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Alive and thriving – the revised regime for
CGT small business concessions

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Alive and thriving – the revised regime for CGT small business concessions

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Abstract

The current range of CGT concessions available for small business operators in Australia is arguably the most generous regime of its kind anywhere in the world. There are four separate concessions potentially available to Australian taxpayers, namely, the 15 year exemption in Subdiv 152-B of the Income Tax Assessment Act 1997 (Cth), the 50 per cent reduction in Subdiv 152-C, the retirement exemption in Subdiv 152-D and the rollover in Subdiv 152-E of that Act.

These provisions are currently (early 2007) undergoing extensive revision, primarily as a result of recommendations made by the Board of Taxation following its post implementation review of the concessions in 2005. In this paper, Professor Evans examines the legislative and administrative amendments that have been implemented, or are currently in the process of being implemented, as a result of the acceptance by the Treasurer and the Australian Taxation Office (“ATO”) of most of the recommendations made by the Board of Taxation.

Article Summary

Alive and thriving – the revised regime for CGT small business concessions

Focus and scope

The provisions of Australian income tax law which provide capital gains tax (CGT) concessions for small business owners and operators are currently (early 2007) undergoing extensive revision, primarily as a result of recommendations made by the Board of Taxation following its post implementation review of the concessions in 2005. In this paper, Professor Evans examines the legislative and administrative amendments that have been implemented, or are currently in the process of being implemented, as a result of the acceptance by the Treasurer and the Australian Taxation Office (“ATO”) of most of the recommendations made by the Board of Taxation.

Background

The current range of CGT concessions available for small business operators in Australia is arguably the most generous regime of its kind anywhere in the world. There are four separate concessions potentially available to Australian taxpayers, namely, the 15 year exemption in Subdiv 152-B of the *Income Tax Assessment Act 1997* (Cth), the 50 per cent reduction in Subdiv 152-C, the retirement exemption in Subdiv 152-D and the roll-over in Subdiv 152-E of that Act.

In October 2005 the Board of Taxation completed a post implementation review of the quality and effectiveness of the small business CGT concessions. The government accepted the majority of the Board’s recommendations for legislative change, and added a few policy changes of its own, going beyond the Board’s recommendations. Legislation implementing the proposed changes is before the Commonwealth Parliament.

The ATO also accepted and has begun to implement the Board’s recommendations for administrative change.

In this paper, the author first examines the Board of Taxation review itself. The paper then considers the government’s response. The changes are then examined in detail, both those that apply to the broad access and eligibility conditions to the concessions and the concessions themselves. Finally, the paper identifies some of the principal planning points that emerge as a result of these changes.

Impact

In the author’s view, virtually all of the changes operate to the direct benefit of those taxpayers able to access the concessions, though some are relatively insignificant in impact. But there are some very significant and beneficial changes that will enable broader access to the concessions than was the previously the case. Most of the changes, moreover, will operate with retrospective and beneficial effect from 1 July 2006, once the legislation is enacted.

Planning opportunities will inevitably arise as a result of the changes, and the author examines some of these at the conclusion of the paper.

Legislation, cases, rulings discussed

- *Income Tax Assessment Act 1997* (Cth), Subdiv 152-A, Subdiv 152-B, Subdiv 152-C, Subdiv 152-D, Subdiv 152-E
- Tax Laws Amendment (2006 Measures No 7) Bill 2006
- Taxation Determination TD 2006/63
- Taxation Determination TD 2006/67

- Taxation Determination TD 2006/70
- Taxation Determination TD 2006/71
- Taxation Determination TD 2006/78
- Taxation Determination TD 2006/79
- Draft Taxation Determination TD 2006/D27.

Alive and thriving - the revised regime for CGT small business concessions¹



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The CGT small business concessions have recently undergone significant legislative and administrative amendment as a result of changes recommended by a review undertaken by the Board of Taxation. The concessions are now potentially even more generous and the changes will enable many small business taxpayers, who may not have previously been eligible, to access the reliefs.

This paper has been subject to a peer review and satisfies the description of a refereed article in current Department of Education, Science and Training categories.

Introduction

Concessions for small business taxpayers have been a feature of the Australian Capital Gains Tax ("CGT") regime³ ever since its commencement on 20 September 1985. The initial single exemption which provided for a 20 per cent reduction on capital gains arising from the disposal of goodwill⁴ has morphed, over the ensuing 20 years, into probably the most generous and comprehensive raft of small business CGT concessions⁵ available anywhere in the world⁶. Four separate concessions⁷ are now potentially available to those taxpayers fortunate, or sufficiently well-advised, to be able to manoeuvre through the complex, tortuous and "enigmatic"⁸ conditions that must be satisfied before access can be granted.⁹

The policy behind this generous suite of concessions is not always clear, and is highly questionable. To the extent that the concessions are designed to encourage the growth of the small business sector, it would seem obvious that it might be better to provide front-ended incentives to enable small businesses to succeed rather than back-ended concessions to those businesses that have actually succeeded. If the policy rationale is to provide small business taxpayers with access to the retirement funds that may have been postponed as a result of the plough back of profits into a growing business rather than investment into superannuation products, the existing concessions are a very blunt and ill-directed policy instrument¹⁰.

But the purpose of this paper is not to consider the policy rationale of the small business CGT concessions. Rather, it is to examine the legislative and administrative amendments that have been implemented, or are currently in the process of being implemented, as a result of the acceptance by the Treasurer and

the Australian Taxation Office ("ATO") of most of the recommendations of the post implementation review of the concessions by the Board of Taxation in 2005.¹¹ The terms of that review specifically precluded any consideration of changes to policy, although major policy changes did feature in the Government's ultimate response.

Virtually all of the changes operate to the direct benefit of those taxpayers able to access the concessions, though some are relatively insignificant in impact. But there are some very significant and beneficial changes that will enable broader access to the concessions than was the previously the case. Most of the changes, moreover, will operate with retrospective and beneficial effect from 1 July 2006, once the legislation is enacted.

Among the more important changes are:

- a shift from a strict 50 per cent controlling individual test to a much more easy to satisfy 20 per cent significant individual test (with both direct and indirect holdings taken into account) for determining whether individuals who dispose of shares in a company or interests in a trust are eligible for the concessions;
- the opportunity for holding and interposed entities to access the concessions so long as 90 per cent of shares or interests are held by concession stakeholders, potentially bringing holdings in multiple tier structures within the concessions;
- refinements that make it easier to satisfy the timing requirements in the active asset test and the \$500,000 retirement exemption;
- an easing of the \$5 million maximum net asset value test by allowing

negative equity and certain provisions to be counted;

- the abolition of the "secondary" partnership \$5 million maximum net asset value test, potentially permitting partners in partnerships worth far more than \$5 million to access the concessions; and
- the opportunity for an automatic two year deferral of capital gains by judicial use of the small business roll-over relief.

The paper starts with an examination of the Board of Taxation review itself. It then considers the government's response, principally in Budget announcements in May 2006, at which point the Board's report was made public. The next part of the paper examines the changes in detail, and considers those changes that apply both to the broad access and eligibility conditions to the concessions and to the concessions themselves. The final part of the paper identifies some of the principal planning points that emerge as a result of these changes.

The paper reflects the position as at 12 March 2007.

The Board of Taxation post implementation review

The review process

Part of the Charter of the Board of Taxation is to advise on the quality and effectiveness of tax legislation and the processes for its development, including the processes of community consultation and other aspects of tax design. Its first post implementation review, publicly released in April 2005, was of the non-commercial losses legislation.¹² Its review of the small business CGT concessions was its second project in this series, and commenced in November 2004.

In undertaking such reviews the Board assesses the relevant legislation to establish the extent to which it:

- gives effect to the Government's policy intent with compliance costs and administrative costs commensurate with those foreshadowed in the Regulation Impact Statement for the measure;
- is expressed in a clear, simple, comprehensible and workable manner;
- avoids unintended consequences of a substantive nature;
- takes account of actual taxpayer circumstances and commercial practices;
- is consistent with other tax legislation; and
- provides certainty.¹³

As noted earlier, the review does not seek to consider the merits of the policy underpinning the legislation. Rather, its intention is to gauge how effective the legislation has been in delivering that policy intent and to find out whether its implementation can be improved. Nonetheless, policy issues did inevitably emerge during the review, and the Board felt compelled to include those policy issues that were identified in a separate chapter in the report (Chapter 4), albeit without evaluation as to the merits of the policy points or recommendations relating to them. Some of those policy issues have subsequently been addressed in the changes ultimately proposed by the

There are some very significant and beneficial changes that will enable broader access to the concessions than was previously the case.

