entitlement to proper administration and to consideration by the trustee in exercising its power of distribution. That is, the direct value shifting rules should not apply to a discretionary trust where no one has an interest which is quantifiable and capable of being acquired and disposed of. The value shifting rules are, however, relevant to hybrid trusts in which case there are separate control tests for non-fixed trusts which would apply. (Section 727-365 or ITAA 97).

In order for Division 725 to apply, an entity must be an affected owner of an interest which has decreased in value (a ''down-interest'') or of an interest which has increased in value (an ''up-interest''). The owner of a down-interest must be either the controller or an associate of the controller at some time during the scheme period, or an active participant in the scheme.

To have an affected owner of an up-interest, there must be an affected owner of a down-interest because the direct value shifting provisions are based on there being a value shift from a down-interest to an up-interest. The entity must also be the controller, and/or an associate of the controller at some time during the scheme period, or an active participant in the scheme. This would normally be the situation where the parents are the owners of the down-interest, and their children are the owners of the up-interest as a result of issuing discounted shares or units to the children.

An important point for succession planning is that a direct value shift will only attract the operation of Division 725 if there has been a decrease in the market value of all down-interests of at least $150,000, providing a de minimus exclusion. There is, however, an anti-avoidance measure which operates if there are a number of arrangements creating direct value shifts, and it is reasonable to conclude that the sole or main reason for these different arrangements is to take advantage of the de minimus exclusion. In such a case the exclusion will not apply.

The tax consequences of the direct value shifting provisions can be an adjustment in the value of up- and down-interests, or both an adjustment in values and a taxing event.

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Where the shift in values has the same effect as a part disposal of an asset to another person, it will be treated as a part disposal and be taxed as a capital gain under CGT event K8.

The best way to illustrate the operation of Division 725 is by an example.

EXAMPLE [10 330] B

Example of Value Shifting

Alan and Cathy operate the family business through ACS Pty Ltd which is valued at $100,000. Alan and Cathy each own 500 shares being 50% of issued capital. Alan and Cathy want their daughter Sarah to have the business, and decide to issue her with 10,000 shares for $1.00 each, i.e., a cost of $10,000.

Alan
500 shares* worth $50,000
Cathy
500 shares* worth $50,000
ACS PTY LTD
Value $100,000

Alan
500 shares* worth $5,000
Cathy
500 shares* worth $5,000
Sarah
10,000 shares worth $100,000
ACS PTY LTD
Value $110,000

[*cost base $1 each]

As a result of the issue of shares to Sarah, there has been a value shift from Alan and Cathy to Sarah of $90,000; i.e., 90% of the value of their shares.

The conditions for the application of Division 725 will be met as:

- there is a controller of the shares at some point during the arrangement; i.e., Alan and Cathy, as associates of each other, hold more than 50% of the shares; and
- the value of some shares have decreased (Alan's and Cathy's), and others have increased (Sarah's) as a result of the new issue of shares to Sarah.

The effects of the operation of Division 725 would be:

- Alan and Cathy would each be subject to capital gains tax under CGT event K8 as if they had sold 90% of their shares as follows:

	Bob	*Mary*	*Total*
Value shifted	45,000	45,000	90,000
Less Cost base	450	450	900
Taxable capital gain*	44,550	44,550	89,100

Note
This gain may be able to be reduced by the CGT general discount and the small business CGT concessions.

- Alan's and Cathy's cost base of their 500 shares would be reduced to 10% of the original cost base of $500 each, i.e., to $50 each; and
- Sarah's cost base would be increased by the amount of the value shift, i.e., by $90,000 giving her a cost base of $90,000 plus the $10,000 paid for her shares; i.e., a total cost base of $100,000.

However under the de minimus rule, the value shifting provisions will not apply where the value shift is less than $150,000. Therefore in this case:

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- there would actually be no tax implications for Alan and Cathy of the share issue to Sarah. They would each have 500 shares worth $5,000 with a cost base of $500.
- Sarah would have a cost base of $10,000 for her $100,000 worth of shares, being the amount she paid for the shares.

However, Sarah may still be taxed under the employee share scheme provisions contained in Division 13A of ITAA97 if the issue of shares can be related to employment in the family business. (See above.)

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SECTION 10(D): TAX ISSUES RELATING TO DISCRETIONARY TRUSTS

[10 400] Introduction

In the case of a discretionary trust, succession may be effected by changing the control of the trust (as discussed at **[8 200]**).

Generally, a change of appointors or a change in shareholders of a trustee company will not have tax consequences. However, there are some tax issues that need to be considered.

[10 410] Trust losses

Where a discretionary trust has prior or current-year losses and debt deductions (e.g., bad debt deductions) a change in control may affect the ability of the trust to claim the losses and debt deductions because of the operation of the trust loss provisions contained in Schedule F of the ITAA 1936.

Where a discretionary trust has no beneficiaries with fixed entitlements to trust income or capital, it must pass three tests in order to claim losses and debt deductions.

1. **The pattern of distributions test** requires the trust to have distributed directly or indirectly more than 50% of every distribution of income to the same individuals, and more than 50% of every distribution of capital to the same individuals during the relevant period, but not including years more than six years before the year in which the trust claims the loss or debt deduction.

   The relevant period starts at the earliest of:

   - the year in which the trust distributed income prior to the loss year that is closest to the loss year;
   - the loss year if income was distributed in that year; and
   - the year in which the trust distributed income after the loss year, and ends two months after the end of the year in which the trust claims the loss or debt deduction, and includes all years in between these dates.

   Therefore if, for example, a trust has losses at the time the change of control occurs, those losses could be lost where the same individuals that received the majority of distributions of income and capital prior to the change did not receive the majority of distributions after the change.

2. **The control test** provides that no group (a person and their associates) starts to control the trust during the period starting from when the loss or debt is incurred, up to when the loss or debt is claimed as a deduction.

   Control may be by way of controlling the trustee to make distributions of income or capital, e.g., as directors and shareholders of a trustee company, or by way of a power to remove and appoint the trustee as appointor.

   Therefore if parents transfer the shares in the trustee company to their successor and/or change appointors while the trust has unrecouped losses, this could result in the trust failing the control test and losing the ability to deduct the losses in the future.

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The control test will not be breached merely because a person in the controlling group dies, becomes incapacitated or separates from their spouse, as long as the other members of that group remain the same (ATO ID2007/59).

3. **The income injection test** is applied where income is injected into a loss trust and it is reasonable to conclude that the income has been derived wholly or partly because the trust has losses.

   If a discretionary trust does have losses, you need to carefully consider the timing of a change of control in light of the trust loss tests.

Family trust elections

If a trust makes a family trust election then the pattern of distribution test and the control test do not have to be passed in order to claim a deduction for losses and debt deductions. (The income injection test still has to be passed.)

