



CGT demergers relief

Detailed information about capital gains tax demergers relief.

Impact on members of the demerger group

There are consequence for members of a demerger group that undertakes a demerger.

Availability of CGT demerger relief

The head entity undertaking a demerger generally advises owners whether CGT relief is available.

Examples of how section 45B of the ITAA 1936 applies to demergers

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QC 66461

Impact on members of the demerger group

There are consequences for members of a demerger group that undertakes a demerger.

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The consequence for members of a demerger group that undertakes a demerger is:

- Capital gains or capital losses are disregarded if they arise under the following CGT events happening to the group's interests in the demerged entity:
 - disposal (CGT event A1)
 - cancellation (CGT event C2)
 - ending of an option to acquire a share (CGT event C3), or
 - capital gain made on certain pre-CGT shares or trust interests (CGT event K6).

No other cost base adjustments

If the cost bases have been adjusted under the demerger provisions, no other adjustments are to be made as a result of the demerger (for example, under the general value shifting rules).

GST and demergers

If your corporate group undertakes a demerger which involved making financial supplies for goods and services tax (GST) purposes, you may be subject to a denial of input tax credits on acquisitions to the extent that they relate to the making of those financial supplies. A financial supply for GST purposes in the context of a demerger includes the provision, acquisition or disposal of securities or units in a unit trust.

If you are denied input tax credits on acquisitions that relate to making financial supplies you may still be entitled to a reduced input tax credit on certain acquisitions which are identified as reduced credit acquisitions under the GST regulations.

Information on GST financial supplies is available in a number of GST public rulings located on the ATO Legal Database including:

- GSTR 2003/9 – financial acquisitions threshold
- GSTR 2004/1 – reduced credit acquisitions
- by requesting a GST private ruling.

QC 54547

Availability of CGT demerger relief

The head entity undertaking a demerger generally advises owners whether CGT relief is available.

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Generally the head entity undertaking the demerger will advise owners whether the CGT relief is available, but you should seek our advice if in any doubt. We may have provided advice in the form of a class ruling confirming that CGT relief is available.

CGT rollover is available to a demerger if it:

- involves a [demerger group](#)
- satisfies the [demerger tests](#)
- is undertaken for [commercial reasons](#).

The following transactions are not eligible for demerger relief:

- share buy-backs (that is, off-market purchases under Division 16K of Part III of the *Income Tax Assessment Act 1936*)
- situations where any owner of the head entity can get rollover relief from other provisions of the tax law for all capital gains tax (CGT) events that happen to their ownership interests under the demerger.

Demerger group

A demerger group consists of a head entity and one or more entities known as demerger subsidiaries. These entities can be companies or

fixed trusts. A discretionary trust can't be a member of a demerger group, but it may be one of the owners of the head entity.

The head entity of a demerger group is a company or fixed trust at the top of the group structure. No other entity in the group can have ownership interests in the head entity. However, where the head entity owns more than 20% and less than 80% of a listed company or widely held trust, the listed company or widely held trust can choose for the head entity not to be a member of the demerger group. In this case, the listed company or widely held trust would usually become the head entity.

A demerger subsidiary is a company or fixed trust in which members of the demerger group, either alone or with other members of the demerger group, own or have the right to acquire ownership interests of more than 20% of that entity (generally measured by rights to income or capital and voting rights).

Example: Demerger group

 Figure 2: demerger group

In the example above the demerger group consists of:

- Head Company
- Company A
- Fixed Trust, and
- Company B.

Where:

- Head Company is the head entity
- Company A, Fixed Trust and Company B are demerger subsidiaries.

Company C is not a member of the demerger group because the group members have less than 20% interest in it.

Although Fixed Trust from the example above is a member of the demerger group, it can't be demerged (see [Same entity type test](#)). Head Company can demerge either Company A or Company B.

Demerger tests

For a demerger to qualify for tax relief there are a number of basic tests that need to be satisfied; including the:


- [80% test](#)
- [Nothing else test](#)
- [Same entity type test](#)
- [Maintenance of ownership test](#)

Other eligibility requirements may apply to certain demergers.


80% test

This test requires that the demerger group must effectively cease to own at least 80% of the interests it holds in the demerged entity. This can occur by disposal of interests, interests ending, swamping or a combination of methods.

Example: Before demerger

 Figure 3a: before demerger

Example: After demerger

 Figure 3b: after demerger

Head Company demerges 80% of its interests in Company A and retains 20%.

Nothing else test

This test requires that the owners of the head entity must acquire a new interest in the demerged entity and nothing else (for example, they cannot also receive cash). The mere existence of a sale facility for new or original interests will not normally breach this rule.

Same entity type test

This test requires that the new interests must be in the same kind of entity as the original interests. This means that if the head entity is:

- a company, the demerged entity must be a company
- a trust, the demerged entity must be a trust.

For example, demerging a fixed trust to unit-holders of a fixed trust would satisfy the test. Demerging shares in a company to unit-holders of a fixed trust would not satisfy the test.

