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Advice Essentials Rollovers Roundup

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March 2019

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1. Introduction – why rollover?

1.1 Company structures are the new black

One of the most asked questions when starting a new business venture is *what is the correct business structure?* While every business is unique and there is no blanket answer, the dominant trend for a number of years now has been to put businesses into company structures.

There are many reasons why companies are the preferred structure, including:

- (a) it is easier for an investor to inject capital into a company;
- (b) key employees may 'buy-in' to the business as part of the owner's exit strategy;
- (c) the business may be sold with considerably less transaction costs via the transfer of shares as:
 - (i) transfer duty will not apply provided the company is not land-rich (in some States);
 - (ii) the company continues to operate the business with minimal administrative costs, as there is no need to obtain a new ABN, bank accounts, contracts, and no need to transfer property etc.;
- (d) profits are taxed at the corporate rate of 30%; and
- (e) shareholders have no tax obligations until the company funds are paid out as either loans or dividends.

1.2 Buying shares in a company

In the past, lawyers, accountants and financial advisers alike have been reluctant to recommend their clients purchase shares in a company due to the risk vested in that company and the director's previous dealings. Although these risks can be addressed with well drafted indemnities and investigated in a rigorous due diligence process, it is impossible to guarantee that there will be no future contingent claims.

Also, if the company has unrealised capital gains, balancing adjustments and retained profits at the time of purchase, the buyer will have to deal with the realised gains and additional dividends post sale.

Despite these risks, there are great advantages for a buyer in acquiring shares in a company, including:

- (a) the buyer will not pay transfer duty (in certain States);
- (b) certain assets will be able to be acquired easier than if the asset was held in another structure e.g. in a trust;
- (c) the transfer of shares provides a better tax outcome for the seller than if the assets were sold directly, e.g. intellectual property;
- (d) continuity of contracts (e.g. customer contracts, leases, licenses, employment contracts);
- (e) continuity of business (e.g. customers receive invoices from the same company, suppliers continue to invoice the same company).

The question the buyer must ask is whether the risk of acquiring the company's liabilities, especially its unknown liabilities, outweigh the benefits.

For those companies which are not land rich, buyers are more willing to purchase shares. The reason being that there are significant transfer duty savings, especially for large-scale transactions, rather than paying duty on a transfer of business assets.

1.3 Restructuring and rollovers

A business owner may benefit from a restructure if their business and/or business assets are currently in a structure that they have outgrown. Some circumstances in which a restructure might be required include:

- (a) the structure does not provide adequate asset protection;
- (b) there are non-business assets held by a trading entity;
- (c) there are valuable business assets that should be separated from the trading entities for asset protection purposes;
- (d) there is more than one trading activity operating from the same structure;
- (e) there is an intention to attract investors to the business; or
- (f) taxation considerations.

In cases where a business may benefit from a restructure it may be eligible to apply for one of many rollovers or concessions available under the *Income Tax Assessment Act 1997* (Cth) (**ITAA97**).

Some of these rollovers which we will discuss in this paper are:

- (a) Subdivision 122-A (individual or trustee to company);
- (b) Subdivision 122-B (partnership to company);
- (c) Subdivision 124-N (unit trust to company);
- (d) Subdivision 124-M (scrip for scrip rollover);
- (e) Subdivision 328-G (small business restructure rollover); and
- (f) Division 615 (inserting a holding company between shareholders and another company).

2. Subdivision 122-A: Individual or trustee to a company

Subdivision 122-A allows an individual or trustee to apply a rollover on the transfer of its business assets to a company.

2.1 Requirements to be satisfied

The following conditions must be satisfied:

- (a) if consideration is received by the individual or trustee for the transfer of the assets, it must only consist of shares in the company or the company taking over the obligations to pay liabilities in relation to the assets;
- (b) the shares must not be redeemable shares;
- (c) the individual or trustee must own all of the shares in the new company following the transfer;
- (d) the market value of the shares which are received must be substantially the same as the market value of the assets transferred less any liabilities assumed;

- (e) either:
 - (i) the individual or trustee and the new company are Australian residents; or
 - (ii) each asset and the shares in the new company must be taxable Australian property;
- (f) an individual or trustee cannot obtain a rollover for *an asset* if the CGT asset is:
 - (i) a collectable or personal use asset;
 - (ii) a decoration awarded for valour or brave conduct unless the individual or trustee has paid money or given property for it;
 - (iii) a precluded asset, which is defined as a depreciating asset, trading stock or an interest in the copyright in a film; or
 - (iv) an asset that becomes trading stock of the company just after the disposal;
- (g) if the individual or trustee transfers *all of the assets* of the business to the company, it cannot obtain a rollover for an asset that it transfers, if the CGT asset is:
 - (i) a collectable or personal use asset;
 - (ii) a decoration awarded for valour or brave conduct unless the individual or trustee has paid money or given property for it; or
 - (iii) an asset that becomes trading stock of the company just after the disposal unless it was trading stock when the trustee disposed of it.

