The Institute of
Chartered Accountants
in Australia

28 February 2005

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

By e-mail: BoardofTaxation@treasury.gov.au

Dear Sir/Madam,

Review of small business capital gains tax concessions

The Institute of Chartered Accountants in Australia ("ICAA") welcomes the post-implementation review of the small business capital gains tax ("CGT") concessions by the Board of Taxation and is pleased to make a submission in this regard. Attached is a detailed submission setting out issues that our members have encountered with the quality and effectiveness of the concessions since they were introduced.

In summary, we consider that the quality and effectiveness of the concessions needs to be improved by:

- extending the availability of the concessions to various common structures;
- improving the clarity of the provisions some of which are currently drafted in a confusing and convoluted form;
- resolving various technical issues with the concessions;
- preparing and releasing ATO rulings and determinations on various aspects of the concessions.

The ICAA would be pleased to be involved in any consultation with the Board of Taxation on our submission or on the development of any recommendations made by the Board of Taxation as a result of this review.

Should you have any queries, or wish to discuss any aspect of the attached submission, please contact Ali Noroozi on (02) 9290 5623 or Julian Cheng on (02) 9290 5750.

Yours sincerely,

Ali Noroozi
Tax Counsel
Institute of Chartered Accountants in Australia

REVIEW OF SMALL BUSINESS CGT CONCESSIONS

1 Introduction

We understand that the purpose of the Board of Taxation's review is to determine how effective the small business CGT concessions have been in delivering the policy intent of those measures. Accordingly, it is useful, at the outset, to restate the policy underlying the concessions.

Reference is made to Attachment E of the Treasurer's Press Release No. 58 on 21 September 1999, which reads:

> *"The capital gains tax rollover relief, retirement exemption and goodwill exemption provisions have the same underlying objective of providing small business people with access to funds for retirement or expansion.*
>
> *The interaction between the existing provisions is unnecessarily complex and, as a consequence, the law is not operating effectively. Examples are:*
>
> - *the rollover provisions to prevent tax avoidance through taxpayers rolling gains into goodwill and then using the goodwill exemption; and*
> - *the goodwill exemption has been litigious and is difficult to administer because the precise meaning and valuation of 'goodwill' are elusive.*
>
> ***Small business taxpayers will now be able to benefit successively from all of the concessions for any one disposal.*** *This will reduce unnecessary compliance costs for taxpayers in working out which concession they should claim."* **[emphasis added]**

The purpose of the small business CGT concessions was also expressed in paragraph 1.2 of the explanatory memorandum to the *New Business Tax System (Capital Gains Tax) Act 1999* as follows:

> *"These amendments to the ITAA 1997 will significantly improve the way in which CGT concessions are delivered to small business entities by:*
>
> - *increasing the range of CGT concessions available;*
> - *rationalising and improving the current law; and*
> - *providing greater flexibility in accessing the various CGT concessions."*

Although the changes in 1999 were positive, we are of the view that the quality and effectiveness of the concessions still needs to be improved by addressing the following concerns to ensure that these policy objectives are met.

2 Exclusion of common structures

Reference is made to the third purpose of the small business CGT concessions as stated in paragraph 1.2 of the explanatory memorandum to the *New Business Tax System (Capital Gains Tax) Act 1999*. That purpose was to provide greater flexibility in accessing the various CGT concessions. Unfortunately, the small business CGT concessions, in their current form, are very inflexible in their application and are not readily available in the context of many of the structures currently adopted by small businesses. Accordingly, the concessions do not give effect to the underlying policy intent and do not "[take] account of actual taxpayer circumstances and commercial practices" (refer to the Board of Taxation's consultation plan for this review).

Some of common structures in relation to which the concessions are not available are discussed below. We note that many of these structures were set up prior to the introduction of the small business CGT concessions. However, there is no scope to change many of these structures to increase the availability of the concessions without, in many cases, incurring a CGT liability.

1.1 Unit trusts owned by discretionary trusts

A common structure through which businesses are carried on is in a unit trust that is owned by one or more discretionary trusts. Such structures are typically set up for asset protection purposes for small to medium-sized family businesses. As it is common for the husband and wife, or business principals, to be at risk, owning units in the business vehicle is not desirable and one or more discretionary trusts are therefore established.

Where a unit in a unit trust is disposed of, one of the basic conditions to access the small business CGT concessions, as set out in paragraph 152-10(2)(a) of the *Income Tax Assessment Act 1997* ("1997 Act"), is that the trust must satisfy the controlling individual test. In the case of a unit trust, that test generally requires that an individual must have been beneficially entitled to at least 50% of the income and capital of the trust just before the CGT event. Where a unit trust is owned by one or more discretionary trusts, there will be no controlling individual even if more than 50% of the income and capital is distributed to a particular individual. Accordingly, none of the small business CGT concessions will be available. This is the view taken by the Australian Taxation Office ("ATO") in ATO Interpretative Decision ATO ID 2003/455.

In contrast, the concessions will be available where an individual holds a controlling stake in the units in a unit trust.

1.2 Companies owned by discretionary trusts

A virtually identical situation to that highlighted in section 1.1 arises in relation to structures in which the business vehicle is a company and all of the shares in the company are owned by one or more discretionary trusts.