Maintenance of ownership test

This test requires that after the demerger:

- each owner of the head entity must own the same proportion of new interests in the demerged entity as they previously owned in the head entity (ignoring any other direct interests they hold in the demerged entity)
- each owner must have the same proportionate total market value of ownership interest in the head entity and in the demerged entity as they owned in the head entity before the demerger. Market value can be a reasonable approximation and can be anticipated by the head entity before the demerger.

In working out whether the proportional ownership tests have been satisfied, the following types of interests may be ignored:

- certain qualifying partly paid shares or rights acquired under an employee share scheme if they total no more than 3% of the ownership interests in the head entity
- certain adjusting instruments in listed entities (for example, reset preference shares or convertible notes) if they total no more than 10% of the ownership interests in the head entity.

Commercial reasons

Detailed examples of how the ATO would assess whether a demerger is undertaken for commercial reasons are provided in [Examples of how section 45B of the ITAA 1936 applies to demergers](#).

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Examples of how section 45B of the ITAA 1936 applies to demergers

Examples of how we determine whether a demerger is undertaken for commercial reasons under section 45B of the ITAA 1936.

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Summary of examples

These examples:

- provide further guidance on how section 45B of the *Income Tax Assessment Act 1936* (ITAA 1936) may apply to various demerger situations
- discuss demerger factors and circumstances that are particularly relevant for small to medium enterprises.

For examples related to:

- plans to dispose of interests in either the demerged or head entity at the time of the demerger, see examples 4, 5, 6, 7, 8 and 9
- succession and estate planning, see examples 2, 6, 8 and 9
- different types of businesses operated within a corporate group, see examples 1, 2, 3, 8 and 9
- shares acquired on or after 20 September 1985, see examples 1, 4, 5, 6, 7, 8 and 9
- shares acquired before 20 September 1985, see examples 2 and 3
- shares subject to CGT discount or other concession, see examples 4, 5, 6, 7, 8 and 9
- profit accumulations and pattern of distributions, see examples 4, 5, 7, 8 and 9
- separating family arrangements or closely held groups where demergers done for specific shareholders, see examples 5, 6, 7 and 8
- asset protection, see examples 1, 2, 3, 4 and 8
- employee share schemes, see examples 1, 4, 5 and 9
- management issues, see examples 1, 2, 4, 6, 7, 8 and 9

- equity raising, see examples 1, 3 and 9.

For detailed advice on the application of section 45B to demergers, see ATO Practice Statement Law Administration PS LA 2005/21.

Example 1: Company wishing to acquire a rival business

The facts

Jellyco Pty Ltd is an Australian resident company operating 2 businesses: an importing and wholesaling business in electrical components and a business of manufacturing lamps. The shareholders of Jellyco are made up of Australian resident individuals and one company. Fred, Sally, Cameron and Simon are all directors of Jellyco. Fred and his wife Sally own the majority of shares in Jellyco.

Jellyco owns all the issued capital in Zapco Pty Ltd. Zapco owns real property currently valued at \$1,000,000. Shares in both Jellyco and Zapco were acquired after 20 September 1985.

Jellyco decides to undertake a corporate restructure to focus and expand its core business of importation and distribution. Jellyco transfers its manufacturing business (including plant, equipment, key intellectual property and staff) to Zapco at market value, with the intention that Zapco operate an independent business of manufacturing lamps.

Jellyco also wishes to expand its importation/distribution business by acquiring a rival business. As part of the purchase price, Jellyco is offering to grant the owners of the rival business an equity stake in Jellyco via a new issue of shares. Certain venture capitalists will also be provided an equity stake in Jellyco for providing funds to help acquire the rival business.

If the takeover of the rival business is successful, key employees in both Jellyco and the rival business will also be given the opportunity to buy shares in Jellyco.

To help its corporate restructure and business expansion, Jellyco wishes to conduct a demerger of Zapco, which it claims will facilitate the takeover of the rival business and enhance the long-term business prospects of both Jellyco and Zapco.

Currently, Jellyco has paid up share capital of \$45,000 and a net market value of \$4,300,000. The net market value of Zapco is \$2,000,000 (\$1,000,000 of this value relates to its real property). Zapco's real property is used 50% for its business operations and the other 50% is rented to Jellyco for its business. Fred is Zapco's sole director.

Jellyco shareholders have no plans to dispose of any of their shares in Jellyco or Zapco after the demerger.

Applicant's stated reasons for demerger

Jellyco states a demerger would provide the following commercial benefits:

- A demerger would help facilitate Jellyco taking over the rival business. Currently, the pre-demerger price of Jellyco is overly high due to its ownership of Zapco. This hinders the rival business owners, their key employees and venture capitalists acquiring an interest in Jellyco, as they would be required to pay a premium to acquire an indirect stake in Zapco. A demerger would allow these parties to acquire an interest in the business of Jellyco only. This is important as offering equity in Jellyco to the above parties is a key factor to help the company take over the rival business.
- A demerger would assist key employees in both Jellyco and the rival business to acquire an equity interest in Jellyco. This should assist the profitability of Jellyco, as these employees have extensive experience and skills in importing and wholesaling electrical products. Without the demerger it would be difficult to grant employees an equity stake, as it would mean giving employees an indirect interest in Zapco's real property and business.
- Asset protection – as Zapco is a wholly owned subsidiary of Jellyco, its real property and other assets are indirectly exposed to Jellyco's creditors in the event that Jellyco is subject to liquidation.