2.2 CGT Consequences of rollover for the individual or trustee

The individual or trustee disregards any capital gain on the transfer of the CGT assets.

If all of the transferred assets were acquired by the individual or trustee pre-CGT then the individual or trustee is taken to have acquired all of the shares issued in the company as consideration pre-CGT.

If all of the transferred assets were acquired by the individual or trustee post-CGT:

- (a) the individual or trustee is taken to have acquired all of the shares issued in the company as consideration post-CGT; and
- (b) the cost base of those shares will be equal to the market value of the precluded assets plus the cost base of the other assets less any assumed liabilities.

If some of the transferred assets were acquired by the individual or trustee pre-CGT and some post-CGT, some of the shares will be taken to be acquired pre-CGT:

- (a) the individual or trustee is taken to have acquired a whole number of shares that does not exceed the following percentage of the shares in the company pre-CGT:
 - (i) the total market value of pre-CGT assets (except any precluded assets) less any liabilities assumed in relation to those assets; and
 - (ii) the total market value of all assets less any liabilities assumed in relation to those assets;

- (b) the cost base of the post-CGT shares will be equal to the market value of the precluded assets plus the cost base of the other assets acquired post-CGT less any assumed liabilities.

2.3 CGT Consequences for the company

If the individual or trustee acquired the asset pre-CGT, the company is taken to have acquired the asset pre-CGT.

If the individual or trustee acquired the asset post-CGT:

- (a) the company is taken to have acquired the asset post-CGT;
- (b) the company takes on the individual's or trustee's cost base of the CGT assets.

2.4 Consequences of Division 40 of ITAA97

Ordinarily, the individual or trustee would have a balancing adjustment equal to the difference between the market value of the depreciating asset and the written down value.

However, there is an automatic rollover relief under section 40-340 of the ITAA97 on the disposal of an asset to a wholly-owned company if the rollover relief conditions in Subdivision 122-A would be satisfied.

For the purpose of the rollover relief under Division 40:

- (a) the fact that a depreciating asset is a precluded asset for the purposes of Subdivision 122-A is ignored;
- (b) there is no requirement that the individual or trustee chooses to apply the rollover under Subdivision 122-A;
- (c) the individual or trustee will disregard the balancing adjustment; and
- (d) the company depreciates the asset using the same method and effective life as the individual or trustee.

3. Subdivision 122-B: partnership to a company

Similarly to Subdivision 122-A, Subdivision 122-B allows all of the partners in a partnership to apply a rollover on the transfer of its business assets to a company.

3.1 Requirements to be satisfied

The same conditions set out in paragraph 2.1 above apply, with the following differences:

- (a) there must be a partnership; and
- (b) the partners must own the shares in the same capacity that they owned their interest in the assets of the partnership.

3.2 CGT Consequences of rollover for partners

The consequence for each partner is the same as those set out in paragraph 2.2 above.

3.3 CGT Consequences of rollover for the company

The consequences for the company are:

- (a) the same as those set out in paragraph 2.3 above; and

- (b) if some partners acquired their interest pre-CGT and some post-CGT, then:
 - (i) the company is taken to have acquired two separate assets:
 - (A) one representing the extent to which the partners' interests in the original assets were acquired pre-CGT: in which case the company is taken to have acquired that asset pre-CGT; and
 - (B) one representing the extent to which the partners' interest in the original assets were acquired post-CGT: in which case the company is taken to have acquired the asset post-CGT;
 - (ii) the cost base of the post-CGT assets is the sum of the cost bases of the partners' interests which were acquired post-CGT.

3.4 Consequences of Division 40 of ITAA97

The same consequences as set out in paragraph 2.4 above.

4. Subdivision 124-N: unit trust to company

If a business is operated via a unit trust and the unitholders would like to restructure into a company structure, they may be eligible to apply one of the following:

- (a) Subdivision 122-A rollover as outlined above; or
- (b) Subdivision 124-N rollover.

Subdivision 122-A requires that the unit trust be the only shareholder of the company. The unitholders will therefore indirectly own their shares in the company via their units in the unit trust. This may be problematic for some business owners, as:

- (a) the unit trust will need to be a fixed trust to pass on the franking credits; and
- (b) if a unitholder wishes to exit, there is less flexibility compared to if they were a direct shareholder of the company.

Subdivision 122-N, on the other hand, allows the unitholders to own the shares in the company directly.

