# *LCG 2016/D3 - Small Business Restructure Roll over: genuine restructure of an ongoing business*

Draft Law Companion Guideline

# LCG 2016/D3

Page status: **draft only – for comment**

# Small Business Restructure Roll-over: genuine restructure of an ongoing business

**Relying on this draft Guideline**

This draft Guideline describes how the Commissioner will apply the law as amended by the Tax Laws Amendment (Small Business Restructure Roll-over) Act 2016. This draft Guideline will, subject to consultation, be finalised as a public ruling when the Act comes into effect to entities that rely on the Guideline in good faith.

If you rely on a Law Companion Guideline in good faith (to the extent it is a public ruling), you will not have to pay any underpaid tax, penalties or interest in respect of matters covered by the Guideline if it does not correctly state how a relevant provision applies to you.

**Table of Contents** **Paragraph**

## What this draft Guideline is about

1. This draft Guideline explains the meaning of '*genuine restructure of an ongoing business'* as the term is used in Subdivision 328-G of the *Income Tax Assessment Act 1997* (ITAA 1997)[1].

2. It discusses the features that indicate that a restructure falls within the scope of that term, and those features that indicate that the restructure falls outside.

## Proposed date of effect

3. This draft Guideline when finalised will apply to transfers that occur on or after 1 July 2016 which involve:

(a) a balancing adjustment event for a depreciating asset,

(b) trading stock or a revenue asset or

(c) a capital gains tax (CGT) event in respect of a CGT asset (that is not a depreciating asset, trading stock or a revenue asset).

[1] Unless otherwise indicated, all legislative references in this Guideline are to the ITAA 1997 as amended by the Tax Laws Amendment (Small Business Restructure Roll over) Act 2016.

## Genuine restructure

4. The small business restructure rollover (SBRR) can apply to transactions that are, or are part of, a 'genuine restructure of an ongoing business'.[2]

5. Whether a transaction is or is part of a 'genuine restructure of an ongoing business' is a question of fact that is determined having regard to all of the circumstances surrounding the restructure.

6. A 'genuine restructure of an ongoing business' is one that could be reasonably expected to deliver benefits to small business owners in respect of their efficient conduct of the business going forward. It is a composite phrase emphasising that the SBRR is *not* available to small business owners who are restructuring in the course of winding down or realising their ownership interests.

7. The following features indicate that a transaction is, or is part of, a 'genuine restructure of an ongoing business':

- It is a bona fide commercial arrangement undertaken in a real and honest sense to
  - facilitate growth, innovation and diversification
  - adapt to changed conditions, or
  - reduce administrative burdens, compliance costs and/or cash flow impediments.
- It is authentically restructuring the way in which the business is conducted as opposed to a 'divestment' or preliminary step to facilitate the economic realisation of assets.
- The economic ownership of the business and its restructured assets is maintained.
- The small business owners continue to operate the business through a different legal structure. For example, there is
  - continued use of the transferred assets as active assets of the business
  - continuity of employment of key personnel
  - continuity of production, supplies, sales, or services.
- It results in a structure likely to have been adopted had the small business owners obtained appropriate professional advice when setting up the business.

8. The Commissioner acknowledges that tax considerations are factors that can be taken into account under a genuine small business restructure. For example, a sole trader subject to the highest marginal rate moving to a company structure to access the lower corporate tax rate.

9. However, this is not without limits. There are concerns where the restructure is contrived or unduly tax driven in the sense that it achieves a tax outcome that does not reflect the economic reality or creates an outcome that would, but for the SBRR, ordinarily attract other integrity measures in the law. For example, a restructure directed at eliminating an impending or existing tax liability, would indicate that a restructure is not a 'genuine restructure of an ongoing business'.

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[2] Paragraph 328-430(1)(a). The remaining paragraphs in subsection 328-430(1) set out further requirements for the SBRR to apply, including that the asset being transferred is an active asset, that the ultimate economic ownership of the asset does not materially change, and that the parties to the transaction both meet a residency requirement and choose for the SBRR to apply.

10. Other factors which tend to indicate that a restructure is not a 'genuine restructure of an ongoing business' include:

- where the restructure is a preliminary step to facilitate the economic realisation of assets
- where the restructure effects an extraction of wealth from the assets of the business (including accumulated profits) for personal investment or consumption or otherwise designed for use outside of the business
- where artificial losses are created or there is a bringing forward of their recognition
- the restructure effects a permanent non-recognition of gain or the creation of artificial timing advantages
- there are other tax outcomes that do not reflect economic reality.

11. The SBRR contemplates restructures to or from more than one entity. Accordingly, there may be circumstances where not all business assets that are necessary for the continued operation of an *'ongoing business'* are transferred. For example, small business owners may decide to transfer plant and equipment to a new entity, but leave real property in the original entity. On its own, this is not a factor that is inconsistent with the conclusion that a restructure is a 'genuine restructure of an ongoing business'.

