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Capital Gains Tax -
The Top Ten CGT Issues

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Preface

Learning objectives

The purpose of this paper is to provide some guidance on a range of capital gains tax issues that many taxpayers and practitioners often find problematic. Careful consideration and planning can maximise opportunities and reduce potential risks for you and your clients' businesses and how the CGT rules will apply to their particular transactions.

In particular, the paper focuses on ten of the more important capital gains tax issues:

- The Small Business CGT Concessions including:
  - The $6 million Maximum Net Asset Value Test in Subdiv 152-A
  - The 90% small business participation percentage rule in Subdiv 152-A
  - The Retirement Exemption under Subdiv 152-D
  - The Replacement Asset Roll-over relief under Subdiv 152-E
- CGT Event E4
- Capital Gains in Trusts — Streaming and Subdiv 115-C
- Scrip for scrip roll-over — Subdiv 124-M
- Demerger relief — Div 125
- Liquidations and the CGT treatment — CGT event G1 and s. 47 of the *ITAA 1936*.
- Main Residence Exemption — Subdiv 118-B.

Currency

This edition of the 'Capital Gains Tax — The Top Ten Issues' paper is current as at 1 January 2014. It takes into account all developments known to the author at that date.

References

Unless otherwise stated, all references in this paper are to the *Income Tax Assessment Act 1997* (*ITAA 1997*).

Definitions

ATO	Australian Taxation Office
CGT	Capital Gains Tax
Commissioner	Federal Commissioner of Taxation
Div	Division
ITAA 1936	*Income Tax Assessment Act 1936*
ITAA 1997	*Income Tax Assessment Act 1997*
MNAV	Maximum net asset value
MRE	Main residence exemption
PS LA	Practice Statement Law Administration
SBE	Small Business Entity
SBPP	Small business participation percentage
TAA 1953	*Tax Administration Act 1953*

Introduction

Capital Gains tax is a complex and challenging area of our taxation laws which requires an analytical approach to ensure that the provisions are applied correctly to transactions. The CGT rules will often have an adverse impact on the calculation of taxation liabilities unless due care is taken to correctly apply the rules to particular transactions.

It is therefore extremely important when considering the CGT rules that ALL aspects of the law are taken into consideration and that the facts of the transaction are identified and thoroughly analysed and the CGT rules correctly applied to the facts.

This is especially important when seeking to rely on a particular exemption provision or when determining whether the transaction qualifies for a concession which treats the gains as tax-free or which permits deferral of the tax.

Warning

When applying the CGT provisions, it is important to understand the full facts to which the CGT provisions may apply and to identify the most specific CGT event that applies to the transaction.

Small business CGT concessions

Overview

- Division 152 provides a range of concessions to reduce or eliminate a capital gain made on a CGT asset used in a business (called an *active asset*). The concessions are:
  - the 50% active asset reduction;
  - the 15-year exemption;
  - the retirement exemption; and
  - the small business roll-over.
- The availability of the concessions is subject to satisfying a range of basic conditions in Subdiv 152-A including satisfying either:
  - the < $2 million SBE test in s. 328-110; or
  - the $6 million Net Asset Value Test in s. 152-15.

Important

- The small business CGT concessions are available only where a capital gain has been made and do not apply to capital losses.
- For a partner's capital gain, the Div 152-A conditions may be satisfied under s 152-10(1)(c)(iii)) if:
  - the partnership is a SBE; and
  - the CGT asset is 'an interest in an asset of the partnership' (s. 152-10(1)(c)(iii)).

  A partner cannot, however, be a SBE in their own right, it is the partnership that is the SBE (s. 328-110(6)).
- There is a general non-business owner rule to allow non-business entity access to SBE status for some Small Business CGT purposes only.

Important

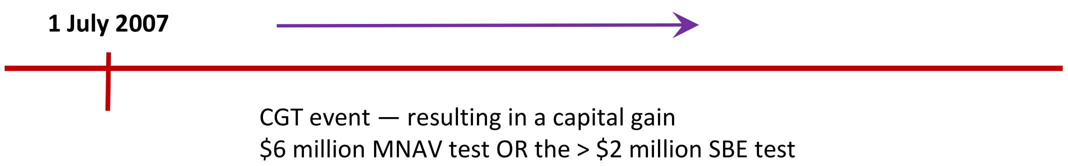
There are a number of specific rules noted below which apply **only** for Div 152 Small Business CGT concession purposes and are not applicable for accessing other SBE concessions.

Note

This paper focuses on specific aspects of the Small Business CGT concessions. A detailed discussion of all small business CGT concessions is outside the scope of this paper.

Basic conditions for the small business CGT concessions: Subdiv 152-A

The basic conditions for relief are set out in s. 152-10 as follows:

Basic conditions for CGT relief	
1	A CGT event happens in relation to a CGT asset of the taxpayer in an income year.
2	The event would otherwise have resulted in a capital gain.
3	At least 1 of the following applies: 1. the taxpayer is an SBE for the income year; or 2. the taxpayer satisfies the maximum net asset value test in s. 152-15; or 3. the taxpayer is a partner in a partnership that is an SBE for the income year and the CGT asset is an asset of the partnership.  **Note** As indicated above, since 1 July 2007, an entity has been able to qualify for the Div 152 concessions by satisfying either one of the two possible tests. Before that date, only the maximum net asset value test was available. A taxpayer satisfies the ‘**maximum net asset value test’** (MNAV) if, just before the CGT event, the sum of the net value of the assets of: ■ the taxpayer; ■ their connected entities; ■ their affiliates; and/or ■ their affiliates’ connected entities is ≤ $6 million **($6 million MNAV test**) (s. 152-15).
4	The CGT asset satisfies the **active asset** test in s. 152-35 which requires the assets to have been used in a business for the **lesser** of: ■ 50 per cent of the ownership period; and ■ 7.5 years (if > 15 year old asset).

	Additional basic conditions – where the asset is a share in a company or interest in a trust
1	If the CGT asset is a **share** in company or an **interest** in a trust, the following additional basic conditions must be satisfied: ■ the taxpayer must be a **CGT concession stakeholder** in the resident company or trust; or ■ the CGT concession stakeholders in the company or trust together have a ≥ 90% small business participation percentage (SBPP) in the taxpayer (s. 152-10(2)).

The $6 million MNAV test

Subdivision 152-A contains the four **basic conditions** which must be satisfied for eligibility for the Small Business CGT Concessions. If these basic conditions cannot be met, none of the four small business CGT concessions will be available.

The four basic conditions for Subdiv 152- A are outlined in the table above. The third basic condition is an either/or condition where the taxpayer making the gain is either an SBE or satisfies the ≤$6 MNAV test.

In this section of the paper we will focus on the ≤$6 MNAV test.

Summary

The main features of the $6 million MNAV test are set out below.

≤ $6 million MNAV test — s. 152-15

It tests **net value** — i.e. the market value of CGT assets **less** liabilities **related** to the CGT assets (including non-business assets).

Note

Some assets are disregarded — the assets which are excluded from the test are listed in ss. 152-20(2) to (4).

Section 152-15 includes **net asset values** of CGT assets of:

- the test entity;
- its connected entities; its affiliate(s); and/or
- its affiliates' connected entities.

Implications

The ≤ $6 million MNAV test looks at the CGT assets not only of the entity that made the gain, but also of:

- other entities; and
- non-business entities with CGT assets.

≤ $6 million MNAV test — s. 152-15

Tip
■ Some assets are excluded from the $6 million MNAV test:
  ▪ include assets of affiliates (or their connected entities) if the assets are used in the test entity's (or its connected entity's) business — s. 152-20(3); and
  ▪ exclude the business assets of a connected entity if it is connected to the test entity only because of the test entity's affiliate:
    □ e.g. spouses are potentially affiliates, however one spouse's business entity assets would be disregarded if the only reason that the business entity would be connected to the other spouse is because of the affiliate relationship of the spouses — s. 152-20(4)).
 	
Tip
■ The ≤ $6 million MNAV test is likely to be beneficial where:
  ▪ the < $2 million SBE test cannot be satisfied but net asset values are likely to be more than $6 million (refer above); or
  ▪ the business has ceased but the assets can still satisfy the active asset requirement, but the entity cannot satisfy the SBE test.

Assets and liabilities that are included in the MNAV test

The meaning of *net value of the CGT assets* of an entity is defined in s. 152-20 as the amount obtained by subtracting from the sum of the market value of the CGT assets the sum of:

1. the liabilities of the entity that relate to the assets; and
2. the provisions made by the entity for:
   (a) annual leave;
   (b) long service leave;
   (c) unearned income;
   (d) tax liabilities.

Liabilities that relate to assets

This includes liabilities directly related to particular assets that are included in the calculation and liabilities that do not specifically relate to assets but indirectly relate to the assets included in the calculation.

Some examples of such liabilities would include:

- a loan to finance the purchase of business premises;
- a bank overdraft; or
- other short-term financing facility that provides working capital for the business.

The following items are **not** taken into account in working out the net value of the CGT assets of Example Pty Ltd because they are **contingent** liabilities, future obligations or expectancies:

- provision for possible damages payout;
- unbilled expenses (management consultant), and
- provision for warranty.

Example — Working out the net value of CGT assets		
Example Pty Ltd is selling its business. The assets and liabilities of the company are as follows:		
Assets:	**$**	**$**
Plant and machinery	1,500,000	
Freehold premises	3,500,000	5,000,000
Liabilities:		
Mortgage (secured over the premises)	2,000,000	
Provision for leave of employees	500,000	
Unbilled expenses (management consultant)	200,000	
Provision for warranty	200,000	
Provision for possible damages payout	100,000	3,000,000
Net assets:		**2,000,000**
The net value of the CGT assets of the company is calculated as follows:		
Assets:	$	**$**
Plant and machinery	1,500,000	
Freehold premises	3,500,000	**5,000,000**
Liabilities:		
Mortgage (secured over the premises)	2,000,000	
Provision for leave of employees	500,000	**2,500,000**
Net value of CGT assets:		**2,500,000**

In *FCT v Byrne Hotels Qld Pty Ltd* [2011] FCAFC 127 the Full Federal Court found that the real estate agent's fees could be taken into account in determining whether the MNAV test under s. 152-15 was satisfied. This was on the basis that the legal obligation for payment of these fees arose prior to the completion of the sale contract.

Bell v FCT – Family Trust loan not a liability related to the CGT assets of the trust

In *Bell v FCT* [2013] FCAFC 32, the Full Federal Court found that the family trust's loan of $2.018 million — the proceeds of which it had used to pay out a capital distribution of the same amount to the taxpayer — was not related to the family trust's CGT assets for the purposes of the MNAV test. This was on the basis that the purpose of the liability when it was incurred — e.g. to preserve existing assets of the trust — did not make that liability 'related to' the CGT assets of the trust forever.

The Full Federal Court stated that as the loan of $2.018 million — which existed just before the CGT event — had been used to pay out a capital distribution, the debt owing was a general one and bore no relationship to the assets of the trust.

Bell's case also examined whether a separate asset — cash of $1,252,112, in a Bank of Adelaide offset account, was included in its entirety in the taxpayer's MNAV test, or instead could be treated as a single account comprising the cash balance less the loan liability of $1,085,824 against which the account was offset. While the Bank records treated the cash balance and the loan balance as separate accounts with separate account numbers; the taxpayer argued it should be treated as a single account with a net balance of $166,288. The loan funds had been used to acquire a residence which was excluded from the MNAV calculation. The Full Federal Court found that the Tribunal's decision not to treat the offset and loan accounts as a single account was a question of fact rather than law, therefore the decision was reasonably open on the material before the Tribunal.

Disregarded assets

Interests in affiliates or connected entities

Section 152-20 also provides that certain assets are to be disregarded in calculating the net asset value of an entity.

Where an entity has:

- an interest in another entity that is a connected entity; or
- an affiliate that has a connected entity;

it can disregard shares, units or other interests (except debt) in that other entity.

The purpose of this exclusion is to ensure that there is no double counting. If an entity is an affiliate or connected entity then its assets will be included in the test. To also count the interest held in such a connected entity would be to double count assets. Any liabilities in relation to the shares or units however, are included in the calculation.

Personal use assets

Individuals may **disregard** assets that are being used **solely** for the personal use and enjoyment of the individual or the individual's affiliate. Examples of such assets would include boats, motorcycles, cars and holiday homes.

Main residence

The market value of an individual's ownership interest in a dwelling used as a main residence is disregarded. However, where the dwelling is being used to produce assessable income and a deduction would be available to any extent for interest incurred, then an amount that is reasonable — having regard to the extent that interest would be deductible — is included in the test.

Assets of affiliates or connected entities

For the purposes of the test, only include those assets of affiliates and connected entities that are **used** by the taxpayer or a connected entity of the taxpayer **in the carrying on of a business**.

The operation of the MNAV test particularly in relation to assets not being used solely for personal use and enjoyment was considered by the AAT in *Altnot's case.*[1]

Altnot Pty Ltd and FCT — Test time for private use of holiday house under the MNAV test

Deputy President Forgie considered whether, for the purposes of deciding whether the taxpayer satisfied the MNAV test[2] in the small business CGT concessions:

- the husband's interest in a holiday house was disregarded as it was not being used solely for his personal use and enjoyment or the personal use and enjoyment of his small business CGT affiliate, and
- the wife was 'connected with' the company that made the capital gain under the former small business CGT affiliate and connected entity provisions.

Facts

Mr Roberts owned 50 per cent of the shares in the taxpayer company and Mrs Roberts did not own any shares in the taxpayer company.

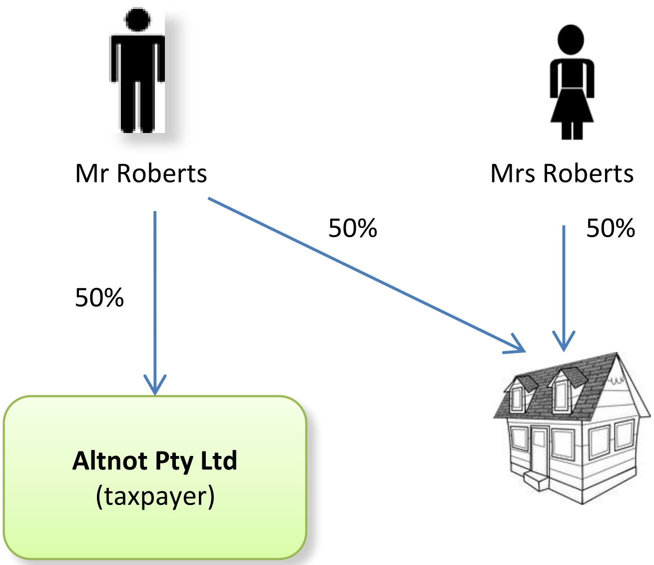
The taxpayer owned 50 per cent of the Clearwater Carwash business (the business). On 30 March 2007, the taxpayer entered into a contract to sell its interest in the business and made a capital gain of $1,029,449. However, the taxpayer did not include a capital gain in its tax return as it reduced the capital gain to nil under the small business CGT concessions on the basis that it satisfied the then MNAV test of $5 million.

The relevant entities that were considered when determining if the taxpayer passed the MNAV test were as follows:

[1] [2013] AATA 140.

[2] The dispute in the *Altnot* case was in relation to the 2006–07 income year when the MNAV threshold was $5 million. The threshold was increased to $6 million for CGT events that happen in the 2007–08 and later income years.

Relevant entities that were considered for the MNAV test



The holiday house had been:

- used for private holidays by Mr and Mrs Roberts and their family since they acquired it on 10 August 2000; and
- leased to unrelated parties for extended periods of time until 31 January 2007.

The evidence indicated that Mr and Mrs Roberts decided on 15 December 2006 that they would:

- no longer lease the holiday house; and
- use it solely for their own use.

Mr and Mrs Roberts did not, however, stay in the holiday house at any time during the period from 31 January 2007 to 30 March 2007.

Decision

For the purposes of the MNAV test, Deputy President Forgie found that:

1. Mrs Roberts was not connected with the taxpayer and therefore her assets were not counted; and
2. Mr Robert's interest in the holiday house was **not** disregarded because the holiday house was not being used solely for his personal use and enjoyment or the personal use and enjoyment of his small business CGT affiliate.

Whether Mrs Roberts' CGT assets were counted in the MNAV test

Deputy President Forgie made the following comments when determining which entities' CGT assets were included in the MNAV test relating to the taxpayer:

1. Entities connected with the taxpayer under former s. 152-15(a)(ii) of the *ITAA 1997*:
   (a) Mr Roberts was connected with the taxpayer as he controlled the taxpayer — he owned 50 per cent of the shares in the taxpayer.
   (b) Mrs Roberts was not connected with the taxpayer as she did not control the taxpayer company because she:
      (i) did not own any shares in the taxpayer; and
      (ii) was not controlled by Mr Roberts.
2. Entities that are small business CGT affiliates of the taxpayer under s. 152-15(a)(iii) of the *ITAA 1997* — the taxpayer did not have any small business CGT affiliates under:
   - former s. 152-25(1)(a) because the taxpayer was not an individual (and could therefore not have a spouse); or
   - former s. 152-25(1)(b) because neither Mr nor Mrs Roberts acted, or could be reasonably expected to act, in accordance with the taxpayer's directions or wishes or in concert with it.

Whether the holiday house was used solely for the personal use and enjoyment of Mr Roberts

When finding that Mr Roberts' interest in the holiday house was not disregarded for the purposes of the MNAV test, Deputy President Forgie stated that:

1. the time for testing whether the asset was being used solely for his personal use and enjoyment was just before the CGT event;
2. the word 'use' refers to a CGT asset being put to a practical purpose 'with some continuity' drawing a distinction between something being used and being held ready for use; and
3. the words 'being used solely' require that the CGT asset be used only or exclusively for that use.

When referring to the 'continuity' of the use, Deputy President Forgie noted the following:

(a) although the concept of a point in time test might seem somewhat at odds with a test that incorporates an element of continuity, she did not think this was the case;

(b) in order to make a decision about what was happening at a particular point in time, the time surrounding that particular point in time must be looked at to determine the point in time in its context; and

(c) whether a holiday house is being used solely for a person's personal use and enjoyment will depend on a conglomerate of matters, including such matters as:
   (i) the pattern of use by the owners and others leading up to that time;
   (ii) the amount of time for which it is used as a holiday house; and
   (iii) how the owners view it.

Although the evidence indicated that the holiday house was no longer used as a rental property just before the CGT event, it was not being **'used'** at that time for the personal use and enjoyment of Mr and Mrs Roberts. They had the property 'available' for their personal use and enjoyment at that time — as they had decided to cease leasing the property — but had not started to use the property as their holiday house.

