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Post-implementation review CGT
The Board of Taxation
c/- The Treasury
Langton Crescent
PARKES ACT 2600

By email; BoardofTaxation@treasury.gov.au

Dear Sir/ Madam

Board of Taxation: Post-implementation review of the small business capital gains tax (CGT) concessions

CPA Australia welcomes the opportunity to provide this submission to the Board of Taxation post-implementation review of the small business capital gains tax (CGT) concessions.

As Australia's pre-eminent professional association representing the diverse interests of more than 105,000 finance, accounting and business advisors, CPA Australia is committed to working with Governments and their agencies and committees to ensure current and future economic and social policies foster an environment that maximises economic efficiency and makes Australia a better place to live, work, save and invest.

The main issues that we believe need to be addressed in this review are:

- clarification of the type of small business taxpayers that are expected to benefit from the concessions in view of the access problems experienced by those who are not 'mum and dad' concerns
- the excessive complexity and consequent uncertainty of the existing provisions and how they can be improved for the benefit of most tax agents and their clients
- the inability of many small business operators to access the various concessions because of the structures they have set up in the past, or even more recently due to their (and their advisers') lack of understanding of the provisions
- the apparent unintended consequences arising from the application of the provisions, particularly due to the wide scope of the maximum net asset value test, and
- the excessive compliance costs associated with the current provisions.

The detailed submission attached addresses the specific points identified for review in the Board's Consultation Plan, and makes recommendations of the changes required to address the above issues and generally improve the operation of the small business CGT concessions.

We trust this submission is of use to the Board of Taxation's review. If you have any questions regarding the above, please do not hesitate to contact me on 03 9606 9701 or via email – paul.drum@cpaaustralia.com.au.

In the interests of the members of CPA Australia and the community generally, this submission will also be made available via our website at www.cpaaustralia.com.au.

Yours sincerely

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

The format of our submission has been tailored to address the specific issues raised by the Board in its consultation plan for the above review.

1. Government's policy intent

The current CGT small business concessions were introduced in 1999 in place of the former CGT concessions. While the current concessions represent a significant improvement on the former provisions, they are ostensibly designed to achieve the same broad purpose of providing small business people with access to funds for retirement or expansion.

It was expected that the reforms would:

- increase the level of benefits available to small business taxpayers
- improve the operation of the law by merging and rationalising the existing provisions, and
- provide greater flexibility in how small business taxpayers can access the various benefits
- ensure that CGT would no longer be an impediment to investment by small business.

In particular, it was stated that, under the reforms announced by the Government, individuals operating a small business would be:

- eligible for the general CGT 50% concession
- eligible for the 50% active assets exemption
- able to elect to roll the remaining 25% of the gain into replacement assets, or
- able to apply the remaining 25% towards the $500,000 CGT retirement exemption
- exempt from CGT where active assets are held for 15 years or more
- able to benefit successively from all of the concessions for any one disposal, thereby reducing any unnecessary compliance costs.

Key design features of the concessions:

- the relevant asset must be an active asset or be a company share, trust unit or other membership interest where the taxpayer is a controlling individual of the entity carrying on the business
- an active asset is an asset used in the business (eg. land and buildings) or an intangible asset inherently connected with the business (eg. goodwill)
- if the asset is a membership interest, it has to satisfy a 'look through' rule to the company's or trust's assets requiring that 80% or more of the entity's total assets be active assets for at least half of the period the assets were owned
- a limit of $5 million on the net value of the assets that the taxpayer and connected entities can own
- certain additional requirements were specified in respect to the 15-year CGT exemption.

The extent to which the current small business CGT concessions are consistent with this policy intent is discussed in some detail below. Part of the problem seems to stem from the apparent lack of clarity in the stated policy intent, including whether it is envisaged that the concessions should be largely confined to 'mum and dad' type businesses, and not say mum, dad and one or more children. If this is the case, then we would submit that the policy intent should be reviewed by the Government as it would not reflect the commercial realities of small business in today's world. If the concessions are not so confined then, for the reasons advanced below, there is a strong case for the present anomalies to be appropriately resolved forthwith.

Recommendation: We recommend that the policy intent of the Division 152 small business CGT concessions be clarified to make it clear whether they are primarily confined to 'mum and dad' type businesses or whether they extend to other small family businesses which may include others, such as family members such as brothers, sisters or children, and/ or other business partners.

