Business reorganisations

Presentation to Private Business Tax Retreat 2012

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1. INTRODUCTION

1.1 I have been asked to discuss in this paper on issues relevant to business restructuring including CGT rollovers. This will then lead on to a workshop where we will consider some practical scenarios.

1.2 I have 45 minutes for the paper itself so I will not have time to provide a detailed coverage of the issues listed in the synopsis for the session. Instead I will consider some specific issues in the paper and hopefully flesh out the requirements for various rollovers in the workshop.

1.3 The conference has a private business focus so the paper and workshop will consider these issues primarily from the perspective of SME clients.

2. CGT ROLLOVERS

2.1 I intend to focus on the main rollovers that may be applicable for SME restructuring which are largely set out in divisions 122, 124 and 126.\(^1\)

I will also briefly discuss issues with demerger relief but, for reasons I will expand on later, the demerger provisions will not have much practical application in SME restructures.

There are other provisions in the tax legislation which effectively allow for rollover relief in different circumstances.\(^2\) However, in this paper I will confine my comments mainly to rollovers available under divisions 122 to 126.

I will also limit the discussion to issues arising from rollovers of a voluntary nature as opposed to involuntary rollovers.

Subdivision 122-A – transfer of assets to wholly-owned company

2.2 Perhaps the most commonly used rollover is that under subdivision 122-A where an individual or trustee transfers a CGT asset to a company in which they own all the shares.

There is a related rollover where the partners in a partnership transfer partnership assets to a company in which the partners own all of the shares.\(^3\) The issues under subdivision 122-A and 122-B are largely similar so I will concentrate on subdivision 122-A.

The basic requirements for subdivision 122A rollover are relatively straightforward.

- The taxpayer must dispose of a CGT asset and the only consideration for that transfer must consist of shares in the acquiring company or an assumption of liabilities in respect of those assets.
- Any shares issued as consideration cannot be redeemable shares and the market value of the shares must be ‘substantially’ the same as the market value of the asset that is transferred to the company (less any liabilities assumed).
- If the company undertakes to discharge liabilities in respect of the assets then the amount of the liabilities cannot exceed the cost base of post-CGT assets or the market value of pre-CGT assets.\(^4\)

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1 Rollover to a wholly owned company, replacement asset rollovers and same asset rollovers
2 For example, subdivision 152-E and section 70-100 in the 1997 Tax Act
3 Subdivision 122-B
4 Section 122-35
One issue that does cause confusion is whether it is necessary to issue shares in consideration for the transfer of the assets and what are the consequences if no new shares are issued. The provisions do not require that any consideration shares are issued. It is sufficient if the taxpayer who transfers the asset to the company owns all of the shares in the company ‘just after the time of the trigger event’.  

In Interpretative Decision ID 2004/94 the scenario was that the taxpayer was the sole owner of shares in the acquiring company immediately before the transaction. No shares were issued as consideration for the transfer of assets to the company but, because the taxpayer owned all of the shares before and after the trigger event, the ATO accepted that the rollover conditions in section 122-25(1) were satisfied.

However, there are some potential problems with this approach if the shares issued prior to the rollover of assets are issued for only nominal value and the transfer asset has a material cost base.

Section 122-40 provides that, where shares are issued in consideration for the transfer of the asset then the cost base of the shares will be the same as the cost base of the asset rolled over (assuming it is a post-CGT asset).

However, there is considerable doubt whether the provisions that attribute the cost base of the transfer asset to the shares in the company will apply if no shares are issued as consideration for the transfer because section 122-45 says that any capital gain on assets transferred under the rollover are ‘disregarded’ and ‘other consequences relate to shares you receive’.

Therefore, my view is that the prudent approach is to issue consideration shares to implement the rollover to ensure that the cost base of the assets is transferred to the new shares.

Another area of potential difficulty involves jointly held assets. The rollover under subdivision 122-A requires that the ‘individual’ who transfers the asset to the company must own all shares in the company immediately after the transfer and this requirement cannot be satisfied if there are two owners.

If the asset the joint owners want to rollover is income producing, the owners may qualify as a ‘tax law’ partnership as they will be in receipt of income jointly and they should therefore be able to apply the ‘partnership rollover’ in subdivision 122-B.

If it is not clear that joint owners will qualify as a tax law partnership, the other option is for each owner to rollover their interest in the asset to a wholly owned company so that, after the transactions, the asset is held jointly by the rollover companies. The ATO accepted this approach in ID 2002/172.

Subdivision 124-E – exchange of shares or units

2.3 These provisions allow a rollover where a company redeems or cancels shares and issues new shares to the taxpayer in substitution for those original shares. This is a similar rollover to where units in a unit trust are cancelled and replaced.

There are a number of misconceptions about this rollover.

It does not apply if the company simply issues more shares to existing shareholders so that they own 100% of the shares before and after the event. No rollover is available in those circumstances as an essential requirement of the rollover is that ‘all shares’ of a particular class must first be redeemed or cancelled (for example by a share buy-back).

5 Section 122-25(1)
6 ID 2002/172
If all that happens is that more shares are issued to existing shareholders this may involve a direct share value shift which results in part of the cost base of the pre-existing shares being apportioned to the new shares.\(^7\)

Also, this rollover does not apply if the company implements a ‘share split’ where existing shares are converted to a larger number of shares with the same aggregate value. In those circumstances there is no CGT event at all and the taxpayers do not need to rely on the rollover provisions.\(^8\)

**Subdivision 124-G – exchange of shares in one company for shares in another company**

2.4 This rollover allows shareholders in a company (original company) to interpose a holding company between themselves and the original company and is one of the more commonly used rollovers.

The requirements to access the rollover are similar for other replacement asset rollovers, namely that the shareholders who dispose of their shares in the original company must only receive shares in the holding company as consideration for that transfer and the shares each shareholder holds in the holding company immediately after the rollover must be substantially equal in value to the shares they held in the original company.