Queries

1. Did Mrs Roberts control the taxpayer?

   Although Deputy President Forgie was not 'comfortable' with the way the Commissioner's submission was cast, it is arguable that Mrs Roberts controlled the taxpayer because her small business CGT affiliate — Mr Roberts — controlled the taxpayer.[3]

2. Would Mrs Roberts control the taxpayer under current legislation?

   For CGT events happening in the 2007–08 and later income years, the definition of 'affiliate' in s. 328-130(1) of the *ITAA 1997* does not automatically include an individual's spouse or child under the age of 18. This means that Mrs Roberts would not control the taxpayer.

3. Is the time for which the individual needs to 'use' the holiday house consistent with current views?

   In the ATO's view, a point in time analysis will not necessarily reflect the true nature of the asset.[4] The ATO's view in ATO ID 2011/41 is that:

   - the use of a holiday house is to be tested over its entire period of ownership; and
   - as the test is a sole use test, the holiday house is not being used solely for the personal use and enjoyment of the individual even if there is only occasional use of the holiday house by others during the ownership period for which rent is paid.

Recent development

On 12 April 2013, the Commissioner lodged an appeal against this decision to the Federal Court.

The 90% Small Business Participation Rule

The 90 per cent small business participation (SBPP) test is relevant when a non-individual entity (e.g. a trust) makes a capital gain on the sale of shares or units. The test applies if there is an interposed entity between the CGT concession stakeholder and the company or trust in which the shares or interests are held: s. 152-10(2)(b)).

The non-individual interposed entity satisfies the test if 90 per cent of the participation percentages in that entity are held by CGT concession stakeholders of the company or trust in which the shares or interests are held.

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3 The Commissioner submitted that Mrs Roberts was a person connected with the taxpayer within the meaning of former s. 152-30(1)(a) because she controlled the taxpayer. She did that because Mr Roberts, who was her small business CGT affiliate, beneficially owned shares in the taxpayer and those shares carried with them the right to exercise, or control the exercise of 40 per cent of the voting power in the taxpayer: see para. 37.

4 See ATO ID 2011/37.

CGT Concession stakeholder

Section 152-60 defines a *CGT concession stakeholder* of a company or trust to mean:

- a *significant individual* in the company or trust; or
- a *spouse of a significant individual* in the company or trust, if the spouse has a SBPP in the company or trust at that time which is greater than zero.

CGT concession stakeholder status – when is it important?
The status of an **individual** as a CGT concession stakeholder for Small Business CGT Concession purposes is important in the following circumstances: ■ CGT events regarding **shares** or **units** as active assets; ■ accessing the **retirement exemption** by a **non-individual taxpayer** (e.g. a company or trust makes the capital gain); or ■ accessing the **15-year exemption** by a **non-individual taxpayer** (e.g. a company or trust makes the capital gain).

Significant individual (SI)

The aim of the significant individual test is to identify those individuals with a substantial interest in a small business. The test looks to a minimum interest of **20 per cent**, which may be satisfied directly or indirectly (i.e. through one or more interposed entities).

An **individual** is a significant individual in a company or trust if the individual has a SBPP in the company or trust of at least 20 per cent (direct or indirect interest) (s. 152-55).

Section 152-65 provides that an **entity's** SBPP in another entity at a time is the percentage that is the sum of:

- the entity's direct SBPP in the other entity; and
- the entity's indirect SBPP in the other entity.

Important

The significant individual test allows up to **eight** taxpayers to qualify as CGT concession stakeholders (or up to **five** significant individuals each with a 20 per cent interest).

Small Business CGT Planning and SI and CCS issues

Tip
■ A structure that maximises the number of Concession Stakeholders (CCS) requires that:
    ■ there are four individuals who are SI each with $\geq$ 20 per cent interest; and
    ■ each has a spouse with **> 0%** (i.e. not necessarily 5 per cent but something > 0 per cent).
■ The above structure could also involve **indirect** interests equal to the above percentages (e.g. via interposed discretionary trusts).

Small Business CGT Planning and SI and CCS issues

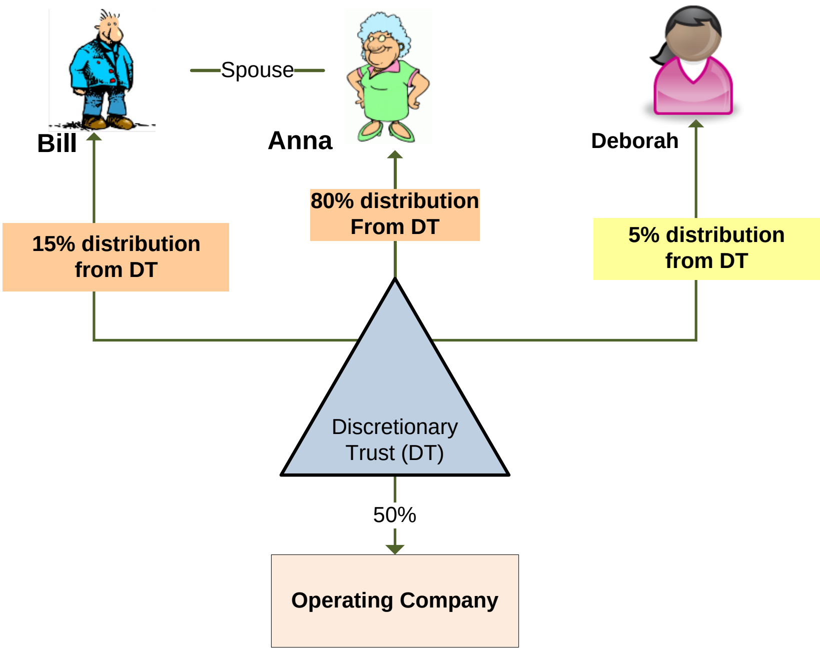
▪ The above structure is important for access to:
  ▪ the 15-year exemption;
  ▪ the retirement exemption; and
▪ business sales through sale of shares or units.
▪ The 15-year exemption requires an SI for a set period of time whereas the retirement exemption and share/unit sale rule do not.

Entity sale

The 90 per cent test will apply where a disposal occurs through the sale of, or a CGT event occurs in relation to, an interest in an entity. This is likely to be the sale of shares in a company or the sale of units in a unit trust. In such situations the test will be relevant if the taxpayer is not an individual.

Example — The 90 per cent test

A Discretionary Trust (DT) sells shares in the Operating Company. Anna receives 80 per cent, Bill receives 15% and Deborah receives 5 per cent of the distributions from the DT. The DT has a 50 per cent interest in the Operating Company.



The DT cannot be a CGT concession stakeholder in the Operating Company because it is not an individual.

However, the DT can satisfy the test as:

- Anna, a significant individual and a CGT concession stakeholder of Operating Company (because her SBPP in the Operating Company is 40 per cent (50% x 80% = 40%), has an 80 per cent SBPP in the DT; and
- Bill, a CGT concession stakeholder of Operating Company (because he is a spouse of Anna and has a SBPP in the Operating Company which is greater than zero), has a 15 per cent SBPP in the DT.

Example — The 90 per cent test
Thus, at least 90 per cent of the participation percentages in the DT are held by CGT concession stakeholders of Operating Company (i.e. Bill and Anna). Deborah, is not a CGT concession stakeholder of Operating Company, as she has a 5 per SBPP in the DT. Accordingly, the DT satisfies the ownership requirement if it sells its shares in Operating Company and can access the concessions on those shares, provided that the other conditions are met. *adapted from s. 152-10 of the ITAA 1997*

Warning

In ATO ID 2012/99 the Commissioner takes the view that references to distributions of 'income' in the context of determining an entity's direct SBPP in a trust mean the income of the trust, determined according to the general law of trusts, to which a beneficiary could be entitled. Depending on the terms of the deed and/or the actions of the trustee pursuant to a power in the deed, this may be an amount that differs from the ordinary income of the trust.

Retirement exemption: Subdiv 152-D

A taxpayer may **choose** to disregard all, or part of, a capital gain where the capital proceeds from the CGT event are used in connection with the taxpayer's retirement (Subdiv 152-D).

Note

- It is **not** necessary that the taxpayer retires.
- There is a lifetime limit of **$500,000** for all choices that can be made in respect of an individual under the small business retirement exemption.

Basic conditions — Retirement exemption
Individual An **individual** may choose to disregard all, or part of, a capital gain where the capital proceeds from the CGT event are used in connection with the taxpayer's retirement, provided that the following conditions are satisfied: ■ the basic conditions in **Subdiv 152-A** — see **page 5**; ■ if the taxpayer is < 55 years of age just before they make the choice — an amount equal to the CGT exempt amount mentioned in s. 152-310 must be contributed to a complying superannuation fund: s. 152-305(1)); ■ the contribution is made at the later of when the individual made the choice and when they received the proceeds.

Basic conditions — Retirement exemption

Important

An amount equal to the CGT exempt amount must be contributed into a complying superannuation fund unless the relevant individual is **≥ 55 years of age** at the time that the retirement exemption choice is made (generally on lodgment of the relevant tax return).

Company or trust

Where a company or trust chooses to apply the retirement exemption to a gain it has made, the company or trust **must** make a payment to at least one of its CGT concession stakeholders if the company or trust makes the choice under the retirement exemption to disregard a capital gain from a CGT event.

There are strict time periods within which the money must be paid either to the individual or CGT concession stakeholder or into a superannuation fund. The time period is the **later** of:

- 7 days after the making of the choice to use the exemption; or
- 7 days after receiving the proceeds from the CGT event.

Example — Age at the time of making the choice

Ross sells his business and makes a capital gain of $500,000. He satisfies the basic conditions in s. 152-10. Ross is aged 54 years when he receives capital proceeds from the sale.

He had not decided what to do with the money at that time.

Ross turns 55 years of age, and decides when lodging his income tax return that he wants to use the retirement exemption — he is not required to pay the money into a superannuation fund because he was aged 55 years just before he made the choice.

Small business roll-over: Subdiv 152-E

CGT roll-over relief is available where some or all of the active assets of a small business are disposed of and active replacement assets are acquired, or existing assets improved.

Eligible small business taxpayers benefit from a two-year deferral of their CGT liability.

Basic conditions — Roll-over relief

The small business roll-over is available for capital gains from a CGT event if the **basic conditions** in Subdiv 152-A above are met (refer to **page 5**).

It is not necessary that the replacement asset has been acquired or that expenditure to improve an asset has been incurred before choosing the roll-over.

This deferral is available whether or not the taxpayer chooses to access any or all of the available small business CGT concessions.

Important

Where the deferral is taken and the replacement assets have not been acquired or existing assets have not been improved after the two years:

- the deferred capital gain crystallises through CGT event J5 or J6; and
- the CGT liability becomes payable.

A taxpayer may disregard all or part of the gain regarding events J5 or J6 (s. 152-415).

Warning

The two-year deferral comes with some important strings attached. A taxpayer who chooses to apply Subdiv 152-E to some or all of a capital gain may, at some later stage, have to deal with the following consequences from the operation of various integrity provisions:

- if any of the three CGT events J2[5], J5[6] or J6[7] occur — the 50 per cent CGT discount (Div 115) will not apply to reduce the capital gain any further;
- for CGT events J5 and J6 — the 15-year exemption, the 50 per cent reduction, and the roll-over cannot apply (however, the retirement exemption can be used); and
- under CGT event J2, the 15-year exemption and the 50 per cent reduction can no longer be applied. However, the small business roll-over and the retirement exemption are still available.

Example — Application of roll-over relief
Peter, aged 55, made a substantial capital gain on the sale of his take-away business in January 2010. He satisfied the $6 million MNAV test and the active asset test. Peter is not eligible for small business 15-year exemption. After utilising: ■ the CGT general discount; ■ the 50 per cent active asset reduction; and ■ the retirement exemption (refer to **page 16**),- Peter is left with a capital gain of $100,000. **When will Peter pay tax on this $100,000?** Under s. 152-410 Peter can **choose** to obtain the roll-over relief. It will be sufficient evidence of his having made the choice if he prepares his tax return and excludes the $100,000 from his assessable income: s. 103-25(2).

5 Deals with changes in relation to replacement asset or improved asset after a roll-over under the small business roll-over in Subdiv 152-E.

6 CGT event J5 happens if a taxpayer chooses the small business roll-over under Subdiv 152-E and fails to acquire the replacement asset and to incur fourth element expenditure within the prescribed time.

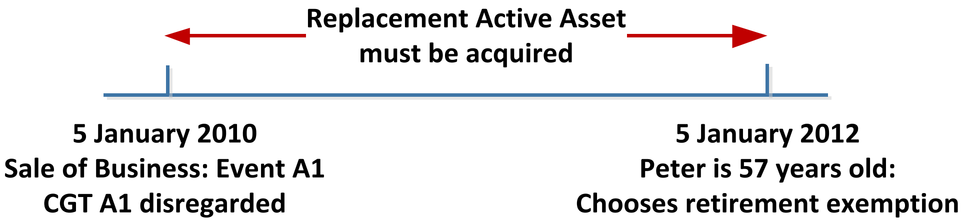
7 CGT event J6 happens if a taxpayer chooses the small business roll-over under Subdiv 152-E but the cost of the replacement asset or the amount of the fourth element expenditure in insufficient to cover the disregarded capital gain.

Example — Application of roll-over relief
Peter is not required to have the intention to acquire a replacement asset.

If Peter does not have any replacement assets by the end of two years after the original CGT event, **CGT event J5** happens (s. 104-197). CGT event J5 will deem a $100,000 capital gain to happen two years after the original CGT event.

Section 152-10(4) operates to prevent the 50 per cent active asset reduction applying to the CGT event J5 capital gain (i.e. to reduce the capital gain any further).

However, as Peter is 57 years old in 2012, he can use the **retirement exemption** (s. 152-305).



Trust capital gains

Enabling streaming of capital gains to beneficiaries

The High Court's endorsement of the proportionate approach in the *Bamford* case[8] created some uncertainty about whether amounts distributed from a trust to beneficiaries retain their character on distribution. Pending resolution of this issue, which is likely to be dealt with as part of the re-write of the trust provisions in Div 6 of the *ITAA 1936*, the Government has enacted interim measures — in Subdivs 207-B and 115-C — to enable streaming of franking credits and capital gains.

Overview of streaming measures

Schedule 2 to the *Tax Laws Amendment (2011 Measures No. 5) Act 2011* made changes to the Tax law which ensure that, where permitted by the trust deed, the capital gains and franked distributions (including any attached franking credits) of a trust can be effectively streamed for tax purposes to beneficiaries by making them 'specifically entitled' to those amounts. Although this paper refers to streaming of both capital gains and franked dividends, the emphasis is on the streaming of capital gains and therefore the examples relate only to capital gains.

Interim changes[9] to allow 'streaming' of capital gains and franked distributions

The taxation of a trust's capital gains and franked distributions (including attached franking credits) has been taken out of Div 6 of Part III of the *ITAA 1936* and is now dealt with under:

- Subdiv 115-C of the *ITAA 1997* (about trusts with capital gains); and
- Subdiv 207-B of the *ITAA 1997* (about receiving a franked distribution through a trust).

Important

This result has been achieved other than by way of direct amendments to Div 6 or by defining the concept of 'income of the trust estate'.

These amendments generally produce an outcome which is the same as the outcome under the law before the amendments for:

1. trusts that have not made capital gains or received franked distributions (including any attached franking credits) during an income year;
2. trusts that have made capital gains or received franked distributions (including any attached franking credits) during an income year but have not made particular beneficiaries 'specifically entitled' to those amounts;
3. managed investment trusts — which have been provided with a 'carve-out' in recognition that these trusts generally do not 'stream' capital gains or franked distributions and instead distribute all of their trust income proportionately.[10]

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8 *FCT v Bamford; Bamford v FCT* [2010] HCA 10.

9 These changes have been introduced as an interim measure pending a re-write of Div 6 of Part III of the *ITAA 1936*

The treatment of capital gains and franked distributions under the interim measure may be summarised as follows:

Type of trust income	Treatment
Capital gains and franked distributions to which beneficiaries are '**specifically entitled**'	Capital gains made and franked distributions derived by a trustee to which beneficiaries are specifically entitled will be 'streamed' on a **quantum** basis to those beneficiaries, along with their tax attributes (e.g. franking credits).
Other trust income or capital gains and franked distributions to which no beneficiary is '**specifically entitled'**	Those amounts to which no beneficiary is specifically entitled will flow **proportionally** to: ▪ beneficiaries based on their share of the 'income of the trust estate' (net of amounts to which a beneficiary is specifically entitled); or ▪ the trustee if there is part of the 'income of the trust estate' to which no beneficiary is presently entitled.

Key points
1. For the 2011 and later income years, where a trustee has the power to appoint or 'stream' capital gains and/or franked distributions (including any attached franking credits) to specific beneficiaries, this will be effective for tax purposes.
2. Where a beneficiary is made 'specifically entitled' to an amount 'attributable' to a franked distribution or a capital gain, the associated tax attributes will flow to that beneficiary regardless of whether part or all of the amount is part of the 'income of the trust estate'.
3. To achieve this result, capital gains and franked distributions are effectively taken out of Div 6 and dealt with under Subdivs 115-C and 207-B respectively.
4. The primary purpose of these amendments is to ensure that, where permitted by a trust deed, the 'streaming' of capital gains and franked distributions to beneficiaries (by making them specifically entitled to those amounts) is effective for tax purposes.
Critical point The amendments do not, in any way, give trustees a power to stream where the deed does not already give them the power to do so. Amending a deed to give trustees a power to stream may give rise to a resettlement or the creation of a new trust if not done in accordance with the trust deed (CGT event E1).[11]

[10] This carve-out enables MITs to use the current 'proportionate approach' in Div 6 until the Government's new MIT regime commences on 1 July 2014. The trustees of these trusts can still choose to apply these amendments provided they make a valid election for the 2011, 2012, 2013 and 2014 income years.

[11] See TD 2012/21.

