



23 February 2005

Mr B. Paine
Secretary
Board of Taxation
Treasury Building
Langton Crescent
Parkes 2600

Dear Mr Paine,

Re: Post-implementation review of the small business CGT concessions

In response to your request for submissions in respect of the Post-implementation review of the small business CGT concessions Taxpayers Australia encloses its submission which outlines the areas we consider need further attention.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Peter McDonald', with a long horizontal flourish extending to the right.

Peter McDonald
National Director.



Board of Taxation - Post-implementation review of the small business capital gains tax concessions

Comments from Taxpayers Australia

Background and legislation

On 21 September 1999 the government repealed the 50% CGT goodwill concession and replaced it with four small business CGT concessions where a small business satisfied the conditions in Division 152 of the *Income Tax Assessment Act 1997*.

The four small business CGT concessions are:

- The 15 year exemption;
- The 50% reduction;
- The retirement concession; and
- The replacement asset rollover concession.

In brief, to qualify for these concessions:

- a capital gain would have resulted from a CGT event in relation to a CGT asset owned by the entity;
- just before the time of that CGT event, the net value of the CGT assets that the entity and the related entities own must not exceed \$5m;
- the CGT asset must satisfy the active asset test; and
- where the CGT asset is a share in a company or an interest in a trust:
 - (a) the company or trust must satisfy the controlling individual test just before the CGT event; and
 - (b) the entity claiming the concession must be a CGT concession stakeholder in the company or trust.

Issues arising

1. Issues relating to the \$5m net asset test

1.1 The \$5 million net asset value threshold

In Policy Statement- Attachment E it was stated that the net asset threshold of \$2.3m for the former goodwill concession would be increased to \$5m, and as a result "capital gains tax will no longer be an impediment to investment by small business".

Unlike the former legislation there is no provision to index the \$5m threshold, so the original concession has been significantly devalued. Indexed using the CPI figures, the threshold would have been $\$5m \times 146.5/123.4 = \$5,935,980$ at January 2005.

Without indexation or a legislative change to increase the threshold, as a business grows it will reach a point that it must either contract or lose the CGT concessions.

Through our help-line we have learned of situations where taxpayers have elected not to grow their business beyond the threshold, while other taxpayers with net assets over the threshold have contracted their business operations prior to retirement to take advantage of the small business CGT concessions.

Recommendation

The threshold is increased to at least reflect its 1999 value. The threshold should then be either indexed or reviewed periodically to ensure that it reflects the prevailing market value held by small business.

1.2 Determining net asset value "just before the CGT event"

The Policy statement said that "The New Business Tax System seeks to provide a basis for more robust investment decisions by improving simplicity, reducing the cost of compliance, and providing fairer, more equitable outcomes". Yet to obtain the small business CGT concessions, the legislation requires the taxpayer to determine the total net value of the business assets owned by the entity, its small business affiliates and their connected entities "just before the CGT event" (s.152-15).

As "net value" is the sum of the market values of assets less liabilities, it would be costly and time consuming for an entity to establish the market value of its own assets "just before the CGT event" without also having to determine the market value of the net assets of its small business affiliates and connected entities at the same point in time. Strict compliance with the requirements in s.152-15 would appear to be a practical impossibility.

When accountants and small business proprietors telephone seeking help on issues involving the CGT small business concessions they nearly all assume that the \$5m threshold is satisfied. Few appear to have checked or to have obtained a valuation to correctly assess that the net values of the assets do not exceed \$5m. Those who have checked and discovered that the entity is close to, or over, the \$5m threshold are looking at ways to transfer assets out of the entity before disposing of the business to ensure compliance with the \$5m threshold.

Recommendation

The ATO issue a Practice Statement to provide guidelines for small business entities as to how a small business is to value its assets, and those of its small business affiliates and connected entities to comply with the strict time requirement in s.152-15.

1.3 No provision to apportion an individual's dwelling as an active asset when interest is claimed as business deduction.

If an individual's own home is not used solely for personal use and enjoyment only because of some income-producing use it is generally excluded from the net asset value threshold. However, if the individual incurred interest expenses in purchasing the home and some of the interest would be deductible from the individual's assessable income,

then the total market value of the home is included in the net asset test, even though the dwelling is predominately used for a private purpose (s.152-20(2)(ii)).

