POST IMPLEMENTATION REVIEW OF SMALL BUSINESS CAPITAL GAINS CONCESSIONS WITHIN ITAA 1997 DIV 152

Dr Mark Burton
Law School
University of Canberra

INTRODUCTION

Given that the Australian Treasury estimates the cost of the capital gains concessions allowed under ITAA 1997 Div 152 at approximately $1.4 billion over the past four years (*Tax Expenditure Statement 2004*), I welcome the Board's review of this massive tax expenditure program. However, given the broadly framed functions of the Board expressed in its Charter, it is unfortunate that the Board has not taken the opportunity afforded by this post-implementation review to consider the merits of the Government's decision to provide small business taxation relief.

This submission is of limited ambit and makes just two recommendations:

1. research into the compliance costs associated with Division 152 and upon the more general issue of actual and perceived barriers to capital investment on the part of small business must be undertaken if the post implementation review is to produce a credible report into the operation of Division 152; and
2. assuming that the Government considers that the policy embodied in the existing provisions should remain in place, those provisions should be rewritten in order to clarify the operation of the legislation.

THE NEED FOR PUBLICLY AVAILABLE RESEARCH DATA TO ASSESS ACHIEVEMENT OF THE GOVERNMENT'S POLICY INTENT

Statements of the Government's Intention

The legislation and associated extrinsic materials provide only general indications of what the government was hoping to achieve by enacting Division 152:

- Section 152-1 begins with the vague statement 'to help small business', but does not elaborate upon exactly what help was considered necessary, for whom (ie whether all small business was intended to benefit equally or not) and why such help was considered necessary;
- Attachment F to the Treasurer's Press Release (No 058, 21 September 1999) suggests that the 15 year held asset exemption will 'provide a further incentive for small businesses'. It also states that the change was necessary to 'reduce impediments to investment by small businesses' and to protect taxpayers from taxation upon purely inflationary gains (the latter objective of which, it might be noted, was already catered for given the cost base indexation rules);
- Paragraph 4.9 of the Regulation Impact Statement accompanying the legislation stated that the CGT reforms would collectively improve capital mobility, reduce complexity and compliance costs and make Australia's CGT regime internationally competitive; and

- Paragraph 4.11 of the Regulation Impact Statement repeated the proposition that streamlining the CGT concessions for small business would 'reduce compliance costs for small business taxpayers'.

From these statements it appears that the Government sought to achieve the following core objectives by enacting Division 152:

1. encouraging small business proprietors to invest in their businesses;
2. enhancing the retirement savings of small business proprietors; and
3. lowering the 'compliance' costs associated with accessing the small business capital gains concessions.

The need for the Government to clearly define the category of small business intended to benefit from Division 152

By virtue of the repeated reference to 'small business' the extrinsic materials associated with Division 152 create the impression that all small businesses were intended to benefit from these tax concessions. However, it should be noted that the operation of Division 152 means that only a particular category of 'small business' will benefit from these concessions.

Division 152 only provides relief with respect to capital gains triggered by the occurrence of CGT Events with respect to small business active assets, yet many small businesses will not hold significant active assets and so Division 152 will be of only marginal benefit to them. It may be that these provisions were intended to be targeted towards 'active asset rich' small businesses which fell within the maximum net asset value threshold. Such businesses may not meet the requirements for entry into the Simplified Tax System (ie turnover threshold) and so would not receive the benefit of accelerated depreciation and other benefits allowed under the STS. Similarly, it would be reasonable to expect that most beneficiaries of the entrepreneur tax reduction would not hold significant depreciating assets nor significant active assets, so that neither the STS system nor Division 152 would afford them significant taxation benefits.

A review of all of the small business taxation concessions suggests that the government is targeting specific concessions to specific categories of small business. If this is the case, it would be better for the government to clearly state the type of small businesses it intended to benefit by enacting each concession. In an era of purportedly purposive interpretation of legislation, the inaccurate description of the intended effect of the legislation devalues extrinsic materials and thereby threatens the legitimacy of reliance upon such materials in the course of interpreting and applying the law.