1.3 Unit trusts with more than two unit holders

It is not uncommon for a business to be carried on through a unit trust that has three or more equal unit holders. If units in the unit trust are sold, the concessions will not be available because the controlling individual test is not passed as required by subsection 152-10(2).

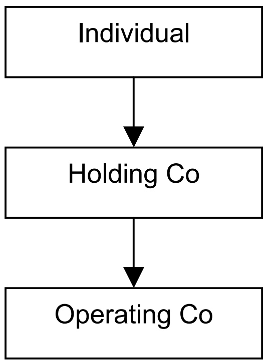
However, if the business was carried on in a partnership, there is no effective restriction on the number of partners. That is, the controlling individual test is not applied when a partnership interest is disposed of. Furthermore, a partnership of discretionary trusts could access the concessions.

1.4 Companies with more than two shareholders

Refer to the discussion in section 1.3 above. The controlling individual test must also be passed before the concessions are available in respect of a disposal of shares in a company that has more than two shareholders.

1.5 Multiple tier structures

In multiple tier structures, where a lower-tier company or unit trust carries on the business, access to the concessions is limited. Consider the following structure in which an individual owns all of the shares in a holding company, which in turn holds all of the shares in the operating company:



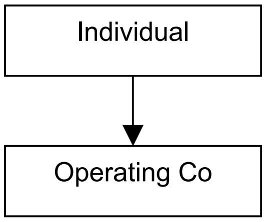
The individual would be potentially entitled to the concessions in respect of a capital gain arising from a disposal of shares in Holding Co. However, Holding Co would not be entitled to any of the concessions if it sold any of the shares in Operating Co. This is because of the basic condition in paragraph 152-10(2)(b) that Holding Co be a CGT concession stakeholder in Operating Co. A CGT concession stakeholder is defined in section 152-60 as a controlling individual of a company or a spouse of a controlling individual that holds legal and equitable interests in any of the shares of the company.

Furthermore, if Operating Co sold its business assets and satisfied the basic conditions for relief set out in section 152-10, it would only be able to avail itself of the small business 50% reduction in Subdivision 152-C and the small business roll-over in Subdivision 152-E. The small business 15-Year exemption in Subdivision 152-B and the small business retirement exemption in Subdivision 152-D would not be accessible because:

- in the case of the 15-year exemption, paragraph 152-110-10(c) stipulates that Operating Co must have had a controlling individual at all times during the whole period for which it owned the asset;

- in the case of the retirement exemption, paragraph 152-305(2)(b) requires that Operating Co must have satisfied the controlling individual test in section 152-50.

This example should be distinguished with one where the individual holds all of the shares in the operating company:



In this example, both the individual and Operating Co would be able to access all of the small business CGT concessions. There is no policy reason why the concessions should not be equally available in the case of a multiple tiered structure where ultimate control rests with the same individual(s).

We understand that, with the introduction of the consolidation rules, the small business CGT concessions are more readily accessible in the context of some multiple tier structures. For example, Taxation Determinations TD 2004/45 and TD 2004/46 provide practical and favourable conclusions on the availability of the concessions to consolidated groups due to the operation of the single entity rule. However, Taxation Determination TD 2004/47 stipulates that a consolidated group should ignore the single entity rule when disposing of shares in a subsidiary member when determining if the controlling individual test is passed. This has increased the complexity of accessing and applying the small business CGT concessions in a tax consolidation context and also highlights the inflexibility of the concessions, which vary in availability depending on the structure and the circumstances.

2. Subdivision 152-A – Basic conditions for relief

2.1 Maximum net asset value test

The ICAA applauds the amendments to the control test of discretionary trusts that were introduced by *Tax Laws Amendment (2004 Measures No. 1) Act 2004*. However, there are various other issues that we have identified which are discussed below.

2.1.1 Non-indexation of $5 million threshold

The $5 million threshold adopted for the maximum net asset value test has also limited the accessibility of the small business CGT concessions. Division 152 applied to CGT events that happened after 21 September 1999. Over five years later, the $5 million threshold has not been indexed, which has resulted in fewer and fewer taxpayers being able to take advantage of the concessions.

The real value of the $5 million threshold has eroded over time and is now much too low especially taking into account previous increases in the CPI and also the significant rises in property prices during the last few years. Accordingly, we believe that the $5 million threshold needs to be increased to compensate for these reductions in its real value. Furthermore, there needs to be some mechanism whereby the threshold is regularly indexed or reviewed going forward.

Although the new provisions were aimed at rationalising and improving the small business CGT concessions, we note that the "goodwill exemption" previously contained in Subdivision 118-C allowed for indexation of the exemption threshold under the repealed subsection 118-260(2).

