

Submission to The Board of Taxation

**Post-implementation review of the
small business capital gains tax (CGT) concessions**

Discussion paper – February 2005

Introduction

In response to the February 2005 Discussion Paper on the post-implementation review of the small business capital gains tax (CGT) concessions, the following submission is provided on behalf of the Association of Grant Thornton firms in Australia. As you are aware, Grant Thornton firms are prominent worldwide in advising owners of growing entrepreneurial and owner managed businesses. We specialise in issues that affect privately owned business groups.

Our submission is separated into general comments and specific comments. The general comments are in relation to broad issues arising from the approach of Treasury to this issue. The specific comments are based on specific circumstances that we have come across.

We understand that:

- The Consultation Plan for the CGT review outlines how the Board of Taxation proposes to undertake a post-implementation review of the small business CGT concessions in Division 152 of the *Income Tax Assessment Act 1997* (“Act”).
- The Board will be assessing the quality and effectiveness of the small business concessions and will have regard to the extent to which the legislation:
 - gives effect to the Government’s intent, with compliance and administration 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
 - provides certainty
- A statement of the Government’s policy intent that underlies the small business CGT concessions was included as an attachment in the Consultation Plan and the Board will not be seeking to revisit this policy intent, but to examine how effectively the policy intent has been translated into legislation.

1. General Comments

- 1.1 It is submitted that the Division 152 CGT concession provisions fail the main criteria by which the Board is assessing their quality and effectiveness.
- 1.2 In particular, for a small business concession, the division is overly complicated and in many cases unworkable, and fails to support the underlying policy by inadequately dealing with the realities of small business structures and commercial practice.
- 1.3 The \$5M net asset value threshold needs to be thoroughly reviewed, in terms of:
 - how and when that net value is to be determined; and
 - whether \$5M is an appropriate threshold
- 1.4 Presently, the law imposes an unnecessary compliance burden on taxpayers to determine the value of their net assets. We also believe that the policy of the legislation would be better supported by phasing the concession so that it is not “all or nothing”.
- 1.5 Further, the requirement to have a controlling individual to access certain concessions is, in practice, denying concessions to parties who, in accordance with the policy of the legislation, should be entitled to the concessions. Family owned business structures often have more than two stakeholders who should be entitled to the concession on the sale of their interests.
- 1.6 We believe that the policy of the legislation would also be better supported by allowing the ‘flow through’ of concession derived by a company or unit trust to its members (as the Division 152B concession presently does).

2. *Specific Comments*

- 2.1 We have approached this part of our submission by outlining a number of circumstances that we have identified in which the CGT concessions have been, in our view, inadequate.
- 2.2 In relation to each of these situations, we have tried to highlight the area of the law that we believe needs review, and the practical problems that have arisen or could arise in these circumstances.

Active Assets

- 2.3 Legislative clarification is needed regarding what assets of an entity are “active” assets. Further, in practice, it is extremely difficult, time consuming and costly to test whether an asset has been “active” during at least half of the period of ownership of the asset. This point is illustrated by the example contained in Appendix 1, which considers whether shares in a company (and therefore the company itself) are “active”.
- 2.4 Generally, shares in a company or interests in a unit trust are active assets provided:
- the market value of the active assets of the company or trust is 80% or more of the market value of all assets of the company or trust; and
 - the above is satisfied within the time period stipulated by the active asset test

In order to satisfy the test, the shareholder must be able to evidence and support the fact that during the period the 80% requirement was satisfied. Application of this would require some form of valuations and regular calculations to ensure the requirement is met. For long periods of ownership (more than 5 years) this would prove, time consuming and costly. Work undertaken to satisfy this test in such situations is an excessive compliance burden.

- 2.5 It is unclear whether the “active asset” test contained in section 152-40 has a “cascading” effect where active assets are held through a chain of companies, as diagrammatically represented in Appendix 2. For example, can it be said that if Company 3’s shares are active, then so too are company 2’s and company 1’s such that a sale, by the individuals, of the shares in company 1 would be the sale of “active” assets? We understand that via the NTLG CGT liaison committee the answer is “yes”, however legislative clarification is required.

- 2.6 The current state of the legislation is biased towards the sale of shares / interests in a unit trust. This is on the basis that the application of the concession to the sale of assets by the entity will give rise to a concessionally taxed capital gain being distributed to an individual shareholder / unitholder which would attract personal tax at marginal tax rates. Such a bias is not reflective of commercial transactions where potential buyers of small businesses, being anxious to limit the risk of being exposed to undisclosed liabilities, will usually favour purchase of a business rather than an entity.

The \$5M threshold

- 2.7 It is submitted that the \$5M threshold is too low in that it does not accurately reflect the value of small businesses in Australia. In addition, the fact that the \$5M limit is not indexed on a year by year basis means that fewer and fewer businesses will be able to utilise the concessions contained in Division 152 over time. It is submitted that the \$5M should be indexed on a year by year basis in accordance with a measure of economic activity such as growth in GDP or CPI movement.
- 2.8 We further submit that the \$500,000 lifetime limit for applying the retirement exemption in subdivision 152-D should also be changed and indexed annually for the same reasons stated in 2.7 above.

Asset value test – principal place of residence

- 2.9 Where the CGT asset sold is held directly by an individual, the principal place of residence is not included in calculating the net asset value (“NAV”). However, where the asset sold is a share in a company or an interest in a trust, the principal place of residence is included in the NAV if it is held by the entity.
- 2.10 Connected entities are essentially determined by establishing a level of control (generally 40% or more of rights).