2. Compliance/Administration Costs

The issue for consideration regarding compliance and administration costs is whether the actual compliance and administration costs arising under the current small business CGT concession provisions are commensurate with those foreshadowed in the Regulation Impact Statement (RIS) for the measure.

The RIS stated:

- streamlining the (former) CGT small business concessions will reduce complexity and provide small business taxpayers with greater flexibility in accessing the benefits, and
- implementation of the measure is not expected to give rise to any significant increase in administration costs for the ATO.

It is clear from the comments that follow in this submission that the current small business CGT concessions are complex and often appear to have unintended consequences. In other words, it is clear that while the changes to the former CGT provisions have improved their coverage and flexibility somewhat, there has been no corresponding reduction in complexity, nor in the associated compliance costs for taxpayers and their advisers.

We are not in a position to comment on the precise impact of the changes on the ATO's administration costs but they would presumably not be significant.

Recommendation: The Division 152 provisions should be amended to remove the existing complexity and thereby reduce compliance costs for affected taxpayers.

3. Clear, simple, comprehensible and workable

With respect, no objective review of these provisions could describe the small business CGT concessions in Division 152 of the Income Tax Assessment Act 1997 (ITAA 1997) as clear, simple or readily comprehensible.

While regular users may not experience great difficulties in dealing with the provisions, intermittent users (who would comprise the great bulk of smaller tax agent practices which typically service the small business taxpayers who are most likely to be eligible for the concessions) find the provisions very difficult and problematic to apply to their particular clients' circumstances. As noted below, this can increase the risk of such agents facing professional indemnity actions in future.

Some examples of these complexities are detailed below.

Small Business Retirement Exemption (Subdivision 152-D)

The relevant provisions in this subdivision refer to eligible termination payments (ETPs) as opposed to the concept of retirement, which is used in respect to the 15-year asset exemption in subdivision 152-B. These differences add to complexity.

This subdivision needs to be substantially rewritten as it is quite incomprehensible to the majority of practitioners. While the concept of a $500,000 exemption limit is simple, the enabling legislation is unnecessarily complex. Unfortunately, the ETP and reasonable benefit rules are similarly complex. In this light, it would be most helpful if rather than referring to the amount of any ETPs being CGT exempt components, it was instead spelt out that it is intended that these payments be tax free up to the CGT retirement exemption limit and it should also spell out the impact that such payments have on the taxpayer's reasonable benefit limit.

Further it is not commonly understood that this is something of a 'Clayton's' concession. It is not difficult to imagine circumstances where taxpayers take action against their advisors who fail to identify that relying on this concession might cause some of what would otherwise have been paid as a ETP (i.e. amounts accumulated before the sale in question) to be taxed as an excessive benefit.

The legislation should also make clear the relationship between this rule and section 109 of the Income Tax Assessment Act 1936 (ITAA 1936), given that it is conceivable that a termination payment contemplated by subdivision 152-D might be considered to be an excessive amount in consequence of retirement under section 109(1)(b) of the above Act.

Controlling Individual Test

Subdivision 152-A, that is the basic conditions for relief, requires that there be a controlling individual where there is a disposal of shares in a company or an interest in a trust.

We then find that when we go to each of the four further subdivisions that provide for the particular reliefs, we need a controlling individual in only some instances. In particular, there needs to be a controlling individual for the purposes of the 15 year exemption in subdivision 152-B but not for the general 50% reduction under subdivision 152-C. However, a controlling individual is required for the purposes of the small business retirement exemption under subdivision 152-D but not for the purposes of the small business rollover under subdivision 152-E.

It follows that the determination of when someone might qualify for this relief is made all the more complex depending on whether it is shares or units being disposed of and which of the 4 types of relief is sought, because it is only in certain circumstances that a controlling individual is necessary. We query whether this test (i.e. the need for there to be a controlling individual) is essential.