This provision would appear to be unfair when other provisions of the legislation allow or require apportionment between business and private usage.

Recommendation

Amend the legislation to allow only the business proportion to be included as an active asset.

1.4. Uncertainty as to whether cash is counted in the net asset value

It is generally understood that cash is a CGT asset unless it is used as a medium of exchange to facilitate a transaction (Tax Determination TD 2002/25). It is unclear as to whether substantial amounts held in a bank account should be included as part of the assets counted towards the \$5 million maximum net asset value test as a CGT asset or be excluded because it is a medium of exchange.

Further, if cash amounts are held in a personal account, it could be argued that such money is for the personal use and enjoyment of a taxpayer and therefore excluded from net asset value.

Recommendation

This issue be clarified.

2. Issues in relation to the controlling individual test

2.1. No small business CGT concessions for typical jointly held small business structures using interposed entities

Where a CGT event happens to interests in a trust or shares in a company, there are two additional basic conditions that need to be satisfied in order to access the small business CGT concessions (s.152-10(2)).

Firstly, the trust or the company must have a controlling individual just before the CGT event (s.152-10(2)(a)) and s.152-50). Secondly, the taxpayer who owning the trust or the company must be a CGT concession stakeholder (s.152-10(2)(b) and S.152-60).

Where an entity is interposed between individual owners and a trust or a company that operates a business, the small business CGT concessions will not be available to the interests held through the interposed entity because the interposed entity is not considered to be a controlling individual. This is on the basis that the small business CGT concessions measures do not allow a trace through to the ultimate beneficial individual owners of the interests.

For example:

Individual A and Individual B go into business together. Individual A and Individual B each own a 50% interest in Company X. Company X purchases all the shares in Company Y which operates a business. If Company X sells all its shares in Company Y,

the small business CGT concessions will not be available because Company Y does not have the requisite controlling individual as Company X is not an individual and s.152-55 does not allow a trace through of beneficial ownership to Individual A and Individual B.

Recommendation

Provisions be introduced to allow a trace through of beneficial ownership to individual owners who hold their interest in a small business through an interposed entity [to enable wider access to the small business CGT concessions].

2.2 No CGT concession if interest held though some trust structures

As outlined in 2.1, the controlling individual test would not be satisfied unless a fixed trust has a direct individual beneficiary. For example, where a unit trust carries on a business and its two unit holders are discretionary trusts each with a 50% entitlement to the income and capital, the controlling individual test is not satisfied even if each of the discretionary trusts had one primary individual beneficiary (s.152-55(2)).

Similarly, if a business is operated as a discretionary trust the controlling individual test is only satisfied if:

- the trust made an income or capital distribution (or both); and
- an individual was beneficially entitled to at least 50% of the total distribution of income and at least to 50% of the total distribution of capital made by the trust in the income year (s.152-55 (3)).

This means that if a discretionary trust does not make a distribution of income or capital during the year, it does not satisfy the controlling individual test and would not qualify for certain small business concessions for that year.

Recommendation

Provisions be introduced to allow a trace through of beneficial ownership to individual owners who hold their interest in a small business through an interposed entity [to enable wider access to the small business CGT concessions].

3. Issues in relation to the CGT concession stakeholder test

3.1. No small business CGT concessions for typical jointly held small business structures using interposed entities

Further to the discussions under 2 above that relate to the issue regarding the controlling individual test, where an entity is interposed between individual owners and a trust or a company that operates a business, the small business CGT concessions will not be available to the interest held through the interposed entity because the interposed entity will never satisfy the CGT concession stakeholder test.

Section 152-60 defines a CGT concession stakeholder to be a controlling individual of a trust or company or a spouse of the controlling individual who has a direct interest in the trust or company.

Given the above discussions in relation to the controlling individual test, an interposed entity can never be a CGT concession stakeholder because the interposed entity can never be a controlling individual and is not a spouse to the controlling individual. Therefore, the small business CGT concessions will not be available if an individual taxpayer owns his or her business indirectly through an interposed entity.