Commissioner's analysis and decision

On examining the proposed demerger together with the relevant circumstances in subsection 45B(8), the Commissioner accepts the applicant's stated reasons above are positive relevant circumstances that are likely to improve the business structures of both Jellyco and Zapco. The applicant's statement that the shareholders of Jellyco have no current intention of disposing of any of their interests in either

Jellyco or Zapco after the demerger is also a relevant factor (paragraphs 73 to 78 of PS LA 2005/21).

Accordingly, in the absence of any evidence that is inconsistent with the above, the Commissioner would not make a determination under subsection 45B(3) that sections 45BA or 45C of the ITAA 1936 apply to the proposed demerger.

Example 2: Corporate group merging with another business

The facts

Lammat Pty Ltd owns and operates a grain broking business. It also owns 100% of the issued capital in 2 subsidiaries, Landco Pty Ltd and Grainbrok Pty Ltd. Grainbrok is also involved in grain broking and is affiliated with Lammat's grain broking business, while Landco owns and operates a separate farming business.

Han owns 100% of the issued capital in Lammat. All shares in Lammat were acquired by him before 20 September 1985. Lammat's shares in Landco were also acquired before 20 September 1985. Han is a director of both Lammat and Landco.

Management and staff in Lammat have dual roles. They manage both a broking business (Lammat) and a farming business (Landco). Until recently, it was common for Lammat to fund activities and capital improvements to the property of Landco.

Lammat is currently negotiating with another grain company to do a merger with their grain broking business. Part of this merger plan involves demerging Landco, so that Lammat and Grainbrok can form a pure grain broking corporate group.

Applicant's stated reasons for demerger

Lammat states a demerger would provide the following commercial benefits:

- separating the 2 businesses (grain broking and farming), which have different commercial drivers
- facilitating the merger negotiations with the other grain company, who do not want to be involved indirectly with the farming business operated by Landco

- enabling flexible financing arrangements for the new grain broking group – after the demerger, finance will be secured over the trading inventory of the grain broking group business, rather than using Landco's farm property as part of the security
- providing asset protection for the farming property – currently the property is at risk should Lammat run into financial difficulties
- the net profit of Lammat will no longer support Landco's farming business, enabling accurate reporting of Landco's financial viability
- allocating staff and management to the separate businesses of the demerged entities, providing a focus on business outcomes without conflicting priorities
- Han does not intend to sell his shares in either of the demerged businesses at the time the demerger is proposed
- allowing Han to take direct interests in Landco for Han's estate planning purposes.

Commissioner's analysis and decision

In examining the current demerger proposal in relation to the relevant circumstances stated in subsection 45B(8), the Commissioner took into account the following factors:

- The taxpayer's reasons for demerger, including 'separating the 2 businesses as they have different commercial drivers', to enable more 'flexible financing arrangements' and separating management, are very common reasons given in demerger cases. While these factors are relevant, the Commissioner does not automatically accept or dismiss these reasons but require proper details to establish what weight should be given to these factors.
- In this case, the Commissioner accepts that the applicants stated reasons above except the last point, are likely to improve the business operations of both Lammat and Landco, with any tax benefits being incidental.
- Another important positive factor is Han's assertion that he has no intention to dispose of his interests in Lammat or Landco after the demerger (paragraphs 73 to 78 of PS LA 2005/21).
- Regarding Han's estate planning however, the Commissioner would not consider this a relevant factor in supporting the business

efficiency merits of a demerger of Landco from Lammat (paragraphs 22 & 23 of PS LA 2005/21).

Accordingly, the Commissioner would not make a determination under subsection 45B(3) that sections 45BA or 45C of the ITAA 1936 apply to the proposed demerger.

Example 3: Demerger of subsidiary to promote its business development

The facts

Realco Pty Ltd owns 100% of the issued capital in Keljo Pty Ltd, which operates a substantial pizza business and also owns passive investments in companies on the Australian Stock Exchange. During the relevant income year, the estimated market value of Keljo is approximately \$3,000,000.

Realco operates a successful property development business and owns land originally acquired as an investment. The land has a current value of approximately \$2,000,000.

All shares in both Realco and Keljo were acquired before 20 September 1985.

Realco now wishes to develop the land it owns into a luxury hotel resort. The hotel project will cost approximately \$10,000,000, which Realco intends to raise by issuing new shares in Realco via a public listing.

However, the current owners of Realco don't want any new shareholders in Realco (via the public listing) having any indirect interest in Keljo. Commercial research has also indicated that Realco's proposed public listing would not be viewed favourably by the market, if Realco indirectly owns Keljo's pizza business.

Accordingly, as part of the hotel project scheme, Realco proposes to demerge Keljo. Realco also confirms that none of its shareholders intend to dispose or otherwise deal with their shares in either Realco or Keljo after the demerger.