Key points	
5.	The amount 'attributable' to: ▪ a franked distribution is the total franked distribution received by the trustee (not including franking credits) reduced by directly relevant expenses; ▪ a capital gain is the capital gain actually made by the trustee (ignoring any discounts) reduced by directly relevant expenses (this will be applied on a 'gain by gain' basis).
6.	For trusts with no capital gains and no franked distributions, the streaming amendments have no effect.
7.	For trusts that have capital gains or franked distributions but do not stream them to specific beneficiaries, the amendments apply but they generally produce the same outcome as the current law.
8.	Consistent with current policy, if there is no 'income of the trust estate', then it is not possible to stream franked distributions (and associated franking credits) to a beneficiary.
9.	Existing integrity rules in Subdiv 207-F (such as the 'qualified person' rules) continue to apply in respect of the streaming of franked distributions — particularly to determine whether a beneficiary can receive the benefit of franking credits.
10.	Consistent with current policy, it is not possible to deal separately with the taxable component and the discount component of a capital gain.
11.	Unlike current policy, it is possible to stream capital gains without being presently entitled to a share of trust income. Beneficiaries no longer need to have an amount of assessable income included under ss. 97, 98A or 100 of the *ITAA 1936* to be treated as having an extra capital gain under s. 115-215. This ensures that a 'capital beneficiary' that is specifically entitled to an amount representing a capital gain of a trust is treated as having an extra capital gain in relation to that amount even if they are not presently entitled to a share of the income of the trust estate. Beneficiaries also no longer receive a deduction [under s. 115-215(6): see below] for extra capital gains they have as a result of Subdiv 115-C. Instead, the amount included in a beneficiary's assessable income calculated under Div 6 is modified by Div 6E, if necessary, to exclude any amount of the taxable income of the trust related to the capital gain.
12.	It is not possible to make a beneficiary specifically entitled to franking credits, or to separately stream franked distributions and franking credits.

The approach to dealing with capital gains and franked distributions involves four 'steps':

Steps in dealing with streaming of capital gains and franked distributions	
Step 1	Division 6 is the starting point for the taxation of trust income. As is currently the case, Div 6 will apply to assess beneficiaries on their share of a trust's net income based on their present entitlement to the same share of the trust income. If the trust has no net income or no capital gains and no franked distributions, the trustee (and beneficiaries) need go no further.
Step 2	The next step is to determine amounts of capital gains and franked distributions to which beneficiaries are specifically entitled — and each beneficiary's 'adjusted Division 6 percentage' of the remaining income of the trust estate. These concepts are used to calculate each beneficiary's 'share' of the trust's capital gains and franked distributions. Generally, if no capital gains or franked distributions have been streamed to specific beneficiaries, each beneficiary's **adjusted Div 6 percentage** will be the same as their original Div 6 percentage of trust income.
Step 3	Amended Subdivs 115-C and 207-B apply to assess beneficiaries (or the trustee) on their share of any capital gain made or franked distribution derived by the trustee. The two subdivisions operate simultaneously so it does not matter which subdivision is applied first.
Step 4	New Div 6E adjusts the amounts otherwise assessed to beneficiaries (or the trustee) under Div 6 to avoid double taxation.

Note

This approach is similar to that which currently applies to the taxation of a capital gain received by a beneficiary of a trust. Where a beneficiary derives net income that is attributable to capital gains derived by the trust:

(a) s. 97 of the *ITAA 1936* requires a taxpayer who is not under a legal disability and who is presently entitled to a share of the income of a trust estate to include in their assessable income that share of the net income of the trust calculated under s. 95 of the *ITAA 1936;*

(b) s. 115-215(3) of the *ITAA 1997* requires the beneficiary to 'gross-up' the capital gain so that the beneficiary can apply:

- their own capital losses against their net capital gain; and
- the appropriate discount percentage (if any) to their net capital gain.

Section 115-215(6) ensures that a beneficiary's share of a trust net capital gain is not taxed both under s. 97 and as part of the beneficiary's net capital gain worked out pursuant to s. 115-215(3) by providing that a taxpayer can deduct for the income year the part (if any) of the trust amount that is attributable to the trust estate's net capital gain mentioned in s. 102-5(1).

See ATO ID 2009/112.

Where streaming is effective — 'specifically entitled'

For streaming of capital gains and franked distributions to be effective for tax purposes, beneficiaries must be specifically entitled to them. That is:

1. the beneficiary must *receive, or reasonably be expected to receive, an amount equal to the 'net financial benefit' referable to the capital gain or franked distribution* in the trust; and
2. the entitlement must be *recorded in its character* as such in the accounts or records of the trust.

It follows that:

- when a beneficiary has a specific entitlement to a capital gain or franked distribution — the associated tax consequences in respect of that distribution will apply to that beneficiary and the beneficiary will not be assessed on any share of the trust's net income over and above the amounts assessed because of Subdivs 115-C and 207-B; and
- capital gains and franked distributions to which no beneficiary is specifically entitled will flow proportionally to beneficiaries and/or the trustee based on their share of trust income excluding amounts to which any beneficiary is specifically entitled.

When a beneficiary has received, or can reasonably be expected to receive

A beneficiary will be taken to have received, or can reasonably be expected to receive, an amount equal to the 'net financial benefit' referable to the capital gain or franked distribution if:

(a) the amount has been credited or distributed to the beneficiary;

(b) the amount has been paid or applied on their behalf or for their benefit; or

(c) the beneficiary has:

- a present entitlement to the amount;
- a vested and indefeasible interest in trust property representing the amount; or
- the amount has been set aside exclusively for the beneficiary.

The entitlement can be expressed as a share of the trust gain or distribution. More generally, the entitlement can be expressed using a known formula even though the result of the formula is calculated later.

For example, a trustee could resolve to distribute to a beneficiary:

- $50 referable to a franked distribution;
- half of the 'trust gain' realised on the sale of an asset;
- the amount of franked distribution remaining after calculating directly relevant expenses;
- the amount of (tax) capital gain included in the calculation of the Trust's taxable income following application of the CGT 50 per cent discount.

‘Net financial benefit’

The ‘net financial benefit’ is the actual proceeds of the trust (irrespective of whether they are characterised as trust income or trust capital) reduced by losses or expenses as follows:

(a) when determining a beneficiary’s fraction of the net financial benefit referable to a ‘capital gain’ — the (gross) financial benefit referable to the gain is reduced by trust losses or expenses only to the extent that tax capital losses were applied in the same way;

(b) when determining a beneficiary’s fraction of the net financial benefit referable to a ‘franked distribution’ — the (gross) financial benefit is reduced by directly relevant expenses only.

Net financial benefit referable to a franked distribution	Net financial benefit referable to a capital gain
This will normally be equal to the amount of the franked distribution after being reduced by directly relevant expenses (such as interest or management fees incurred in respect of managing an investment portfolio of shares).	This will generally be the trust proceeds from the transaction or circumstances that gave rise to the CGT event, reduced by: (a) any costs incurred in relation to the relevant asset; and (b) other capital losses.

Streamed amount must be recorded in its character as referable to the capital gain or franked distribution

The accounts or records of the trust would include the trust deed itself, statements of resolution or distribution statements, including schedules or notes attached to, or intended to be read with them.

Important

A record merely for tax purposes is not sufficient.

Where a beneficiary is entitled to unspecified amounts (or shares) — such as ‘the balance’ of trust income, ‘all of the trust income’, ‘half of the trust income’ or ‘$100 of trust income’ — this is not sufficient to create a specific entitlement. This is because the entitlements have not been recorded in their character as referable to a capital gain or franked distribution.

For example, the following resolutions or trust entitlements **would** satisfy the requirement of being ‘recorded in its character as referable’:

- Under the trust deed, a beneficiary is entitled to all of the capital gains of the trust.
- The trustee resolves to distribute all of the dividends of the trust to a beneficiary.
- Under a trust deed that includes capital gains as income (either by default or because the trustee exercises a power to re-characterise the amount as income), a beneficiary is entitled to all of the profits made on or derived from an asset.
- Under a trust deed that does not include capital gains as income, the trustee resolves to advance capital representing profits from the sale of a property equally to the beneficiaries.

Critical point

A record of the net financial benefit of the capital gain or franked distribution *in its character* that the beneficiary has received, or can reasonably be expected to receive, must be made by the following times:

- for capital gains — a beneficiary's entitlement must be recorded **no later than two months** after the end of the income year;
- for franked distributions — a beneficiary's entitlement must be recorded **by the end of the income year**.[12]

Application of capital gains — Subdiv 115-C

Broadly, the amendments to Subdiv 115-C ensure that only beneficiaries who are specifically entitled to capital gains are assessed on them. Taxable capital gains derived by trusts are taken into account in calculating the net capital gain or loss of beneficiaries that are specifically entitled to related trust amounts, notwithstanding that the related amounts are part of the income or capital of the trust estate.

Where no beneficiary is specifically entitled to trust capital gains, the capital gains are allocated on a proportionate basis. For beneficiaries, this amount depends on their adjusted share of trust income (i.e. adjusted Div 6 percentage). For trustees, to the extent that there is an amount to which no beneficiary is presently entitled the trustee is assessed based on the trustee's adjusted Div 6 percentage.

Calculating the extra capital gain for the beneficiary

The follow four steps can be used to calculate the beneficiary's extra capital gain:

Step No.	Explanation
1	Determine beneficiary's share of the capital gain of the trust – i.e. defined as the amount of the gain. Beneficiary's share of trust capital gain equals = **capital gain to which beneficiary specifically entitled** **+** **beneficiary's adjusted Div 6 percentage to which no beneficiary is specifically entitled**
2	Divide the amount by total capital gain. This results in the beneficiary's fraction of the capital gain

12 As a one-off transitional measure, the ATO allowed the beneficiary's entitlement to be recorded for the 2011 income year **no later than two months** after the end of the income year, consistent with the rule which applies to capital gains.

Step No.	Explanation
3	Multiply the fraction of the capital gain by the taxable income of the trust relating to the capital, resulting in the attributable gain. In some cases, under s. 115-225(2), the taxable amount of the capital gain can be rateably reduced to ensure beneficiaries and the trustee are not assessed on more than the total taxable income of the trust. This applies where the total of trust's net capital gain and total franked distributions (net of expenses) exceed the taxable income of the trust (excluding franking credits).
4	Gross up the result of Step 3 for CGT discount or small business 50 per cent reduction as applied by the trustee to the capital gain

It is not effective for tax purposes to stream the taxable component of a capital gain to one beneficiary and the tax-free (discount) portion to another beneficiary as the beneficiary's trust entitlement must be to a net financial benefit and not a tax concept.

Calculating the extra capital gain – adapted from Example 2.8 in the Explanatory Memorandum

Assume the following facts

- Batman Trust (**Batman**) has two beneficiaries, Alfred and Bruce.
- Batman derives income of $100 rent and $600 which is entitled to the discount capital gain.
- Batman also has a capital loss of $100.
- Batman's trust deed does not define income, so capital gains do not form part of the trust income.
- Batman's trust income is $100.
- Batman's taxable income is $350 ($100 + ($600 - $100) / 2).
- The trustee of Batman resolves to distribute $300 relating to the capital gain (after reduction of the capital loss) to Alfred and the rent of $100 to Bruce.

Following is the calculation of the extra capital gains for Alfred and Bruce.

Step No.	Description
1	*Determine beneficiary's share of the capital gain of the trust.* **Alfred's share of the capital gain** Alfred's specific entitlement = $300 of capital gain. Under s. 115-228(1), Alfred is reasonably expected to receive 60% [$300/($600-$100)] of the capital gain. His specific entitlement to the capital gain is 60%. This means, that Alfred's share of the capital gain under s. 115-227 is $360 (60% of $600 capital gain). **Bruce's share of the capital gain** Bruce does not have a specific entitlement to the capital gains under section 115-228. As Bruce receives100% of trust income not representing capital gains, his adjusted Div 6 percentage is 100%. Bruce's share of the capital gain under section 115-227 is $240 ($600 - $360), the amount to which no beneficiary is specifically entitled.
2	*Divide the amount by the total capital gain. This is the beneficiary's fraction of the capital gain.* Alfred's fraction is 0.6 ($360 / $600) Bruce's fraction is 0.4 ($240 / $600)
3	*Multiply the fraction of the capital gain by the taxable income of the trust relating to the capital, resulting in the attributable gain* The taxable income relating to the capital gain is $250 ($600 - $100) / 50%) Alfred's attributable gain is $150 ($250 x 0.6) Bruce's attributable gain is $100 ($250 x 0.4)
4	*Gross up the result of Step 3 for CGT discount or small business 50 per cent reduction as applied by the trustee to the capital gain* Under s. 115-215(3), Alfred is required to double his attributable gain to $300 as the trustee had applied the 50% general discount. Bruce also doubles his gain to $200 under s. 115-215(3). Alfred and Bruce can then apply any capital losses and subsequently the 50 per cent general discount to the remaining amount.

Assessment of trustee on capital gains

Under s. 98

If the trustee is assessed and liable to pay tax under s. 98 of the *ITAA 1936*, the trustee increases the assessable amount in accordance with the beneficiary's attributable gain, which is calculated as above in steps 1 to 4, but the application of the discount will be prevented for corporate beneficiaries.

Under s. 99 or 99A

A trustee increases the amount on which it is assessed and liable to pay tax under s. 99 or 99A of the *ITAA 1936* to reflect the trustee's share of each capital gain.

For s. 99 assessments, steps 1 to 3 apply as above, without gross up for discounts.

For s. 99A assessments, steps 1 to 4 apply.

A trustee can only be specifically entitled to amount of a capital gain where they choose to be assessed on it under s. 115-230. The only other times a trustee will have a share of the capital gain is where there is:

- no beneficiary specifically entitled; or
- a share of trust income to which no beneficiary is presently entitled or there is no trust income.

Option for resident trustee to be assessed on capital gain

Where the trust deed permits, the trustee of a resident trust can choose to be assessed on a capital gain where a beneficiary has not received any amount referable to the capital gain during the income year or within two months after the end of the income year. If this choice is made, no beneficiary is treated as having an extra capital gain. The trustee is then assessed on the taxable income referable to the capital gain under s. 99 or 99A of the *ITAA 1936*, by deeming that the trustee is specifically entitled to the capital gain.

The Adjusted Div 6 percentage

Capital gains and franked distributions not streamed to beneficiaries (or to the trustee) will flow proportionally to beneficiaries of the trust. This proportion is based on the beneficiaries' 'adjusted division 6 percentage' and not the share determined under Div 6.

The adjusted Div 6 percentage is the share of trust income **excluding** capital gains and franked distributions to which beneficiaries or trustee are specifically entitled.

Adjusted Div 6 percentage

Adjusted Division 6 percentage

=

Beneficiaries present entitlement to trust income

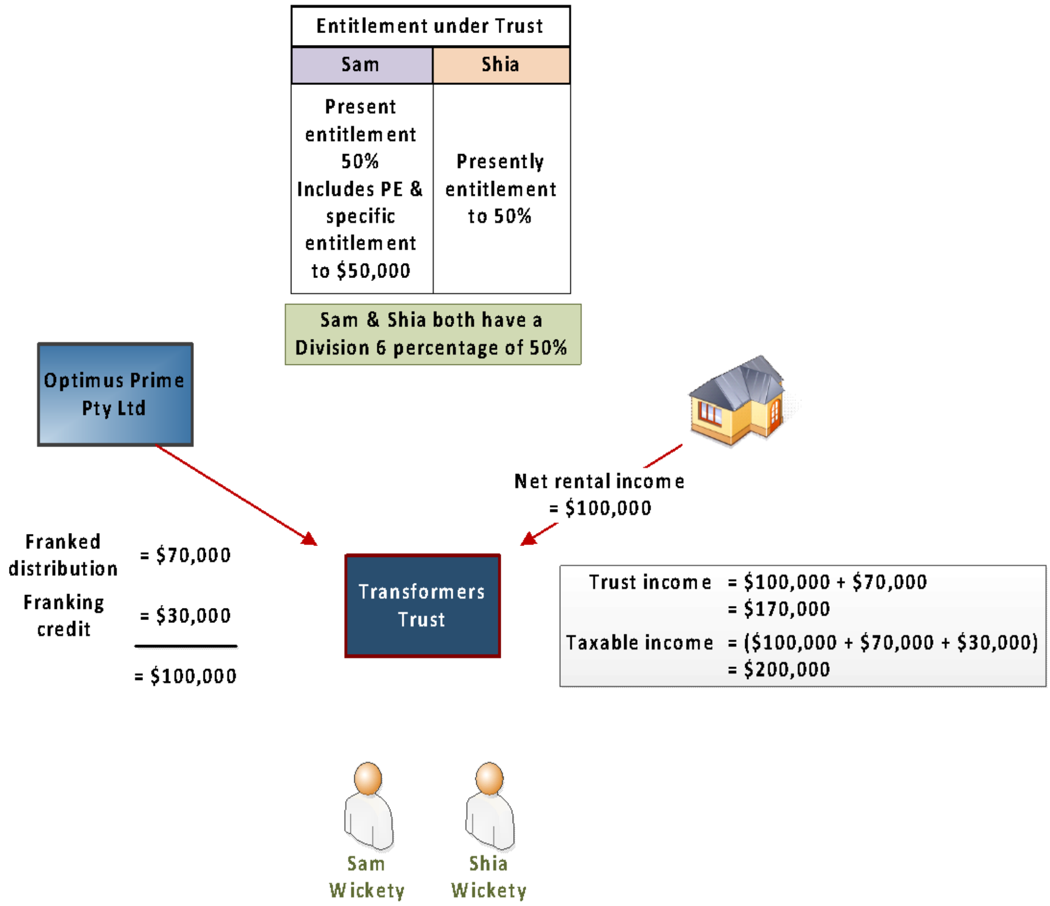
-

Specifically entitled capital gains + Specifically entitled franked distributions

÷

Trust income - Specifically entitled capital gains + Specifically entitled franked distributions

Example — Adjusted Div 6 percentage



Sam's adjusted Division 6 percentage

Share of trust income = \$170,000 x 50%
= \$85,000

$$\text{Adjusted Div 6 percentage} = \left(\frac{\$85K - \$50K}{(\$170K - \$50K)} \right) \times 100\%$$

= 29%

Shia's adjusted Division 6 percentage

Share of trust income = \$170,000 x 50%
= \$85,000

$$\text{Adjusted Div 6 percentage} = \left(\frac{\$85K}{(\$170K - \$50K)} \right) \times 100\%$$

= 71%

Adapted from example 2.7 of the Explanatory Memorandum

Where the sum of the beneficiaries' adjusted Div 6 percentage does not exceed 100 per cent, the difference is the trustee's adjusted Div 6 percentage.

If no trust income remains after reducing specifically entitled amounts to which beneficiaries are entitled, the trustee has an adjusted Div 6 percentage of 100 per cent.

Division 6E income

The Div 6E income of a trust estate is calculated as the income of the trust based on the assumption that it does not include any amounts attributable to capital gains and net franked distributions. This amount cannot be less than nil.

Example of calculation of Div 6E income adapted from example 2.22 of the Explanatory Memorandum

Assume the following facts:

- Y-Men Trust has income of $470,000, made up of $100,000 rental income, $70,000 franked distribution (with an attached $30,000 franking credit) and a $300,000 capital gain (which is eligible for the 50 per cent discount).
- The Y-Men Trust also has prior year net capital losses of $100,000
- The Y-Men Trust has taxable income of $300,000 ($100,000 + $70,000 + $30,000 + (($300,000 - $100,000) x 50%)

The Div 6E income of the trust is $100,000 ($470,000 – $70,000 – $300,000).