Government, and are identified later in the paper.

Responsibility for day to day carriage of the review was delegated to a three person Working Group comprised of Board members, with oversight provided by the Chair of the Board. Two consultants were also engaged by the Board to assist with the review: Webb Martin to provide a general evaluation from a technical legislative perspective, and the Australian School of Taxation ("Atax")¹⁴ to conduct an evaluation of the compliance and administrative costs of the provisions.

In addition the Working Group called for submissions from interested parties in the tax and business communities (20 submissions were received) and also consulted extensively with the ATO and with Treasury.

Outcomes of the review

The Board of Taxation considered that overall the legislation dealing with the small business CGT concessions was well received by small business, but that it could nonetheless be improved as a result of some amendments or additional guidance designed to give better effect to the operation of the provisions. The Board evaluated the operation of the provisions against each of the six criteria identified above and reached the following conclusions:

Do the provisions give effect to the Government's policy intent, with compliance costs and administrative costs commensurate with those foreshadowed in the Regulation Impact Statement for the measure?

It was the Board's conclusion that this criterion was broadly satisfied, although it noted that there were some areas where the current provisions did not give effect to the policy. Recommendations for improvement were therefore made in this regard. The Board also concluded that the compliance costs for taxpayers of the provisions were high in absolute terms (approximately \$110 million in 2002-03), and that practitioners were often unable to pass many of these costs on to

clients. But relative to the generosity of the concessions, the Board considered that compliance costs were not a significant issue. The costs incurred by the ATO in administering the concessions were not perceived to be either absolutely or relatively high.

Is the legislation expressed in a clear, simple, comprehensible and workable manner?

While the Board accepted that this criterion was generally met, it was also of the view that there were a number

of important concepts in the provisions that required clarification, particularly through rulings, practice statements or other guidance by the ATO. A number of recommendations, therefore, emanated from concerns with this criterion.

Does the legislation avoid unintended consequences of a substantive nature?

The Board noted that the way in which the provisions had been introduced in and before 1999 tended to disadvantage some small business taxpayers with structures that involved interposed or grouped entities. Their conclusion, however, was that this was a policy issue and therefore beyond the scope of the review. Interestingly, the Treasurer's proposals relating to significant individuals, dealt with below, will go some way to addressing this concern.

Does the legislation take account of actual taxpayer circumstances and commercial practices?

The Board noted that the small business CGT concessions apply in an easy and workable way to the majority of straightforward transactions entered into by eligible small business entities. But they were also aware that some were denied access to the legislation because of the particular way that transactions had had to be structured for commercial purposes. The Board noted that it was not always possible to cater for all circumstances, but felt that some of the recommendations could assist in bringing more businesses within the eligibility criteria where it was clearly the case that those businesses were within the policy intent of the legislation.

Is the legislation consistent with other tax legislation?

Whilst there was a high level of consistency at a general level, the Board also noted that there were some inconsistencies both within the small business CGT concession provisions and in the way that the provisions meshed with other parts of the tax system. Accordingly, recommendations were made which sought to iron out some of these inconsistencies.

Does the legislation provide certainty?

The Board considered that the operation of the provisions in uncomplicated situations was clear and provided certainty of outcome. The report did, however, identify uncertainty in a number of areas,

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including the application of tests where a time period was involved, and in the meaning of a number of the concepts used in the provisions. Accordingly, a number of recommendations were made in relation to this criterion.

As a result of the evaluation of the provisions against these six criteria, the Board came up with a total of 39 recommendations, covering two broad areas:

- fine-tuning a small number of the provisions relating to the application of the eligibility criteria to improve the current outcomes of the legislation; and
- minor legislative changes to address unintended consequences and administrative changes to assist understanding of the law.¹⁵

Of these 39 recommendations, 14 were considered by the Board to likely have a high positive impact on taxpayers; 12 recommendations were considered to have a lower, though still positive, impact; and 13 were recommendations to the ATO for additional guidance in relation to the provisions.

A total of 10 of the recommendations (including four higher impact proposals) related to the \$5 million net asset value test and a further seven (including three higher impact proposals) related to the other major eligibility condition – the active asset test. The other 22 recommendations related to the concessions themselves, with eight relating to the roll-over, eight to the retirement exemption, four to the 15 year exemption, one relating to the 50 per cent small business reduction and one (involving special treatment where deceased estates were concerned) relating to all four concessions.

Details of all of recommendations, to the extent that the proposals have been accepted and/or modified, are provided later in the paper.

The Government's response

The Board of Taxation's report was passed to the Treasurer in October 2005, and in May 2006 the Treasurer announced his response, as well as publicly releasing the Board report.¹⁶ The Government accepted 38 of the 39 recommendations, three with minor amendments favouring the taxpayer. In addition the

Government announced other significant policy changes, going beyond the recommendations of the Board. The main one of these was the decision to replace the existing "controlling individual" 50 per cent test with a "significant individual" 20 per cent test that can be satisfied either directly or indirectly through one or more interposed entities. The impact of this additional change is to broaden the accessibility of the provisions to a large number of taxpayers who had hitherto been denied access.

The one recommendation that was rejected by the Treasurer related to the retirement exemption. The Board had recommended that amendments should be introduced to ensure that where payments were made by a company none of the deemed dividend provisions¹⁷ applied in relation to CGT exempt components within the meaning and limits of the legislation relating to the small business retirement exemption. The Treasurer felt unable to accept this recommendation on the grounds that the proposed amendment could potentially undermine the safeguarding nature of the deemed dividend provisions.

Details of the 38 recommendations that were accepted (including the Treasurer's favourable modification of three of them) are contained below. The legislation dealing with those 25 recommendations that required technical amendments, as well as the new significant individual amendment, was tabled in Parliament in December 2006.¹⁸ At the time of writing (March 2007) the legislation has been debated in the House of Representatives, and has now passed to the Senate. The Senate Economics Committee has recommended that the Senate should pass the Bill (27 February 2007). It is not anticipated that there will be any major changes to the Bill, and the current paper is based on the provisions as tabled. Once passed, virtually all of the amendments will have operative effect from 1 July 2006. In the meantime the ATO has accepted and moved forward on the 13 Board of Taxation recommendations that required administrative amendment. Many of these changes have been dealt with through the issue of a number of draft Taxation Determinations, most of which have now been finalised. Some of the changes are being dealt with through an update of the ATO's *Advanced guide to capital gains tax concessions for small business*. A revised version is likely to be issued in the near future.

In the May 2006 Budget the Treasurer also announced that the \$5 million net asset value test would be increased to \$6 million.¹⁹ This change is scheduled to come into effect on 1 July 2007.

Later in 2006 the Treasurer and Minister for Small Business and Tourism also announced that a new small business framework would be implemented, with legislation designed to standardise the eligibility criteria for a range of small business tax concessions (including the small business CGT concessions, the concessions available under the STS, GST, FBT, and PAYG Instalments) from 1 July 2007.²⁰ Exposure draft legislation to implement this small business alignment, with a proposed common \$2 million turnover eligibility threshold but with fall-back access to existing thresholds if that common threshold cannot be satisfied (so that no-one is worse off), was released on 8 February 2007. These separate provisions are beyond the scope of this paper, although they also include the proposal to increase the net asset value test from \$5 million to \$6 million from 1 July 2007.

The changes in detail

The changes to the small business CGT concessions that have been implemented, or are in the process of being implemented, can conveniently be explored under two broad headings. In the first place there are changes to the eligibility conditions that must be satisfied before an entity can access any or all of the concessions. There are always two such conditions – the maximum net asset value test (currently \$5 million, but scheduled to be increased to \$6 million from 1 July 2007), and the active asset test. A total of 17 of the Board recommendations related to these two conditions. In addition, where the gain arises from the disposal of shares in a company or interests in a trust, a third eligibility condition must be satisfied – what up until now has been referred to as the controlling individual/concession stakeholder test, but what in future will become the significant individual/concession stakeholder test.

The second broad heading covers changes to the concessions themselves. As noted above, there were 22 recommendations relating to the various concessions, although one (relating to the retirement exemption) was not ultimately accepted by the Government.

Accordingly, the various changes that have occurred or are in prospect are dealt with under these two broad headings.