Do we have the data to assess whether the legislation has achieved the desired outcome?

Assuming that the government intended to provide benefits to a limited class of small businesses, to assess the success of the legislation against its objectives it would be necessary to have access to credible data upon these aspects of the former concessional rules and also current data to measure the operation of the revised rules. Unfortunately, it appears that data with respect to these matters is either not in existence or is not publicly available. Indeed, in proposing these measures, the Government appears to have had limited credible data available for the purposes of determining the exact nature and scale of the problem which it sought to address. For example, although submissions to the Ralph Review referred to small business compliance costs and the perceived disincentives to capital investment arising out of the taxation of capital gains, no credible data was referred to by the Review Committee when it proposed the reform of the small business capital gains provisions (note *A Platform for Consultation*, para 11.79).

In the absence of such baseline data, it is difficult to determine whether or not the Government's reformed small business capital gains concessions have succeeded or not. At the least, credible qualitative and quantitative longitudinal data is necessary if we are to test the Government's claims that the Division 152 concessions will foster small business investment and innovation as well as lowering compliance costs. Establishing a causal link between capital gains concessions and business investment decisions may be problematic (see *A Platform for Consultation*, paras 11.7 – 11.10), but expending the substantial sums involved with this tax expenditure without any attempt to assess the impact of this program merely fosters cynicism amongst taxpayers who do not benefit from these tax concessions. As the experience of the 1970's shows, such cynicism undermines the foundations of voluntary compliance upon which our tax system relies.

A study of the operation of Division 152 could examine:

- the categories of 'small business' which benefit from the provisions (micro businesses? Industry groupings of principal beneficiaries, effective tax rates borne by the beneficiaries);
- the use of the gains which are subject to concessional treatment (for example, is the income falling under section 152-105 invested for retirement or expended upon consumption? Similarly, is the additional benefit afforded by the small business discount applied to investment or consumption?);
- actual and perceived barriers to small business investment and the extent to which the capital gains concessions figure in investment decisions; and
- compliance costs borne by the taxpayer in obtaining the benefit of the provisions.

The Board's current post implementation review of Division 152 may consider such issues, but I suggest that such information can only be reliable if obtained from a credible research project. Here I note that the Board's consultation plan only makes reference to receiving submissions from interested parties rather than undertaking or commissioning research. No matter how many submissions either supporting or criticising the provisions are received by the Board, at best an analysis of such submissions will offer only a partial, and perhaps prejudiced, view of the provisions. Assuming that no rigorous critical analysis of the claims regarding Division 152 has been undertaken, I recommend that the Board fund such research or, alternatively, recommend that such research be undertaken as a priority. Without such research and/or analysis available to the Board, how can the Board meaningfully undertake this post-implementation review?

THE CONCESSIONS WITHIN DIVISION 152 ARE EXPRESSED IN VAGUE TERMS

The Government's claim – lowering compliance costs

Although the Government claimed that the new CGT concessions would lower compliance costs, the legislation is framed in terms which makes it nigh on impossible to apply the legislation in a straightforward manner.

Without exhaustively detailing the interpretive difficulties associated with the operation of Division 152, some illustrative examples drawn from section 152-105 will suffice in making the point that the legislation needs to be redrafted if compliance costs are to be minimised.

An example of legislative opacity – Section 152-105

The operation of section 152-105 hinges upon the question of whether the relevant taxpayer is either:

1. 55 or over at the time of the CGT event and the relevant CGT event happens in connection with the taxpayer's retirement; or
2. permanently incapacitated at the time of the CGT event.

There are a number of problematic terms here: 'retirement', 'in connection with the taxpayer's retirement' and 'permanently incapacitated'. I will briefly outline the problems with respect to the first two.