In order to make a family trust election the trust must pass the ''family control test'' and nominate a (primary) test individual. The ''family control test'' requires that the controlling group of the trust consist of:

- the test individual and/or members of that person's family (the ''family group'' as defined – see **[8 600]**);
- professional or legal advisors to the family; or
- the trustees of family trusts, provided the same test individual is specified for those trusts and the family group has more than a 50% stake in the income or capital of the trust.

Before making a family trust election it is important to understand the definition of the family group because this definition will limit the family members who can receive distributions of income and capital in the future without the trust incurring ''family trust distribution tax'' at the highest personal tax rate, as discussed at **[3 110]**.

As the family group is defined around the primary individual, the selection of this individual needs to be carefully considered.

The existence of the family trust election may impact on the practicality of effecting succession through a mere change of control, given its effect of limiting the potential beneficiaries. For example, this may be of concern where there is a desire to benefit great-nephews or great-nieces of the primary beneficiary who are outside the definition of the family group. Even great-grandchildren would be outside the family group if the Federal Government successfully reintroduces its legislation to restrict the definition of family group from all lineal descendants of the primary individual, as it is currently, to children and grandchildren of the primary individual (see below).

If the trust has not yet made a family trust election, it may be preferable to leave the change of control until after losses have been utilised rather than make a family trust election. However, if a family trust election is to be made, the primary individual should be selected in light of the succession plan. For example, if the new ultimate controller of the business is to be the son of the current controller, you may wish to make the son the primary individual, which would ensure that the son's grandchildren would be included in the family group. Being the great-grandchildren of the current controller, under the amendments proposed by the Federal Government but not passed by Parliament in 2008, they would not be included in the family group if the father were nominated as the primary individual.

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The situation is more difficult if siblings are to be joint controllers of the trust. If either of them were nominated as the primary beneficiary under a family trust election, then that person's grandchildren would be included in the group but the grandchildren of the other sibling would not. In such a case, for the sake of equity, they may prefer to nominate the father of the joint controllers, meaning that as primary individual all lineal descendants of the father would be included in the family group under the current definition. Alternatively, if the Labor Government's amendments are eventually passed, then both siblings' grandchildren would be excluded from the family group. A family trust election can only be revoked or varied in very limited circumstances.

[10 420] Dividend imputation credits flowing through trusts

It should be noted that a family trust election may also be required to allow the flow of dividend imputation credits through a trust to beneficiaries. This applies to shares acquired by a discretionary trust after 3pm on 31 December 1997, unless the ''tax imputation credits offset'' entitlement (dividend imputation credits) does not exceed $5,000 in an income year. Therefore, where a discretionary trust has acquired shares after 31 December 1997, for example in a company operating the family business (or in passive investments which produce franking credits of more than $5,000 in a year) the trust will need to make a family trust election to ensure that it can pass franking credits through to the beneficiaries who receive the distribution of dividends.

[10 430] Trust resettlement

Whenever changes are being contemplated in relation to a trust you need to consider whether these changes could result in a resettlement of the trust.

A resettlement basically ends the existing trust and creates a new trust. Consequently, any assets held by the existing trust will be treated as having been disposed of to the new trust with all the capital gains tax, other tax liabilities, and stamp duty consequences of such disposals.

It is therefore vitally important that the implementation of the succession plan does not result in a trust resettlement.

The Taxation Office released *Creation of a New Trust Statement of Principles* in August 2001 following the High Court decision in Commissioner of *Taxation v Commercial Nominees of Australia Ltd* (2001) HCA 33.

The ATO's view, as expressed in its statement, is that a new trust arises where there is a fundamental change to the trust relationship, i.e., the relationship between the trustee and beneficiaries in respect of the trust property. Such a fundamental change requires change in the essential nature and character of the trust relationship.

These changes may result from varying a power of the deed or a variation by agreement among the beneficiaries.

Changes that raise the possibility of resettlement include:

- change in the beneficial interest in trust property – this would include changes to fixed entitlements of beneficiaries;
- introducing a new class of beneficial interest;
- redefining beneficiaries;

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- changes to the terms of the trust or the rights or obligations of the trustee;
- a change in the trust's termination date;
- a change in the essential nature and purpose of the trust;
- a merger of two or more trusts or a splitting of a trust into two or more trusts; and
- changes in the nature or features of trust property.

Whether such changes amount to a fundamental change in the essential nature and character of the trust relationship, or whether they amount to a mere variation of a continuing trust, will depend on their nature and extent.

Some examples of when changes may be fundamental changes are:

Changes to beneficiaries

This is when the trustee of a family discretionary trust exercises a power of nomination to nominate members of a family not already part of the beneficiary group as defined in the trust deed.

Example (1): A successor's family may be the defined beneficiaries of their family trust under the trust deed, but the family of the successor's spouse may not. If the trustee exercises a power of nomination to nominate the spouse's extended family as beneficiaries, this may represent a fundamental change to the trust as the trust has been changed to benefit another family.

Example (2): A discretionary trust has as beneficiaries the children of Y and anyone else named in the deed as a beneficiary at a particular time. The trustee has a power to nominate a beneficiary but only if they are parents or grandchildren of Y or their spouses. If the trust nominates Y's mother as a beneficiary this will constitute only a change of membership within the defined wider group and there will be no new trust.

Ordinarily the ATO will accept that there has been only a change in the membership of a continuing class when:

- an already existing power to nominate new beneficiaries is only exercisable under the terms of the trust in favour of a clearly defined group which it could be reasonably inferred that the trust was intended to benefit; and
- it can be shown from the deed and surrounding circumstances that the actual objective purpose or theme of the trust was to benefit that group.

Changes to trust property

The ATO's view is that, as a general principle, the mere addition of new property to an existing trust will not give rise to a new trust estate.

Change of trustee

A change of trustee does not in itself result in a termination of the trust. However, a change in the trustee or control of the trustee may be an element in arrangements which, in their entirety, amount to the creation of a new trust.

Changes to the terms of the trust

Some changes are merely procedural while others fundamentally redefine the relationship between the trustee and beneficiaries, and it is generally the latter type which may result in a new trust, for example:

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- the conversion of a fixed trust to a unit trust; and
- the conversion of fixed trust to a ‘‘hybrid’’ discretionary trust.

These principles must be kept in mind when changes are made in respect of trusts as part of the succession plan. While a change of trustee and a change of appointor in themselves would not cause a resettlement, if these changes were accompanied by the introduction of new beneficiaries and/or removal of existing beneficiaries, the risk of a resettlement increases. The same could be said for the situation where beneficiaries' entitlements become fixed instead of purely discretionary, for example where certain of the beneficiaries become entitled to share equally in the trust income and/or capital. Even the statement of such principles in the Family Business Constitution could raise resettlement questions.