2.1.2 Confusing wording of subsection 152-20(4)

Subsection 152-20(4), together with the example that follows this provision, has generated some confusion amongst practitioners. This provision states:

> *"Disregard assets of that entity* [in working out the net value of the CGT assets of that entity] *that are not used, or held ready for use, in the carrying on of a business (whether alone or jointly with others) by:*
>
> *(a) you; or*
>
> *(b) an entity connected with you (unless the connection with you is only because of your small business CGT affiliate)."*

Reference is made to the minutes of the NTLG CGT Subcommittee meeting on 13 June 2001, which read:

> *"The important words were contained in paragraph 152-20(4)(b) –*
>
> *'(unless the connection with you is only because of your small business CGT affiliate)' – which could be translated as saying that you treat paragraph (b) as not being there at all and only apply paragraph 152-20(4)(a). That means that you disregard assets unless they are used in carrying on a business by you.*
>
> *It was noted that the provision is difficult to construe because of the triple negative contained within the words of the subsection. It is possible to explain the provisions in subsections 152-20(3) & (4) as follows:*
>
> *'In working out the net value of the CGT assets of your small business CGT affiliate or of an entity that is connected with your small business CGT affiliate including assets only if:*
>
> - *they are used in carrying on a business by you; or*
> - *they are used in carrying on a business by an entity connected with you provided the connection arises because of something more than your small business CGT affiliate'.*
>
> *The professional bodies expressed a preference for a technical correction to remove the triple negative, or a Taxation Determination to clear up the confusion. The ATO stated that the minutes to this meeting will have to suffice for the time being. The bodies' request for a Taxation Determination was noted."*

No further guidance has been provided since the meeting.

This issue is one example of where the quality and effectiveness of the small business CGT concessions has been reduced because the provisions are not expressed in a clear, simple and comprehensible manner.

2.1.3 Main residence

When working out the net value of the CGT assets of an individual, subparagraph 152-20(2)(b)(ii) allows the main residence of the individual, or the individual's ownership interest in a main residence, to be disregarded provided the main residence is not used, to any extent, for income producing purposes. However, if there is any income producing use, the entire market value of the main residence is taken into account albeit less any related liabilities, e.g., a mortgage is included in the calculation of the net value of the CGT assets. It is submitted that only the market value of that part of the main residence that was actually used to produce income should be included in that calculation.

Arguably the policy of the small business CGT concessions would not have been to take into account the entire market value of a main residence that was only partly used to produce income. Given the significant increases in property prices in recent years, minor income-producing use of a main residence could result in an unintended consequence of a substantive nature being the failure of the maximum net asset value test by a growing number of taxpayers.

2.1.4 Partnerships

Where the taxpayer is a partner in a partnership and the CGT event happens in relation to a CGT asset of the partnership, there is an additional requirement in paragraph 152-15(b) that the net value of the CGT assets of the partnership does not exceed $5 million. This requirement is confusing given that it is the partners, not the partnership, that hold the assets of the partnership for CGT purposes.

The ATO, in its "Advanced guide to capital gains tax consequences for small business", interprets this requirement as follows:

> *"This additional test does not apply if a partner in a partnership disposes of an interest in a partnership asset (and the other partners retain their interest in the partnership asset). This is because a partner's interest in a partnership asset is a CGT asset of the partner and not of the partnership."*

This view, if correct, effectively means that a partner could potentially access the small business CGT concessions even if the partnership had net assets well in excess of $5 million. However, the net assets of the partnership could be taken into account if the partnership was connected with the partner under section 152-30, e.g., if the partner had the right to receive at least 40% of any distribution of income or capital by the partnership.

This additional requirement for partnerships has generated considerable confusion in practice. Some taxpayers and practitioners are not aware of the ATO's interpretation and have adopted the approach that the small business CGT concessions are not available to a partner in a partnership with net assets of over $5 million even if the other partners are not concurrently disposing of their partnership interests. Accordingly, this is another area where the concessions have not being expressed in a clear, simple and comprehensible manner thereby resulting in confusion as to their correct interpretation.

2.1.5 Connected with

Subparagraph 152-15(a)(ii) requires a taxpayer to take into account the net value of the CGT assets of any entities "connected with" the taxpayer. Section 152-30 provides that an entity is connected with another entity if:

(a) either entity controls the other entity; or

(b) both entities are controlled by the same third entity.

The meaning of "control" is also defined in section 152-30. However, the rules are complicated and difficult to apply in practice. For example, subsection 152-30(2) provides that an entity and/or its small business affiliates will control another entity if they beneficially own, or have the right to acquire the beneficial ownership of, interests in the other entity that carry between them the right to receive at least 40% of any distribution of income or capital by the other entity. The complexity of the definition of "control" is illustrated as follows:

- An entity will be taken to control another entity even if the entity itself has no interest in the other entity but its small business CGT affiliate holds, say, at least 40% of the other entity.

- The test focuses on beneficial ownership. It is unclear whether it is necessary to trace through interposed entities, for example, where there is a chain of unit trusts with the ultimate unit holder being a natural person. One view might be that the unit holder has beneficial ownership of units that carry between them the right to receive at least 40% of any distribution of income or capital made up the chain of unit trusts. However, the ATO, in Taxation Determination TD 2000/32, appears to take the view that, at least for CGT purposes, a unit holder has no interest in the underlying assets of a unit trust. It is the units in a unit trust that are the relevant assets for CGT purposes.

- Whilst the test clearly stipulates a control percentage of 40%, the Commissioner has a discretion in subsection 152-30(3) to determine that there is no control where the control percentage is at least 40% but less than 50%. This imposes another layer of compliance on taxpayers and practitioners.