Division 6E and present entitlement to trust income

A beneficiary's Div 6E present entitlement to trust income is essentially the Div 6E income of the trust estate to which the beneficiary is presently entitled, which excludes amounts attributable to capital gains and franked distributions.

The present entitlement is calculated as the beneficiary's present entitlement to the trust income under Div 6 reduced by:

- for each capital gain taken into account in calculating the taxable income of the trust — the beneficiary's share as determined under Subdiv 115-C
- for each franked distribution taken into account in calculating the taxable income of the trust — the beneficiary's share of the franked distribution as determined under Subdiv 207-B.

In some cases, Div 6E can increase the amount that Div 6 includes in the beneficiary's assessable income. This can arise where:

- another entity is specifically entitled to an amount of capital gains or (net) franked distributions that is included in the income of the trust estate; and
- for all of the other income of the trust, the taxable income exceeds the income of the trust.

However, an increase in the Div 6 amount will have a corresponding decrease in the amount assessed to another beneficiary.

Example of the operation of Div 6E — adapted from example 2.25 of the Explanatory Memorandum

Assume the following facts:

- The Brash Trust has two beneficiaries, Nick and Steve.
- Nick is entitled to all of the capital gains of the trust and Steve is entitled to all the other income of the trust.
- The Brash trust deed defines income to include capital gains.
- The trust derived income of a $100 capital gain (no CGT concessions or discount is available), $100 of other income. However, as a result of a timing difference, the amount of other income for tax purposes is $900,
- Under the ordinary operation of Div 6, income of the trust is $200 ($100 capital gain + $100 other income).
- The taxable income under Div 6 would ordinarily be $1,000 ($100 capital gain + $900 other income).
- Nick and Steve are each entitled to 50 per cent of the trust income as:
- Nick is entitled to $100 capital gain; and
- Steve is entitled to $100 of the other income.
- For s. 97 purposes, each would be assessed on $500 (50 per cent of the taxable income of $1,000).

However, Div 6E ignores the capital gains included in the assessable income of Nick and Steve, resulting in the following adjustments:

- Div 6E income of the trust is $100 (ignoring capital gains)
- Div 6E net income (or taxable income) of the trust is $900
- Nick does not have a present entitlement to any of the Div 6E income as he was only entitled to the capital gains.
- Steve has a present entitlement to $100 being all of the Div 6E income of the trust.

CGT EVENT E4

Fixed trust distributions — CGT event E4

CGT event E4 is about capital payments for a trust interest. It happens when an entity that has a unit or an interest in a trust receives a payment in respect of that unit or interest and some or all of that payment is not included in their assessable income.

Section 104-70 provides that CGT event E4 happens if:

- the trustee of a trust makes a **payment** to a beneficiary in respect of their interest in the trust; and
- some or all of the amount is **non-assessable** to the beneficiary.

s. 104-70(1)

Examples of non-assessable receipts distributed by a trustee that may attract the operation of CGT event E4 include:

- an excess of trust income over trust taxable income;
- frozen CGT indexation;
- the small business CGT 50 per cent reduction; or
- income sheltered by building allowance deductions.

Important

CGT event E4 will generally **not** apply to a discretionary trust — a beneficiary's potential entitlement under a discretionary trust is **not** an 'interest in a trust' for the purposes of s. 104-70.

The interest of a mere object of a discretionary trust (i.e. a potential beneficiary) is not one in which another person can invest — it is a bare right of action and cannot be purchased or assigned. The interest of a default beneficiary may be capable of assignment, but it is not an interest subject to CGT event E4, unless it has been acquired for consideration, or by assignment (TD 2003/28, at para. 5).

Important

CGT event E4 does not happen to gains which have been subject to the **CGT discount, or the 15-year exemption** — such gains can be paid out of a fixed trust and will be tax-free to the beneficiary.

s 104-71(1)

How CGT event E4 applies

CGT event E4 operates in the following manner:

- when the non-assessable amount is distributed to the unit holder (such as the amount of 50 per cent active asset reduction), the trustee makes this distribution in respect of the unit holder's interest in the trust, and that payment is not included in the unit holder's assessable income.

- The cost base of the units in the trust is **reduced** by the amount of the non-assessable part paid to the unit holder (s. 104-70(6)).
- If the non-assessable part of the payment is greater than the cost base of the units in the trust, a CGT event E4 will happen (s. 104-70(4)). CGT event E4 will reduce the cost base of the interest to nil and the unit holder will make a capital gain in respect of the excess of the non assessable payment over the cost base of the interest (s. 104-70(5)).

Note

The beneficiary can apply the CGT discount and any of the CGT small business concessions to the capital gain (if any) made under CGT event E4.

Example — CGT Event E4

Billy has received a non-assessable amount

Billy owns units in Really Good Investment Fund which distributed income to him in the current income year. The fund gave him a statement showing his distribution included the following capital gains:

- \$100 calculated using the discount method (grossed-up amount \$200)
- \$75 calculated using the indexation method, and
- \$28 calculated using the 'other' method.

These capital gains add up to \$203.

The statement shows Billy's distribution did not include a tax-free amount but it did include:

➔ \$105 tax-deferred amount.

From his records, Billy knows that the cost base and reduced cost base of his units are \$1,200 and \$1,050 respectively.

Billy has no other capital gains or capital losses in the current income year and no unapplied net capital losses from earlier years.

As Billy has a capital gain that the fund reduced under the CGT discount of 50% (\$100), he includes the grossed-up amount (\$200) in his total current year capital gain.

Billy adds the grossed-up amount to his capital gains calculated using the indexation method and 'other' method to work out his total current year capital gains:

\$200 + \$75 + \$28 = \$303

As Billy has no other capital gains or capital losses, and he must use the discount method for the capital gains calculated using the discount method from the trust, his net capital gain is equal to the amount of capital gain included in his distribution from the fund (\$203).

Records Billy needs to keep

The tax-deferred amount Billy received is not included in his income or his capital gains but it affects the cost base and reduced cost base of his units in Really Good Investment Fund for future income years. Billy deducts the tax-deferred amount from both the cost base and reduced cost base of his units as follows:

Example — CGT Event E4	
Cost base	$1,200
less tax-deferred amount	$105
New cost base	$1,050
Reduced cost base	**$1,095**
less tax-deferred amount	$105
New reduced cost base	**$945**

ATO ID 2012/63 — CGT event E4 and timing differences relating to expenses

ATO ID 2012/62 deals with whether CGT event E4 (s. 104-70 of the *ITAA 1997*) happens if a unit holder receives a distribution of trust income for an income year which exceeds the trust's net income for that year, and the difference results from an expense being deductible for taxation purposes in that year which was properly charged against income for trust law purposes in an earlier income year.

Facts

A resident taxpayer owns units in a resident unit trust ('the trust').The trust deed requires the trustee to distribute to the unit holders so much of the trust income as remains after provision has been made for expenses of the trustee that are properly chargeable against income.

In the 2008–09 income year, the net income of the trust ($11 million), calculated under s. 95 of the *ITAA 1936*, exceeded the income of the trust that was available for distribution to the unit holders ($7 million). Part of this difference related to certain expenses that were properly chargeable against trust income for that income year but were not deductible for tax purposes in that year.

In the 2010–11 income year, those expenses became deductible for tax purposes which resulted in the income which was available for distribution to the unit holders ($10 million) exceeding the net income of the trust ($8 million) for that year.

Decision

Yes, CGT event E4 happens in the income year in which the trust income distributed by the trustee exceeds the net income included in the unit holder's assessable income under s. 97.

Note

Where CGT event E4 happens, the non-assessable payment from the trust reduces the beneficiary's cost base, and reduced cost base, in the trust. If the non-assessable payment exceeds the beneficiary's cost base, the excess is a capital gain (ss. 104-70(4) and (6)). Note that CGT event E4 is subject to a number of adjustments and exceptions in respect of certain non-assessable amounts.

In this case, the income of the trust for the 2008–09 income year is less than the net income of the trust for that year, and the amount assessed to the taxpayer under s. 97 of the *ITAA 1936* will exceed the amount that is distributed to the taxpayer.

However, in relation to the 2010–11 income year, the net income of the trust is less than the trust income with the result that the taxpayer will not be assessed under s. 97 on the total distribution received.

As some of that distribution for the 2010–11 income year has not been included in the taxpayer's assessable income under s. 97, the requirements for CGT event E4 to happen are satisfied.

The fact that the taxpayer was assessed on an amount of net income in relation to the 2008–09 income year which exceeded the total amount that was distributed for that year is not relevant for the purposes of CGT event E4.

Scrip for scrip roll-over

Overview

- Another merger/acquisition option may involve a scrip for scrip roll-over.
- The relief may be available when interests held in one entity are exchanged for replacement interests in another entity (Subdiv 124-M: ss. 124-775 to 124-810).
- Scrip for scrip roll-over in respect of CGT events happening on or after **10 December 1999**.

Implications

This roll-over allows a capital gain made on the disposal of the original interests to be **deferred** (rolled over) until the disposal of the replacement interests.

Important

The *Tax Laws Amendment (2008 Measures No. 6) Act 2009* introduced cost base reduction rules for **Div 124-M scrip for scrip roll-overs** occurring after 13 May 2008 which constitute 'restructures' under the new legislation.

Warning

- Unlike most CGT roll-over relief, scrip for scrip roll-over does not allow the **pre-CGT** status of original shares or units to be transferred to the replacement shares or units;
- Scrip for scrip roll-over does **not** apply to a **capital loss**.

Scrip for Scrip Roll-over Requirements

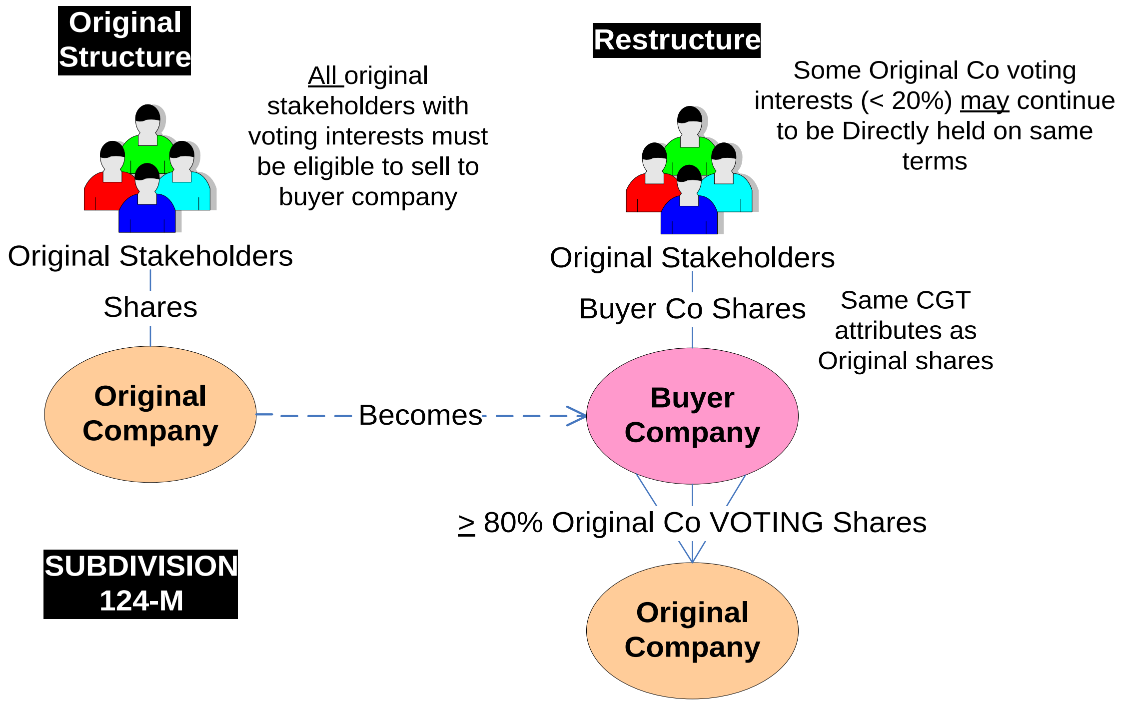
Overview of scrip for scrip roll-over requirements

Broadly, the roll-over enables an equity holder — whether a shareholder in a company or a unit holder in a unit trust or a beneficiary of a fixed trust — to choose to defer the liability to CGT that arises under a takeover when the equity holder exchanges their original interest in the target entity for a replacement interest in the acquiring entity.

Important

Scrip for scrip roll-over could also apply to a structure similar to that shown below but involving an **original unit trust** and **buyer unit trust** in the same circumstances. However, **'like'** interests must be exchanged (i.e. the roll-over could never apply to an exchange of original shares for units or vice versa).

Overview of scrip for scrip roll-over requirements



Implications

- Scrip for scrip roll-over relief can be used in a variety of circumstances including:
  - A taxpayer (e.g. Buyer company) seeking to expand and acquire a new business (e.g. original company) without causing adverse consequences for the original stakeholders, potentially advantageous in negotiations (i.e. a takeover scenario); or
  - an original company may be expanding/restructuring and require an interposed new head company; (or head unit trust) (e.g. buyer company) without adverse CGT consequences; or
  - the stakeholders would prefer the capital proceeds from sale of an original company to be received by the buyer company instead of themselves personally (e.g. to establish a new business venture or for asset protection reasons etc.).

Tip

- A scrip for scrip roll-over may be an effective way to interpose a new head company to facilitate formation of a tax consolidated group although it would be essential that 100 per cent (instead of the minimum 80 per cent above) is acquired by the buyer company in this case.
- While a unit trust could not achieve an interposed head company through the above restructure (i.e. shares cannot be exchanged for units under Subdiv 124-M), a Subdiv 124-N asset transfer restructure maybe an effective means of achieving a head company in place of a unit trust for purposes including those noted above.

The requirement that the acquisition occurs in a single transaction was explored in *Dickinson and FCT*, and *Fabig and FCT*, where the AAT determined that the scrip for scrip roll-over was available.

Dickinson v FCT and Fabig v FCT test — scrip for scrip roll-over available

Dickinson and FCT [2013] AATA 25; *Fabig and FCT* [2013] AATA 25

Deputy President of the AAT, Professor Deutsch, found in favour of the taxpayers. However, his decision was overturned on appeal[13] to the Full Federal Court.

Issues

Whether scrip for scrip roll-over under Subdiv 124-M was available — specifically, whether the exchanges were in consequence of a single arrangement under which participation was available on substantially the same terms for all the owners of the interests of a particular type in the original entity.

Facts

On 22 May 2006, the shareholders in iMega Pty Ltd (iMega) entered into a Shareholders Agreement under which they agreed that any consideration paid311 for shares sold within 36 months of execution of the Agreement would be paid in proportions that differed from the proportion in which each shareholders held their ordinary shares.

On the sale of their shares in iMega Pty Ltd, the taxpayers received consideration — in cash and shares — which was not in proportion to their shareholding.

On 3 July 2006, a Share Purchase Agreement (SPA) was entered into with Photon Group Ltd (Photon) under which Photon would purchase 90 per cent of the shares in iMega with the shareholders each selling 90 per cent of the shares they held. However, the consideration of $8 million was paid to each shareholder — in cash and shares in Photon — in accordance with the proportions specified in the Shareholder Agreement.

Although the SPA also provided for earn-out payments and an option to purchase the remaining shares, the shareholders and Photon entered into a Deed of Variation which cancelled these arrangements and provided for the sale of the remaining 10 per cent of the shares in iMega. The consideration under the Deed of Variation was also paid to each shareholder — in cash and shares in Photon — in accordance with the proportions specified in the Shareholder Agreement.
Mr Dickinson and Ms Fabig both chose scrip for scrip roll-over relief under Subdiv 124-M.

Relevant Legislation

There is a roll-over under s. 124-780 if, relevantly:

- when the non-assessable amount is distributed to the unit holder (such as the amount of 50% active asset reduction), the trustee makes this distribution in respect of the unit holder's interest in the trust, and that payment is not included in the unit holder's assessable income;
- an entity exchanges a share in a company for a share in another company; and
- the exchange is in consequence of a single arrangement:
  - that results in a company that is not a member of a wholly-owned group becoming the owner of 80 per cent or more of the voting shares in the original entity;
  - in which at least all owners of voting shares in the original entity could participate; and
  - in which participation was available on substantially the same terms for all of the owners of interests of a particular type in the original entity.

[13] *FCT v Fabig and Dickinson* [2013] FCAFC 99.

Tribunal Decision

The Tribunal member found that scrip for scrip roll-over under Subdiv 124-M was available in the circumstances of this case. In particular:

1. The arrangement that resulted from each of the two share exchanges included more than just the SPA and Deed of Variation. Critically, a relevant part of the arrangement was the indifference of Photon as to the break-up of the consideration between the shareholders.
2. Photon made its offer **available** on substantially the same terms for all the shareholders in iMega. There is no requirement in the legislation for the exchange to take place on the same terms.

On Appeal to the Full Federal Court — FCT v Fabig [2013] FCAFC 99

On appeal, the Full Federal Court held that the Tribunal made an error in law in:

- identifying the relevant arrangement; and
- finding that the arrangement was available to all shareholders on substantially the same terms.

Full Federal Court decision

Edmonds, Griffiths and Davies JJ unanimously allowed the Commissioner's appeal, and ordered that the Commissioner's objection decision be affirmed.

The Court held that:

1. the only 'arrangement', of which the exchange of shares was a consequence, was the contractual relationship under the SPA and the Deed of Variation. The arrangement did not include or encompass any other fact, matter or circumstance;
2. the Tribunal made an error of law by reasoning that the condition in s. 124-780(2)(c) was satisfied because Photon was willing to buy the shares on the same terms from all shareholders, and was, under the global offer, indifferent to the break-up of the consideration amongst the shareholders.

The Court observed that there are four elements that identify the features of 'an arrangement' to which Subdiv 124-M applies, namely:

1. there must be something capable of constituting an 'arrangement' as defined in s. 995-1;
2. the 'arrangement' must satisfy ss. 124-780(2)[312] or (2A);
3. that 'arrangement' must be a 'single' arrangement; and
4. the relevant share exchange must be in consequence of that 'single arrangement'.

The Court held that the Tribunal had correctly found that:

- the contractual arrangements between the parties satisfied the description of 'arrangement';
- the share exchange was in consequence of the share sales under the SPA and the Deed of Variation; and
- the share exchange was in consequence of a single arrangement.

However, the Tribunal was wrong to conclude that Photon's indifference to the allocation of the purchase price among the shareholders meant Photon's offer could have been accepted by the shareholders on the same terms.

That conclusion was reached without regard to the legal obligations on the shareholders under the Shareholders' Agreement. Photon may have been indifferent about the allocation of consideration when it made the offers, but the Shareholders' Agreement meant that it was not open to the shareholders to accept Photon's offer on the same terms.