Applicant's stated reasons for demerger

Realco states a demerger would provide the following commercial benefits:

- A demerger will assist in the public listing of Realco, as new investors will not have to pay an extra premium to pay for the assets of Keljo.
- A demerger will allow the different businesses of Realco and Keljo to develop independently of each other.
- Asset protection – a demerger will ensure Keljo's established business and passive investments are protected from the financial risks associated with Realco's hotel resort development.

Commissioner's analysis and decision

The Commissioner accepts that the demerger was being undertaken to create 2 distinct companies operating significantly different businesses – a property development business and a pizza business.

The Commissioner accepts the applicant's stated reasons above constitute positive relevant circumstances, as provided for in subsection 45B(8), that are likely to improve the business structures of both Realco and Keljo. The applicant's statement that the shareholders of Realco have no current intention of disposing of any of their interests in either Realco or Keljo after the demerger is relevant (paragraphs 73 to 78 of PS LA 2005/21).

Accordingly, in the absence of any evidence that is inconsistent with the above, the Commissioner would not make a determination under subsection 45B(3) that sections 45BA or 45C of the ITAA 1936 apply to the proposed demerger.

Example 4: Scheme involving pre-arranged disposal of ownership interests

The facts

Sam owns 100% of the issued capital in Engin Pty Ltd and is its sole director. Engin owns 50% of the issued capital in Subang Pty Ltd. The other 50% of issued capital in Subang is owned by Amanda.

Both Engin and Subang operate successful engineering businesses, although both companies operate in different localities and have different segments of the engineering market.

Sam paid \$1,000 for his shares in Engin, and Engin paid \$2,000 for its 50% stake in Subang. All the shares in both Engin and Subang were acquired after 20 September 1985.

Although both Engin and Subang have paid dividends to their shareholders in previous years, considerable profits have been retained resulting in increased share value. Engin has a current market value of \$1.9 million (with \$1.4 million of this value relating to Engin's holdings in Subang).

Sam acknowledges he was negotiating to dispose of Engin's shares in Subang to a third party (an employee of Subang). These negotiations fell through due to a failure of Sam and the employee agreeing on the sale price. The negotiations were not conditional upon a demerger.

Applicant's stated reasons for demerger

Sam states a demerger would provide the following commercial benefits:

- Sam is conducting negotiations to sell 50% of his shares in Engin to Lucy, an employee of Engin. The proposed sale is conditional on a demerger occurring, as there has been an established history of conflict between Lucy and the half owner of Subang, Amanda. For the last 10 years, Lucy and Amanda have taken legal action against each other over various commercial and civil disputes. Accordingly, Lucy doesn't want to acquire an indirect interest in Subang, due to the high risk of disputes occurring with Amanda. Any disputes may affect the business performance of both Subang and Engin.
- Admission of new equity participants into the business of Engin will enhance its performance, as these new equity participants will have a stake in the business.
- A demerger will allow a separation of risk should either business fail.

Commissioner's analysis and decision

In examining the current demerger proposal in relation to the relevant circumstances in subsection 45B(8), the Commissioner took into account the following factors:

- The significant profit accumulations in both Engin and Subang. This is of particular importance given that the investment in Subang had a cost of only \$2000 and the company now has a market value of \$1.4 million (paragraphs 57 to 58 of PS LA 2005/21).

- A demerger would deliver significant tax concessions to Sam due to the large profit accumulations in Subang, a large tax-free demerger dividend of \$1.4 million would be paid to him (paragraphs 94 to 95 of PS LA 2005/21).
- The proposed subsequent sale of Sam's 50% stake in Engin is significant as it indicates the tax effective disposal of the Engin shares is a significant factor of the scheme (as this sale would be entitled to the CGT discount). Therefore, a significant purpose of the demerger is arguably the tax concessions granted to Sam (paragraphs 73 to 78 of PS LA 2005/21).
- A demerger would not enhance the effectiveness of asset protection for Engin should Subang's business fail, as Engin is a separate legal entity from Subang.
- While a demerger would provide some asset protection for Subang should Engin's business fail, this factor alone does not preclude the application of section 45B.
- While Lucy's conflict with Amanda may be a factor, where there exists more than one purpose for a demerger, the tax purpose must be incidental and subordinate to the other substantial purpose or purposes. It is the Commissioner's view that a substantial purpose in this case is to obtain a tax benefit for Sam (paragraphs 43 to 45 of PS LA 2005/21).
- It is acknowledged that the introduction of an experienced employee as an equity owner in Engin is a relevant factor and may increase productivity and profit. However, where there exists more than one purpose for a demerger, the tax purpose must be incidental and subordinate to the other substantial purpose or purposes. It is the Commissioner's view that the substantial purpose is to obtain a tax benefit (paragraphs 43 to 45 of PS LA 2005/21).

Based on the above facts, the Commissioner would exercise his discretion to make a determination under paragraph 45B(3)(a) of the ITAA 1936 that section 45BA of the ITAA 1936 applies to the demerger benefit provided to Sam under the scheme.