Changes to the eligibility conditions

The maximum net asset value test

Four of the Board's 10 recommendations, currently being enacted, which relate to the maximum net asset value test are likely to have a significant and positive effect for entities when they are testing the sum of the net asset values of their own, their connected entities and their small business CGT affiliates to establish whether they fall below the \$5 million threshold (which may be increased to \$6 million from 1 July 2007). These are:

- (a) Negative asset values of entities, connected entities and small business CGT affiliates can be taken into account

Recommendation 6.2 of the Board of Taxation report proposed: "To ensure

70 per cent of the shares of Ice Cream Co and Ice Cream Co is a connected entity. Net asset value includes the value of connected entities, therefore Ice Cream Co's negative net asset value is included in Joe's net asset value.

- (b) Certain provisions can be taken into account

Recommendation 6.3 proposed: "The meaning of net value of the CGT assets in s 152-20 should be amended so that, in addition to the present legal obligations that relate to the assets, the following provisions are included in liabilities that relate to the assets of a business: annual leave and long service leave; unearned income; and future tax liabilities."

From 1 July 2006 (subject to the relevant legislation being passed) the net asset calculation will allow an entity to take these four provisions into account. Note that the Bill, in amending the wording of sec 152-20(1), makes it clear that it is only these four provisions, and no others, that can be taken into account. The legislation is very clearly expressed

million, liabilities relating to the assets of \$1.1 million and has made provisions for \$100,000 of annual leave for her employees, \$20,000 for unearned income and \$50,000 for tax liabilities for the financial year. Hanna has a net asset value of \$5.93 million.

- (c) Abolition of separate partnership test

Recommendation 6.8 proposed: "To improve the certainty of the operation of the maximum net asset value test for partners and partnerships, paragraph 152-15(b) should be repealed so that the treatment of a disposal of an interest in a partnership asset is aligned with the disposal of other active assets held by the partner."

As originally enacted, the maximum net asset value test, when it applied to a partner disposing of an interest in an asset of a partnership, required the partner to satisfy two separate maximum net asset value tests. In the first place the partner had to calculate and satisfy the maximum net asset value test in the usual fashion (the net value of own assets, plus those of connected entities and small business CGT affiliates, subject to specified exclusions). Secondly, it was a requirement²¹ that the value of the CGT assets of the partnership did not exceed the \$5 million threshold.

This second, separate test will now be repealed. As a result, many partners with net asset values below the threshold but who have partnership interests in partnerships which themselves exceed the threshold, will now be able to potentially access the concessions (assuming other conditions are met). The following example, adapted from Example 1.6 of the EM, illustrates the point.

Example

Dan is a partner in an accounting firm. The firm has net assets of \$10 million and Dan has a 20 per cent stake in the partnership. The partnership sells the building from which it operates. In applying the net asset test, Dan only includes \$2 million in net assets in relation to his interest in the partnership.

As noted earlier, the repeal of the "secondary" maximum net asset value test as it applies to partnerships (paragraph 152-15(b)) does not mean that the partnership assets are not to be counted where the individual controls the partnership within the meaning of subs 152-30(2) – the "primary" maximum net asset value test still operates. Hence where a partner "controls" a partnership (for example, by having a 40 per cent to 50

There are changes to the eligibility conditions that must be satisfied before an entity can access any or all of the concessions... and changes to the concessions themselves.

consistency of application of the maximum net asset value test for assets and liabilities held in connected entities and affiliates compared to assets and liabilities within the one entity, the definition in s 152-20 should be amended to clarify that a negative value of the net assets of the entity, a connected entity or a small business CGT affiliate is able to be taken into account."

From 1 July 2006 (subject to the relevant legislation being passed) the net asset calculation will therefore allow an entity to have a negative net asset value, and for that to be taken into account in determining if another entity satisfies the test. The following example is adapted from Example 1.5 of the Explanatory Memorandum ("EM") accompanying the Bill.

Example

Ice Cream Co has CGT assets with a value of \$2 million and liabilities relating to those assets of \$3 million. Ice Cream Co has a net asset value of negative \$1 million. Joe owns

in exclusive rather than inclusive terms, precluding the possibility of any other provisions, such as provisions for sick leave or for bad debts, being taken into account. This is understandable, as the extension beyond present legal obligations to the four specified provisions is a "bonus" to reflect statutory obligations and commercial reality. Sick leave is not typically something that has to be paid out when an employee leaves or dies. And any uncertainty relating to the recoverability of bad debts could, if appropriate, be taken into account in ascertaining the market value (as opposed to book or face value) of debtors in computing the net assets of the entity, and so does not need special mention.

The following example, adapted from Example 1.4 of the EM, illustrates the operation of the proposed amended legislation.

Example

Hanna has CGT assets with a value of \$7.2

per cent interest where no other partner controls the partnership, or by having a 50 per cent or greater interest), that partner will still need to bring the full value of the partnership assets into account as a connected entity when testing for the \$5 million maximum net asset value under the primary test.²²

(d) Pro-rata inclusion of value of dwelling where assessable income involved

The position at present is that where an individual uses a dwelling to generate assessable income in part and is (or would be) entitled to pro-rata interest deductions in relation to money borrowed to acquire the dwelling, the full value of the dwelling is included in the maximum net asset value test.

The Board (in Recommendation 6.9) proposed: "To give effect to the policy intent and to improve the certainty of the outcome of the maximum net asset value test, s 152-20 should be amended in relation to the inclusion of dwellings to:

- only include that percentage of the value of the dwelling that reflects the proportion of interest deductibility on the dwelling; and
- have regard to that deductibility over a specified period, rather than at the time of the CGT event."

The amended legislation will give effect to this recommendation. An individual will only include in their net assets the current market value of a dwelling to the extent that it is reasonable, having regard to the amount that the dwelling has been used to produce assessable income which gives rise to deductions for interest payments. If the dwelling has never had any income producing use, the value is not included at all. If the dwelling has had some income producing use, the percentage of income producing use is multiplied by the current market value to work out the value of the dwelling that should be included. This will take account the length of time and percentage of income producing use of the dwelling, as shown in Example 1.9 from the EM.

Example

Ben owns a house that has a market value of \$750,000 just before applying the net assets test. Ben owned the house for 12 years — for the first three years, 20 per cent of it was used for producing assessable income, for the following two years it was used 40 per cent for producing assessable income, for two

years it was used solely as a main residence and for the last five years it was used 10 per cent for producing assessable income

Ben's dwelling has had 15.8 per cent income producing use (3/12 × 20 per cent) + (2/12 × 40 per cent) + (2/12 × 0 per cent) + (5/12 × 10 per cent).

Ben will include \$118,750 in his net asset test (\$750,000 × 15.8 per cent). Ben has a liability of \$500,000 attached to the house. Therefore 15.8 per cent (\$79,166) of the liability is also included in the net asset test.

In addition to these four changes that are likely to be relatively more significant in their positive impact on entities affected by them, there are a further six changes to the maximum net asset value test that will have a less significant, though still positive, impact. Three of the recommendations require legislative amendment and three require clarification from the ATO.

The three minor legislative changes currently being enacted are:

- co-directors and co-trustees will no longer automatically be assumed to be acting in concert with each other in determining whether they are small business affiliates (which can impact on whether their assets, or assets of entities connected with them, have to be included in the maximum net asset value test). The position will therefore mirror the position for partners²³;
- directors of companies are not automatically small business CGT affiliates of their companies merely because of the position held as directors, and vice versa²⁴;
- a taxpayer takes into account assets of an entity connected with them that are used in the entity's business when working out whether or not that taxpayer exceeds the maximum net asset value test. However the taxpayer does not take into account such assets if the entity is connected with the taxpayer just because another entity is the taxpayer's small business CGT affiliate. This amendment does not change the law; it merely expresses a couple of what were very convoluted subsections²⁵ (involving at least one triple negative) more clearly and in a more meaningful fashion.²⁶

The three recommendations relating to the maximum net asset value test that have led to clarification from the ATO are:

- the Board recommended that the Commissioner should publish guidance on those liabilities (which are taken into account in arriving at the net asset value position) which are taken to "relate to" the CGT assets of an entity in commonly encountered situations.²⁷ In draft Taxation Determination TD 2006/D27 (not yet finalised) the ATO says that the term "liabilities" has its ordinary meaning and extends to legally enforceable debts due for payment and to presently existing obligations to pay either a sum certain or ascertainable sums. The draft Determination notes that it does not extend to contingent liabilities, future obligations or expectancies. Note that the draft suggests that provisions for long service and annual leave entitlements, provisions for income and other taxes, and accounting liabilities arising as a result of receiving prepaid income are not taken into account in calculating liabilities for the purposes of determining the net value of the CGT assets. The draft also indicates that negative equity in connected entities cannot be taken into account. While all of this was correct when the draft was issued (June 2006), it has, of course, subsequently been overturned by the draft legislation that was tabled in December 2006. Such provisions can now be taken into account, as can the negative equity in connected entities. The draft is correct in identifying some of the other provision that will still not be taken into account, such as provisions for possible obligation to pay damages in a pending law suit, provision for guarantee of a loan, and expenses that are not yet due.
- the Board recommended that the Commissioner should publish guidance in relation to the circumstances in which a person will be taken to control a discretionary trust.²⁸ In Taxation Determination TD 2006/67 (initially issued as draft Taxation Determination TD 2006/D28) the ATO states that a person who has the power to remove the trustee of a discretionary trust and appoint a new trustee controls the trust for the purposes of establishing control under the maximum net asset value test (subject to certain exceptions). The following example, contained in paragraphs 2-4 of the Determination, illustrates the point.