The shareholders were contractually obliged to sell their shares for different consideration and in consequence, participation in the share sales was not available to them on substantially the same terms. The Tribunal was wrong to conclude otherwise.

Scrip for scrip roll-over amendments — original company cost base restrictions

The *Tax Laws Amendment (2008 Measures No. 6) Act 2009* introduced **cost base reduction rules** for Div 124-M scrip for scrip roll-overs generally occurring after 13 May 2008 which constitute 'restructures' under the new legislation. The amendments were directed at preventing companies from obtaining a market value cost base uplift by using the scrip for scrip roll over in what is essentially a restructure rather than a corporate takeover.[14]

Under a scrip for scrip roll-over, the **buyer company** (or unit trust) simply acquired its new shares in the original company for the consideration provided (i.e. the roll-over relief applied at original stakeholder level).

In the case of a restructure between non-arm's length parties where a tax consolidation was contemplated following the scrip for scrip roll-over, the effect was:

- high buyer company cost base for original company shares bought at a high price; and
- tax effective treatment for original stakeholders; but
- no real change in the underlying assets of the original company, nor its underlying ownership.

The buyer company therefore obtained a much higher ACA for the original company assets upon consolidation than would ordinarily have been possible without the scrip for scrip restructure.

When is an arrangement taken to be a s. 124-784A restructure?

Section 124-784A(2) of the *ITAA 1997* provides a method statement to determine whether a 'restructure' has occurred which results in cost base restrictions applying to the original entity shares (or units).

[14] Scrip for scrip was designed for corporate takeovers, whereas the roll-over in Subdiv 124-G of the *ITAA 1997* (about exchange of shares in one company for shares in another company) was designed for corporate restructures. Subdiv 124-G provides a tax neutral outcome for corporate restructures where there is no substantive change in the underlying assets or the ownership of the original entity. Before the changes made by this Act, the scrip for scrip roll-over was preferred for corporate restructures because the market value substitution rule generally applied so that the cost base of the shares that the acquiring entity received in the original entity reflected the market value of the underlying net assets of the original entity.

Method statement in s. 124-784A(2)	
Step 1	Add up the market value of buyer company interests issued under the current scrip for scrip roll-over
Step 2	Add to Step 1 the **market value** of all buyer company interests issued by the buyer entity under any **earlier arrangement** for which this section applied in exchange for original entity (i.e. earlier arrangements taken to be restructures
Step 3	Add up the market value of all: ■ buyer company shares on issue; and ■ options rights etc. giving the holder an entitlement to acquire a buyer company share after completion time.

If **Step 2/Step 3** > 80 per cent then the arrangement is taken to be a restructure subject to cost base restrictions for the original entity shares.

Example of arrangement taken to be a restructure

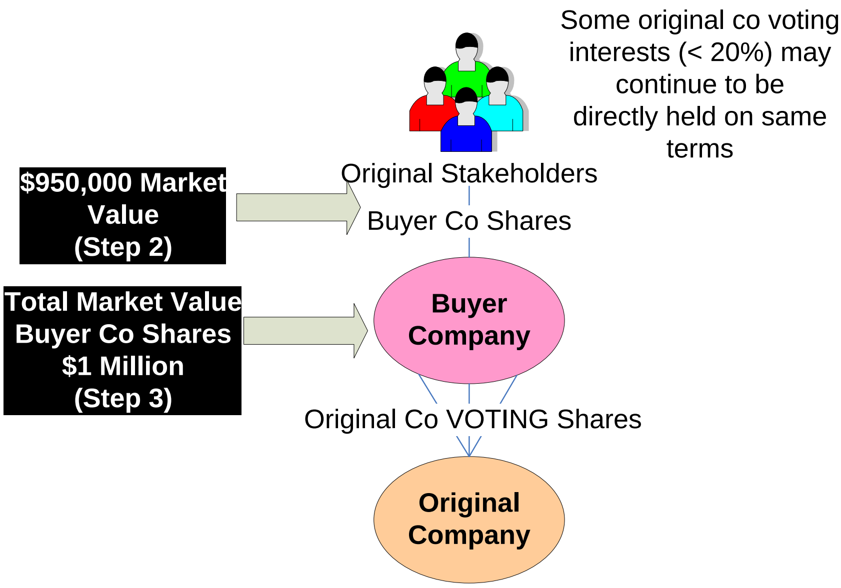
Nestar Online Pty Ltd (buyer entity) enters into an arrangement to acquire Miky Jay Toys Pty Ltd (original entity). Just prior to the arrangement:

- Buyer entity has a net market value of $50,000; and
- Original Entity has a net market value of $1 million.

Under the arrangement, the shareholders of Miky Jay Toys receive:

- shares with a value of $950,000 in Nestar Online in exchange for their Miky Jay Toys shares; and
- $50,000 cash.

The arrangement qualifies for a scrip for scrip CGT roll-over.



Applying the Method statement in s. 124-784A(2):

Because:

Example of arrangement taken to be a restructure

$$\frac{\text{Step 2}}{\text{Step 3 above}} \quad = 95\% \text{ (i.e. } > 80\%\text{)}$$

The cost base of the original company shares is therefore modified under s. 124-784B below.

Tip

The reasons steps 2 and 3 above may differ is that step 3 may comprise:

- non-voting buyer company shares (i.e. not part of scrip for scrip roll-over); and/or
- < 100% of voting shares are held by original stakeholders above (i.e. between 80% and 100% can still qualify for scrip for scrip roll-over).

CGT cost base modification rules when arrangement is a s. 124-784A 'restructure'

Under the new measures, the **cost base** and **reduced cost base** of the original entity interests are worked out by applying the formula and Method statement in s. 124-784B(2) below.

$$\frac{\underline{\text{Original entity's assets (step 1 + step 2 + step 3) – Original entity's liabilities}} \text{ (step 4)}}{\text{Number of interests (step 5)}}$$

= Cost base/reduced cost base per Original Entity interest

Method statement in s. 124-784B(2))	
Step 1	Add together: ■ Market value of original entity pre-CGT assets (except trading stock); ■ cost base of original entity post-CGT assets (except trading stock); or ■ if no cost base for such a post-CGT asset — use consideration which would result in no assessable income or deduction on disposal. + Step 2 Below + Step 3 Below
Step 2	For the original entity's trading stock, add together: ■ opening stock on hand value at start of income year; ■ natural increase livestock cost for natural increase during year; ■ outgoings for acquiring other trading stock; ■ outgoings incurred since stock held but forming part of stock cost

Method statement in s. 124-784B(2))	
Step 3	For any original entity asset not covered by steps 1 and 2, work out the amount that would be the asset's cost base if it were a CGT asset.
Step 4	STEP 1 RESULT LESS original entity liabilities (if any) in respect of step 1 assets = COST BASE LIMIT
Step 5	Cost Base Per Original Entity Interest = STEP 4 RESULT / No. of Original Entity Interests (if 1 class) OR Apportion STEP 4 RESULT across different classes of original entity interests and then divide by number of interests in each class. *adapted from Example 1.1 of the Explanatory Memorandum*

Modification of tax cost setting rules — Div 715-W

Under the previous law, if the original entity became a member of a consolidated group or MEC group under the arrangement, the head company of the group was **obliged** to apply the consolidation tax cost setting rules to reset the tax costs of the original entity's assets.

The new legislation provides that if the original entity becomes a member of a consolidated group or MEC group under the arrangement, then the head company of the group can **elect** to retain the original tax costs of the original entity's assets.

Recent development — Integrity rules

The *Tax Laws Amendment (2013 Measures No. 1) Act 2013* which received Royal Assent on 29 June 2013 as Act No. 119 of 2013 amended the *ITAA 1997* to ensure that certain integrity rules in the small business concessions and the scrip for scrip roll-over apply to life insurance companies, superannuation funds and trusts in the same way that they apply to other types of entities. These changes are summarised below.

Strengthening the small business concessions and the scrip for scrip roll-over provisions

The amendments were considered necessary because the connected entity test and the stakeholder tests seek to determine whether an entity controls or has the potential to control or influence another entity having regard to the interests held in that other entity that carry voting, income and capital rights. Prior to these amendments, the tests applied only if the entities held the relevant interests 'for their own benefit'.

The amendments ensure that the connected entity test in s. 328-125 and the stakeholder test in s. 124-783 have regard only to the legal ownership of the asset rather than who benefits from the ownership.

The significant stake test and common stake test in s. 124-783 of the *ITAA 1997* are designed to ensure that an entity that has a sufficiently high level of ownership in both the original and acquiring entity cannot use the roll-over to defer tax indefinitely on the disposal of the underlying assets of the original entity.

Broadly, an entity has a:

1. **significant stake**:

   (a) in a company under s. 124-783(6) — if the entity and its associates have 30 per cent or more of the voting, dividend or capital distribution rights — where the relevant rights to receive are 'for their own benefit'; or

   (b) in a trust under s. 124-783(7) — if the entity and its associates have a right to receive 'for their own benefit' 30 per cent or more of any distribution of income or capital of the trust.

2. **common stake** in the original entity and acquiring entity at the relevant time:

   (a) under s. 124-783(9) — where the original entity and the acquiring entities are companies — if the entity and its associates have 80 per cent or more of the voting, dividend or capital distribution rights of the relevant entity at the relevant times — where the relevant rights to receive are 'for their own benefit'; or

   (b) under s. 124-783(10) — where the original entity and the acquiring entities are trusts — if the entity and its associates have a right to receive 'for their own benefit' 80 per cent or more of any distribution of income or capital of the trust at the relevant times.

The amendments delete the words '***for their own benefit***' from the relevant tests so that the integrity rules will apply where life insurance companies, superannuation funds and trusts own their interests for the benefit of others rather than for their own benefit.

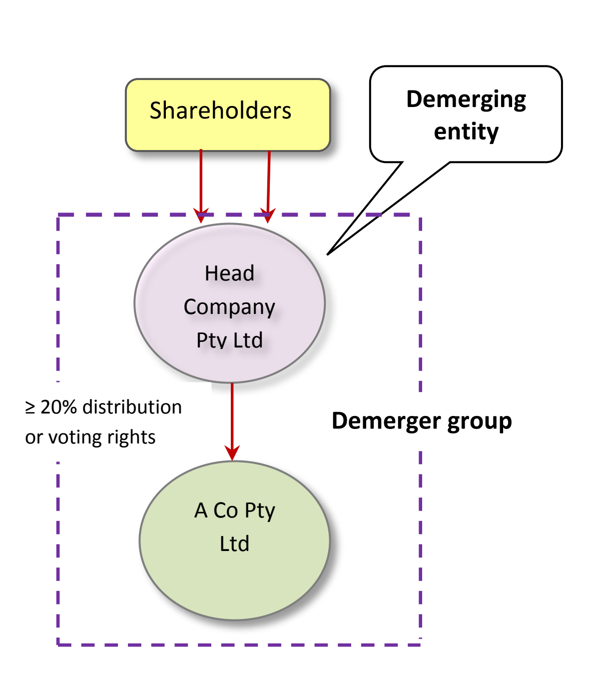
DEMERGERS

Demergers — Division 125

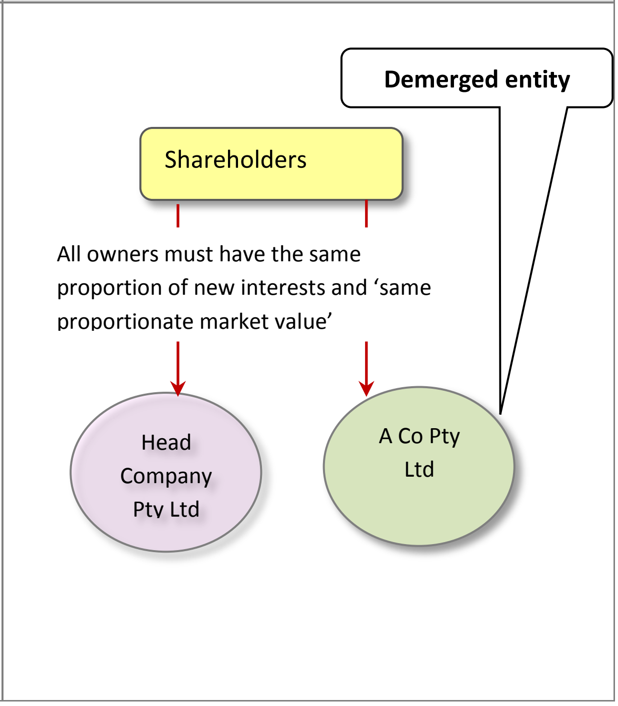
Demergers (sometimes called 'spinoffs') are frequently used to restructure the business of a group to improve management of a particular segment of the business. It is said that spinoffs allow the separate entities to pursue their own interests and therefore to provide better shareholder value.

In the diagram below, Head Company demerges A Co Pty Ltd to its shareholders. The ultimate shareholders remain the same.

Before demerger



After demerger



Note

Although the above diagram illustrates a demerger restructure under which 100 per cent of A Co shares were demerged to the stakeholders, Head Company could retain ownership of up to 19 per cent of A Co after the demerger and still obtain the benefit of demerger relief.

Important

Demerger roll-over is also available to a structure similar to that shown above but which instead has a head entity that is unit trust and a subsidiary unit trust. 'Like' interests must be exchanged (i.e. the demerger must be of two unit trusts or two companies) but it is possible for an interposed unit trust between two demerging companies to have no adverse effect and vice versa.

The demerger in the above diagram could be achieved by any one or a combination of three ways:

1. The shares in A Co Pty Ltd (the demerged entity) are disposed of to the shareholders of Head Co Pty Ltd;
2. the shares in A Co Pty Ltd are cancelled and new shares are issued to the shareholders of Head Co Pty Ltd;
3. A Co Pty Ltd issues shares in itself to the shareholders of Head Co Pty Ltd to bring about a transfer of ownership by effectively 'swamping' Head Co's shares.

Like the restrictions imposed on scrip for scrip roll-over discussed earlier, a demerger under Div 125 may occur between:

- a head company and demerger subsidiary company; or
- a head unit trust and demerger subsidiary unit trust,

but cannot occur between a head company and demerger subsidiary trust or vice versa.

Implications

- A Div 125 demerger roll-over comprises **both**:
  - a **CGT roll-over** for shares/units; and
  - a **dividend exemption** (i.e. in specie distributions of shares can be assessable as a dividend).

Tip

A demerger roll-over can be useful where:

- part of the business is to be sold by stakeholders separately from the rest of the business (subject to the s. 45B anti-avoidance rules — refer below);
- the business has grown to such an extent that commercial requirements dictate **two separate 'branches'** to the business;
- the head entity is being acquired by a third party which is not interested in one or more of its subsidiaries, which will continue to be operated by the original stakeholders.

When a roll-over is available for a demerger

Condition	Note
You own an ownership interest in a company s.125-55(1)(a)	Foreign residents must obtain taxable Australian property in exchange s. 125-55(2)
The company is the head company of a demerger group s. 125-55(1)(b)	No other member of group has shares in this company s. 125-65(3)

Condition	Note
There is a demerger to the demerger group s. 125-55(1)(c)	This can be a capital reduction, share cancellation or other method.
The Head company stops owning at least 80 per cent of the interests in the demerged entity s. 125-70(7)	All owners must have same proportion of new interests and same proportionate market value.

Conditions to be satisfied — s. 125-70(2)

One of the conditions for a demerger is that ownership interests in the demerger group are maintained.

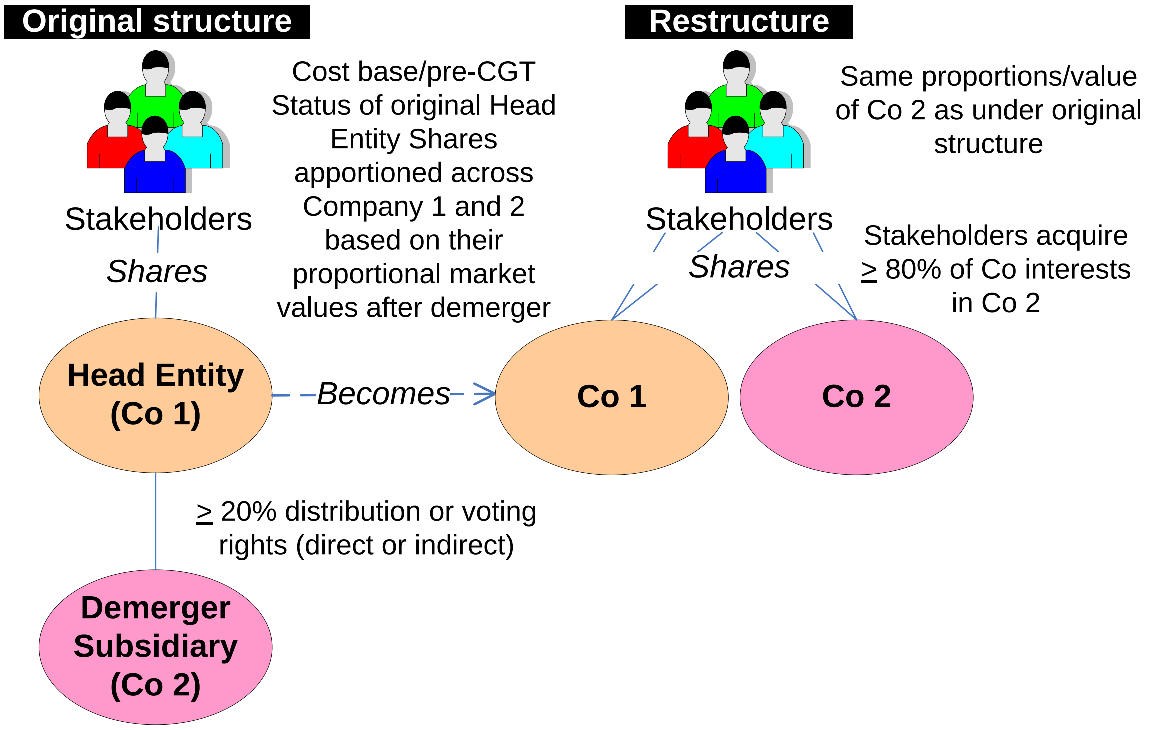
There are two tests that determine whether this condition is met:

Tests of continuity of ownership interests	Test is satisfied if…
1. The proportionate ownership test —s. 125-70(2)(a)), and	The proportionate interests in the head entity and in the demerged entity must, so far as is practicable. remain the same.
2. The market value test — s. 125-70(2)(b)	Ownership interests in the demerger group are maintained. i.e. after the demerger the market value of the head entity and the demerged entity must have the same proportionate value as they had before the demerger.

These conditions are depicted below.

Condition for obtaining demerger relief

The key requirements of Demerger roll-over involve the following type of restructure.