  Furthermore, the ATO, in ATO ID 2003/846, takes the view that the Commissioner cannot exercise his discretion under subsection 152-30(3) in relation to an entity that, say, holds at least 40% but less than 50% of the shares in a company unless there is another shareholder that has a control percentage of at least 40%.

- The assets of a trustee of a discretionary trust could be taken into account in the maximum net asset value test under subparagraph 152-30(2)(c)(i), which would typically be an unusual result because a trustee normally does not benefit under many discretionary trusts (whilst the trustee might be a beneficiary, no distributions would be made to the trustee for asset protection purposes). The exception in subsection 152-30(4) only applies in limited circumstances such as where a beneficiary has received distributions of income and capital of at least 40% of the total distributions of income and capital in the relevant years of income.

In addition to the general control test in subsection 152-30(2), there are specific tests to determine control of different types of entities, which further exacerbates the complexity of determining when two entities are connected – refer to paragraph 152-30(2)(b) for companies and to paragraph 152-30(2)(c) and section 152-30(5) for discretionary trusts.

In summary, the following issues exist in relation to the process of determining whether entities are connected:

- The relevant provisions can be confusing and are not expressed in a clear, simple and comprehensible manner.

- It is often uncertain whether two entities are connected.

- The concept of control is potentially interpreted more broadly than what was intended by the drafters.

- The process of determining whether two entities are connected is a complicated one, which has resulted in increased compliance costs in practice.

2.1.6 Small business CGT affiliates

When applying the maximum net asset value test, it is necessary to include the net value of CGT assets of any small business CGT affiliates. Subsection 152-25(1) defines a small business CGT affiliate of an individual as:

(a) a spouse or child under 18 years of the individual;

(b) a person that acts, or could reasonably be expected to act, in accordance with the directions or wishes of the individual, or in concert with the individual.

The legislation is unclear as to who constitutes a "spouse" of an individual for the purposes of Division 152. A "spouse" is defined in section 6 of the *Income Tax Assessment Act 1936* ("1936 Act") to include "another person who, although not legally married to the person, lives with the person on a bona fide domestic basis as the husband or wife of the person". The ATO, in ATO ID 2004/538, take the view that two people that are legally married but permanently separated are spouses and, therefore, small business CGT affiliates under paragraph 152(1)(a). However, no guidance has been provided in relation to spouses that are divorced or in de facto relationships.

If an individual is separated, but not divorced, from his or her spouse and is currently living with another person, one possible interpretation might be that the individual has two spouses.

Significant uncertainty has also arisen in practice in relation to the second limb of the definition of a “small business CGT affiliate”. Determining if a person acts, or could reasonably be expected to act, in accordance with the taxpayer’s directions or wishes, or in concert with the taxpayer, is a subjective exercise. ATO Interpretative Decisions ATO ID 2001/712 and ATO ID 2003/450 illustrate how difficult it can be to apply the second limb and, indeed, how wide the second limb of the definition is capable of being applied.

It is evident that the provisions are not clear and do not provide taxpayers and practitioners with certainty in practice.

2.1.7 Liabilities related to the assets

The net value of the CGT assets of an entity is defined in subsection 152-20(1) as the amount by which the sum of the market values of those assets exceeds the sum of the liabilities of the entity that are related to the assets.

The requirement that the liabilities be related to the assets would seem to encompass only those liabilities that are incurred, say, where the particular assets is used as security. This means that many general liabilities will be excluded even though those liabilities may be connected with the carrying on of the business. For example, a business overdraft, annual leave and sick leave provisions and other general liabilities would be excluded from the calculation of the net value of CGT assets of an entity.

It is noted that the ATO, in ATO Interpretative Decision ATO ID 2004/205, took the view that a bank overdraft or other short term financing facilities that provide working capital for the operation of a business by an taxpayer constituted liabilities that were related to the assets of the business and could therefore be taken into account in working out the net value of the CGT assets of that taxpayer. Nevertheless, we consider that legislative clarification is desirable especially given that ATO ID 2004/205 only relates to the circumstances of a particular taxpayer. It would appear to be possible to insert a provision similar to section 122-37 of the 1997 Act. That provision contains a formula for working out what a liability is in respect of an asset for the purposes of obtaining roll-over relief under Subdivision 122-A.

It is noted that ATO ID 2004/206 provides that contingent liabilities do not fall within the meaning of the term “liabilities” as used in subsection 152-20(1) and gives the examples of amounts that could not be included in the calculation of the net value of CGT assets of a taxpayer:

- provisions for long service leave and annual leave;
- provisions for income and other taxes;
- accounting liabilities arising as a result of receiving prepaid income.

Such contingent liabilities are intricately connected with the carrying on of a business and there is no policy reason for their exclusion from the calculation of the net value of CGT assets of a taxpayer. Even if these provisions fall within the meaning of “liabilities” for the purpose of section 152-20, we query whether they would be related to any specific assets. It is noted that these liabilities do not relate to the overall working capital or financing of the entity (for the purpose of ATO ID 2004/205) and are usually created by “debiting” the retained earnings of an entity. We would expect that the policy behind the small business CGT concessions would have been to include such liabilities when determining the net value of a business. Failure to do so produces a result that does not take account of actual taxpayer circumstances and commercial practice.

