

Subdivision 328-G: the limitations become apparent

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Abstract: The Subdiv 328-G roll-over, originally considered a “one stop shop” for small business owners to restructure their businesses into appropriate entities, has started to show its cracks. A little more than a year on from its commencement, the limitations of the Subdiv 328-G roll-over have become starkly apparent due to the complexity of the legislation and the narrow interpretation adopted by the ATO on issues such as “ultimate economic ownership”. The drafting of the relevant provisions and the ATO’s subsequent interpretation have meant many small businesses that philosophically should be able to access the roll-over relief have been left unable to qualify. This article explores the circumstances in which small businesses are unable to be restructured under Subdiv 328-G and highlights that the roll-over should be relied on with caution, as much will hinge on the application of technical requirements to the specific client circumstances and structure.

Introduction

The announcement by the then Treasurer on 12 May 2015 that “new businesses create new jobs. That is why we will ... [allow] ... business owners to ... receive tax relief when restructuring their existing business”¹ brought much optimism for small businesses and their advisers.

The subsequent introduction of Subdiv 328-G of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) on 4 February 2016 through the Tax Laws Amendment (Small Business Restructure Roll-Over) Bill 2016 continued the optimism with favourable comments made in the explanatory memorandum regarding the importance of flexibility for existing small business owners to restructure the ownership of their businesses.

A little more than a year and two ATO law companion guidelines² on from the commencement of Subdiv 328-G, the potentially significant limitations of the roll-over are becoming starkly apparent.

Despite the optimism of early commentary (including articles by the authors³), the drafting of the relevant provisions and the ATO’s subsequent interpretation has meant many small businesses that (arguably) philosophically should be able to access the roll-over relief have been left unable to qualify.

Parliamentary intention

Introduced as the Tax Laws Amendment (Small Business Restructure Roll-Over) Bill 2016, parliament noted that the then existing

roll-over relief available to taxpayers was limited in scope, for example, restructures from a company to a sole trader, partnership or trust were prohibited.⁴

By introducing Subdiv 328-G, parliament intended for the provisions to provide flexibility for small business owners wishing to restructure into a suitable structure.⁵ For instance, the explanatory memorandum stated:⁶

“The most appropriate structure for a small business may change over time, or a new small business may choose an initial legal structure that it later finds to be inappropriate. Restructuring into a more appropriate legal structure may help a business to:

- continue to develop and grow;
- avoid unnecessary compliance costs;
- enhance business efficiency;
- move to a more efficient structure for tax purposes; or
- adapt to current conditions.”

The purpose of the roll-over relief is further emphasised with conditions requiring the restructure to be:

- “genuine” (to distinguish the restructure from artificial or inappropriately tax-driven schemes);⁷ and
- implemented in a manner that ensures the “ultimate economic ownership” of the business remains the same.⁸

Examples of limitations

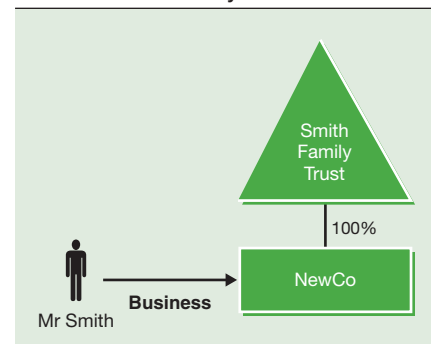
The authors’ previous article in this journal explored in detail the framework

of the Subdiv 328-G legislation, and is deliberately not reproduced here.³ Instead, the focus of this article is to highlight, via case study examples, the limitations of Subdiv 328-G. The case studies are extracted from various private binding rulings issued by the ATO since the provisions commenced, client situations the authors’ firm has assisted with and from the ATO law companion guidelines.²

The facts are as follows:

- Mr Smith operates a business as a sole trader;
- he proposes to transfer his business into a company (NewCo) with the Smith Family Trust as the sole shareholder (with a family trust election made with Mr Smith as the test individual);
- Mr Smith’s rationale is that he now has a family who is actively involved with the business and he would like for them

Example 1. Sole trader to a company with a discretionary trust shareholder⁹



to benefit from their collective efforts, while also achieving asset protection and limited liability; and

- other than the ultimate economic ownership test that is in question, all other conditions for Subdiv 328-G have been satisfied.