Consequences for demerging entity (the head entity)

Relief from CGT

CGT roll-over relief is optional: s. 125-55(1).

- Any capital gain or capital loss a demerging entity makes from a CGT event A1, C2, C3 or K6 happening to its ownership interests in a demerging entity under a demerger is disregarded (s. 125-155).
- CGT event J1 does not happen to a demerger entity or a member of a demerger group (s. 125-160).
- A capital loss that arises to an entity that was a member of a demerger group from a CGT event happening to a CGT asset as a result of a demerger is reduced to the extent that the loss is attributable to the reduction in market value as a result of a demerger.

Consequences for shareholders

If roll-over is chosen

A capital gain or loss from a CGT event happening to the original interests under the demerger is disregarded (s. 125-80(1)).

Requirement to re-allocate cost base

The first element of the cost base and reduced cost base of the post-CGT interest is allocated between the new interests that are taken to have been acquired on or after 20 September 1985 and the post CGT original ownership assets that have not ended (s. 125-80(2)). The allocation must be in such proportions as is reasonable having regard to the market value of:

- the remaining original interests, just after the demerger; and
- the new interest just after the demerger (s. 125-80(3)).

Methods of reallocating cost base

The Commissioner has stated in TD 2006/73 that there may be more than one method of allocating the cost base over a taxpayer's post-demerger interests that results in a reasonable apportionment.

The relative market value method

The Commissioner considers that the apportionment using the relative market value method which calculates the new cost base of each post-demerger interest in accordance with the market value of that interest relative to the total market value of all of their post-demerger interests is reasonable.

Example — Relative market value method [based on TD 2006/73]

Astrid acquired shares in Top Co Ltd, a public company, after 20 September 1985. Top Co had one wholly-owned subsidiary Sub Co Pty Ltd. Top Co demerged all of its shares in Sub Co under a demerger.

Both Top Co and Sub Co had only ordinary shares on issue.

Just before the demerger Astrid held the following post-CGT shares in Top Co:

- 1,000 with a cost base of $2 each; and
- 1,000 with a cost base of $4 each.

Astrid received one Sub Co share under the demerger for each Top Co share that she owned (i.e. she received 2,000 Sub Co shares as a result of owning 2,000 Top Co shares). Astrid chose roll-over under subsection 125-55(1) of the *ITAA 1997*.

Immediately after the demerger, the market value of each Top Co share was $8 and each Sub Co share was $12.

Top Co advised shareholders that 40% of the summed cost base should be allocated across the remaining interest in Top Co and 60% across the new interests in Sub Co.

Astrid has calculated the new cost base for her Top Co shares, using the relative market value method, as follows:

(i) Work out the sum of the cost bases just before the demerger was:

$2,000 (1,000 shares × $2) + $4,000 (1,000 shares × $4) = $6,000

(ii) Allocate the summed cost bases by reference to the relative market value:

Example — Relative market value method [based on TD 2006/73]	
Top Co — 40% of summed cost	**Sub Co — 60% of summed cost**
Cost base of \$6,000 × 40% = \$2,400 \$2,400/2,000 shares = \$1.20 as first element of cost base for each share in Top Co	Cost base of \$6,000 × 60% = \$3,600 \$3,600/2,000 shares = \$1.80 as the first element of cost base for each Sub Co share.

The effect of using the relative market value method is that each of the shares in Top Co will have the same cost base just after the demerger. Similarly, each of the shares in the demerged Sub Co will have the same cost base. Hence, the relative market value method is sometimes called the averaging method.

The 'parcel by parcel' approach

Using the 'parcel by parcel' method can produce different results. This is illustrated in the example which follows which is based on the facts of the previous example.

Example — Parcel by Parcel method based on TD 2006/73

Assume the same facts in relation to Astrid's shares in Top Co and Sub Co as in the previous example.

Astrid uses the parcel by parcel method to allocate her cost base.

Cost base of original shares	Top Co — 40% of the original cost	Sub Co — 60% of the original cost
Parcel 1 1,000 at \$2	2,400 × (2,000/6,000)/1,000 = 80 cents per share	3,600 × (2,000/6,000)/1,000 = \$1.20 per share
Parcel 2 1,000 at \$4	2,400 × (4,000/6,000)/1,000 = \$1.60 per share	3,600 × (4,000/6,000)/1,000 = \$2.40 per share

Comparison of cost bases using the two different methods:

	Top Co shares	Sub Co shares
Original cost		
Parcel 1	\$2.00	
Parcel 2	\$4.00	
Relative market Value	\$1.20	\$1.80
Parcel by Parcel method		
Parcel 1	\$0.80	\$1.20
Parcel 2	\$1.60	\$2.40

The Commissioner has stated in **TD 2006/73** that he will accept other methods of allocating cost base if those methods are reasonable in the circumstances and provided that they are not distorted.

Original interests that are pre-CGT

If all of a shareholder's original interests in the demerging entity (the head entity) are pre-CGT interests, and the shareholder chooses roll-over, all of the new interests will also be taken to have been acquired before 20 September 1985 (s. 125-80(4)).

If only some of a shareholder's interests were acquired before 20 September 1985, a reasonable whole number of the new interests will also be taken to have been acquired before 20 September 1985. The amount which is reasonable is determined having regard to the market values of the original interests and the market value of the new interests (s. 125-80(6)).

Example — Some original shares are pre-CGT shares
Harold owns 500 shares in Top Co and 200 of those shares were acquired before 20 September 1985. That is, 40% of his shares are pre-CGT shares. Top Co demerges Sub Co and issues one share in Sub Co for every five Top Co shares held. Harold therefore receives 100 new shares in Sub Co. Accordingly, 40% of Harold's shares in Sub Co, namely 40 shares, will be taken to be pre-CGT shares.

Dividend relief

Shareholder	Nature of Relief
Resident shareholders	Dividend relief is provided by ss. 44(3) and 44(4) of the *ITAA 1936* which state that a dividend arising as a result of a demerger happening (called a 'demerger dividend') is not assessable or exempt income to the owners of the head entity.
Non-resident shareholders	Section 128B(3D) of the *ITAA 1936* provides an exemption from withholding tax.

Without the dividend relief the head entity giving its property, for example its shares in its subsidiary, to its shareholders would be a payment of a dividend to the extent that the distribution represents realised or unrealised company profit.

Warning

The dividend relief is subject to an integrity provision in s. 45B of the *ITAA 1936* that broadly limits the relief to genuine demergers. It is strongly recommended that a ruling is sought from the ATO regarding the possible application of s. 45B to a demerger dividend.[15]

[15] A demerger dividend paid by a private company could potentially be treated as a deemed dividend under Div 7A of the ITAA 1936. Section 109RA provides that Div 7A does not apply to a demerger dividend if s. 45B does not apply to it.

The purpose of the integrity provision in s. 45B of the *ITAA 1936* is to treat as dividends amounts of a demerger dividend which are:

- not proper allocations between capital and profit that correctly reflect the circumstances of the demerger;
- payments, allocations or distributions made in substitution for dividends.

The Commissioner has issued **TR 2003/8**[16] which deals with the taxation implications for shareholders receiving distributions of property from a company. Property includes shares held by the company in another company.

The Commissioner takes the view that in relation to a distribution of property to a shareholder in their capacity as such:

1. The amount of the dividend is the money value of the property at the time it is distributed reduced by the amount that is debited to a share capital account of the company making the distribution.

   Exceptions

   - Where a person pays or credits any money or property to the company and the company credits its share capital account with the amount of money or the value of the property; and
   - Dividend substitution cases to which s. 45B applies, i.e. some amounts debited to capital account can be treated as dividends.

2. The dividend is considered to be paid out of profits derived by the company if, immediately after the distribution of property, the market value of the assets of the company exceeds the total amount (as shown in the company's books of account) of its liabilities and share capital.

Note

The Commissioner issued Practice Statement **PS LA 2005/21** as a guide to the application of s. 45B to arrangements that are, or include, a demerger within Div 125 of the *ITAA 1997*.[17]

Section 45B was amended to apply to demerger dividends. The many tests in s.45B are directed at determining whether the demerger is a genuine demerger that is a restructure in the interests of business efficiency rather than mainly a means of providing a tax benefit to shareholders.

[16] TR 2003/8: Income tax: distributions of property by companies to shareholders — amount to be included as an assessable dividend.

[17] The Practice Statement is relevant only to demergers, after 1 July 2002, of a company or those trusts that are treated as a company under the ITAA 1936 (corporate unit trusts and public trading trusts). It is an integrity measure relating to dividends and therefore does not apply to fixed trusts.

Example from PS LA 2005/21

Facts

Doris, Noreen and Bob are siblings, each with a one-third interest in Family Farm Pty Ltd ('Family Farm') which in turn owns all of the issued capital in Secure IT Pty Ltd ('Secure IT').

Family Farm was incorporated in 1966 by the parents of Doris, Noreen and Bob who were the only shareholders. In the same year Family Farm purchased a grazing property of 5,000 acres set in what proved to be rather poor country. In 1987 the parents installed a farm manager on the property and moved to the city where they started a security business in the newly established subsidiary of Family Farm.

Doris and Noreen went to university and studied medicine while Bob helped his father in the security business.

In 1995 the parents passed away leaving a one-third interest in Family Farm to each of Doris, Noreen and Bob.

Doris and Noreen practise medicine in partnership and Bob carried on the security business.

All of the siblings use Family Farm's grazing property for family holidays and, though a manager is still employed to run it, the property barely produces enough income to cover costs and it has not contributed to the distributable fund of profits for many years. Family Farm's distributable profits have traditionally come from an annual dividend paid to it by Secure IT.

Demerger proposal

It is proposed that Family Farm will demerge Secure IT by transferring all of the issued shares in Secure IT to Doris, Noreen and Bob.

Doris and Noreen will then sell their interests in Secure IT to Bob.

All three siblings wish to retain their underlying ownership interests in the grazing property.

The demerger will involve each of the siblings receiving a significant demerger dividend which, but for the demerger concession, would be assessed at the top marginal tax rate in their hands. Family Farm has a very small amount of contributed capital, and the demerger will involve the return of a nominal capital amount of $1 per share.

However, since Doris and Noreen have never taken an active interest in Secure IT and have in fact left all of the decision-making to Bob, they agree with Bob's suggestion that he buy them out. They have agreed to dispose of their interests in Secure IT to Bob immediately after the demerger at their market value.

The security business is now a mature business with established clientele and stable profit history. Bob is a careful and conservative manager and, after acquiring 100% of the equity in Secure IT, he proposes to continue to run the business exactly as he has and hopes to eventually dispose of it to a larger competitor for a healthy capital gain.

Doris and Noreen will make a capital gain on the disposal of their Secure IT shares to Bob (the cost base of their Secure IT shares is a proportion of the cost base of their Family Farm shares, determined under s. 125-80 of the *ITAA 1997*). However, they will return only a small net capital gain in the income year of disposal as they each have carry forward capital losses to offset part of the capital gain. The remaining capital gain from the disposal of their shares will be eligible for the 50% CGT discount.

Example from PS LA 2005/21
Commissioner's decision under s. 45B(3) There is nothing in the manner or effect of the scheme to suggest that its purpose is to, in any way, improve or restructure either the farm or security businesses. Rather, it is apparent that the overall object of the scheme is for Doris and Noreen to realise their economic interests in Secure IT in the most tax effective way. The demerger concession is simply the means chosen to obtain tax free access to the Secure IT shares. In this case, the distribution and disposal of the shares results in the permanent tax advantage inherent in the conversion of an income receipt (in the nature of a dividend) into a tax preferred capital receipt (in the nature of a capital gain). It is illustrative of a scheme with a non-incidental purpose of obtaining a tax benefit, and one which section 45B of the *ITAA 1936* is designed to counter. Section 45BA of the *ITAA 1936* applies to deny the demerger dividend status to the demerger benefit provided under the scheme.

Tip

If, in the above example, an unrelated third party had offered to purchase the shares in Family Farm Pty Ltd but only on the basis that the unrelated Secure IT business was not included in the sale, there may have been a sufficient genuine commercial reason to demerge potentially preventing the above application of s. 45BA *ITAA 1936*.

Warning

PS LA 2005/21 suggests that where a demerger is undertaken between related/closely held parties, in the absence of strong evidence that a demerger had a genuine commercial reason, there is a high risk that s. 45B may apply to the demerger. Consequently, PS LA 2005/21 should be carefully considered prior to undertaking a demerger for a closely held entity.

Demergers and consolidated groups

The Government has announced that it will introduce legislation to alleviate the tax consequences that arise when a consolidated group or MEC group restructures by undertaking a demerger and the demerged entity and its wholly owned subsidiaries form a new group. A discussion paper has been released setting out, in broad terms, the way the proposal may be implemented.

It is proposed to amend the income tax law so that, if a consolidated group restructures by undertaking a demerger and the demerged entities form a new group, then any capital gain that a head company makes under CGT event L5 as a result of the demerger will be disregarded and the tax costs of assets held by subsidiary members of the new consolidated group will be retained. To qualify for this treatment, the demerger must satisfy the demerger requirements in Div 125 of the *ITAA 1997*.

The amendments will apply to demergers that take place after 9 November 2010. However, as a transitional rule, if a demerger took place on or before 9 November 2010 and a capital gain arose under CGT event L5 when the demerged entity left the original consolidated group, then any liabilities that were extinguished as a result of the demerger will be excluded from the consolidation tax cost setting calculations.

The following example has been extracted from the discussion paper.

Example 1: Demerged entity leaves a consolidated group and forms a new group

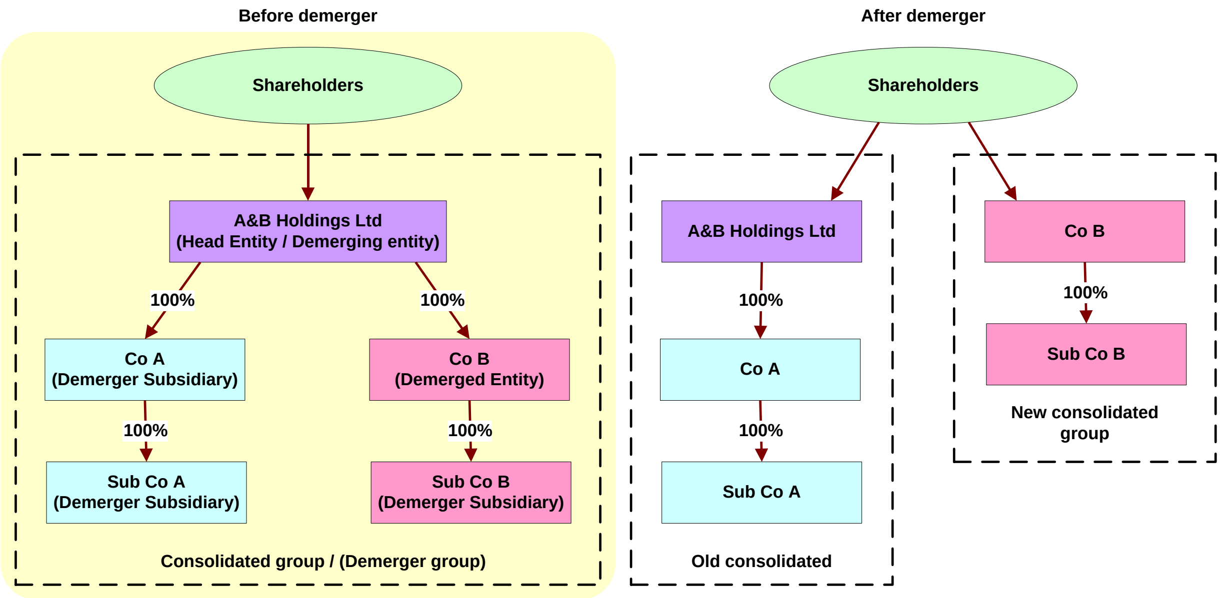
The head company of a consolidated group, A&B Holdings Ltd, wholly owns Co A and Co B. Co A and Co B wholly own Sub Co A and Sub Co B respectively. A&B Holdings Ltd is a wholly owned Australian resident company and all of the assets and liabilities of the group are held by Sub Co A and Sub Co B.

On 1 July 2011, Co B and Sub Co B demerge from the A&B Holdings Ltd consolidated group. Co B and Sub Co B have a combined market value of $3 million. At that time, the tax costs of Sub Co B's assets is $1 million and the value of its liabilities is $2 million. Sub Co B also has intangible assets with a market value of $4 million. These intangible assets have a nil cost base.

To facilitate the demerger, A&B Holdings Ltd cancels all its shares in Co B. Co B then proportionally issues new shares to the shareholders of A&B Holdings Ltd. The cancellation of Co B shares gives rise to a capital loss under CGT event C2. This loss is disregarded because A&B Holdings Ltd qualifies for demerger relief.

Co B immediately elects to form a new consolidated group with Sub Co B.

Consolidated group before and after the demerger



Outcome under current law

When Co B and Sub Co B leave the A&B Holdings Ltd consolidated group, the tax costs of their membership interests are reconstructed. As the tax costs of Co B and Sub Co B's liabilities ($2 million) exceeds the value of their assets ($1 million), A&B Holdings Ltd consolidated group makes a capital gain of $1 million under CGT event L5.

When Co B and Sub Co B form a new consolidated group, the entry allocable cost amount for Sub Co B is calculated as follows:

Example 1: Demerged entity leaves a consolidated group and forms a new group

Step 1: Cost of membership interests in Sub Co B Nil

Step 2: Liabilities

$2 million

Entry allocable cost amount

$2 million

As a result, the tax cost of Sub Co B's assets are reset as follows:

- assets (other than intangible assets) are reset to $0.4 million
  - (i.e. $2 million x 20% of market value of assets); and
- intangible assets are reset to $1.6 million
  - (i.e. $2 million x 80% of the market value of assets).

Outcome under proposed tax treatment

When Co B and Sub Co B leave the A&B Holdings Ltd consolidated group, the capital gain of $1 million that arises under CGT event L5 will be disregarded.

When Co B and Sub Co B form a new consolidated group, Sub Co B's assets will retain their existing tax costs. That is, the tax costs of the assets (other than intangible assets) in Sub Co B will be $1 million and the tax costs of intangible assets will be nil.

Main Residence Exemption

The main residence exemption

Subdivision 118-B provides any capital gain or capital loss an **individual** taxpayer makes from a CGT event happening in relation to a dwelling (or interest in a dwelling) that is the person's main residence is disregarded.

A dwelling includes a unit of accommodation that is:

- a building or is contained in a building, and consists wholly or mainly of residential accommodation; and
- a caravan, houseboat or other mobile home,

and any land immediately *under* the unit of accommodation (s 118-115).

TD 51 identifies the factors that are taken into account in determining whether or not a dwelling is a taxpayer's sole or principal residence.