Simplifying These Rules

There is an inconsistency in drawing the net very widely in aggregating assets of various parties for the purposes of determining the $5 million net asset value ceiling (see further below), whereas the concept of a controlling individual is narrowly drafted. In our view, the legislation would be considerably simplified if, rather than expanding the definition of controlling individual, the concept of connected entities and small business affiliates was either drawn far more narrowly or removed. Then, if the meaning of net value of assets in section 152-20 was simplified and the meaning of CGT concession stakeholder was simply and more equitably defined, these rules ought to be far easier to understand and follow. It would, of course, still be necessary to re-write subdivision 152-D to address the issues raised above, but this would seem to be relatively straightforward as this is a matter of plain English drafting and providing better links to the rest of the legislation, rather than a substantive change to the law.

As noted above, there is only the need for a controlling individual in some circumstances. This complicates these rules by differentiating between a sale of shares/units and other active assets, and then complicates them further by requiring a controlling individual under (only) the 15-year asset and retirement exemptions.

As Division 152 stands at present, it is quite conceivable that the cost of specialist tax advice could exceed the apparent tax saving in some circumstances. This is clearly inappropriate on an on-going basis.

Recommendation: We recommend that the following changes be made to the existing Division 152 provisions to make them clearer, simpler and more workable:

- the existing provisions in subdivision 152D relating to the small business retirement exemption be substantially revised, particularly to clarify the interaction between this exemption and relevant parts of the superannuation provisions of the income tax law relating to ETPs and reasonable benefit limits;

- narrow the ambit of the existing $5 million net assets threshold by amending the provisions relating to connected entities and small business affiliates to ensure that they are drawn far more narrowly or done away with entirely, and also simplify the meaning of the net value of assets and CGT concession stakeholder.

4. Unintended consequences

General

The easiest way to access the current small business CGT concessions is to hold assets in individuals' names. Individual taxpayers acquiring appreciating CGT assets in the course of carrying on a business will be entitled to the full range of concessions if the various tests are satisfied. This includes the active asset test and the $5 million net asset threshold in sub-division 152-A (ITAA 1997).

Operating as a sole trader, however, is not always practical given the need for small business owners to take appropriate steps to protect their assets. For this reason, many small businesses are conducted via company and/or trust structures. Even where such structures are reasonably straightforward, problems can arise where family members other than spouses (eg. brother, sister, children, etc) are involved. These problems can be compounded in the case of more complex structures which may be required where, say, more than one family is involved. In general, the concessions will normally be unavailable where assets are held through numerous tiers of entities.

There is no indication in the Government's stated policy on the concessions that they are intended to be primarily confined to 'mum and dad' businesses. The reality, however, is that the concessions are generally more difficult to access by other types of small business, largely due to the operation of the 'controlling individual' requirement, particularly in the case of the retirement exemptions.

Among other things, the outcomes which arise from the application of the 'controlling individual' test seem to be clearly inequitable and at odds with the primary purpose of the small business CGT concessions. A common example is where a company with three (3) equal owners is at an unfair disadvantage compared to a business with, say, a 60% majority owner and two (2) other minority owners. There are many cases where a small private company has a number of shareholders who have combined their capital and expertise to form a viable business. It is unjust that these businesses should be denied access to the small business concessions on the basis that they do not have a controlling individual. We question the need for a controlling individual test and recommend that this requirement be removed.

In the event, however, that the controlling individual test is retained, it is our view that the percentage required to have a controlling individual be reduced from 50% to 40%. This reduction would ensure consistency within the Division 152 provisions. As the connected entity test states that a control percentage will be 40%, it is our view that the controlling individual test should utilise the same percentage.

This matter is discussed further in respect to particular structures in the next section.

Maximum Net Asset Value Test

The net $5 million asset test which is a basic condition for the small business relief is a set amount, with no review or indexation factor to be applied. Due to the growth of the economy and increased property prices, many taxpayers have exceeded this limit. In order to ensure that these small business concessions are available to the taxpayers intended we believe that the net asset limit be subject to regular review and appropriate adjustments and/or that a yearly indexation factor (similar to the old indexation factors for the CGT cost base) be applied on an annual basis.