In the course of succession planning, consideration is often given to removing some beneficiaries; for example, removing the current controllers as beneficiaries in exchange for a capital payment. The removal of beneficiaries and the change of control of the trust risk a resettlement. On the other hand, in a discretionary trust, leaving the current controllers as beneficiaries does not generally give them ongoing entitlements to trust income and capital unless the trustee exercises its discretion to make distributions to them. Of course, you must always review the terms of the trust deed to ensure you understand the nature of the beneficiaries' interests in the trust.

It should also be noted that, where a beneficiary of a trust unilaterally renounces his/her interest in the trust, as opposed to being removed, this will generally not constitute a resettlement.

[10 440] Tax-free distributions from discretionary trusts

Succession arrangements involving family discretionary trusts often result in the change of control of the trust, say, from parent to child; and distributions of income or capital by the trust to the parents in lieu of proceeds from the sale of the business.

While it is clear that distributions of current-year income will normally be subject to income tax under Sections 97 or 98 of ITAA 36, distributions from other sources require careful analyses. Some succession plans purport to make tax-free distributions to the parents, but there are traps involved in such strategies.

In considering a distribution other than from current-year income you must, as always, review the provisions of the trust deed to determine:

a) whether a distribution from capital or accumulated profits is permitted;

b) what form such a distribution may take;

c) when the distribution may be made; and

d) which beneficiaries are entitled to such a distribution.

You must then determine what the source of the distribution will be. Most family discretionary trusts have only a nominal amount of settled capital but the trust deeds provide what amounts are to be treated as accretions to trust capital. Some provide that accumulated income is added to trust capital as well as accumulated capital profits.

Because trusts are taxed at the highest marginal tax rate on accumulated taxable income (‘‘net income’’) most trusts distribute virtually all of their annual net income.

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However, in some cases the excess of accounting profits (trust income) over the taxable income (net income) may be accumulated. Such differences may arise from differences between the treatment of certain items of income and expenditure for accounting and tax purposes; for example, depreciation may have been expensed for accounting purposes at a lower rate than that allowed for tax purposes – especially in periods where the Commissioner has allowed the use of accelerated depreciation rates. Distributions from such accumulated profits will generally not be taxable. This will be the case even where the trust has an unpaid distribution to a company.

The situation is not so simple where the distribution is made from an asset revaluation reserve. In many cases this would be the source of distributions where the major asset of the trust is the goodwill of the business or equity in the business.

An asset revaluation reserve may be created where the trustee of the trust assesses that the current market value of the assets held by the trust exceeds their current book value and the trustee credits the amount of the increase in value to an asset revaluation reserve (debiting the asset itself to bring its carrying value to the current market value).

This increment in the value of the assets of the trust would normally be treated as an accretion to the trust fund which represents the value of the net assets of the trust. Subject to the terms of the trust deed, the trustee may then pass a resolution to distribute all or part of the revaluation reserve to one or more beneficiaries.

The revaluation of an asset and the crediting to the asset revaluation reserve has no income tax consequences to the trustee. When that revaluation reserve is advanced to a beneficiary, it retains its character and therefore it would not be income, under ordinary concepts, in the hands of a beneficiary.

Nor is the amount likely to be assessed under Section 99B of Division 6 of ITAA 1936. This is because the distribution would be treated as representing ''corpus of the trust estate'' and is an amount which would not have been included, if it had been derived by the beneficiary, in the beneficiary's assessable income.

In considering whether the distribution of the asset revaluation reserve is subject to capital gains tax, the following summarises the application of relevant CGT events.

CGT event E4 (Section 104-70(i)): which happens where a trustee of a trust makes a payment to a taxpayer in respect of a unit or interest in the trust and some, or all, of the payment is not assessable income.

As the distribution from an asset revaluation reserve would not be included in the beneficiary's assessable income, in order for CGT event E4 to apply, the distribution would have to be in respect of an interest in a trust. Where, for example, the trust was a unit trust, the distribution from the revaluation reserve would result in CGT event E4 happening. This would reduce the cost base of the units and, where the distribution exceeds the cost base of the units, a taxable capital gain would arise. However, in the case of a discretionary trust, the general view (based on the decision in *Gertrude v IRC* (1968) AC 553) is that a beneficiary in a discretionary trust has no interest in trust assets, only limited equitable rights against the trustee. This view is also the view of the Commissioner of Taxation expressed in Taxation determination TD 97/15; nor does he consider the interest of a default beneficiary to be sufficient to constitute an ''interest in the trust'' for the purposes of Section 104-70(1). Therefore, a distribution from an asset revaluation reserve of a discretionary trust would not result in CGT event E4 happening.

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If the distribution is not assessable income or a taxable capital gain to the beneficiary, you still need to ensure that no CGT events happen in relation to the trust itself. A brief analysis of the application of CGT events to a distribution from an asset revaluation reserve is as follows:

- There has been no disposal of an asset by the trustee and therefore CGT event A1 has not happened;
- CGT event E1 does not happen because the distribution to a beneficiary does not create a trust over a CGT asset;
- CGT event E2 does not happen because it requires a transfer of an asset to a beneficiary;
- CGT event E5 does not happen because the distribution does not involve the beneficiary becoming absolutely entitled to an asset of the trust. Nor do CGT events E6, E7 or E9 happen in relation to the distribution; and
- CGT event D1 should not happen, which requires there to be a contractual right, nor CGT event H2 which requires there to be an act, transaction, or event which occurs in relation to a CGT asset.

Therefore a distribution from an asset revaluation reserve of a discretionary trust should not subject to tax either the beneficiary or the trustee of the trust.

The practical difficulty with such distributions relates to how they are funded. Where a distribution is from an unrealised gain there are no proceeds available for distribution, as there are when an asset is sold and the gain is realised. Unless the trust has liquid assets, the obvious solution is for the trust to borrow the funds necessary to make the distribution. However, interest on funds borrowed for the purpose of making a distribution from an unrealised gain is not considered by the Commissioner of Taxation to be deductible (TR 95/25).

Other complications arise where a distribution from an asset revaluation reserve is made at a time when the trust has an unpaid distribution to a company. In such a situation, subdivision EA of Division 7A of ITAA1936 may operate to deem the payment to be a dividend. Section 109XA(1) and 109XB operate when:

- a trustee makes a payment to the shareholder of a company or an associate of a shareholder;
- the payment represents that person's entitlement from an unrealised gain; and
- the company is, or becomes, presently entitled to a distribution from the trust that is not paid by the trust before the due date for lodgement of the trust's income tax return for the year in which the payment of the distribution took place.

A deemed dividend would arise under these provisions to include the distribution from the asset revaluation reserve in the assessable income of the beneficiary (the distribution, although deemed to be dividend, is not able to be franked). The amount of the dividend is limited to the lower of the amount of the distribution, and the distributable surplus of the company.

