

Trusts holding underlying interests in entities

PROPOSED LEGISLATIVE AMENDMENTS MAKE IT POSSIBLE FOR TRUSTS TO HOLD UNDERLYING INTERESTS IN ENTITIES AND ACCESS THE SMALL BUSINESS CGT CONCESSIONS.



Amendments to the small business capital gains tax (CGT) concessions introduced on 7 December 2006 in the Tax Laws Amendment (2006 Measures No. 7) Bill 2006 (the Bill) included a previously unannounced change. That change is to repeal subs 152-10(2) of the Income Tax Assessment Act 1997 (ITAA 97) and substitute a new provision that allows entities holding underlying interests in a company or trust to access the small business CGT concessions in certain circumstances.

The proposed amendment is a significant change to the operation of the concessions. Currently it is not possible for a trust to use the small business CGT concessions in reducing the capital gains tax payable on CGT events relating to shares held in companies or interests held in trusts.

THE CURRENT TEST

Access to the concessions by trusts holding underlying interests is denied by the operation of subs 152-10(2) of the ITAA 97. This subsection provides that where the relevant CGT asset is a share in a company or an interest in a trust an additional threshold test must be satisfied to allow access to the small business CGT concessions.

The first limb of this additional test requires that the entity in which the underlying interest is held must satisfy the controlling individual test.¹ An entity satisfies the controlling individual test if the entity had a least one controlling individual just before the CGT event.² Unravelling the defined terms further, a controlling individual in respect of a trust is an individual entitled to at least 50 per cent of the income and

capital of a fixed trust or at least 50 per cent of the distributions of income and capital made in the relevant year by a non-fixed trust.³ A controlling individual of a company is an individual with entitlements to at least 50 per cent of the voting rights, to at least 50 per cent of any dividends declared by the company to at least 50 per cent of any distributions of capital made by the company.⁴ Therefore although the trust holding the underlying interest cannot itself be a controlling individual, the first limb of the test can be satisfied so long as the entity in which the underlying interest is held has a controlling individual.

The problem for trusts results from the second limb of the test. The second limb requires that the taxpayer itself be a "CGT concession stakeholder" in the relevant company or trust.⁵ A CGT concession stakeholder is defined as a controlling individual or the spouse of a controlling individual who also holds an interest in the entity.⁶ As noted above, a controlling individual by definition can only be a natural person individual. Therefore, trusts holding underlying interests in other entities cannot access the small business CGT concessions when selling those underlying interests. This has continued to create difficulties where taxpayers have chosen to structure themselves with a unitised trust structure or a company with interests held by trusts. Selling those units or shares to third parties or amongst the equity holders triggers a liability to capital gains tax that can only be reduced by the general discount capital gains tax concession in Div 115 and not the small business CGT concessions.

Taxpayers currently adopt a variety of means of addressing this issue. Such

measures include the use of partnerships of trusts or hybrid trusts where taxpayers attempt to balance wealth protection, flexibility of income distribution, administrative ease and access to CGT concessions in making their structuring decisions. Whilst the proposed amendment allowing trusts holding underlying interests to access to the small business CGT concessions does not provide one easy solution to the structuring decision, it does assist in reducing the impact of one of those hurdles to the decision of what is an appropriate structure for a given investment or trading activity.

HOW DOES THE PROPOSED AMENDMENT OPERATE?

The proposed amendment operates by replacing the current two limb test with two tests which operate in the alternative. The first test is effectively a continuation of the current test and simply requires that the taxpayer holding the underlying interest be a CGT concession stakeholder in the relevant company or trust.⁷ As with the current test that provision requires the taxpayer to be a natural person individual.

The second test is new. It states as follows:

(2) If the CGT asset is a share in a company or an interest in a trust (the object company or trust), one of these additional basic conditions must be satisfied just before the CGT event.

(a) ...

(b) CGT concession stakeholders in the object company or trust together have a small business participation percentage in you of at least 90 per cent.⁸

Although still referring to CGT concession stakeholders, the test no longer requires those individuals to hold the underlying interest personally. The test can be satisfied where a trust holds the direct underlying interest in the relevant entity and those CGT concession stakeholders hold what is defined as a “small business participation percentage” of at least 90 per cent in the trust holding the underlying interest. By including the reference to CGT concession stakeholders, the new test practically still has two limbs that must be satisfied.

FIRST LIMB

The first limb involves identifying a CGT concession stakeholder in the object company or trust. As noted above, under the current test this relates to a controlling individual or a spouse of a controlling individual and requires those individuals to hold a direct interest in the object company or trust.

The proposed amendments made by the Bill also include amendments to the definition of CGT concession stakeholder. The proposed new test defines a CGT concession stakeholder by reference to a “significant individual” rather than a controlling individual.⁹ A significant individual is an individual that has a “small business participation percentage” in the company or trust of at least 20 per cent.¹⁰ Again, unravelling the definitions further, a small business participation percentage is defined as the combination of an individual’s direct and indirect participation percentages in the relevant entity.¹¹ Those participation percentages are effectively the extent to which the individual participates directly and indirectly, in the income or capital of a trust or voting power, dividends or distributions of capital from a company.¹² Where the percentages differ in relation to those various categories of entitlement in the one entity then it is the smallest percentage that applies. For non-fixed trusts such as discretionary trusts it is only where the trust makes a distribution of income or capital in the relevant year that the percentage of that distribution received by the individual as compared to all distributions made that is to be included in the calculations. For example, if a discretionary trust does not distribute any capital but does distribute \$100 of income to which an individual is directly and/or indirectly beneficially entitled to \$20, that individual would have a participation percentage of 20 per cent. Alternatively, if

in addition to the income distribution the trust distributed \$100 in capital to which the individual is directly and/or indirectly beneficially entitled to \$10, the individual would have a participation percentage of 10 per cent (the smaller of the two potential participation percentages).