Example 5: Scheme involving pre-arranged disposal of ownership interests after

demerger

The facts

Sally, Mandy and Anne each own a third of the total shares in Chowder Pty Ltd (Chowder) which operates the Chowgood restaurant. Chowder also owns 100% of the issued capital in Vegan Pty Ltd (Vegan). Vegan operates the Vege Delight Restaurant. Both the share capital of Chowder and Vegan can be precisely identified as \$80,000 and \$30,000 respectively. All shares in Chowder and Vegan were acquired after 20 September 1985.

Both Chowder and Vegan operate successful restaurants. The estimated market value of Chowder is \$1.5 million (this includes its indirect interest in Vegan) and the estimated market value of Vegan is \$500,000.

In previous income years, both Chowder and Vegan paid regular large dividends to their shareholders. In 2004, Chowder paid \$300,000 in dividends and in 2005 paid \$350,000.

In the 2006 income year Chowder did not distribute its net profit. Instead, although Chowder had an operating profit of \$250,000 and received a dividend of \$200,000 from Vegan, it only declared dividends of \$40,000.

In August 2007, Sally, Mandy and Anne decide to demerge Vegan from Chowder. However, the demerger benefit of Vegan shares to Sally, Mandy and Anne does not reflect a correct attribution between capital and profits.

It was agreed that the following would happen once the demerger was completed:

- Sally will sell some of her shares in Chowder to Phillip, who is the restaurant manager of Chowgood
- Sally would sell the remainder of her shares in Chowder to Mandy and Anne, and
- Sally would retain her shares in Vegan.

Applicants stated reasons for demerger

The following reasons were provided by Sally, Mandy and Anne for the demerger:

- The demerger would allow the owners of Chowder to separate their equity interests in both Chowder and Vegan and deal with these interests separately. This is not possible under the current structure where Vegan is a wholly-owned subsidiary.
- Although Sally would like to dispose of her interests in Chowder, she wishes to retain her shareholding in Vegan. This is not possible under the current structure.
- A demerger would allow persons wishing to acquire an equity stake in one restaurant but not the other to acquire shares in either Chowder or Vegan. This is not possible under the current structure.
- A demerger would facilitate Phillip, the manager of the Chowgood restaurant, acquiring shares in Chowder.
- The above factors would facilitate a more efficient running of the businesses, by having separate equity ownership for both companies.

Commissioner's analysis and decision

In examining the current demerger proposal in relation to the relevant circumstances in subsection 45B(8), the Commissioner took into account the following factors:

- There was a clear interruption of the pattern of profit distribution by Chowder in the 2006 income year. There was no apparent business purpose for the concentration of these profits in Chowder before the demerger and this interruption was also inconsistent with past dividend practice (paragraphs 57 and 84 to 95 of PS LA 2005/21).
- The clear interruption of the pattern of profit distribution in Chowder before the demerger clearly benefits Sally, as it effectively converts what would otherwise be dividend income into a tax beneficial capital amount. This is significant as Sally would be entitled to the CGT discount on any subsequent sale of the Chowder shares, as she has held these shares for more than 12 months. This would provide Sally with a significant tax benefit (paragraphs 84 to 95 and 107 to 108 of PS LA 2005/21).
- The demerger allocation of Vegan shares to Sally, Mandy and Anne did not reflect a correct attribution of capital and profits (paragraphs 49 to 56 of PS LA 2005/21).

- The prearranged disposal of Chowder after the demerger suggests that it was undertaken to transfer corporate assets to shareholders rather than restructure the businesses of the respective companies (paragraphs 73 to 78 of PS LA 2005/21). It is also clear based on the facts provided that the demerger was conducted for a more than incidental purpose to facilitate the tax effective disposal of Sally's shares in Chowder.
- After the demerger there were no alterations to the business operations of either Chowder or Vegan, other than the sale of shares to the manager of the Chowgood restaurant.
- While Sally wishing to retain her interests in a demerged Vegan is a relevant factor, where there exists more than one purpose for a demerger, the tax purpose must be incidental and subordinate to the other substantial purpose or purposes. The Commissioner's view is that the substantial purpose in this case is to obtain a tax benefit for Sally and the other shareholders of Chowder.
- While it is acknowledged that the manager of the Chowgood restaurant taking an equity stake in Chowgood may promote some business efficiencies, this factor does not result in the purpose of obtaining a tax benefit being reduced to an insignificant purpose (paragraphs 43 to 45 of PS LA 2005/21).

Based on the above facts, it is clear that a significant purpose of the proposed demerger and subsequent sale was to obtain a tax benefit. The tax benefits were to provide Chowder's shareholders with a tax-free demerger dividend and entitle Sally to reduce her assessable income by applying the discount capital gain to the sale of her shares. The demerger also resulted in profits in Vegan being distributed as preferentially taxed capital to Sally, Mandy and Anne. The facts also do not disclose the intention to substantially improve business efficiency.

Accordingly, the Commissioner would make a determination under paragraph 45B(3)(a) of the ITAA 1936 that section 45BA would apply to treat the demerger dividend as assessable income to the shareholders of Chowder.