<u>The meaning of retirement is not absolute</u>
'Retirement' is not defined for the purposes of section 152-105. Further, it is doubtful that there is one finite 'ordinary meaning' of the expression – some would consider that retirement entailed complete cessation of all commercial activities as well as withdrawal from public life. Others would suggest that retirement entailed only complete cessation of income earning activities while others would suggest that a retiree might remain in 'retirement' despite the fact that they carry on an active public and business life. Those holding the latter view may disagree amongst themselves as to just how active a person may be while nevertheless being 'retired'. The vagaries of the retirement concept are perhaps attributable to, and significant because of, the substantial numbers of taxpayers who do not see their own retirement as an absolute – the concept of a 'working retirement' is now commonly referred to.

The Australian Taxation Office attempted clarification of the meaning of 'retirement' in ID2003/864:

> 'Whether there is a 'retirement' for the purposes of the 15-year exemption will depend on the circumstances of each particular case. However, it is considered for the term to be satisfied, there must at least be a significant reduction in the number of hours the individual is engaged in present activities, or a significant change in the nature of present activities. It is not necessary for there to be a permanent and everlasting retirement from the workforce.'

Unfortunately, this interpretative decision does little by way of clarifying the operation of the law in this area. This ruling is extraordinary given that it seems to imply that a person may be 'retired' if they sell their business and then commence full time employment – there would be a ‘significant reduction in the number of hours the individual is engaged in present activities’ as well as a ‘significant change in the nature of present activities’. In passing, it should be noted that the apparent lenience of the ATO here may not cater for a small businessperson who owns several businesses. A ‘significant reduction in the number of hours the individual is engaged in present activities’ would be problematic for the owner of multiple businesses as it seems to suggest that the taxpayer would need to dispose of more than one business in a ‘fire sale’ in order to trigger the exemption for the first active assets sold.

It remains to be seen whether the approach adopted in ID 2003/864 will be upheld by the Australian Taxation Office in future cases. Curiously, the Interpretative Decision does not refer to the consideration of this issue in the National Tax Liaison Group CGT Subcommittee Meeting of 28 November 2001 (pity the poor taxpayer/advisor who merely enters ‘retirement’ in the ATO search engine, or who uses the ‘lookup’ function from the ATO legislative database – in neither case would a reference to the CGT Subcommittee minutes appear). In any case, in both ID 2003/864 and the CGT Subcommittee minutes the ATO emphasises that what is ‘retirement’ must be determined on a case by case basis. From the perspective of taxpayers and tax administrators alike, such case by case determinations upon vague concepts such as ‘significant reduction in the number of hours the individual is engaged in present activities’ is undesirable.

An ancillary issue with respect to the retirement concept is the question of how a taxpayer can prove that they have ‘retired’ – is this an objective purpose test or a subjective purpose test? For example, what of a taxpayer who sells their business on a going concern basis and is legitimately considered to have retired, but then enters another income earning activity shortly after the sale of the original business? This resumption of income earning activity may be precipitated by the vicissitudes of life – divorce, financial losses, health expenses, and so forth. The taxpayer may quite honestly have intended to retire when the business was sold, but then finds themselves in a position where they cannot afford to cease all income earning activity. This scenario is obviously quite different from a taxpayer who actually intends to resume full time income earning activities after taking a relatively short rest from business life. There are a myriad of factual possibilities for which the legislation provides no ready answer.

<u>‘In connection with’</u>

The nexus requirement embodied in the words ‘in connection with’ have proven to be some of the most troublesome in the tax lexicon, and their use in section 152-105 is unexceptional in this regard. A taxpayer who meets the requisite age requirement must demonstrate that the CGT event with respect to the relevant active asset occurred ‘in connection with’ their retirement. Here the nexus words may assume a subjective or an objective hue, and the application of the exemption may vary depending upon which approach is adopted.

The subjective interpretation of the nexus requirement arguably would allow a taxpayer to obtain the benefit of the concession in circumstances where a small business person planning for their retirement progressively sells down their small business active assets to optimise the prices received. Where the taxpayer continues to conduct their business during this progressive sale process, it is most unlikely that they will be considered to have retired. Yet in a sense the sale of the relevant active assets will be connected with the retirement of the taxpayer. Further, the terms of the provision support this subjective approach to the nexus requirement. Given that the time of the relevant CGT Event will often be the time at which the taxpayer enters into a contract for the sale of the asset, and given that such contracts are often entered into well before the date upon which the assets are actually transferred, a reasonable interpretation of section 152-105 would hold that the disposal of assets in contemplation of retirement will attract the exemption. The question, however, is how far this interpretation may be pushed – what if the taxpayer progressively disposes of active assets over a period of years?