Therefore, while a capital distribution from a discretionary trust may be tax-free to the recipient you need to consider the source of the distribution, how it is funded, and

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whether the trust has an unpaid present entitlement to a company before determining whether it is the most effective strategy for making payments to the retiring family members.

Where a capital gain on sale of equity in a business by a trust qualifies for capital gains tax concessions, it may be preferable for the trust to transfer all or part of the equity to another trust, then realise the gain and distribute it to the retiring family members as a realised gain. Where the acquiring trust funds the purchase with borrowed funds, the interest on these borrowings would be tax deductible.

Such an arrangement may be appropriate where there is more than one successor and it is desirable for each to have a separate family trust, or where there is only one successor but the existing trust is restrictive in its terms, or has a narrow definition of beneficiaries.

While the combination of a CGT discount and small business concessions may produce a nil tax position, there may still be stamp duty in relation to the transfer of the equity in the business.

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SECTION 10(E): SUPERANNUATION AND RETIREMENT BENEFITS

[10 500] Superannuation contributions

Superannuation is a tax-effective means of transferring funds from a business for the benefit of family members. In an ideal world, sufficient funds would be contributed into superannuation for senior family members to provide for their financial needs in retirement, minimising their need for further payment on retirement, or financial support from the business after retirement.

However, many small- and medium-sized businesses are under-funded and, at least during their early growth phase, all available cash is reinvested in the business with little available for discretionary expenditure such as superannuation (in excess of the mandated 9%).

Therefore, in many cases additional superannuation contributions will be made only once the business is well established and as the current owners move towards retirement. Continued contributions to superannuation are an effective way for the business to fund the succession plan, not only prior to retirement of the current owners, but also after retirement when other successors are running the business.

Succession plans may be fully or partly funded by superannuation contribution from the business, depending on the period of time available – bearing in mind that contributions cannot be made at all after age 75 – and the amount that is required to be funded.

With the reduction in the concessional contribution cap effective from 1 July 2009 to $25,000 generally, and to $50,000 for people aged 50 and over until 30 June 2012, it is now more difficult to build up substantial amounts of superannuation benefits. Nevertheless, a husband and wife aged over 50 are still able to have contributions of $50,000 each made over the next 3 financial years, allowing a total of $300,000 to be contributed before 30 June 2012. Unless the succession is able to be effected and funded by tax-free capital payments (e.g., pre-CGT capital gains, or capital gains exempted through the operation of CGT concessions) superannuation should at least be part of the structuring of succession payments, as it usually provides a tax deduction to the business of at least 30% and is only taxed at 15% in the hands of the superannuation fund, providing a net tax benefit of at least 15% and allowing this part of the succession funding to be provided directly by the business without the deemed dividend issues that arise under Division 7A of ITAA when a company (and in some cases, a trust) pays funds out to shareholders or their associates by way of loan.

This also means that the superannuation contributions may be funded from borrowings by the business. Interest on borrowings used by a business to fund superannuation contributions is deductible, as long as the contributions are deductible. (However, interest on borrowings used to fund personal superannuation contributions is not deductible.)

A superannuation fund may accept contributions on behalf of a member as long as the member is under age 65 or is over 65 and passes the work test. This test requires the member to have worked at least 40 hours in a period of no more than 30 consecutive days in that financial year. Only mandated employer contributions can be made after the age of 75 (generally these will be limited to the 9% SGC contributions).

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It is not uncommon for even retired family members to continue to have some role in a family business; for example: consulting, mentoring, relieving their successor when the latter is on leave, maintaining relationships with stakeholders, and public relations. It would therefore often be possible for even retired family members to pass the work test, and have superannuation contributions made for them.

These contributions need not be directly made by the employer; in certain circumstances it may be possible, and preferable, for contributions to be personal contributions, funded from income received from the business as either a distribution of trust income or company dividends. Personal superannuation contributions are not subject to payroll tax and workers compensation insurance as employer contributions are. These on-cost savings may be significant where contributions are being maximised. With payroll tax rates of around 5% in most states of Australia, and workers compensation insurance rates generally ranging from around .5% up to 7%, personal superannuation contributions may save up to 12% in on-costs.

Personal superannuation contributions are only deductible where less than 10% of the person's assessable income and reportable fringe benefits for the year relates to employment. Once the person turns 65, care must be taken to check that the person passes the work test and also that the payment for that work does not exceed 10% of their total assessable income.

[10 510] Employment termination payments

The succession plan should also consider other forms of retirement payments, in particular ''golden handshakes'' or employment termination payments.

Payments made in recognition of past service will generally not be deductible under Section 8-1 of ITAA97, but may be deductible under Section 25-50 to the extent they are paid in good faith in consideration of past services of an employee in any business carried on by the employer for the purpose of producing assessable income. (A deduction under Section 25-50 cannot result in a loss for tax purposes.) It should be noted that Section 109 of ITAA36 allows the Commissioner of Taxation to treat such payment as dividends paid by private companies to shareholders, directors and their associates to the extent that he considers the payments to be excessive, thereby denying deductibility of the payments to the company and denying any concessional tax treatment to the recipient.

In IT 2152 the Commissioner determined that, as a general rule, the deduction available to private companies should be limited to an amount which, when aggregated with any payment from, or interest in, a superannuation fund would not exceed the maximum amount permitted in the Commissioner's lump sum guidelines on superannuation funds. The relevance of this guideline is now questionable with the removal of reasonable benefit limits.

The Commissioner also stated that the deductibility of a payment under Section 78(1)(c) of ITAA36 (the predecessor provision to Section 25-50 of ITAA97) has to be determined in light of all relevant factors, and cites factors such as: the terms of employment, length of service, level of remuneration during the period of service, other benefits to which the employee may have been entitled, and the reason for the payment.

While reasonable benefit limits no longer apply, the extent of employer provided superannuation benefits would presumably still be a relevant factor.

It is common for family businesses to underpay family employees, especially in the early years of a business, and the payment of a retirement payment in compensation for

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this is not unreasonable. The taxation treatment of such an employment-termination payment paid during the life of the employee is:

Amount relating to pre-1 July 1983 service		– tax free
Balance:		
Age 55 & over	– up to ETP cap. (150,000 2009/10)	– 16.5%*
	– Excess over ETP cap	– 46.5%

Note
*the rate is 31.5% for people under age 55

If a retirement payment is considered to be appropriate, this decision and the basis for calculating the payment should be documented.

EXAMPLE [10 510]

Employment Termination Payments

Judy is 65 and has been employed in the family business for 35 years. She was the driving force in developing the export market for the business which enabled it to achieve a turnover and profit that could not have been obtained only from the Australian market. Twenty years ago she became the CEO but it is only in the last 10 years that she has received an arm's length remuneration package, including superannuation contributions. For the previous 10 years, while the profits in the business were being reinvested for growth, she was paid at least $50,000 per year less than an arm's length salary, as advised by a remuneration consultant. In the 15 years before that, she was paid marginally less than a commercial salary.