Example 6: Scheme involving later disposal of ownership interests after demerger

The facts

Zador and its shareholders before the demerger

Ralph is the managing director of Zador Pty Ltd (Zador), which conducts a business of importing, wholesaling and distributing widgets and other products.

Zador has 3 shareholders:

- Noddy Pty Ltd (holding 3 shares – 60% of total shares and is wholly owned by Ralph, who is also the managing director of Noddy)
- Ralph's wife Carol (holding 1 share – 20% of total shares)
- Ralph's sister Melissa (holding 1 share – 20% of total shares).

The shares in both Noddy and Zador were acquired after 20 September 1985.

A few years later, Noddy proposes a demerger of Zador.

Before the demerger, Zador undertakes a one for ten share split in proportion to each shareholder's holding in the company, so that Noddy will hold 30 Zador shares and Carol and Melissa will hold 10 Zador shares each.

A day after the share split, Zador is demerged from Noddy. Ralph now holds the Zador shares previously held by Noddy and Zador's shareholders are now:

- Ralph holding 30 shares (60% of total shares)
- Carol holding 10 shares (20% of total shares)
- Melissa holding 10 shares (20% of total shares).

Zador and its shareholders after the demerger and Ralph's sale of shares

It was agreed between the parties that following the demerger, Ralph will sell 5 Zador shares each to Carol and Melissa. The consideration for the sale will be the current market value of the shares, which is \$500,000 per Zador share.

After the sale of Ralph's 10 shares in Zador, 5 each to Carol and Melissa, the shareholdings in Zador's are now:

- Ralph holding 20 shares (40% of total shares)

- Carol holding 15 shares (30% of total shares)
- Melissa holding 15 shares (30% of total shares).

Applicant's stated reasons for demerger

The following reasons were provided by Noddy for the demerger:

- it would simplify the shareholding structure of Zador for Ralph – by removing Noddy as a shareholder
- Ralph's asset portfolio would be simplified
- it would remove one layer of ownership and thus reduce the administrative costs for the relevant entities
- the management and shareholding decisions regarding Zador could be done directly through Ralph, rather than through Noddy
- as Ralph is intending to take a less active role in the management of Zador, the share sale to both Carol and Melissa was designed to reflect that they're taking a more active management interest in the business.

Commissioner's analysis and decision

In examining the current demerger proposal in relation to the relevant circumstances in subsection 45B(8), the Commissioner took into account the following factors:

- The facts indicated that the demerger was done to facilitate Ralph disposing of 20% of his total shareholding in Zador as soon as practicable after the demerger, rather than to promote any business efficiencies in either Noddy or Zador (paragraphs 73 to 78 and 89 of PS LA 2005/21).
- The disposal (at market value) of the Zador shares by Ralph would be to related parties (paragraphs 81 to 98 of PS LA 2005/21).
- The substance and effect of the scheme involves Ralph obtaining significant tax and financial benefits from the demerger and subsequent sale of 10 of his Zador shares. Ralph would be entitled to the CGT discount concession on the sale of these shares (paragraphs 94 to 95 of PS LA 2005/21).
- The purposes mentioned by Noddy did not disclose any change or improvement to the businesses of the demerger group, apart from

managerial changes which were not dependent on undertaking a demerger.

- Some of the reasons for the demerger describe the effect of the demerger (that is, reducing administration costs, simplifying the business structure, management decisions being made by Ralph rather than Noddy) and these appear relatively insignificant.
- In the absence of substantial business reasons for the demerger, the significant tax benefits obtained by Ralph assume greater significance (paragraphs 22 to 23 of PS LA 2005/21).

Based on the above facts, the Commissioner would make a determination under paragraph 45B(3)(a) of the ITAA 1936 that section 45BA of the ITAA 1936 applies to the demerger benefit provided under the scheme.

Example 7: Scheme involving family arrangement and later disposal of ownership interests after demerger

The facts

In the relevant income year PEP Pty Ltd owned 100% of Sabu Products Pty Ltd. Sabu operates a business of manufacturing and marketing various commercial products. All shares in Sabu were acquired after 20 September 1985.

All shares in PEP are owned by 6 members of the Butcher family – Fred and Wendy Butcher and their 4 children, Al, Mark, Karen and Judy. Each family member has 10 ordinary shares in PEP which were acquired after 20 September 1985.

During the relevant income year, Sabu's managing director was Fred Butcher, with his son Al Butcher as technical manager. However bitter management disagreements between Al and Fred on how Sabu should be run occurred, which led to discord within the entire Butcher family.

The ongoing and continual feuds between Al and Fred encouraged the Butcher family members to agree to sell Sabu to Al's company, Al Butcher Pty Ltd. It was agreed between the family, that Sabu should be demerged from PEP before the sale.

Accordingly, on the same day the demerger occurred, Fred, Wendy and their children sold their demerged interests in Sabu to Al's company ABP and Fred resigned as Sabu's managing director. Al became Sabu's sole director and manager.