2.1.8 Control test for trusts

Tax Laws Amendment (2004 Measures No. 1) Act 2004 made amendments to the control test for discretionary trusts. The main reason for the change was to correct the issue originally identified in ATO ID 2002/921 as follows:

> *"The gift deductible or income tax exempt bodies are taken to have a 100% interest in the discretionary trust under subsection 152-30(5) of the ITAA 1997 and are therefore taken to control the trust under subsection 152-30(2) of the ITAA 1997. The bodies are therefore connected with the discretionary trust under subsection 152-30(1) of the ITAA 1997 for the purposes of the maximum net asset value test under sub-paragraph 152-15(a)(ii) of the ITAA 1997."*

The previous control test for discretionary trusts deemed all beneficiaries to control the trust (which caused issues as it deemed charities to also control the trust). Although the amendments corrected this issue, they inadvertently created another issue for a number of family groups that would have otherwise satisfied the small business concessions. Consider the following example:

- Johnny controls two discretionary trusts and is also a beneficiary of both trusts. Trust A is a property trust that holds a building. Trust B is a business trust that rents the building from Trust A to run its manufacturing business. Under the previous control test, both Trusts would be connected entities under subsection 152-30(5) (as Johnny would have been taken to control both trusts). Accordingly, the building would have met the definition of an active asset because it would have been used in the business of a connected entity (paragraph 152-40(1)(c)).

- However, the new tests look at the prior year distributions to determine whether two entities are connected. Accordingly, if the trusts accumulated their distributions, the active asset test would not be satisfied (where the trusts are not otherwise connected entities). A similar conclusion was reached on slightly different facts in ATO ID 2004/665.

In summary, the new control test can make it difficult for entities to satisfy the small business exemption tests where they have structured their assets and businesses in different entities. This result is not consistent with commercial practice.

2.2 Active assets

2.2.1 Cash

One of the basic conditions for relief, set out in paragraph 152-10(1)(d), is that the CGT asset satisfies the active asset test. The active asset test in section 152-35 requires the CGT asset to be an "active asset" at certain times including just before the earlier of the

CGT event and, if the relevant business ceased to be carried on in the last 12 months or any longer period that the Commissioner allows, the cessation of the business.

The definition of an "active asset" is contained in section 152-40. It includes various assets including shares in a company or interests in a trust where the total of:

(i) the market values of the active assets of the company or trust; and

(ii) any capital proceeds that the company or trust received from CGT events happening to its active assets that are held in the form of cash or debt pending the acquisition of new active assets;

is 80% or more of the market value of all of the assets of the company or trust.

This definition is problematic in that it does not cater for a scenario where a company or trust has disposed of its business assets and holds the resulting capital proceeds in the form of cash but not pending the acquisition of new active assets. The cash cannot be taken into account in determining if the 80% threshold has been met. Accordingly, an individual that disposes of shares or interests in such a company or trust will not be entitled to access the concessions to reduce any resulting capital gain because the shares or interests will not be active assets.

Furthermore, there is no reason why cash should not more generally be treated as an active asset. Cash is currently excluded either because it is held as Australian currency or in a bank account. The ATO, in both cases (refer ATO ID 2003/167 and ATO ID 2003/168), consider that the exception for financial instruments in paragraph 152-40(4)(d) applies.

Cash reserves are often maintained by businesses to meet working capital requirements, e.g., payment of expenses, acquisition of plant, etc. We note that the ATO, in ATO ID 2002/1003, takes the view that trade debtors are active assets because they are a "business facilitation mechanism that assists in the conduct of the business". Our view is that cash reserves can often be described as such and that to treat cash differently to trade debtors is to penalise those companies and trusts that hold large cash reserves due to the nature of the business they carry on or for working capital purposes.

2.2.2 Rights to contingent and unascertainable consideration

It is not uncommon for the consideration for the sale of a business to comprise a lump sum together with a right to a further unascertainable amount based on some performance criteria such as certain profit hurdles being met in subsequent years of income. In such cases, the consideration for CGT purposes equals the lump sum amount received up front plus the market value of the right to the further amount. The ATO take the view in Taxation Ruling TR 93/15 that this right is a separate asset for CGT purposes.

The right to the further amount will be disposed of when it is eventually exercised or it expires. A capital gain or loss may arise at this time. If a capital gain arises, the small business CGT concessions will not be available because the right is not an active asset, i.e., it is not used, or held ready for use, in the course of carrying on a business. The ATO have adopted this view in ATO Interpretative Decision ATO ID 2002/766.

This result is not consistent with commercial practice nor or with the policy of the small business CGT concessions. Any capital gain arising from the disposal of such a right clearly relates back to the sale of the business.

2.2.3 Determining if shares or units are active assets

Share and units can be active assets.

Section 152-35 provides that the active asset test will be passed "if the asset was an active asset of yours:

(a) just before the earlier of:

- (i) the CGT event; and
- (ii) if the relevant business ceased to be carried on in the last 12 months or any longer period that the Commissioner allows – the cessation of the business; and

(b) during at least half of the period beginning at the later of:

- (i) when you acquired the asset; and
- (ii) if you have owned the asset for more than 15 years – 15 years before the time that applies under paragraph (a);

and ending at the time that applies under paragraph (a).