In relation to a discretionary trust, control is also deemed to be with a trustee or other party that determines how the trustee exercises its powers (such as an appointor).

In a family entity structure where individuals may themselves be the trustees or directors of a corporate trustee of a family trust, the family trust will be connected with the individuals and the value of the individual aggregated with that of the trust under the connected entity test. This sometimes produces extremely inequitable consequences when the family trust holds assets for the generational benefit of a family which may be divorced from the business assets of, say, a company owned by the individual trustees that is functionally separate from the trust and practically unrelated. Mere trusteeship of a trust should not mean the trustee and the trust are connected in all circumstances.

Excluded superannuation fund assets – committed entities

- 2.11 In relation to the net value tests, you disregard the value of rights to an asset of a superannuation fund – if you are working out the value of an individual. If the entity is a company, and an individual is connected with that company, section 152-20 does not appear to exclude the individual’s superannuation fund assets from the net asset value calculation. This appears to be manifestly unfair and unintended and the law should be amended to exclude the value of all superannuation fund assets – of the entity, and connected entities as appropriate.

Controlling individual test

- 2.12 Currently the concession does not apply to individuals where husband 1 and wife 1 and husband 2 and wife 2 each own a 25% interest in a company.

Assume that the company sells its business to a third party, which includes the sale of post-CGT assets. The company is entitled to the 50% active asset concession. Were the individual shareholders to sell their shares, each shareholder would not be entitled to any of the concession. The denial of the concession is based on no one shareholder being a “controlling individual”. The “controlling individual” test requires one individual to hold at least 50% interest in the company.

In our opinion, the ownership structure of the company and access to Division 152 concessions is unfairly restricted by the definition of “controlling individual”. Yet in this simple example, the individuals should be entitled to the concession and not denied on the basis of their shareholding pattern/structure.

- 2.13 The recent changes made to the controlling individual test whereby an individual is deemed to control a trust in accordance with distributions that have been made in prior years, needs reviewing. There are a number of legitimate reasons why a distribution from the trust may have been made in a particular year to a particular beneficiary that may not ordinarily receive any distribution at all from the trust. Innocently making such a distribution can mean that that beneficiary's assets are included for the purposes of the \$5M net asset test, possibly resulting in the \$5M test being breached. It is submitted that the law has too rigid an application in this regard and should be rewritten.
- 2.14 The commercial reality is that a majority of small business structures utilise a discretionary trust to own shares in a company conducting the business. As such, the company does not have a "controlling individual" and the small business concessions cannot therefore be accessed where the trust sells its shares.

Given the prevalence of such structures, consideration should be given to providing a legislative "look-through" of the trust to the beneficiaries. A test similar to the "control test" could then be used to determine if there is, in essence, a "controlling individual" of the company.

15-year exemption

- 2.15 Even where an asset has been held by a company for more than 15 years, s152-105(c) requires that "at all times during the period for which you owned the CGT asset, the company... had a controlling individual". In other words, the exemption is premised on the basis of a controlling individual throughout the ownership period. The "at all times" requirement bears no correlation to the 15 year period which is the minimum requirement of the exemption. This additional requirement should be removed.

Appendix 1- Active Asset Test

Active Asset – analysis of ABC Pty Ltd Balance Sheet

	2003	2002	2001	2000	1999
Cash at bank	3,782	18,146	554	0	0
Cash deposits	0	0	0	0	0
Other	430	467	575	557	674
Trade debtors	508,905	428,709	345,161	661,231	818,973
Shareholders loans	261,701	250,273	246,885	254,911	229,189
Investments	0	0	0	0	0
Plant & equipment	21,800	21,424	3,422	6,308	12,571
Goodwill	730,000	580,000	300,000	250,000	130,000
Total assets	1,526,618	1,299,019	896,567	1,173,007	1,191,407
Total active assets	1,264,917	1,048,746	649,712	918,096	962,218
% active assets	83%	81%	72%	78%	81%
	PASS	PASS	FAIL	FAIL	PASS

	1998	1997	1996	1995	1994
Cash at bank	21,744	0	28,709	5,850	0
Cash deposits	0	0	500	500	1,869
Other	914	436	556	580	300
Trade debtors	560,020	949,395	1,143,433	558,683	408,962
Shareholders loans	229,188	216,246	169,295	183,131	192,527
Investments	0	0	4,612	0	0
Plant & equipment	16,580	14,389	19,097	23,879	31,580
Goodwill	400,000	250,000	350,000	550,000	300,000
Total assets	1,239,238	1,430,466	1,716,202	1,322,623	935,238
Total active assets	999,258	1,214,220	1,541,795	1,138,992	740,842
% active assets	81%	85%	90%	86%	79%
	PASS	PASS	PASS	PASS	FAIL

	1993	1992	1991	1990
Cash at bank	1,984	0	60,821	36,752
Cash deposits	228,977	1,592	500	500
Other	300	300	300	301
Trade debtors	166,425	148,173	205,517	266,433
Shareholders loans	171,107	128,222	102,014	69,199
Investments	0	0	0	100,000
Plant & equipment	35,981	40,021	48,694	43,517
Goodwill	225,000	120,000	120,000	120,000
Total assets	829,744	438,308	537,846	636,702
Total active assets	429,690	308,494	435,332	467,003
% active assets	52%	70%	81%	73%
	FAIL	FAIL	PASS	FAIL

Conclusion

- Years passed: 8
- Years failed: 6

therefore, active asset test is **passed**

Appendix 2