Unlike other rollovers, the parties can claim rollover under this division even if the original shareholders do not own all shares in the holding company immediately after the rollover. There can be a maximum of five other shareholders but the market value of their shares must be inconsequential.\(^9\)

In order to access this rollover, there must be at least two shareholders.\(^10\) If there is only one shareholder, the appropriate rollover is under subdivision 122-A.

If any shares are held jointly then the shareholders must hold their shares in the holding company jointly.\(^11\)

If this rollover is chosen:

- the shares in the holding company that are issued to the shareholders have the same cost base as their shares in the original company; but

- the shares the holding company acquires in the original company will have a cost base equal to the cost base of the assets of the original company (assuming they are all post-CGT assets) less the liabilities in respect of those assets.\(^12\)

SME clients sometimes apply this rollover as part of an asset protection strategy under which, after the rollover, the original company distributes substantially all its retained earnings by paying a dividend to the holding company and the holding company lends the funds back to the original company (sometimes as a secured loan). There are several issues with this strategy.

The first is that it is uncertain whether the holding company can obtain the benefit of franking credits if a dividend is paid to the holding company within 45 days of the rollover.

To claim the tax offset arising from receipt of a franked dividend the shareholder must be a qualifying person under the former section 160APHO(2) of the 1936 Tax Act.\(^13\)

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\(^7\) Neutral value shift – section 725-220
\(^8\) TD 2000/10
\(^9\) Section 124-380(3)
\(^10\) Section 124-360(1)(b)
\(^11\) ID 2005/217
\(^12\) Section 124-385(3)
\(^13\) Section 207-145 of 1997 Tax Act
The potential problem is that, while the table in section 109-55 deems a holding company that acquires shares under a subdivision 124-G rollover to have acquired the shares when the original company acquired them – that section only applies for the purpose of Part 3-1 of the 1997 Tax Act – it does not deem the holding company to have ‘held’ the shares from that date for the purpose of section 160APHO(2).

It may also be important for SME clients that the shares in the holding company remain active assets so they can claim the small business concessions if they sell the shares. One of the conditions that must be satisfied if claiming the small business concessions on a sale of shares is that at least 80% of the assets of the holding company are active assets.\(^\text{14}\)

If the loan the Holding company makes to the original company represents more than 20% of the holding company’s assets the potential problem is that generally, a loan will not be an active asset.\(^\text{15}\)

However, the loan may be an active asset if it is inherently connected with a business carried on by the holding company.\(^\text{16}\) There are a number of authorities that suggest a holding company which controls an operating company does carry on a business.

In *American Leaf Blending Co Sdn Bhd v Director-General of Inland Revenue*\(^\text{17}\), Lord Diplock said that:

\[
\ldots in the case of a company incorporated for the purpose of making profits for its shareholders any gainful use to which it puts any of assets prima facie amounts to the carrying on of a business\ldots
\]

The carrying on of "business" no doubt, usually calls for some activity on the part of whoever carries it on, though, depending on the nature of the business, the activity may be intermittent with long intervals of quiescence in between.\(^\text{18}\)

The ATO indicated in Taxation Ruling TR 2002/11 (about STS average turnover) that:

the use by a company of its assets to produce profits for its shareholders prima facie amounts to the carrying on of a business by the company.\(^\text{19}\)

There is also authority for the proposition that a holding company can carry on a business, even if the holding company is not involved in the active management of the business of its subsidiaries.\(^\text{20}\)

The rollover under subdivision 124-G also creates problems for shareholders with pre-CGT shares in a company whose pre-CGT assets are deemed to have been acquired after September 1985 under division 149 (because there has been a change in the underlying majority interest).

If a shareholder in sells pre-CGT shares in a company with deemed post-CGT assets (as a result of the application of division 149), the ATO will treat those assets as if they were pre-CGT assets for the purpose of determining whether CGT event K6 will apply.\(^\text{21}\)

However, if the shareholders in the original company exchange their shares for shares in a new holding company and apply rollover relief under subdivision 124-G:

- their shares in the holding company will retain their pre-CGT status; but

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\(^{14}\) Section 152-40(3)

\(^{15}\) Private Ruling, Authorisation Number 65170

\(^{16}\) Section 152-40(3)(b)(ii)

\(^{17}\) [1978] 3 All ER 1185

\(^{18}\) at 1188

\(^{19}\) at paragraph 25


\(^{21}\) TR 2004/18
• if they sell those shares, **all of the assets of the holding company** will be treated as post-CGT assets for the purpose of CGT event K6.

Section 124-385 sets out the consequences of the rollover for the new holding company and provides that some of the shares in the original company may still be treated as pre-CGT assets if any of the assets of the original company were pre-CGT assets.

However, where the assets of the original company are deemed post-CGT assets as a result of the application of division 149, all of the shares that the holding company acquires as part of the 124-G rollover, will be treated as post-CGT assets.

Our firm recently had this situation and sought a private ruling as to whether the ATO would adopt a similar approach in this situation as under TR 2004/18 and calculate the proportion of pre and post-shares acquired by the holding company under section 124-385 by reference to the actual acquisition date of assets rather than the deemed acquisition under division 149. The ATO ruled that, for the purpose of determining whether any of the shares the holding company acquires under a subdivision 124-G rollover are pre-CGT assets, the relevant date is the deemed acquisition date where division 149 has previously been applied to the original company – not the actual acquisition date.22.

If there are pre-CGT shareholders in a ‘division 149 company’ it may be preferable to utilise the scrip for scrip rollover provisions instead of utilising subdivision 124-G. That could be achieved if for example 99% of the shares in the original company were acquired by the new holding company.