The accountant for the business calculates that, if Judy had received $50,000 per year over that 10 year period and invested the after-tax amount at 5%, Judy would have accumulated over $400,000 by the time of her retirement on 31 December 2009. The company resolved to pay Judy an employment termination payment of $200,000 in recognition of her contribution to the business, and her lower-than-market remuneration.

Since Judy's employment commenced on 1 January 1975, some of this ETP will relate to pre 1983 service. The components of her ETP are:

				Tax Treatment	Tax Payable
Pre 1983 service (1,827 days ÷ 12,784 total days)			28,582	Tax free	Nil
Post 1983	– cap	150,000		16.5%	24,750
	– balance	21,418		46.5%	9,959
			171,418		
			200,000		34,709

The effective tax rate on Judy's ETP is

$$\left(\frac{34,709}{200,000}\right)$$

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[10 520] Genuine redundancy payments

In rare cases, genuine redundancy payments may be justified. Such payments are tax-free where they do not exceed a prescribed maximum calculated as a base amount plus a per annum amount for each year of service.

$$\text{Base amount} + [\text{service amount} \times \text{years of service}]$$

In TR 2009/2 the Commissioner gives his view on what constitutes a genuine redundancy payment under Section 83-175 of ITAA97:

- it must be made in consequence of a termination of employment;
- the termination involves the employee being dismissed;
- the dismissal is caused by the redundancy of the employee's position; and
- the redundancy payment must be made genuinely because of a redundancy.

Other conditions include:

- the employee must generally not be less than 65 years old; and
- the actual amount paid must be determined on an arm's length basis.

In order to be a genuine redundancy, the position of the departing employee must be redundant: i.e., no longer required by the business. This will rarely be the case in a succession arrangement where the retiring person was the CEO. In addition, a person who is a company director may not be able to qualify for a genuine redundancy payment from that company on the basis that a genuine redundancy must be involuntary and, where the employee is also a director of the employing company, that person may have consented to the redundancy decision as a director.

A lack of consent will only exist where external circumstances mean that there is no real or practical choice other than to terminate the person's employment.

This will generally not be the case where, as a director, the person made the decision to sell the business, and consequently terminate his/her employment, and where the business had ongoing viability (TR 2009/2). In this situation, there would be no genuine redundancy.

Obviously, great care must be taken in considering any redundancy payment by a family business for a family member.

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SECTION 10(F): OTHER TAXES AND DUTIES IN RELATION TO TRANSACTIONS

[10 600] Stamp duty

- **Transfer of business assets (other than real estate)**

  Where business assets are transferred from the existing owner to a successor, or another entity controlled by the successor, stamp duty may be payable by the acquirer.

  Stamp duty is payable on the transfer of certain business assets, including goodwill, in all states and territories except Victoria, Tasmania and the ACT.

Jurisdiction	Stamp duty applies			
	Plant & Equipment	Inventory	Debtors	Goodwill
Victoria	✗	✗	✗	✗
Tasmania	✗	✗	✗	✗(1)
ACT	✗	✗	✗	✗
New South Wales	✔	✗	✗	✔
Queensland	✔	✔	✔	✔
South Australia	✔	✔	✔	✔
Western Australia	✔	✗	✗	✔
Northern Territory	✔	✗	✗	✔

Note
(1) In Tasmania some assets, such as site goodwill, are still subject to duty.

Even if the business is situated in a state where stamp duty doesn't apply to business assets, e.g., Victoria, where the business operates, or even sells into another state, a relevant portion of the assets may still be subject to stamp duty in the other state.

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EXAMPLE [10 600]

Pure Juice Bars Pty Ltd sells its business to a new company controlled by the children of Bob and Mary. The business assets comprise inventory, debtors, equipment and goodwill. The business is based in Victoria but for the past three years it has sold products to other retail juice bars in New South Wales. Although no stamp duty will be payable in Victoria (except in relation to motor vehicles) stamp duty will be payable in New South Wales in respect of the transfer of goodwill. The value of goodwill for New South Wales stamp duty purposes will be based on the proportion of sales that are made to customers in New South Wales.

- **Real estate**

  Stamp duty applies to the transfer of real property in every state and territory. Rates vary between jurisdictions and are generally progressive, meaning that the applicable rate is higher for higher-value properties. The maximum rate in Victoria, New South Wales and South Australia is $5.50 for every $100 in excess of the relevant threshold.

- **Transfer of shares and units**

  Stamp duty applies on the transfer of unlisted shares and unlisted units in unit trusts in New South Wales, South Australia and the ACT, at the rate of .6%.

- **Land rich companies and unit trusts**

  Where a private company or private unit trust is ‘‘land rich’’, stamp duty may apply to the transfer of shares or units at the rate applicable to the transfer of property, instead of the rate relating to transfer of shares or units. These ‘‘land rich’’ provisions apply in all states and territories.

  In order for the higher ‘‘land rich’’ stamp duty rate to apply:

  – the company or trust must own land worth more than the threshold applying in the relevant jurisdiction (except in the ACT which has no minimum threshold);

  – total land value as a proportion of all the relevant assets of the company or trust, must exceed 60% (other than in Western Australia, Northern Territory and the ACT where there is no maximum threshold); and

  – the percentage of ownership being transferred must generally also exceed a specified minimum. For example, in most jurisdictions there needs to be an acquisition of at least a 50% interest in a private company. In the case of unit trusts, the acquisition threshold is 20% in some jurisdictions, 50% in others, but in Queensland there is no minimum. Therefore, in Queensland, if the first two tests are passed any acquisition of units in a land-rich unit trust will be subject to the higher stamp duty rates

[10 610] Goods and Service Tax (GST)

- **Shares and units**

  GST does not apply to the transfer of shares in companies or units in unit trusts. These are financial supplies and are input-taxed under the GST legislation.

- **Business assets**

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GST applies to the transfer of business assets and non-residential property. (It only applies to residential property where it is new, or substantially renovated, property.)

However, the GST legislation provides an exemption from GST where a business is sold as a "going concern".

Where a business is transferred to a successor, it will be desirable to access the "going concern" exemption contained in Section 38-325 of the GST Act. This means that the successor would not need to find the funds to cover the GST liability in respect of the assets being transferred, while waiting for the refund of the input tax credit. Further, because stamp duty applies to the GST-inclusive value, a permanent stamp duty saving will result from being able to apply the GST exemption.

In order to qualify for this exemption, the following conditions apply:

- the purchaser must be registered for GST (or required to be registered);
- the vendor and the purchaser must have agreed in writing that the supply is of a going concern;
- the vendor must carry on the business until the date of sale; and
- the vendor must supply the purchaser with everything necessary for the continued operation of a business.