The proposed transaction will not satisfy the ultimate economic ownership test outlined in s 328-430(1)(c) ITAA97 on its face, as the transaction will have the effect of changing the ultimate economic ownership of the business from Mr Smith to a discretionary trust, despite the family trust election being made.

As a discretionary trust will be a shareholder of the transferee, s 328-440 ITAA97 must be considered to determine whether the ultimate economic ownership test is satisfied.

Section 328-440(1)(a) provides that the ultimate economic ownership of an asset does not change provided, either (or both) just before the transaction or just after the transaction, “the asset was included in the property of a non-fixed trust that was a family trust”.

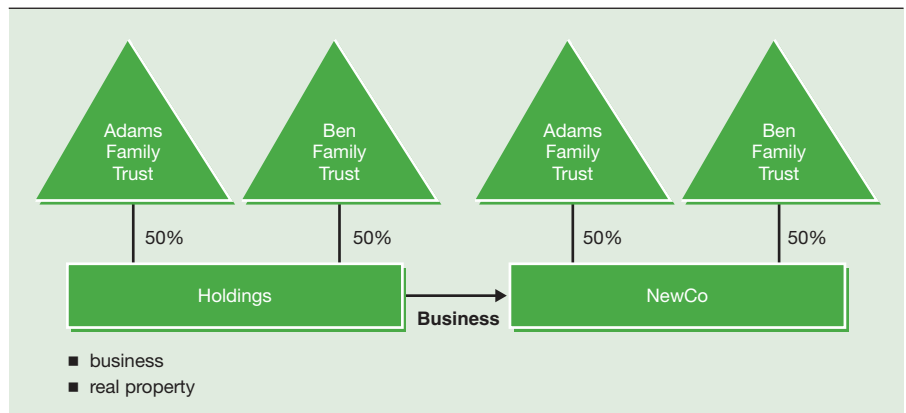
In Mr Smith’s case, the ATO’s view is that s 328-440(1)(a) will not be satisfied as the Smith Family Trust did not directly hold the asset being transferred, despite holding the shares in the company that acquires the business.

A similar example to example 1 is as follows (example 2):

- the Adams Family Trust and the Ben Family Trust each hold a 50% interest in Holdings Pty Ltd;
- Holdings Pty Ltd conducts a business, as well as holds real property; and
- due to the high potential for litigation against the business, Holdings Pty Ltd proposes to transfer the business into NewCo Pty Ltd (with the shares held by the Adams Family Trust and the Ben Family Trust in equal proportions) — that is, essentially achieving the same structure that would be achieved via a demerger.

Analogous with example 1, as discretionary trusts hold an interest in the relevant entity, s 328-440 will apply. In this regard, neither of the Adams Family Trust nor the Ben Family Trust holds, or will hold, the business directly, and therefore the ATO’s view is that the ultimate economic ownership requirement will not be satisfied, despite the shareholders of

Example 2. Company to company¹⁰



Example 3. Shares in company from an individual to a discretionary trust¹²



both Holdings Pty Ltd and NewCo Pty Ltd being identical.

The ATO also argues that this same limitation will apply in situations where individuals in a partnership restructure their business to be held through a unit trust, with one (or more) of the partners holding their interest in the unit trust through a discretionary trust.¹¹

The facts are as follows:

- Ms Yetti currently is the sole shareholder of a trading company, TradeCo; and
- she wishes to transfer her shares in the trading company to a discretionary trust that has made a family trust election with Ms Yetti as the test individual.

