

TAX TALKS

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64 | Subdiv 122- A

Subdiv 122-A ITAA97 is about changing a business from a sole trader or trust to a company.

Subdiv 122-A

The full title of Subdiv 122-A ITAA97 is already a good description of what this subdivision is about.

DISPOSAL OR CREATION OF ASSETS BY AN INDIVIDUAL OR TRUSTEE TO A WHOLLY-OWNED COMPANY

This was THE rollover provision before Subdiv 328-G came along. Its twin sibling is Subdiv 122-B. It is basically the same as Subdiv 122-A but for the partners of a partnership.

Division 122

Div 122 just has two subdivisions: A and B. That's all. They both cover the sale of CGT assets from another entity to a company. And allow a rollover. These rollovers are particularly useful for small to medium sized businesses that want to incorporate.

The rollovers are not mandatory. A taxpayer can choose to apply them. And that might be a good idea or a really bad one.

It might be a bad idea when you qualify for the 50% CGT concession plus the small business CGT concessions. In that case, it might be much better to just sell the asset and recognise the capital gain. But then reduce the capital gain to nil through Div 115 and 152. And have the company starting with a much higher cost base.

Subdiv 122-A

This subdivision allows a sole trader or trustee to apply CGT rollover relief, when they dispose of an asset or all the assets of their business to a company. And the taxpayer then owns all shares in this company.

The subdivision can also apply to "creation" event, for example CGT event D1. This is an important factor if the taxpayer does not wish to transfer the asset. But wishes to transfer the limited economic benefits associated with the asset.

However, this CGT rollover relief does not provide a blanket relief as it only applies to capital gains arising from certain CGT events. These are CGT event A1 (disposal), D1 (creation of legal right in the company), D2 (grant of an option), D3 (grant of right to income from mining to company) and F1 (grant of a lease to the company)(a 122-15).

Conditions

To apply Subdiv 122-A the set-up needs to meet 8 conditions.

1 Eligible CGT Event

The CGT rollover relief only applies to capital gains arising from certain CGT events. These are CGT event A1 (disposal), D1 (creation of legal right in the company), D2 (grant of an option), D3 (grant of right to income from mining to company) and F1 (grant of a lease to the company)(a 122-15).

1 Eligible Asset

The CGT asset transferred to the company must be an eligible CGT asset to qualify for the rollover. Only some CGT assets are eligible for a Subdiv 122-A rollover.

s122-25 lists assets that are not eligible such as collectables, personal use of assets and decorations awarded for valour or brave conduct unless the taxpayer purchased them.

Trading stock, depreciating assets, intellectual property and an interest in a film copyright are precluded assets unless they are disposed of as a part of the disposal of all the assets of a business to the company. For depreciable assets also refer to s 40-340.

An asset that becomes the trading stock of the new company immediately after the disposal will still qualify for rollover relief but only if they were transferred as part of the disposal of all assets of a business to new company and the asset was a trading stock of the individual or trust before the transfer.

2 Shares Only Consideration

The only consideration for the disposal of the assets must be shares in the company or shares in the company and the company undertaking to discharge one or more liabilities in respect of the asset or assets of the business (as appropriate). So the consideration cannot comprise cash or shares and cash.

3 Net Assets = Market Value of Shares

The market value of the shares received must be substantially the same as the net assets transferred to the company

4 Non-Redeemable Shares

The shares must be non-redeemable.

5 Company Subject to Tax

The company must be subject to tax

6 Tax Residents

Both the individual (or trust) are residents at the time of the CGT event, then from 12 December 2006, each CGT asset must be taxable Australian property at that time and the shares in the transferee company must be taxable Australian property just after that time.

7 Individual or Trust Owns All Shares

Immediately after the transfer of assets, the transferor taxpayer owns all of the shares in the transferee company

Capital Gain or Loss

When applying Subdiv 122-A, the capital gain or loss resulting from the CGT event is disregarded.

Cost Base

The cost base of the shares acquired in the new company depends on whether the assets transferred were post, pre or a mix of post and pre-CGT assets.

Post-CGT

If post-CGT assets were the only assets transferred to the new company, the shares in the new company will have a cost base equal to the sum of the cost bases of the assets transferred to the new company, less any liabilities relating to those assets that the new company undertakes to discharge (ss 122-40 and 122-50).

Pre-CGT

If pre-CGT assets were the only assets transferred (and there were no precluded assets) to the company, the shares in the new company acquired by the individual or trustee will be pre-CGT assets (ss 122-40 and 122-55).

Both

When a mixture of pre- and post-CGT assets are transferred to the new company (and all the assets of a business are transferred to the company), the shares in the new company will comprise pre- and post-CGT shares (s 122-60)

The cost base of the shares is equal to the sum of the market values of the precluded assets and the cost bases of the assets transferred less any liabilities relating to those assets that the new company undertakes to discharge

The following formula determines the allocation of pre- and post-CGT (whole) shares.

$$\frac{\text{Number of Shares Issued} \times \text{Market Value of Pre-CGT assets (less Precluded Assets)}}{\text{Total market value of all assets transferred to the company}}$$

The market value of pre-CGT assets does not include precluded assets.

The balance of the shares will be treated as post-CGT shares with a cost base equal to the sum of market values of the precluded assets and the cost bases of the post-CGT assets that were transferred to the new company, less any liabilities relating to those assets that the new company undertakes to discharge.

Example

Bob owns a business and transfers all its CGT assets to a new company wishing to apply Subdiv 122-A. The company issues 20 new shares to Bob.

The post-CGT assets include goodwill (cost \$100, MV \$500), plant and equipment (WDV \$100, MV \$200) as well as stock (cost \$200, MV \$400).

If all assets are post-CGT, Bob receives the 20 shares at a cost base of \$700 (\$100 goodwill, \$200 plant and equipment and \$400 stock).

If the goodwill was instead a pre-CGT asset, then 9 shares will have pre-CGT status:

$$\frac{\text{Number of Shares Issued} \times \text{Market Value of Pre-CGT assets (less Precluded Assets)}}{\text{Total market value of all assets transferred to the company}}$$

So 20 shares times the goodwill's market value of \$500 divided by the total market value of assets transferred being \$1,100.

$$\$500/\$1,100 = 9 \text{ shares (pre-CGT)}$$

The remaining 11 shares will have a total cost base of \$600 (ie \$200 plant and equipment and \$400 stock)

So assets that are not precluded assets and that the individual or trustee acquired pre-CGT will retain their pre-CGT status in the hands of the company.

And assets that the individual or trustee acquired post-CGT will retain their cost base. And continue to be post-CGT in the hands of the company.

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