

25th February, 2005

The Board of Taxation
Treasury Building
Langton Crescent
PARKES ACT 2600

Dear Sir,

RE: POST IMPLEMENTATION REVIEW OF THE SMALL BUSINESS CAPITAL GAINS TAX CONCESSIONS

Thank you for the opportunity to our submission in relation to the operation of the small business capital gains tax concessions.

Hayes Knight is a national federation of accounting firms with a focus on small and medium business. The vast majority of our clients are SMEs. In addition we provide a support service to other small to medium accounting firms who focus on the SME market. This support service is provided through the Hayes Knight Professional Network which currently has approximately 430 member firms. As part of our support service we provide a help desk to those firms where they can put to us questions in relation to tax technical problems they may be encountering. Last year, alone, our help desk dealt with over 8,000 questions. Of this number 27% were based on CGT issues with the vast majority relating to the CGT small business concessions. Our Professional Network is based throughout Australia in both regional and metropolitan areas and we estimate the number of SMEs represented by these firms together with Hayes Knight offices across Australia to be approximately 120,000 SMEs or about 12% of the SME population. On this basis we believe our experience is representative of the SME market in Australia.

Our submission is based on our own experience in dealing with the small business concessions and areas raised by our Professional Network as they deal with issues on behalf of their clients.

You have indicated that the intent of your review is to 'gauge how effective the legislation has been in delivering the policy intent'. We understand that broadly the policy intent of the small business concessions provided in Division 152 were to:

- provide an additional taxation benefit to the small business community
- remove the CGT impediment that may have existed for small business owners to invest in their business
- provide flexibility for small business owner in accessing the benefits and with view to dealing with the life cycle of a small business owner
- reduce complexity and to ensure that compliance costs for both SMEs and the Australian Taxation Office were not increase
- provide a clear and effective piece of legislation capable of being utilised by SME owners and their advisers

Associated Offices

QLD Brisbane
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The balance of our submission will focus on these areas initially by providing you with a brief general commentary on the effectiveness of the legislation relative to the policy intent. From there we will focus on specific areas where the current legislation may be at conflict with the policy intent.

GENERAL COMMENTARY

It is recognised and acknowledged that the small business CGT concessions have provided additional taxation benefits to the small business community and in turn encouraged investment by SME owners through the flexibility provided to them. We have many examples of where these concessions have worked well for SME owners and where these taxpayers have been able to move between businesses or from business to retirement. For these taxpayers the concessions have provided avenues for them to manage ongoing investment in business and to provide for their retirement. They work at their best with a family business where the shareholding is held by husband and wife. The flexibility of the concessions provide taxpayers with some options and encourages some longer term planning.

The areas where the concessions seem to fall short or fail the policy intent include:

- clarity and simplicity of understanding and use of the concessions
- resultant complexity and compliance costs
- SME's outside of the husband wife family business and generational succession issues

We comment on each of these briefly.

a) Clarity and Simplicity

The small business concessions provided in Division 152 fail any test of simplicity or clarity. They are generally not understood at all by the SME community and in many cases even their advisers struggle with understanding their operation. The fact that approximately one in every five questions we field from our Professional Network deals with a small business CGT concession is a testament to this. This is not new legislation. It has been around for a number of years and yet we continue to see a general lack of understanding of its operation and continuing anomalies arising.

The difficulty and consequence of this is magnified through two facts.

1. CGT events are not every day events for most SME owners and their advisers. They deal with these on an infrequent basis by comparison to other taxation transactions.
2. A CGT event can often be a major financial transaction for an SME owner. If they get it wrong there can be a significant financial impact.

There is a general willingness on the part of the SME community and their advisers to be tax compliant however this willingness is not assisted by the operation of Division 152. It too easily gives rise to unintended errors in self assessing taxation treatments of events.

b) Complexity and Compliance Costs

The complexity of the small business CGT concessions together with their operation, often relating to significant financial transactions by SMEs, ensures an increase in compliance costs. To be able to provide clear, accurate and meaningful advice around the application of the concessions is generally expensive. Many advisers decline to provide such advice because they are not dealing in this area frequently enough and are not sufficiently certain around the application of the legislation. As a result their clients are often referred to a firm with greater experience in the area. Typically advice fees are significant.

In some cases clients decline advice on the basis of the fees being charged and deal with their CGT event 'on a best endeavours basis'. From an advisers perspective it is not possible to provide quick or inexpensive advice because of the nature of the legislation and the considerations that are generally required. There are too many anomalies within the legislation or areas where there are fine dividing lines. These dividing lines, at times, are driven by different rules for different structures. Under this legislation SMEs can be treated differently simply based on the nature of their operating structure, whilst the fundamental business unit is consistent.

A further reflection of the complexity and increase in compliance costs can be seen in the initial reviews undertaken by the ATO approximately two years ago. These reviews were initiated where SMEs had declared CGT events and the subsequent utilisation of the small business concessions. In a number of cases reviews were undertaken by forwarding the taxpayer who claimed the concessions a questionnaire for their completion. This questionnaire needed to be completed and returned to the ATO together with documentation to support the questionnaire response. The fact that a single CGT event and application of the concessions could result in a questionnaire that ran to more than fifteen pages suggests that the application of the legislation is complex. Very few SMEs would be able to complete the review on their own behalf. For taxpayers involved in such a review they incur the additional costs of their advisers completing the review questionnaire. We understand that these reviews completed by the ATO identified a number of errors in the application of the concessions and this has resulted in ongoing compliance work in this area. Compliance costs for both taxpayers and the regulator are likely to have increased as a result of the operation of these concessions.

c) SMEs outside of the husband wife family business and generational succession issues

The effectiveness of the concessions start to break down once the family unit extends beyond a simple husband wife format. Where there are other family members holding equity in the business there are increasing challenges to meet some of the tests. This can be further aggravated where generational succession is contemplated and where family members are looking to take equity in the business over a progressive time period. The legislation does not readily accommodate generational succession, particularly as it relates to the controlling individual test.