Applicant's stated reasons for demerger

PEP provided the following reasons for the demerger:

- It was necessary for commercial reasons as Sabu's business future was in jeopardy due to the family disputes over its management.
- Due to the disputes, it was crucial that changes were made to the ownership and management of Sabu to ensure no further disputes arose.

Commissioner's analysis and decision

In examining the current demerger proposal in relation to the relevant circumstances in subsection 45B(8), the Commissioner took into account the following factors:

- The demerger was conditional on the subsequent sale of Sabu. They occurred on the same day. The facts indicate that the demerger was undertaken for a more than incidental purpose in moving the ownership interests in Sabu to the owners of PEP in a tax effective way, rather than facilitating a restructure of the Sabu business (paragraphs 73 to 78 and 89 of PS LA 2005/21).
- While there is a genuine commercial reason for Al's company acquiring the shares in Sabu, where there exists more than one purpose for a demerger, the tax purpose must be incidental and subordinate to the other substantial purpose or purposes. The Commissioner's view is that a substantial purpose in this case is to obtain a tax benefit for the Butcher family members who sold their interests in Sabu. Although there is a significant non-tax reason to sell Sabu, there is no objective commercial explanation for the demerger discernible from the facts.

The Commissioner would take the view that the manner, form, substance and timeframe of the scheme all indicate that there was a significant purpose for the shareholders of PEP to obtain a tax benefit. Accordingly, the Commissioner would make a determination under paragraph 45B(3)(b) of the ITAA 1936 that section 45C of the ITAA 1936 applies to the demerger benefit provided under the scheme.

Example 8: Scheme involving family arrangement and later disposal of ownership interests

The facts

SOC Pty Ltd owns 100% of the issued capital in Mode Pty Ltd.

SOC's business largely consists of investing activities and holding passive real estate investments. Mode carries on an aquaculture business. All shares in Mode were acquired after 20 September 1985.

Previously, SOC had carried on a manufacturing business. However, it had received a damages claim against it in respect of one of its products that was later settled. As a result of the product liability claim it ceased its manufacturing business 9 years ago.

On 30 June 2004, SOC was owned by James and his wife Heidi. All shares were acquired before 20 September 1985. At this time SOC had a market value of approximately \$6 million. James is sole director and manager of both SOC and Mode.

For some years SOC has built up retained profits from dividend income received from Mode. On 30 June 2005, Mode had share capital of \$20,000 and a market value of approximately \$1.2 million.

In September 2004 James decides to demerge Mode from SOC, with all Mode shares distributed to SOC shareholders in proportion to their holdings. James's accountants also advised that a demerger would facilitate any future sale of Mode.

Both before and after demerger, James remained manager and director of both SOC and Mode. Both before and after the demerger Heidi continued in her role as bookkeeper of both SOC and Mode. The rest of the structure and management of both companies also remained the same.

In September 2005, the business of Mode was sold to an unrelated third party.

Applicant's stated reasons for demerger

SOC and Mode state a demerger would provide the following commercial benefits:

- separate Mode from the potential of future product liability claims being made against SOC in respect of its now ceased manufacturing activities
- allow the management of Mode to focus on its existing customer base and to expand this base
- allow management to focus on Mode's trading activities and invest the necessary time to grow the business without hindrance from the potential for future claims to be made against SOC
- allow SOC to focus on its real estate investment business
- facilitate any future sale of Mode.

Commissioner's analysis and decision

In examining the current demerger proposal in relation to the relevant circumstances in subsection 45B(8), the Commissioner took into account the following factors:

- The facts indicated that the demerger was undertaken to dispose of Mode in a tax effective manner, rather than protect Mode from any potential liability claims made against SOC for its past manufacturing activities (particularly as the product liability claim against SOC occurred many years ago).
- The management structure of both SOC and Mode has remained the same (with James acting as manager and director of both companies) both before and after demerger. The demerger did not bring about a separation of control in the decision-making activities of either SOC or Mode.
- With the management structure being the same both before and after the demerger, it's not apparent how a demerger allows management to focus more on the passive real estate business of SOC or assists the business activities of Mode.
- The essential nature of the scheme allowed Mode shares to be received by SOC shareholders in a tax-free form. In addition, there has been a transformation of profits into a capital asset in the hands of SOC shareholders, who were then able to utilise the small business CGT concessions on the later disposal of the Mode business (paragraphs 43 to 45 and 84 to 95 of PS LA 2005/21).

- The existing documentation suggests that the demerger was also done with a view to a future possible sale of the Mode business (paragraphs 73 to 78 of PS LA 2005/21).

Based on the above, it is not apparent that the demerger was entered into for commercial reasons. Therefore, the tax benefits to the relevant shareholders of SOC have greater significance (paragraphs 22 and 23 of PS LA 2005/21). Due to the above facts, the Commissioner would make a determination under paragraph 45B(3)(a) of the ITAA 1936 that section 45BA of the ITAA 1936 applies to the demerger benefits provided under the scheme.