## Genuine restructure – safe harbour rule

12. To provide certainty to small business owners, the SBRR contains a safe harbour rule[3]. This rule provides an alternative way of meeting the 'genuine restructure of an ongoing business' condition. It is satisfied if no significant assets, apart from trading stock, are disposed of, or used for private purposes, by the small business owners for three years after the transfer. Those assets must continue to be active assets of the business.

13. Where the safe harbour is satisfied, it is not necessary to consider whether the arrangement would otherwise be a 'genuine restructure of an ongoing business' under section 328-430(1)(a).

14. The safe harbour rule does not limit or expand what would otherwise be considered to be a 'genuine restructure of an ongoing business' in circumstances where the safe harbour requirement is not met.

15. The safe-harbour only operates to treat the restructure as being genuine for the purposes of paragraph 328-430(1)(a) and does not impact any consideration of the purpose and effect of the restructure for other tax purposes.

16. The general anti-avoidance rule in Part IVA of the *Income Tax Assessment Act 1936* (ITAA 1936) is a provision of last resort and is not prevented from applying in appropriate cases to restructures where the safe harbour is otherwise satisfied.

## Examples – What is a 'genuine restructure of an ongoing business'

### *Example 1: Asset protection*

*Facts*

17. Mark has been operating a small bookkeeping business and has branched out into financial planning after receiving his financial planning licence. Mark's business has grown significantly and his financial advice arm now generates much larger profits.

[3] See section 328-435.

18. After being sued by a client for negligent financial advice, Mark has decided he is not prepared to conduct his business on his own account.

19. Mark transfers his active assets used to carry on his financial planning business into a discretionary family trust. He and his wife are the beneficiaries and Mark is the primary individual specified in the family trust election in force in respect of the trust. For asset protection purposes, a corporate trustee is appointed and the trust contracts with clients. Mark does not personally provide guarantees or indemnities. Mark has also caused the trustee to employ other staff to service the larger client base. The trustee pays Mark and the other employees a salary commensurate to the services they provide to the business.

20. Mark and the trustee of the discretionary family trust choose to apply the SBRR.

*Relevant considerations*

21. Mark is transferring assets from the original entity (himself) to quarantine his business from his personal assets. This is a benefit to Mark in terms of his ability to grow the riskier operations and enhance its profits.

22. The evidence available supports Mark's claim of asset protection. Mark's asset protection strategy and commitment to expand his business is comprehensive and effective.

*Conclusion*

23. Mark has achieved benefits to the ongoing efficient conduct of his small business. The restructure is a response to his business needs, facilitates further growth and is not unduly tax-driven. The economic ownership of the business is maintained. Accordingly the 'genuine restructure of an ongoing business' condition is satisfied.

***Example 2: Maintaining essential employees***

*Facts*

24. Adrian carries on a business with his two siblings in a discretionary family trust. They are all beneficiaries of the trust and the family trust election specifies Adrian as the primary individual .The family business has several highly skilled, long-standing and trusted employees.

25. The family transfers the active assets to a company owned by Adrian and his two siblings. Sometime later, the company issues shares to those essential employees (who are not members of the 'family group[4]') with vesting conditions attached to provide incentives for their ongoing involvement in the business.

*Relevant considerations*

26. There is commercial advantage in restructuring to be able to provide incentives to essential employees.

27. Subsequent admission of employees as equity participants into the business is undertaken to enhance business performance and enable it to adapt to changed conditions in order to increase productivity and profit.

28. The company's conduct after the transfer of assets is appropriately taken into account when considering the genuineness of the restructure. Here, even if the issue of new shares to the employees after the time of asset transfer is not insignificant, there is no additional tax advantage to an existing shareholder, nor access to the worth of the shares.

[4] Section 272-90 of Schedule 2F to ITAA 1936.

*Conclusion*

29. Adrian and his siblings have achieved benefits to the ongoing efficient conduct of the business. The restructure is authentic in the way it changes the operation of the business going forward while maintaining continuity of use of the assets and of key personnel. Accordingly, this is a genuine restructure of an ongoing business.

### *Example 3: Raising new capital*

*Facts*

30. Melvin and Jenny operate a ‘mobile app development’ business in partnership and need new capital to fund a major expansion into new ventures.

31. A local investor, Steve, has expressed interest in making a capital contribution in return for an equity stake into the business, if suitable terms can be reached.

32. Melvin and Jenny transfer their active assets to a newly incorporated company where they each own shares in the same proportions as their interests in the partnership assets (50:50). If the SBRR is available, the business assets will be transferred from the partnership in a tax free manner.

*Relevant considerations*

33. Operating a business through a company more readily allows Melvin and Jenny to attract the necessary investors needed to facilitate expansion, innovation and diversification.