Our concern arises in relation to the requirement in paragraph 152-35(b) and how subsection 152-40(3) of the 1997 Act provides that a share in an Australian-resident company can be an active asset in certain circumstances. It seems that the accounts of the company or trust would need to be examined over the period of ownership. If no accounts were prepared, it seems that accounts would need to be drawn up. Furthermore, the assets would either need to be valued at market value in the accounts or would result in significant compliance costs for entities required to continually revalue underlying assets over a period of time.

2.2.4 Deceased estates

Where a taxpayer dies and his or her CGT assets devolve to a legal personal representative of his or her estate, the active asset test will not be passed unless the legal personal representative continues to carry on the business. Reference should be made to issue 2.6 of the NTLG CGT Subcommittee meeting on 7 August 2002 where the ATO stated that:

> *"The business premises will not satisfy the active asset test in relation to any capital gain made on their later sale by the LPR. The premises are not an active asset (that is, used in a business) of the LPR just before their sale by the LPR (subparagraph 152-35(a)(i)) because no business is being carried on by the LPR. The premises are also not an active asset of 'yours', that is, the LPR, just before the cessation of the business (subparagraph 152-35(a)(ii)) because at that time they are not an asset of the LPR."*

Our view is that the provisions should be amended to allow the concessions to be accessed where the legal personal representative disposes of the business in the process of administering the deceased estate.

2.3 Controlling individual test

Where the CGT asset disposed of is a share in a company or an interest in a trust, there is an additional basic condition that the company or trust satisfies the controlling individual test. As discussed in Section 1 of this submission, this test has resulted in the non-accessibility of the small business CGT concessions in the context of many commonly used structures. For completeness, we also note that a controlling individual test is also adopted in relation to some of the concessions namely the small business 15-year exemption and the small business retirement exemption but not the other concessions. This lack of consistency has increased the complexity of the provisions as well as the compliance costs involved in determining when the various concessions will be available.

3 Subdivision 152-B – Small business 15-year exemption

3.1 Roll-overs

One of the conditions to access this exemption is that the taxpayer must have continuously owned the CGT asset for at least 15 years. Section 152-115 provides that involuntary disposals such as those arising from compulsory acquisitions or marriage breakdowns will not be taken to break the 15-year period. However, there is no similar concession for roll-overs, which means that the exemption is inaccessible, for example, where an individual owned an asset for, say, 14 years, and then rolled it over into a company under Subdivision 122-A of the 1997 Act. We do not consider that the operation of section 152-115 is not in line with the policy intent underlying the small business CGT concessions and is not consistent with the roll-over relief that is available under Subdivision 122-A.

4 Subdivision 152-C – Small business 50% reduction

4.1 Dilution under CGT event E4

The amount of the small business 50% reduction under Subdivision 152-C constitutes a non-assessable amount to which CGT event E4 applies. This means that the benefit of the concession is diluted where a unit trust is used as the vehicle for carrying on a business.

The dilution of the concession is illustrated by the following simple example:

	$	**Section reference**
Unit trust		
Capital gain	1,000	
Less: 50% CGT discount	(500)	115-10, 102-5
Less: small business 50% reduction	(250)	152-205, 102-5
Net capital gain (distributed to unit holder)	250	95, 97

Unit holder		
Net capital gain (received from unit trust)	250	97
Extra capital gains	1,000	115-215
Deduction	(250)	115-215(6)
Capital gain arising from distribution	1,000	102-5
Net capital gain from distribution	250	102-5
Capital gain under CGT event E4	250	104-70
Less: 50% CGT discount	(125)	115-10,102-5
Less: small business 50% reduction	(62.5)	
Net capital gain from CGT event E4	62.5	
Total net capital gain	312.5	
Tax @ 48.5% on total net capital gain	15.16	

If the unit holder had made the capital gain of $1,000, they would have been entitled to the full benefit of the 50% CGT discount and the small business 50% reduction resulting in a net capital gain of $250. However, the application of CGT event E4 in the case of a unit trust dilutes the benefit of the small business 50% reduction resulting in a net capital gain of $312.5. Assuming the top marginal rate of tax of 48.5% applies, the tax payable would be $151.6, which equates to an effective tax rate of 15.16%. If the unit holder had carried on the business in his or her own name, or in a discretionary trust, the effective tax rate on the capital gain would have been 12.13%.

We can discern no policy reason for the application of CGT event E4 to capital gains that are non-assessable by virtue of the small business 50% reduction. Accordingly, whilst the introduction of Division 152 increased the range of CGT concessions available to taxpayers by introducing the small business 50% reduction, the benefit of that concession has been diluted in the case of businesses carried on through unit trusts.

4.2 Loss of small business concession for companies

In the case of a company that claims the small business 50% reduction, the distribution of the exempt capital gain will only be distributable as an unfranked dividend to shareholders. This will result in up to 48.5% tax being paid in relation to the payment and a dilution of the concession. However, where a trust claims the small business 50% reduction, there are provisions that allow this reduction to be passed through undiluted to beneficiaries. The small business CGT concessions were aimed at rationalising the previous concessions. However, under the previous 50% exemption for goodwill, the exempt component was not treated as a deemed dividend when a company was liquidated (refer to Taxation Determination TD 2001/14).

