The Tax Summit

Pre-CGT assets – Could you be facing a capital gain

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1. Overview

Capital gains tax was introduced in Australia from 20 September 1985. This is almost 40 years ago, and you may be surprised at how many taxpayers still hold assets and investments that were acquired prior to this time. These "pre-CGT" assets remain very much a part of the tax landscape today.

Australia chose to largely grandfather those assets acquired prior to 20 September 1985 from the capital gains tax provisions. Which, in principle, means that gains on assets acquired before this date are generally not taxed on their first disposal after that date.

This is different to the approach taken in some other countries, such as Canada and the US, where the grandfathering of CGT assets did not occur on the introduction of CGT.

The grandfathering policy has arguably created some complexity given the integrity provisions that flowed from this approach. There are a few provisions, specifically Division 149 and CGT Event K6 in the *Income Tax Assessment Act 1997* (Cth) which can mean that an otherwise "pre-CGT" asset nevertheless gives rise to a taxable gain.

These provisions can be complicated in their own right, but especially in their interactions with other provisions and events, such as rollovers, restructures and death of a person.

Sometimes a pre-CGT asset can provide a useful planning strategy (as we saw in the case of Ierna v Commissioner of Taxation [2024] FCA 592), however in other times there could be a 'dormant' tax liability of which the owners are not yet aware.

This paper will discuss the two main provisions, being Division 149 and CGT Event K6, and is designed to be used in conjunction with the presentation which will further explain some of the intricacies through numerical examples.

This paper has been prepared for the purposes of general training and information only. It should not be used for specific advice purposes, or for formulating decisions under any circumstances. All readers and practitioners are advised to undertake their own research or to seek professional advice to keep abreast of any reforms and developments in the law. William Buck (NSW) Pty Limited and Danielle Constantine exclude all liability relating to relying on the information and idea contained within. This paper is based on the legislation as it stood on 28 August 2024.

Unless stipulated otherwise, all legislative references are to the *Income tax Assessment Act 1997* (Cth) and the *Income Tax Assessment Act 1936* (Cth).

I wish to thank my colleague Amelia Switalski for her assistance with this paper.

2. Division 149

Where an asset is acquired before 20 September 1985 (i.e. “pre-CGT”), Division 149 can have application to treat the pre-CGT asset as becoming post-CGT where there has been a change in the majority underlying ownership of the asset.

Subdivision 149-B covers assets held by a non-public entity, and Subdivision 149-C covers assets held by certain public entities. This paper will focus on the former.

2.1 When Division 149 applies

Subsection 149-30(1) states:

> *The asset stops being a *pre-CGT asset at the earliest time when *majority underlying interests in the asset were not had by *ultimate owners who had *majority underlying interests in the asset immediately before 20 September 1985.*

Division 149 is designed to apply where pre-CGT assets are held within a structure. It does not apply where an asset is owned directly by an individual.

Section 149-15 of ITAA 1997 defines the terms “ultimate owner” and “majority underlying interests” in a CGT asset.

> *149-15(1)* ***Majority underlying interests*** *in a *CGT asset consist of:*
>
> *(a) more than 50% of the beneficial interests that *ultimate owners have (whether directly or *indirectly) in the asset; and*
> *(b) more than 50% of the beneficial interests that ultimate owners have (whether directly or indirectly) in any *ordinary income that may be *derived from the asset.*
>
> *149-15(2) An* ***underlying interest*** *in a *CGT asset is a beneficial interest that an *ultimate owner has (whether directly or indirectly) in the asset or in any *ordinary income that may be *derived from the asset.*
>
> *149-15(3) An* ***ultimate owner*** *is:*
>
> > *(a) an individual; or*
> > *(b) a company whose *constitution prevents it from making any distribution, whether in money, property or otherwise, to its members; or*
> > *(c) the Commonwealth, a State or a Territory; or*
> > *(d) a municipal corporation; or*
> > *(e) a *local governing body; or*
> > *(f) the government of a foreign country, or of part of a foreign country.*

Section 149-15(4) and (5) define when an ultimate owner has indirect beneficial interest in an asset.

> *149-15(4) An *ultimate owner indirectly has a beneficial interest in a *CGT asset of another entity (that is not an ultimate owner) if he, she or it would receive for his, her or its own benefit any of the capital of the other entity if:*
>
> > *(a) the other entity where to distribute any of its capital; and*

(b) the capital were then successively distributed by each entity interposed between the other entity and the ultimate owner.

*149-15(5) An *ultimate owner indirectly has a beneficial interest in *ordinary income that may be *derived from a *CGT asset of another entity (that is not an ultimate owner) if he, she or it would receive for his, her or its own benefit any of a *dividend or income if:*

(a) the other entity were to pay that dividend, or otherwise distribute that income; and
(b) the dividend or income were then successively paid or distributed by each entity interposed between the other entity and the ultimate owner.

A simple example to illustrate the above:

- Company A owns an asset acquired pre-CGT
- Immediately before 20 September 1985, it had two individual shareholders each holding 50% of the ordinary shares (Shareholder A and Shareholder B)
- On 1 July 2024, Shareholder B sold their shares to a third party.
- Section 149-30 was triggered on 1 July 2024, as not more than 50% of the beneficial interests in the entity remained the same.
- The pre-CGT asset held by Company A would stop being a pre-CGT asset
- If Shareholder B had instead retained 0.1% of its shares in Company A, then Division 149 would not have been triggered.

2.1.1 IT 2530

The Commissioner has confirmed in IT 2530 that a change in proportions (between the majority owners) in which the natural persons held interests in the asset should not have a bearing on a determination of whether a majority of underlying interests is maintained.