For example:

Individual A and Individual B go into business together and decided to conduct their business through Company X. Individual A owns 50% of the shares of Company X directly while Individual B owns 50% of the share of Company X indirectly via a discretionary trust (Trust Y). If Individual A and Individual B decide to sell Company X, Company X would satisfy the controlling individual test because Individual A owns 50% of Company X. However the small business CGT concessions are only available to Individual A but not Individual B because Individual B held his shares of Company through Trust Y. This is on the basis that Trust Y, which holds interests in Company X, is not a CGT concession stakeholder as it cannot be a controlling individual and is not a spouse to Individual A.

It would appear a discriminatory outcome would arise between taxpayers in substantially the same circumstances who adopted different ownership structures.

Many small business structures established before the introduction of these measures; for example a unit trust, owned 50/50 by two discretionary trusts, cannot access these concessions where units are disposed of.

Recommendation

Provisions be introduced to allow a trace through of beneficial ownership to individual owners who hold their interest in a small business through an interposed entity [so that the small business CGT concessions will be available in such circumstances].

4. Issues in relation to the 15-year exemption

4.1. No exemption relief for certain taxpayers who continuously operated a small business for more than 15 years.

The 15-year exemption requires a taxpayer to continuously own, legally and equitably, a CGT asset for more than 15 years (s.152-105(b)).

Taxpayers who maintained beneficial ownership of a CGT asset used in their business for more than 15 years would not meet the above requirement if there has been a change of legal ownership as a result of a business restructure during the 15-year period.

For example:

A taxpayer who is a sole trader commenced business on 1 July 2000. On 1 July 2002, the taxpayer rolled over his business assets into a new company and continued trading

through the new company. If the taxpayer retires in July 2016, the 15-year exemption would not be available to the taxpayer because the company has not continuously owned the business assets for more than 15 years, even though the taxpayer has operated the business and beneficially owns the business assets for more than 15 years.

Recommendation

Section 152-110 is amended to allow continuation of the 15-year period if there has been a mere change of legal ownership which does not result in a change of beneficial ownership.

4.2. No exemption for taxpayer who does not retire from the business.

Unless the taxpayer is permanently incapacitated at the time of the CGT event, the 15-year exemption also requires the disposal of the CGT asset to be in connection with the retirement of the taxpayer if the taxpayer is an individual, or in connection with the retirement of the controlling individual if the taxpayer is a company or a trust (s.152-105(f))

It is generally understood that the retirement condition requires cessation of present activity or employment in some form.

Where a taxpayer merely owns shares in the company or interests in a trust and does not work in the business or does not have a role in the business, the 15-year exemption would not be available (unless the taxpayer is otherwise permanently incapacitated at the time of the CGT event) because it would be difficult to argue that the taxpayer retires from the present business as the taxpayer might not cease any form of activity or employment with the company or trust.

Similarly, where the taxpayer has worked in the business and sold that business or interests in it and is required by the new owner to continue to work in the business for a period, he may not be entitled to the 15-year exemption.

It would appear that the outcome is discriminatory and unintended.

Recommendation

The nature of what constitutes retirement be reviewed to remove discriminatory and unintended outcomes.

5. Issues in relation to the active assets tests

5.1. No small business CGT concessions for a discretionary trust that holds active assets used in an associate's business if the trust did not make a distribution to the associate in any of the past four income years

An active asset is an asset that is used in the course of carrying on a business (s.152-40). An active asset includes an asset that is used by an entity that is connected with the entity.

An entity is connected with a discretionary trust if the discretionary trust has previously distributed to that entity more than 40% of the income or capital distributed by the trustee for that particular income year in any of the past four income years.

Accordingly, where an associated entity uses an asset held by a discretionary trust in its business but the trustee of the discretionary trust did not make a distribution to the associated entity in any of the previous four income years just before the disposal of the asset, the asset will not be considered to be an active asset. This is on the basis that the associated entity is not treated as a connected entity of the discretionary trust.

As a result, the discretionary trust will not be able to access the small business CGT concessions in respect of the asset disposed of.

For example:

A discretionary trust leases its only asset, being factory premises, to an associated company which conducts a business from that factory. The company is a potential beneficiary of the discretionary trust. Where the asset is sold as part of the disposal of the business carried on by the associated company, the discretionary trust cannot access the small business CGT concession if it did not make a distribution of more than 40% of the income or capital distributed for a particular income year to the associated company in any of the previous four income years.

Recommendation

The meaning of 'active assets' to be broadened to include assets used by an associate (as defined under s. 318 of ITAA 1936) in the course of carrying on a business.