Example 9: Demerger of subsidiary due to several problems with current corporate structure

The facts

ACMORE Pty Ltd operates a legal practice and is owned equally by Larry, Jill and Gwen, each of whom owns 100,000 \$1 dollar shares in the company. All ACMORE shares were acquired after 20 September 1985. While Larry, Jill and Gwen are the senior partners in the law practice, ACMORE also employs 8 other senior and junior lawyers.

ACMORE also owns 100% of the issued capital (made up of 50,000 \$1 dollar shares) in Malachi Mortgages Ltd. All of Malachi's shares were acquired after 20 September 1985. Malachi operates a mortgage business. Although Malachi has a share capital of only \$50,000, it has approximately \$2.3 million in retained earnings due to the success of its business. Larry, Jill and Gwen are directors of Malachi, along with 4 other independent directors.

Currently, both ACMORE and Malachi operate out of the same premises.

Applicant's stated reasons for demerger

Larry, Jill and Gwen state a demerger would provide the following commercial benefits:

- The 2 companies have distinct separate businesses, with different management protocols, regulatory requirements, IT systems, employees, etc.

- Immediately after the demerger of Malachi, the company will issue shares to new investors, who will provide additional capital that will be used to expand Malachi's mortgage business. These new shareholders, (who have extensive experience in the mortgage business) will also be appointed as directors of Malachi and are expected to improve its commercial performance.
- A demerger will allow the separate board of directors to focus on their respective company's direction independently of the other company's regulatory and business requirements.
- A demerger will facilitate employee share schemes that both companies wish to implement immediately after the demerger. It is asserted that the current corporate structure impedes implementation of effective employee share schemes, as any legal employee of ACMORE would have to pay a premium to buy an equity stake in ACMORE due to the company's ownership of Malachi. ACMORE states that its legal employees are not interested in investing or being involved in Malachi's mortgage business. It is also asserted that Malachi's employees are not interested in being linked to the incorporated law practice of ACMORE.
- It is stated that employee share schemes (by the issue of new shares in the respective company) will encourage key staff to remain in both companies and will assist both businesses to grow and become more efficient.
- As Larry and Jill are of retirement age, they intend to sell part of their interests in ACMORE to key employees over the next 5 to 10 years as part of succession planning for the business. This plan will allow the legal practice to continue smoothly, with new lawyers gradually taking over the business in the coming years. Gwen, who is 45, has no intention of selling her shares in ACMORE and will remain a senior partner in the business. However, Larry, Jill and Gwen have no immediate intention to sell their shares in either ACMORE or Malachi after the demerger.
- Larry, Jill and Gwen also believe that the current corporate structure of ACMORE owning Malachi potentially breaches their legal regulatory body's rules, that forbids a legal incorporated practice or a related entity (which Malachi is) from conducting a managed investment scheme. As Malachi's mortgage business conducts managed investment schemes, Larry, Jill and Gwen state that ACMORE's ownership of Malachi may breach these rules. The

partners also state that the penalty for breaching the legal regulatory body's rules could lead to deregistration of ACMORE's incorporated legal practice.

Commissioner's analysis and decision

In examining the current demerger proposal in relation to the relevant circumstances in subsection 45B(8), the Commissioner took into account the following factors:

- Both ACMORE and Malachi operate distinct independent businesses. Malachi has its own independent directors and the companies are financially independent of each other both before and after demerger.
- A demerger will allow both businesses to pursue independent growth strategies. Malachi will also have new shareholder/directors whose capital and experience should improve the business performance of the company.
- Employee share schemes will be implemented immediately after the demerger by both ACMORE and Malachi so that key staff will maintain their employment with the companies and have a vested financial interest in improving the operational performance of the 2 businesses.
- Although Larry and Jill have an intention to sell some of their interests in ACMORE to new equity partners over several years in the future, they assert that they have no immediate intention of selling their holdings in ACMORE after the demerger (paragraphs 73 to 78 of PS LA 2005/21).
- Regarding ACMORE's potential breach of the legal regulatory body's rules, it is the Commissioner's position that contravention of an existing rule, regulation or law does not by itself, justify a demerger for section 45B purposes. Rather, it is a relevant factor to consider amongst other relevant factors of the particular case.
- If succession planning is a purpose for the demerger, it is likely that the Commissioner will closely examine the issue in relation to section 45B. However, section 45B may not apply in situations where the demerger is being driven by proper commercial considerations that require a demerger and the succession planning will occur at a much later time in the future. In this case the demerger is being driven by those proper commercial purposes,

namely the need for additional equity capital for the business of Malachi and the implementation of employee share acquisition arrangements in both ACMORE and Malachi.

- It is also significant that the existing ACMORE shareholders will retain the same proportion of their ownership in Malachi as they own in ACMORE before the demerger for a significant period of time after Malachi has been demerged from ACMORE.

In examining the current demerger proposal in relation to the factors mentioned above, the Commissioner accepts that a demerger will improve the business operations of both ACMORE and Malachi (paragraphs 6 to 9 and 22 of PS LA 2005/21). Accordingly, the Commissioner would not make a determination under subsection 45B(3) that sections 45BA or 45C of the ITAA 1936 apply to the proposed demerger.

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