Those shareholders in the original company who had post-CGT shares could then elect to apply the scrip for scrip rollover and the shareholder with pre-CGT shares could choose not to take the rollover, which means that their shares in the holding company would still be post-CGT assets, but they would have a market value cost base.

Of course, it will be necessary to assess the other consequences of the different outcomes for the holding company under the two alternative rollovers - namely that the cost base for the assets under subdivision 124-G is the cost base of assets in the original company whereas under the scrip for scrip provisions the cost base of the shares the holding company acquires will be equal to the cost base of those shareholders who take the rollover (assuming that the conditions in section 124-780(2) are met, which will generally be the case in a non-arms length situation).

**Subdivision 124-M - Scrip for scrip rollover**

2.5 Scrip for scrip rollover may be available where one company acquires at least 80% of the shares in an original company under a ‘single arrangement’ and some part of the consideration paid to the shareholders in the original company consists of shares in the acquiring company.

The basic conditions are set out in section 124-780. The main requirements for parties to access the concessions, in addition to the transaction being a ‘single arrangement’, is that the arrangement must be one in which at least all holders of voting shares in the original company can participate and in which their participation is available on ‘substantially the same terms’ for all shareholders of a particular class.

If the shareholder in the original company would have made a capital gain on the disposal of their shares, then they may choose to obtain a rollover relief under this subdivision.

There are special rules where there is a ‘significant stakeholder’ or a ‘common stakeholder’ involved in the scrip for scrip rollover.

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22 Binding private ruling – authorisation number 1011708175325
An entity has a significant stake if they and their associates between them hold shares carrying entitlements to 30% or more of voting rights, dividends or capital. Entities and their associates have a ‘common stake’ if they have an interest in the original company and the holding company, which an aggregate consists of 80% or more of the voting rights, dividend entitlements or capital entitlements in the original company and the holding company.

If there is a significant stakeholder or a common stakeholder, then section 124-780(3)(d) requires that both the shareholder and the holding company must jointly choose to obtain the rollover.

Also, if the scrip for scrip restructure is not undertaken between parties dealing at arm’s length, the original and holding company did not have at least 300 members, then additional conditions in section 124-780(5) must be complied with. These are that the capital proceeds issued to the shareholders must be at least substantially the same as the market value of their original shareholding and the replacement shares must carry ‘the same kind of rights and obligations as those attached to’ the original shares.

If there is a significant stakeholder or common stakeholder involved, the cost base of the shares acquired by the holding company will be equivalent to the cost base of the shares that the vendors had in the original company. Also the shareholders in the original company and the holding company must jointly elect to apply the rollover.

Scrip for scrip rollover is not available if the shareholders in the original company could have applied rollover under division 122 (transfer of assets to a wholly-owned company) or subdivision 124-G (exchange of shares in one company for shares in another company).

In some cases it may be significant from the perspective of the holding company that rollover relief under the scrip for scrip provisions is applied, rather than say under 124-G.

One significant consequence is that, if there is rollover under division 124-G, the acquiring entity has a cost base for the shares it acquires equal to the cost base of the assets in the original company, whereas (assuming the transaction is not arm’s length) the cost base that the acquiring company will have for its shares in the original company if scrip for scrip rollover is applied will be the same cost base as the shares held by the transferors. If these two cost bases are different, then it may be important to ensure that the correct rollover is selected.

Another advantage of applying scrip for scrip rollover, rather than say rollover under subdivision 124-G, is that not all of the shareholders who transfer their shares have to elect to apply the rollover.

If it is important for any reason that scrip for scrip rollover relief is applied rather than rollover under division 122 or subdivision 124-G, then one way of achieving this is to transfer less than 100% of the shares in the original company. For example, if only 99% of the shares are rolled over to the takeover company, then the rollover relief under division 122 and subdivision 124-G is simply not available and rollover relief under the scrip for scrip provisions is available because it only requires that at least 80% of the shares are acquired. This then provides the flexibility of some shareholders electing to apply rollover and others not and also to provide a mix of shares and other consideration for the takeover.

Matrimonial rollovers and small business concessions

2.6 Another situation where it may not always be beneficially to accept the most obvious rollover is if parties transfer ‘active’ assets as part of a matrimonial property settlement.

If for example, one party to the marriage is transferring an interests in assets of a business or shares that qualify as active assets and the relevant assets are transferred to the other spouse,
the matrimonial rollover in subdivision 126-A will automatically apply and the acquiring spouse will have a cost base equal to the cost base of the disposing spouse.

This may not be a particularly good outcome for the acquiring spouse if the marked value of the asset is substantially greater than its cost base as they will have to deal with the capital gains tax consequences when the asset is ultimately sold.

Assuming the disposing spouse can access the small business CGT concessions it may often be possible to get a ‘win win’ outcome if, instead of the asset being transferred to the other spouse, the order of binding financial agreement provides that the asset is transferred to a connected entity (such as a trust).

Under those circumstances, the matrimonial rollover will not apply as the transferee is not a spouse. However, if the small business concessions can be applied the disposing spouse will in many cases not trigger any CGT liability and the acquiring spouse (or their trust) will have a market value cost base for the asset.

There may also be some duty implications of this strategy that need to be considered.

3. DEMERGERS INVOLVING SMES

3.1 On the face of it, the demerger rollover provisions in division 125 provide significant opportunities to allow SME clients who have interests in a chain of companies to ‘demerge’ the companies so that they hold shares directly in all or some of the entities rather than a single holding company.

This can be advantageous where the parties want to sell off part of the business only and want to maximise their access to the small business CGT concessions (because if they can demerge, it would allow them to sell shares in a company rather than having a holding company or another company in the group sell assets or shares in companies which would not achieve the same capital gains outcomes).