In GST Ruling GSTR 2002/5, the Tax Commissioner gives his detailed interpretation of these requirements; in particular, what things are necessary for the continued operation of an enterprise. For example, where particular premises are necessary for the continued operation of the business, these must be supplied. This would include a factory building that has specially modified floors to take the weight of certain essential machinery. However, the supply of premises may be in the form of an assignment of lease or, alternatively, the vendor may surrender the lease and the landlord grant a new lease to the purchaser.

Where an enterprise is necessarily conducted from premises, but particular premises are not necessary, then suitable premises, or the right to occupy such premises, must be supplied.

Where the succession plan provides for the business to be transferred to another entity controlled by the successor, and business premises are held, and being retained, in a separate entity to the business – say, a trust – it may be advisable for the trust to enter into a lease with the existing business entity prior to the transfer of the business. That lease may then be assigned to the successor's entity that is acquiring the business, in order to facilitate access to the GST "going concern" exemption.

Farm land may be supplied GST-free under Section 38-480 of the GST Act, where there has been a farming business carried on for at least the period of 5 years preceding the supply, and the recipient of the land intends that a farming business be carried out on the land.

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This exemption enables farm land to be supplied GST-free to a successor, without the need to supply everything necessary to carry on the farming enterprise which would be required for the GST-free "going concern" provision.

- **GST and distributions of assets by trusts**

  Occasionally a succession plan may require assets to be distributed in specie from the family discretionary trust to a family member. This may be in order to transfer non-business assets from the trust to family members who do not work in the business, leaving business assets in the trust to be controlled by the business successor. It may simply be desirable for asset-protection or estate-planning purposes to keep business and non-business assets separate.

  Care needs to be taken where the trust is registered for GST (as most business entities are) and the distribution of the asset is to a beneficiary who is not registered for GST.

  Although the distribution of the asset is not made for consideration, it may still be a taxable supply under Division 72 of the GST Act. This division provides that a supply to an associate for no consideration will be a taxable supply if the associate is not registered for GST, or is registered but acquires the asset otherwise than solely for a creditable purpose (is not entitled to claim a full input tax credit). Therefore, unless the supply was input taxed (such as shares, units, and residential property), or GST-free, then GST would apply to the value of the asset being distributed. The beneficiary, being unregistered, or not acquiring the asset for a creditable purpose, would not be able to claim the input tax credit.

EXAMPLE [10 610]

The Miller Family Trust conducts a business and also owns a commercial investment property. Under the succession plan, Mr and Mrs Miller will pass control of the trust to their son and as trustees of the trust, will distribute the investment property to their daughter Amy. The annual rent from the investment property is $60,000 (i.e., less than the GST registration threshold) and Amy is not, and is not required to be, registered for GST. Even though Amy is not paying any consideration to the trust for the property, the distribution of the asset to her will be treated as a taxable supply and the trustee will be required to pay GST on the value of the property. As she is not registered for GST, Amy will not be able to claim the GST back as an input tax credit.

If distributions of assets are being contemplated, the GST registration status of the proposed beneficiaries should be reviewed. In the above example, if Amy had registered for GST and was acquiring the investment property for commercial rental (i.e., a creditable purpose) then the distribution by the trust would not fall within the provisions of Division 72 of the GST Act and would not be a taxable supply. (It should be noted that capital gains tax and stamp duty may still apply to the distribution.)

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SECTION 10(G): RESTRUCTURING FOR SUCCESSION PLANNING

[10 700] Introduction

Sometimes the existing business structure is not suitable for the succession plan, and the succession planner needs to consider how to restructure with minimal costs in terms of income tax, capital gains tax, stamp duty, and GST.

The opportunities to move assets from one legal owner to another without these costs are, deliberately, limited; even more so since the government amended the tax legislation to prevent ‘‘cloning of discretionary trusts’’.

Any arrangement designed to move the ownership of assets without tax has to be considered in the light of the general anti-avoidance provisions of Part IVA of ITAA36.

[10 710] Demergers

Where two (or more) business units are operated by one company, it may be desirable for the units to be separated. It may be that siblings currently operate both businesses jointly and are conflicting so greatly, that it is effecting the performance of one or both businesses.

With great caution, you may wish to consider a demerger arrangement, in which a new subsidiary of the existing company is incorporated. The two companies then form a tax-consolidated group and one of the businesses is transferred to the subsidiary. The transfer of the business between the two companies is disregarded for tax purposes because the tax-consolidated group is regarded as one entity. In exchange for the business, the subsidiary issues new shares to the first company.

At that point the businesses have been separated but the first company still owns the subsidiary and therefore, effectively, the business that has been transferred to the subsidiary. The next step is for the first company to demerge the subsidiary.

This could be effected by transferring the shares in the subsidiary to the shareholders of the first company. This is effectively in exchange for part of their interests in the first company, and may be sourced from a combination of a return of capital and a dividend from the first company.

Division 125 of ITAA97 provides CGT relief for demergers. Under these provisions, the shareholders can elect to defer any capital gain that would otherwise result from the capital reduction in the first company. The cost base of their shares in the first company is then apportioned across the shares in the first company and the new company on the basis of market value. Also, any gain made by the first company in disposing of the shares in the new company is disregarded.

In regard to the dividend component of the value of the shares in the new company, a demerger dividend is treated as non-assessable, non-exempt income under Section 44 of ITAA36 (this is income which is both excluded from taxable income and does not affect available losses). However, there are integrity rules in Section 45B of ITAA36 which limit taxation relief for a demerger dividend where the Commissioner considers there is a scheme that has the purpose of obtaining the non-assessable income status for the dividends. The Commissioner’s practice statement, PSLA 2005/21, makes it clear

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that any purpose other than improving the business could bring Section 45B into operation. Some commentators believe that the demerger dividend relief was never intended to benefit private businesses. However, the Commissioner gives examples in PSLA 2005/21 of the demerger of private businesses that would not attract the operation of Section 45B. These examples are of demergers which benefit the businesses involved by allowing them to separately raise capital, pursue different growth opportunities, and improve management.

In order for a demerger dividend to be non-assessable, at least 50% of the new company's CGT assets must be used in carrying on business. Therefore, passive assets may be best left in the first company.

When the new company is demerged, you need to consider that CGT Event L5 may apply as the company leaves the tax-consolidated group, where its liabilities exceed the tax cost of its assets at that point.

You also need to consider that stamp duty may apply to the transfer of assets and in some jurisdictions, to the transfer of shares (see **[10 600]**).

If a demerger is conducted in the context of a succession plan, even where it is for the benefit of the business, the danger is that the Commissioner could apply Section 45B on the basis that the purpose of the demerger is to facilitate the succession plan, and thereby disallow the tax exemption for the demerger dividend.