Some relevant factors may include, but are not limited to:

- the length of time the taxpayer has lived in the dwelling;
- the place of residence of the taxpayer's family;
- whether the taxpayer has moved his or her personal belongings into the dwelling;
- the address to which the taxpayer has his or her mail delivered;
- the taxpayer's address on the Electoral Roll;
- the connection of services such as telephone, gas and electricity; and
- the taxpayer's intention in occupying the dwelling.

The relevance and weight to be given to each of these or other factors will depend upon the circumstances of each particular case.

The mere intention to construct a dwelling or to occupy a dwelling as a sole or principal residence, but without actually doing so, is insufficient to obtain the main residence exemption (MRE).

Important

The MRE applies **only** where an **individual or individuals** make the capital gain. For example, the exemption cannot apply to a residence that is owned by a family trust even if the family occupies it as their main residence.

Adjacent land or other structure

Where a CGT event also happens to land adjacent to a dwelling (or part of the dwelling), that is also used primarily for private or domestic purposes, the exemption will apply to a total of two hectares of land. That includes the land on which the dwelling is built.[18] A taxpayer can choose the two hectares to which the MRE applies. Section 118-120(2), however, specifies that the total area of the land (including the land on which the dwelling is situated) must not exceed two hectares. Refer to **TD 1999/67** for examples of what is considered to be reasonable apportionment.

This exemption also applies to a garage, storeroom or other structure that may be associated with a flat or home unit (that is also used primarily for private or domestic purposes).

Adjacent land

Adjacent land is defined in s. 118-120(2) as land used**:**

- for **private and domestic** purposes;
- in **association** with the **dwelling**,

For example, the garden of a main residence is usually its adjacent land.

Adjacent structures (flat or home units)

Adjacent structures of a flat or home units (e.g. separate car parking space or store room) used for private and domestic purposes, are treated as if they were dwellings for MRE purposes.[19]

The two hectare rule

Two hectares (approx. 4.94 acres) is the maximum area of adjacent land and dwelling which can be eligible for the MRE.

This rule also applies for purposes of the new adjacent land exemption with proposed s. 118-245(1)(f) requiring the sum of the following to be < two hectares for full adjacent land exemption purposes:

Total current adjacent land of dwelling
+
Land under dwelling itself
+
Dwelling's adjacent land previously subject to adjacent land exemption
is $\leq$ two hectares

18 Section 118-120.

19 Section 118-120(5) and (6).

☞ **Note**

- The above formula is similar to the usual two-hectare rule for MRE purposes but also takes account of land previously subject to the adjacent land exemption.
- To the extent > 2 hectares is involved, only a partial adjacent land exemption will apply, with the individual taxpayer choosing whether to apply the adjacent land exemption to various parts of the land under proposed ss. 118-245(2) and 118-255.

Changing main residences

Where a taxpayer acquires a dwelling that is to become a main residence, in circumstances where the taxpayer already has a residence that has been nominated for the MRE, both residences can benefit from the exemption for the shorter of:

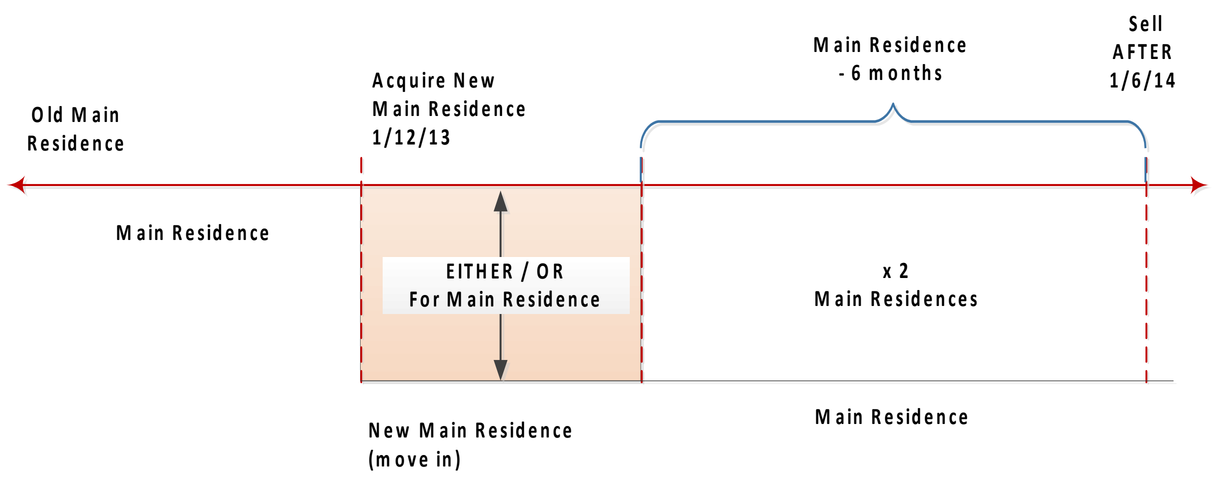
- six months (ending when the CGT event happened to the existing residence); or
- the period from the acquisition of the new residence to the CGT event happening to the existing residence.

However, this exemption is only available if the existing main residence was the main residence for at least three months in the 12 months prior to the CGT event, and provided that it was not used to produce assessable income in that 12-month period when it was not the main residence.[20]

Example – Changing main residences
In 2005, Rob acquired a house which he has used solely as his principal residence. With the impending birth of his first child, his existing residence was too small for his family. He signed a contract to purchase a larger house in the same suburb, which settled on 1 December 2013. Rob is having trouble selling his old house. Despite it being small it has been renovated with all the luxuries and he is hoping to make a significant gain. With settlement on the new residence looming, he is concerned that he may be the owner of two houses concurrently. Financially, he will be able to deal with this, however, with such a large gain hoped for, he does not want to lose the CGT exemption. Based on s. 118-140, if Rob is able to sell his existing residence by 1 June 2014, he will be able to obtain the MRE on both residences. If the existing residence is not sold before 1 June 2014, Rob will have to choose which residence to nominate for the exemption. In making this decision, it would be advisable to calculate the expected capital gain or capital loss on both, and rely on the exemption applying to the residence that will generate the highest capital gain. An example where the sale occurred on or after 1 June 2014 for this example is as follows:

[20] Section 118-140.

Example – Changing main residences



Absences from main residence

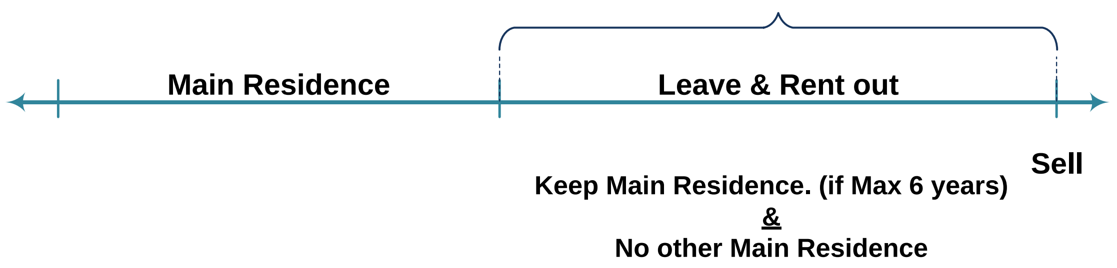
Where a taxpayer ceases to reside in their main residence but still retains ownership of the residence, the taxpayer can continue to treat the old residence as the main residence.

However, if the old residence is being used for income producing purposes, such as an investment property, the MRE can only continue for six years after the residence is vacated.

Each time the residence again becomes a taxpayer's main residence, the six-year period starts again for a subsequent absence from the property.[21]

Main Residence Absence Rule – General Rule – Income Producing Use

If the former main residence shown below is rented out for **no more than 6 years**, a **full main residence exemption** may apply to the property provided the main residence exemption has not been chosen for any other property.



Note

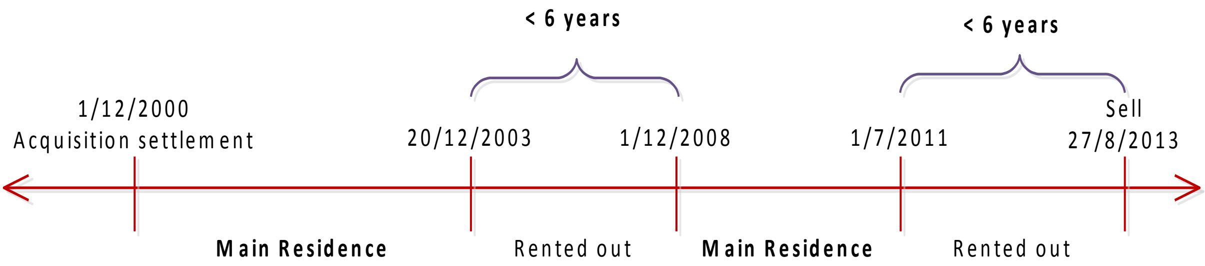
If the main residence were instead left **vacant** (i.e. there was no income producing use) then no six year maximum would apply and the MRE could potentially continue indefinitely.

[21] Section 118-145.

Example – Absences from main residence

Jason acquired a house with settlement taking place on 1 December 2000. He used the house as his main residence for three years. On 15 November 2003, he was posted to the UK for a five-year contract. He chose to rent his residence out for the five-year period, commencing on 20 December 2003. On 1 December 2008 when Jason returned, he moved back into his home and started to look around for another overseas contract. From 2011, he managed to land a two-year contract in the USA commencing 1 July 2011 and again he rented his house out from that date.

While in the USA, Jason decided he wanted to travel the world indefinitely and planned to sell his house when he returned, to give him the funds to do so. He sold his house on 27 August 2013.



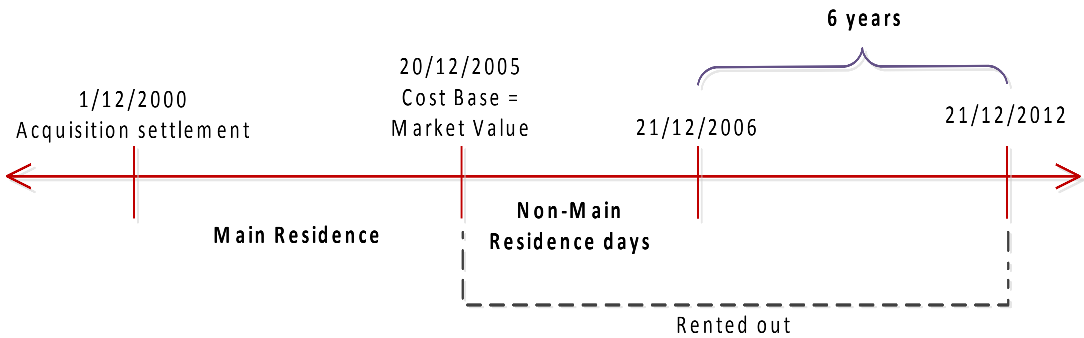
As the absences from Jason's main residence were not longer than six years at a time, that is, five years and two years, he is able to continue treating the residence as his main residence for the entire ownership period, from 1 December 2000 to 27 August 2013.

Jason will make this choice when preparing his tax return for the income year in which he sold his house.

Example – Absences from main residence – partial exemption

Assume that Jason was posted to the UK for a seven-year contract on 20 December 2005. He rented his residence out for seven years commencing 20 December 2005. When Jason returned in 2012, he sold his residence on 21 December 2012, packed his bags and set off to travel the world.

When Jason prepared his income tax return for the 2013 financial year, the year in which the disposal took place, he elected to continue the MRE for a further six years from 2005. That is, the exemption expired on 19 December 2011.



Jason is only entitled to a partial main residence exemption, as the seventh year is not eligible.

In calculating any taxable capital gain, because Jason first used his dwelling to produce income after 20 December 2005, he is taken by s. 118-192(2) to have acquired it on 20 December 2005 for its market value at that time.

For the purposes of apportioning any capital gain on the sale, the ownership period will be taken to be from 20 December 2005 (deemed acquisition date) to 21 December 2012.

Mixed use of a main residence

A residence can have mixed use in one of two ways:

1. the main residence is used subsequently for income production (similar to Jason's situation described above); or
2. the residence is used for both income production and as a main residence concurrently (e.g. where part of a house is rented out or used as business premises).

Income production and main residence over separate periods of time

Where, during an ownership period, a taxpayer only partly uses their residence as a main residence, only a partial exemption is available. However, this is subject to the six-year absence rule in s. 118-145.

The partial capital gain (CG) or capital loss (CL) is calculated as follows:

$$\textbf{CG or CL amount} \quad \times \quad \frac{\textbf{Non-main residence days}}{\textbf{Days in ownership period}}$$

Example – Partial exemption
Following on from the previous example, if the capital gain Jason would have made on his house was \$80,000 (taking into account the market value acquisition cost), the taxable capital gain would be: $\$80,000 \quad \text{X} \quad \frac{366 \text{ days }*}{2,557 \text{ days }**}$ = \$11,451 taxable capital gain * 19 December 2011 to 21 December 2012 ** 20 December 2005 to 21 December 2012 Note 1: The ownership period is taken to have commenced on the deemed acquisition date under s. 118-192. Note 2: Jason would also be eligible for the 50 per cent general discount which would reduce this capital gain to \$11,451 x 50% = \$5,725.

Income production and main residence concurrently

A partial exemption is also available where a CGT event happens to a residence that was used for the purpose of producing assessable income during all or part of the ownership period, and if interest had been incurred on money borrowed to acquire the dwelling, the interest would have been deductible.

TD 1999/66 states that this is a hypothetical test which assumes that a taxpayer had borrowed money to acquire the dwelling and had incurred interest on the money borrowed. The taxpayer is entitled to a deduction for interest to the extent to which the dwelling is used for producing assessable income.

If you use part of a dwelling for income producing purposes, an interest deduction is normally allowed on the basis of the percentage of the floor area used for income producing purposes.

In most cases, it is appropriate to increase the capital gain or capital loss that would have been made apart from s. 118-190 on this basis of floor area, also taking into account the time that the area has been used for income producing purposes.

In some cases, an interest deduction is allowed on other than a floor area basis. This may be the case if it can be shown that the value of the income producing part of the dwelling, as a proportion of the value of the entire dwelling, is greater or less than the proportion of the income producing part calculated on an area basis. Here, the capital gain or capital loss will be increased having regard to the interest that would have been able to be deducted on the basis of value, also taking into account the time that the area has been used for income producing purposes.

If an amount actually borrowed relates exclusively to the part of the dwelling that is income producing, the deduction allowable is 100 per cent. However, the capital gain or capital loss will be increased by an amount that is reasonable on the facts having regard to the interest deduction that would have been allowed if the money had been borrowed to acquire the dwelling and the interest which would have been incurred rather than the amount of interest actually allowed.

An Addendum to **TD 1999/66** was released 27 November 2002. The Addendum corrects the original Examples contained in the Determination for the operation of s 118-192.

Example adapted from Example 2 in TD 1999/66
Peter owns a home that he has lived in since October 1994. In October 1995, after taking a redundancy package, he extended the rear of the home and built a one-bedroom studio to rent out. He has derived rental income from these premises since October 1996. Peter borrowed $50,000 to build the studio. On the basis that the interest on the $50,000 relates solely to the studio, Peter has claimed 100 per cent deduction. In October 2004, Peter sells the property. Because Peter first used his dwelling to produce income after 20 August 1996 he is taken by s 118-192(2) to have acquired it in October 1996 for its market value. Having regard to the market value acquisition cost, Peter made a capital gain of $10,000 on the disposal of the property in October 2004. As the dwelling was Peter's main residence for the whole period from October 1996 (when he is taken to have acquired the dwelling) to October 2004, apart from s. 118-190(2) he would have been able to disregard the $10,000 capital gain, so that he would have made a capital gain of nil. Section 118-190(2) requires Peter to increase the capital gain by an amount that is reasonable having regard to the amount of interest he would have been able to deduct had he borrowed to acquire the whole house, including the studio, and incurred interest. The interest Peter actually incurred on the money he borrowed to build the studio is irrelevant. Under the hypothetical test, assuming that the studio is 10 per cent of the floor space of the house, the proportion of the hypothetical interest deduction is 10 per cent. Peter would increase the capital gain from nil to 10 per cent of the capital gain made on the disposal of the house (10% of $10,000) being $1,000. No adjustment is made to take account of the use of the property prior to October 1996 because Peter is not regarded as having owned it before that time for these purposes.

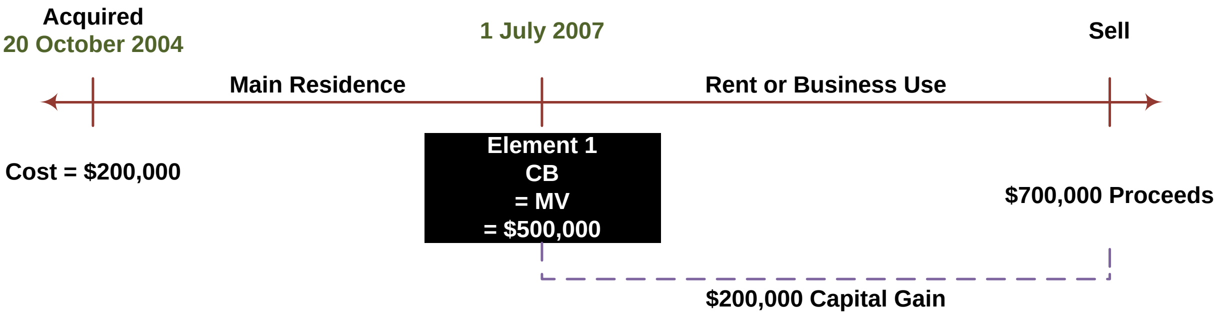
Calculating the cost base where there is mixed use

The elements of cost base are modified in relation to a property that has been used partly for income producing purposes.

The first element

Where a taxpayer is only eligible for a partial MRE due to part income producing use and that income producing use occurred for the first time after 7.30pm on 20 August 1996, the dwelling is taken to have been acquired at that first time for its market value at that time.[22]

Example – First income producing use
Jack acquired his former main residence on 20 October 2004 and then moved out and used the house for income producing purposes from 1 July 2007. He is therefore taken by s. 118-192(2) to have acquired the house on 1 July 2007 for its market value at that time.



The third element of the cost base

For CGT events happening on or after 1 July 2005, s. 110-25(4) states that the third element of an asset's cost base is the non-deductible costs of ownership (but only if the asset is acquired after 20 August 1991).

Where a residence has had mixed use, in order to calculate the cost base to determine any capital gain, the non deductible costs of ownership of that asset are taken into account. It is, therefore, imperative for record keeping purposes to keep this information where mixed use is intended.