An example from this ruling illustrates this point. Immediately before 20 September 1985 underlying interests in an asset of a company were owned by four natural persons in the proportions set out below. A change in shareholding happened after 20 September 1985 such that a new shareholder acquired shares in the company. The proportions at the relevant times are set out in the table below:

Shareholder	A	B	C	D	E
Percentage shareholding immediately before 20 September 1985	90%	5%	3%	2%	0%
Percentage shareholding after a change in shareholdings at a time after 20 September 1985	1%	2%	48%	0%	49%

The natural persons who owned underlying interests both immediately before 20 September 1985 and after the change in ownership were A, B and C. Immediately before 20 September 1985 A, B and C between them owned more than half of the underlying interests (i.e., 98%). After the change A, B and C between them still owned more than half of the underlying interests (i.e., 51%).

It is relevant to note that IT 2530 is based on former section 160ZZS. Section 160ZZS was rewritten into sections 149-30 and 149-35. Further, IT 2530 is in relation to the underlying ownership of assets in a publicly traded unit trust, however the way in which the Commissioner calculates a change in underlying ownership interests can be equally applied for changes in privately held companies and unit trusts.

2.1.2 Class shares

As set out above, the majority underlying interest in a CGT asset consists of both more than 50% of the beneficial interests in the asset and the ordinary income that may be derived from the asset. Where there are share or units with different rights, it can be more complicated to work out whether the majority underlying interests have remained the same.

For example, say there are three shareholders in a company, Jake, Marcel and Zane. Immediately before 20 September 1985, Jake holds 1 A class share, Marcel holds 1 B class shares and Zane holds 1 C class share. Each class of shares gives the shareholder the right to vote, discretionary dividends on that class, and a right to surplus capital on winding up.

This means that a dividend could be paid on one class of share over another. In which case, no shareholder has a beneficial interest in the ordinary income that may be derived from the assets owned by the company. Where there is no change in the shareholders, this should not be a problem for Division 149, as confirmed by the Commissioner in ATO ID 2011/101.

If Zane sells their C class share to Marcel, this should also not be a problem for Division 149 (given the Commissioner’s views in IT 2530).

However, if Zane were to sell their C class share to another third party, how will Division 149 apply?

— There would have been still 2/3rd continuity of the majority underlying interests in the asset (as all class shares share equally in the surplus capital on winding up)
— Theoretically, all the dividends could be paid to the new shareholder of the C class share, therefore it is not possible to identify the same group of shareholders who have had more than 50% of the underlying interest in the ordinary income of the asset from before 20 September 1985 to date.

It is noted that a variation of rights in shares can also make the application of Division 149 more complicated, as well as giving rise to other tax issues for consideration such as the value shifting rules.

2.1.3 Discretionary Trust

Another complicating factor is where interests in an asset are held by a discretionary trust.

It is not possible to determine the ultimate interest owner where the interest is held by a discretionary trust, because the beneficiaries do not have any beneficial interest in the income or capital of the trust until the trustee makes a determination to do so.

Subsection 149-30(2) provides a discretion to overlook the factual test in subsection 149-30(1) if the Commissioner is satisfied, or thinks it reasonable to assume, that at all times after 20 September 1985 when the asset was held by the taxpayer, majority underlying interests in the asset was held by a natural person who, immediately before that date, held majority underlying interests in the asset.

We have an indication of how the Commissioner may exercise his discretion from IT 2340, as well as some private binding rulings.

IT 2340 refers to former section 160ZZS, however it remains relevant for the way in which the Commissioner administers current Division 149.

As stated in paragraphs 5 to 7 of IT 2340:

> *"5. In relation to what are generally referred to as discretionary trusts, i.e., family trusts, the trustees of which have discretionary powers as to the distribution of trust income or property to beneficiaries, in considering the question of whether majority underlying interests have been maintained in the assets of the trust it will be relevant to take into account the way in which the discretionary powers of the trustees are in fact exercised.*
>
> *6. Where a trustee continues to administer a trust for the benefit of members of a particular family, for example, it will not bring section 160ZZS into application merely because distributions to family members who are beneficiaries are made in such amounts and to such of those beneficiaries as the trustee determines in the exercise of his discretion.*
>
> *7. In such a case the Commissioner would, in terms of sub-section 160ZZS(1), find it reasonable to assume that for all practical purposes the majority underlying interests in the trust assets have not changed."*

Where a trustee distributes in such a way that there is in practical effect a change in 50% or more in the underlying interest in the trust's assets, such as distributions to members of a new family, then there would be a change in majority underlying interests and Division 149 would be triggered.

Practically, where there have been no changes to the trust deed during the ownership period, and the distributions have always been within the family (noting the comments on the definition of 'family' below), we have seen the Commissioner apply the concessional treatment from IT 2340.

However, not all situations are that simple, and where there have been restructures, even within the family, it very much depends on the facts as to whether the Commissioner will consider that Division 149 has not been triggered.

For example, in PBR 1051895822817 (6 September 2021), shares in a company were transferred from one family trust, to another family trust. Even though the transferee trust holds the shares for the benefit of the same family, the Commissioner noted that:

> *In the present case, the family trust held its shares in the Company from incorporation until 20XX when the restructure occurred. The shares were then transferred to Child A Trust and Child B Trust in 20XX. Although the trustees of those respective trusts may have continued to administer those trusts for the benefit of members of the family group, it is clear that these trusts are not the same trust (being the family trust) that held the goodwill as at 20 September 1985. The view in IT 2340 therefore cannot be applied to the present case.*

This differs from the result in an earlier PBR 1051228325810 (20 July 2017) where shares were effectively transferred from one family trust to another. In that PBR, the Commissioner found that the trustees for both trusts "have administered each trust for the benefit of members of the family group, both pre and post 20 September 1985" such that Division 149 was not triggered. The Commissioner also considered the actual dividend flows and income distributions throughout the relevant period.

All this to say that the matter can be complicated, and taxpayers may require a private ruling from the Commissioner.