4.1 Requirements - Subdivision 124-N

The following conditions must be satisfied:

- (a) all assets of the unit trust must be transferred to the company within the trust restructure period, i.e. six months from the date of the first transfer of the assets;
- (b) the company must:
 - (i) never have carried on commercial activities;
 - (ii) not have any CGT assets other than small amounts of cash or debt; and
 - (iii) not have any losses of any kind;
- (c) after the restructure:
 - (i) the unitholders must own shares in the company in the same proportion as their unit holding in the unit trust; and

- (ii) the market value of the shares each unitholder owns in the company must be substantially the same as the market value of their units in the unit trust;
- (d) both the unit trust and company must choose the rollover.

4.2 Tax consequences for the unitholders

The cost base of the units become the cost base of the shares and the unitholders can disregard any capital gain on the cancellation of their units¹.

4.3 Tax consequences for the unit trust and the company

The unit trust ignores any capital gain on the transfer of the CGT assets² and any balancing adjustment on the transfer of plant and equipment³.

The company takes on the cost base of the CGT assets and adjustment value (written down value) of the depreciating assets.

5. Subdivision 124-M: Scrip for Scrip Rollover

Subdivision 124-M allows an entity to apply a rollover on the transfer of post-CGT shares or trust interests for other shares or trust interests.

This rollover is not only available if the shareholders in the original company could have applied a rollover pursuant to Subdivision 122 or Division 615⁴.

5.1 Requirements for satisfaction

The following conditions must be satisfied:

- (a) the shareholder exchanges a share in a company for a share in another company;
- (b) the exchange is a single arrangement which results in:
 - (i) the acquiring company that is:
 - (A) not a member of a wholly-owned group becomes the owner of 80% or more of the voting shares in the original company; or
 - (B) a member of a wholly-owned group increasing the percentage of voting shares that it owns in the original company, and that company or member of the group becomes the owner of 80% or more of those shares;
 - (ii) the arrangement must be one in which at least all owners of voting shares in the original company could participate; and
 - (iii) the arrangement must be one in which participation was available on substantially the same terms for all of the owners of shares of a particular type in the original company;
- (c) the shareholder acquired the original shares post-CGT;

¹ section 124-870 ITAA97

² section 124-875(1) ITAA97

³ section 40-340 ITAA97

⁴ section 124-795 ITAA97

- (d) if not for the rollover, the shareholder would make a capital gain;
- (e) the new share is in a company that is:
 - (i) the acquiring company; or
 - (ii) the ultimate holding company of the wholly-owned group;
- (f) the shareholder:
 - (i) chooses to obtain the rollover; or
 - (ii) if the shareholder is a significant stakeholder or common stakeholder, the shareholder and company jointly choose to obtain the rollover;
- (g) if the shareholder is a significant stakeholder or common stakeholder, the shareholder must inform the acquiring company in writing of the cost base of its original shares just before a CGT event;
- (h) if the scrip for scrip restructure is not undertaken at arm's length, and both the original and acquiring companies do not have at least 300 members, then:
 - (i) the capital proceeds issued to the shareholders must be at least substantially the same as the market value of their original shareholding; and
 - (ii) replacement shares must carry the same kind of rights and obligations as those attached to the original shares.

5.2 CGT consequences for the shareholder

The capital gain on the shareholder's original share is disregarded, if there are no ineligible proceeds. There will be a partial rollover if the capital proceeds for the original shares include ineligible proceeds, i.e. something other than the replacement shares. The cost base of the replacement share is worked out by reasonably attributing the cost base of the original share to the replacement share. However, the cost base of the original share must first be reduced by the amount that is attributable to the ineligible part.

5.3 CGT consequences for the acquiring company

If there is a significant stakeholder or common stakeholder involved, the cost base of the shares acquired by the acquiring company will be equivalent to the cost base of the shares that the shareholders had in the original company.

6. Division 615: Inserting a holding company between shareholders and another company

Division 615 allows a trading company to insert a holding company between the shareholders and the trading company, utilising the capital gains tax rollover relief. This is a common strategy for trading companies that have significant assets and retained earnings that are exposed to business risk.

Subdivision 122-A can also be utilised for circumstances where the one person owns all the shares in the holding company. Whereas, Division 615 allows two or more persons to be shareholders of the holding company. We will be reviewing Division 615 only in this part of the paper.

The strategy of interposing a holding company and declaring dividends from the trading company provides asset protection benefits for the group, and then the holding company can lend funds back to the trading company or to shareholders.