Examples 1 and 2 highlight the difficulty satisfying the ultimate economic ownership requirement when discretionary trusts are involved as indirect owners of the asset being transferred.

In example 3, the ultimate economic ownership requirement under s 328-440 may indeed be met as:

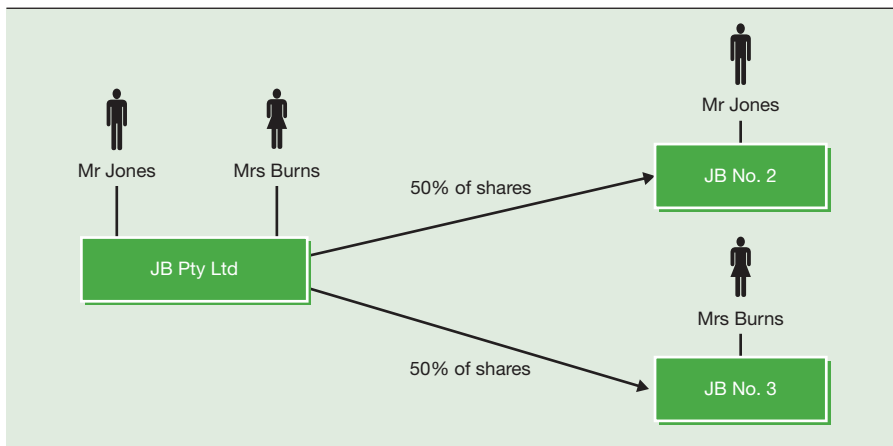
- just after the transaction, the asset (the share in the trading company) is included in the property of a non-fixed trust that is a family trust;
- every individual (Ms Yetti) who, just before the transfer took effect, had the ultimate economic ownership of the asset (ie the shares in TradeCo) was a member of the family group (which Ms Yetti is) relating to the discretionary trust acquiring the share; and
- every individual who, just after the transfer takes effect, has the ultimate economic ownership of the asset is a member of that family group.

However, despite this initial conclusion, the asset being transferred must also be an active asset satisfying one of the requirements under s 328-430(1)(d).

Under s 328-430(1)(d)(ii), the shares in TradeCo must be an active asset to which s 152-10(1A) ITAA97 applies.

An asset that satisfies s 152-10(1A) is an asset that is used, or held ready for use, in the course of carrying on a business

Example 4. Company to two companies¹³



conducted by an affiliate or entity connected with the transferor/transferee.

As this is not the case for the shares in TradeCo held by Ms Yetti nor the New Trust, the active asset requirement will not be satisfied.

The above outcome is particularly disappointing given it is, in the authors' experience, such a common situation and objectively appears to be a legitimate restructure based on the original announcement of the rules.¹

In example 4, the facts are as follows:

- Mr Jones and Mrs Burns are individual shareholders (in equal shares) of JB Pty Ltd;
- JB Pty Ltd conducts a professional services business;

- due to differing opinions of the business, Mr Jones and Mrs Burns wish to restructure the business so that each person has operational control over "their" half of the business; and
- the proposed transaction is to transfer 50% of the business of JB Pty Ltd into a newly established company, JB No. 2 Pty Ltd (with Mr Jones as the sole shareholder), and the remaining 50% of the business into another newly established company, JB No. 3 Pty Ltd (with Mrs Burns as the sole shareholder).

Aside from the issues with satisfying the ultimate economic ownership test (as flagged above), LCG 2016/3 states the ATO's view that "succession planning" is not indicative of a genuine restructure of

an ongoing business as required under s 328-430(1)(a).

In addition to the failure to satisfy the "genuine restructure" requirement, the company which applied for a private binding ruling¹⁴ in analogous circumstances to those outlined above in fact held investment assets such as equities in publicly listed companies, securities and cash which are not permitted to be the subject of roll-over relief.