Therefore, ideally, any restructuring should be conducted as far away as possible from a succession (or sale) event. An application for a private binding ruling should be made to the Commissioner prior to undertaking the demerger, setting out the purpose of the restructure, and seeking his opinion on the possible application of Section 45B of ITAA36. If a favourable response is received, you are then able to proceed with the demerger, having minimised the risk of costly tax consequences.

EXAMPLE [10 710]

Joe and Danila operate a family company with their sons Tony and Nick. The company manufactures sun-dried tomatoes which are sold direct to delicatessens. The business has been operating for 10 years, and has reached a turnover of $10m. Tony has built the turnover through his network in the deli industry. Two years ago the company established a food distribution business, under the direction of Nick, buying sun-dried tomatoes and olives from other food manufacturers and on-selling these to delis, restaurants and catering businesses. The company invested $3 million on refrigerated vehicles.

The distribution business has not developed as quickly as was hoped. Tony did not agree with the decision to make a major investment in the new enterprise, and will not approve a further investment in the marketing plan Nick has proposed.

Tony believes that the sun-dried tomato business is suffering because the distribution business is selling into the same market. Tony wishes to raise capital to buy additional dryers for the tomatoes but Nick wants to buy additional facilities for the distribution business.

The arguments between Tony and Nick are getting worse, staff do not know who to take direction from, and senior managers have threatened to leave rather than get caught between the conflicting brothers. Joe and Danila are convinced that the only way that the two businesses will prosper is for them to be separated – with separate boards and separate finance facilities.

They decide to demerge the businesses and apply to the Commissioner for a private binding ruling in relation to the possible application of Section 45B to the resulting demerger dividend. Assuming that the Commissioner issues a favourable ruling on the basis that the demerger is for the purpose of improving the operations of the two businesses, the demerger would proceed as outlined below.

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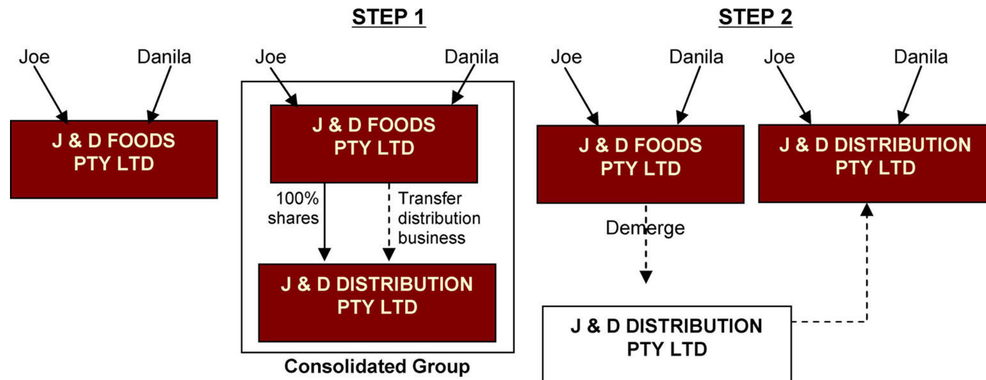

Prior to the demerger, the net value of J & D Foods Pty Ltd is $5m, made up as follows:

	Total
Paid up capital (original issues to Joe & Danila)	500,000
Accumulated profits/reserves	4,500,000
Value of shares	5,000,000

Step 1 A new company, J & D Distribution Pty Ltd, is formed which issues $10 of shares to J & D Foods Pty Ltd, making it a 100% owned subsidiary. The two companies elect to form a tax-consolidated group. The net assets of the distribution business are transferred to J & D Distribution Pty Ltd. They are valued at $1.5m. In exchange for the assets, J & D Distribution Pty Ltd issues a further $1.5m in shares to J & D Foods Pty Ltd.

Step 2 J & D Foods Pty Ltd transfers its shares in J & D Distribution Pty Ltd equally to Joe and Danila. This distribution is worth $1.5m and is made up of:

Return of paid up capital	150,000
Demerger Dividend	1,350,000
	1,500,000

Under the CGT demerger provisions Joe and Danila can elect to defer the capital gain from the capital reduction. The cost base of their $500,000 of shares in J & D Foods Pty Ltd is apportioned as:

Shares in J & D Foods Pty Ltd	350,000
Shares in J & D Distribution Pty Ltd	150,000
	500,000

All of the CGT assets of J & D Distributions Pty Ltd are business assets and therefore the requirement for at least 50% of its CGT assets to be used in carrying on the business has been met. On the basis that a favourable private binding ruling in regard to the application of Section 45B of ITAA36 has been received from the Commissioner, the demerger dividend will be treated as non-assessable, non-exempt income under Section 44 of ITAA36.

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When J & D Distribution Pty Ltd is demerged and leaves the tax-consolidated group, the tax costs of its assets exceed its liabilities (largely because there is little internally generated goodwill). Therefore CGT event L5 will not apply to produce a taxable gain on the exit from the group. Although the business of J & D Distribution Pty Ltd is in Victoria, it will have to pay stamp duty in some other states where it has made sales over the last two years (see **[10 600]**).

Depending on how the businesses operate after the demerger, and how Nick and Tony perform in managing the respective companies, Joe and Danila may decide to leave the shares in J & D Foods Pty Ltd to Tony and the shares in J & D Distribution Pty Ltd to Nick in their wills, or even transfer them prior to their deaths.

[10 720] Trust cloning and CGT rollover for transfer of assets between trusts

In recent years "trust cloning" arrangements have been used to facilitate succession planning. These arrangements accessed a CGT exemption for the transfer of assets between two trusts with the same terms and beneficiaries. This enabled assets to be transferred from one trust, usually a discretionary trusts, to another, without incurring CGT and then, at some point in the future, changing control of the trusts in favour of different successors.

Under the proposed legislation, the CGT trust-cloning exemption will be removed effective from 31 October 2008, and from that date a new limited CGT rollover will be introduced (Subdivision 126-G of ITAA 97) in relation to the transfer of an asset from one trust to another trust where:

- both trusts have the same beneficiaries with the same entitlements;
- both trusts have no material discretionary elements; and
- the receiving trust is a "clean skin": i.e., it is a newly created trust or is a trust with no CGT assets other than a small amount of cash or debt.

Therefore, the rollover will not apply to discretionary trusts. Its application will be to fixed trusts, which in practice will most commonly be unit trusts without any discretionary units.

Interests in the trust cannot be defeated

In order for the rollover to apply, each interest held by a beneficiary in each of the trusts must be an interest in, or a right relating to, the income and/or capital of the trust; the nature and extent of which must be able to be determined solely by reference to the trust deed. For example, this requirement would not be met if different beneficiaries have interests in the income and capital of the trust and the trustee has a discretion that allows it to characterise receipts and outgoings as being on either income or capital account. On the other hand, the requirement will be met where the beneficiary holds units in a unit trust which have rights under the trust deed to a proportionate share of the income and capital of the trust, based on the number of units on issue.