Section 152-15 includes in the $5 million net asset value ceiling the net value of CGT assets of entities connected with the taxpayer. The old section 152-30(5), which brought within the 'connected' net other trusts under which a beneficiary might benefit, was clearly inappropriate and unworkable. Unfortunately, it was replaced with similarly deficient rules. The new section 152-30(5) looks at distributions of income or capital within the previous four years and the relevant taxpayer is taken to control the trust if they or one or more of their small business CGT affiliates received at least 40% of any income or capital which was distributed. A simple example of the inappropriate application of this rule is where a trust confers an entitlement to capital on an individual, say to enable them to buy a house. It might be that they would never again benefit under this trust. If that was the only capital distributed in that year, the assets of the trust would be taken into account for the purposes of applying the $5 million net asset value ceiling, even though the relevant taxpayer (or their small business CGT affiliate) might never receive any further benefit from that trust.

A further difficulty in applying the net asset value test in section 152-20 is that it seems that we include trading stock, because it is an asset, but gains on disposal of trading stock are exempt under section 118-25. This apparent inconsistency adds to the complexity of these rules.

Further difficulties arise in determining whether liabilities 'relate to' the relevant assets for the purposes of section 152-20(1), particularly as businesses evolve and strict identity between assets and liabilities becomes less clear over time.There are also significant problems in interpretation and application regarding contingent liabilities and provisions.

Section 152-15(a)(iii) also includes within the $5 million ceiling the net value of CGT assets of small business CGT affiliates and entities connected with them. A difficulty which can arise is that spouses can separate but still be spouses. It might well be that one party is considerably more wealthy than the other and yet the less wealthy partner might be denied the benefit of the CGT small business relief because the assets of their spouse must be taken into account.

Alternatively, in a situation like this, it might be that the less wealthy spouse receives a distribution of capital from the trust of a relative in order to help them through this difficult time. The result could be to cause the assets of the relative's trust to be taken into account and the CGT small business exemption would not be available.

In ATO ID 2004/698 the ATO says that the appointor of a trust is a controller for section 152-30(2)(c)(ii) purposes. This means that they are connected and it is necessary to aggregate the appointors' net assets with those of the trust making the capital gain.

In a situation where the appointor is, say, an unrelated person such as a professional advisor, the aggregation of assets is clearly unreasonable. The appointment of a professional advisor might happen because the original appointor does not want one or more family members to be appointors on his or her (the original appointor's) death.

Subdivision 152-B Small Business 15 Year Exemption

The relevant provisions dealing with this exemption (see particularly section 152-105(c)) require that there be a controlling individual and, as mentioned earlier, there are good grounds for removing this test or at least reducing the percentage required to have a controlling individual from 50% to 40%. .

A further inconsistency also appears to exist where a taxpayer owned a business as a sole trader and rolled this business into a company structure and in so doing effectively resets the clock on the 15 year exemption. Whilst the same individual continues to beneficially own the asset, the 15 year asset exemption will be unavailable to the company on the basis that the company (being the relevant taxpayer) has not owned the asset for the required 15 years. It is inequitable that a small business that is rolled into a company structure from a partnership or a sole trader entity should be required to re-commence the 15 year period from the date of incorporation as this requirement can result in some partnerships and sole traders electing not to change their business structure and thereby electing not to expand their business.

A further problem is that a company or trust must have a controlling individual in every year that the asset was owned not just the preceding 15 years.

The legislation would be more consistent if the existing roll-over events in section 152-120 (currently confined to marriage breakdown and compulsory acquisition) were widened to include a roll-over from the abovementioned entities into a company. This would ensure that the 15 year time period did not commence again in such circumstances and that any existing time in ownership is rolled over to the company structure.

Small Business Asset Roll-Over Concession

This concession is subject to certain conditions which often impose a compliance burden on the taxpayer concerned. Under the relevant conditions, the replacement asset can be purchased from one year before until two years after the CGT event happening. At the time the taxpayer's return is being prepared, they may intend to purchase a replacement asset (new business) but may not be certain.

The decision is then whether to include the capital gain and pay capital gains tax or leave the capital gain out of the return. If the capital gain is not included in the return and no replacement asset is purchased then the return must be amended and interest paid, so the operation of the rule leaves a difficult decision to be made by the taxpayer. A practical solution to this problem would be to amend the legislation to allow the taxpayer to include the capital gain in any of the years from when the sale occurred to the second year thereafter. Thus, when no replacement asset is acquired within two years, the gain is assessed from that date. This proposed amendment should ensure that the taxpayer would not incur interest and/or penalties until two years after the initial sale of the former business.