The requirements to implement a demerger under division 125 are as follows:

- There must be a demerger group (which involves a single holding company with one or more subsidiaries).
- Essentially a demerger involves the holding company or another subsidiary in the group transferring their shares in a subsidiary to the shareholders in the holding company (described as the ‘owners of original interests’).
- The entity transferring the interest in the downstream company (usually the holding company) is described as the demerging entity and the downstream entity whose shares are transferred is referred to as the demerged entity.
- The ultimate owners must acquire at least an 80% interest in the demerged entity and that their interests in the demerged entity are exactly the same as their interests in the holding company.

Generally speaking, the transfer of shares in a subsidiary from a holding company to the ultimate shareholders will be a dividend (if it is implemented other than as part of a wind-up). Section 44 was amended when the demerger provisions were introduced to specifically provide that a ‘demerger dividend’ is not assessable.

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24 section 125-70(1)
25 sections 44(3) and (4)
However that exception does not apply unless immediately after the demerger, at least 50% of the CGT assets of the demerged entity (by value) are used directly or indirectly in one or more businesses that are carried on by the entity (or its subsidiaries).

This therefore precludes implementing a demerger where shares in a passive property holding company for example are to be transferred to the ultimate shareholders.

One potential trap if you do implement a demerger for clients is that the shares in the subsidiary which are transferred to the ultimate shareholders as part of the demerger will be acquired at the date of the demerger. The provisions in section 115-30 that deem assets received under certain rollovers to have been acquired at the date of acquisition of the original asset do not apply to demergers.\textsuperscript{26}

### Section 45B

3.2 The real difficulty with implementing demergers is that, while section 44 has been amended to provide that a demerger dividend is not assessable, the Commissioner has a discretion under section 45B of the 1936 Tax Act to treat a demerger dividend as being assessable in circumstances where components of the demerger allocation between capital and profit do not ‘reflect the circumstances of the demerger’ or certain payments, allocations or distributions are made in substitution for dividends.

The discretion under section 45B will apply where:

- having regard to the relevant circumstances… it would be concluded that the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme, did so for a purpose (whether or not the dominant purpose but not including an incidental purpose) of enabling a taxpayer… to obtain a tax benefit.

The concept of obtaining a tax benefit is defined in section 45B(9) as being where an amount of tax payable by a taxpayer as a result of the arrangement would be less than the amount that would have otherwise been payable if the demerger benefit had been an assessable dividend.

The ATO issued PS LA 2005/21 outlining how the discretion under section 45B will be applied. The practice statement puts a great deal of emphasis on the underlying objects of the demerger provisions and refers to statements in the explanatory memorandum and second reading speech when the legislation was introduced.

The view of the ATO in PS LA 2005/21 is that the demerger concession is:

- directed at restructuring a business in the interest of business efficiency…. in the absence of substantive business reasons for a demerger the income tax benefits it provides for shareholders will assume greater significance.\textsuperscript{27}

The difficulty in dealing with section 45B is that shareholders who participate in a demerger will almost always receive a tax benefit as defined in section 45B(9) and the fact that obtaining that benefit does not have to be the dominant purpose, makes it very difficult to defend against a determination by the Commissioner that section 45B will apply. Because of this uncertainty, it is effectively an essential requirement if implementing a demerger that the taxpayers must apply for a private ruling as to whether section 45B will be applied.

In our firm’s experience, it is all but impossible to get the Commissioner to exercise the discretion under section 45B favourably where the demerger involves a private company group.

In a number of cases where we have sought a demerger ruling, we have been informed verbally that the policy of the ATO is that the demerger exemptions were intended to facilitate restructuring of public company groups and that the Commissioner will only give a favourable

\textsuperscript{26} ATO ID 2003/916
\textsuperscript{27} paragraph 22
exercise of discretion under section 45B for private group demergers in extremely rare circumstances.

It is telling that in PS LA 2005/21, the ATO specifically note that the ‘characteristics of shareholders’ will be a relevant factor in deciding whether to exercise the discretion under section 45B (paragraph 59). The practice statement indicates that where the tax characteristic of the shareholders in the head entity are such as to indicate a tax preference for capital distribution as opposed to profit, then ‘this may be suggestive of a more than incidental purpose of delivering a tax benefit’ from the demerger. This is clearly a reference to the fact that individuals and trusts holding shares in a holding company would prefer to realise their indirect investment in subsidiaries via direct sale of shares (as capital), rather than have the head company sell the subsidiary and distribute taxable dividends.

Another important factor is that if the ATO considers that a purpose of the demerger is to allow the individual shareholders in the holding company to acquire a direct shareholding in subsidiary entities and there is any suggestion of a ‘later disposal of those interests’, then it is more likely that the discretion under section 45B would be applied to treat the demerger dividend as a taxable amount.28

4. ATO FOCUS ISSUES WITH RESTRUCTURES OF PROFESSIONAL PRACTICES

Issues of concern for ATO

4.1 There is clear evidence that the ATO intends to continue ‘cracking down’ on professional practice firms.

In an address to the Canberra conference of the Tax Institute in March 2009, Deputy Commissioner Mark Konza delivered a paper titled ‘Is the Tax Office widening its crack down on lawyers and accountants?’ in which he acknowledged that the ATO was examining practice structures of legal and accounting practices and said that ‘now that the use of service trust is generally within the law we have broadened our examinations, again, to look more widely at what is happening in these two professions’.

Also, the taskforce the ATO set up to undertake the review of service trusts has now turned its attention to practice restructures and, from recent discussions with the head of that group, my understanding is that the ATO intends to undertake a substantial number of reviews and audits of professional practices over the next few years.

Practices that have recently restructured are the most likely targets for those reviews and audits and therefore it is important that you and your clients are aware of the issues that may be raised and how you might deal with them if and when an audit eventuates.