Therefore, because the new significant individual test operates on an indirect and direct basis it is no longer necessary for the individual to hold the underlying interest in the object company or trust in order to be defined as a CGT concession stakeholder of that entity. In summary, the first limb requires the identification of individuals who ultimately hold a small business participation percentage of at least 20 per cent.

SECOND LIMB

The second limb relies on those individuals defined as CGT concession stakeholders of the object company or trust having a significantly strong connection to the trust holding the direct underlying interest. The strength of that connection is again determined using the same small business participation percentage as outlined above in relation to the first limb. However, in relation to this second limb of the test the individual CGT concession stakeholders of the object company or trust must collectively hold a participation percentage of at least 90 per cent in the trust with the underlying interest in order for the test to be passed.

COMBINATION OF THE TWO LIMBS

The operation of the two limbs of the proposed new subparagraph 152-10(2)(b) of ITAA 97 requires the identification of an individual or individuals that each hold a small business participation percentage of at least 20 per cent in the object company or trust and who collectively hold a small business participation percentage of at least 90 per cent in the trust with the underlying interest.

EXAMPLE 1

Assume a small business is operated by a unit trust with two equal unit holders (A and B). Each of those unit holders is a discretionary trust. Assume unit holder A wishes to sell their units to unit holder B. For unit holder A to be able to apply the small business CGT concessions in reducing any taxable capital gain on the sale of the units unit holder A could

ensure that 90 per cent of any distributions of income or capital made in the year of the CGT event are distributed to an individual. In addition to the small business participation percentage of 90 per cent in unit holder A that individual would have a small business participation percentage of 45 per cent in the object unit trust (unit holder A’s 50 per cent interest multiplied by the extent to which the individual is beneficially entitled to distributions made by unit holder A – 90 per cent).

EXAMPLE 2

As described above, the small business participation percentage of at least 90 per cent in the trust holding the underlying interest may be satisfied by aggregating the small business participation percentage of a number of CGT concession stakeholders. Assume the same facts as outlined in example 1 save that of the distributions of income or capital made by unit holder A in the year of the CGT event, 50 per cent are to individual X and 50 per cent are to individual Y.

In that case both limbs of the test are still satisfied. Each of X and Y are CGT concession stakeholders as each have small business participation percentages of 25 per cent in the object unit trust (unit holder A’s 50 per cent interest multiplied by the extent to which each individual is beneficially entitled to distributions made by unit holder A – 50 per cent). As the CGT concessions stakeholders in the object unit trust collectively have a 100 per cent small business participation percentage in unit holder A the 90 per cent threshold test is satisfied.

EXAMPLE 3

Assume that there are five equal unit holders in the unit trust (A to E) and unit holder A ensures that 90 per cent of any distributions of income or capital made in the year of the CGT event are distributed to one individual. In this case the test would not be satisfied. Although the individual has a small business participation percentage of 90 per cent in unit holder A that individual only has a small business participation percentage of 18 per cent in the object unit trust (unit holder A’s 20 per cent interest multiplied by the extent to which the individual is beneficially entitled to distributions made by unit holder A – 90 per cent). In this example the individual is

not a CGT concession stakeholder as the individual does not hold the requisite 20 per cent significant interest.

If instead of 90 per cent of any distributions of income or capital made in the year of the CGT event being distributed to the individual, unit holder A ensured that 100 per cent of distributions were made to the individual, then the individual would be a CGT concession stakeholder of the object unit trust (20 per cent multiplied by 100 per cent), in turn satisfying the first limb of the new threshold test.

CONCLUSION

Despite the Bill not yet being enacted at the time of writing this article,¹³ item 68 of Schedule 1 of the Bill provides that the amendment applies “to CGT events happening in the 2006/2007 income year or later income years.” Therefore, not only is it important for practitioners to consider the proposed amendment today when advising clients in relation to structuring decisions, practitioners should also consider advice provided in respect of proposed and actual sales of shares and interests relating to the period on and after 1 July 2006.

Finally it is important to note that the above analysis considers only one of the threshold tests. The remainder of the threshold tests in addition to the tests applicable to each of the four individual small business CGT concessions still need to be satisfied in each case.

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Reference notes

- 1 Subparagraph 152-10(2)(a) of ITAA 97.
- 2 Section 152-50 of ITAA 97.
- 3 Sections 152-55(2) and (3) of ITAA 97.
- 4 Subsection 152-55(1) of ITAA 97.
- 5 Subparagraph 152-10(2)(b) of ITAA 97.
- 6 Section 152-60 of ITAA 97.
- 7 Item 20 of Schedule 1 of the Bill, proposed new subparagraph 152-10(2)(a) of ITAA 97.
- 8 Item 20 of Schedule 1 of the Bill, proposed new subparagraph 152-10(2)(b) of ITAA 97.
- 9 Item 39 of Schedule 1 of the Bill, proposed new subsection 152-60 of ITAA 97.
- 10 Item 39 of Schedule 1 of the Bill, proposed new subsection 152-55 of ITAA 97.
- 11 Item 39 of Schedule 1 of the Bill, proposed new subsection 152-65 of ITAA 97.
- 12 Item 39 of Schedule 1 of the Bill, proposed new subsections 152-70 and 152-75 of ITAA 97.
- 13 Parliament next sits on 6 February 2007.