Meaning of 'family'

In IT 2340 the Commissioner refers merely to a 'family trust' and a 'family' but does not specifically reference those terms as defined in Schedule 2F of the *Income Tax Assessment Act 1936*, i.e. a trust that has made a family trust election.

Helpfully, some comments were made in the National Tax Liaison Group (NTLG) CGT Sub-committee on 28 November 2001 by the ATO representatives, as follows:

> *What constitutes a member of a particular 'family' will require consideration of the facts of particular cases. The ATO considers that what is contemplated is narrower that a 'relative' (eg. a distant relative would not normally be thought to qualify), but equally, the concept of 'family' is not intended to be limited to the 'nuclear' family (ie, father, mother and children). What is often described as an 'extended' family (ie, including grandparents, children, grandchildren and their spouses) would ordinarily qualify as a 'family' for these purposes. Also, if distributions are made to post-19 September 1985 additions to a family (for example, the birth of new family members and new persons joining a family through marriage), the 'family' distribution criteria would ordinarily still be satisfied.*

2.2 Consequences of Division 149 applying

When section 149-30 is triggered:

- An asset stops being a pre-CGT asset and is taken for the purposes of capital gains tax provisions to be acquired at that time (being the earliest date Division 149 was triggered)[1]; and
- The first element of the cost base and reduced cost base of the asset is the asset's market value at the earliest trigger time[2].

This means that if there have been multiple changes in ownership of an entity, taxpayers will need to go back to the earliest time that Division 149 was triggered and determine the market value of the asset at that date.

This can cause difficulties where the application of Division 149 is not discovered until a later date (when the entity is looking to sell or restructure the asset) and the information required for a valuation may not be as readily available. Taxpayer and their advisors should be familiar with Section 262A which imposes certain record keeping requirements on taxpayers as well as Division 121 which imposes additional requirements in relation to CGT assets.

2.3 Change in ownership due to death or marriage rollover

Section 149-30(3) and (4) provide that, in assessing the issue of the majority underlying interests, if a person holds an interest in an asset because it was transferred to them by way of a marriage breakdown roll-over or because of the death of a person, then the person is taken to have held the interests held by the former owner – in other words, changes in ownership resulting from marriage breakdowns or death are ignored.

[1] Subsection 149-30(1A)
[2] Subsection 149-35(2)

Specifically, the legislation states:

149-30(3) Subsection (4) affects how the majority underlying interests in the asset are worked out if an ultimate owner (the new owner) has acquired a percentage (the acquired percentage) of the underlying interests in the asset because of an event described in column 2 of an item in the table. The former owner is the entity described in column 3 of that item.

Events leading to new owner standing in for former owner		
Item	*For this kind of event:*	*The former owner is:*
1	*CGT event A1 or B1 if there is a roll-over under Subdivision 126-A (about marriage or relationship breakdowns) for the event*	*the entity that, immediately before the event happened, owned the GST Asset to which the event relates*
2	*the death of a person*	*that person*

149-30(4) This section applies as if the new owner had (in addition to any other underlying interests), at any time when the former owner had a percentage (the former owner's percentage) of the underlying interests in the asset, a percentage of the underlying interests in the asset equal to the acquired percentage, or the former owner's percentage at that time, whichever is the less.

In these circumstances, the ultimate owner who acquired the interest in the underlying assets because of the death of a person or a marriage breakdown roll-over is treated as “standing in the shoes” of the former owner.

It is common to see shares initially acquired before 20 September 1985 that have since been passed through either one or multiple deceased estates, given the time elapsed. It is important to trace through the changes in shareholders, not just for Division 149 purposes, but also to ensure the correct cost base in the shares themselves is recorded. For example, a pre-CGT share which passes to a beneficiary on death, will have a cost base equal to market value at date of death[3] and the share is now a post-CGT asset. If that post-CGT share then passes on to another beneficiary on death of the first beneficiary, the cost base of the share will, generally speaking, be inherited from the first beneficiary[4].

2.4 Share restructures

2.4.1 Bonus shares

Generally, an issue of bonus shares should have no impact on the composition of the ultimate owners of the shares i.e. the ultimate owners of the shares remained the same where the bonus shares have been issued to shareholders in their existing proportions. Therefore, the issue of bonus shares should not trigger the asset changing from a pre-CGT asset to a post-CGT asset under Division 149.

[3] Item 4 of the table in subsection 128-15(4)
[4] Item 1 of the table in subsection 128-15(4)

The acquisition date and cost base of the bonus shares may be affected by section 130-20 of the *Income Tax Assessment Act 1997* as well as section 130-20 of the *Income Tax (Transitional Provisions) Act 1997*.

2.4.2 Share splitting

Depending on the circumstances, the splitting of shares post-CGT by a company may not trigger a change in the underlying ownership interest of an asset for the purposes of Division 149[5].

PBR 1051449588551 (5 November 2018) examines the pre-CGT status of a company which undertook a share split. The PBR notes that the share split in this instance did not result in any change to the majority underlying interests and Division 149 was not triggered. PBR 1051799006782 (8 February 2021) notes that the share split detailed in this PBR was not a CGT event and therefore the shares retained the same acquisition date and elements of cost base.

2.4.3 Rollovers

As Division 149 traces through to the underlying owners of the assets, it is possible to restructure the interests in between the asset and the ultimate owner without triggering Division 149.

However, as we will discuss in the section on CGT Event K6, beware how any CGT rollovers used in a restructure may impact the pre-CGT status of the shares or units themselves.

[5] TD 2000/10

3. CGT Event K6

CGT event K6 was designed to stop a tax advantage being obtained by owners of pre-CGT interests in an entity disposing of those interests instead of the entity disposing of its post-CGT assets.

When CGT event K6 happens, a capital gain will arise where the capital proceeds from the disposal of the shares is reasonably attributable to an unrealised gain on the underlying entity's post-CGT assets.