Several years ago the ATO promulgated a template questionnaire that I understand is used as the basis for initial letters to newly incorporated practices selected for review. That letter identifies some key issues of interest for the ATO and requires information on a range of issues such as:

- details of the capacity in which each partner held their interest in the partnership;
- the reasons for the restructure;
- the capacity in which parties hold their interests in the practice entity after the restructure;
- any ‘post-restructure’ changes in the capacity in which parties hold their interests in the practice entity;

--paragraph 73
- whether all parties having an interest in the practice have the necessary legal/accounting qualifications;
- whether the business entity operates the business as nominee or manager for other entities;
- particulars of any capital gains arising on the restructure and how these were dealt with; and
- if the partnership was a no goodwill practice, information to support application of IT 2540.

This issues list provides a useful pointer to the key issues that should be considered in implementing a restructure so that the practice is prepared to deal with an ATO audit.

**Rollover of practice assets to a wholly owned company (subdivisions 122-A and 122-B)**

4.2 While requirements to implement these rollovers appear reasonably straight forward, there will be cases where there may be issues in satisfying the conditions because of the way in which some partnerships are structured.

For example, it is quite common to have equity and ‘salaried’ partners. Salaried partners will often be included in the ‘partners’ who must transfer their interest in the partnership assets to the practice company. Care will be required to ensure the rights attaching to shares issued to ‘salaried partners’ are substantially the same as their interest in the partnership.

Also, the partnership agreement may provide that a partner can be expelled by a vote of a special majority of partners. In the context of a corporate structure this would generally mean that the partner’s shares were subject to redemption.

However, as the shares issued in the practice company cannot be redeemable, the constitution of the company will have to be drafted to ensure that this power of expulsion is implemented in other ways.

One requirement of the rollover under subdivision 122-B is that the partners must own the shares in the new company in the same capacity as they held their partnership interests.

This necessarily means that incorporation in that context does not provide any opportunity for income splitting (at least initially).

Therefore, the primary goal of many practices that chose to incorporate and apply subdivision 122-B rollover may be just to achieve a measure of asset protection by removing the partners from a joint and several liability environment but the ongoing tax consequences will not be significantly different to continuing to practice as a partnership of individuals.

Where the partnership as a whole elects to incorporate and apply subdivision 122-B rollover, this does not preclude individual partners from transferring their interest in the practice to another entity such as a family trust to achieve some income splitting. This could be done before the rollover (e.g. via an Everett assignment) or after by transferring shares.

However, any transfer of partnership interests or shares following the restructure will have duty and CGT issues and is an issue that is on the ATO checklist. Also, as discussed later, if the practice does not recognise goodwill, any attempt by some partners to achieve income splitting benefits may impact on the other partners.

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29 *Stekel v Ellice* [1973] 1 All ER 465 and *Walker v McLelland* - NSW Supreme Court, Equity Division, 24/2/1988 - unreported
An alternative approach will be to for the partnership to transfer the relevant assets of the partnership to a company and for each partner to apply the available CGT discounts (particularly the small business discounts available under division 152).

For practices that can avail themselves of these concessions this may be an effective way to get an uplift in the cost base of their interest in the practice without triggering any material tax consequences.

However, the ATO will closely examine the transactions to ensure that the partners satisfied the basic conditions required to apply the small business concessions.

Partnerships involving trusts

4.3 As a result of the relaxation of restrictions on who can practice as accountants and lawyers, many firms have elected to carry on practice in a trust structure. The model many firms have adopted is to operate through a partnership of trusts rather than a unit trust as the partnership model will generally give better access to the small business CGT concessions.

In order to maximise the asset protection benefits of the trust structure, many firms will have a corporate trustee(s).

For ease of administration, where there are multiple principals, there is often a preference to have a single company as the ‘face of the firm’ rather than having a large number of corporate trustees that have to be disclosed on firm documents.

This is usually achieved by appointing a single company to hold the goodwill and operate the practice as the ‘nominee’ of the partners or to have a single company that acts as trustee of all the trusts that make up the ‘partnership’.

The ATO has flagged that it has concerns about arrangements involving partnerships of trusts. The main areas of concern appear to be as follows.

Partnerships with nominee entity holding partnership assets

4.4 There are a number of cases where the courts (and the ATO) appear to have accepted that there can be a partnership for tax law purposes even though the trust property is held in the name of a nominee. Also there is authority that a person will still be held to carry on a business even though a manager is appointed to operate the business.

However, the ATO has indicated in Taxation Determination TD 2005/28 that syndicates that are ‘registered managed investment schemes’ should be treated as trust estates and therefore taxed under division 6 of the 1936 Tax Act and not as partnerships under division 5.

It is arguable the determination should be confined to registered managed investment schemes as it appears to be based on the fact that section 601FC(2) of the Corporations Act stipulates that the responsible entity of a registered scheme, holds the scheme property ‘on trust’ for scheme members.

Colonial First State Investments Limited v FCT involved a situation where interests in a head trust were held by a custodian for a sub-trust. The court determined that the trustee of the sub-trust was the beneficiary of the head trust – not the custodian. This is inconsistent with the ATO argument that partners whose assets are held by a nominee have an interest as beneficiaries in a trust rather than a direct interest in the assets as partners.

30 A.R.M. Constructions Pty Ltd v FCT 87 ATC 4790 and Ryvitch v FCT 2001 ATC 4403.
31 Howland Rose & Ors v FCT 2002 ATC 4200 and Hance v. FCT [2008] FCAFC 196.
32 [2011] FCT 16
In the decision impact statement on *Colonial First State*, the ATO acknowledged there is some uncertainty as to the correct tax treatment where assets are held by a nominee and noted that reform options to address this issue are discussed in the options paper released in November 2011 in relation to modernising the taxation of trust income. However, they indicated that, until reforms are actually introduced, they will continue to apply their view that a custodian arrangement creates a separate trust estate that is subject to division 6 of the *1936 Tax Act* – except for cases on all fours with the facts in *Colonial First State*.