34. The potential new investment from Steve is not part of the restructure and will represent a fresh source of capital for the entity post restructure. On these facts the restructure is not a mechanism by which Melvin and Jenny are realising their interest in the business, which they continue to operate.

*Conclusion*

35. Restructuring in this manner provides benefits to Melvin and Jenny in their ongoing efficient conduct of the business. Melvin and Jenny are undertaking the arrangement to facilitate growth and innovation, and not as a preliminary step in divesting the business to Steve. Accordingly, this is a ‘genuine restructure of an ongoing business’.

36. However, the Commissioner will be concerned if Steve’s capital contribution is used to facilitate a divestment of the business, as this would be inconsistent with it being a ‘genuine restructure of an ongoing business’.

### *Example 4: Simplifying your affairs*

*Facts*

37. Trent, a cabinet maker, runs a business in a complicated legal structure where the active assets are held in a company and a trustee of a discretionary trust is the sole shareholder of the company.

38. Trent is the sole director of the company and also the primary individual specified in the family trust election in respect of the trust. When Trent established his business, his accountant thought this structure was suitable for Trent’s current and future circumstances.

39. However, Trent has no family members and he finds his yearly accountant fees are significant relative to his modest income.

40. Given the type of work Trent does, and his client base, he provides personal guarantees for all his work.

41. The active assets held by the company are transferred to Trent and the SBRR is claimed. The trust vests in the manner contemplated by its deed, and the company is wound up.

### *Relevant considerations*

42. The asset protection features of Trent's existing structure are minimal given Trent's practice and the commercial need to provide personal guarantees. Any benefits it offers can be seen to be outweighed by the costs and administrative complexity involved in dealing with his business affairs.

43. Trent has no family and a modest income. The legal structure he has is not fit for his purposes and there are many disadvantages to running his business through such a complex structure.

### *Conclusion*

44. Trent has achieved significant benefits to the ongoing efficient conduct of his business. On the evidence, the restructure has relieved Trent from additional outlays, and administrative and compliance burdens in running his business, and is a 'genuine restructure of an ongoing business'.

## Examples – What is *not* a 'genuine restructure of an ongoing business'

### *Example 5: Disposal of a business*

### *Facts*

45. Willing buyers are prepared to purchase a business carried on by You Beaut Pty Ltd. However, the buyers do not want to purchase the company shares because they are concerned about undisclosed liabilities.

46. Ben Silverfox is the sole shareholder of You Beaut Pty Ltd. He causes it to transfer its active assets to himself. You Beaut Pty Ltd and Ben Silverfox assert this transaction is a 'genuine restructure of an ongoing business'.

47. After 12 months have passed, Ben Silverfox disposes of the assets to the buyers. Ben Silverfox claims the general 50% CGT discount, which would not have been available to You Beaut Pty Ltd had it disposed of the assets directly to the buyers.

### *Relevant considerations*

48. Ben Silverfox disposes of the assets inside a three year period after the roll-over transaction takes place. Accordingly, Ben Silverfox cannot access the safe harbour rule in section 328-435. Therefore, whether this restructure is a 'genuine restructure of an ongoing business' under the ordinary meaning of that expression must be considered.

49. Ben Silverfox has no expectation of continuing to run his business on an ongoing basis after the transfer.

50. The restructure is not undertaken to enhance business efficiency in terms of facilitating growth, innovation or diversification. Rather, Ben Silverfox is attempting to use the relief provided by the SBRR to facilitate the economic realisation of his interest in the business.

51. Ben Silverfox's conduct before and subsequent to the transfer of assets forms part of the evidence taken into account when considering the genuineness of the restructure.

*Conclusion*

52. The SBRR is not available to You Beaut Pty Ltd and Ben Silverfox as these circumstances do not exhibit the hallmarks of a 'genuine restructure of an ongoing business'. This arrangement is undertaken as a preliminary step in the economic realisation of Ben Silverfox's business.

### *Example 6: Succession planning*

*Facts*

53. Nick owns all the shares in Holding Co a company that operates two restaurants, *Fish* and *Chips*. Nick has two sons and is looking to retire.

54. Nick causes the company to transfer the active assets relating to *Fish* to Gone Fish Inc a newly incorporated company that he also owns. The SBRR is claimed.

55. Sometime later, but within three years, Nick retires and disposes of the shares in the Holding Co (which now holds the active assets of *Chips* only) to his first son and the shares in the new company to his other son, so that each of them can run their own restaurants separately.

*Relevant consideration*

56. Because Nick retires and disposed of his companies within the three-year period after the transfer of the active assets, he cannot use the safe harbour rule. Therefore, whether this restructure is a 'genuine restructure of an ongoing business' must still be considered.

57. Nick is breaking up the business to enable a tax-effective inter-generational wealth transfer. He has no expectation of running his business going forward.