Alternatively, the nexus requirement may be interpreted in an objective sense. This approach would look to the objective actions of the taxpayer in determining whether there was a connection between the relevant CGT Event and the taxpayer's retirement. Possible approaches would include:

1. Evidence that the disposal of the asset triggered the cessation of the taxpayer's income earning activities or that the taxpayer's cessation of income earning activities meant that the disposal of the asset was commercially inevitable; and
2. Regardless of the existence of a direct causal connection between the relevant CGT Event and the taxpayer's retirement, evidence that the taxpayer applies the funds arising from the relevant CGT Event towards their retirement savings. Here, of course, there is room for interpretation with respect to what constitutes an appropriate application of the capital gains towards retirement savings – what if the taxpayer uses some of the funds for a holiday?

Thus, for example, a taxpayer may terminate their business but retain some active assets in order to maximise the price obtained for those assets (ie in the event of a market downturn in asset prices for the particular asset category). The first objective approach possibly not be satisfied (ie if the active asset is real property it might be commercially reasonable to retain that property indefinitely, perhaps owing to the favourable commercial leasing market) while the second would be if the taxpayer applied the funds in an appropriate way.

Clearly, in the context of section 152-105 the nexus requirement raises problematic interpretive issues of a sufficiently general nature as to cause one to question the Government's claim that the section would lower compliance costs.

Potential operation of Part IVA

Having regard to the general legislative scheme with respect to the taxation of retirement savings, section 152-105 is extraordinary in that it offers taxpayers the prospect of taking a tax free capital gain which is not included for the purposes of applying the Reasonable Benefits Limit requirements. Undoubtedly, this provision will attract considerable attention from those taxpayers who are prepared to alter a commercial transaction such as the closing/sale of a business in order to minimise their taxation liability.

The uncertain operation of the operative rules within Division 152, such as those illustrated above with respect to section 152-105, not only raise 'compliance' costs but also raise the prospect of retrospective amendment of a taxpayer's return under the general anti-avoidance provisions of ITAA 1936 Part IVA (note the extended time period: ITAA 1936 s 177G(1)). The High Court decision in *Spotless*, and the prospect that a very limited approach to the definition of 'scheme' will be upheld by the High

Court in future (*Hart*), suggests that taxpayers who 'creatively comply' with the tax law in order to attract a specific tax concession may nevertheless fall foul of Part IVA.

For example, the deferral of CGT Events with respect to active assets laden with capital gains until the threshold requirements of section 152-105 (ie age requirement) are satisfied, while disposing of the remainder of the business, may be undertaken for the purpose of attracting the beneficial operation of section 152-105. Depending upon the particular circumstances of the case, and also upon the particular interpreter's reading of Part IVA, such an arrangement may attract Part IVA particularly where there is no or limited evidence of other commercial justifications for the delayed sale of some business assets. Even if commercial considerations might justify the deferred disposal of the asset, identifying whether or not the relevant 'scheme' exhibits the requisite dominant purpose is fraught with difficulty and, once again, a time consuming and costly exercise for taxpayers and tax administrators alike.

CONCLUSION

The objectives of Division 152 have not been clearly stated by the Government and this vagueness has carried over into the legislation. Some of the vagaries of the core terms of section 152-105 have been noted above merely for the purpose of illustrating the sub-optimal legislative expression of the vague statements of purpose promoted by the Government. Once again, in the absence of credible research it is not possible to ascertain the scale of the problem that such interpretive difficulties create in terms of the targeting of this tax expenditure and also compliance costs incurred by taxpayers seeking access to these concessions. I recommend that a comprehensive and credible study of these aspects of Division 152 be commissioned by the Board of Taxation as part of its post implementation review.