Section 104-230 contains the provisions relevant to CGT event K6. CGT event K6 happens where, pursuant to subsection 104-230(1):

(a) You own shares in a company or an interest in a trust you acquired before 20 September 1985; and

(b) A specified CGT event happens in relation to the shares or interest, including CGT event A1; and

(c) There is no roll-over for the other CGT event; and

(d) The 75% test in subsection 104-230(2) is satisfied.

The timing of CGT event K6 is when the other relevant CGT event occurs.

3.1 When does CGT event K6 happen?

3.1.1 Condition in paragraph 104-230(1)(a)

CGT event K6 is only relevant in relation to assets that are shares in a company or an interest in a trust.

The shares or interests must have been acquired before 20 September 1985, noting that other provisions may affect the acquisition date for these purposes including:

- Division 149, as already discussed, where the shares or interests are in turn held within a structure (e.g. another company)
- CGT rollovers, as not all CGT rollovers will preserve the pre-CGT status of an interest held by the original holder. For example:
    - Subdivision 124-M does not preserve pre-CGT status (more on the interaction between Subdivision 124-M and CGT event K6 in section 3.5 below).

3.1.2 Condition in paragraph 104-230(1)(b)

CGT event K6 is a secondary CGT event. That is, it requires another CGT event to happen.

Only the following CGT events can give rise to CGT event K6; A1, C2, E1, E2, E3, E5, E6, E7, E8, J1 and K3

CGT events I1 and I2, in relation to a change in residency status, do not trigger CGT event K6.

CGT event G1 is another event that does not trigger CGT event K6. This is discussed further in section 4 of this paper.

3.1.3 Condition in paragraph 104-230(1)(c)

CGT event K6 will not happen if there is a rollover applied in relation to the other CGT event.

The term rollover is not defined in this context, and indeed the CGT provisions do not refer to a 'rollover' generally but to either a 'same-asset rollover' or a 'replacement asset rollover'.

The undefined term 'rollover' is also used in Subdivision 124-M. The Commissioner is of the view that the term 'rollover' as used there includes not just the same-asset and replacement asset rollovers but also any provision that has the effect of deferring, but not eliminating, tax recognition of a capital gain and providing for a cost base/reduced cost base transfer[6]. It is therefore implied that the same interpretation would apply in respect of the use of 'rollover' in CGT event K6 provisions.

Division 128 provides a form of rollover in respect of the assets owned by an individual when they die. In applying the Commissioner's view, CGT event K6 cannot apply where Division 128 applies in relation to the transaction.

A taxpayer cannot apply a rollover under Subdivision 124-M for an interest that was acquired before 20 September 1985, therefore CGT event K6 can still apply to those interests. However, as discussed in section 3.5 there is effectively a rollover available for any gain occurring under CGT event K6 for such situations.

3.1.4 Condition in 104-230(1)(d)

This condition requires either of the limbs in subsection 104-230(2) to be satisfied, known as the 75% test.

The 75% test compares the value of the post CGT assets of the company to the total value of the company. If the post CGT assets constitute more than 75% of the value, then CGT event K6 can apply. Subsection 104-230(2) states:

> *(2) Just before the other event happened:*
>
> > *(a) the * market value of property of the company or trust (that is not its * trading stock) that was * acquired on or after 20 September 1985; or*
> >
> > *(b) the market value of interests the company or trust owned through interposed companies or trusts in property (except trading stock) that was * acquired on or after 20 September 1985;*
>
> *must be at least 75% of the * net value of the company or trust.*

The 75% test requirement involves a number of different aspects:

- The time of assessing this requirement is just before the other event happens.
- The definition of 'property' in this context is based on its ordinary legal meaning. The Commissioner considers that the definition would include, amongst many others, items such as land and buildings, shares in a company, units in a unit trust, plant and equipment, debts owed to the company and intangible assets like goodwill. It does not include items like deferred tax assets.
- The definition of 'property' for the purposes of this calculation also does not include trading stock. However, as noted below, the value of trading stock may still impact on the net value of the company.

[6] TR 2006/9

- The ‘net value of the company’ is defined in section 995-1 as the amount by which the sum of the market values of the assets of the company exceeds the sum of its liabilities. Neither the term ‘assets’ or ‘liabilities’ is defined.
- The relevant ‘property’ and the net value need to be determined on the basis of market value.

Once the above-mentioned aspects have been considered, the following calculation is performed as at the time of the CGT event, for the purposes of the first limb of the 75% test:

Market value of relevant post-CGT property of the company	÷	net value of the company	= %

If the above formula results in a percentage equal to or greater than 75%, the first limb of the 75% test will be satisfied.

The second limb of the 75% must also be considered. Even if CGT event K6 has already been triggered by the first limb, as this will impact the calculation of any capital gain. The calculation required by the second limb is as follows:

Market value of relevant post-CGT property owned by the company through interposed entities	÷	net value of the company	= %

For the purposes of the second limb, the Commissioner notes the following in TR 2004/18[7]:

- The post-CGT property taken into account is the first company’s interest in the post-CGT property owned by the lower tier companies. For example, if a lower tier company has $1,000,000 in relevant post-CGT property, and the first company owns 40% of the shares in the lower tier company, $400,000 is included.
- For this purpose, it does not matter whether the shares in the lower tier company are pre- or post-CGT
- Shares that one lower tier company owns in another lower tier company are not included in post-CGT property.

That is, only property that the first company has an interest in through downstream entities is included in the second limb of the 75% test.

As the two limbs of the 75% test apply different property to the same net value of the first company, a different mix of assets between the first company and the subsidiaries can give rise to a different result under CGT event K6. There are integrity measures which can apply where certain assets are acquired or liabilities discharged for a purpose which included ensuring CGT event K6 did not happen.