Example

Discretionary Trust (DT) makes distributions of 25 per cent each to beneficiaries B1, B2, B3 and B4 in each of the last four years. None of the beneficiaries are small business CGT affiliates of each other. The terms of the trust deed specifies that the appointor has the power to remove any trustee and appoint a new trustee.

As there is no beneficiary (together with any small business CGT affiliate) who has received a distribution of at least 40 per cent of the total distribution, none of the beneficiaries will control DT under subs 152-30(5) of the ITAA 1997. As none of the beneficiaries control the trust, subs 152-30(4) of the ITAA 1997 will not apply.

As the terms of the trust permit the appointor to remove and appoint trustees, the appointor controls the trust under subparagraph 152-30(2)(c)(ii) of the ITAA 1997.²⁹

- the Board recommended that the Commissioner should publish guidance in relation to the practical application of “to act in concert” or “reasonably expected to act in accordance with your directions or wishes” in relation to determining entities that might be small business CGT affiliates.³⁰ Taxation Determination TD2006/79 (initially issued as draft Taxation Determination TD 2006/D34) provides some additional guidance (in paragraphs 40-42) on the ATO’s interpretation of these terms. The Determination notes that the key consideration is the actions of the parties, and that these would be based on relationships (such as close family ties or friendships) rather than simply upon formal agreements.

The active asset test

The active asset test is the second of the major eligibility requirements for access to the small business CGT concessions. Essentially, the CGT asset involved in the CGT event that gives rise to the claim for the concessions must be an active asset.³¹ The Board of Taxation made seven recommendations relating to this active asset test, and the Government accepted all seven, though modifying one of them in favour of the taxpayer. Three of the seven recommendations were considered by the Board as likely to have a higher level impact, and will almost certainly have significant implications in practice. They are:

- (a) The pre-existing legislation required the asset to be active for the lesser of half the period of ownership or 7.5 of the previous 15 years, and also required the asset to be active just before the CGT event. Where a business has ceased, the asset which was active immediately before the cessation of the business could still attract the concessions provided it was sold within 12 months of the cessation of the business (or longer at the Commissioner’s discretion).³² The Board suggested that to avoid unintended consequences there should be an amendment to allow for a similar 12 month period for the disposal of the asset after it stops being used in the business (regardless of whether the business itself had actually ceased).³³

The Government has decided to go even further, and get rid of the 12 month rule. From 1 July 2006 the asset only has to be an active asset for the lesser of 7.5 years or half the period of ownership. The asset does not need to be active just before the CGT event, or sold within 12 months of the cessation of the business.³⁴

There are two significant implications here:

- if the asset has been owned for more than 15 years, it only needs to have been active for 7.5 years to be classified as an active asset (if it has been owned for less than 15 years, it needs to be active for at least half that period);
- the asset no longer has to be active just before the CGT event.

Example 1.11 from the EM illustrates the operation of these generous new rules.

Example

Alice ran a farming business on a property that she has owned for 17 years. She ran the farm for three years, and then leased it to an unrelated party for five years. She then ran the farm for another five years before retiring and leasing the farm for another four years before selling it. The farm satisfies the active asset test because it was actively used in Alice’s farming business for at least 7½ years – even though the period was not continuous and the property was not used in the business just before it was disposed of.

There may still be some level of uncertainty (which also existed before the change to the timing rules for active

assets) in situations where one entity owns and operates the business and a separate, connected, entity owns the business premises. Assume, for example, that a factory is held by discretionary trust and the business operations are run through a company. The company leases the factory from the discretionary trust. Assuming both entities sell their assets to a third party, does the discretionary trust have to be a connected entity (ie to the company) for half the period it owned the factory, or merely at the point where the assets were sold?

There are different schools of thought concerning this issue. There are some who consider that as long as the trust was a connected entity just before the CGT event, the trust (as the owner) would then look at the meaning of active asset and work out whether it satisfied the conditions. In other words once the trust was a connected entity, the time that the asset was active was read in terms of the trust’s ownership period. The alternate view is that the trust has to be a connected entity for every year that the trust has to satisfy owning an active asset. A close reading of the legislation suggests that the former view is, arguably, the better view, but the matter is not free from doubt.

- (b) The pre-existing legislation contained an additional test for establishing whether shares in a company or interests in a trust were active assets.³⁵ An 80 per cent look through test was applied to the active assets of the company or trust. The Board recommended that to align this test with actual taxpayer circumstances and commercial practices, the 80 per cent test should be amended so that cash and financial instruments of the company or trust which are inherently connected with a business are included for the purposes of the 80 per cent look through test.³⁶

The Government has accepted this recommendation, so that cash and the market value of financial instruments are now treated as active assets in conducting the 80 per cent test.³⁷ There may, however, still be some on-going uncertainty in particular situations. For example, the original problem with subparagraph 152-40(3)(b)(ii) was that the cash or debt had to be held “pending the acquisition of new active assets”. This always posed a problem when the company was to be liquidated and the

small business CGT concessions were being claimed on the liquidation C2 event.

The original subparagraph has been replaced with:

- “(ii) the market value of any financial instruments of the company or trust that are inherently connected with a business that the company or trust carries on; and*
- “(iii) any cash of the company or trust that is inherently connected with such a business”.*

The tense used here is the present tense, whereas, in the liquidation scenario the business in most instances will have ceased to be carried on. The problem has not been entirely resolved notwithstanding the observation made in the EM (at paragraph 1.40) that the provision which related to the business that has ceased to be carried on is no longer necessary because the new inclusion for cash and financial instruments covers such capital proceeds.

In addition, the words “inherently connected with” may call for some clarification by the ATO of situations that would qualify.

- (c) The Board noted that monitoring this 80 per cent test on a continuous basis or over long periods of time was somewhat onerous in terms of the compliance burden, and recommended that the 80 per cent test should be deemed to have been met where breaches were only temporary in nature and in circumstances where it was reasonable to conclude that the 80 per cent threshold has been passed.³⁸ Again the Government has accepted this suggestion, and the amended legislation will apply from 1 July 2006. Examples 1.12 and 1.13 from the EM illustrate the operation of the amended legislation so far as the temporary clause is concerned.

Example

John sells an active asset, meets the basic conditions and makes a capital gain of \$500,000. He acquires shares in Fruit and Veg Co, which runs his family business, as replacement assets. The shares in Fruit and Veg Co meet the 80 per cent test and thus are active assets. Some time later, Fruit and Veg Co borrows money to pay a dividend, and fails the 80 per cent test. Two weeks later the dividend is paid and the shares pass the 80 per cent test again. For the two weeks, the shares are treated as active assets even though they do not pass the 80 per cent test.

Example

Georgina buys shares in a company that buys a property in order to start a farm. The property makes up 50 per cent of the asset value of the company. For the first year that she owns the shares, the company does not actively use the property. After that time, the company starts the farming business. The property is not active for the first year therefore the company does not pass the 80 per cent test. The shares are not treated as active because the company failed the 80 per cent test for an extended period of time (not just a temporary failure).

Note that the first example suggests that “temporary” is what it implies – of a short term nature (two weeks only). The amending legislation³⁹ is not forthcoming as to what is meant by temporary, which implies reliance on the ordinary dictionary meaning of the term if the matter were to come before the courts. The Macquarie Dictionary (Third Edition 1997) defines temporary as “lasting, existing, serving, or effective for a time only; not permanent...”. This is not entirely helpful and there will almost certainly be some interesting debate about how long a temporary failure to meet the active asset criterion can last.