6.1 Requirements to be satisfied

- (a) The following conditions must be satisfied:
- (i) the shareholder and at least one other entity own all of the shares in a company;
 - (ii) the shareholders dispose of all of the shares to the holding company in exchange for shares in the holding company and nothing else;
 - (iii) the holding company must own all of the shares in the company immediately after all of the shareholders have transferred their shares in the company.
- (b) Immediately after, each shareholder must own:
- (i) a whole number of shares in the holding company;
 - (ii) the percentage of shares in the holding company must be the same as the percentage of the shares in the company; and
 - (iii) all of the shares in the holding company must be owned by the shareholders.
- (c) The following ratios must be equal:
- (i)

the market value of each shareholders' shares in the holding company	:	the market value of the shares in the holding company issued to all the shareholders immediately after
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 - (ii)

the market value of that shareholders' shares in the company	:	the market value of the shares in the holding company issued to all the shareholders immediately after
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- (d) Either:
- (i) the shareholder is an Australian resident at the time their shares in the company are disposed; or
 - (ii) the shares in the original company and the holding company are taxable Australian property.
- (e) The shares must not be redeemable shares.
- (f) The holding company must make one of the following choices:
- (i) if the company was the head company of a consolidated group, then the holding company must make a choice that the consolidated group continues within 28 days;
 - (ii) if the company was not a head company, the holding company must make a choice that section 615-65 of the ITAA97 applies within 2 months.

- (g) The choice cannot be revoked.
- (h) The way the holding company prepares its income tax return is sufficient evidence of the making of the choice.

6.2 CGT consequences of rollover for shareholders

The shareholder disregards any capital gain on the transfer of the shares in the company.

If the shareholder acquired the shares in the company pre-CGT, then the shares issued in the holding company will be taken to be pre-CGT.

If the shareholder acquired the shares in the company post-CGT, then:

- (a) the shares issued in the holding company will be post-CGT; and
- (b) the first element of the cost base of each of the shares in the holding company will be calculated as follows:

$$\frac{\text{Cost base of the shares in the company}}{\text{Number of shares issued in the holding company}}$$

Number of shares issued in the holding company

If the shareholder acquired some of the shares pre-CGT and some of the shares post-CGT, the whole number of shares in the holding company which are pre-CGT will be the amount which does not exceed the following calculation:

$$\frac{(\text{Number of shares issued in the holding company} \times \text{Number of pre-CGT shares in the original company})}{\text{Number of shares in the original company}}$$

Number of shares in the original company

If the above calculation is less than one, then none of the shares in the holding company will be taken to be acquired pre-CGT.

The remaining number of shares in holding company will be post-CGT shares. The first element of the cost base of each of the post-CGT shares in the holding company will be calculated as follows:

$$\frac{\text{Cost base of the post-CGT shares in the company}}{\text{Number of post-CGT shares issued in the holding company}}$$

Number of post-CGT shares issued in the holding company

6.3 CGT consequences for the holding company

If any of the company's assets were acquired pre-CGT, then the number of shares which the holding company acquires which will be taken to be acquired pre-CGT is the greatest possible whole number that does not exceed the following calculation:

The market value of the company's assets acquired pre-CGT less its liabilities in respect of those assets; expressed as a percentage of the market value of all the company's assets less all of its liabilities

The first element of the cost base is of the holding company's shares in the company that are post-CGT shares is calculated as follows:

The total cost bases of the company's assets that it acquired post-CGT less its liabilities in respect of those assets

7. Subdivision 328-G: Small business restructure rollover

Subdivision 328-G provides small business entities (**SBE**) with the opportunity to choose to rollover for gains and losses arising from the transfer of business assets – including CGT assets, depreciating assets, trading stock or revenue assets – as part of the restructure of a small business.

7.1 Requirements to be satisfied

We provide a summary of the requirements in the following table:

1	Genuine restructure of an ongoing business: <ul style="list-style-type: none">(a) genuine restructure;(b) safe harbor rule.
2	Both transferor and transferee must satisfy SBE requirement: <ul style="list-style-type: none">(a) be an SBE;(b) be 'connected to' or have an 'affiliate' which is a SBE;(c) be a partner in a partnership which is a SBE.
3	Active asset at time of transfer. If the SBE is a 'connected entity', 'affiliate' or partnership then the asset must be used by the SBE.
4	No change in ultimate economic ownership: <ul style="list-style-type: none">(a) trace through to individual owners;(b) special rule for discretionary trusts.
5	Both transferor and transferee must be Australian residents for tax purposes
6	Both transferor and transferee must choose to apply the small business restructure rollovers.

7.2 Consequences for the transferor

The transferor will disregard tax consequences on CGT assets, revenue assets, depreciating assets and trading stock including Division 7A implications where the transferor is a company.

7.3 Consequences for the transferee

The transferee:

- (a) acquires assets for their rollover cost (no uplift in cost base);
- (b) retains pre-CGT status; and
- (c) for the 15-year exemption, the asset is deemed to be acquired when the transferor acquired it.