3.2 Calculation of the K6 Capital Gain

Just because you breach the 75% threshold and K6 happens, does not mean you necessarily have a gain under CGT event K6.

[7] Paragraphs 18 and 19 of TR 2004/18

A capital gain under CGT event K6 is equal to that part of the capital proceeds from the sale of the interest that is reasonably attributable to the amount by which the market value of the post-CGT property is more than the sum of the cost bases of that property.

This means, that where there is no unrealised gain on assets of the company (i.e. market value = cost base), then there is unlikely to be any capital gain under CGT event K6.

It is not possible to make a capital loss from CGT event K6.

Subsection 104-230(6) reads:

> *You make a *capital gain equal to that part of the *capital proceeds from the *share or interest that is reasonably attributable to the amount by which the * market value of the property referred to in subsection (2) is more than the sum of the * cost bases of that property.*

Although there is no prescribed methodology to determine the reasonable attribution of the capital proceeds, the Commissioner suggests a two-step approach outlined in TR 2004/18.

The Commissioner also notes that where only one of the limbs of the 75% test in subsection 104-230(2) is satisfied, the capital gain is calculated by reference to the property referred to in that limb[8].

Conversely, where both limbs of the 75% test are satisfied, the property in each limb is separately taken into account under subsection 140-230(6). That is, you could make two capital gains under CGT event K6, however the Commissioner considers it appropriate to disregard the lesser capital gain.

3.2.1 Single tier structure

In a single tier structure, the Commissioner's suggested approach is a 2-step process, as follows:

— Step 1 amount = Capital proceeds * (Market value of post-CGT property / Market value of all property)

— where:

  - ***Market value of post-CGT property*** means the sum of the market value of the post-CGT property taken into account under paragraph 104-230(2)(a); and
  - ***Market value of all property*** means the sum of the market value of all property (including pre-CGT acquired property and trading stock) owned by the company.

— Step 2 amount = Step 1 amount * (Market value excess / Market value of post-CGT property)

— where:

  - ***Market value excess*** means the excess of the market value of property taken into account under subsection 104-230(6) over the sum of the cost bases of that property.

If a capital gain calculated under this method exceeds the market value excess, then the capital gain would be limited to the market value excess.

[8] Refer to paragraphs 104 and 105 of TR 2004/18

3.2.2 Multi-tier structure

The Commissioner considers that modifications of the above approach would likely be needed for multi-tier structures[9]. Specifically, the Commissioner notes in paragraph 129 of TR 2004/18:

> *Where the property taken into account is the paragraph 104-230(2)(b) property, the presence of paragraph 104-230(2)(a) property will affect the extent to which the capital proceeds relate to the property in the lower tier companies. As a result, it is necessary to exclude that part of the proceeds attributable to the paragraph 104-230(2)(a) property before the two step approach can be applied. Further complications can also arise in the case of multi-tier structures due to the presence of property, such as loans between lower tier companies, the value of which is not reflected in the capital proceeds received.*

Consequently, taxpayers and advisors will need to consider the particular facts of the case in determining how to reasonably attribute the market value excess to the capital proceeds.

3.3 Goodwill

Often a critical part of the 75% test, and therefore whether CGT event K6 would apply, is the status of the goodwill of the entity. If the goodwill represents a significant part of the value of the company, then whether it is pre-CGT or post-CGT could mean the difference between a capital gain arising under CGT event K6, or not.

TR 1999/16 provides the Commissioner's views on the concept of goodwill for tax purposes.

Paragraph 17 states that:

> *"The whole of the goodwill of a business that commenced before 20 September 1985 remains the same single pre-CGT asset…provided the same business continues to be carried on. This is so even though:*
> *a) the sources of the goodwill of a business may vary during the life of the business; or*
> *b) there are fluctuations in the goodwill during the life of the business."*

Paragraph 18 of TR 1999/16, states that "*A business or the sources of its goodwill may change so much it can no longer be said to be the same business as that previously conducted*." The ruling goes onto say:

> *20. Whether the same business is being carried on is a question of fact and degree that ultimately depends on the circumstances of each particular case. The test to use for whether the same business is being carried on is not the same test as that*

For the purposes of this paper, a few key aspects of the Commissioner's view are included here:

— Goodwill is a CGT asset for tax purposes, and goodwill has the meaning it bears under general law. It is the legal definition of goodwill that is relevant for tax law, not the accounting or business definition.

— Goodwill is the product of combining and using the tangible, intangible and human assets of a business in such ways that custom is drawn to it. The attraction of custom is central to the legal concept of goodwill, and it is a composite thing that is legally distinct from its sources. However, goodwill is attached to a business and is inseparable from the conduct of the business, and it cannot be dealt with separately from the business.

— The goodwill of a business is considered a single CGT asset for tax purposes.

— If the 'essential nature or character' of a business is not changed, that business remains the same business for the purpose of the CGT goodwill provisions and therefore its goodwill is the same CGT asset.

[9] Paragraph 128 of TR 2004/18

- If a new business operation or activity introduced by a taxpayer is an expansion of an existing business (whether it commenced before or after 20 September 1985), any internally generated goodwill built up in conducting the expanded business is merely an expansion of the existing goodwill of the business.
- Whether an increase in business operations or in the scale of activity constitutes an expansion of an existing business is question of fact dependant on the circumstances of each case. The relevant factors to consider include:
    - the nature of the new business or operation or activity;
    - the types of customers that the business operation or activity attracts; and
    - the extent to which the business operation or activity:
        - is subject to the same integrated management and control as the existing business;
        - is treated for banking and accounting purposes as an extension of the existing business or as a separate business;
        - uses one or more different trading names; and
        - is related to or dependant on the existing business in a practical, economic or commercial sense.
- If a pre-CGT business is combined with another business acquired post-CGT and those businesses are conducted as one business without the pre-CGT business losing its essential nature or character, the goodwill of the post-CGT business is subsumed into the goodwill of the pre-CGT business. Consequently, all the goodwill of the business is taken to have been acquired before 20 September 1985.
- The purchase of a post-CGT business that merely involves organic growth of the pre-CGT business or an expansion or accretion to it in reasonable proportions would support the pre-CGT business as not having lost its essential nature or character.