5. Subdivision 152-D – Small business retirement exemption

5.1 ETP requirement

For an individual seeking to access the exemption, subsection 152-310(2) provides that a consequence of choosing this exemption is that the capital proceeds are, to a certain extent, treated as an eligible termination payment ("ETP"). Paragraph (jaa) of the definition of an ETP in section 27A of the 1936 Act specifically includes an amount referred to in subsection 152-310(2). There is no requirement in Subdivision 152-D that the individual actually retire.

However, where a company or trust seeks to obtain the exemption, section 152-325 requires that an ETP must be made to its CGT concession stakeholders. In other words, there must be a payment made in respect of the taxpayer in consequence of the termination of any employment of the taxpayer. This would require the CGT concession stakeholders to resign as employees of the company or trust or as directors of the company. This is the approach taken by the ATO in ATO ID 2003/748. The note in Interpretative Decision recognises this inconsistency between individuals vis-à-vis companies and trusts:

> *"If a business is carried on by an individual there is no requirement for the individual to cease their business activities and retire in order to choose the retirement exemption. Rather, the amount an individual chooses for the retirement exemption is taken to be an ETP under subsection 152-310(2) of the ITAA 1997 and paragraph (jaa) of the definition of ETP in subsection 27A(1) of the ITAA 1936."*

In this regard, we note the policy intention stipulated in Attachment E of the Treasurer's Press Release No. 58 on 21 September 1999:

> *"The retirement exemption requires that a director and owner of a small business company resign the directorship to gain access to the exemption. The director will now no longer be required to resign the directorship."*

Apart from being inconsistent with the policy intention, these differences in the requirements for individuals as compared with companies and trusts are confusing and make the exemption more difficult to access for companies and trusts.

5.2 Capital proceeds

Where the capital proceeds received on the disposal of an active asset are less than the market value, the ATO take the view, in ATO ID 2002/269, that the retirement exemption under section 152-315 can only apply to the extent of the capital proceeds actually received. We note that this interpretation is not clear from the provisions. Subsection 152-315(1) simply provides that "[y]ou can choose to disregard all or part of each capital gain to which this Subdivision applies". In support of its view, the ATO refers subsection 152-310(2), which treats the capital proceeds received as an ETP and to subsection 152-310(3), which requires the market value substitution rule to be ignored in working out those capital proceeds. However, we are of the view that sections 152-310 and 152-315 operate independently of each other. Adopting the ATO's view would deny access to the small business retirement exemption in the following example:

- Johnny, aged 65, owns all the shares in Company X. Assume all the conditions are satisfied to access the retirement exemption under Subdivision 152-D. The shares are worth $500,000. Johnny transfers the shares to his daughter who is taking over the business, allowing Johnny to retire. Johnny realises a capital gain of $500,000 (assume no cost base). Per ATO ID 2002/269, Johnny cannot apply the small business retirement exemption as no capital proceeds are received. Query whether a different result would be achieved if Johnny instead sold the shares to his daughter for $500,000 (and provided her with an interest free loan of $500,000 repayable at call).

Accordingly, the ATO's narrow application of section 152-315 restricts the ability for small business owners to retire and allow for succession planning, which we submit is inconsistent with the policy objective of the small business CGT concessions to "[provide] small business people with access to funds for retirement or expansion" (refer Attachment E of the Treasurer's Press Release No. 58 on 21 September 1999).

5.3 Whether amount paid is "unreasonable"

The lifetime limit on the total capital gains that a taxpayer can disregard under the small business retirement exemption is $500,000. Assume a company has one natural person shareholder. If the company disposes of business assets and makes a capital gain of $500,000, it can chose to disregard the entire amount by paying an ETP of $500,000 to the shareholder. However, in ATO Interpretative Decision ID 2003/743, the ATO appears to take the view that section 109 of the 1936 Act can possibly apply to an ETP that is not reasonable for the purposes of that provision. Under section 109, the Commissioner can deem to be a dividend the excess of a payment by a private company to its shareholders over what the Commissioner considers is reasonable. In the context of an ETP paid under the small business retirement exemption, the Commissioner states, in ATO ID 2003/743, that he will have particular regard to:

- the purpose behind the payment;
- the length of service with and level of contribution to the business by the shareholder/employee;
- the election by the taxpayer to use the small business retirement exemption;
- the policy intention behind the exemption; and
- the level of the CGT retirement exemption limit ($500,000).

We do not consider that there should be any risk of section 109 applying when a taxpayer seeks to rely upon the small business retirement exemption. The potential application of section 109 is inconsistent with the policy behind the small business retirement exemption, which was to replace the previous law "with streamlined provisions that allow better access to the concession" (refer paragraph 1.6 of the explanatory memorandum to the *New Business Tax System (Capital Gains Tax) Act 1999*.

5.4 Compliance requirements

For a company or trust to access the small business retirement exemption, an ETP must be paid to its concession stakeholders by the later of:

(a) 7 days after it makes the choice to claim the exemption; and

(b) 7 days after it receives an amount of capital proceeds from the CGT event.

The timeframe for making the payment is extremely short and imposes an unnecessary compliance burden upon taxpayers. Failure to make the payment by the stipulated due date disqualifies the company or trust from choosing the exemption. Having such onerous compliance requirements detracts from the availability and effectiveness of the small business retirement exemption.