Even, if the appointment of a nominee creates a trust estate, there are good arguments that, for CGT purposes, any dealing with the practice assets should be treated as a dealing by the partners as they will be ‘absolutely entitled as against the’ nominee – which would preserve their ability to claim the small business concessions. 33

In TR 2004/D25, the ATO argue that where there is more than one beneficiary, those beneficiaries are not absolutely entitled to the trust assets unless the assets are ‘fungible’ (paragraph 90) and clearly, practice goodwill is not a fungible asset. However there are strong arguments that the ATO view is incorrect.

The key element which must be satisfied for section 106-50 to apply is that the capital must be ‘absolutely entitled to the CGT asset as against the trustee’. Unlike section 104-55, there is no additional requirement that that beneficiary is the ‘sole beneficiary’.

The expression ‘absolute entitlement as against the trustee’ is taken from similar provisions in the UK legislation and there have been some case authorities as to what it means in that context.

The commentaries and cases appear to suggest that there will be an absolute entitlement if the beneficiaries are entitled to demand immediate transfer of the trust asset from the trustee and can give a good and valid discharge and that this requirement can be satisfied if there is more than one beneficiary. 34

For example, in *Booth v Ellard* the court considered that it was possible for several beneficiaries to be ‘jointly and absolutely entitled as against the trustees to the assets vested in the trustees’.

In GSTR 2008/3 the ATO acknowledge that where an entity holds an asset as nominee for several parties and ‘has no discretion regarding the use and disposal of the trust property’ then the entity that holds as nominee is a bare trustee 35 and that this principle applies ‘regardless of whether there is a single beneficiary or multiple beneficiaries of the bare trust’. 36

**Mark Konza issue**

4.5 Mark Konza raised the issue of ‘whether trust is capable or actually involved in, the carrying on of a business in common with a view to profit’. It is difficult to understand the ATO concerns on this issue but I am aware of one audit of a legal firm where the ATO argued that a transfer of partnership interests to partners acting as trustee was invalid because the same individuals were purporting to act as partners in their own right and also as trustee of a trust.

I also understand that the Federal Court has heard a matter involving similar issues but that the decision has not yet been handed down.

In the ATO position paper for the audit referred to above, they conclude that a natural person acting in the capacity of trustee can become a partner in that capacity, but argue that there are ‘legal difficulties’ where the same person holds a partnership interest in their own right and also as trustee.

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33 Section 106-50 – 1997 Tax Act
35 paragraph 13
36 paragraph 84
The ATO conclusion in the position paper in that case was that, in Queensland at least:

…it is not valid or enforceable for a partnership to be comprised of a legal personality acting as partner in their capacity as an individual while at the same time acting as a partner in their capacity as trustee.

The reasoning of the ATO in that position paper is confusing to say the least and is inconsistent with the decision in Everett\(^ {37} \) where the High Court had no difficulty in accepting a situation where a partner retained some of their interest in the partnership in their own right and held the assigned portion on trust for the assignee under the Everett assignment.

The ATO argument that a person cannot act in their own right and as trustee in the context of a partnership arrangement appear to rely solely on their interpretation of section 14 of the Property Law Act - which refers to leases and conveyances.

In particular, the ATO rely on section 14(4A) which says that, if a person in whose favour a conveyance is made is precluded from validly carrying out the transaction because of a fiduciary relationship, then the conveyance or lease ‘shall be liable to be set aside’. The section does not say the transaction is void but merely that it would be liable to be set aside – presumably only in the event of a complaint by the person to whom the fiduciary relationship was owed.

The ATO position also ignores the provisions of both section 50 of the Property Law Act and section 59 of the Trusts Act 1973 (Qld). Section 50 clearly states that an agreement between a party and themselves with one or more other parties can be capable of being enforced and section 59 of the Trusts Act provides that a trustee may sue themselves in a different capacity.

In Browne v Commissioner of State Revenue\(^ {38} \), the court held that section 50 of the Property Law Act provided that contracts between a person and themselves and another person were enforceable and, importantly (in view of the ATO position in the audit position paper referred to above), also commented that section 14 of the Act similarly authorised transfers of property from an owner to the owner and another.\(^ {39} \)

Therefore, it is difficult to understand why the ATO adopted this position I understand that they may be reconsidering whether to pursue the argument.

**Practice is structured as partnership of trusts with single corporate trustee**

4.6 The position is somewhat more difficult where a practice is structured as a partnership of trusts, but with a single corporate trustee.

It does seem clear that such a structure does not actually qualify as a ‘partnership’ as the definition of partnership in the tax legislation requires that there must be ‘an association of persons’.\(^ {40} \)

If there is only one legal entity (a company) then there is not an association of ‘persons’.

While the Acts Interpretation Act 1901 provides that, in any commonwealth act, ‘words in the singular include the plural’\(^ {41} \) this is qualified by section the requirement in section 2 that the application of the Act is subject to a contrary intention.

\(^{37}\) [1980] HCA 6
\(^{38}\) [2002] QCA 388
\(^{39}\) paragraph 11
\(^{40}\) 995-1(1)
\(^{41}\) Section 23
Given that the expression used in the definition of partnership in section 995-1(1)) is to an ‘association of persons’ it seems clear that the context requires more than one person and that the general rule that the plural includes the singular and vice versa will not apply.

While each trust estate is a separate entity for the purposes of the tax legislation, the requirement in the act is that there is an association of persons, not an association of entities.

In Fagenblat v Feingold Partners Pty Ltd the court was prepared to allow litigation to proceed on the basis that a legal practice was carried on by a partnership or trusts where each trust had the same trustee.