This concept of determining whether the goodwill is still pre-CGT is not the same analysis as required under the business continuity tests in Division 165 in respect of company losses.

A business will need to consider many factors in determining the status of their goodwill and ensure that there is sufficient documentation to support their assertions. This could be anything from accounting records to marketing materials to ASIC records. Some questions which are worth considering are:

- What are the sources of the goodwill (e.g unique products, location, or technical knowledge)?
- Has the business name changed?
- Has the business been dormant at any time?
- How has the customer demographics and market evolved over time?
- Has the business vertically, or horizontally, integrated its operations?

If a tax advisor has knowledge that a significant change in business is about to occur, it may be an opportune moment to discuss restructuring the business with your client. It may be possible to crystallise the pre-CGT gain and move it into a more desirable structure (as the structure in place since 1985 may no longer be serving the owners), and have a cost base going forward for any future sale.

If the goodwill is no longer pre-CGT, then the pre-CGT goodwill ceases to exist and a new goodwill asset is created. There is no cost base reset from a change in business (unless the goodwill loses pre-CGT status due to the application of Division 149, but the same goodwill still exists).

3.4 Interaction with Division 149

As discussed, if Division 149 is triggered, then subsection 149-30(1A) states that "Part 3-1 and this Part (except this Division) apply to the asset as if the entity had acquired it at that earliest time". That is, for capital gains tax purposes, the asset is taken to have been acquired at the earliest trigger time.

This would imply that for CGT event K6 purposes, an asset held by a company that is no longer pre-CGT because of Division 149, would need to be treated as post-CGT.

Despite this, the Commissioner has stated in TR 2004/18 at paragraph 15 that where a CGT asset is treated as having been acquired post-CGT because of Division 149, the item of property continues to be treated as having been acquired pre-CGT for CGT event K6 purposes. The Commissioner states that, at paragraph 66 of the ruling:

> *Continuing to treat the item of property as acquired pre-CGT is consistent with the objective of CGT event K6. As an anti-avoidance or transitional provision, it is designed to capture the accumulation of post-CGT acquired property in a company with pre-CGT shareholders. CGT event K6 is not targeted at the accumulation of property which is only deemed post-CGT acquired because of the operation of another anti-avoidance or transitional provision in Division 149.*

In certain cases, where an asset of a company was acquired by the company before 20 September 1985, but a change in shareholders meant that the land is treated as being acquired post-CGT under Division 149, it may be worthwhile to calculate whether there is a better tax outcome if the shares in the company are sold rather than the underlying asset (for those shareholders that still have pre-CGT shares).

3.5 Interaction with Subdivision 124-M

A taxpayer cannot apply a rollover under Subdivision 124-M in relation to an interest that was acquired pre-CGT[10]. If there is a pre-CGT share or interest that is exchanged as part of the overall scrip for scrip arrangement, then the cost base of the replacement interest is its market value just after you acquired it[11].

However, a gain under CGT event K6 is disregarded where Subdivision 124-M would otherwise apply.

Subsection 104-230(10) states:

> *A *capital gain is disregarded for a *share in a company an interest in a trust to the extent that, had you *acquired it on or after 20 September 1985, you could have chosen a roll-over for the other *CGT event under Subdivision 124-M (scrip for scrip roll-over).*

In that case, the cost base of the replacement interest is reduced by the amount of the disregarded CGT event K6 gain[12], allowing an effective rollover of any CGT event K6 gain.

[10] Paragraph 124-780(3)(a)
[11] Section 124-800
[12] Section 124-800

4. Winding up a company

Where a company makes a disregarded capital gain on a pre-CGT asset, the next consideration is how can that gain been extracted from the company, in a tax effective manner.

Ordinarily, any distribution of profits from a company would be a dividend, and generally assessable to the shareholder. However, where the profits are distributed by a liquidator, it is possible to treat a component of the distribution as capital for capital gains tax purposes.

An alternative is to make a capital reduction, however the anti-avoidance provisions, particularly section 45B must be considered and those provisions may deem that some of the capital reduction amount is treated as a dividend for tax purposes.

4.1 Overview

On the winding up of a company, a liquidator will generally realise the assets of the company, discharge outstanding liabilities and distribute to the shareholders any surplus which remains.

From a tax perspective, a distribution by a liquidator on the winding up of a company will comprise one, or both, of the following components:

- A dividend; or
- A capital receipt.

Distinguishing between the two components requires an analysis of where the amounts to be distributed have been sourced from.

4.2 Liquidation dividend component

An amount will be considered an assessable dividend component to the extent that section 47 applies:

> ***47 Distributions by liquidator***
>
> *(1) 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 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.*
>
> *(1A) A reference in subsection (1) to income derived by a company includes a reference to:*
>
> > *(a) an amount (except a net capital gain) included in the company's assessable income for a year of income; or*
> > *(b) a net capital gain that would be included in the company's assessable income for a year of income if the Income Tax Assessment Act 1997 required a net capital gain to be worked out as follows:*

> ***Method statement***
> *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.*
>
> *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*

The key aspect in determining whether section 47 applies is establishing whether the amount being distributed is income of the company determined according to the above methodology.

The first exclusion from the income definition is amounts used to replace paid up share capital. As paid-up share capital is not in itself income of the company, an amount used to replace paid-up capital will also not be considered income.

The methodology used to determine the amount of net capital gains included as income for the purpose of section 47 is different to the methodology which may be used to calculate capital gains in accordance with other parts of the tax laws. A method statement is set out in section 47(1A)(b) (as outlined above).