The rollover is not available if the interests of the beneficiary can be defeated; in particular, no entity can have the power to:

- materially alter the beneficiary's membership interest in the trust; or
- issue or redeem membership interests in the trust at a discount of more than 10% of their market value.

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Examples of such powers are:

- a power to appoint new beneficiaries;
- a power to issue new interests with rights that effectively change the rights attached to interests already on issue; and
- a power to amend the trust deed to include a power that is capable of materially altering a beneficiary's membership interests.

Where the rollover is being contemplated as a part of the succession plan, the trust deed of the original trust should be carefully reviewed to ensure that these requirements are met and, if not, consideration should be given as to whether amendments to the deed are required prior to the creation of the new trust, and the transfer of assets to the new trust.

Careful consideration should also be given as to whether any amendments that are required could cause a trust resettlement (see **[10 430]**) and whether they are desirable in regard to the future operation of both trusts.

Trust must make the same tax choices

In order for the rollover to apply, both trusts must have the same tax choices (or elections) in force just after the transfer. This applies to any choice made under the tax laws where the absence of the same choice in the other trust would, or could, have an ongoing impact on the calculation of any entity's net income or taxable income. An example of such a choice is a family trust election. Therefore, if the transferring trust has made a family trust election, then the receiving trust must make the same election.

Tax consequences for the trusts

In order to access the rollover, the trustees of both trusts must choose the rollover. As a result of making the choice, any capital gain or capital loss made by the trustee of the transferring trust, in relation to the transferred asset, is disregarded.

The cost base of the asset in the hands of the receiving trust will be the asset's cost base in the hands of the transferring trust just before the transfer. If the transferring trust acquired the asset before 20 September 1985, the receiving trust will also be taken to have acquired the asset before 20 September 1985.

Tax consequences for beneficiaries

Beneficiaries will be required to adjust the cost base of their interests in both trusts. The cost base of interests in the transferring trust will be a proportion of the total of the cost base of interests in the transferring trust just before the transfer. The proportion is to be based on the market value of membership interests in both trusts just after the transfer. The remaining proportion of the cost bases of those interests is added to the cost base of the interests in the receiving trust.

Beneficiaries are deemed to have acquired their interests in the receiving trust at the time of the transfer. However, where interests in the transferring trust were acquired before 20 September 1985, the interests in the receiving trust will be taken to have been acquired before 20 September 1985.

For the purposes of the CGT discount, the ownership of interests in the receiving trust will include the period of ownership of the interest in the transferring trust.

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Application of rollover in succession planning

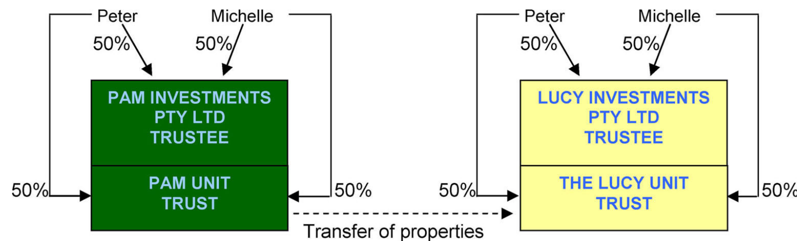
This rollover may be useful for asset protection; for example, by facilitating the separation of investments from the business by transferring either the business or the investments to a new trust. Its value for succession planning will be limited, but nevertheless may be useful in certain circumstances.

EXAMPLE [10 720]

Peter and his wife Michelle own the units in the PAM Unit Trust. The unit trust has no discretionary elements. The unit trust operates the family business and also owns two investment properties.

Peter and Michelle would like to be able to ultimately transfer the business to their daughter Kate, who works in the business, and the investment properties to their daughter Lucy who does not work in the business.

They decide to establish a new unit trust with the same terms as the PAM Unit Trust, and transfer the two investment properties to the new unit trust. They choose, for CGT rollover relief, to apply to the transfer as the properties have inherent capital gains of $800,000.



The value of the PAM Unit Trust prior to the transfer of the properties is:

Net business value	1,500,000	60%
Investment properties	1,000,000	40%
Total value	2,500,000	

Peter and Michelle originally invested in 500,000 units of $1.00; i.e., $250,000 each, in the PAM unit trust. The increase in value of their units has largely resulted from capital appreciation of the properties, and the goodwill of the business.

PAM Investments Pty Ltd as trustee for the PAM Unit Trust transfers the properties to Lucy Investments Pty Ltd as trustee for the Lucy Unit Trust. Both trusts choose, for the CGT rollover relief, to apply in their tax returns for the year in which the transfer took place. As a result of choosing the rollover:

- The capital gain inherent in the properties is disregarded;
- The Lucy Unit Trust is taken to have a cost base for the properties equal to their cost base to the PAM Unit Trust, ie $200,000; and
- The cost base of Peter's and Michelle's interests in the PAM Unit Trust will be reduced and allocated to their units in The Lucy Unit Trust as follows:

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	Original Unit Cost Base		*PAM Proportion of Market Value*	*Cost base PAM units*	*Cost base Lucy units*
	No.	*$*			
Peter	250,000	250,000	60%	150,000	100,000
Michelle	250,000	250,000	60%	150,000	100,000
		500,000		300,000	200,000

If Peter and Michelle later transfer the units in the first trust to Kate, and the second trust to Lucy, they will make taxable capital gains based on the allocated cost base of the units.

However, the use of the rollover has allowed them to leave the units in each trust to their respective daughters in their wills, thereby providing the daughters with effective separate ownership of the properties and the business. No CGT is payable on death, and therefore CGT will be deferred until Kate and Lucy sell the units or the assets of their respective trusts. They will take over their parents' cost base in respect of the units.

It should be noted that stamp duty would apply to the transfer of the properties from one trust to another, and GST may also apply unless the "going concern" exemption applies to the leasing activities of the properties.

The rollover may also be useful where the units are held by a discretionary trust. While both the transferring trust and the receiving trust would still be owned by the same discretionary trust, and therefore a transfer of ownership to successors could not be effected tax-free through a will, the restructure could allow the units in one trust to be transferred by the discretionary trust to a successor for a lower tax cost than a sale of assets out of the unit trust.

For example, the rollover may enable access to the small-business CGT concessions in relation to a transfer of units in the unit trust which owns the business, where the ownership of non-active assets, e.g., investment properties, has prevented the units from passing the active asset test (see **[10 210]**). Although the unit trust may be able to access the CGT discount and the small-business CGT concessions, the application of CGT event E4 on distribution of the non-assessable active asset exemption would result in a partial claw back of that exemption (see **[10 210]**). Such a claw back would not occur on a transfer of the units by the discretionary trust.

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