Similarly there is a marked lack of clarity as to when it will be reasonable to conclude that further testing of the active status of an asset (through the 80 per cent test) is necessary. The legislation⁴⁰ simply posits a “reasonable to conclude” test. The EM suggests that taxpayers “are not required to continually apply the 80 per cent test if the test has been passed at some stage and there is no reason to think that the test will be failed at a later time. An example of when it will be reasonable to think the share or trust interest is still an active asset is when there have been no significant changes to the assets or liabilities of the company or trust”.⁴¹ This is not particularly helpful and may not provide the “safe harbour” that many wanted – it is ironic that a quest for greater certainty may have provided yet more uncertainty in the application of the legislation.

In addition to these “higher impact” changes affecting the active asset test, there are two “lower impact” legislative changes and two clarifications by the ATO. These are:

- the definition of active asset⁴² is amended to ensure that intangible assets that are inherently connected

with the business of a small business CGT affiliate or connected entity are also active assets, in line with the original policy intent (Recommendation 7.4);

- the definition is also amended to limit the situations when shares and trust interests held in widely held entities can be active assets to those situations where the shares/trust interests are held by a CGT concession stakeholder, again in line with the original policy intent (Recommendation 7.7);
- the Board recommended that the Commissioner should provide detailed written guidance indicating the circumstances in which he would exercise the discretion to extend the 12 month limit for a taxpayer to dispose of a formerly active asset (Recommendation 7.2). The removal of the requirement that the asset be active within 12 months of the cessation of the business has rendered this recommendation otiose; and
- the Board recommended that the Commissioner should provide detailed written guidance clarifying the interpretation of some of the concepts and terms used in the active asset definition and test, such as “hold ready for use”, “main use” and “temporary use” (Recommendation 7.3). This clarification has been provided within some of the Taxation Determinations that were issued in 2006, including TD2006/63, 2006/67, 2006/70 and 2006/78.

The controlling/significant individual and concession stakeholder test

The change from controlling individual to significant individual

As noted earlier, where an individual made a capital gain in respect of the disposal of shares in a company or interests in a trust, that individual could only access the small business concessions if (under the pre-existing legislation) there was a controlling individual. To be a controlling individual, an individual had to hold legal and equitable interests in at least 50 per cent of the votes, rights to dividends and rights to capital distributions. For a fixed trust, the test involved the individual being beneficially entitled to at least 50 per cent of the capital and income of the trust. With discretionary trusts, the test related to any capital or income distributions in the year in which the disposal occurred, and again

required at least a 50 per cent distribution of either (or both where both categories of distribution occurred in the year) for the test to be satisfied. Only directly held interests counted in all cases.

This controlling individual test will, from 1 July 2006, be replaced with a significant individual test. This particular change is not a response to the Board of Taxation report (although the Board alluded to the need for change in the policy section of the report), but certainly represents the most far-reaching and positive of all the changes currently being enacted. The test to be satisfied will now only require a 20 per cent test to be satisfied, and both direct and indirect interests can be taken into account. As a result of the change, up to eight taxpayers will be able to benefit from the full range of concessions instead of the current limit of two controlling individuals.

The EM⁴³ notes that the small business concessions are intended for active participants in a small business, and the significant individual test represents a readily verifiable proxy for active participation. This reflects the fact that there is typically minimal separation between significant underlying ownership and management in small businesses. Put more simply, those who own a small business tend to run the business.

The new significant individual test is therefore predicated upon the concept of establishing whether the individual has a *small business participation percentage* ("SBPP") in the company or trust of at least 20 per cent. The manner in which this SBPP is calculated broadly follows the mechanism of the old controlling individual test, though with changed terminology and also taking into account indirect as well as direct interests.

Hence an entity's direct SBPP in a company is the smaller or smallest percentage of voting power that the entity is entitled to exercise, or any dividend payment that the entity is entitled to receive, or any capital distribution that the entity is entitled to receive. An entity's indirect SBPP in a company is calculated by multiplying together the entity's direct SBPP in an interposed entity, and the interposed entity's total SBPP (both direct and indirect) in the company.

An entity's direct SBPP in a trust, where entities have entitlements to all the income and capital of the trust, is the smaller percentage of the income

and capital of the trust that the entity is beneficially entitled to receive. An entity's indirect SBPP in such a trust is calculated by multiplying together the entity's direct SBPP in an interposed entity, and the interposed entity's total SBPP (both direct and indirect) in the trust.

An entity's direct SBPP in a trust, where entities do not have entitlements to all the income and capital of the trust and if the trust made distributions of income or capital in the year, is the smaller percentage of the income and capital distributions of the trust that the entity is beneficially entitled to receive in the income year. An entity's indirect SBPP in such a trust is calculated by multiplying together the entity's direct SBPP in an interposed entity, and the interposed entity's total SBPP (both direct and indirect) in the trust. If such a trust did not make a distribution of income or capital during the income year, it will not have a significant individual in that income year.

Example 1.2 from the EM illustrates how these rules operate to identify who may, or may not be significant individuals.

Example

Discretionary Trust owns 100 per cent of the shares in Operating Company; therefore Discretionary Trust has a 100 per cent direct interest (and no indirect interest) in Operating Company.

Anna receives 80 per cent of the distributions from Discretionary Trust; therefore she has a direct participation percentage of 80 per cent in Discretionary Trust. To find Anna's participation percentage in Operating Company, multiply together Anna's direct participation percentage in Discretionary Trust and Discretionary Trust's total participation percentage in Operating Company.

$$80 \text{ per cent} \times 100 \text{ per cent} = 80 \text{ per cent}$$

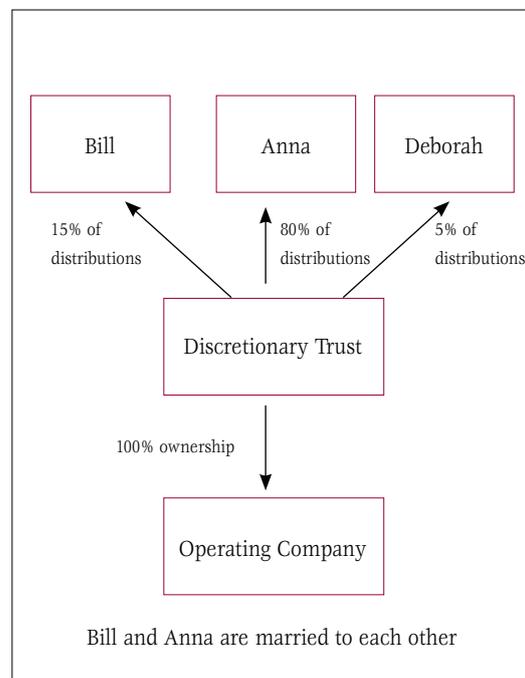
Anna has an 80 per cent participation percentage in Operating Company and is therefore a significant individual of Operating Company.

Bill receives 15 per cent of the distributions from Discretionary Trust; therefore he has a direct participation percentage of 15 per cent in Discretionary Trust. To find Bill's participation percentage in Operating Company, multiply together Bill's direct participation percentage in Discretionary Trust and Discretionary Trust's total participation percentage in Operating Company.

$$15 \text{ per cent} \times 100 \text{ per cent} = 15 \text{ per cent}$$

Bill has a 15 per cent participation percentage in Operating Company and is therefore not a significant individual of Operating Company. (As a spouse of a significant individual with a participation percentage greater than zero in the entity, Bill will be a CGT concession stakeholder.)

Deborah receives 5 per cent of the distributions from Discretionary Trust; therefore she has a direct participation percentage of 5 per cent in Discretionary Trust. To find Deborah's participation



percentage in Operating Company, multiply together Deborah's direct participation percentage in Discretionary Trust and Discretionary Trust's total participation percentage in Operating Company.

$$5 \text{ per cent} \times 100 \text{ per cent} = 5 \text{ per cent}$$

Deborah has a 5 per cent participation percentage in Operating Company and is therefore not a significant individual of Operating Company. (Deborah is not a CGT concession stakeholder.)

These changes from the controlling individual test to the significant individual test also mean that there can now be more than two concession stakeholders able to access the concessions. A person is a CGT concession stakeholder if they are a significant individual or the spouse of a significant individual with some SBPP in the company or trust. Hence four 20

per cent shareholders in a company, plus their four spouses (each with a small stake in the company) could be concession stakeholders. The SBPP held by the spouses can be held directly or indirectly through interposed entities, and is calculated in the same way as for the significant individual test.