Step 1 of the method statement in section 47 excludes a disregarded capital gain from being included as income, such as a gain on a pre-CGT asset.

The dividend component of a liquidation distribution will be included in the shareholders' assessable income. If there are franking credits available, the liquidator may choose to frank the dividend.

4.3 Liquidation capital component

To the extent the liquidator's distribution is not a dividend in accordance with section 47, it will be a capital component.

The capital component of a liquidator's distribution is used to calculate whether the shareholder makes a capital gain or a capital loss on the cancellation of their shares. This is because CGT event C2 happens as the company is wound up and the liquidator cancels all the shares in the company.

Should the company continue to exist greater than 18 months after the payment of a distribution by a liquidator comprising of a capital component, CGT event G1 can happen instead. This could occur especially where an interim liquidator's distribution is made early in the liquidation process, but the liquidation takes longer than expected and the company continues to exist 18 months after the interim distribution.

Importantly, if a shareholder acquired their shares pre-CGT, any capital gain or loss made as a result of CGT event C2 or CGT event G1 happening will be disregarded.

4.3.1 CGT event K6

One of the pre-conditions for CGT event K6 to happen is that one of the CGT events listed at section 104-230(1)(b) must happen. CGT event G1 is not listed, therefore CGT event K6 is only relevant for shareholders where they receive capital proceeds from a CGT event C2.

CGT event K6 tests the market value of property "just before the other event happened" that is, just before CGT event C2 happened. CGT event C2 happens when the shares are cancelled and generally the shares are cancelled 3 months after the liquidator lodges the final report with ASIC. At that time, the company would have no assets at all and therefore it would not be possible to apply the test in subsection 104-230(2). This position is supported by the ATO in TR 2004/18, paragraph 48:

> *Although CGT event K6 is theoretically capable of happening, it is most unlikely that the company would have any property of the kind referred to in subsection 104-230(2) just before the time CGT event C2 happens. That is, the company is highly likely to be a 'shell' at that stage.*

Therefore, in a liquidation scenario, CGT event K6 would ordinarily not apply (although it will always depend on the facts of the case).

Depending on the assets in the company, and the shareholder’s tax characteristics, it may be more tax efficient to liquidate the company rather than merely selling the shares or selling the asset and paying a dividend out of the company. However, it is worth noting that a liquidation does come with some risks, in that the liquidators will control the distributions.

4.4 Classifying the liquidation components

The ability of a liquidator to identify and determine the source of the distribution is critical from a tax perspective as it will determine how whether the amounts are treated as a dividend or capital.

The *Archer Brothers*[13] principle provides guidance on how a liquidator can classify the components of a payment. This is considered in more detail in TD 95/10, as follows:

1. *In a joint judgment, the Full High Court of Australia in Archer Bros Pty Ltd (In Vol Liq) v. FCT (1952-53) 90 CLR 140 at 155; 10 ATD 192 at 201 observed by way of obiter dicta:*

> *'By a proper system of bookkeeping the liquidator, in the same way as the accountant of a private company which is a going concern, could so keep his accounts that...distributions could be made wholly and exclusively out of...particular profits...or income...'*
>
> *2. These observations have given rise to what is known as the Archer Brothers principle. The principle is that if a liquidator appropriates (or 'sources') a particular fund of profit or income in making a distribution (or part of a distribution), that appropriation ordinarily determines the character of the distributed amount for the purposes of section 47 and other provisions of the Income Tax Assessment Act 1936 (the Act).*

Although the separation of particular types of profits in the books and financials of the company assists with the classification of the liquidators’ distributions, TD 95/10 continues to explain that this is not crucial:

> *5.“It has been suggested that the Archer Brothers principle operates only if separate accounts have been kept for each specific fund or profit so that a liquidator's appropriation from any account is unequivocally from a particular fund or profit. Although the maintenance of separate accounts makes it easier to identify the source of a distribution, and is, in our opinion, preferable from a practical point of view, we do not consider that separate accounts are essential provided the liquidator is able to identify a fund or profit from which a distribution is made. For example, if pre-CGT non-assessable profits and*

[13] *Archer Bros Pty Ltd (In Vol Liq) v FCT* (1952-53) 90 CLR 140

post-CGT capital gains have been accumulated in the same reserve, but can still be separately identified, we will accept a liquidator's nominated appropriation.”

5. Case Study

5.1 Key Facts

Notes Pty Ltd carries on a business of manufacturing stationery products, predominantly notebooks, diaries and journals for use predominantly in schools and offices. Notes Pty Ltd was founded in 1980 by Bob Brown and his ex-wife Jane Brown. At the time they each acquired one ordinary share in the company. Bob also acquired one A class share in the company and Ed Green as trustee for the family trust the "Bob Brown Family Trust" acquired 6 "B class" shares in the company.

The A class shares have equal right to dividends on that class, but no right to capital and have super voting rights equal to 4 times an ordinary share.

The B class shares only have equal rights to dividends on that class and capital but no voting rights.

In 1999 Bob and Jane divorced, as part of the divorce proceedings Jane transferred her share to Bob as part of the orders made in the Family Court. At the same time Ed Green transferred the class B shares to Write Style Pty Ltd as the new trustee for the Bob Brown Family Trust.

Bob now wishes to retire from the business and is considering selling the business to Pen to Paper Pty Ltd for $30 million and would like to understand the tax implications.

5.2 Tax Considerations

5.2.1 Date of acquisition of shares

Bob acquired the first ordinary share and the A Class share in 1980, before the commencement of CGT.