There are also instances where the ATO has accepted an arrangement involving a ‘partnership’ of trusts with the same trustee in the past but it seems clear that they will challenge such arrangements where the structure involves legal or accounting practices. For example, in discussions with ATO officers undertaking an audit I am currently advising on, they have indicated that the ATO does not accept that it is possible to have a partnership of trusts with a single trustee.

However, I am not aware of any litigation pending on this issue or exactly what the ATO considers will be the practical consequences if such a structure does not qualify as a partnership. Irrespective of whether a grouping of trust estates with a single trustee qualifies as a partnership, it is difficult to see that this will result in any materially different outcome from an income tax or capital gains perspective.

Even if there is not a partnership, the operation of the tax acts will still result in each trust estate deriving a share of practice income and any capital gain as each trust estate is a tax ‘entity’.

The problem that practices structured in this way may have if they are audited is that the ATO may argue that they are incorrectly registered for GST purposes. For example, if the parties have registered as a ‘partnership’ the ATO may argue that the incorrect entity has been registered and GST has not been properly accounted for. While this may not impact on the actual amount of GST payable, this approach could result in significant penalties and interest.

In view of the current uncertainty, practices and clients who have adopted this type of structure should consider alternatives that will reduce the risk of an ATO attack. For example, if each trust had the same two trustees, there would be an association of ‘persons’ carrying on the business and it would therefore be arguable that the structure satisfied the requirements for a partnership.

Restructure of ‘no goodwill’ practice

4.7 The issue that appears to be causing most concern in the context of practice restructures relates to the CGT implications where a ‘no goodwill’ practice is restructured.

The ATO has accepted for many years that where partnership interests are transferred as a result of normal partner exit and entry arrangements, these transactions will generally be on an arm’s length basis and, if the partners agree there is no goodwill value in the practice, the ATO will not attempt to impute a market value for goodwill.

The ATO has recently issued a final and several draft determinations indicating that they will adopt a similar approach in relation to no goodwill practices which have incorporated but only in situations where there is a dealing in relation to shares in the company.
However, the ‘concession’ granted by the ATO in that ruling is subject to reasonably stringent conditions. The explanatory part of the ruling indicates that, for a partnership to take advantage of the ‘no goodwill concession’ in IT 2540:

- the partners in the partnership are all natural person practitioners who hold a fractional interest in the ‘no goodwill’ partnership;
- the acquisition or disposal of an interest in the partnership must be reflective of that person’s status as an active practitioner in the practice and held by that person both legally and beneficially; in this context “active partner” will include managing partners who do not undertake client work and non-practitioner consultants (for example legal counsel in an accounting firm);
- the partnership has capital which reflects merely a nil or immaterial value for goodwill, except in circumstances where the partnership has taken over another practice with goodwill, and such acquired goodwill remains on the partnership’s books; in that circumstance, provided the partners cease to recognise that goodwill in dealings between themselves for the admission and exit of partners this condition will be satisfied;
- the partnership adopts an agreement that regulates the basis for admission and exit of partners and the amount that is paid for it; and
- the partnership agreement provides that no or an immaterial payment is to be made for acquiring a partnership interest, disposing of a partnership interest or any change to the profit distribution entitlements attached to an interest in the partnership, in respect of goodwill.’

The ruling also indicates that similar requirements will apply for incorporated practices (with necessary modifications to accommodate a corporate structure).

The effect of these conditions is that the ATO is arguing the value of an asset can vary depending on the capacity in which a person holds the asset or the capacity in which other parties own interests of the same character.

While it is difficult to see how the ATO’s position can be correct, the reality is that principals in ‘no goodwill’ practices will need to make a conscious decision whether they comply with the ATO conditions in order to avoid a dispute.

The ATO has also indicated in a number of forums that, where the entire practice is assigned from an existing entity (usually a partnership) to a new entity (trust or company) then, even though the partners themselves may not recognise goodwill, there is goodwill that can be valued and that the market value substitution rule will apply.

This is a substantial obstacle for larger practices that may be considering incorporation because the ability of the partners to apply the small business concessions in those situations will either not exist or be very limited.

While the ATO position is questionable, the reality is that practices that elect to incorporate or convert to a trust structure will have to accept the likelihood that, irrespective of whether they recognise goodwill, the ATO is likely to argue that the market value substitution rule applies and to assess on a capital gain based on the market value of the goodwill.

In many cases, the terms of the practice partnership or stakeholder agreement may be an obstacle to disputing the Commissioner’s position because many agreements stipulate that, although goodwill is not recognised, the principals are still subject to restraint of trade covenants.

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47 Paragraph 3
If the principals continue to be subject to those restraints once the practice is transferred to a company or trust structure, there may well be an argument that there is a market value for the goodwill of the practice, bearing in mind that the definition of ‘market value’, which is generally accepted is the price that a willing but not anxious purchaser would have had to pay to a vendor who was not unwilling but not anxious to sell. A similar test was adopted by the High Court in Abraham v FCT.

If a practice is a genuine no goodwill practice and the principals agree that none of them is subject to any restraint of trade covenant in the event of their retirement from the practice, then it will be more difficult for the Commissioner to successfully contend that any significant market value should be attributed to goodwill.

It must be at least arguable that a willing but not overanxious buyer is unlikely to be prepared to pay a material amount for goodwill where all of the principals of the business are free to compete with the business immediately after the sale.

Therefore, partnerships that are considering restructuring need to weigh up the potential tax arguments that they may have in terms of goodwill issues if they accept that they are not subject to any restraint of trade after the restructure as opposed to the Commercial benefits that they may see which will arise if restraints remain in place.

There is an ancillary issue for non-goodwill practices which purport to impose restraints of trade on partners or principals.

If the partnership or company documents stipulate that there is no goodwill or that the goodwill has a minimal value, there may be a threshold question of whether the restraint of trade covenant is enforceable in any event because restraints are generally only enforceable if they protect goodwill and go no further than is necessary to protect that goodwill.