While the shift from controlling individual to significant individual is a welcome and generous change, there are still areas of uncertainty (some of which are not new) in the way that the rules will operate. For example, the participation percentage for a discretionary trust is based on whether the trustee makes a distribution of income and or capital in a particular income year. If there are no distributions in a particular year, there is no one with a participation percentage.⁴⁴ An important issue (still unresolved) is what does the term 'distribution' mean? Is a present entitlement sufficient or does the trustee need to actually make a payment in that particular year. The EM is not helpful on this point.

The alternative concession stakeholder test

Under the pre-existing legislation, the small business concessions were unlikely to be available on the disposal of shares in a company or interests in a trust where there was an interposed entity between the individual disposing of the shares and the entity operating the business. Hence the typical structure involving individuals with beneficial interests in a discretionary trust where the trust owned the shares in an operating company (hence protecting the individuals from possible claims if the company were to fail) was not, in the past, amenable to access to the concessions. This will all change for the better as a result of another current amendment to the legislation, again not based specifically upon a Board of Taxation recommendation.

This amendment sees the introduction of an alternative test to the concession stakeholder test mentioned above. From 1 July 2006, where the CGT event happens to a share in a company or an interest in a trust, either the entity making the gain must be a concession stakeholder (which means the entity must be an individual: the existing test) or concession stakeholders must hold a SBPP of at least 90 per cent in the interposed entity that is disposing of shares or interests (the alternative test). This 90 per cent test only applies if there is an interposed entity between the CGT concession

stakeholder(s) and the company or trust in which the shares or interests are held (referred to as the object company or trust in the amending legislation⁴⁵). The interposed entity satisfies the test if 90 per cent of the SBPP in that entity are held by CGT concession stakeholders of the company or trust in which the shares or interests are held.

The following example, adapted from an example in the amending legislation, illustrates the operation of this alternative test.

Example

A discretionary trust sells shares in an operating company (the object company). Anna receives 90 per cent of the distributions from the trust. The trust has a 50 per cent interest in the object company.

The trust cannot be a CGT concession stakeholder in the object company under the existing test because it is not an individual.

However the trust can satisfy the alternative test because Anna is a concession stakeholder in the object company (because her SBPP in the object company is 45 per cent, which is more than 20 per cent) and her SBPP in the trust is 90 per cent.

Changes to the concessions

In addition to the welcome changes to the three eligibility tests, there are also a number of changes that impact directly upon the specific conditions that apply within the rules for each of the four small business concessions.

The 15 year exemption

The revised small business concessions bring one very significant and useful change to the 15 year exemption, amplified by modifications put forward in the Government's response to Board of Taxation Recommendation 10.2. The pre-existing legislation required that there be a controlling individual (though not necessarily the same one) over the entire period of ownership of the asset before the 15 year exemption could be claimed. The Board proposed that the period in which there had to be a controlling individual during the period in which the asset was owned by an entity should be restricted to just the last 15 years of ownership where the entity was claiming the 15 year exemption. The Government has introduced amendments, operative from 1 July 2006 once enacted, that not only require ownership simply by a significant

individual (20 per cent test) rather than a controlling individual (50 per cent test), but also enable the 15 years of ownership to be satisfied by any 15 year period (or periods) in total, not just the last 15 years. As with the controlling individual test, it does not have to be the same significant individual over the 15 year period(s).⁴⁶ Thus individuals claiming the 15 year exemption in respect of directly held active assets or shares in a company or interests in a trust, or trusts or companies claiming the 15 year exemption in respect of assets they own, will find access to the 15 year exemption much easier than hitherto.

Examples 1.16 and 1.17 from the EM show how the new provisions work.

Example

Julie owned 10 per cent of the shares in Juice Company for 18 years from 1987 to 2005. For five years (1987 to 1992) she owned another 10 per cent and was a significant individual. For a different 10 years (1995-2005), another person (Edward) was a significant individual. The significant individual requirement is met for Julie's shares.

Example

From the previous example, Juice Company had a factory for the last 18 years. Julie was a significant individual for five years and Edward was a significant individual for 10 years. Juice Company will satisfy the significant individual requirement in relation to the factory.

In addition to this increased flexibility, there are three minor amendments to the operation of the 15 year exemption:

- amending legislation clarifies that a payment to a concession stakeholder from a company or trust that is disregarded under the 15 year exemption will have no other tax consequences – it will not constitute a dividend and will not be a frankable distribution. Further, the amending legislation also makes it clear that a payment relates to the exempt amount to the extent that it represents the distribution of the capital gain;⁴⁷
- amending legislation gives the Commissioner a discretion to extend the two year period in which a company or trust must make the payment of the exempt amount to a CGT concession stakeholder;⁴⁸
- Recommendation 10.1 of the Board report suggested that the ATO should

provide guidance in relation to the meaning of “in connection with retirement” and “permanent incapacity” in the context of the 15 year exemption. It is understood that guidance on this point is likely to be provided in the updated version of the *Advanced guide to capital gains tax concessions for small business*, which is due to be issued in the near future.

The 50 per cent small business reduction

Very little revision has taken place to the 50 per cent small business reduction, reflecting the fact that there are very few further rules or conditions to be met for this concession once an entity has satisfied the broad eligibility requirements. The only change recommended by the Board⁴⁹ sought administrative guidance from the ATO on the impact of the distribution of the 50 per cent reduction amount to interest holders in a trust – clarifying that CGT event E4 would arise which could give to further capital gains.

In Taxation Determination TD2006/71 the Commissioner confirms that this is the case, and provides two extensive examples which show the interaction of the 50 per cent CGT discount, the 50 per cent small business reduction and CGT event E4, in the context of distributions by a unit trust.

The retirement exemption

The Board report made a total of eight recommendations concerning the retirement exemption. Of these, two were considered to be of higher level impact. However, as noted above, one of these two recommendations (relating to the potential interaction with the deemed dividend provisions) was not accepted by the Government. As a result there is only one change which the Board of Taxation considered to be significant in this area, and a number of minor changes.

The significant change is that payments made by a company or trust to an employee of an amount exempted under the retirement exemption are deemed to be payments in respect of the termination of employment of the employee. There is now no need for an actual termination of employment. Further, payments made by a company or trust to a non-employee of an amount exempted under the retirement exemption are deemed to be an eligible termination payment.⁵⁰

The other changes to the retirement exemption, less significant in the view of the Board of Taxation, though practitioners

Re-assess existing structures to identify significant individuals and concession stakeholders

may well be expected to differ so far as the first two at least are concerned, cover the following points:

- amending legislation clarifies that the time at which an individual has to be 55 or over is the point at which the choice for the retirement exemption is made (ie when the return is lodged), rather than the time at which the capital proceeds are received (which would usually be earlier).⁵¹ Example 1.18 from the EM illustrates the point:

Example

Jamie sells his factory, satisfies the basic conditions and makes a capital gain of \$400,000. Jamie is aged 54 when he receives capital proceeds from the sale. He had not decided what to do with the money at that time. Jamie turns 55 years of age, and decides when lodging his income tax return, that he wants to use the retirement exemption – he is not required to pay the money into a superannuation fund because he was aged 55 just before he made the choice.

Practitioners will immediately recognise that this change gives their clients who are approaching the age of 55 considerably more flexibility.

- previously the retirement exemption did not apply to the gifting of property. As a result of the amendments, the retirement exemption can also apply to the gifting of property. As there are no capital proceeds from the event the market value substitution rule applies to determine the amount of deemed capital proceeds. If the individual disposing of the asset is 55 or over, they can use the retirement exemption if they meet the basic conditions. If they are under 55, they can access the retirement exemption provided that they meet the basic conditions and pay an amount equal to the disregarded capital gain into a superannuation fund. Example 1.19 from the EM illustrates the point:

Example

Amber, a farmer aged 52, decided that she wanted to give her farm to her son Frank. She made a capital gain of \$150,000 on the gift of the asset to Frank. Provided that

Amber meets the basic conditions, she can put \$150,000 into a superannuation fund and use the retirement exemption to disregard the capital gain. (If Amber was 55 or over she would not need to pay the amount into a superannuation fund to gain access to the retirement exemption.)

Again, this change will provide welcome enhanced flexibility to retirement and inter-generational succession planning strategies.