Example – Third element of cost base

Steve acquired a one bedroom apartment on 1 February 1992 for $210,000. Incidental costs of acquisition, such as stamp duty and conveyance fees, totalled $11,500.

On 1 February 1996, Steve purchased a two bedroom house to move into as his main residence and decided to rent out the apartment. At this time the apartment had a market value of $250,000. This is however irrelevant because the house was first used for income producing purposes **before 20 August 1996**. After six years of rental, he sold the apartment on 1 February 2002 for $350,000, plus incidentals of $3,500.

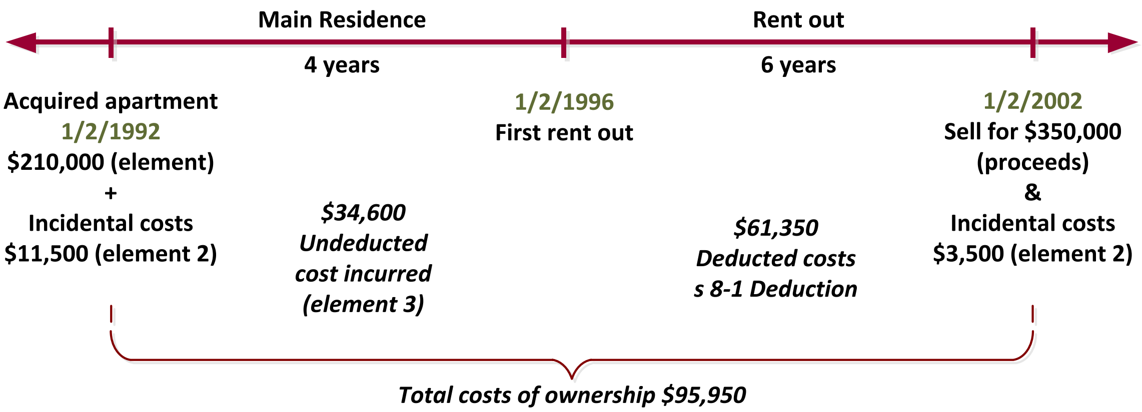
During the period of ownership, Steve incurred the following expenses:

[22] Section 118-192.

Example – Third element of cost base

	Period 1/2/1992 To 1/2/1996	Period 2/2/1996 To 1/2/2002	Total costs
Mortgage interest	$30,000	$45,000	
Council rates	$3,300	$6,900	
Repairs	$ -	$7,000	
Insurance	$1600	$2,450	
	$34,600	$61,350	$95,950

As the apartment was rented out for six of the ten years of ownership, Steve claimed an income tax deduction for the expenses above that relate to the rental period, against the rental income received. The remaining expenses that he hasn't claimed may be included in the third element of the apartment's cost base thereby reducing Steve's capital gain. The scenario can be shown in the following diagram.



Total Cost Base is:

Element 1	$210,000	(s. 118-192)
Element 2	$15,000	$11,500 + $3,500)
Element 3	$34,600	Expenses not claimed when Main Residence
	$259,600	
Proceeds of sale	$350,000	
Gross Capital Gain	$90,400	
Taxable capital Gain	$54,240	60% income producing use (i.e. 6 out of 10 years).

Recent development

There were two main residence cases late 2013.

Gerbic and FCT — Main residence exemption did not apply

Gerbic and FCT [2013] AATA 664.

On 17 September 2013, the Tribunal decided this case in favour of the Commissioner.

Facts

In 2002, the taxpayer jointly purchased a property with his son for the son to reside in. In 2007, the property was sold and the proceeds from the sale were applied against a debt relating to another property.

The taxpayer contended that he should not be assessed on the capital gain because he was registered as a joint tenant only to prevent his son from selling the property.

The argument put forward by the taxpayer was based on the existence of a constructive trust, and the taxpayer's ability to discharge the onus of proof. In Gerbic's case the taxpayer failed to discharge the burden of proof, and the Tribunal held that Mr Gerbic was assessable on his share of the capital gain.

Decision

The Tribunal found that the taxpayer:

- made a capital gain on the sale of the property;
- was deemed to have received the proceeds under s. 103-10 of the *ITAA 1997* because he chose to apply the proceeds against the debt;
- did not hold the property on trust for his son; and
- could not apply the main residence exemption under s. 118-110 because he did not reside in the property.

Had there been sufficient documentation to establish that Mr Gerbic did hold his half share as bare trust for his son, he may have been able to show that whilst he had legal title to 50 per cent of the property, his son had 100 per cent beneficial ownership. Such could not be established in the circumstances.

Keep and FCT — Taxpayer was not entitled to the MRE

Keep and FCT [2013] AATA 709

On 26 September 2013, the Tribunal decided this case in favour of the Commissioner.

The Tribunal reviewed the Commissioner's decision that the taxpayer was not entitled to the CGT MRE.

Facts

The dates and factors which were relevant for the purpose of establishing whether the taxpayer satisfied the requirements for treating the house as his main residence are summarised in the table below.

Date	The taxpayer …
July 2002	acquired property with his de facto partner for a purchase price of $174,000;
April 2004	began construction of a house (the house) on the property;
September 2004	ended his relationship with his de facto partner;
October 2004	redirected his mail to the Queensland address;
December 2004	nominated the Queensland address as his residential address on his driver's licence;
May or June 2005	moved into the house with his former de facto partner — the taxpayer stated to the Tribunal that they moved into the house: 'as friends (no longer in a relationship) to enable us to meet the requirements to sell the property without being subject to [CGT]';
September 2005	moved out of the house and went to live with his sister and her partner in Queensland (the Queensland address);
November 2005	sold the house for $703,000;
23 December 2005	left Australia for the UK, where he resettled;
27 February 2013	sent an email to the ATO advising that he moved out of the house in the first week of September 2005.

The Commissioner assessed the taxpayer on $114,675, being his share of the capital gain on the disposal of the property, in the 2005–06 income year. The taxpayer contended that he should not be assessed on the capital gain because he was entitled to the MRE.

The taxpayer also:

1. nominated the Queensland address as his home address on his 2004–05 income tax return;
2. alleged that, whilst living at the house, he shared the utility expenses with his former de facto partner; and
3. advised the Tribunal that he incurred about $70,000 of construction costs which should be added to the cost base to reduce the net capital gain from $114,675 to $66,271.

The taxpayer did not provide any evidence:

- that the house became his main residence as soon as practicable after the construction of the house;
- of any gas or electricity accounts for the house held in his name; and
- of the additional $70,000 for construction costs that he submitted should be added to the cost base.

Decision

Senior Member Walsh found that the evidence failed to establish that the taxpayer was entitled to the MRE because he did not:

- move into the house as soon as practicable after its construction; and
- continue to maintain it as his main residence for at least three months.

Liquidations

Overview

Broadly, there are three types of formal liquidations under the *Corporations Act 2001 (*CA*)*, namely:

- a members' voluntary winding-up, which would occur where the company is solvent (s. 491 and s. 494 of the *CA*)
- a creditors' voluntary winding up occurs, where the company is insolvent and is wound up at the request of the creditors (s. 497 of the *CA*), but does not involve a court appointment.
- a compulsory winding up occurs pursuant to a court order (ss. 459A, 459P, or 464 of the *CA*).

Beneficial ownership of shares in a company in liquidation

While, over the years there has been some contention in the courts regarding the beneficial ownership of shares in a liquidating company (e.g. in *Linter Textiles Australia Ltd (in liq) v FCT (2004)* the Commissioner argued, although unsuccessfully, that on a winding up, the assets of a company cease to belong beneficially to the company, but were held in trust by the liquidator), the Commissioner confirms in **ATOID 2003/964:** Consolidation: subsidiary in liquidation – that the beneficial ownership of shares in a liquidating company does not change, stating that -

> '…The appointment of a liquidator to a company **does not affect a shareholder's beneficial ownership of their shares in the liquidating company**, although those shares may be worthless.'

Taxation issues

The date of appointment of a liquidator will have ramifications for other matters such as when the company is wound up, at which time there will be taxation consequences.

According to the Commissioner of Taxation, a company is deregistered on the date the Court orders, as a result of a company winding up order, or three months after the liquidator lodges a return of holding the final meeting of members or members and creditors (TD 2007/7). The deregistration date is relevant in determining both when tax consequences occur for shareholders, and also for when a company ceases to be a member of a group. The date is also important in relation to s. 104-25(6) of the *ITAA 1997* and s. 47(2B) of the *ITAA 1936* (about when a company does not cease to exist within three years).

In general, a liquidator's distribution is either a return of capital or a taxable dividend.

Dividends (s. 44) and deemed dividends (s. 47)

Section 44 of the *ITAA 1936* — Dividends

Section 44(1) of the *ITAA 1936* provides that the assessable income of a shareholder in a company includes:

1. dividends (other than non-share dividends) that are paid to the shareholder by the company **out of profits** derived by it from any source; and
2. all non-share dividends paid to the shareholder by the company.

Section 44(1B) of the *ITAA 1936* — about '**certain dividends deemed** to be **paid out of profits'** – states that where –

- the amount of the moneys or of the value of other property of which a dividend paid by a company consists is debited against an amount standing to the credit of a share capital account of the company; or
- a dividend paid by a company is a repayment by the company of an amount paid up on a share,

the dividend shall, for the purposes of this section, be **deemed to have been paid** by the company **out of profits** derived by it.

However, it is also noted in s.44 (1) that this provision does not apply to a dividend (or non-share dividend) to the extent to which another provision of the Act that expressly deals with dividends includes or excludes some or all of that dividend from the shareholder's assessable income (see below for some commentary on s. 47 of the *ITAA 1936*).

Dividends – s. 47(1) — Distributions by Liquidator

Section 47(1) of the *ITAA 1936* deals with distributions by a liquidator, and states:

> 'Distributions to shareholders of a company by a liquidator in the course of winding-up the company**, to the extent to which they represent income derived by the company** (whether before or during the liquidation) other than income which has been properly applied to replace a loss of paid-up share capital, shall, for the purposes of this Act, be **deemed to be dividends** paid to the shareholders by the company **out of profits** derived by it.'

It is noted that 47(1A) of the *ITAA 1936* extends the meaning of income to include amounts otherwise included in assessable income and net taxable capital gains. Section 47(1A) provides that income derived by a company includes:

1. an amount (except a net capital gain) included in the company's assessable income for the year of income, e.g. balancing charge for plant machinery (*Wood Brothers (Birkenhead) Limited* (1959) 2 WLR 47).
2. a net capital gain that would be included in the company's assessable income for a year of income if the *ITAA 1997* required a net capital gain, to be worked out as follows:
   (a) Step 1 Work out each capital gain (except a capital gain that is disregarded) that the company made during that year of income. Do so without indexing any amount used to work out the cost base of a CGT asset.
   (b) Step 2: Total the capital gain or gains worked out under Step 1. The result is the net capital gain for that year of income.

Thus, s. 47 extends the reach of s.44.

Access to pre CGT profits

Archer Bros principle

The High Court in *Archer Brothers Pty Ltd (in Vol Liq) v FCT [1953] HCA 23,* observed:

> 'By a proper system of book-keeping the liquidator, in the same way as the accountant of a private company which is a going concern, could so keep his accounts that these distributions could be made wholly and exclusively out of those particular profits or income.'

The observations in this case gives rise to what is known as the '*Archer Brothers* principle'. In **TD 95/10,** the Commissioner accepts the *Archer Brothers* principle, with some reservations. In paragraph 4 of the determination he states:

> 'We consider that the *Archer Brothers* principle applies if:
>
> (a) the company accounts have been kept so that a liquidator can clearly identify a specific profit or fund in making a distribution, and
>
> (b) it is clear from either the accounts or statement of distribution that the liquidator has appropriated the specific profit or fund in making the distribution.'

The effect of the above is that a liquidator can return capital to shareholders in a manner that represent a return of capital and not a dividend. This is particularly relevant for those companies that have maintained capital profits reserves that represent the proceeds or gains on the disposal of pre-CGT assets.

This view is reinforced in **TD 2000/5 —** 'Income Tax: capital gains: does the requirement to disregard capital losses in Step 2 of the method statement in s. 47(1A)(b) of the *ITAA 1936* affect the application of the *Archer Brothers* principle?'

Example
A liquidator of ABCD Pty Ltd has $160,000 cash available for distribution after paying creditors (and the costs of the liquidation).
■ $50,000 issued share capital, return of capital – not assessable
■ $60,000 pre-CGT capital gains, *Archer Bros* applies – NOT a s. 47 deemed dividend
■ $20,000 post-CGT capital gains s**. 47(1A)** deemed dividend
■ $30,000 retained earnings **s. 47(1)** deemed dividend

Section 47(2A)of the *ITAA 1936* – Informal winding-up

In **FCT v Blakely** (1951) 9 ATD 239, the husband and wife shareholders/directors of the company appropriated all of the assets of the company, paid off its liabilities and carried on the business previously carried on by the company. The company continued to exist until it was ultimately struck off.

The Court held that s. 47 of the *ITAA 1936* did not apply as there was no liquidator involved in the process and there was not a 'distribution by a liquidator'.

Similarly, s. 44 of the *ITAA 1936* did not apply, as the company was passive in the transaction. It did not pay anything to the shareholders — they simply helped themselves to the assets of the company.

Accordingly the distribution was **not** assessable to the shareholders.

Whether a 'Blakely result' would be obtained where directors and shareholders are the same persons is a matter for speculation. The modern Court could find that the company made the distribution to the shareholders and the amounts were simply dividends under s. 44 of the *ITAA 1936.*

As would be expected, the government (albeit some sixteen years later) legislated against a 'Blakely' type event, with the introduction of s. 47(2A) of the *ITAA 1936*.

Section 47(2A) deems the appropriation of the assets or moneys in an 'informal winding up', to be is a liquidator's distribution. In the event that the company is not dissolved within three years of the distribution, the amount is considered to be a dividend paid by the company – i.e. no '*Archer Brothers'* allocation.[23]

The Commissioner has dealt extensively with distributions by a company to its shareholders and the extent to which such distributions constitute assessable dividends. The Commissioner has stated in **TR 2003/8** Income Tax: distributions of property by companies to shareholders – amount to be included as an assessable dividend, that:

- Distributions of property by a company to its shareholders constitute an assessable dividend to the shareholder to the extent that the distributions represent profits of the company.
- The term 'profits' has a wide scope and, in his view, debiting an amount other than to the share capital account would represent a distribution of profits.

Debiting an amount to the share capital account represent a return of capital and is not a dividend unless s. 45B of the *ITAA 1936* applied to the arrangement.

Capital gains tax issues

CGT event C2 on cancellation of shares

Section 104-25 of the *ITAA 1997* (about cancellation, surrender and similar endings) provides that CGT event C2 happens on the cancellation of the shares on liquidation of the company at which time there is a disposal of the share in the company by the shareholder. The time of disposal would be three months following the final report by the liquidator, or the date ordered by the Court in a Court appointed liquidation.

CGT event G1 happens when a liquidator makes an interim distribution that is a capital repayment to a shareholder in respect of their shares. **Section 104-135(6)** of the *ITAA 1997* provides that CGT event **G1** will be disregarded where the liquidator makes an interim distribution and the company is dissolved within eighteen months of the payment. In this case, the interim distributions would form part of the capital proceeds for the purposes of the CGT event C2 that happens in relation to the shares.

[23] Section 47(2B) of the *ITAA 1936*.

Where there are no pre-CGT assets in a company, the liquidation of a company can give rise to the following taxation outcome:

- A liquidator's distribution debited against the share capital account is not a dividend under s. 47(1) of the *ITAA 1936*.
- A liquidator's distribution debited against an asset revaluation reserve, to the extent that it represents profits of the company, would constitute a dividend paid to the shareholders under s. 47(1**)** of the *ITAA 1936*.
- Notwithstanding that certain parts of the liquidator's distribution constitute an assessable dividend, all of the distribution also constitutes a capital receipt for the purposes of CGT event C2 and the full amount of the capital gain would also be assessable.
- Section 118-20 of the *ITAA 1997* then operates to ensure that, to the extent that the liquidator's distribution is assessable under s. 47(1) of the *ITAA 1936*, any capital gain otherwise arising is disregarded.
- A similar, although more convoluted result arises in the case of **CGT event G1.**

Disregarded Capital Gains

Section 47(1A) which deems certain amounts which are capital to be income derived by a company and therefore a dividend when paid out to shareholders does not deem the following amounts to be income:

- gains from the disposal of pre CGT assets
- gifts — inter vivos or testamentary
- capital gains that are disregarded under the Tax law, namely:
  - gains under the 15-year exemption in s. 152-110(1)
  - gains under the retirement exemption in s. 152-305(2)

Note

The small business 50 per cent reduction concession in Subdiv 152-C is a 'reduction' not a gain that is 'disregarded' (but see **TD 2001/14**[24] below**).**

TD 2001/14 deals with how a distribution of the 'exempt 50% component of a capital gain attributable to goodwill is treated when it is distributed to shareholders by a liquidator in the course of winding up a company.

[24] **TD 2001/14** explains how the distribution of the exempt 50% component of a capital gain attributable to goodwill (as worked out in accordance with s. 47(1A)(b) of the *ITAA 1936)* is treated for the purposes of ss. 47 and 44 of the *ITAA 1936* and the CGT provisions in the *ITAA 1997* when a company's business ends and the capital gain is distributed to shareholders by a liquidator in the course of winding up the company. The 50% concession that applied to goodwill referred to in the determination was replaced with the small business 50% active asset reduction in Subdiv 152-C. The principles in TD 2001/14 which applied to the treatment of the goodwill concession apply equally to the reduction under the small business 50% active asset reduction.

Applying the principles established in TD 2001/14 to the exempt 50 per cent of the capital gain under the small business 50 per cent reduction concession in Subdiv 152-C, it follows that:–

1. A distribution by a liquidator of the 'exempt 50% component of a capital gain under the Subdiv 152-C concession is not deemed to be a dividend under s. 47(1).

2. The 'exempt' 50% component is not 'income derived by the company according to ordinary concepts for the purposes of s. 47(1) of the *ITAA 1936*. Nor is it 'income derived by the company under the extended definition of that expression in s. 47(1).

3. The 'exempt' 50% component does not come within the extended definition of 'income derived by a company' in s. 47(1A) of the *ITAA 1936* because it is a 'capital gain' that is disregarded' within the meaning of s. 47(1A)(b). Specifically this is because a capital gain attributable to active assets is reduced by 50% in accordance with Step 4 in the method statement in s 102-5(1) of the *ITAA 1997*. The amount by which the capital gain is reduced is appropriately treated as a capital gain that is 'disregarded' for the purposes of s. 47(1A).

4. Being a capital gain disregarded under Step 1 of the method statement in s. 47(1A)(b), the 'exempt 50% component is not included in the net capital gain of the company under Step 2 of that method statement.

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