We also note that an ETP that is received by a concession stakeholder of a company or trust is counted towards the stakeholder's reasonable benefit limit. However, we have received many queries as to the documentation that needs to be lodged with the ATO disclosing the receipt of the ETP. There is no guidance in the legislation or from the ATO as to what documentation needs to be prepared and lodged in this regard.

6 Subdivision 152-E – Small business roll-over

6.1 Replacement asset conditions

The small business roll-over allows a capital gain arising from a CGT event happening to an active asset to be disregarded if one or more replacement assets are acquired. For an asset to be eligible to be a replacement asset, subsection 152-420(1) requires that it must be acquired during the period starting one year before, and ending two years after, the happening of the last CGT event in the income year for which the small business roll-over is sought. Furthermore, subsection 152-420(4) stipulates that a replacement asset must be an active asset when it is acquired or an active asset by the end of two years after the last CGT event in the income year for which the small business roll-over is sought.

The Commissioner has discretion in subsection 152-420(3) to extend the time period in subsection 152-420(1) but does not have a similar discretion to extend the time period in subsection 152-420(4), which has produced anomalous results in practice. For example, an active asset was disposed of on 20 June 2002. This was the last event during the year ended 30 June 2002 for which the small business roll-over was sought. A contract was entered into to purchase a replacement asset, say, plant, on 30 June 2004, which was past the two-year deadline stipulated in subsection 152-420(1). Settlement did not occur until 30 September 2004. The plant was not used in the business until settlement. Even if the Commissioner granted an extension of time to extend the time period in subsection 152-420(1), the plant would still not have complied with the time periods stipulated in subsection 152-420(4) and the Commissioner has no discretion to extend these.

This appears to be a technical defect in the provisions that is not consistent with the policy intent of the drafters.

6.2 Timing of election

There appears to be a technical issue with the ability to choose roll-over relief under Subdivision 152-E. A choice is generally not effective under section 103-25 of the 1997 Act unless it is made by the time a taxpayer lodges their tax return. However, roll-over relief cannot be chosen under section 152-405 until a replacement asset has been acquired within the period from one year before to two years after the happening of the last CGT event in the income year for which roll-over relief is sought. Accordingly, there is some uncertainty as to whether a choice can be made under Subdivision 152-E where a replacement asset has not been acquired by time that the income tax return is lodged. This issue arose because of the decision in *Sherlinc Enterprises Pty Ltd v FC of T* (2004) 54 ATR 1001. A choice must be made (generally) by the time a taxpayer lodges their tax return.

The issue was previously raised at the National Tax Liaison Group CGT subcommittee in November 2004 (issue 9.4). The relevant discussion is replicated below:

> *"At the last CGT Subcommittee meeting the Tax Office indicated that it was considering the effects of the decision in Sherlinc Enterprises Pty Ltd v FCT.*
>
> *If a taxpayer wishes to choose to obtain the small business roll-over in subdivision 152-C but has not acquired a replacement asset by the time the taxpayer lodges their tax return but intends to do so within the required period, should the taxpayer include the capital gain in their tax return?*
>
> *For ease of administration purposes it would be best if taxpayers were not required to include the capital gain in their tax returns where they intended to acquire a replacement asset within two years after the CGT event occurring. Can the Tax Office please provide an update of its view in this matter?"*

The ATO is currently drafting a practice statement but, in the meantime, the position remains uncertain and detracts from the ability of taxpayers to access the small business roll-over under Subdivision 152-E.

6.3 Non-availability of roll-over where replacement asset constructed

For an asset to be eligible to be a replacement asset, subsection 152-420(1) stipulates that ti must be acquired during the period starting one year before, and ending two years after, the happening of the last CGT event in the income year for which the small business roll-over was sought. The requirement that a replacement asset be acquired has created difficulties in the context of buildings that are constructed on land that was acquired post-20 September 1985. In such cases, the building is not a separate asset from the land on which it is constructed (refer subsection 108-55(1)). As the building is not a separate asset, it cannot be acquired (rather it is the underlying land that was acquired) and therefore is not eligible to be a replacement asset. Given that it is becoming increasingly common for taxpayers to construct buildings on land that they own, we consider that this result is out of line with the policy of the small business CGT concessions and will reduce the accessibility of the concessions going forward.

7 ATO interpretation and guidance

Since the introduction of the small business CGT concessions, the ATO has, to its credit, expanded and improved its guidance on the concessions, responding in part to calls by the ICAA and others as to the difficulties experienced by taxpayers and practitioners in applying the concessions. The fact that there are 99 ATO Interpretative Decisions (as at the time of writing this submission) on various issues such as the application of the active asset test and the maximum net asset value test indicates that there has been considerable uncertainty as to how certain aspects of the concessions apply.

We consider that the guidance provided by the ATO can be improved by collating many of these issues in a series of Rulings or Determinations, e.g., there might be a Ruling dealing with the meaning of an active asset or a Ruling on the maximum net asset value test. Having a series of Rulings or Determinations would reduce the compliance costs involved in taxpayers and practitioners having to work their way through a large number of Interpretative Decisions. Additionally, Rulings and Determinations, unlike Interpretative Decisions, would be binding on the ATO and would therefore provide more certainty to taxpayers and practitioners.