Definition of 'Active Asset'

The definition of 'active asset' (section 152-35) means that if an individual that owns and uses an active asset dies, the asset will not remain an active asset unless the legal personal representative (LPR) carries on the deceased person's business after their death. This view is supported by ATO Interpretative Decision 2003/165 which refers to a taxi operator. The practical operation of this section results in certain situations (eg. due to licensing requirements) where the LPR is unable to meet the requirements of an active asset. It is considered that the LPR should have time to dispose of the assets of the business without having to continue its operation. This time should be allowed so that the active asset concessions are available to the LPR where the LPR is not able to continue the business because of legal or licensing requirements (eg. in the case of a medical practitioner, solicitor, accountant, builder, even a taxi operator, etc) or because the LPR does not have the expertise to do so. Accordingly, we recommend that s.152-35 be appropriately amended to ensure that the LPR is allowed sufficient time to dispose of the relevant business without having the requirement of continuing to operate it.

A further problem arises as the definition of active asset does not include cash. For example if we consider an example where a balance sheet shows stock and debtors the taxpayer is ok for the purposes of the provisions. However if that same business was extremely efficient and only has cash on hand (i.e the debtors have paid and stock on hand has been run down to zero) the concession does not apply.

Also in the circumstances of where there is unearned income such prepayments – this can negatively impact the balance sheet for the 80% test for active assets.

Recommendation: We recommend that the following changes be made to the small business CGT concessions to remove the apparent unintended consequences arising from the existing provisions:

- remove the controlling individual tests from the existing provisions or, alternatively, reduce the percentage required for a controlling individual from 50% to 40%;
- the $5 million net asset threshold be subject to regular review and appropriate adjustments and/or that it be indexed, say to CPI increases, on an annual basis;
- amend the net asset value tests to remove the anomalies identified above;
- widen the existing roll-over relief in the 15-year asset exemption provisions to ensure that the 15 year ownership period is not broken where a small business is rolled from a sole trader/partnership into a company structure; and
- amend s.152-35 to ensure that a LPR of a deceased business owner is allowed sufficient time to dispose of the relevant business without having the requirement of continuing to operate it.

5. Taxpayer circumstances and commercial practices

The problems arising with the concessions where different structures are used by small business operators for sound commercial reasons are reflected in the following discussion.

Discretionary trust

This is the preferred vehicle for most small business operators as it generally allows individual beneficiaries access to the full range of CGT concessions, asset protection, and flexibility in income distributions. However, problems are encountered with access to the CGT concessions where the trust holds shares or units in a company/trust which serves as the main operating vehicle for the business.

Where assets are held by a discretionary trust, the concessions will be available if distributions are made to 'controlling individuals' (with at least a 50% interest in the income and capital distributions of the trust in the year of the capital gain). Some care needs to be taken, of course, to ensure that the concession is not forgone in such circumstances such as where the small business owners inadvertently make distributions to other beneficiaries of the trust (eg. children) in that year.

Company

If it is assumed that a company meets the $5 million net asset threshold, then it may qualify for the small business retirement rollover provided there is a controller of the company in the year of the gain. The 15 year retirement exemption may also be available to it, provided there is a controller of the company at all times.

By contrast, the active asset rollover is available to the company even if there is no controller by simply including 50% of the capital gain amount in its assessable income. However, if the company wishes to pay the gain out as a dividend to shareholders, the non-assessable portion of this dividend will be unfranked and thus fully assessable in the hands of shareholders.

In this case, it would be possible to access some of the benefit of the 50% exemption claimed by a company if the company is liquidated. As the 50% exempt amount is not income of the company, it will not be a deemed dividend under section 47 (ITAA 1936), but will constitute capital proceeds on disposal of the shares. If the liquidator's distribution exceeds the cost base in the shares, then a capital gain will arise. This gain can be reduced under section 118-20 to the extent that the gain has already been assessed as a section 47 dividend (ie. the taxable portion of the company's gain).and may benefit from the general CGT discount concession in the hands of shareholders if they are individuals or trusts. Effectively, 25% of the initial capital gain would be received tax free.

As regards other concessions in this case, the company cannot claim the small business active asset retirement exemption as it does not have a controlling individual. However, the residual gain could be deferred by a roll-over into replacement active assets under the small business roll-over concession.