- the Board recommended that the Commissioner should publish guidance to assist taxpayers in three areas: on the interaction of the retirement exemption and the provisions relating to ETPs, superannuation and SMSFs,⁵² on the application of the deemed market value provisions and cost base rules where non-arm's length transactions (for example with inter-generational family transfers) were involved,⁵³ and on required RBL reporting requirements where an ETP arises under the retirement exemption.⁵⁴ Some further guidance on these points has been provided in Taxation Determinations 2006/67 and 2006/68. It is understood that further guidance will also be provided in the updated version of the *Advanced guide to capital gains tax concessions for small business*, which is due to be issued in the near future.

The roll-over

The Board of Taxation made five recommendations for legislative change to the small business roll-over⁵⁵, and three further recommendations seeking administrative clarification or guidance from the ATO.⁵⁶ All of the recommendations have been adopted in Government and ATO responses. Sadly, in fine-tuning and “tidying up” the provisions relating to the small business roll-over, new layers of complexity have been added. Practitioners may find these provisions ultimately rewarding for their clients and themselves, but they will not find them easy. Almost capriciously, two new CGT events – J5 and J6 – are introduced (when it might have been thought that careful legislative design would have got away with only one new

event at worst); and two old events (J2 and J3) have been integrated into one (J2).

The better news is that, in essence, the changes that have been made are relatively simple to explain. Moreover, one of the changes appears to give all taxpayers that satisfy the basic requirements for access to the small business concessions an automatic two year deferral of the tax liability, regardless of whether or not they wish to access any or all of the small business concessions. Tax holidays are not easy to come by, but this seems a remarkably, if not ridiculously, generous bonus for the small business sector.

Reduced to the simplest level, the three more significant changes to the roll-over that will apply from 1 July 2006 are as follows:

- (a) a taxpayer can choose to roll-over all or part of a capital gain. Previously the taxpayer only had an all or nothing option;
- (b) replacement assets can be newly acquired assets or improvements to assets that the taxpayer already owns. Previously a replacement asset could only be a newly acquired asset; and
- (c) a taxpayer can choose to roll-over a capital gain before acquiring a replacement asset or making a capital improvement (also counted as a replacement asset). Previously the taxpayer would have had to return a capital gain if they had not yet acquired a replacement asset, and would then have had to have sought an amended assessment following the later acquisition of a replacement asset. Under the new rules, CGT event J5 will happen if no replacement assets are held at the end of the two year period, and CGT event J6 will happen if insufficient replacement assets are held at the end of two years. In addition, the Commissioner has the discretion to extend the replacement asset period (which normally ends two years after the CGT event to which the roll-over applies).

Examples 1.21 and 1.23 from the EM show how CGT events J5 and J6 will operate.

Example

In 2004, Jennifer makes a capital gain of \$80,000 on an active asset and meets the maximum net asset value test. Jennifer disregards the whole capital gain under the small business roll-over.

In 2006, Jennifer does not have any replacement assets by the end of the two-year period. CGT event J5 happens and Jennifer makes a capital gain of \$80,000.

Example

In 2004, Abby makes a capital gain of \$700,000 on an active asset and meets the maximum net asset value test. Abby chooses to disregard the whole capital gain.

In 2005, Abby purchased new business premises for \$300,000 and spent \$150,000 on improving some other assets. The replacement assets meet all of the relevant conditions. However, the amount of expenditure on the replacement assets is only \$450,000. The capital gain that was rolled over was \$700,000.

In 2006, two years after the original CGT event, CGT event J6 happens because there has been insufficient expenditure and Abby makes a capital gain of \$250,000. The roll-over of \$450,000 of the original capital gain continues.

Note, however, that the tax deferral before J5 or J6 comes into play may potentially come at a cost. If there is ultimately a J5 or J6 CGT event rather than a capital gain two years earlier, the 50 per cent CGT discount will not be available. Taxpayers may therefore decide that it is better to take the CGT hit at the earlier point, when they can potentially access the 50 per cent CGT discount, rather than defer the CGT event and lose the discount.

As noted above, the Board also made three recommendations for ATO clarification and guidance in relation to the small business roll-over:

- Recommendation 13.2 suggested that the Commissioner should provide guidance in relation to when the discretions to extend the timeframe in which to acquire replacement assets, and in which the assets must be “active”, is likely to be exercised. It is understood that guidance on this point is likely to be provided in the updated version of the *Advanced guide to capital gains tax concessions for small business*, which is due to be issued in the near future;
- Recommendation 13.6 suggested that the Commissioner should issue a practice statement or other guidance clarifying whether taxpayers should include capital gains in their returns when they are intended to be rolled over or whether the return may be lodged without the gain, together

with guidance in relation to the circumstances in which tax shortfall penalties and/or interest charges will be remitted. The decision to adopt Recommendation 13.5 (the “automatic” deferral of the capital gain, with possible later crystallisation under J5 or J6 – see (c) above) has rendered this particular recommendation otiose in most circumstances; and

- Recommendation 13.9 suggested that the Commissioner should provide further guidance on the interaction of the small business roll-over (and particularly CGT events J2 and J3) with the death provisions in Div 128. It is understood that further guidance is likely to be provided in the updated version of the *Advanced guide to capital gains tax concessions for small business*, which is due to be issued in the near future.

Deceased estates

One final change relates to the availability of all four of the concessions in situations where a taxpayer, who would otherwise have been eligible for the concessions, dies. The Government has accepted Recommendation 13.8 of the Board of Taxation report, and the legislation is being amended to allow both the legal personal representative (LPR) or the beneficiary of the deceased to continue to be able to access the four concessions in respect of CGT events that occur within two years of the death of the individual. In effect this mirrors the two year timeframe available to LPRs and beneficiaries to dispose, tax-free, of a main residence of the deceased.

The Commissioner also has the discretion to extend this two year period.

So far as the 15 year exemption is concerned, the requirement that the CGT event happens in relation to the retirement of the individual is waived. So far as the retirement exemption is concerned, there is no need for the amount to be paid into a superannuation fund, even if the deceased was less than 55 years of age just before the death.

Planning points under the new regime

The previous section of this paper has provided details of the very broad range of changes that have been implemented, or are currently in the process of being

implemented, so far as the small business CGT concessions are concerned. With the exception of the increase in the maximum net asset value test from \$5 million to \$6 million (which takes effect from 1 July 2007), the changes will apply from 1 July 2006 once enacted.

Virtually without exception the changes make an already generous set of provisions even more generous, although many of the changes are really only fine-tuning and tinkering at the margin. Nonetheless there are some significant changes, and practitioners need to ensure that they have a good understanding of the revised regime in order to ensure that they maximise the benefits for their clients (and for themselves). The remainder of this concluding section highlights a number of key planning points that practitioners should not overlook.

Consider the opportunity for tax deferral

All taxpayers that satisfy the basic eligibility criteria for the small business concessions and who make relevant capital gains should consider lodging their returns for the year of gain on the assumption that the small business roll-over will be claimed (ie not returning the capital gain). They will thus defer payment of any tax on the capital gains for two years, regardless of whether they do wish to use any of the small business concessions.

Obviously this will not be of any true economic value for those taxpayers able to use the 15 year exemption, the retirement concession or the small business 50 per cent reduction to reduce capital gains made on active assets. But if there are any residual gains, they can be effectively deferred for two years whether or not replacement assets are acquired. Note, also, though, the potential loss of the 50 per cent CGT discount if the deferral is taken and where a CGT event J5 or J6 is subsequently crystallised.

Re-assess existing structures to identify significant individuals and concession stakeholders

The new rules for significant individuals/concession stakeholders create the opportunity for far more individuals to qualify for the concessions than did the old controlling individual/concession stakeholder test. Practitioners should re-assess existing entity structures to establish:

- whether the new 20 per cent significant individual test now brings clients who were previously outside the regime within it (particularly those holding more than 20 per cent but less than 50 per cent interests);
- whether the new 90 per cent alternative test to establish small business concession stakeholder status brings previously non-compliant structures within the new regime, particularly where interposed entities are involved and particularly enabling individuals with interests in such entities to qualify as concession stakeholders.

Take advantage of the repealed partnership test

The repeal of the secondary maximum net asset value test for partnerships will enable many partners belonging to high value partnerships to take advantage of the small business concessions where previously they would have been precluded. This modification to the rules will be particularly advantageous to partners who are disposing of interests in partnership assets in high net worth partnerships. But note that the maximum net asset value test will still potentially have to include 100 per cent of the value of the partnership where the partner controls the partnership through a 40 per cent or greater interest.