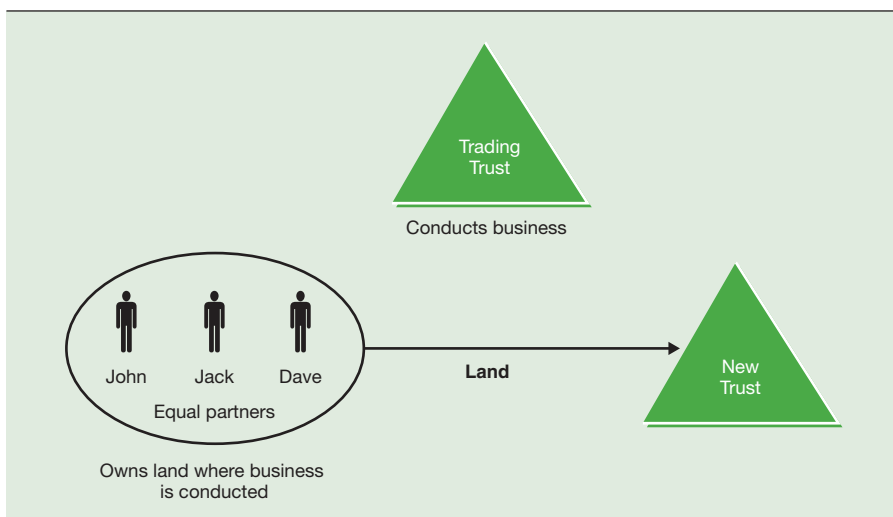
In example 5, the facts are as follows:

- John, Jack and Dave are owners of land, in partnership, in equal shares as tenants in common;
- the land is leased (informally) to a family trust (Trading Trust) which carries on a small business;
- the Trading Trust is controlled by Dave, and Dave has received 100% of all distributions the past four income years; and
- it is intended to move the land into New Trust to achieve asset protection and flexibility for future expansion.

While the transfer of land by the partnership may qualify for Div 152 ITAA97, roll-over relief under Subdiv 328-G will be problematic as neither the partnership nor the New Trust will be either a small business entity or an affiliate or entity connected with a small business entity as required under s 328-430(1)(b).

While Dave may be connected with the Trading Trust, and therefore be eligible for the roll-over, John and Jack will not be eligible given they are not connected with the Trading Trust. This is because they neither control the Trading Trust nor have received more than 40% of the distributions from the Trading Trust.

Example 5. Partnership to trust



Conclusion

Despite originally being seen as a powerful restructuring tool to small business owners, Subdiv 328-G has been limited in its application due to the (arguably unnecessary) complexity of the legislation and, in turn, the apparently narrow interpretation adopted by the ATO on issues such as "ultimate economic ownership".

As a result, the roll-over should be relied on with caution as, similar to the small business concessions under Div 152, much will hinge on the application of technical requirements to the specific client circumstances and structure.

Indeed, the conservative approach, at least in the short term, appears to be that a private ruling should be obtained before seeking to rely on Subdiv 328-G — an entirely unsatisfactory situation, given the marketing spiel used to herald the introduction of the regime.

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- 1 The Hon. JB Hockey, MP, Treasurer of the Commonwealth of Australia, "Budget speech 2015", delivered on 12 May 2015.
- 2 LCG 2016/2 and LCG 2016/3.
- 3 M Burgess, "Tricks, traps and tantalising opportunities: new Subdiv 328-G explained", 2016 50(11) *Taxation in Australia*.
- 4 Para 1.8 of the explanatory memorandum to the Tax Laws Amendment (Small Business Restructure Roll-Over) Bill 2016 (EM).
- 5 Para 1.16 of the EM.
- 6 Para 1.6 of the EM.
- 7 Para 1.20 of the EM.
- 8 Para 1.29 of the EM.
- 9 PBR 1013065150311 and PBR 1013094571188.
- 10 PBR 1051221825911.
- 11 PBR 1051180333927.
- 12 Example 11 in LCG 2016/3.
- 13 Example 6 in LCG 2016/3.
- 14 PBR 1051205846278.