Where the relevant disposal asset is a share in a company, the company must have a controlling individual if a shareholder is to access any of the Division 152 small business concessions. This is because section 152-10(2) makes it a basic condition that where shares in a company (or interests in a trust) are sold, the company (or trust) must satisfy the controlling individual test and the taxpayer disposing of the shares must be the controller or their spouse. This precludes the availability of the concessions to multi-tiered groups.

For instance, if a discretionary trust owns shares in a company, a capital gain realised on those shares will not be eligible for any of the small business concessions. However, the 50% discount would be available, subject to the 12 month holding requirement being met. Depending on the precise circumstances, this could be a better outcome then a sale of the business by the company.

Unit Trust

A unit trust structure may be used by small business operators if a discretionary trust is inappropriate for commercial reasons (eg. where two families want to go into business together, they may establish a unit trust in which the units are owned by each of the respective families' discretionary trusts). In the absence of the previous claw-back provisions, a 'fixed trust' can claim the general 50% CGT discount and distribute the non-assessable amount of the capital gain to individual beneficiaries. However, the small business CGT retirement concessions would not be available in this situation since the trust would not satisfy the ‘controlling individual’ test

The unit trust could also claim the 50% small business active asset exemption, so reducing the discounted gain by a further 50%. The benefit of this reduction could also flow through to individual beneficiaries. However, it is likely that CGT event E4 will apply to the distribution of this non-assessable amount. To the extent that this non-assessable amount exceeds the cost base of the units, a capital gain will arise. As the units are held by discretionary trusts, this CGT event E4 gain could be reduced using the 50% CGT discount.

The small business active asset replacement roll-over would be available.

Partnership of Discretionary Trusts

A partnership of discretionary trusts should in fact be considered where there are numerous family groups involved in a business. For instance, each couple can have their own discretionary trust acting in partnership with other families’ discretionary trusts. A company can act as nominee for the partnership – the public would deal with this entity. However, the assets and income would belong to the discretionary trusts.

While it is all very well to say that in future people will have partnerships of discretionary trusts, rather than unit trusts owned by discretionary trusts, this is of little comfort to those businesses which have been structured in the traditional way and which now find themselves unable to qualify for such relief. It is difficult to see any good policy reason why they should be denied such relief.

In addition, until the need to change the way in which such investments are structured is commonly understood amongst advisors, there is a real risk of professional indemnity actions arising.

Further, section 152-55 (ITAA 1997) looks to an individual who holds at least a 50% interest. This is to be contrasted with the net asset value test in section 152-15 which looks at the net asset values of assets of yours and a variety of other entities connected with you and your CGT small business affiliates. If there is to be the aggregation of interests for net asset value test purposes, there ought also to be aggregation for the purposes of determining whether there is a controlling individual. Such inconsistency adds to the complexity of these rules.

Recommendation: We recommend that the Division 152 provisions be appropriately amended to address the inability of many small business operators to access the various concessions because of the structures they have set up in the past, or even more recently due to their (and their advisers’) lack of understanding of the concessions.

6. Consistent with other tax legislation

There are some situations where the provisions are inconsistent with other tax legislation. For example:

- the interaction between section 104-70 and 104-71 (ITAA 1997) allows the tax free flow through unit trusts of the amount which is exempt from CGT under the general 50% exemption. However, amounts exempt under Division 152 are not afforded the same treatment; and

- section 152-105(d)(i) relating to the 15-year asset exemption requires retirement, as does section 152-110(1)(d)(i). This is inconsistent with the ETP rules which only require a termination of office or employment. It is difficult to see any good policy reason why these rules should be inconsistent and more restrictive.

Recommendation: We recommend that the income tax law be amended to:

- allow the tax free flow through unit trusts of amounts exempt from CGT under Division 152;

- replace the existing 'retirement' requirement in the 15-year asset exemption with the same requirements in respect to termination of office/employment that apply under the ETP provisions.

7. Certainty

The legislation does not provide certainty for taxpayers because taxpayers and their advisors do not generally understand, and cannot reasonably be expected to understand, precisely how these rules operate.

The current uncertainty in the application of the Division 152 provisions should be ameliorated or removed by implementing the recommendations made above.