For established businesses, and who presumably represented a significant stakeholder group, for the original policy intent, there is a tension between pre existing structures and the ability to maximise the effectiveness of the concessions offered. Whilst new businesses are afforded a clearer planning route there is the tension between structuring the business to maximise the longer term taxation concessions and other shorter term non tax considerations. This raises the question about to what extent the concessions offered reflect normal commercial SME life in Australia. We do not believe that the policy intent was to modify commercial direction but rather to enhance it through greater tax flexibility and incentive.

SPECIFIC ISSUES

Below we identify a range of specific problems being encountered in the operation of the small business CGT concessions.

CONTROLLING INDIVIDUAL TEST

A number of SMEs are disadvantaged relative to the small business concessions where they have pre existing structures that may not meet some of the concession tests. Examples of these can include:

1. where company or trust interests are held by family members but where no family member holds a 50% interest e.g a family company where mum, dad and child are equal shareholders
2. where company or trust interests are held by interposed entities and not individuals
3. where trust deeds provide different income and capital beneficiaries
4. companies where directors have discretion to pay dividends to one class of shareholder at the exclusion of another
5. where the business is owned by two family groups rather than one

These examples frequently exist with entities established prior to the implementation of the small business concessions. Whilst they are family businesses and presumably within the intent of the policy provision, they are disadvantaged as a result of the design of their structure. The existing controlling individual test needs to be relaxed to accommodate typical SME business ownership structures.

15 YEAR EXEMPTION

Where a company or trust applies the 15 year asset concession, for the exempt amount to remain tax free in the CGT concession stakeholders hands, it is required that the exempt amount be paid to the CGT concession stakeholders in the required proportions within 2 years. This can cause difficulties where the proceeds of a business sale are received in instalments over a period greater than 2 years. CGT events for businesses where some form of instalment payment of the consideration is made are on the increase. The 2 year period needs to be extended.

A further problem in this area is the requirement that the CGT event must be in connection with the taxpayer's retirement or the retirement of the controlling individual. This can often be a 'grey area' for many SMEs where they are seeking to scale down their activities toward retirement. The dividing line on what satisfies this test is not always clear. This is likely to be an area of continuing tension over coming years as the baby boomer generation of SMEs move through the system. The 'greyness' of this area causes continuing uncertainty.

\$5 MILLION NET ASSET THRESHOLD

This net asset test is difficult to substantiate where the net assets are near the threshold level and in particular where assets exist that are subject to a market valuation and where no ready market exists. This causes a continuing uncertainty around whether or not a taxpayer has met this basic test. Further the threshold has no indexation mechanism resulting in a dilution of the limit originally available.

50% ACTIVE ASSET CONCESSION

Businesses operating through companies or unit trust structures are disadvantaged in the application of this concession. Whilst the entity can apply the concession, tax free amounts relating to the active asset concession can not be passed through to shareholders or unit holders. They are often left in the position of having to liquidate the company to extract the proceeds in a tax effective manner. In the event they don't liquidate the company they risk exposure to Division 7A applications if money moves from the entity to the shareholders.

ACTIVE ASSET TEST

To pass the active asset test it is required that the asset be an active asset just before the CGT event or just before the business ceased (if within 12 months prior to the CGT event).

This can cause problems where the business owner dies and the legal personal representative (LPR) disposes of the asset. Unless the LPR continues to carry on the business, the asset will not be an active asset. This seems an inequitable position, where the small business concessions would have otherwise applied. The legislation should be amended to allow an (LPR) a time period in which to sell the business, we suggest a one year period, without the requirement of continuing to operate the business.

REPLACEMENT ASSET ROLLOVER CONCESSION

The existing concession provides the taxpayer with a time period extending from one year prior to the CGT event to two years after the CGT event in which to roll proceeds of a CGT gain into a replacement asset. This concession is designed to allow for movement between businesses and which is becoming increasingly common with SMEs. In many cases the rollover will occur once they have sold their existing business, have the proceeds, and are then in position to secure a replacement business. In this case and where the SME intends to access the replacement asset rollover concession, they may have to lodge their income tax return for the year in which the CGT event took place prior to having purchased the replacement asset. This leaves them in a position of declaring the original gain, not taking up the concession at that time, with the result that they do not have all of the available proceeds to invest in the replacement asset. Alternately if they claim the concession and a replacement asset is not acquired within the required time period then they must amend their return, pay the tax and be exposed to additional interest charges. A taxpayer in this situation is left with a difficult decision on how to treat their tax position in the year of the CGT event. They either forgo capital that may be required to fund the replacement asset or alternately risk exposure to interest and penalties.

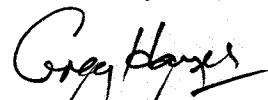
To remove this uncertainty the legislation should be amended to allow a taxpayer who nominates the application of the asset rollover concession to be able to amend their return within a two year period, in relation to the non access to the rollover concession without the application of penalties or interest.

Each of the above areas is reflected in real life case situations where SMEs have been disadvantaged in their access to the capital gains tax small business concessions. They reflect major and continuing areas of tension around the application of the concessions and how they are applied. We see these problem areas being repeated consistently reflecting the fact that they are continuing structural tensions within the existing provisions and ones, which need to be addressed to meet the original policy intent of the legislation.

Should you require further particulars or more detailed information on any of the issues identified in this submission then please do not hesitate to contact the writer at our Sydney office or by email at greg@hayesknight.com.au.

Thank you for the opportunity to provide this submission to the Board.

Yours faithfully



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