Set the clock running on active assets

Active assets do not have to be active for half the period of ownership where that period exceeds 15 years. It suffices for them to be active (or to have been active) for a maximum of 7.5 years. As a result of the changes they now no longer need to be active at (or close to) the point of disposal. Hence it will make sense for practitioners – wherever possible – to establish the on-going active asset status of an asset as early as possible in the period of ownership, by keeping it active for 7.5 years. Thereafter, its subsequent use (active or inactive) will not matter.

Keep the clock running on active assets

Once it has been established that a share in a company or an interest in a trust is an active asset through the 80 per cent trace through test, there is no need to keep checking for active status so long as any change is temporary or so long as there are no significant changes in the assets or liabilities of the company or trust. Nonetheless, ensure that full documentary evidence exists that the 80 per cent test

has been properly conducted in the first place.

Death doesn't have to be terminal for the concessions

Where relevant, take advantage of the two year extension period after death for disposals now available to LPRs and beneficiaries of deceased estates. Remember that the assets will need to have been active business assets so far as the deceased person was concerned, and the deceased would have to have been otherwise eligible for the small business concessions. There will only be limited (and unfortunate) circumstances where this modification of the rules will be useful, but it would be a shame not to take advantage of it where it is available.

Chris Evans

Reference notes

- 1 This article is based upon a paper presented by Chris Evans at the 22nd National convention of the TIA in Hobart, March 2007.
- 2 Professor of Taxation and former Director, the Australian School of Taxation, UNSW. The author is grateful to Moira Merrick and Ken Schurgott for their comments on an earlier draft.
- 3 Initially contained in Part IIIA Income Tax Assessment Act 1936 (ITAA36), and from 1 July 1998, rewritten as Parts 3-1 and 3-3 Income Tax Assessment Act 1997 (ITAA97).
- 4 Section 160ZZR ITAA36.
- 5 Contained in Div 152 ITAA97.
- 6 TIA Media Release (1999), 19R-22R, Sydney, Taxation Institute of Australia (21 September); Chris Evans (2000), "The new regime: CGT after Ralph", *The Tax Specialist*, Vol 3 No 6 (June). For a concise summary of the legislative development of the small business concessions in the period from 1985 through to 2005, refer to Chapter 3 of "Post implementation review of the quality and effectiveness of the small business capital gains tax concessions in Division 152 of the Income Tax Assessment Act 1997: A report to the Treasurer", Board of Taxation, October 2005, accessed at http://www.taxboard.gov.au/content/post_imp_small.asp.
- 7 The 15 year exemption in Subdiv 152-B, the 50 per cent reduction in Subdiv 152-C, the retirement exemption in Subdiv 152-D and the roll-over in Subdiv 152-E ITAA97.
- 8 Peter van den Broek (2006), "CGT small business concessions and interposed entities: between a rock and a hard place", *Capital Gains Tax Bulletin*, 19 (2), Thomson ATP.
- 9 In a 2002 survey of over 300 Australian tax practitioners dealing regularly with the small business concessions, an overwhelming majority (77 per cent) agreed that "the CGT small business concessions are difficult to understand" and most (56 per cent) disagreed with the view that they "are easier to apply now than five years ago". Chris Evans (2003), *Taxing personal capital gains: operating cost implications*, ATRF, pp 209-210.
- 10 For a full discussion of the policy implications of the small business CGT concessions, refer to Chapter 6 of Chris Evans (2003), *Taxing personal capital gains: operating cost implications*, ATRF.
- 11 "Post implementation review of the quality and effectiveness of the small business capital gains tax concessions in Division 152 of the Income Tax Assessment Act 1997: A report to the Treasurer", Board of Taxation, October 2005, accessed at http://www.taxboard.gov.au/content/post_imp_small.asp.
- 12 Division 35 ITAA97.
- 13 Para 1.2 "Post implementation review of the quality and effectiveness of the small business capital gains tax concessions in Division 152 of the Income Tax Assessment Act 1997: A report to the Treasurer", Board of Taxation, October 2005, op cit.
- 14 Chris Evans, Binh Tran-Nam and Gordon Cooper.
- 15 Para 1.34, "Post implementation review of the quality and effectiveness of the small business capital gains tax concessions in Division 152 of the Income Tax Assessment Act 1997: A report to the Treasurer", Board of Taxation, October 2005, op cit.
- 16 Treasurer's Press Release No. 038 "Capital Gains Tax (CGT): Government response to the Board of Taxation's report on the post-implementation review of the small business CGT concessions and other improvements", 9 May 2006, accessed at <http://www.treasurer.gov.au/tsr/content/pressreleases/2006/038.asp?pf=1>.
- 17 Section 109 and Division 7A ITAA36.
- 18 Tax Law Amendment (2006 Measures No. 7) Bill 2006.
- 19 Treasurer's Press Release No. 039 "Further measures to simplify and streamline the tax system", 9 May 2006, accessed at <http://www.treasurer.gov.au/tsr/content/pressreleases/2006/039.asp?pf=1>.
- 20 Treasurer's Press Release No. 123 "Making tax compliance easier for small business – the new small business framework", 13 November 2006, accessed at <http://www.treasurer.gov.au/tsr/content/pressreleases/2006/123.asp?pf=1>.

- 21 Section 152-15(b) ITAA97.
- 22 Note that there is some uncertainty as to whether a partnership is an 'entity' for these purposes. The word 'entity' is not asterisked and it might be argued that it doesn't refer to the definition in Division 995, which would in turn take you to section 960-100 (which treats a partnership as an entity).
- 23 Recommendation 6.6 Board of Taxation report, *op cit*.
- 24 Recommendation 6.7 Board of Taxation report, *op cit*.
- 25 Subs 152-20(3) and (4) ITAA97.
- 26 Recommendation 6.10 Board of Taxation report, *op cit*.
- 27 Recommendation 6.1 Board of Taxation report, *op cit*.
- 28 Recommendation 6.4 Board of Taxation report, *op cit*.
- 29 Arguably the example may be wrong because subpara 152-30(2)(c)(ii) requires the person to have the power to determine the "manner" in which the trustee exercises the power to make payments of income or capital. Simply having a power to replace the trustee is not the same as a power over the exercise of power by the trustee. The ATO's view appears to ignore the quite pointed use of the word "manner" in the legislation.
- 30 Recommendation 6.5 Board of Taxation report, *op cit*.
- 31 Section 152-10(1)(d) and sec 152-35 ITAA97.
- 32 Section 152-35 ITAA97.
- 33 Recommendation 7.1 Board of Taxation report, *op cit*.
- 34 Section 152-35 ITAA97, as amended.
- 35 Section 152-40(3) ITAA97.
- 36 Recommendation 7.5 Board of Taxation report, *op cit*.
- 37 Section 152-40(3)(b)(ii) ITAA97, as amended.
- 38 Recommendation 7.6 Board of Taxation report, *op cit*.
- 39 Section 152-40(3B) ITAA97, as amended.
- 40 Section 152-40(3A) ITAA97, as amended.
- 41 Para 1.41 Explanatory Memorandum to the Tax Laws Amendment (2006 Measures No. 7) Bill 2006.
- 42 Section 152-40 ITAA97, as amended.
- 43 At para 1.19.
- 44 Note that there is an exception for the 15 year exemption where a trust has a tax loss or no taxable income.
- 45 Section 152-10(2) ITAA97 as amended.
- 46 Paras 152-105(1)(c) and 152-110(1)(c) ITAA97 as amended.
- 47 Section 152-125 as amended, based upon Recommendation 10.3 Board of Taxation report, *op cit*.
- 48 Section 152-125 as amended, based upon Recommendation 10.4 Board of Taxation report, *op cit*.
- 49 Recommendation 11.1 Board of Taxation report, *op cit*.
- 50 Section 152-325 as amended, based upon Recommendation 12.1 Board of Taxation report, *op cit*.
- 51 Section 152-305 as amended, based upon Recommendation 12.2 Board of Taxation report, *op cit*.
- 52 Recommendation 12.3 Board of Taxation report, *op cit*.
- 53 Recommendation 12.4 Board of Taxation report, *op cit*.
- 54 Recommendation 12.6 Board of Taxation report, *op cit*.
- 55 Recommendations 13.1, 13.3, 13.4, 13.5 and 13.7 Board of Taxation report, *op cit*.
- 56 Recommendations 13.2, 13.6 and 13.9 Board of Taxation report, *op cit*.

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