58. Nick's conduct subsequent to the transfer of assets forms part of the evidence that is taken into account when considering the genuineness of the restructure.

*Conclusion*

59. The SBRR is *not* available to Nick and Holding Co, as the restructure is undertaken in the course of him winding down and facilitating a wealth transfer as opposed to a bona fide restructure of an ongoing business.

### *Example 7: Extraction of wealth from the business assets*

*Facts*

60. Peterson Pauper is a successful business that has been operating through a trust (the Peterson Trust) since its commencement.

61. Each year, the trustee of the Peterson Trust has made its corporate beneficiary, Peterson Pty Ltd, presently entitled to the income of the Peterson Trust.

62. However, none of Peterson Pty Ltd's entitlements have been paid. Instead, the associated funds relating to the unpaid present entitlements (UPEs) have been retained for use in the Peterson Trust.

63. Patricia, the controller of the group, causes the Peterson Trust to satisfy Peterson Pty Ltd's UPEs with the transfer of its active assets to Peterson Pty Ltd. It is assumed that the *ultimate economic ownership* requirement is satisfied. In effect, the business is transferred to Peterson Pty Ltd, and the SBRR is claimed.

64. Peterson Pty Ltd in turn transfers those active assets to a newly established trust, the Patricia Family Trust, and the SBRR is claimed again. The Patricia Family Trust subsequently seeks to dispose those assets, and transfer any related proceeds to Patricia as a capital distribution.

*Relevant considerations*

65. The restructure of the business is undertaken as 'back-to-back' transfers. There is no real business benefit from undertaking the arrangement in this way.

66. There is no reasonable expectation that Patricia will continue to run the small business in the different legal structure.

67. The arrangement results in a legal structure that largely replicates the original structure, but has the effect of extinguishing the UPEs on foot. This assists Patricia to divest the business in a manner that involves the extraction of accumulated profits accrued in the corporate tax environment without 'top up' tax ever being paid (that is, the difference between Patricia's marginal tax rate and the corporate rate).

*Conclusion*

68. There is no bona fide commercial arrangement undertaken with respect to the efficient operation of the business going forward. The series of transactions involving the transfer of assets effectively from the Peterson Trust to the Patricia Family Trust replicates the original structure and eliminates existing and impending tax liabilities. Furthermore, the Patricia Family Trust has divested the business. The arrangement is not undertaken to authentically restructure the way in which the business is conducted, but rather as a preliminary step to facilitate the economic realisation of assets. There are no commercial advantages outside of the undue tax considerations of this restructure.

69. In these circumstances, the application of the SBRR will be denied.

70. Where the safe harbour rule is met before the Patricia Family Trust divests the business, the application of Part IVA of the ITAA 1936 will also need to be considered.[5]

***Example 8: Variation on Example 7 – 'genuine restructure of an ongoing business'***

*Facts*

71. Altering the facts from Example 7, Patricia instead causes the Peterson Trust to transfer all the active assets of the business to Peterson Pty Ltd in satisfaction of the UPEs, and continues carrying on the business in the company without further asset transfers.

72. Immediately after the transfer, the trustee winds up the Peterson Trust and the SBRR is claimed.

*Relevant considerations*

73. The restructure results in a new legal structure that does not replicate the original structure, but authentically changes the way in which Patricia operates the business on an ongoing basis.

[5] The safe-harbour only operates to treat the restructure as being genuine for the purposes of paragraph 328-430(1)(a) and does not impact any consideration of the purpose and effect of the restructure for other tax purposes.

74. The reduction in compliance costs derived by simplifying the business structure relieves the administrative burden of tracking all the UPEs on foot.

75. The available evidence indicates that the restructure is not directed at eliminating impending tax liabilities or extracting accumulated profits for personal consumption.

### *Conclusion*

76. This variation delivers a benefit to Patricia in respect of the ongoing efficient conduct of her business. The restructure is not a preliminary step to facilitate the realisation of assets and Patricia has been relieved of the administrative and compliance burden involved in running the business through the original structure to focus on improving the business operations. This restructure satisfies the 'genuine restructure of an ongoing business' condition.

**Commissioner of Taxation**
24 March 2016

## Your comments

77. You are invited to comment on this Draft Law Companion Guideline including the proposed date of effect. Please forward your comments to the contact officer by the due date.

**Due date: Friday, 29 April 2016**

**Contact officer details have been removed as the comments period has ended.**

### References

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|---|---|
| Legislative references | ITAA 1936<br>ITAA 1936 Pt IVA<br>ITAA 1997<br>ITAA 1997 328-430(1)(a)<br>ITAA 1997 328-435<br>ITAA 1997 Div 86<br>ITAA 1997 Subdiv 328-G<br>Tax Laws Amendment (Small Business Restructure Roll over) Act 2016 |
| Related Rulings/Determinations | LCG 2016/D2 |