The better protection that a practice has in those contexts where there is a ‘rogue partner/director’ is more to rely on the duties of good faith and fiduciary obligations that partners and directors are subject to.

5. BUSINESS SPLITTING/LICENSEING

5.1 It is not uncommon for clients who start a business in a company or trust to build up substantial value in that entity only to then realise that their substantial asset base is fully exposed to the risks associated with the operation of the business.

The problem usually is that, by the time they realise the problem the tax and other transaction costs of transferring assets to a protected entity may be substantial.

In those circumstances, an alternative to transferring valuable assets from the operating entity is to move the business operations to a new corporate or trust structure which has few tangible assets and leave the valuable assets in the original entity.

While this will not protect against claims arising from events prior to the restructure, it may provide a measure of protection against future claims.

5.2 One option is for the clients to transfer the goodwill to a new entity that will conduct the business and retain the tangible assets in the original entity or retain the operating entity and transfer the tangible assets to a new entity (often a trust).

The problem with this ‘fix’ is that it will usually trigger significant transaction costs. If the assets are transferred to a trust, it is unlikely that any of the usual CGT rollovers will be applicable.

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48 Spencer v The Commonwealth (1907) 5 CLR 418
49 (1944) 70 CLR 23
50 Amoco Australia Pty Ltd v Rocca Bros Motor Engineering Co Pty Ltd (1973) 133 CLR 288
If the existing entity is a trust, then it is still possible in Queensland to transfer the assets to a cloned trust without triggering any duty.\(^{51}\) If the clients can access the small business CGT concessions, they may also be able to eliminate any CGT on the transfer of assets but will still have to deal with duty issues.

### An alternative - licensing the business assets

5.3 An alternative is for the asset holding entity to grant a licence to a company or trust to utilise the business assets to operate the business.

Under a typical business license arrangement:

- the existing entity grants a licence to the related company or trust to operate the business;
- the asset holding entity retains ownership of the goodwill and other tangible assets; and
- the licensor retains the right to terminate the licence on short notice.

The grant of a licence to operate a business should not trigger any material capital gains tax or stamp duty implications. There is authority that it is possible to grant a licence of goodwill without incurring stamp duty on the value of goodwill.\(^{52}\) The ATO also appears to accept that it is possible to licence goodwill.\(^{53}\)

The asset protection consequences of licensing a business were considered in Harrington v Harrington Services Pty Ltd (In Liquidation).\(^{54}\)

The grant of a licence to operate the business will involve the creation of contractual rights and, if a premium is paid, this would constitute capital proceeds from CGT event D1. However if no premium is payable, there should be no CGT consequences arising from the grant of the licence, as the market value substitution rule will not apply.\(^{55}\)

The grant of the licence will be the grant of a new right for duty purposes but, if the licence can be terminated on short notice, the OSR in Queensland accept that only nominal duty is payable.

As a result of the introduction of the Personal Property Securities Act 2009 it will also be necessary for the owner of the business assets to register their interest on the PPS Register.

### 6. ANTI-AVOIDANCE ISSUES

In all restructures it is necessary to consider the potential application of Part IVA if any of the parties will achieve tax benefits from the restructure.

For example, if the partners in a legal or accounting practice transfer practice assets to a related company or trust and achieve an income splitting benefit, the ATO is likely to raise questions about the objectives of the restructure and Part IVA may be an issue.

In his March 2009 paper, Mark Konza indicated that one area of interest for the ATO when reviewing practice restructures was where ‘accountants or lawyers contribute, and work, at a partner level but derive less gross income than the employees of the same firm, or where a partner’s taxable income is well below the industry norm for a similar practice’.

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\(^{51}\) Section 53(2) – Duties Act 2000  
\(^{52}\) Roussos v. Commissioner of Stamp Duties (Tas) 92 ATC 4370  
\(^{53}\) Interpretative Decision ID 2003/517 and Interpretative Decision ID 2004/7  
\(^{54}\) [2002] NSW SC 859  
\(^{55}\) section 116-30(3)
The ATO has not historically applied Part IVA to arrangements involving the disposal of income producing assets from one entity to another or to restructures involving the selection of alternative tax entities.

The CCH Australian Federal Tax Reporter suggests that:

> In general, the Commissioner considers that Part IVA will not apply in a true business situation “(as opposed to a personal services business)” where the assets of the business are transferred to a family company or trust which then carries on the business for the benefit of family members.\(^{56}\)

Also, in Everett and subsequent rulings on Everett assignments, the ATO did not seek to invoke section 260 or Part IVA.\(^{57}\)

In Taxation Determination TD 95/4 the ATO posed the question whether a ‘simple disposition of an income producing asset by a natural person to a wholly owned private company’ would trigger Part IVA and concluded that it would not.

In that determination the ATO specifically acknowledged that the intention of the arrangements would be to allow earnings on shares to be retained in a company tax environment rather than assessed to the individual.

However, recent history suggests that the ATO may not adopt such a benevolent approach when considering restructures of legal and accounting practices and caution is required.

The approach adopted by the ATO in TR 2006/2 (on service trusts) perhaps provides some guide posts in this context. In that ruling the ATO did accept that, when considering Part IVA ‘asset protection does make objective business sense where an arrangement has the effect of protecting assets’ but that it is more likely Part IVA will apply where ‘service fees are excessive and not negotiated in a commercial manner’.

This suggests the risk of a Part IVA attack may be diminished if the level of income that the principals derive after the restructure is commercially realistic. In particular, Mark Konza highlighted that arrangements where principals are paid less than employees in the practice will be targeted.

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\(^{56}\) p 48-494

\(^{57}\) Taxation Ruling IT 2501

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This paper is only intended as a general overview of issues relevant to the topic and is not legal advice. If there are any matters you would like us to advise you on in relation to this paper, please let us know.

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