Jane also acquired her ordinary share in 1980. She transferred this to Bob in 1999. While on its face this appears that the disposal of this share would be subject to CGT, there is a roll-over under section 126-5. This states;

> *126-5(1) There is a roll-over if a *CGT event (the trigger event) happens involving an individual (the transferor) and his or her *spouse (the transferee), or a former *spouse (also the transferee), because of:*
>
> *(a) a court order under the Family Law Act 1975 or under a *State law, *Territory law or *foreign law relating to breakdowns of relationships between spouses; or*
>
> *(b) a maintenance agreement approved by a court under section 87 of the Family Law Act 1975 or a corresponding agreement approved by a court under a corresponding *foreign law; or …*
>
> *…126-5(6) For a disposal case where the transferor *acquired the asset before 20 September 1985, the transferee is taken to have acquired it before that day.*

Therefore, this roll-over should apply, and Bob shall be deemed to have acquired the second ordinary share before 20 September 1985.

As per the facts, the other shares were acquired by Ed as trustee for The Bob Brown Family Trust in 1980. The change of trustee to Write Style Pty Ltd in 1999 should not affect this.

5.2.2 Division 149

The ordinary shares and the "A" Class shares should not be affected by Division 149, as they have been owned (or deemed to have been owned) by an individual since before 20 September 1985.

The B class shares owned by the Bob Brown Family Trust are more problematic, as this trust is a discretionary trust. As discussed, the Bob Brown Family Trust would need to consider the Commissioner's view in IT 2340 and whether there has been sufficient continuity in the trust. For the purposes of this case study, we will assume that this is the case.

5.2.3 CGT event A1

Assuming that Division 149 is not triggered for any of the shares in Notes Pty Ltd, they should all be treated as acquired prior to 20 September 1985 and therefore any capital gain made under CGT event A1 on disposal of the shares in Notes Pty Ltd can be disregarded.

However, we need to consider CGT event K6.

5.2.4 CGT event K6

As this is a single tier structure, the first limb of the 75% test in subsection 104-230(2) is relevant. It is likely that the result of this test will be largely dependent on whether there is any goodwill in Notes Pty Ltd and whether it is considered to be pre-CGT.

Although not specified in the legislation, the Commissioner's view is any application of Division 149 to the goodwill would not need to be taken into account for the purposes of CGT event K6[14]. It is worth noting that if Bob was instead selling the business out of the company, then the impact of Division 149 on the assets of the company would need to be considered.

Regardless, Bob will need to consider whether goodwill of Notes Pty Ltd is still the same goodwill that was established prior to 20 September 1985.

5.3 Variation to facts

Bob unfortunately passed away before selling the business, and his shares passed to his daughter Mia in accordance with his will. The shares held by The Bob Brown Family Trust were not affected, however control of the trust passed to Mia.

Mia decided to hold onto the business for another decade or so, until she received an unsolicited offer to sell that she could not refuse. The buyer is open to buying either the shares or the business.

[14] Paragraph 15 of TR 2004/18

5.3.1 Mia's shares in Notes Pty Ltd

In accordance with Division 128, Mia's shares in Notes Pty Ltd will have a cost base equal to their market value on Bob's date of death[15]. The shares are acquired for CGT purposes, on the date of death, i.e. they do not maintain pre-CGT status.

5.3.2 Sale of shares

CGT event A1 would happen on sale of the shares. The gain would not be disregarded for Mia as they were not acquired prior to 20 September 1985. Any gain on the shares held by the trust would be disregarded (but the trust would also need to consider whether CGT event K6 was triggered).

However, in calculating Mia's capital gain, she will use the cost base as noted in section 5.3.1

5.3.3 Sale of business

Even though the shares in Notes Pty Ltd have not maintained pre-CGT status, the goodwill may still be considered pre-CGT. Division 149 should not be triggered on the basis that Mia would step in the shoes of the former shareholders of those shares, and therefore the ultimate owners in the company have not changed (in these circumstances). We do note that:

— As there are class shares on issue, it can be difficult to apply Division 149 to the assets of Notes Pty Ltd. This is because a dividend could be paid on one class of share over another. In which case, no shareholder has a beneficial interest in the ordinary income that may be derived from the asset. However, in this case, the A class shares were transferred only because of a marriage breakdown rollover and then the death of a person, therefore, in accordance with subsection 149-30(3), Mia 'stands' in for Bob who 'stood' in for Jane as the former owner.

Consequently, if the goodwill of Notes Pty Ltd is the same goodwill that begun prior to 20 September 1985, then it may be possible to sell the goodwill and have any capital gain disregarded[16].

In order for Mia to extract the funds from Notes Pty Ltd tax effectively, Mia may decide to liquidate the company and have the disregarded capital gain distributed by the liquidator as capital. Mia will need to consider the following:

— Maintaining appropriate records to identify the disregarded capital gain component separately from other income of the company

— Any other non-business assets of the company and how they may be transferred out of the company.

— Any CGT event K6 implications if the capital component is capital proceeds under CGT event C2 (but not if under CGT event G1).

[15] Item 4 of the table in subsection 128-15(4)
[16] Subsection 104-10(5)

6. Key takeaways

Hopefully this paper highlights the complexity that can arise when dealing with pre-CGT assets. There may be a capital gain on disposal of what appears, at first blush, to be a pre-CGT asset. Therefore care needs to be taken in restructures and disposals.

Here are a few practical key takeaways to leave you with, gathered from our experience dealing with pre-CGT assets:

- You may need to dig deeper than shareholding registers and unit registers. Have there been any transfers due to CGT rollovers, deceased estates or marriage breakdown? Do we have sufficient information to support the historical transactions which might have an impact on the current day transaction?
- Supporting documentation and evidence is important, especially in relation to a position that goodwill is pre-CGT. Think outside the box on what documentation may assist, such as marketing materials. Consider any publicly available information that may assist or hinder your position.
- If assets have changed hands, do we have the correct cost base information, which may require market valuations from a prior date?
- If winding up and/or liquidating a company, consider the timing of any distributions and the potential differing tax impacts.
- Apply for a private binding ruling from the Commissioner where certainty is needed in complex situations.